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One distinctive feature of Chinese state capitalism is the existence of approximately 120 large, state-owned enterprises (SOEs) controlled by organs of the national government in critical industries such as steel, telecom and transportation. Although only a few of these firms are household names outside China, they dominate major industries within that country and are increasingly active in global markets. As *The Economist* recently noted, “as the economy grows at double digit rates year after year, vast state-owned enterprises are climbing the world’s league tables in every industry from oil to banking.”¹ China now has the world’s third largest concentration of Global Fortune 500 companies (sixty-one)², and the number of Chinese companies on the list has increased at an annual rate of 25% since 2005.

More than two-thirds of Chinese companies in the Global Fortune 500 are state-owned enterprises. Excluding banks and insurance companies,³ controlling stakes in the largest and most important of the firms are owned ostensibly on behalf of the Chinese people by a central holding company known as the State-Owned Assets Supervision and Administration Commission (SASAC), which has been described as “the world’s largest controlling shareholder.”⁴ Though the elite firms such as Sinopec and China Mobile (commonly referred to as “national champions”) are listed on stock exchanges in Shanghai, Hong Kong or other world financial capitals, they are nested within vertically integrated groups. Their majority shareholder is the “core” company of the group – which is itself 100% owned by SASAC. The core company coordinates the group’s activities and transmits business policy to group members. Individual corporate groups are often linked through equity ownership and contractual alliances to groups in the same or complementary industries, to provincial-level business groups, and even to state-controlled institutions without a direct economic role, such as universities. Top corporate managers simultaneously hold important positions in the government and the Chinese Communist Party.

¹ The Economist, March 12, 2011, p. 79.

² Behind the United States and Japan. Global Fortune 500 rankings are based on revenues.

³ The banks are majority owned by other agencies of the state, and supervised by the Chinese Banking Regulatory Commission and the People’s Bank of China.

⁴ Boston Consulting Group, SASAC: China’s Megashareholder (Dec. 1, 2007), available at http://www.bcgperspectives.com/content/articles/globalization_strategy_sasac_chinas_megashareholder/.

While the basic outlines of this system are now widely known, in many respects the concept of state capitalism in China – particularly the organizational structure and broad governance regime surrounding the SOEs under SASAC supervision – remains a black box. Understanding the full implications of “state ownership and control” in the Chinese context requires expanding the unit of analysis beyond individual, listed companies and examining the larger organizational ecology in which the national champions operate.

In this brief written statement, I hope to shed some light on the mechanisms of state capitalism in China by exploring the architecture of its central SOEs,⁵ and to raise some of the potential policy implications of my analysis.

The Architecture of Chinese SOEs

State capitalism in China has a remarkably complex architecture. Critical to understanding Chinese SOEs is an appreciation of the extensive networks in which they are enmeshed. The national champions that serve as the external face of the SOEs are typically part of a vertically integrated business group focused on a particular industry or sector, not diversified groups involved in a range of industries. Corporate groups must be registered with the central government in order to be recognized as such. One of the key benefits of group registration is eligibility to establish a finance company, described below. Shareholding within these groups is hierarchical: firms higher in the structure own downstream subsidiaries, but there is very little upstream or cross-ownership among group firms. These features of Chinese corporate groups contrast with most Japanese (so-called horizontal) *keiretsu*, which are diversified groups with extensive cross shareholding among member companies.

The individual business groups have several distinct components:

1. Core (Parent) Company: The top firm in the group is the core company, whose shares are wholly owned by SASAC. Core companies were typically formed by “corporatizing” a government ministry with jurisdiction over a particular industry. For example, each of the core companies in the national petroleum groups was hived off from the former oil ministry and transformed into a corporate entity with limited liability, a board of directors, and shares held by a state-affiliated shareholder. The core company acts as a holding company, serving as an intermediary between SASAC and group firms that engage in actual production. The core company coordinates information flow and resource allocation within the group. It transmits policy downward from the state to group members, and provides information and advice upward from the group to state economic strategists and planners.⁶

⁵ A more detailed analysis of the subject can be found in Li-Wen Lin & Curtis J. Milhaupt, We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623.

⁶ Internal group governance structures are specified in a legally binding agreement called Articles of Grouping, which is adopted by all members. The core company dictates the terms of the Articles, and the internal governance rules grant it veto rights with respect to the group. Many Articles of Grouping provide for plenary or management bodies to facilitate group or delegated decision making, respectively, but these

2. Listed company: The external face of the national champion is not a group of companies but a single firm, a minority of whose shares are publicly traded on Chinese or Hong Kong stock exchanges and often on other major exchanges as well. For example, PetroChina, one of the largest oil companies in the world, whose shares are listed on the Shanghai and New York Stock Exchanges, is the external face of the CNPC Group, whose core company is the China National Petroleum Corporation.

While the listed firms are the focus of most scholarly and media attention devoted to Chinese corporate governance, a much broader lens is required to fully understand Chinese state capitalism.

3. Finance company: As noted, one of the key benefits of registration as a corporate group is eligibility to establish a finance company – a nonbank financial institution that provides services to group members. Finance companies are exempt from the general prohibition in Chinese law on inter-company lending. Under the current legal framework, a finance company provides services on behalf of group members similar to those of commercial and investment banks. Subject to approval by banking regulators, they are authorized to engage in a wide range of activities, including accepting deposits from and making loans to member companies, providing payment, insurance, and foreign exchange services to members, and underwriting the securities of member firms. They also engage in consumer finance related to the products of group members, and invest in securities issued by financial institutions. Deposits from group member companies comprise their main source of funds. Almost all finance companies are members of state-owned groups, either at the national or provincial level, and many are formidable in size.

The creation of nonbank finance companies within business groups – what one commentator has called “outside the plan financial intermediaries”⁷ – poses an obvious competitive threat to the largely state-owned commercial banking sector. As such, Chinese regulators have been vigilant about not expanding the scope of finance company activities to the point that they constitute a complete substitute for Chinese commercial banks, which remain an important source of funding for SOEs.

4. Research Institutes: Chinese policy makers have encouraged business groups to include research institutes as members in order to promote high technology development and increase international competitiveness. Most of the national business groups contain one or more research institutes. The research institutes conduct R&D, particularly applied research in areas related to the group’s products and production processes. Often, the research institutes collaborate with universities on particular projects to derive complementarities between the applied focus of business R&D programs and the

organs typically either have only advisory power or are structured so that the core company effectively controls their decision making processes.

⁷ Yingyi Qian, Financial System Reform in China: Lessons from Japan’s Main Bank System, in Masahiko Aoki & Hugh Patrick eds., *The Japanese Main Bank System: Its Relevance to Developing and Transforming Economies* 552, 569 (1994).

theoretical approach of academic researchers. Typically established as not-for-profit institutions, the research institutes receive funding from the core company in the group.

Larger Networks

The foregoing are the main components of the corporate groups and the mechanisms by which member firms are linked. But the individual groups are embedded in larger networks involving the Chinese state and the Party.

1. Inter-group Networks: While groups in the same industry do compete domestically, SASAC has encouraged collaboration among the national groups in overseas projects to increase their global competitiveness. These linkages (in the form of joint ventures or contractual alliances among SOEs in the same or complementary industries), are designed to facilitate technological development, as well as a host of other objectives, such as information sharing, marketing, and pooling of capital for capital-intensive projects.
2. National-Provincial Champion Networks: National groups under SASAC supervision are sometimes linked to business groups under the control of local governments. These linkages are the result of an evolving dynamic between the central and local governments. Initially, local governments sought investment from the national groups to rescue moribund local SOEs. As the national groups expanded, local governments began to view them as a competitive threat to local businesses. Local protectionism increased, and a push was made to create “provincial champions.” The relationship between national and local groups appears to be in flux again as a result of the global financial crisis, which prompted renewed cooperation. The local governments now view the national champions as sources of support for small and medium-sized enterprises, which suffered when they lost the backing of foreign and private companies. For the national groups, which are under pressure from their governmental supervisors to grow, tie-ups with local groups are an avenue of expansion.
3. Business Group-Government/Party Networks: The leading business groups are tied to institutions of the central government and the Chinese Communist Party in many ways. For example, an organization called the China Group Companies Association is formally designed as an intermediary between the national business groups and the central government. Its board of directors is composed of senior government officials and top managers of the most important national business groups. The Association is a vehicle for conveying the concerns of top SOE managers to the State Council. A second bridge between the groups and the party-state is the practice, with roots dating to the period prior to the establishment of SASAC, of granting substantive management rights over a nationally important SOE to the ministry with supervisory authority over the industry in which it operates. Personnel exchanges between SASAC and the SOEs it supervises creates another link. Finally, a number of positions in elite government and party bodies such as the National Peoples Congress and the National Congress of the Communist Party are reserved for leaders of the national SOEs.

SASAC as Controlling Shareholder

Atop the national groups is SASAC, ostensibly “the world’s largest controlling shareholder.” But drawing definitive conclusions about SASAC’s precise role and the scope of its authority in the governance of the national SOEs is difficult. The agency has both less and more power vis-à-vis the SOEs under its supervision than meets the eye.

SASAC, established under the State Council in 2003, represents an attempt to consolidate control rights over the national SOEs. In the past, the corporatization effort was complicated by dispersed control rights held by a variety of ministries with jurisdiction over separate activities such as trade and investment, as well as the Communist Party, which was involved in wage and labor issues. This legacy persists: SASAC defers to other agencies, and even to the SOEs themselves, on substantive issues outside its realm of expertise. SASAC’s location in the government organizational chart may contribute to this tendency. Although SASAC is a ministerial level agency, so are fifty-three of the most important SOEs under its supervision. As one commentator notes, “In practice, SASAC has faced an uphill struggle to establish its authority over the SOEs that it supposedly controls as a representative of the state owner.”⁸

In a key area of control – senior managerial appointments in the central SOEs – SASAC shares decision rights with the Communist Party in a highly institutionalized arrangement. The top positions in fifty-three central enterprises, including board chairmen, CEOs, and Party Secretaries, are appointed and evaluated by the Organization Department of the Party. This is a legacy of appointments practice prior to the establishment of SASAC. Some of these positions hold ministerial rank equivalent to provincial governors and members of the State Council; others hold vice-ministerial rank. Deputy positions in these enterprises are appointed by the Party Building Bureau of SASAC (the Party’s organization department within SASAC). A separate division of SASAC, the First Bureau for the Administration of Corporate Executives, assists in this appointment process. Appointments and evaluations of top executives in the remaining central enterprises are made by yet another division of SASAC, the Second Bureau for the Administration of Corporate Executives.

Note that the standard corporate mechanism for the appointment and evaluation of senior executives – the board of directors – is missing entirely from this process. Indeed, only thirty-five of the core companies of the national business groups even have boards of directors as of this writing. Although SASAC and the Party have begun taking steps to bring boards of directors into the appointments process and to create boards for those core companies which do not yet have them, the steps taken thus far leave little doubt that the Party does not intend to relinquish appointment authority with respect to the most important enterprises and the highest level appointments.

SASAC and the Party also rotate senior corporate and party leaders among business groups. (See Table 1) Most of the corporate rotations reflected in the table are of

⁸ Mikael Martin, *Whose Money? The Tug-of-War over Chinese State Enterprise Profits*, FIIA Briefing Paper No. 79 (April 2011).

directors or vice CEOs, and the party rotations are for positions below Secretary of the Party Committee. However, from time to time top executives in key industries have been rotated. For example, in April 2011, SASAC rotated the CEOs of the three central petroleum enterprises, each of which is a Global Fortune 500 Company. Such rotations are obviously in tension with the separate corporate and competitive identities of the firms. The practice may suggest that the national SOEs are treated for some purposes as a diversified meta-group under common, if attenuated, control of SASAC. As Table 1 shows, leaders are also rotated among the spheres of business, government, and the Party.

[Insert Table 1 here]

In contrast to these institutional constraints against SASAC's sole authority over the SOEs, the agency's legal footing places it in a position of unusual strength as a shareholder. Until recently, there was no overarching legal authority governing SASAC in its role as controlling shareholder. In 2008, a Law of the Peoples Republic of China on State-Owned Assets of Enterprises (SOE Asset Law) was enacted to "safeguard[] the basic economic system of China..., giving full play to the leading role of the State-owned economy in the national economy."⁹ In essence, the law formally recognizes SASAC as an *investor* – a shareholder in the national SOEs, with the ordinary rights and duties of a shareholder. Ostensibly, the law confines SASAC to this role¹⁰ and governs the agency's performance of its functions as an investor.¹¹ But there are no formal mechanisms in the law to enforce SASAC's responsibilities, and in reality, the law grants SASAC powers *greater* than those available to it as a shareholder under China's Corporate Law. Most importantly, the law essentially grants SASAC veto power over share transfers that take place downstream within the SOE corporate groups. Thus, SASAC can bypass the board of directors in consolidating or transferring control of corporations under its supervision.

Potential Policy Implications

State-owned and affiliated enterprises are an important part of the Chinese domestic economy, and are likely to be influential actors in China's political economy for the foreseeable future.¹² They are also likely to be increasingly active players in the global economy. At the current pace, China will soon surpass Japan as home to the second largest number of Global Fortune 500 companies.

There is a danger, of course, in treating all "SOEs" – even those from a single country, as monolithic actors who march to a single drummer. The reality is much more complex, and we should expect heterogeneity among Chinese and other SOEs to increase as they

⁹ SOE Asset Law, Art. 1.

¹⁰ SOE Asset Law, Arts 11-14.

¹¹ See e.g., SOE Asset Law, Art. 69 provides for unspecified disciplinary measures against SASAC staff who neglect their duties as investor. Art. 70 subjects a shareholder representative appointed by SASAC to personal liability for loss caused by failure to carry out SASAC's instructions.

¹² For a similar conclusion, see the prepared statement of Dr. Derek Scissors before this Commission on March 11, 2011, available at http://www.uscc.gov/hearings/2011hearings/transcripts/11_03_30_trans/11_03_30_final_transcript.pdf.

interact in global markets. This obviously complicates the task of policymakers in determining how to respond to investment and other market activities by SOEs. The United States has a robust regulatory framework for foreign investment provided by the CFIUS process under Exon-Forio and the Foreign Investment and National Security Act (FINSAs), as well as industry specific requirements. I doubt that the benefits of additional, general screening requirements directed at Chinese and/or SOE investments in the United States would outweigh the costs, including the likelihood that other governments will reciprocate with restraints on U.S. foreign investment activity.¹³

However, as I hope the foregoing analysis indicates, the Chinese SOE sector is highly complex in its organizational structure and deeply linked to other organs of the Chinese party-state. Outward appearances of adherence to standard corporate law norms and governance principles may be somewhat misleading without a complete understanding of the larger organizational ecology in which these firms operate. In order to evaluate the adequacy of the U.S. regulatory regime, legislators, policymakers and scholars must extend the focus of analysis beyond individual (particularly listed) firms, and take account of the broader networks in which Chinese SOEs operate. They must also come to a better understanding of the role and objectives of SASAC in the governance of the national business groups.

The reality of SOEs – Chinese and otherwise – as major actors in the global economy raises a basic question for U.S. legislators and other policymakers: Do existing laws regulating market activity adequately contemplate an economy in which state-owned or controlled enterprises are major players?

In some specific areas of law, measures have been taken to address the issue. For example, the Department of Justice, with judicial support, takes the position that under the Foreign Corrupt Practices Act, a bribe to an employee of an SOE is treated as an improper payment to a foreign government official. And in FINSAs, Congress resolved several possible areas of ambiguity in the CFIUS process with respect to mergers and acquisitions of U.S. corporations by government-controlled enterprises.

In other important areas, however, it may be necessary to re-examine the adequacy of the current legal regime in the face of SOE market activity. Without attempting to provide an exhaustive list, I offer three examples. First, does the federal securities law disclosure regime provide investors with a complete and accurate picture of the ownership and governance of Chinese SOEs? This question is important both where the shares of a Chinese SOE are listed on a U.S. exchange, and where a Chinese SOE acquires shares of a U.S. publicly listed company. Problems with Chinese firms listed on U.S. securities markets through the so-called reverse merger process have generated significant skepticism about the quality of auditing practices and the accuracy of public disclosures of Chinese firms accessing the U.S. capital markets. While reverse mergers have not been the listing method used by Chinese SOEs, these problems do highlight potential

¹³ Numerous U.S. entities might plausibly be defined by foreign lawmakers as state-owned or controlled, including General Motors, Fannie and Freddie, the Alaska Permanent Fund Corporation, and any financial institution with outstanding liabilities to the government under an emergency program such as TARP.

inadequacies in the U.S. listing and disclosure regime vis-à-vis Chinese issuers. With respect to securities investments in U.S. firms, the Williams Act disclosure regime should be re-examined to ensure that it is adequately designed to reveal all material information about a foreign state-owned or controlled shareholder, particularly where the shareholder may be investing in concert with other entities under ultimate control of the state.

Second, is the antitrust regime equipped to accurately assess the competitive effects of SOE behavior in U.S. markets? At a very basic level, it is worth noting that the Sherman Act speaks only of *private* restraints of trade. Are SOEs private actors for purposes of the antitrust laws? What is the relevant unit of analysis in considering market effects of SOE conduct – a specific firm, the business group to which it belongs, or a number of groups under common control of a state shareholder? The European Commission appears to have adopted a sensible approach to this issue. In two recent cases involving Chinese SOEs, the Commission “delved deeply into ... [the] SOE’s relationship with the wider Chinese state.”¹⁴ In those cases, the Commission took the position that since the SOEs are owned by the Chinese state, it is necessary to assess whether the SOE is an independent entity or whether it belongs to a larger group, including other enterprises over which the state exercises decisive influence.¹⁵

A third example is the proper scope of investment treaties to which the United States is a party. Bilateral investment treaties (BITs) generally provide for investor-state, but not state-to-state, dispute resolution. Where an investment is made by a state-owned or controlled enterprise, should that entity be characterized as an “investor” for purposes of the treaty, such that a dispute relating to the investment falls within the scope of the BIT’s procedures? Or is the dispute more properly characterized as state-to-state, and thus outside the scope of the BIT?¹⁶

As these brief examples illustrate, given the increasing interactions of Chinese SOEs in the global economy, evaluating the adequacy of U.S. laws regulating market activity by state-owned or controlled enterprises requires a deeply contextualized understanding of the organizational structure of Chinese business groups and their relationship to the wider Chinese state.

¹⁴ Herbert Smith Competition, Regulation and Trade e-bulletin, October 3, 2011, available at <http://www.herbertsmith.com/NR/rdonlyres/62CCAAB3-61E6-4CCB-A116-8D7C8122110F/0/ChineseStateownedEnterprisesundertheMicroscope28September2011.html>)%20%20ND RC.

¹⁵ China National Bluestar/Elkem (Case COMP/M.6082), notified to the Commission on Feb. 24, 2011; DSM/Sinochem/JV (Case COMP/M.6113) notified to the Commission on April 8, 2011.

¹⁶ For analysis of this issue, see Mark Feldman, *The Standing of State-Owned Entities under Investment Treaties*, in Karl Sauvant ed., *Yearbook on International Investment Law and Policy 2010-2011*, at p. 615.

Table 1 Leader Rotations in the Chinese Central Enterprises

Year	Leader Rotations:				
	Between Central Enterprises	From Central Enterprises to Government/Party	From Government/Party to Central Enterprises	From Local SOEs to Central SOEs	Total Rotations
2004	27	6	13	0	46
2005	27	5	14	0	46
2006	20	3	10	1	34
2007	33	7	16	0	56
2008	NA	NA	NA	NA	50
2009	NA	NA	NA	NA	27

*Leaders including members of board of directors, CEOs, vice CEOs, chief accountants, secretaries of Party Committee, deputy secretaries of Party Committee, and secretaries of the Party's Discipline Inspection Committee.

** Data Source: China's State-owned Assets Supervision and Administration Yearbooks 2005, 2006, 2007, 2008, 2009, 2010.