Corporate governance reforms in China and India: Challenges and opportunities

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Abstract

In this article, we examine the evolution of corporate governance reforms in the emerging economies of China and India. We first describe the two major driving forces behind governance reforms in these countries: privatization and globalization. After summarizing the evolution of governance reforms in each context, we identify four major obstacles that impede their implementation in both countries, namely: (1) lack of incentives, (2) power of the dominant shareholder, (3) underdeveloped external monitoring systems, and (4) shortage of qualified independent directors. Next, we highlight practical implications of these governance challenges for foreign firms contemplating, or already involved in, major investments in these emerging economies. We emphasize that foreign firms that are sensitive to context-specific challenges are more likely to put in place appropriate contractual or other safeguards, as well as identify more practical and meaningful forms of participation in the governance of their ventures. Finally, we conclude with some implications for future research.

KEYWORDS
Corporate governance; Emerging economies; China; India

1. Corporate governance in China and India: Crucial and timely?

Corporate governance describes the structure of rights and responsibilities among the parties that have a stake in a firm (Aguilera & Jackson, 2003). Research to date on corporate governance has mainly dealt with the efficacy of various mechanisms that can protect shareholders from self-interested executives, and the focus has generally been on (Western) developed economies (Daily, Dalton, & Cannella, 2003). Thus, relatively little research effort has been devoted to corporate governance issues in emerging economies such as China and India. These economies, however, provide unique opportunities and challenges for governance practices and research (Davis, 2005).

Well-functioning corporate governance mechanisms in emerging economies are of crucial importance for both local firms and foreign investors that are interested in pursuing the tremendous opportunities for investment and growth that emerging economies provide. From the perspective of local firms, there is evidence that firms...
in emerging economies (compared with their counterparts in developed countries) are discounted in financial markets because of their weak governance (LaPorta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). As such, improvements in corporate governance can enhance investor confidence in firms in emerging economies and increase these firms’ access to capital. According to a 2002 McKinsey investor opinion survey, investors who were open to paying premiums were, on average, willing to pay a 25% premium for well-governed Chinese firms and a 23% premium for well-governed Indian firms (Barton, Coombes, & Wong, 2004). From the perspective of foreign investors, emerging economies such as China and India have become increasingly important sources of growth and investment opportunities. For example, foreign investors are now allowed—for the first time since China started permitting foreign direct investment (FDI) in the late 1970s—to acquire a significant shareholding in state-owned enterprises on China’s renminbi-dominated, A-share exchanges in Shanghai and Shenzhen. The changing of rules for the types and extent of direct investment in both China and India increases opportunity for economic gains, but it also increases exposure to risks and problems posed by under-developed and lax governance. The governance rules in these countries are both opaque and evolving, and foreign investors need to appreciate the domestic sensitivities and complexities stemming from country-specific political and institutional landscapes so that appropriate types and levels of involvement can be designed to protect their short-term and long-term interests.

Emerging economies also represent unique challenges for corporate governance practices. First, many emerging economy firms are noted for their lack of transparency and are unwilling to accept global best governance practices. Second, due to the institutional differences between developed and emerging economies, governance practices employed in Western developed economies may not be applicable in the emerging economy context. Significant differences in the legal and institutional environments exist between China and India, and between either one and the US or other Western countries. Fundamental differences in ownership structures, business practices, and enforcement standards imply major gaps between formal adoption of progressive and sophisticated governance codes and the actual implementation of these codes. While regulators in emerging economies may be quick to adopt best corporate governance practices from the West, the presence of these practices is no guarantee that they will be strictly implemented to uphold investors’ interests. In the following sections of this article, we will highlight further implications for firms seeking to invest in these emerging markets.

2. Driving forces behind corporate governance reforms in China and India

While many factors have contributed to governance reforms in China and India, the most important are arguably privatization and globalization. In this section, we will discuss how these two forces have shaped corporate governance reforms in China and India, while also identifying differences in their effects between the two emerging economies.

2.1. The effect of privatization on corporate governance reforms

In the past few decades, emerging economies have launched ambitious plans to privatize their state-owned enterprises (SOEs). The volume of privatization in emerging economies has increased from $8 billion in 1990 to about $65 billion in 1997 (Dharwadkar, George, & Brandes, 2000). In privatization, ownership is transferred from the state to new private and public owners, which may include management, employees, local individuals, institutions, and foreign investors, with the state also retaining a certain percentage of ownership after privatization. The new diversified ownership structure after privatization makes corporate governance an important issue in emerging economies. On the one hand, the new ownership structure creates the traditional principal–principal agency problem whereby self-interested executives aim to maximize their private interests rather than the owners’ interests. To address this problem, it is necessary to design effective incentive mechanisms to align management interests with owners’ interests and/or to design effective control mechanisms to regulate management behaviors. On the other hand, the new ownership structure can also create principal–principal agency problems that are unique to emerging markets. In these unique agency contexts, large or majority shareholders often control the firm and expropriate minority shareholders’ interests in the firm (Dharwadkar et al., 2000). As a result, it is also important to design governance mechanisms and safeguards to protect minority shareholders’ interests from expropriation by majority shareholders.

As Dharwadkar et al. (2000, p. 650) note, agency problems may also exist in SOEs prior to privatization in emerging economies. However, critical agency problems associated with SOEs have more to do with issues of political control than with agency issues of managerial discretion and expropriation.
While China and India have both experienced large-scale privatization (and the related two types of agency problems), a key difference between them is the extent to which the state retains its influence over firms. In India, state ownership is found most often in public sector units (PSUs), where the government very often is the majority shareholder and the general public holds a minority stake, often as little as 20%. However, equity ownership by the state is still significantly lower than that controlled by the promoters of large and small companies, who, along with their friends and relatives, owned, on average, in excess of 45% of shareholdings in all Indian companies in 2002.

In China, the government controls firms in almost all strategically important industries. For example, at the end of 2002, the average state ownership in publicly listed companies on the Shenzhen and Shanghai Stock Exchanges was about 70% (Tai & Wong, 2003). This ownership structure probably will not change significantly in the foreseeable future because (1) the state does not yet seem to want to sell its controlling stakes in most key industries, and (2) regulators are concerned that the sale of a large volume of state stakes could seriously destabilize the fledgling stock markets. Even where the Chinese government is a minority shareholder in a privatized SOE, it still retains its control over the firm through appointing top managers and boards of directors (Xu & Wang, 1997). The continuing influence of the state in Chinese firms may adversely affect the speed at which, and the extent to which, Chinese firms can adapt to Western standards in corporate governance.

2.2. The effect of globalization on corporate governance reforms

Since China started its economic reforms in the late 1970s and India embarked on liberalization in the early 1990s, both countries have been increasingly integrated into the global economy. In 2002, China replaced the US as the most attractive investment destination in the world, and in 2004 India displaced the US to become the second most attractive FDI location among manufacturing investors (A.T. Kearney, 2004). Globalization, in particular, has greatly contributed to governance reforms in China and India. First, although emerging economies are generally characterized by weak corporate governance, foreign investors face higher standards of corporate governance in their home countries. To preserve their global integrity, foreign investors need to maintain these higher governance standards in their operations in emerging economies. Thus, they have a strong incentive to protect their reputation by avoiding direct or indirect involvement with local firms in emerging economies that are associated with scandals. Second, because foreign investors have access to governance expertise and extensive experience with governance issues, they have reduced costs in monitoring management; this means that they have a greater ability to enforce governance rules when they invest in emerging economies. As observed by Karin Finkelstein, Associate Director, East Asia and the Pacific, at the International Finance Corporation (IFC), "Everyone seems to think our name can be helpful. But there's a lot of work involved in getting our name attached to the company" (International Finance Corporation, 2005). Indeed, before it commits to providing any consulting or financial services, the IFC emphasizes the importance of gaining agreement from client companies regarding the value and importance of good corporate governance practices.

In addition, global investors see China and India differently. China is viewed as the world's leading manufacturer and the fastest growing consumer market, whereas India is viewed as the world's most significant business process and IT services provider, and a consumer market with longer-term potential (A.T. Kearney, 2004). Foreign direct investments in China and India, therefore, are qualitatively quite different. China has been able to attract a larger amount of annual FDI (approximately $65 billion in 2006) than India (approximately $9 billion in 2006). Moreover, FDI in China tends to be primarily capital intensive, while that in India tends to be more skill intensive, with a focus on the information and technology industries (A.T. Kearney, 2004).

Such differences have important implications for how globalization affects governance reforms in China and India. Because FDI in China is primarily capital intensive, governance reforms in Chinese firms seem to have been mainly driven by firms' aspiration for foreign capital. As the International Finance Corporation (2005) report notes, "Many client companies don't set up a proper corporate governance system until they're about to go public. We now try to encourage them to do it earlier." It has been seen that governance improvement can, indeed, enhance Chinese firms' access to foreign capital. For example, due primarily to its improved corporate governance, Bank of Shanghai was able to attract the HSBC Group to take an 8% equity stake in the bank in 2003. This was the first such investment that a foreign commercial bank had made in a Chinese bank. The total foreign equity participation in the Bank of Shanghai has now reached 18%.

In comparison, because foreign direct investments in India tend to be more skill intensive than capital intensive, the major motivation for Indian firms' corporate governance improvement is the need to
attract talent from a worldwide employment pool, a need that is further enhanced by global product market competition. Access to global capital markets is a consequence, rather than the cause, of Indian companies’ motivation to adopt international corporate governance standards (Khanna & Palepu, 2001).

The preceding suggests that China and India are not only different from the US and other Western developed countries, but also from each other. As discussed next, governance reforms in China and India are embedded in, and greatly influenced by, their broader institutional, economic, and social environments.

3. The evolution of corporate governance reforms in China and India

3.1. China’s corporate governance reforms

China’s Company Law is an important starting point in the evolution of China’s corporate governance reforms. Passed in December 1993 and effective July 1, 1994, the law was subsequently amended in 1999. Two types of companies are stipulated under the Company Law: limited-liability companies and joint-stock companies. The law articulates the responsibilities, rights, and liabilities of shareholders, the board of directors, managers, and the board of supervisors. All limited-liability companies are required to set up a board of directors, and "large" companies need to set up a separate board of supervisors, consisting of at least three independent (i.e., non-company) supervisors. Under the Company Law, both directors and managers are considered "insiders," but the board of supervisors is made up of independent "outsiders" that are supposed to monitor the company’s managers and directors. The law also gives shareholders the right to appoint and to remove directors and supervisors, and to decide their remuneration.

China’s Securities Law, which became effective in December 1998, regulates capital market issuance, trading activities, and related matters. According to this law, all stock exchanges, securities houses, securities clearing houses, and securities regulators must file regular reports with the State Statistics Bureau for auditing purposes. The law also strictly prohibits insider trading and market manipulation.

It was, however, the corporate scandals and capital flight cases that emerged in mid-2001 (e.g., Caijing Magazine’s exposé of an RMB745-million fraud in YingGuangXia [a publicly listed company], the largest economic scandal in mainland China’s history) that prompted officials of the China Securities Regulatory Commission (CSRC) and other state regulatory bodies to further improve Chinese firms’ governance.

In January 2002, the CSRC released its Code of Corporate Governance for Listed Companies in China, which follows the US regulatory system. The code aims to establish solid corporate governance in stock market listed companies by elevating requirements related to accounting procedures and information disclosure, introducing independent director systems, and tightening the supervision of corporate management (Shi & Weisert, 2002).

The code also expands the rights of shareholders, mandating that minority shareholders should have equal status with other shareholders and giving shareholders the right to protect their interests through civil litigation and other legal actions. On the other hand, the code gives institutional investors more weight in the decision-making process (including the nomination of directors) and it attempts to strengthen the roles of the board of directors and the board of supervisors. Finally, it also requires that listed companies adhere to the following governance rules:

- Transparent procedures must be established to select the board of directors.
- If the controlling shareholder owns a stake in excess of 30%, a cumulative voting mechanism must be adopted to ensure that the voting interests of minority shareholders are given appropriate consideration.
- There must be at least two independent (i.e., outside) directors on or before June 30, 2002, and one-third of the board members must be independent directors on or before June 30, 2003.
- Members of the board of supervisors must be given access to information related to operational status and must be allowed to hire independent intermediary agencies for professional consultation.
- Corporate governance-related information (e.g., the composition of the board of directors and the board of supervisors, the attendance records of independent directors) must be disclosed.
- Prices of related-party transactions must be fully disclosed, and listed companies cannot provide financial collateral to related entities.
- Detailed information on controlling shareholders must be promptly released, and controlling shareholders are required to honor the independence of the listed companies and to avoid interfering or directly competing with the listed entities.
- The establishment of functional subcommittees and their operating details, discrepancies
between the existing situation and the requirements of the code, and the corporate governance improvement plan must be disclosed.

3.2. India's corporate governance reforms

In India, the urgent need for corporate governance came to the fore following several significant stock market scandals (many of which were linked to insider trading) that occurred following major liberalization in 1991. In addition to stock market frauds committed by large stock brokers, there were several incidents of companies allotting preferential shares to their promoters at highly discounted prices, as well as several instances of “start-up” companies that simply disappeared with their investors’ money (Goswami, 2002). The most significant event in the evolution of corporate governance in post-liberalization India was the establishment of the Securities and Exchange Board of India (SEBI) in 1992 and its increasing jurisdiction over matters related to corporate governance since then. Since its establishment, SEBI has constituted several major committees to review governance challenges, and to propose governance laws and reforms. The first formal corporate governance committee, formed in 1996 and chaired by a leading Indian industrialist, Rahul Bajaj, submitted its recommendations in April 1998. The second committee, also chaired by a leading industrialist, Kumar Mangalam Birla (the Birla Committee), submitted its report in 2000. The third committee, chaired by Naresh Chandra (the Chandra Committee), was constituted in August 2002 to focus on corporate audit practices. The fourth committee — the Murthy committee, chaired by Narayana Murthy, founder and Chairman of Infosys, one of India’s leading software companies — provided recommendations in 2003. While a detailed review of the various committees’ reports is beyond the scope of this article, we would like to highlight some of their major recommendations to establish a sense of the comprehensiveness and rigor of the formal governance reforms advocated by these committees.

The Birla Committee’s recommendations were formally implemented by SEBI through the enactment of Clause 49 of the Listing Agreements. The major recommendations (summarized below) focused on the board of directors, audit procedures, and shareholder rights.

- **Composition of the board**: If there is a full-time chairman, 50% of the directors must be non-executives and 50% must be executives.

- **Constitution of audit committee**: The committee must contain three independent directors and a chairman with a sound financial background. A finance director and an internal audit head are to be special invitees, and a minimum of three meetings are to be convened. The committee is responsible for review of financial performance on a half-yearly/annual basis, appointment/removal/remuneration of auditors, and review of internal control systems and their adequacy.

  - **Board procedures**: At least four meetings are to be held each year. A director cannot be a member of more than 10 committees, and a chairman cannot serve on more than 5 committees across all companies.

  - **Management discussion and analysis report**: This should include a discussion of industry structure and trends, opportunities and threats, segment performance, analysis of financial performance, future outlook, and risks and concerns.

  - **Shareholder rights**: Shareholders are entitled to have access to quarterly results, analyst presentations, half-yearly financials and significant event reports, reviews of complaints and grievances by non-executive directors, etc.

The Chandra Committee recommendations on audit reforms were also formalized as part of the Companies (Amendment) Bill, 2003. This committee recommended a list of disqualifications for audit assignments, such as: direct relationship with the company to be audited, any business relationship with the client, or a personal relationship with a director. In addition, it recommended preventing auditing firms from providing non-audit services to clients and requiring that the CEO and CFO of listed companies certify to, and take responsibility for, the fairness and correctness of their company’s annual audited accounts.

Finally, the Narayana Murthy Committee further reviewed the existing code of corporate governance in 2003 and proposed additional and more refined governance reforms and rules, particularly in relation to the role of the board of directors. Specifically, its recommendations included the implementation of formal training for board members, the elimination of nominee directors, the establishment of rules for treatment of independent directors, and board oversight of business risk and risk management strategies. Other recommendations of the Murthy Committee, which are being implemented through amendments to Clause 49, include the strengthening of the responsibilities of the audit committee, improving the quality of financial disclosures, the establishment of rules for the utilization of proceeds from IPOs, the review of subsidiaries of
holding companies, and the implementation of policies to protect “whistle blowers” who approach corporate audit committees.

4. Challenges of corporate governance reforms in China and India

It must be evident by now that the regulatory bodies of China and India have advocated comprehensive and rigorous corporate governance reforms which emphasize the importance of the credibility and integrity of listed companies, the responsibilities of directors and management, the protection of minority shareholders, and the necessity for information disclosure. Over-regulation and under-enforcement are common themes that characterize most Asian governance systems, however, and China and India are not exceptions in this regard (Tai & Wong, 2003). For example, the World Bank’s Reports on the Observance of Standards and Codes (ROSCs) include country-specific analyses of the implementation of corporate governance codes of the Organization for Economic Cooperation and Development (OECD). Its 2004 report on India documented major gaps and lapses in the implementation of governance rules, particularly in relation to the role of nominee directors from financial institutions, stock-listing laws and regulations, insider trading, and dividend and share transfer transactions (World Bank, 2004). In addition, the Chinese, Indian, and international business press regularly document many instances of non-compliance with disclosure norms, lax enforcement of audit rules and regulations, failure to protect the rights of creditors and minority shareholders, etc. Interestingly, the areas in which significant governance lapses have been noted in practice are also the very areas where a plethora of formal rules and regulations exist. Clearly, then, the lax governance environment can be attributed not to the absence of formal governance laws, but to the relatively weak or absent enforcement mechanisms.

While many companies in China and India have in place basic governance structures such as boards of reasonable size, some independent directors, and independent auditors, few implement the whole range of governance mechanisms found more commonly in the developed world. Foremost in this regard is the Indian software giant Infosys Technologies, which discloses the extent of its compliance with ten OECD corporate governance codes, reconciles its financial statements with eight (including two international) accounting standards, and has boards with a majority of independent directors, as well as independent audit, nomination, and compensation committees (Barton et al., 2004). Eventually, governance reforms in these countries will only prove effective if many more companies and all relevant regulatory bodies strictly implement these, or similar, provisions. At least four major challenges, however, impede progress in the implementation of governance reforms in both China and India. Next, these are explored in more detail.

4.1. Lack of incentives

Despite the encouraging changes in China’s and India’s governance laws, key parties (e.g., regulatory bodies, boards of directors/supervisors, management) do not yet possess compelling incentives to implement these changes. In both China and India, it often takes scandals to truly motivate legislators and regulators to become stringent in applying the rules. Unless spurred into action by such events, regulatory bodies may not have the political will to investigate improprieties; indeed, the government’s desire to promote short-term economic growth often makes it less willing to go after large corporations to protect minority shareholders. Moreover, investors, both domestic and foreign, are reluctant to get involved in implementing governance reforms. Investors (particularly domestic, but also international) are largely seeking short-term price gain rather than long-term shareholder value (Barton et al., 2004).

Management, of course, does not have strong incentives to implement governance reforms unless they help them accomplish their immediate objectives; for example, the need to gain access to foreign capital has prompted proactive governance practices among some large Chinese firms. Further, outside directors often do not have strong incentives to implement governance reforms. In emerging economies, outside directors are often political allies (in the case of privatized SOEs) or friends and relatives of the senior managers/owners (in the case of family controlled businesses). These directors may represent a dominant interest group but not all shareholders. In the Chinese context, listed companies also need to have a board of supervisors, the membership of which features at least 33% employee representation. Because employee members of the board of supervisors have reporting relationships with senior managers who conduct performance evaluations and make promotion and remuneration decisions, however, it is hard for these employee members to play an independent role. Overall, unless such incentive problems are alleviated, implementing governance reforms will continue to be much more challenging.
than passing additional governance laws in both China and India.

4.2. Power of the dominant shareholder

A dominant theme in US and UK corporate governance literature is the role the board plays in ensuring that managers actually act on behalf of the owners of a company: its shareholders. In both countries, the major agency problem arises from goal incongruence between shareholders and management. In contrast, a closer scrutiny of the governance challenges in China and India suggests that the central problem in these contexts is not goal conflicts between management and owners, but rather unaddressed conflicts between the dominant shareholders and the minority shareholders (Varma, 1997). Because the board derives its power mostly from the dominant shareholder, it is not practical to expect the board to discipline or punish the dominant shareholder; this, in turn, contributes to the ineffectiveness of boards of directors in the Chinese and Indian contexts.

There are at least two types of dominant shareholders in the Chinese and Indian contexts. The first type is state ownership, which is manifested in India’s public sector units (PSUs) and in China’s broad range of strategically important industries. When the state dominates a firm, it is obvious that the state can use its influence to achieve the objectives of politicians, rather than protecting the interests of investors and shareholders. The second type of dominant shareholder is evident in large, often family owned or controlled, business groups. In this corporate form, the promoters (together with their friends and relatives) are often the dominant shareholders, with large, minority stakes; government-owned financial institutions often hold comparable stakes, and the balance is held by the general public. In 2002, the average shareholding of promoters (and their allies) in all Indian companies was in excess of 45%. Even with significantly smaller shareholdings, the promoters effectively become the dominant shareholders because a large proportion of the shares is then held by state-owned financial institutions that have historically played a passive role in the governance of firms. Similarly, it has also been found in China that family owners use pyramidal ownership structure to control large business groups.

Dominant shareholders can benefit, at the expense of minority shareholder interests, through both economic and social mechanisms (Dharwadkar et al., 2000). In economic mechanisms, dominant shareholders use pyramidal ownership structures whereby they can achieve greater control of the firm through interlocking ownership, and can benefit from related-party transactions. Using social mechanisms, dominant shareholders appoint allies, friends, and family members to top management positions, and these managers may then have incentives to disregard minority shareholders’ interests. In summary, the dual challenge of governance reforms in emerging economies is how to simultaneously resolve the traditional agency problem between shareholders and management, and the unique agency problem between dominant shareholders and minority shareholders.

4.3. Underdeveloped external monitoring systems

So far, China’s and India’s corporate governance reforms have mainly focused on internal mechanisms, emphasizing the responsibilities of directors and management and the necessity to disclose information. It is important to note, however, that effective governance is contingent upon the existence and efficient operation of other (external institutional) regulatory, legal, and financial frameworks. The board of directors, shareholders, and management are the key internal components, and in the US system the external institutional framework includes the Securities and Exchange Commission (SEC; the equivalent regulatory bodies in China and India are the CSRS and the SEBI, respectively), the courts, securities analysts, institutional investors, stock markets, professional auditing companies, insurance companies (which insure directors and officers against liability), and private law firms. Accordingly, effective governance mechanisms include both internal mechanisms, such as the board of directors and its major committees, and external mechanisms such as hostile takeover bids, leveraged buyouts, proxy contests, legal protection of minority shareholders, and the disciplining of managers in the external managerial labor market (Dharwadkar et al., 2000).

Given the short histories of China’s and India’s economic liberalization, the external monitoring system is still in its infancy, and this can prohibit the effective implementation of governance reforms in these countries. For example, the Chinese government controls about 70% of the stakes of publicly listed companies in the Shenzhen and Shanghai Stock Exchanges, and family controlled businesses own over 45% of all Indian companies. The extremely high ownership concentration in these countries makes hostile takeovers and leveraged buyouts unlikely to occur, which means that as long as a firm’s management can appease the dominant shareholder(s), it is unlikely to be challenged.
Effective government reforms also require determined efforts by government to clamp down on corruption. Over several decades of a centrally controlled and socialist economy, a large parallel black-market economy developed in China and India in which transactions were carried out in cash and typically not recorded in accounting and financial statements. Some industries in India were, at one stage, so strongly permeated by the black-market economy that it was almost impossible to carry on business without using black-market money. Most businessmen in China believe that corruption (e.g., kickbacks and “red envelopes”) is a necessary condition and a norm for conducting business. In addition, many companies in China and India record losses in their official accounting statements but are, in fact, quite healthy because of the profits obtained unofficially via “black” channels.

A key approach to addressing the corruption issue is improving transparency. Without greater transparency, new governance laws and codes will do little to improve governance in China and India. China’s CRSC, for example, now forces companies to rotate their senior external auditors every five years, and India is also exploring such a requirement. Further, recent reforms in the Indian and Chinese banking sectors mark a fundamental shift toward letting market forces encourage competition and accountability in banking (Reddy, 2002). The emerging market orientation in the banking sector accompanies the evolution of stronger disclosure norms and the emphasis on more regular surveillance by these countries’ regulatory bodies.

4.4. Shortage of qualified independent directors

The governance reforms of China and India have emphasized the importance of independent directors, and the governance laws in these countries define the minimum number, and the roles and responsibilities, of these directors. A major obstacle to implementing the governance reforms in China and India, however, is that there are few qualified candidates; that is, individuals who understand and can carry out the role of an independent director. China, alone, needs to fill over 3000 independent director positions in its listed companies (Tai & Wong, 2003). One solution to this challenge is training, and China’s CSRC regularly conducts training programs to educate directors for listed companies. However, these training programs, most of which are short, can provide only very general guidance. In addition, the unique cultural and business environments of China and India can limit the applicability of best governance practices developed in the West. Western experience must be combined with local knowledge in order to be effective in responding to the specific requirements of listed companies in China and India. Another solution to the shortage of qualified independent directors is to appoint more foreign directors. As China and India continue to open up their capital markets to foreign investors, it is likely that more foreign directors will fill the boardrooms.

An even more important issue is that most directors view their directorships as sinecures, without real responsibilities. Most independent directors are government officials, university professors, and nominee directors from large financial institutions who have traditionally shown little interest in monitoring the actions of management. In order to motivate independent directors to really carry out their responsibilities, their liabilities must be made credible so that those who fail to exercise due diligence have to make serious financial restitution. However, many candidates for directorships in China and India are not wealthy by international standards; thus, they would not be able to pay if they were held liable for substantial fines. As such, there would have to be risk mitigation insurance for directors and their offices. Interestingly, this would also motivate insurance companies to monitor the individuals and organizations that they insure (International Finance Corporation, 2005). Ultimately, China and India will have to develop a business culture in which directors know what is expected of them and are motivated to carry out due diligence.

5. Implications for practice and research

At the beginning of this article, we highlighted the practical importance of corporate governance in China and India. In this section, we will focus on other specific implications for firms that are entering these economies or planning to expand their presence there in the near future. We then conclude the article with some promising avenues for future research.

5.1. Implications for practice

The unique challenges of the governance environments in China and India have several implications for US and other foreign firms that are either contemplating direct investments for the first time or are planning significant increases in participation levels, either through wholly owned ventures or joint ventures with local partners. China and India pose some common, and some unique, governance
challenges for foreign firms. While the extent of these problems will vary across these markets, many problems are salient in both markets, and foreign firms that are sensitized to these issues are more likely to put in place contractual or other safeguards, as well as identify more practical and meaningful forms of participation in the governance of their ventures. Aspects of the governance environment that foreign firms need to be aware of in both emerging economies include, among others:

1. The accuracy of financial reports and related information provided by joint venture and alliance partners;
2. The efficiency and fairness of legal recourse in the event of violations of venture terms and conditions;
3. Difficulty in resolving potential conflicts of interest due to the absence of independent directors in state-owned or family owned firms;
4. Protection of minority equity investments given the control exercised by dominant shareholders (the state or the family, or local promoters); and
5. The secondary importance of profits or shareholder value creation compared with other non-financial objectives such as retention of family control, employment levels, political interests, etc.

In addition, these contexts pose unique challenges. For example, in China the Communist Party still plays a central role in key governance decisions, including the selection, promotion, and compensation of senior executives; asset acquisitions and disposal; and corporate restructuring (Huang & Orr, 2007). Hence, the types and degree of involvement of foreign investors in local governance should be based on a pragmatic understanding of the forms of participation that are likely to be permitted by the Communist Party. For example, while participation on the nominating committee or the compensation committee may be impractical, membership on the strategy committee of the board of directors may be more feasible (Huang & Orr, 2007). In the Indian context, firms may benefit from negotiating contracts and arbitration agreements that can be enforced by courts in the investor’s home country (such as the US). This may enable the foreign investor to get around the notoriously slow and complex Indian legal system and, further, to incentivize local partners to adhere to international rather than local governance standards.

5.2. Implications for research

5.2.1. Challenges to fundamental assumptions of governance frameworks

The unique institutional, legal, regulatory, and cultural contexts of China and India enable governance researchers to understand and appreciate the applicability, as well as the limitations of, corporate governance frameworks that have been formulated in the context of Western developed nations. It appears that in the contexts of China and India, some of the fundamental assumptions underlying existing governance frameworks apply either not at all or only to a limited extent. For example, separation of ownership and control is intrinsic to the tenets of agency theory, and one of the primary issues that has garnered much research attention is how to ex-ante motivate managers to make decisions in the interests of shareholders and how to sanction/punish them ex-post for violating shareholder interests. Hence, much research has focused on the role of boards (e.g., the power and expertise of directors, particularly outside directors), especially in the context of CEO succession and compensation, dismissal, strategic decision making, and corporate restructuring (Daily et al., 2003). However, the formal separation of ownership and control does not exist in a sizeable portion of the corporate sector in either China or India. Governance concerns regarding the dominant shareholder more often than not outweigh concerns about the role of the board. Hence, researchers need to think carefully about the proper research questions to pose in these contexts, and critically evaluate the applicability of dominant governance theories and frameworks in examining these research questions.

5.2.2. Institutional embeddedness and governance research

The relative recency of corporate governance reforms in China and India offers unparalleled opportunity to study in real time the co-evolution of institutional, legal, and corporate mechanisms related to the emergence of corporate governance practices. Much of traditional corporate governance research, at least in the leading US academic management journals, has focused on the board and its role. Although these studies have contributed greatly to our knowledge of the operations of some of the institutions of corporate governance (particularly boards of directors and the market for corporate control), they have not yet examined the interplay between the macro-environmental and micro/firm-level governance practices; perhaps rightly so, given the advanced stages of the economies studied.
According to Davis (2005, p. 43), “The most promising contemporary work seeks to analyze governance in terms of the dynamics of institutions—where they originate, how they operate, how they change, and how they spread beyond their original purposes.” In this regard, China and India are particularly exciting as research contexts for analyzing corporate governance. As we discussed earlier, although China and India have both experienced privatization and globalization, their experiences differ from each other. For example, the state has greater influence in firms in China compared with India, and foreign direct investments in China are mainly capital-intensive, while those in India are more skill intensive. Obviously, these institutional and market differences affect these countries’ governance reforms, and so by examining the interplay between the social structures (culture and norms included), governmental institutions, and legal-regulatory codes and frameworks, researchers can contribute to the development of a “robust sociological and institutional” view of corporate governance (Davis, 2005, p. 153).

In conclusion, we highlighted in this article the recent evolution of corporate governance in China and India. We believe that a deeper understanding of the historical evolution of corporate governance rules, laws, and regulations, and the context-specific challenges and opportunities in China and India, will permit researchers to not only identify more appropriate research questions, but also design sample selection and data collection methods that are more sensitive to the concerns and constraints of local stakeholders. Such deeper understanding can also help practitioners, both local and foreign, to combine Western expertise and local knowledge to improve governance in these promising yet challenging economies.

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References


