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A Network Anatomy of Chinese State-Owned Enterprises

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Abstract

This Article provides an anatomy of Chinese state-owned enterprises (SOEs) by unpacking their various relations with different types of state organs. It shows that Chinese SOEs are embedded in a network composed of dense and complex links with the state. Shareholding ties, albeit important, are only one of the many relations with the state. This network perspective provides a rather comprehensive overview of the basic architecture of China's state-owned sector. It illustrates important governance institutions that are unobservable from the laws on the book and distinctive from international standards. It clarifies some SOE behaviors that appear puzzling when taking the individual firm as the unit of analysis. It also raises challenging questions to various areas of law in the globalization context.

Keywords

China, party state, state-owned enterprise, business group, financial institution.

Introduction[*]

China now ranks second behind the United States in number of the world's largest companies on the Fortune Global 500 list.[1] A great majority of these globally gigantic Chinese companies are state-owned enterprises (SOEs) controlled by the central government's ownership agency, known as the State-Owned Assets Supervision and Administration Commission (SASAC). The rising Chinese SOEs in the global economy have attracted great scholarly attention to their governance attributes. When approaching Chinese SOEs, scholars tend to take the publicly-listed company as the unit of analysis and benchmark the governance attributes of Chinese firms against international standards. As a result, they focus on the board of directors, independent directors, disclosure rules and other monitoring institutions commonly adopted by Western companies. This typical approach often leads to a conclusion that these internationally-recognized governance institutions are lacking or dysfunctional in China's SOEs. This common conclusion raises an obvious puzzle: how can a system void of the formal institutions that are deemed important to Western companies produce an array of the world's largest companies? What are the mechanisms that actually govern these gigantic companies?

To answer these questions, we need to look beyond the individual listed firm and investigate the relational ecology in which the firm is embedded. As scholars of Chinese economic development often observe, networks of interpersonal and inter-organizational relations play a critical role in China's economic success (Keister, 1998; Gold eds., 2002; Allen et al., 2005). Therefore, this Article provides an anatomy of the relational ecology in which Chinese non-financial SOEs operate, with a focus on institutional linkages among SOEs themselves and between SOEs and other organs of the party-state. This network perspective, looking beyond the individual firm, reveals Chinese SOEs' actual governance practices that are unobservable through the lens crafted by Western (primarily U.S.) experience.

This Article shows that China's large non-financial SOEs are organized as business groups within which a large number of member companies are connected with one another through many types of relations. Each state-owned business group has connections extending to various types of entities including other state-controlled business groups, state-controlled financial institutions, SASAC and a variety of government bureaus and party organs. Chinese SOEs are embedded in a complex state-controlled network composed of institutional linkages that are largely invisible in the company law or securities regulations to which scholars of Chinese corporate governance pay most attention.

This Article proceeds as follows. Section I gives an overview of the institutional network in which Chinese non-financial SOEs are embedded. For analytical purposes, it takes the non-financial SOE as the focal actor in the network with institutional linkages extending to different state affiliates. Starting with the SOE as the focal actor, Section II illustrates the organizational structure and internal governance of the SOE as a business group. Section III looks beyond a single business group and examines relationships between national business groups. Section IV discusses SASAC's role as the controlling shareholder. Section V discusses how the national groups are connected with the various parts of the party-state in addition to the formal shareholding ties with SASAC. Section VI explores the non-financial SOEs' connections with the financial institutions. Section VII, it discusses the legal implications and possible future evolution of Chinese SOEs, particularly in light of their increasing global expansion.

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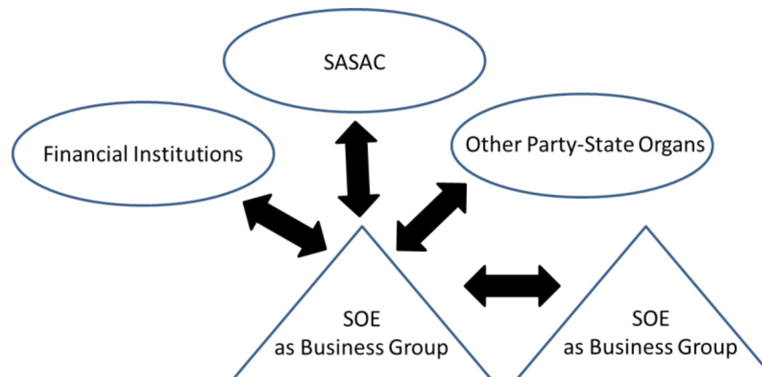
[1] Fortune Global 500 is Fortune Magazine's annual list that ranks the world's largest companies by revenue.

I. An Overview of Chinese SOEs' Network Ecology

A network anatomy of Chinese SOEs is to reveal how the SOEs are connected by various types of relations with one another and with other types of entities. This network approach, drawing on the terminology of network analysis in sociology, comprises two rudimentary concepts: actors and relational ties (Faust and Wasserman, 1994). The actors consist of SOEs, SASAC, various government organs, and financial institutions while the relational ties include ownership, strategic alliance, personnel, and supervisory connections. Figure 1 shows the framework of the network approach.

Figure 1. The Network Anatomy of China's SOEs



A non-financial SOE is the focal actor in the network anatomy. In China, financial and non-financial SOEs are structured and regulated in different ways. In this Article, non-financial SOEs are the focal actors while state-owned financial institutions are brought into analysis through their connections with non-financial SOEs. Most of the large non-financial SOEs in China are organized as business groups. Each business group has a hierarchical ownership structure coupled with top-down governance features. Within each group there are a large number of member firms connected with one another through equity, personnel, and trading relationships. Each business group is not an isolated network of its own but with pervasive institutional connections through ownership, personnel, financing, supervision and strategic cooperation that unit other parts of the broader network. As I recently argued in a co-authored work, this connecting activity may be understood as "institutional bridging" and the resulting connected structure as a "network hierarchy" -- a vertically integrated corporate group with institutional bridges to various parts of the party-state system (Lin and Milhaupt 2013). The following sections will discuss the SOE's business group structure and its institutional bridges with other parts of the network.

II. Chinese SOEs as Business Groups: Structure and Internal Governance

Today, most of the large Chinese non-financial SOEs are organized as multi-tiered business groups. Inside each group, there are several types of actors performing different functions. The major actors include a core company, a finance company, listed companies and research institutes.

The core company is a holding company wholly owned by SASAC, the ownership agency exercising controlling shareholder rights on behalf of the state. Below the core company are multiple tiers of subsidiaries including listed companies, finance companies, research institutes and many other firms related to the production chain. Many of the core companies are actually former government ministries/bureaus that supervised SOEs (Howie and Walter 2006). The core company lays down the group's development strategies and coordinates the relationships among member subsidiaries. It also plays a vertical coordination role between the state and group members by transmitting policy downward to member firms and information and advice upward to the state.

The group's primary interface with the outside world is the listed company rather than the core company. For example, PetroChina, one of the largest oil companies in the world, has shares listed on the Shanghai and New York Stock Exchanges and is the external face of the CNPC Group, the core company of which is China National Petroleum Corporation. Typically the group's high quality assets are consolidated into the listed company.

Another important group member is the finance company. It is a non-bank financial institution that provides an expanding range of financial services for group members. The primary advantage of having a finance company in the group is that it allows flexible management of financial resources across member companies.[2] A financial company is essentially a mini-hybrid of a commercial bank and an investment bank. A finance company may accept member companies' deposits, lend money to member companies, provide loan syndication services, offer foreign exchange services, provide financing consulting services, underwrite group members' securities, participate in the interbank securities market, provide consumer loans related to member companies' products, and so on.

Most of the national business groups contain one or more research institutes. The research institutes engage in applied research related to the group's products and production processes. Some research institutes also offer graduate-degree awarding programs approved by the state. Intellectual property arising out of the research activities is typically owned by the holding company or allocated by contract in joint projects with outside institutes. For instance, State Grid Corporation of China, which is a state-owned holding company and controls more than a dozen of research institutes, has been one of the largest patent filers in China (SIPO 2015).[3]

As illustrated, the major actors and a large number of subsidiaries related to the production chain form a vertical ownership network in which the core company stands at the top of the corporate hierarchy. Cross-shareholding is very rare in China's state-owned groups. This vertical ownership structure facilitates the state's centralized control through the core companies. As some Chinese commentators note, "The state can control the nationally important industries and key areas to lead the economy simply by grasping a few hundred large state-owned holding companies or business groups" (Zheng et al., 2009).

III. Inter-group Relations: Competition, Collaboration and Consolidation

When reforming the SOEs at the turn of the twenty-first century, the Chinese government organized several business groups in each of critical industries such as oil, mining, steel, nuclear, aerospace, telecommunication and transportation. As a result, there are three national groups in the oil sector, three groups in the telecommunication sector, five in the power sector, three in the air transportation sector and so forth. Within each sector, the national groups compete against each other, though in some industries the competition is limited due to oligopolies.

Although groups in the same industry do compete domestically, they have been encouraged by the state to collaborate in overseas projects to increase their global competitiveness. National groups in different industries are also encouraged to collaborate in their global expansion. These collaborative linkages typically take two forms: equity joint ventures and contractual strategic alliances. These linkages, often among groups in complementary industries, are designed to facilitate technological

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[2] Traditionally Chinese courts took the position that inter-company loans were invalid. However, as of August 6, 2015, the People's Supreme Court of China issued a new ruling on matters related to lending among non-financial institutions. Under the new ruling, inter-company loans are not necessarily invalid; however, if the lending company uses borrowed money from another company and issues a loan for profit, the loan contract is unenforceable. The finance company can overcome this restriction.

[3] SIPO (State Intellectual Property Office of the People's Republic of China), 2015 Corporate Ranking by Number of Patent Applications (in Chinese), available at http://www.sipo.gov.cn/twzb/2015ndzygztjsj/bjzl/201601/t20160114_1228816.html.

development and a host of other objectives, such as information sharing, marketing, and pooling of capital for capital-intensive projects.

The closest form of collaboration among the national groups is mergers and acquisitions (M&A). There were nearly 200 national groups when SASAC was created in 2003. Over the years the numbers has been halved to about 100 because of a series of M&A orchestrated by the government. Typically the M&A were between national groups in the same industry. The Chinese government has taken M&A as a solution to inefficient management problems of the state-owned sector. Recent important M&A include: a merger between China National Building Material Company (CNBM, ranked 265th on Fortune Global 500 list) and China National Materials Group Corporation (SINOMA); an acquisition of China Metallurgical Group Corporation (MCC, ranked 290th on Fortune list) by China Minmetals Corporation (ranked 323th on Fortune list), etc.

Obviously, these forms of collaboration including joint ventures, strategic alliances and M&A raise antitrust concerns. In particular, they usually occur among the largest companies in the same industry. China has an Antitrust Law, enacted in 2008, that, as a formal matter, would appear to subject these intra-group collaborations to antitrust scrutiny. In practice, however, the national groups have thus far been virtually exempt from antitrust enforcement (Zhang 2016).

IV. SASAC as Controlling Shareholder

Atop the national groups is SASAC, established in 2003. It is legally tasked with a mission to consolidate the shareholder control rights that used to be dispersed among various government agencies. In practice, SASAC's controlling shareholder status is often overshadowed by the persistent old power structure. This is evidenced in SASAC's location in the government organizational charts. Although SASAC is a ministry-level agency, so are fifty-three of the most important SOEs under its supervision. SASAC faces potential resistance not only from the firms it supervises but also from the competing agendas pursued by other important ministries, such as the Ministry of Finance (Naughton 2008). While ostensibly SASAC has legal shareholder rights over the SOEs, SASAC in reality can only exercise its rights in the shadow of party control. SASAC actually has both less and more power than those available to a typical controlling shareholder under corporate law. Unpacking the way how SASAC exercises its shareholder rights reveals that the behavior of the Chinese SOEs cannot be explained solely from the perspective of individual firms.

As with controlling shareholders everywhere, one of SASAC's main formal powers is the selection and compensation of top managers. But SASAC exercises this power in the shadow of party control. Each Chinese SOE has two parallel personnel systems: the regular corporate management system and the party system.[4] In the corporate management system, positions are similar to those commonly found in firms elsewhere and include CEO, Vice-CEO, chief accountant, and if the company has a board of directors, a chairman and independent board members. A leadership team in the party system includes the secretary of the Party Committee, several deputy secretaries, and a secretary of the Discipline Inspection Commission (an anticorruption office), along with other members of the party committee. The personnel of the two systems customarily overlap and correspond to each other. For instance, a chairman is typically the secretary of the Party Committee.

In fifty-three central enterprises, the occupants of top positions, including board chairmen, CEOs, and party secretaries, are appointed and evaluated by the Central Organization Department of the Chinese Communist Party. This appointment practice predates the establishment of SASAC and persists until today. 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

[4] For detailed information on the party personnel system, see generally Burns (1994) and Chan (2004).

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. In addition, ministries that supervise relevant business operations provide significant input in the appointment process and all appointments are subject to the State Council's approval. The board of directors that is legally responsible for appointing and evaluating top managers is entirely bypassed by the process.

An important feature of the SOE personnel management under SASAC is rotations of senior corporate and party leaders among the national business groups (Lin, 2013, 2017a). From time to time, SASAC has rotated top executives in key industries. For example, in March 2015, the chairman of China National Offshore Oil Corporation (CNOOC) was transferred as the chairmen of China National Petroleum Corporation (CNPC); earlier in the same year, the two state-owned shipbuilding giants, China State Shipbuilding Corporation (CSSC) and China Shipbuilding Industry Corporation (CSIC), swapped top management.

Related to its appointment power, SASAC in coordination with the Party's Organization Department, the Ministry (Bureau) of Human Resources and Security, the Ministry (Bureau) of Finance and a number of other government agencies also supervises executive compensation at the SOEs. The current managerial compensation system under SASAC's supervision consists of base salary, performance bonuses, and mid- to long-term incentives. The board of directors as the formal organ responsible for executive compensation is again skirted by the process. Indeed, there is evidence that even executive compensation approved by the board and disclosed in the annual report of the state-owned listed firms is quite misleading (Lin, 2017b). The actual compensation received by the executives is set by SASAC and the actual amount remains mysterious to the public.

In contrast to its active exercise of executive appointment and evaluation rights, the state-owner has been reluctant in exercising its financial rights. For a long time, the state-owner had relieved the SOEs from any dividend distribution given their long-lasting financial struggles. It was not until 2007 that the dividend distribution requirement was reinstated. The Ministry of Finance collects the dividends and coordinates with SASAC regarding the use of the money. The dividend rates are set mainly based on broad-brush industrial categories rather than an individual firm's performance. At present, the dividend payouts for the central SOEs are between 10%-20% of net profits depending on their industry sector. However, the financial return to the state-owner is more in form than substance. Dividends collected from the SOEs are in fact recycled back to the SOEs for corporate restructuring, technology invention and emergency support for failing firms.

The ways the state-owner exercise its shareholder rights suggest that the goal of the state-owner is to balance interests of multiple groups and organs (and their ruling elite) embedded in the network instead of maximization of shareholder wealth at individual firms. It provides a useful perspective to explain many governance behaviors of Chinese SOEs. For example, the Chinese state-owner has placed heavy emphasis on corporate social responsibility (CSR) for the SOEs (Lin, 2007, 2009, 2010). Through the CSR campaign, the state-owner might aim to buy domestic political support for the SOEs (and their managerial elite), improve its international image, and other reasons inexplicable merely from the perspective of profitability and efficiency of individual firms.

V. More than Just Shareholding Ties to the Party-State

By definition, all the SOEs are obviously connected to the state by ownership. But this inference oversimplifies the density of the state-controlled network in which Chinese SOEs are embedded. Shareholding ties are simply one of many institutional bridges that increase the network density. Besides ownership ties, there is an institutional bridge of the routine personnel exchange between SASAC and the SOEs it supervises, which is a practice entirely beyond SASAC's shareholder rights.

Every year fifty to sixty SOE managers are seconded to SASAC for one-year periods and vice versa. The corporate managers seconded to SASAC are fairly senior and come from leading enterprises, while the SASAC officials are relatively junior. This suggests that the primary purpose of the exchanges is more to build SASAC capacity and promote cooperation between the SOE sector and the government than to monitor the SOEs.

Another institutional bridge is the China Group Companies Association (the Association), which is formally designed as an intermediary between the national business groups and the central government.[5] SASAC and the Ministry of Commerce oversee the Association, which has a board of directors composed of senior government officials from these and other economic ministries, as well as top managers of the most important national business groups. The Association functions as a vehicle for airing issues of concern to the central SOEs and reporting to the State Council.

Another bridge is the practice, which has roots dating to the era before SASAC's establishment, of granting substantive management rights in a nationally important SOE to the ministry with supervisory authority over the industry in which that SOE operates. For example, the Ministry of Industry and Information Technology retains important management powers over China Mobile, including the power to nominate its top managers. In some industries, high-level, two-way personnel exchanges between ministries and national groups reinforce this link.[6]

An additional institutional bridge between the large SOEs and the government is the practice of reserving a number of positions in several elite (if functionally obscure) government and party bodies for leaders of the national groups. Chief among these bodies are the National People's Congress, the central government's symbolic legislative body; the National People's Political Consultative Conference, an advisory body composed of representatives of different social and political groups; and the National Congress of the Chinese Communist Party, the Party's general assembly. For example, the Party Committee of SASAC nominated 52 top managers as representatives of the current (18th) National Congress of the Party.

As noted, the Party also plays a major role in personnel appointments in the national business groups. One-third of the employees in the national SOEs are members of the Party,[7] and Party organizations exist within each level of the business group hierarchy. Instead of retreating from the SOEs, the Party has been adamant in strengthening and institutionalizing its ties with the SOEs as they are undergoing corporate governance reforms. The Party's recalcitrant institutionalization involvement in the SOEs has a convincing political economy reason. Before the SOE reform in the 1980s, the role of the Party in the SOEs was pervasive in every aspect as there was no separation between the Party, the government and the enterprises. Modernization and corporatization of the SOEs however could have threatened the Party's encompassing control. The continuing presence of the Party organs in the post-reform SOEs ironically may be viewed as a way of buying the Party's support for reforms that it might have otherwise blocked. From a functional perspective, the Party through its extensive cadre screening and training is also well-situated to monitor personnel in the SOEs. As one commentator notes:

The Party's control over personnel was at the heart of its ability to overhaul state companies, without losing leverage over them at the same time. . . .

[5] Interview with senior administrative official, China Grp. Cos. Ass'n, in Beijing, China (June 21, 2011).

[6] A recent example is the virtually simultaneous move in 2011 by the Vice-Minister of the Ministry of Industry and Information Technology to become Party Secretary of China Mobile, and the appointment of China Mobile's Vice-CEO to the newly vacated Vice-Minister position.

[7] As of the end of 2009, 3.03 million of the 9.36 million employees of the central SOEs were party members. *See* SASAC (2010) (in Chinese).

The party body with ultimate power over personnel, the Central Organization Department, is without a doubt the largest and most powerful human resources body in the world (McGregor, 2010: 69).

VI. The Loose and Tight Connections with the Financial World

When creating the state-owned business groups in the 1980s, the Chinese government consulted the model of Japanese business groups (*keiretsu*). In the *keiretsu*'s heyday, a large commercial bank (known as the main bank) as the central actor in the business group provided financial resources and governance monitoring through its lending, equity and board connections with member companies (Aoki and Patrick 1994). Yet, as noted, the Chinese state-owned business group has a finance company rather than a bank within the group. Unlike the situation in Japan, traditionally there have been very limited equity connections or directorate interlocks between banks and industrial firms.

The sparse ownership ties between the state-owned industrial groups and the major banks are a calculated decision by Chinese policymakers. In China, banks are prohibited from owning equity stakes in industrial companies. [8] Industrial groups are discouraged (albeit legally allowed) from holding controlling stakes in banks, though in recent years some industrial SOEs have gradually expanded into the financial sector, especially by using finance companies as a portal to the financial world. Besides sparse ownership ties, few interlocks of boards of directors exist between banks and industrial SOEs in China (Ren et al., 2009). Moreover, tracing the career paths of the banks' and industrial SOEs' managerial elite reveals that virtually none of the top managers have any work experience across the financial and non-financial sectors (Lin, 2017a). In other words, the Chinese government seldom rotates managers between the financial and non-financial SOEs.

While equity and personnel ties are rare between the financial institutions and industrial SOEs in China, the flows of money from the former to the latter are strong and pervasive. Although the number of Chinese SOEs has declined significantly over the past decades, the SOEs still accounted for nearly 50 percent of the outstanding business loans and 30 percent of the total loans in China as of 2014 (Wells Fargo Securities, 2016). In the corporate bond market, industrial SOEs account for more than 50% of the total outstanding balance of corporate bonds and their bonds are mainly purchased and held by commercial banks, which typically are state-owned (Lin and Milhaupt, forthcoming). Such strong financial flows are not sustained by lateral shareholdings or personnel exchanges but through vertical relations that ultimately tie the financial and non-financial SOEs together to a common entity: the State Council (ultimately the Party).

China's large industrial groups are supervised by SASAC and its large banks are controlled by the Ministry of Finance, and both SASAC and the Ministry of Finance are subordinate to the State Council (the highest administrative body in the government system) and ultimately the Party. The State Council and the Party use their vertical ownership and supervisory relations to coordinate the industrial SOEs and national commercial banks. Given that capital availability is guaranteed through the vertical relations, the major concern for the state as the owner and as the policymaker shifts toward risk control in the system. Lateral shareholdings and personnel connections between the industrial SOEs and the major banks increase management complexity and risk connectivity of the state-owned sector. This raises concerns as both the industrial and financial SOEs are suffering from their own management problems. Moreover, the absence of lateral connections reinforces the vertical control of the party- state. Unlike other capitalisms where banks are the central actor in the corporate network, China's state-owned sector is characteristic of "party-state centricity" rather than "bank-centricity."

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[8] Law of the People's Republic of China on Commercial Banks, Article 43.

VII. Implications and Questions

A. Legal Implications in the Globalized Context

Over the past decade the world has witness an undeniable rise of Chinese SOEs. At present, Chinese SOEs are major actors in the international capital market, important sources of foreign direct investment, and formidable competitors of firms around the world. This raises a basic question for policymakers worldwide: do existing laws regulating market activity adequately contemplate an economy in which state-owned or state-controlled enterprises are major players? This Article considers three areas of law that have increasing interaction with Chinese SOEs: securities regulations for international cross-listing, foreign investment regulations, and international trade rules.

1. Securities Regulations for International Cross-Listing

Since the 1990s many Chinese SOEs have shares listed in the world's leading capital markets including Hong Kong, Singapore, the United Kingdom and the United States. The main purpose of international listing, according to the government, is to improve the SOEs' corporate governance. The proclaimed purpose is consistent with the bonding hypothesis in corporate governance literature: cross-listing is a bonding mechanism that firms can "voluntarily subject themselves to higher disclosure standards and stricter enforcement in order to attract investors who would otherwise be reluctant to invest" (Coffee, 2002:1767). The actual bonding effect in Chinese listed SOEs however remains a big question mark (Clarke, 2015). As noted, available evidence suggests that basic corporate information such as executive compensation disclosed in Chinese listed SOEs' annual reports has been illusory despite cross listing in the U.S. and other advanced capital markets (Lin, 2017b). Part of the reason is that foreign issuers often enjoy many disclosure exemptions and often compliance with the listed company's domestic rules is deemed sufficient. Moreover, private securities litigation against Chinese SOEs actually is futile because substantially all of their assets are located in China and unfortunately China has not entered into bilateral judicial cooperation agreements with the U.S. and U.K., the two major capital markets where Chinese SOEs sell securities to foreign investors. Without such an agreement, the Chinese court will not recognize and enforce a foreign judgment and instead will judge the entire case with its own opinions that have been known in favor of Chinese SOEs. This reality on the Chinese side raises questions about whether and how securities regulations of the cross-listed foreign countries provide sufficient protection for investors in pertaining jurisdictions.

2. Foreign Investment Regulations

China now ranks as the second largest country by foreign direct investment (FDI) outflows (UNCTAD, 2015). This astonishing amount of outward investment has been mainly contributed by the SOEs. The Chinese government provides financial and diplomatic resources for SOEs to go on a shopping spree, acquiring prominent companies and valuable assets worldwide.[9] Chinese SOEs' global acquisition activity has aroused great controversies in many host countries. Some countries including Australia, Canada and the United States have welcomed Chinese SOEs with great caution through (usually politicized) regulatory reviews (Lin, 2015). While each country has some unique characteristics in its own system to regulate foreign investment, in many ways the different systems struggle with similar thorny issues. For example, it is generally agreed that foreign SOEs are more likely than foreign non-SOEs to pose threats to national interests of the host country and therefore it is justifiable to subject SOE investments to closer scrutiny. However, it is an uneasy task to determine whether or not a firm is a SOE. What is it meant by "foreign government investors" under Australia's Foreign Investment

[9] It has been estimated that 95-97% of the outward foreign investment lending provided by the policy banks in China went to the SOEs. *See* Irwin and Gallagher (2014).

Policy? What is it meant by "government-controlled entities" for the Committee on Foreign Investment in the United States? And what is it meant by "state-owned enterprises" under Investment Canada Act? Partly in fear of Chinese SOEs' audacious takeovers of national natural resources, Canadian regulators recently have broadened the definition of SOE as any "enterprise that is owned, controlled or influenced, directly or indirectly by a foreign government." On the one hand, this definition echoes a network perspective on Chinese SOEs and recognizes that ownership is one of many kinds of connections that a SOE may have with the state. On the other hand, the boundary of the network under this SOE definition is very blurry, which gives ample room to politicize an investment case.

Another issue is related to the status of SOE in bilateral investment treaties (BITs). BITs generally provide for investor-state, but not state-state, dispute resolution. When an investment is made by a state-owned or state-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-state and thus outside the scope of the BIT?[10] When is the SOE so embedded in the state-controlled network that BIT protection would be unnecessary?

3. International Trade Rules

China was anticipated to transition from a "non-market economy" to "market economy" at the time of its WTO accession in 2002. China's Protocol Accession includes special anti-dumping rules to accommodate this transitional stage, and the special rules formally expired on December 11, 2016. Immediately after the expiration date, China filed a WTO dispute against the United States and the European Union regarding the price comparison methods. It now leaves room to argue about the status of China's economy with respective to anti-dumping issues.[11] While China's private sector has made impressive growth since its accession, its state-owned sector remains resilient and powerful – tellingly, in 2000 there were only ten SOEs made to the Fortune Global 500 list, and in 2016 there are close to 90. The transition remains far from complete. As noted, SOEs remain dominant players in most critical industries in China and the way the Chinese party-state controls its SOEs is more complex than a normal controlling shareholder exercising rights permitted under corporate law. In this regard, it lends some support to the view that China shall not be automatically bestowed with a market economy status.

Meanwhile, although Chinese SOEs are embedded in the state-controlled network, it does not mean that they have no autonomy in corporate management and business decision-making. Indeed in many situations, the state-owner has hard time in controlling the behavior of the SOEs and their managerial elite (Milhaupt and Zheng, 2015). For instance, SASAC has limited track on SOE overseas investment, especially for downstream subsidiaries distant from the core of the network (Lin, 2015). Each SOE has some transactions that are certainly subject to the state's control and at the same time enjoys great freedom in other transactions. For instance, the largest three oil SOEs in China (CNPC, Sinopec and CNOOC) have limited power to set the domestic oil price as it is determined by the National Development and Reform Committee (NDRC) of the State Council. However, the three oil SOEs do have considerable discretion in other matters such as patent licensing related to oil production. The heterogeneous nature of different transactions suggests that regulators should be sensitive to the characteristics of a given behavior rather than dogmatically stick to the type of entity *per se*.

Another example of the uneasiness between Chinese SOEs and international trade rules is found in the determination of "public body" relating to subsidy issues (Wu, 2016). The WTO Agreement on Subsidies and Countervailing Measures (SCM) specifies that a subsidy exists if "there is a financial

[10] For analysis of this issue, see Feldman (2012).

[11] For discussion on China's market status after the expiration date, see e.g.,Wu (2016); Bown and Mavriodis (2012).

contribution by a government or any *public body* within the territory of a Member … and a benefit is thereby conferred." Whether a SOE is a public body under the rule has been a central issue of recent WTO dispute cases. In a dispute filed by China, the WTO Appellate Body declared that a public body "must be an entity that possess, exercises or is vested with government authority." It continued that "the mere fact that a government is the majority shareholder of an entity does not demonstrate that the government exercises meaningful control over the conduct of that entity, much less that the government has bestowed it with governmental authority."[12] Furthermore, an inference of entity exercising governmental authority is permitted when "evidence shows that the formal indicia of government control are manifold" and "such control has been exercised in a meaningful way." The Appellate Body's opinion suggests multiplicity of relations between an SOE and the government, which is consistent with this Article's network perspective on Chinese SOEs.

B. Questions for the Future Evolution

If the current network structure represents a certain level of stability, what potential forces, short of political regime transformation, might destabilize this system? This section offers some possible pathways of change and suggests the directions of future research.

1. Legal reform?

More than two decades have passed since the landmark enactment of China's Company Law in 1993. The original purpose of the company law was to corporatize SOEs. Some of the basic features of the organizational form in modern corporate law indeed have been well-exploited by the government. Separate legal personality delimits the boundary between the state and the SOEs. Share transferability allows easy asset transfers among SOEs, which makes possible the creation of a listed company packed with the group's crown jewel assets. Limited liability offers a financial relief for the state-owner. Meanwhile, some other basic governance devices of modern corporate law such as the board of directors often have been practically sidestepped by the government. As Chinese corporate and securities law keep reforming in the future, it is reasonable to expect that more and more SOEs will establish boards of directors, recruit independent directors, and adopt modern executive compensation practices, etc. However, it remains unclear how they will actually alter the fundamental control exercised by the party-state. To be sure, this does not mean that corporate and securities law reforms are irrelevant. Incremental improvements in corporate governance are taking place in the SOEs. But the most important long-term effects of such reforms probably lie in the creation of an institutional environment in which firms without access to the state network can grow and thrive, ultimately reducing the importance of the SOEs to China's economy.

2. Temasek-ization of SASAC?

Another possible pathway of change is a reorientation of SASAC in its role as controlling shareholder. At present, SASAC plays the roles of regulator, shareholder, and sometimes manager. The party-state's latest SOE reform policy makes it clear that SASAC should retreat from the involvement of direct corporate decision-making and focus on its role as capital provider (investor).[13] This policy declaration suggests that SASAC might shift toward Singapore's Temasek model, which is a favorite of Chinese economic strategists. Temasek, wholly owned by Singapore's Ministry of Finance, holds major equity stakes in numerous Singapore corporations. Temasek's major mission is "to . . .

[12] United States – Definitive Anti-Dumping And Countervailing Duties On Certain Products From China, WT/DS379/AB/R (March 11, 2011).

[13] CCP Central Committee and the State Council's Guiding Opinions on Deeping the Reform of State-Owned Enterprises (in Chinese), released on August 24, 2015, available at http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm.

safeguard [the country's] critical assets and past reserves" (TAMASEK 2012:45). The Minister for Finance appoints the board of directors, with the concurrence of the President. A majority of the board is comprised of nonexecutive directors, who are all businesspeople, though the current board is chaired by a former official of the Cabinet of Singapore. Publicly, Temasek claims to exercise only the rights of an investor and to leave management of its portfolio companies to their respective boards of directors. But Temasek maintains strong ties to the ruling People's Action Party, which has presided over the country's economic development (Mauzy and Milne, 2002: 28-30, 71-77). A reorientation of SASAC toward the Temasek model would require a relaxation of party involvement in key managerial appointments and further devolution of control over the national groups to outside investors and independent directors. If SASAC would be reoriented as the written policy says, it would lead to more transparency and independence of the SOE management.

3. Relationship between Financial and Industrial SOEs?

As noted, the state-owned banks are not only major lenders but also bondholders of the industrial SOEs. The strong flows of financial resources from the state-owned banks to the industrial SOEs have been to a great extent directed in accordance to the state policies. As China's economy has been in a prolonged slowdown, many of the industrial SOEs are having difficulties to repay debts. To rescue the debt-laden SOEs, recently the government has actively promoted the debt-for-equity swap programs in which lenders would forgive debts of borrowing companies in return for equity stakes.[14] It technically delays the bankruptcy of the borrowing firms, if the underlying inefficiency problems remain unsolved. It also complicates the risk allocation between debt and equity and between the financial and non-financial systems. The debt-for-swap strategy seems a throwback to the government-led bank reform in the 1990s where the state-owned banks transferred non-performing loans to state-owned assets management firms that became shareholders of the borrowing companies. However, unlike the 1990s where China's major banks were wholly state-owned, today most of the major banks are publicly listed companies, often also listed overseas. It raises questions about whether China's major banks will follow the government's instructions as in the past, especially when they are being exposed to international markets. Some recent cases suggest that the state-controlled banks against the government's instructions refused to stand by the financially difficult SOEs.[15] Meanwhile, as access to the global capital market becomes more available to Chinese SOEs, will they have more autonomy from the state-owned banks? Will the two forces jointly lead to arm's length lending relationships between the industrial SOEs and state-owned banks in China? Alternatively, will there be growing equity links between the industrial SOEs and state-owned banks that strengthen the state-owned sector and further suppress the private sector? Any of these potential changes of the relationship between the financial and industrial sectors may have profound consequences for Chinese state capitalism.

4. Ownership Reform?

When it comes to reforming Chinese SOEs, most commentators tend to focus on ownership. This tendency is understandable as state ownership seems to be the root of all the SOE problems. Privatization that cuts off ownership ties with the state appears to be the obvious solution. However, as noted, ownership is one of the many ties that connect Chinese SOEs to the state. As Chinese SOEs are

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[14] As previously noted, as a matter of law, banks in China are prohibited from holding equity stakes in non-financial institutions such as industrial SOEs. Given this prohibition, common practices of debt-for-equity swaps are made through an intermediary. A bank first transfers its debt to the intermediary and then the intermediary becomes a shareholder of the indebted company by converting the debt into equity.

[15] A salient example is Dongbei Special Steel Group Co., whose major shareholder is the provincial government of Liaoning in northeastern China. The provincial government tried to get Dongbei's creditors, including 17 banks and investment funds, to convert their debt into equity of the company. But the creditors rejected the proposal and instead filed to court in September 2016 for a judiciary order of bankruptcy restructuring. The court granted the order.

embedded in a control network densely knitted by various types of relations in addition to legally-defined ownership, making SOEs independent of the party-state's control is rather than simply a matter of privatization. Dis-embedding the SOEs entails drastic political reform that destabilizes all the ties with the single-ruling party. But such political reform is nowhere in sight.

Very recently, the Chinese government has announced a new round of SOE governance reform. The most salient part of the latest SOE reform policy is the so-called "mixed ownership": private capital is invited to buy a partial stake of SOEs. Mixed ownership is proclaimed by the government to "preserve SOEs' value and increase their competitiveness" as well as to "exploit the comparative advantages of various types of ownership." State ownership and private ownership have their own distinctive merits and problems. Ownership integration across the state-owned sector and private sector, if done in a right way, may produce synergy and gain competitive edges; but if done improperly, it may complicate the situation. As mixed ownership is expected to be more extensive in the years to come, will it distance SOEs from the state's control, as hoped by advocates of liberalization? Alternatively, will ownership integration instead embed private enterprises deeper into the party-state system? The SOEs' dense and complex relations with the party-state, as noted in this Article, give little reason for optimism about the consequences of ownership change.

Conclusion

This Article offers an anatomy of the network in which Chinese large SOEs are embedded. The network perspective has provided a richer illustration of the architecture of China's state-owned sector. It has explained some idiosyncratic governance institutions deviant from the laws on the books and international standard practices. It has raised challenging questions to various areas of law in the globalization context. It has also raised many other questions to be investigated in the future. For example, how do the close links between the SOEs and the party-state affect the legal development in China? How will the increasing importance of the high-technology sector in China affect the role of the SOEs that primarily dominate in the heavy industries? How will globalization in trade and in capital markets influence the internal governance and external network of the SOEs? This Article does not attempt to answer all these questions but hope that it has provided a basic structure of the SOEs with which researchers may begin to explore possible answers.

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