Adaptive Efficiency and the Corporate Governance of Chinese State-controlled Listed Companies: Evidence from the Risk Tolerance of Chinese Domestic Venture Capitalists

Lin Zhang[1]

Abstract

The existing literature on the corporate governance of Chinese state-controlled listed companies (the SCLCs) focuses more on agency costs. There is inadequate attention being paid to its adaptive efficiency through the perspective of venture capital (VC). With the template of American VCs, this article tries to fill this gap on the basis of the evidence from the risk tolerance of Chinese domestic venture capitalists. The existing research has established the linkage between the prosperity of the American VC industry and the remarkable risk tolerance of American venture capitalists. Unfortunately, with the institutional barriers imposed by the control-based model of the SCLCs, the risk tolerance of Chinese domestic venture capitalists is lower than their American counterparts. The implication from this study is that adaptive efficiency and agency costs are equally important factors which ought to be considered when we put forth any reform proposal for the corporate governance of the SCLCs. In case of neglecting either of them, the overall efficiency will be jeopardized.

Key Words: SCLCs, Venture Capital, Risk Tolerance, Adaptive Efficiency

I. Introduction

The issue of corporate governance has gained unprecedented attention in the international community after the ravages of the Asian financial crisis. In recent years, laying down the more sophisticated governance guidelines has become a vibrant campaign with the participation of various interested groups.[2] Given the on-going lackluster performance

1 Assistant Professor, Korea University School of Law. LLB (Hons), LLM (SDUST), Ph.D (HKU). Assistant Professor at Schools of Lwa of Korea University. His research interests include business law, human rights law Chinese law. The author wishes to show gratitude to Korea University Law School and Springer for their generous financial and intellectual support on the completion of this article.

2 For instance, the government of South Korea has taken a series of steps to reform the corporate governance of chaebol since 1998. The Organization of Economic Cooperation and Development (OECD) also released "OECD Principles of Corporate Governance" in 1999 in order to provide member and non-member countries with specific guidelines in improving the legal, institutional and regulatory framework that underpins corporate governance. In addition, intermediaries, such as McKinsey & Company, are also urging the overhaul of corporate governance in emerging and transitional economies. See Bernard Black, Barry Metzger, Timothy J O'Brien & Young Moo Shin, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 Journal of Corporation Law 537-608 (2001). In this report, with the request of the South Korean government, Professor Black and his colleagues proposed a systematic legal reform framework to the Ministry of Justice of South Korea for the purpose of improving the porous governance structure of chaebol; OECD, Principles of Corporate Governance, http:// www.oecd.org/dataoecd/32/18/31557724.pdf (Aug 7, 2009). Since its first issuance, this document was revised in 2003 and 2004. The above hyperlink leads to the 2004 revised version; McKinsey & Company, *Corporate Governance in Emerging Markets*, 3 McKinsey on Finance 15-18 (2002).

of its state-owned enterprises (SOEs) and the substantial competition emerging from its entry into the World Trade Organization (WTO), China has also put considerable emphasis on corporate governance in recent years.[3] At the core of such attention is the debate on how China can design an effective corporate governance system for the SCLCs through the perspective of agency theory.[4] Taking into account of a series of scandals related to the poor governance practices of the SCLCs after the establishment of Chinese stock markets,[5] it is not difficult to understand this kind of efforts. Correspondingly, along this Berle-Means path, the existing literauture contributed by company law scholars have almost exclusively linked the corporate governance of the SCLCs to the minimization of agency costs.[6] While these literatures have exerted positive influence on the improvement of the SCLCs' governance framework, they have also omitted another crucial efficacy - adaptive efficiency. As Nobel Prize laureate Douglass North defined,

> "adaptive efficiency...is concerned with the kinds of rules that shape the way an economy evolves through time. It is also concerned with the willingness of society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society through time." [7]

On the basis of North's description, we can find out that adaptive efficiency is reinforced by an institutional structure that fosters technological innovation. According to taxonomy, technological innovation is usually divided into two kinds: the "in-house innovation" and the "external innovation".[8] The in-house innovation typically occurs in large, well-established firms and existing industries.[9] To the contrary, the external innovation generally takes place in the start-ups set up by entrepreneurs.[10] Those start-ups do not only have impact on existing industries but also develop entirely new industries.[11]

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3 Shuguang Li, *Company Control of China and the Reform in Its Transition*, 21 Tribune of Political Science and Law (Journal of China University of Political Science and Law) 3 (2003).

4 Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants*, 52 CESifo Economic Studies 415-16 (2006); Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 China Economic Review 494 (2003).

5 Black, Metzger, O'Brien & Shin, *supra* note 2, at 600.

6 The literature in this category includes but is not limited to the following ones. See Leping Shen, *Analysis of the Current Situation of Enterprise Group Corporate Governance Structure and Counter-measures*, 25 Journal of Jinan University (Philosophy & Social Science Edition) 28-9 (2003); Peizhong Gan, *Government and Market in the Reduction of State Shares- the Analysis of this Failed Reform through the Perspective of Economic Law*, 4 Jurists' Review 87-90 (2002); Liufang Fang, The Setback Stemming from Over-regulation, http://www.civillaw.com.cn/article/default.asp?id=17186 (Aug 7, 2009).

7 Douglass C. North, Institutions, Institutional Change And Economic Performance 80 (1990). Cambridge University Press.

8 Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 Northwestern University Law Review 874 (1997).

9 *Ibid.*

10 *Ibid.*

11 Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 Stanford Law Review 1068 (2003).

Since both the in-house innovation and the external innovation contribute to the enhancement of adaptive efficiency, an ideal institutional environment should be compatible with each of them. When an institutional environment principally focuses on financing the in-house innovation, it actually strengthens the vested interest and the monopolistic position of large, well-established companies. It cannot simultaneously facilitate the booming of the external innovation which represents the competition and the challenge to large companies by entrepreneurs. However, when an institutional environment aims to sponsor the external innovation, in fact, it encourages increasing the magnitude of competition in its economy by bringing in new participants. In turn, the intensified competition provides incentives for large companies to more efficiently and more initiatively conduct the in-house innovation. Therefore, theoretically and logically, we can reach the conjecture that an institutional framework with the orientation to the external innovation should be the Holy Grail to promote adaptive efficiency.

The existing comparative study on the innovation patterns of the United States, Germany and Japan has provided persuasive evidence to support the above postulation. According to those studies, the overall adaptive efficiency of the United States which has been considered to typically promote the external innovation is fairly higher than those of Japan and Germany which have been thought to spotlight on the in-house innovation.[12] Furthermore, those studies have also indentified that a vibrant venture capital (VC) market is the cornerstone of America's success in fostering the external innovation. Therefore, an institutional structure facilitating VC is connected to the significant enhancement of adaptive efficiency.

In the last decade, western corporate law scholars drew a strong linkage between the corporate governance systems of large public companies and the institutional environments for the vitality of VC markets. For example, Black and Gilson analyzed the importance of a highly developed stock market for the exit of VC;[13] Milhaupt examined how VC failed to fit into the corporate governance system of Japanese large, well-established public companies.[14] These academic products have opened up a new insight to observe and estimate the corporate governance system of listed companies. The value of listed companies' governance framework is not just to minimize agency costs along the path set by Berle and Means.[15] It also imposes substantial influence on the legal and other institutional settings for the booming of VC and in turn the enhancement of adaptive efficiency. Therefore, any proposal for reforming the corporate governance of listed companies in a country must be on the basis of a thorough evaluation on that system from the perspectives of both agency theory and adaptive efficiency. Otherwise, it is probable to improve one value at the expense of damaging the other and to make the final result worse off**.** As I have mentioned before, there have been a lot of efforts to

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12 Milhaupt, *supra* note 8; Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 Journal of Financial Economics 243-77(1998).

13 *Ibid*., Black & Gilson

14 Milhaupt, *supra* note 8.

15 Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1933), The MacMillan Company (New York).

explore the corporate governance of the SCLCs underpinned on agency theory. However, the attempt to examine it from the standard of VC and adaptive efficiency is still absent. It is the research gap which I try to fill with this article.

In China, "venture capital" burgeoned in the early 1980s. However, until 1998, the development of VC was just on the theoretical discussion and the pilot trial stage. In 1998, the Central Committee of Chinese National Democratic Constructive Association presented 'Proposal for Developing China's VC Industry' at the Ninth Chinese People's Political Consultative Conference (the CPPCC). Since then, VC has become a fast growing segment in China's financial system.[16] During the last ten years, China had made remarkable progress in the development of its venture capital market.[17] However, the striking expansion of China's VC market cannot disguise the embarrassing fact that the risk tolerance of Chinese domestic venture capitalists is still lower than their American counterparts. Given the strong linkage between the corporate governance of listed companies and the institutional environment for the vitality of VC markets, I assume that the corporate governance system of the SCLCs has substantially lowered the risk tolerance of Chinese domestic venture capitalists. In other words, I want to use the mirror of the high risk tolerance of American venture capitalists to reflect the negative effects of the corporate governance of the SCLCs on adaptive efficiency.

This article consists of five parts. Part II examines the status quo of corporate governance of the SCLCs to show that a control-based model is its feature. Part III compares the risk tolerance of American venture capitalists with that of their Chinese competitors in the light of the empirical evidence. Through this comparison, I have found that the risk tolerance of Chinese domestic venture capitalists is lower. Part IV aims to verify the connections between the lower risk tolerance of Chinese domestic venture capitalists and the negative effects of the control-based model. Conclusions follow in Part V.

II. The Status Quo of Corporate Governance in the SCLCs

The current SCLCs are the transformative results of traditional SOEs.[18] Therefore, their corporate governance cannot be understood thoroughly apart from their history. [19] Prior to the corporatization of SOEs after the first company law of the People's Republic of China (PRC) was enacted in 1993, the governance systems of SOEs had gone through two stages. First, from the establishment of the PRC to the middle of 1980s, the function of SOEs was merely satisfying the production plans made by government agencies and

16 Rob Dixon, John Ritchie & Di Guo, The Impact of Governance Structure and Financial Constraints on Risk Tolerance of VCs: An Empirical Work on China's Venture Capital Industry, http://www.cass.city.ac.uk/emg/seminars/EMGpapers1stOct/Dixon_Guo_Ritchie.pdf (Aug 7, 2009).

17 In 2003, the total amount of VC in China was RMB 32.534 billion. Three years later, this number increased to RMB 58.385 billion. See China Venture Capital Research Institute Limited, China Venture Capital Yearbook 107 (2007), Democracy and Construction Press (Beijing).

18 Clarke, *supra* note 4.

19 Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 1 Columbia Business Law Review 6 (2002).

guaranteeing social stability. Not only did the state own all the assets of SOEs, but it also completely held their managerial powers. The governance structure of SOEs was an integral layer of the governmental hierarchy.[20] Hence, SOEs were not real business entities from scratch and they were just a type of government affiliates. Second, from approximately 1984 to 1993 when the first Company Law of the PRC was promulgated, the contracting system was dominant in the movement of SOEs' reform. In accordance with the contracting model, the goal of reform was to grant SOEs the status of legal persons and to make them be responsible for their own profits and losses. [21]This strategy revealed that the Communist Party of China (CPC) and the Chinese government wanted the enterprises which they owned to be operated efficiently through authorizing them managerial autonomy to some degrees. However, the state's consideration behind the above expectation was not to render SOEs solely concerned with the maximization of wealth. Conversely, it just intended to implement its policies better with the support of robust SOEs.[22] Therefore, it meant that there were no possibilities for the state to abandon control on SOEs even if it had tactically authorized a share of power to them. The personnel power as the core component of the governance framework of SOEs was tightly held in the hands of the local CPC committees.[23]

The failure of the contracting model induced the national debate on the transformation and diversification of public ownership of SOEs into different forms at the end of the 1980s.[24] However, this move was halted by the Tiananmen Square protests in 1989. In the following three years after this demonstration, the speed of SOE reform was slowed down and the voice of restoring the centrally planned economy resurged.[25] Confronted with the circumstances, Mr. Deng Xiaoping called for the CPC and the whole nation to further emancipate their minds and put forward the economic reform with great courage during his inspection trip to South China in 1992.[26] Under his theory, the market economy did not solely belong to capitalism and it was compatible with the needs of socialist economic division and productions.[27] The support from Mr. Deng Xiaoping provided fresh political impetus to the transformation of SOEs in China. In late 1992, the Fourteenth National Congress of the CPC put the establishment of the market economy into its

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20 The Fifteenth CPC Central Committee, Decisions on SOEs Reform, http://cpc.people.com.cn/GB/64162/71380/71382/71386/4837883.html (Aug 7, 2009). In this Decision, the CPC Central Committee declared administrative ranks should not be granted to SOEs and their leaders any more. It demonstrated that leaders of SOEs used to be state cadres.

21 The Twelfth CPC Central Committee, The Decision of the CPC Central Committee on the Reform of the Economic System, http://news.xinhuanet.com/ziliao/2005-02/07/content_2558000.htm (Aug 7, 2009). After this Decision was published in 1984, the slogan of "separation between the state ownership and the SOE management authority" and the phrase "legal person" become popular among Chinese.

22 Clarke, *supra* note 4, at 494-95.

23 *Ibid.*

24 Shutang Gu & Siquan Xie, *Revisiting the Reform Process of SOEs*, 9 Economic Review 3 (2002).

25 Hongbo Xie, *From the Planned Economy to the Market Economy-The Transformation of the Economic Framework in China*, 5 Macroeconomic Management 24 (2008).

26 Xiaoping Deng, The Comments Made by Deng Xiaoping during His Inspection Tour to South China, http://cpc.people.com.cn/GB/33837/2535034.html (Aug 7, 2009).

27 *Ibid.*

charter.[28] Soon afterwards, the Fourteenth CPC Central Committee passed "Decisions on the Establishment of the Socialist Market Economy" in 1993 in which the setting up of a modern corporate system in SOEs was an urgent and important objective.[29] A series of policy signals for the corporatization of SOEs from the CPC and its paramount leaders promoted the enactment of the first Company Law of the PRC at the end of 1993 (Company Law 1993). After that, on the legal foundation laid by the Company Law 1993, two new approaches were put into practice for the reform of SOEs. First, small and less important SOEs were privatized and diversified into other business forms. The overall amount of SOEs has been drastically diminished.[30] Second, recapitalization with the governance system of modern corporations was encouraged for big and key SOEs instead of total privatization.[31] Some of them were listed on the emerging domestic stock markets in order to raise as much money as possible.[32] These listed companies whose predecessors were the traditional SOEs have constituted the cornerstone of the whole state-owned economy in China. On the basis of the traditional policy-implementation orientation to SOEs which has been analyzed above, I presume that the state must tightly control these pivotal listed companies through the specific governance institutions which have been stipulated by the Company Law of the PRC.[33] In other words, the corporate governance of the SCLCs in China is still the control-based model as traditional SOEs, which is the result of path dependence. Next, I will illustrate this model from the aspects of three principal corporate governance institutions applied in China-the shareholder meeting, the board of directors and the supervisory committee.

A. The Shareholder Meeting

In China, the shareholder meeting which is viewed as a supreme power organ of a corporation occupies the central position in corporate governance.[34] In terms of the latest Company Law of the PRC which came into effect in 2006 (Company Law 2006), the shareholder meeting holds the following comprehensive decision-making powers: (1) to determine corporate operation guidelines and investment plans; (2) to elect and replace directors and shareholder supervisors and determine their remuneration; (3) to review and approve the report submitted by the board of directors; (4) to review and approve the report submitted by the supervisory committee; (5) to review and approve the corporate fiscal

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28 Xinhuanet, Fourteenth National Delegate Conference of the CPC, Xinhuanet. Http://news.xinhuanet.com/ziliao/2003-01/20/content_697129.htm (Aug 7, 2009).

29 The Fourteenth CPC Central Committee, Decisions on the Establishment of the Socialist Market Economy, http://www.people.com.cn/GB/shizheng/252/5089/5106/5179/20010430/456592.html (Aug 7, 2009).

30 Bin Liang, The Changing Chinese Legal System, 1978-Present-Centralization of Power and Rationalization of The Legal System 30 (2008), Routledge (London).

31 *Ibid.*

32 Those enterprises are generally called "the SCLCs" in official documents and academic literature in China.

33 The Company Law 1993 was revised in 2005 and the latest Company Law came into effect in 2006. However, its overall structure with the three main sections of the shareholder meeting, the board of directors and the supervisory committee has remained in the new Company Law to which the author will make reference tin the following analysis.

34 Lin Ye, *The Distribution of Corporate Powers,* http://www.civillaw.com.cn/article/default.asp?id=37502 (Aug 8, 2009).

budgets and final account report on an annual basis; (6) to review and approve the corporate plans regarding allocating profits and making up for losses; (7) to determine the increase and decrease of the corporation's registered capital; (8) to determine the issuance of corporate bonds; (9) to make decisions regarding corporate mergers, divisions, dissolution and liquidation; and (10) to amend the Articles of Incorporation.[35] By this enumeration, we can find out that the shareholder meeting of a corporation in China keeps substantial managerial powers some of which are reserved to the board of directors in the United States and other western countries. This arrangement has given rise to the probability that the majority shareholder can control the operation of the corporation to considerable degrees through the governance institution of the shareholder meeting in China.

As I have mentioned above, the current SCLCs in China are the transformative results of traditional SOEs. Even if they have privatized a portion of shares to the public during the process of corporatization, the ownership structure of these enterprises still characterizes the substantial concentration of the state shares. Given the limits of available data, I am not able to show the ownership constitution of each SCLC in China to prove the above proposition. However, Table 1 provides the empirical evidence regarding the biggest shareholders of the SCLCs in the sector of steel. I believe that these enterprises can be used as a sample to reflect the concentrated state shares in this kind of listed companies in China to a large extent. In the light of the data in Table 1, all of the biggest shareholders of the twelve SCLCs producing steel and iron were state holding corporations which are solely held by the state.[36] The appointments to the top tier corporate leadership positions in these state holding corporations are made by state-owned asset management commissions and CPC committees.[37] Moreover, almost all of the candidates for these positions have the backgrounds of working in related government agencies. [38]Therefore, state holding corporation leaders are seldom held accountable for the economic performance of the enterprise and its subsidiaries as long as it does not deteriorate massively. [39] Their obligations are to guarantee the implementation of state and local policies in those entities. With the tier of state holding corporations as their biggest shareholders, the state has tightly gripped the SCLCs through the shareholder meeting. Even if the equity division reform in 2005 has made state shares tradable on the secondary market, it has not shaken the state's position in the SCLCs as the largest shareholders due to the impediments of vested interests groups.[40]

B. The board of directors

According to the stipulation of the Company Law 2006, the board of directors plays the role as the executive branch of the shareholder meeting in a corporation. It is mainly

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35 Article 100 of the Company Law 2006.

36 Christopher A. McNally, *Strange Bedfellows: Communist Party Institutions and New Governance Mechanisms in Chinese State Holding Corporations*, 4 Business and Politics 97(2002).

37 Can Yi & Yumin Zhang, *Research on the Corporate Governance of Wholly State-owned Corporations*, 7 Journal of Southwest University for Nationalities (Humanities and Social Science) 89 (2007).

38 *Ibid.*, at 104.

39 *Ibid.*, at 102.

40 Ye, *supra* note 34.

Table 1: The Biggest Shareholders in the SCLCs in the Sector of Steel in China in 2009

Corporation Name	Name of the Biggest Shareholder	Amount of Shares Held by the Biggest Shareholder	Ratio to the Total Shares (%)
Anyang Iron and Steel Incorporated	Anyang Iron and Steel Group Corporation Limited	1,438,934,489	60.11
Baoshan Iron and Steel Incorporated	Bao Steel Group Corporation	12,953,517,441	73.97
Guangzhou Iron and Steel Incorporated	Guangzhou Iron and Steel Group Corporation Limited	291,104,974	38.18
Handan Iron and Steel Incorporated	Handan Iron and Steel Group Corporation Limited	1,060,810,380	37.66
Hangzhou Iron and Steel Incorporated	Hang Steel Group Corporation	545,892,750	65.07
Hongxing Iron and Steel Incorporated	Jiuquan Steel Group Corporation Limited	1,712,955,075	83.74
Laiwu Iron and Steel Incorporated	Laiwu Iron and Steel Group Corporation	688,503,152	74.65
Lingyuan Iron and Steel Incorporated	Lingyuan Group Corporation	431,473,247	53.67
Ma Anshan Iron and Steel Incorporated	Ma Steel (Group) Holding Corporation	3,886,423,927	50.47
Nanjing Iron and Steel Incorporated	Nanjing Iron and Steel Group Corporation Limited	1,056,120,000	62.69
Hebei Iron and Steel Incorporated	Tangshan Iron and Steel Group Corporation Limited	1,853,409,753	51.11
Wuhan Iron and Steel Incorporated	Wuhan Steel Group Corporation	5,072,021,816	64.71

Source: The Annual Reports of These Companies in 2009 [41]

responsible for the enforcement of the operation decisions made by the latter.[42] The state has controlled the board of directors by means of their personal arrangements. Generally speaking, the chairman and the vice chairman of the board of directors and the director who is concurrently the chief executive in a SCLC are actually determined by local

41 China Stock Markets Web, Announcements of Listed Companies, http://static.sse.com.cn/sseportal/ps/zhs/ggts/ssgsggqw_full.shtml (Jan 17, 2014) .

42 Article 109 of the Company Law 2006.

CPC committees.[43] After that, this decision is forwarded to local governments and their state-owned asset management commissions.[44] Next, state-owned asset management commissions require state holding corporations who are the biggest shareholders to convene the shareholding meeting of the SCLCs and appoint the candidates on the shortlist.[45] Moreover, in terms of local government regulations, it is a prevalent requirement that the chairman of the board of directors should act as vice CPC secretary and then the vice chairman should act as CPC secretary in this sort of listed companies.[46] In addition, a large portion of directors in a SCLC are former officials in disbanded component government departments.[47]

With regard to the independent directors in the SCLCs, they also represent the voice of the state. In the light of the "Guidelines on the Establishment of the Institution of Independent Directors in Listed Companies" (Guidelines on Independent Directors 2001) issued by the China Securities Regulatory Commission (CSRC) in 2001, independent directors are elected by the shareholding meeting.[48] Therefore, in the SCLCs, the state as the largest shareholders through the tier of state holding corporations actually dominates the selection of their independent directors.[49] Consequently, independent directors keep tight ties with governments and act on behalf of the state.

C. The supervisory committee

In China, the principal function of the supervisory committee in a corporation is to monitor the behaviors of directors and managers in the interests of shareholders.[50] The members of the supervisory committee in the SCLCs tend to be drawn from two sources. First, state holding corporations as the largest shareholders select external shareholder supervisors through the shareholder meeting.[51] Generally, these external shareholder

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43 Liaoning Securities Supervisory Bureau, Analysis on the Behavioral Changes of the Majority Shareholders and the De Facto Controllers of Listed Companies and the Corresponding Supervisory Approaches after the Equity Division Reform , http://www.csrc.gov.cn/n575458/n870331/n10217417/10264959.html (Aug 10, 2009); People's Daily Online, Behind the Dismissal of Qiao Hong: No Contest for the Successor of Maotai, http://finance.people.com.cn/GB/67815/71134/5870908.html (Aug 10, 2009). The appointment procedure is also applicable to the listed companies invested by the central government which are the minority of all of the SCLCs.

44 *Ibid.*

45 *Ibid.*

46 Yi & Zhang, supra note 37, at 105. In practice, it is also common that the chairman of the board of directors act as that corporation's party secretary.

47 Xinhuanet, Black Record of Chinese Listed Companies in 2005, http://news.xinhuanet.com/stock/2006-01/06/content_4015864.htm (Aug 10, 2009).

48 Article 4 of the Guidelines on Independent Directors 2001.

49 Jianmin Su, Yanbin Yao & Yuehui Su, *Analysis on the Problems of Independent Directors in China*, 14 Finance & Economy 79 (2007); Xiangping Cao, *Reasons for the Dysfunction of Independent Directors in China*, 1China National Conditions and Strength 47 (2008).

50 Article 118 of the Company Law 2006.

51 Jian Zhao, *Consideration on the Improvements of the Supervisory Committee of Chinese Listed Companies*, 11 China Economists 113 (2003); Jianwei Li, *On the Improvements of the Supervisory Committee of Chinese Listed Companies through the Perspective of Its Relationship with Independent Directors*, 2 Law Science 76 (2004).

supervisors are retired government officials, famous economists and accountants who have close relationship with the authorities. Second, within corporations, the secretaries of corporations' disciplinary committees of the CPC and worker representatives constitute internal shareholder supervisors.[52]

The two sources clearly convey the two main purposes of the supervisory committees of the SCLCs. First, the committee is applied to further internalize the oversight of competent government departments over how the SCLCs are operated, thus assuring the maintenance and increase of state assets and the implementation of state policies.[53] Second, the disciplinary committees of the CPC within corporations can play the traditional role as the primary organs of managerial discipline through their personnel overlap with the supervisory committees.[54] Therefore, this corporate institution in charge of management supervision in the SCLCs is also firmly held by the state. Even if it has not obviously taken effect in practice, it is another issue which is not essentially relevant with my analysis in this article.[55]

Just as Donald Clarke claimed, "China's legal system cannot be understood apart from its history and that history-whether imperial or modern- is overwhelmingly a story of centrality of the state."[56] It is also applicable to the corporate governance of the SCLCs. Through the retrospect to the governance structures of their predecessors, we are able to truly understand why the corporate governance of the SCLCs is a control-based model for the purpose of implementing state policies. In other words, without looking back to the historical path, it is not explicable that "the policy of corporatization does not involve a renunciation by the state of its ambition to remain the direct owner of enterprises in a number of sectors"[57] because "this ambition makes no sense if profits are the only objective."[58] Consequently, to a large extent, this control-based model has given rise to the lower risk tolerance of Chinese domestic venture capitalists, which I will demonstrate in the remaining parts of this article.

III. The Comparison of Risk Tolerance: Findings from Empirical Studies

As defined by Bernard Black and Ronald Gilson, VC refers to "investment by specialized venture capital organizations in high-growth, high-risk, often high-technology firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt".[59] On the basis

52 Linqing Wang, The Tragedy of the Supervisory Committee of Chinese Listed Companies: Curious Performance in the Past Eleven Years, http://www.civillaw.com.cn/article/default.asp?id=25935 (Aug 10, 2009).

53 Yi & Zhang, *supra* note 37, at 106.

54 *Ibid.*

55 Kaifu Li, *Brief Analysis on the Shortcomings and Improvements of the Supervisory Committee of Chinese Listed Companies*, 130 Law Review 123-27 (2005).

56 Donald Clarke, Lost in Translation? Corporate Legal Transplants in China, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913784 (Aug 10, 2009).

57 Clarke, *supra* note 4, at 497.

58 *Ibid.*

59 Black & Gilson, *supra* note 12.

of the definition, it is clear that VC features two dimensions. One dimension is related to its affinity for investing in the early stage of firms as described by "to finance product development or growth".[60] The other dimension refers to its preference for investing in the high technology industry. On the basis of the two dimensions, I extract two indicators - financing stages and technological intensity, which will be used to measure the risk tolerance levels of Chinese domestic venture capitalists and their American counterparts in this article.

As for financing stages, I am principally concerned with the investment magnitudes of Chinese domestic VCs and American ones in the startup stage. In the VC sector, the development of a company is usually divided into four stages - the seed stage, the startup stage, the expansion stage and the pre-IPO stage.[61] The seed stage refers to the situation in which entrepreneurs only generate their ideas and are yet to convert those ideas into products.[62] The startup stage determines that trial production and early marketing has been carried out.[63] The expansion stage means that products have been recognized by consumers and have achieved a major share of the market.[64] The pre-IPO stage implicates that the VC-backed company is mature and possesses the scale to raise funds in the stock markets.[65] VCs, as the common practice, very rarely invest at the seed stage.[66] Instead, at this stage, entrepreneurs whose companies just have good ideas usually acquire equity investment from a group of wealthy individuals who are commonly called "angel investors".[67] Except the seed stage, VCs are willing to be involved in the other three stages. However, this kind of investment portfolio does not simply mean that the other three stages are equally important in the eyes of VCs. Theoretically, VCs ought to be much more interested in the startup stage because the returns from investing at this stage are fairly higher than those from investing at the expansion stage or the pre-IPO stage. But along with large profits, the risks in the startup stage are also much higher than those in the later two stages. Therefore, in order to disperse risks, VCs also put some money into enterprises at their expansion stages or pre-IPO stages, which are more secure than investing in early stage ones. From this analysis, I intend to convey two points. First, only the investment in the early stage can validly reflect the risk tolerance of venture capitalists. Maybe the expansion stage and the pre-IPO stage represent different risk levels. But both of them are means adopted by VCs to offset the high risks stemming from the early stage. In this sense, they are not directly related to the risk-neutrality character of VCs. Second, since the early stage represents a variable to measure the risk tolerance of venture capitalists, we ca n compare the risk tolerance of venture capitalists in different VCs by calculating the different weights of new investment in this stage by those VCs during a certain period.

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60 *Ibid.*

61 The four stages have already been recognized by the VC industry. For such an example, see Ingenious Haus Group, http://www.ingenioushaus.com/service_vc.htm (Jan 17, 2014).

62 *Ibid.*

63 *Ibid.*

64 *Ibid.*

65 *Ibid.*

66 Hank Heyming, Where Venture Capital Fits, http://www.kciinvesting.com/articles/9958/1/Where-Venture-Capital-Fits-Part-2/Page1.html (Jan 15, 2010).

67 *Ibid.*

Technology intensity is related to the fact that the risk levels of different high technologies are never identical although all of them are usually associated with high uncertainty and high risks. Theoretically, the determinant factor of the risk magnitudes of different high technology sectors is their different technology intensity.[68] The higher the technology intensity, the higher the risks a high technology sector has. Therefore, we are able to measure the degrees of risk tolerance of different venture capitalists if we know the technology intensity of various high technology sectors and the distribution of new investment among such sectors by the subject venture capitalists during a certain period.

In the aspect of investing in startup companies, the empirical evidence does not show any substantial differences between Chinese domestic venture capitalists and their American rivals. According to the data regarding the respective new investments by Chinese domestic VCs and foreign ones in China in 2005, among a total of 187 projects financed by Chinese domestic VCs, 80 were at the startup stage with a percentage of 42.8;[69] likewise, among 102 projects financed by foreign VCs, 44 were at the startup stage with a percentage of 43.1.[70] From this comparison, we can basically conclude that no obvious divergence exists between Chinese domestic venture capitalists and their foreign counterparts concerning their preference for startup companies. Even though this set of data did not specially measure the performance of American venture capitalists in this aspect, I think that the performance of foreign venture capitalists can be virtually applied to American ones because the latter plays a dominant role among all the members of the former in China.[71] Thus, I will use "American venture capitalists" in the following similar quotations instead of "foreign venture capitalists". Another piece of supplementary empirical proof to support my findings comes from the research collectively carried out by Rob Dixon, John Ritchie and Di Guo.[72] In their research, the three authors statistically compared the propensity of Chinese domestic venture capitalists and American ones to opt for different stages of companies in terms of their investment from 2002-2003 in China.[73] Finally, Dixon, Ritchie and Guo found that there was not a statistically significant difference between American venture capitalists and Chinese domestic ones in their preference to invest in projects at the startup stage.[74] On the basis of the above two pieces of empirical evidence, the risk tolerance of Chinese domestic venture capitalists and American ones toward startup companies is tight. The explanation for this phenomenon is that Chinese domestic VCs as learners have imitated the practice of seasoned American ones in the aspect of choosing investment stages. As Jianbiao Xiang who was the founder of the Holding VC said, our standards of selecting

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68 Dixon, Ritchie & Guo, *supra* note 16.

69 China Venture Capital Research Institute Limited, China Venture Capital Yearbook 277 (2006),.

70 *Ibid.*

71 Zero2ipo Group, "China Venture Capital & Private Equity Annual Ranking 2012" http://events.pedaily.cn/2012/vcranking/Ranking.asp (Jan 17, 2014)

72 Dixon, Ritchie & Guo, *supra* note 16.

73 *Ibid.*

74 *Ibid.*

projects were mainly transplanted from those of IDG which is a famous American VC.[75] In addition, my interviewee from a provincial government-backed VC (GVC) also held the same position on this matter.[76]

In the aspect of choosing high technology sectors, the empirical evidence indicates that there are clear differences between Chinese domestic venture capitalists and American ones. In 2006, 20.3% newly invested projects with a monetary injection of RMB812 million yuan by Chinese domestic VCs were in the fields of new energy and new materials.[77] Both of the data ranked No. 1 among all the projects financed by Chinese domestic VCs that year.[78] By contrast, in the same year, 51% newly invested Chinese projects with a monetary injection of RMB5,669 million yuan by American VCs were in the fields of IT.[79] Likewise, both of the data also ranked No. 1 among all the Chinese projects financed by American VCs that year.[80] From this comparison, Chinese domestic venture capitalists are more interested in new energy and new materials while American venture capitalists focus more on IT. At this point, my finding is supported by the above-mentioned research of Dixon, Ritchie and Guo as well. In their research, the three authors concluded that there was a statistically significant difference between American venture capitalists and Chinese domestic ones in their preference for high technology sectors - the former concentrated on IT-related technologies and the latter was attracted to new energy and new materials.[81] The explanation for American venture capitalists' favouring IT is that IT is their traditional advantage and they have accumulated rich experiences about making their fortune in this sector from their past successes and failures. Especially, many senior members of American VCs directly come from IT companies, which is why they are more willing to invest in their formerly specialized area.[82] The reasons for Chinese domestic venture capitalists' inclination towards new energy and new materials can be divided into two cases. For GVCs, this kind of inclination mainly results from the environmental policy of the State Council. In 2002, the State Council issued "The National Report of Sustainable Development" in which new energy and new materials were deemed the urgent fields for development.[83] In order to echo the calling from the central government, local governments subsequently made their own plans for rapidly developing the two fields.[84] In those plans, one common method is to finance the startup

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75 CEO & CIO Magazine, The Pain of Chinese Private Domestic VCs, http://tech.163.com/09/0722/10/5EQOCTER000915BF.html (Jan 15, 2010).

76 Interview with a venture capitalist from a provincial GVC. In China, Chinese domestic VCs consist of GVCs and private domestic VCs.

77 China Venture Capital Research Institute Limited, supra note 17, at 236.

78 *Ibid.*

79 *Ibid.*

80 *Ibid.*

81 Dixon, Ritchie & Guo , *supra* note 16.

82 IT Time Weekly, IT Experts Jump into the VC Sector, http://news.zero2ipo.com.cn/n/2009-11-14/20091114114800.shtml (Jan 16, 2010).

83 The State Council, The National Report of Sustainable Development (2002).

84 We are able to find that almost every province has issued its plan for developing new energy and new materials if we search for them through Google or Baidu.

companies with the technologies related to new energy and new materials.[85] Therefore, GVCs which are affiliated to local governments inevitably play the role of investor for those companies. For private domestic VCs, their partiality for new energy and new materials principally stems from the backgrounds of their VC investors. As Jiaqing Li who is the CEO of the Legend Capital Limited said, almost all VC investors of private domestic VCs in China are privately held companies in the manufacturing industry.[86] With the increasing prices of traditional energy and the more stringent environmental responsibilities, entrepreneurs of those privately held companies had realized that the profit room for their enterprises had been significantly narrowed.[87] Therefore, they put part of the retained profits of their companies into the VC industry in order to earn more money.[88] From Mr. Li's explanation, we are able to discover that one of the direct reasons for the participation of privately held enterprises in the VC industry is the pressure caused by the state policy of protecting traditional energy and the environment. Given their sufferings from this kind of pressure as well as the political advocacy from the Chinese central government, we have enough reason to believe that the entrepreneurs of those companies can definitely identify the big market potential of new energy and new materials in China, which means that they have more incentive to participate in the two fields. In addition, different from VC investors in America, they always require the status of decision makers,[89] which implicates that they possess the discretion to select their preferred areas. Thus, the combination of the two factors explains why private domestic VCs also show a preference for new energy and new materials.

Related to the technology intensity of different high technology sectors, little quantitative research has been conducted so far. In all likelihood, this inadequacy is attributed to the potential huge and complicated task of designing measurable indicators and collecting data across sectors and even across nations. Therefore, I can only qualitatively measure the technology intensity of the high technology sectors respectively preferred by American venture capitalists and Chinese domestic ones by conducting an interview. From the viewpoint of my interviewee from the provincial GVC, IT is more technological intense and riskier than new energy and new materials.[90] As he explained, the profits of IT projects mainly come from attracting and maintaining a huge number of users.[91] However, from an initial IT product to a widely-accepted one, this process usually takes several years during which almost all of the work is technology-based

85 *Ibid.*

86 First Financial Daily, The Temperature of Private Domestic VC Needs to Be Cooled, http://www.china-cbn.com/s/n/000002/20080722/020000084359.shtml (Jan 16, 2010).

87 *Ibid.*

88 *Ibid.*

89 In China, venture capitalists in both GVCs and private domestic VCs are not independent in the process of selecting investment projects. They face serious intervention from their principal VC investors. See Lin Zhang, *Adaptive Efficiency and the Corporate Governance of Chinese State-controlled Listed Companies: Evidence from the Fundraising of Chinese Domestic Venture Capital*, 10 U.C.Davis Business Law Journal 151-81 (2010).

90 Interview with the venture capitalists from the provincial GVC.

91 *Ibid.*

because most IT products are intangible.[92] The longer growth period of IT products resulting from technology-intensity commonly means that they are not able to create money before maturing.[93] Moreover, nobody could guarantee that they can definitely build a huge client base within a few years' time.[94] Therefore, the uncertainty is fairly great.[95] By contrast, investing in technologies with tangible products, like new energy and new materials, is less technologically intense and risky because they are able to generate profits with a mature product in a much shorter period.[96] My interviewee's opinion has been supported by Qifa Liu who is the investment manager of the Fitch Crown Venture Capital Management Company. In a VC forum organized by the Net Ease Company, Mr. Li expressed the same position regarding the technology intensity and risks of IT, new energy and new materials.[97] In addition, in their research, Dixon, Ritchie and Guo mentioned that their interviewee who was a domestic venture capitalist also confirmed that IT was more technological intense and riskier than new energy and new materials.[98]

In terms of the aforementioned empirical evidence, we can basically arrive at the conclusion that the risk tolerance of American venture capitalists is higher than that of Chinese domestic venture capitalists. However, as analyzed elsewhere, venture capitalists in GVCs and private domestic VCs are not independent decision makers in the process of choosing investment projects.[99] And passive selection cannot authentically represent the risk tolerance of venture capitalists. Therefore, in order to truly reflect the risk tolerance of Chinese domestic venture capitalists, we must assess whether or not they would have been willing to catch up with or even overtake their American rivals in this aspect if we assume everything is the same except that they are able to independently make decisions.

For venture capitalists in GVCs, their answers to the above question are "No". In my interview with the venture capitalist in the provincial GVC, he expressed the view that even if they obtained the sufficient autonomy to make investment decisions, venture capitalists in GVCs were inclined to choose the projects favoured by governments, such as startup companies developing new energy or new materials.[100] As he explained, on the one hand, they could get rescued by governments when they are in trouble with the projects recommended by the authorities; on the other hand, they cannot earn more because of the fixed income system in GVCs but must be blamed for losses if they independently choose riskier projects like IT startups.[101] My interviewee's opinion has also been supported by the interview conducted by Dixon, Ritchie and Guo in their quoted research.[102] Therefore, in comparison with American venture capitalists, a lower

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92 *Ibid.*
93 *Ibid.*
94 *Ibid.*
95 *Ibid.*
96 *Ibid.*
97 The Net Ease, Chinese Domestic VCs Stay away With IT in the Three Years Ahead, http://tech.163.com/08/0117/00/42CCME3K000922QC.html (Jan 16, 2010).
98 Dixon, Ritchie & Guo, *supra* note 16.
99 Zhang, supra note 89.
100 Interview with the venture capitalist from the provincial GVC.
101 *Ibid.*
102 Dixon, Ritchie & Guo , *supra* note 16.

level of risk tolerance of venture capitalists in GVCs can be ascribed to the effects of risk absorption and incentive inadequacy.

For venture capitalists in private domestic VCs, their answer to the above question is "No" as well. As explicated before, the main funding source for private domestic VCs is the limited retained profits of privately held enterprises. Therefore, without alternative large funds, the failure of investment for a private domestic VC generally means that it has to leave the VC industry. Consequently, in order to survive, we have enough reason to believe that venture capitalists in private domestic venture capitalists do not invest in the areas riskier than those currently invested in by them if they have the discretion to select projects. My analysis has been testified by Fenglin Chen who is the vice CEO of the privately held Shanghai Huile Investment and Management Corporation. According to Mr. Chen's illustration, foreign VCs generally hold billions of dollars for investment.[103] If they fail in a project, they can also get compensated by other successful ones.[104] But for private domestic VCs, their funds are quite limited.[105] If they fail in a project, it usually means that all is lost.[106] Therefore, private domestic VCs pay more attention to risks while foreign VCs are more concerned with profits.[107] In addition, my interviewee in the GVC also agreed with my reasoning on this matter. As he said, even though neither GVCs nor private domestic VCs have as much money as American ones, the budgets of GVCs are much softer than that of private domestic VCs.[108] Hence, for private domestic VCs, project failure is almost the equivalent of their bankruptcy.[109] Consequently, they are more cautious in relation to risks.[110] From the above analysis, the lower level of risk tolerance of private domestic venture capitalists can be attributed to their shortage of funds.

To sum up, the empirical evidence has shown that the risk tolerance of American venture capitalists is higher than that of Chinese domestic venture capitalists. For GVCs, the difference is because of the effects of risk absorption and incentive inadequacy. For private domestic VCs, the difference results from their more limited fund sources. In the next section, I will try to prove that these reasons are linked to the control-based model.

IV. The Lower Risk Tolerance of Chinese Domestic Venture Capitalists: What the Control-based Model Explains

According to the empirical findings from the preceding section, in order to prove the linkage between the control-based model and the lower risk tolerance of Chinese domestic venture capitalists, I must testify the following two propositions in this section: (1) the effects of risk absorption and incentive inadequacy faced by GVCs largely result from the

103 The CVCRI Online, The Differences between Chinese Domestic VCs and Foreign Ones, http://bbs.chinavcpe.com/topic.action?topicId=7004 (Jan 17, 2010).

104 *Ibid.*

105 *Ibid.*

106 *Ibid.*

107 *Ibid.*

108 Interview with the venture capitalists from the provincial GVC.

109 *Ibid.*

110 *Ibid.*

control-based model; (2) the more severe funding shortage suffered by private domestic VCs is mainly attributed to the control-based model as well. Next, I will attempt to verify them in sequence.

A. Risk Absorption and Incentive Inadequacy: The Reflection of Paternalism

In the second part, I have pointed out that the corporate governance of the SCLCs is the control-based model. This model has the effect to align the interests of governments with those of their controlled listed companies. Consequently, this kind of alignment has maintained the paternalism of governments which pervasively existed in traditional SOEs before their corporatization. With the paternalism, on the one hand, governments have the incentive to transfer as many resources as possible to the SCLCs, which I have empirically proved elsewhere; on the other hand, they are also willing to absorb any risks which threaten the operation and vested interests of those companies. As a result, when GVCs emerged since the end of the 1990s,[111] the behavioural inertia inevitably made governments apply the risk-absorption aspect of paternalism to this new type of firm which is homogeneous with the SCLCs. Naturally, when GVCs experience trouble after investing in projects recommended by governments, the authorities will try to bail them out by providing more money. Here, I believe that some may argue that the bailout of governments should have the effect of increasing the risk tolerance of venture capitalists in GVCs. Thus, is it inconsistent with its role as the reason to lower the risk tolerance level of venture capitalists of GVCs? My answer is "No". As the existing academic research has identified, the two factors that measure the risk tolerance level of venture capitalists are financing stages and technology preference as adopted in this chapter. The ability or willingness of venture capitalists to use risk-controlling mechanisms can only influence their risk tolerance at each level but cannot upgrade or downgrade their levels. For example, Professor Curtis Milhaupt once compared the risk tolerance levels of American venture capitalists and Japanese ones through the above two indicators.[112] Even though he also found that Japanese venture capitalists seldom made use of convertible securities or stock options, it did not change their lower risk tolerance level in comparison with their American rivals because they generally focus on late stage financing and traditional industries.[113] Therefore, based on this reasoning, we can understand that the bailout of governments lowers the risk tolerance level of venture capitalists in GVCs as the empirical evidence shows but may increase their risk tolerance at this lower level.

On the basis of the above analysis, what I ought to do next is prove that the practice of risk absorption maintained by the control-based model really exists in the SCLCs. In order to achieve this, I will explore the interaction between the control-based model and the risk absorption of governments in three situations which cause risks to the SCLCs. The three situations are fraudulent information disclosure, hostile takeovers and bankruptcy. Next, I will analyze them one by one.

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[111] Dixon, Ritchie & Guo, *supra* note 16.

[112] Milhaupt, *supra* note 8, at 894.

[113] *Ibid.*, at 889.

a. Fraudulent Information Disclosure

Pursuant to the Securities Law of the PRC, when the fraudulent information disclosed by a state-controlled listed company is spotted by the CSRC, the company will suffer administrative fines and warnings.[114] In addition, according to the judicial interpretation entitled "Notice regarding Dealing with the Disputes Resulting from Fraudulent Information Disclosure" which was made by the Supreme Court of the PRC in 2002, the shareholders which fall victim are also entitled to file lawsuits against the company for compensation after the administrative penalty from the CSRC is imposed.[115] Therefore, for the SCLCs, fraudulent information disclosure theoretically means the loss of money and confidence from public investors.

With the risks of heavy punishments from the regulatory body, courts and market, the SCLCs should be dissuaded from issuing fraudulent information. But in reality, false information disclosed by them has been rampant in the Chinese stock markets. Professor Peixin Luo from the East China University of Political Science and Law once conducted an interview with a government official who was responsible for investigating securities crimes.[116] In this interview, the official admitted that it was common practice for the SCLCs to issue fraudulent information, but only a few of them had been punished by the CSRC or courts.[117] Likewise, Professor Liufang Fang from the China University of Political Science and Law also expressed the same opinion in an interview with an influential newspaper in China.[118] During this interview, Professor Fang even commented that the information frauds of the SCLCs had made accounting firms forget how to provide true auditing reports.[119] Facing the divergence between the punishment risks and the flooding of false information from the SCLCs, some may wonder why it happens. From my point of view, among others, the main reason is because governments absorb most risks from disclosing fraudulent information for the SCLCs, which was implicitly revealed by the official in his or her interview with Professor Luo.[120]

As I have analyzed in the second part, the underlying purpose of the control-based model is to ensure that the SCLCs are able to faithfully implement the policies of the CPC and governments. This fact determines that the administrative penalty made by the CSRC against the behaviour of information frauds of the SCLCs definitely impairs the interests of local governments or the SASAC. Therefore, when the fraudulent information from the SCLCs is identified by the CSRC, local governments and the State-owned Assets Supervision and Administration Commission (SASAC) inevitably wade in and prevent the CSRC from taking any punitive action. Moreover, this kind of intervention

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114 Article 193 of the Securities Law of the PRC.

115 The Supreme Court of the PRC, "Notice regarding Dealing with the Disputes Resulting from Fraudulent Information Disclosure", http://www.csrc.gov.cn/pub/newsite/flb/flfg/sfis_8249/200802/+20080227_191599.htm (Jan 17, 2014)

116 Peixin Luo, *The Establishment of Legal System for the Harmonized Ecology of Chinese Securities Markets*, 4 China Legal Science 101-02 (2005).

117 *Ibid.*

118 Fang, *supra* note 6.

119 *Ibid.*

120 Luo, *supra* note 116.

also deprives victim shareholders from the right to approach courts for remedies because the penalty decisions of the CSRC are the prerequisite for filing lawsuits in terms of the "Notice regarding Dealing with the Disputes Resulting from Fraudulent Information Disclosure". Consequently, the risks from issuing false information for the SCLCs have been substantially absorbed by governments.

Even though it is impossible to know how many the SCLCs governments have helped escape the administrative penalties after disclosing fraudulent information, we can still indirectly identify this kind of practice from some cases investigated and announced by the CSRC. Next, in order to further demonstrate my claim in this section, I will choose the Hongguang case as an example.[121]

Chengdu Hongguang Industrial Corporation (Hongguang) was a television manufacturer which was in the charge of Chengdu Municipal Government. In June 1997, upon the recommendation of Sichuan Provincial Government and the approval of the CSRC, Hongguang was listed on the Shanghai Stock Exchange. In its prospectus, Hongguang predicted that it could achieve profits of RMB70.55 million yuan by the end of 1997. However, according to its annual report of 1997, Hongguang eventually suffered net losses of RMB203 million yuan. Consequently, it became the first company to report losses in its listing year in China. The tremendous difference between the prospectus and the annual report aroused intensified criticism and skepticism among the media and public investors. Under this kind of pressure, the CSRC announced its intention to investigate Hongguang at the beginning of 1998. At the end of that year, the CSRC reported its investigation results to the public. According to the results, Hongguang provided fraudulent accounting information in its prospectus for the purpose of acquiring the listing quota. For example, in terms of its prospectus, Hongguang was continuously profitable from 1994 to 1996. But in fact, till 1996, it had suffered losses of RMB103 million yuan.

From this brief description of the Hongguang case, I intend to convey three points. First, as the SOE was located in its area and enjoyed its subsidy, Chengdu Municipal Government had no reason to say that they did not know about the losses of Hongguang before its listing. But they never declared any objection to the false financial data included in the prospectus when Hongguang sought to be listed. Therefore, it just means that the local government allowed the fraudulent practice of its enterprise. Second, ex ante conniving must be associated with ex post harbouring. From the almost one-year investigation, we have enough reason to imagine how much resistance from the local governments the CSRC went through. Hence, if Hongguang did not generate such huge negative influences in China, it may have escaped the punishments of the CSRC. Finally, the combination of the above two points can basically prove the risk absorption of governments for the SCLCs after they issue false information. More importantly, it is largely ascribed to the control-based model.

[121] Yuming Zhang, The Red and Black of Chinese Stock Markets, http://www.guosen.com.cn/webd/eBook/redandblack/hongguan.html (Jan 21, 2010).

b. Hostile Takeovers

Hostile takeovers are an important and effective external governance mechanism to discipline the performance of the management of a listed company.[122] Along with the success of a hostile takeover, the controlling power of the target company will be transferred to the bidder; its incumbent managers will be probably replaced and its overall operation strategies will usually be changed. Therefore, for a listed company, hostile takeovers threaten the vested interests of the controlling shareholders and the management, and the established tactics of operation.

However, the prerequisite for the survival of hostile takeovers is the dispersed ownership structure of listed companies. In the case of concentrated ownership, a bidder can only negotiate in a friendly way with the controlling shareholders and the management if it intends to acquire the target company. Thus, with the control-based model, governments as the majority shareholders, not only guarantee the implementation of their policies in the SCLCs, but also discourage any hostile takeover attempts against those companies. In this sense, I think that governments absorb the risks from hostile takeovers for the SCLCs. Actually, in addition to hostile takeovers, friendly negotiations usually mean that a bidder is not able to ultimately control the target the SCLCs as well. According to the "Provisional Administration Regulation regarding the Transferring of State-owned Shares of Listed Companies" jointly enacted by the SASAC and the CSRC in 2007, the selling of state-owned shares of listed companies must obtain the approval of the SASAC or provincial governments[123] Given the vested interests from the control-based model, in most cases, those authorities are reluctant to hand over their identities as controlling shareholders to friendly bidders. Ultimately, such bidders at most become minority shareholders of the target state-controlled listed company. On this point, I think that the Tsingtao Beer case has provided persuasive empirical evidence.[124] Although this case occurred before the enactment of the "Provisional Administration Regulation regarding the Transferring of State-owned Shares of Listed Companies", governments also possessed the power to transfer state-owned shares of listed companies at that time. Therefore, time is not a factor to weaken the illustration ability of this case. Next, I will briefly analyze it so as to support my position in this section.

The Tsingtao Brewery Corporation (Tsingtao Beer) is a listed company which is controlled by Tsingtao Municipal Government. Given the popularity of Tsingtao Beer among Chinese consumers, the Anheuser-Busch Company (AB) which is the largest beer producer in the US once negotiated with Tsingtao Municipal Government to acquire the controlling shares of Tsingtao Beer at the very beginning of the 1990s. But Tsingtao Municipal Government refused its request. In 1993, Tsingtao Beer was listed on the Hong Kong Stock Exchange. Since then, it had begun to take over small beer producers in

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[122] Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 Fordham Law Review 169-71 (1992).

[123] Article 7 of "Provisional Administration Regulation regarding the Transferring of State-owned Shares of Listed Companies".

[124] China Business Newspaper, The Takeover Defense of the Tsingtao Beer in the Past Sixteen Years, http://finance.aweb.com.cn/2009/5/19/22520090519082155840.html (Jan 21, 2010).

China. Till 2001, this kind of takeover movement made Tsingtao Beer heavily burdened with debts. In order to enhance its financial liquidity, with the support and involvement of Shandong Provincial Government and Tsingtao Municipal Government, Tsingtao Beer approached AB with regard to equity investment. After almost one year of negotiations regarding the controlling power, Tsingtao Beer and AB eventually reached an agreement in 2002. According to the agreement, Tsingtao Beer issued 1.4 billion HK dollars worth of convertible bonds to AB, which meant that AB would hold 27% of the shares of Tsingtao Beer after the complete conversion of those bonds and the percentage owned by Tsingtao Municipal Government would be diluted from around 40 to 31 by then. In order to stabilize the status of Tsingtao Municipal Government as the controlling shareholder, the agreement also stipulated that AB only held the voting rights of 20% of the shares of Tsingtao Beer even though it actually owned 27%. The voting rights of the extra 7% shares had to be transferred to Tsingtao Municipal Government.

With the Tsingtao Beer case, I think I have empirically proved that governments are reluctant to hand over their controlling power of the SCLCs to outside bidders in friendly takeovers. In turn, it indirectly supports the fact that with the protection of governments through ownership concentration, hostile takeovers are not a threat to the SCLCs because bidders have to friendly negotiate with governments for their controlling blocks in the target SCLCs. Again, the root of the protection can be found in the control-based model as explicated above.

c. Bankruptcy

For a listed company, bankruptcy represents its demise as a legal person. With the completion of the bankruptcy procedures, the company does not legally and physically exist any longer. Therefore, in comparison with fraudulent information disclosure and hostile takeovers, the risks from bankruptcy look more severe.

Specifically referring to the SCLCs, as repeatedly mentioned above, they are the tools for governments to implement their policies. Thus, if they are announced to be bankrupt by courts, the vested interests of governments must be jeopardized. Consequently, this interest chain built by the control-based model determines that governments have the incentive to bail out the SCLCs which face the risk of bankruptcy.

In reality, the frequently used bail-out method by governments is to provide extra financial subsidies for the SCLCs which are in trouble. This method is commonly called "soft budget constraints".[125] Even though there are no statistics regarding the magnitude of "soft budget constraints" in the SCLCs, we can still easily find many cases involving this sort of practice from the mainstream media.[126] To some extent, it is fair to say that we can always find the figures of governments when the SCLCs are on the brink of bankruptcy. Next, I will use the Zheng Baiwen case to further justify this point.[127]

125 Donghua Chen, Tiesheng Zhang & Xiang Li, *Implicit Contract without Law - EmpiricalEvidence from China Capital Market*, (unpublished manuscript, on file with author).

126 Such as the "Houwang" case Shuang Xu, "Examining the Houwang Case through the Perspective of Government", cenet http://web.cenet.org.cn/upfile/4992.doc (Jan 20, 2010).

127 Yuhui Chen, *Innovation or Illegality?*, 23 Modern Economic Science 57-58 (2001).

Zhengzhou Baiwen Corporation (Zheng Baiwen) was listed on the Shanghai Stock Exchange in 1996. At that time, the biggest shareholder was Zhengzhou Baiwen Group Corporation which was wholly held by Zhengzhou Municipal Government. Therefore, Zhengzhou Municipal Government was the actual biggest shareholder of Zheng Baiwen. Because of bad operations, in 2000, Zheng Baiwen owed China Cinda Asset Management Corporation (Cinda) RMB2.1 billion yuan. Given Zheng Baiwen's inability to repay the debt, in the same year, Cinda filed a bankruptcy lawsuit against it. However, under the pressure of Zhengzhou Municipal Government and Henan Provincial Government, Zhengzhou Intermediate People's Court dismissed the application by Cinda. After that, in order to salvage Zheng Baiwen, Zhengzhou Municipal Government and Henan Provincial Government persuaded Shandong Sanlian Corporation which is a large SOE in Shandong province to restructure this moribund listed company with equity investment. In addition, with their efforts, Cinda which was wholly owned by the MOF also agreed to cancel Zheng Baiwen's debt worth 1.2 billion yuan out of the total 2.1 billion yuan payable to it. For the remaining 0.8 billion yuan debt, 0.3 billion was repaid by Shandong Sanlian Corporation and 0.5 billion was repaid by Zheng Baiwen Group Corporation with a guarantee from Zhengzhou Municipal Government. Finally, with the series of arrangements above, Zheng Baiwen successfully escaped the consequence of bankruptcy. Through this brief introduction to the Zheng Baiwen case, the efforts made by governments to save the the SCLCs on the brink of bankruptcy are clear. Thus, it empirically proves the existence of the soft budget constraints in reality.

I believe that I have proved that the risk absorption of governments really exists in the SCLCs due to the control-based model. In turn, the effect of risk absorption resulting from the control-based model inevitably leads to incentive inadequacy. As we know, incentive mechanisms are generally associated with discretion and risks.[128] Hence, it is not difficult to understand that incentive is not paid much attention to in an environment featuring control and protection. The long-term lack of a well-devised and regular system of stock options in both the SCLCs and GVCs is just a persuasive piece of evidence.[129]

To sum up, in this section, I have demonstrated that the risk absorption and incentive inadequacy faced by GVCs are the outcomes of the paternalism of governments. The culture of paternalism is in turn largely cultivated and maintained by the control-based model. Finally, on the basis of this correlation, I have verified the linkage between the lower risk tolerance of venture capitalists working for GVCs and the control-based model.

B. Severe Funding Shortage: An Old Problem

In another article, I illustrated that GVCs and private domestic VCs are commonly confronted with the problem of funding shortage because the control-based model hinders the huge amount of money held by various institutional investors flooding into the VC sector.[130] However, in terms of the empirical evidence in this article, it is clear that the

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[128] For example, stock options as an incentive mechanism connect the income of managers to their independent management performance. It is typically the combination of autonomy and risks.

[129] Lin Zhang, *Rethinking the Corporate Governance of Chinese State-controlled Listed Companies through the Perspective of Venture Capital*, (unpublished manuscript, on file with author).

[130] Zhang, *supra* note 89.

shortage suffered by private domestic VCs is much more pressing than that of GVCs in that it has become the main factor affecting the risk tolerance of venture capitalists in private domestic VCs. Therefore, more accurately speaking, the more severe funding shortage determines the lower risk tolerance of venture capitalists working for private domestic VCs.

The reason for the badly funding insufficiency plaguing private domestic VCs, is principally that privately held enterprises as their main VC investors lack financing channels in China. The fundraising difficulties of privately held enterprises are not a new problem. As I explicated in another article, it is largely ascribed to the interest-aligned effect of originating from the control-based model.[131] Consequently, the cash flows of privately held enterprises are very easy to dry up. Therefore, when they participate in the VC industry, they just put up a small amount of retained profits in order not to endanger the financial liquidity of their main business. For example, the biggest VC investor of Shunli VC which is a private domestic one in Foshan City only contributed RMB3.6 million yuan.[132] According to Zhiqiang Ouyang who is the CEO of Shunli VC, their VC investors were all privately held enterprises with limited fundraising sources.[133] Thus, for them, investing with small amounts of money would not risk their operations.[134] Next, in order to further illustrate the severe financing difficulties of privately held enterprises, I will make an analysis of the Sun Dawu case.[135]

Hebei Dawu Farming and Husbandry Group (Dawu Group) was established by Sun Dawu in 1985. Under the excellent management of Sun Dawu, Dawu Group developed very fast during its first ten years. By 1995, Dawu group was among the 500 biggest privately held enterprises in China. However, the expansion of enterprises is usually associated with the larger demand for cash. In order to enhance its cash flow, Dawu Group made loan applications with banks many times before 1996. But the banks almost refused all of those attempts because only SOEs were their traditional clients in this aspect. Under such circumstances, Sun Dawu decided to let Dawu Group take deposits from its employees and the residents living nearby. From 1996 to 2003, this kind of fundraising which is deemed a crime by the Criminal Law of the PRC significantly improved the financial liquidity of Dawu Group.[136] In addition, during the period, Dawu Group did not default on any borrowings. In 2003, Sun Dawu was arrested by the police with the charge of illegally taking deposits and then was sentenced to 3 years in prison by judges.

With reference to the Sun Dawu case, I do not mean to discuss whether or not the action of Sun Dawu is lawful per se. I just want to reflect the tough financing ecology of Chinese privately held enterprises under the gloom of the control-based model. In turn, this kind of negative effect of the control-based model has given rise to the lower risk tolerance of venture capitalists in private domestic VCs as the empirical evidence has shown above.

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131 *Ibid*.

132 Guangzhou Newspaper, VCs in Foshan Have Appeared, http://www.ezcap.cn/News/200815330.html (Jan 22, 2010).

133 *Ibid.*

134 *Ibid.*

135 Faren Magazine, Sun Dawu Fell before the Regulation of Chinese Financial Market, http://finance.sina.com.cn/leadership/crz/20080305/14364583433.shtml (Jan 23, 2010).

136 Article 176 of the Criminal Law of the PRC

V. Conclusion

The risk tolerance of venture capitalists directly influences the returns of VC investment.[137] With the existing empirical evidence, I have discovered that the risk tolerance of Chinese domestic venture capitalists is lower than that of their American counterparts. For GVCs, the reason for this disadvantage is because of risk absorption and incentive inadequacy; for private domestic VCs, the reason is because of severe funding shortage. Further, on the basis of the empirical findings, I have proved that those reasons are all linked to the negative effects of the control-based model. The implication from this study is that adaptive efficiency and agency costs are equally important factors which ought to be considered when we put forth any reform proposal for the corporate governance of the SCLCs. In case of neglecting either of them in this process, the overall efficiency must be jeopardized.

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