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Institutional investors in China: Corporate governance and policy channeling in the market within the state

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The extraordinary rise of China's economy has made understanding Chinese corporate governance an issue of global importance. A rich literature has developed analyzing the Chinese Communist Party's (CCP's) role as China's largest controlling shareholder and the impact that this has on Chinese corporate governance. However, the CCP's role as the architect —and direct and indirect controller—of institutional investors in China has been largely overlooked in the legal literature.

This lack of focus on institutional investors in Chinese corporate governance may have made sense two decades ago. At that time, in listed Chinese companies, institutional investors' shareholdings were miniscule, the CCP had an iron grip on corporate governance through the government's non-tradable controlling block shareholdings, and stringent caps on foreign institutional investor shareholdings rendered them negligible. All of these facts are relics of a bygone era.

The most recent statistics on China's shareholder landscape reveal that institutional investors now hold 18.7% of China's A-Shares market capitalization—almost double the percentage they held in 2014 and over ten times the amount in 2003. Institutional investors now account for almost half of the free float of shares in A-Shares companies, more than a ninefold increase since 2007—making institutional investors China's most important minority shareholders. At the end of 2019, the assets under management by institutional investors in China reached US$16 trillion—a tenfold increase over the past 10 years, making it the world's most important market for growth in the asset management industry. This now makes any analysis of Chinese corporate governance that does not consider institutional investors incomplete.

Our recent working paper—*Institutional Investors in China: Corporate Governance and Policy Channeling in the Market Within the State*—aims to address this conspicuous gap in the legal literature by drawing on Chinese sources and fresh hand-collected empirical, interview, and case study evidence, to provide an in-depth analysis of the role played by institutional investors in Chinese corporate governance. It provides a taxonomy of institutional investors in China, which reveals that as the percentage of the A-Shares market owned by institutional investors has grown, there has been a proliferation in the different types of institutional investors in China—what we coin the 'atomization' of the market for institutional investors. An analysis of the regulations that have driven the growth and atomization of institutional investors demonstrates that, for decades, the CCP has actively promoted the growth of institutional investors to improve corporate governance and stabilize the stock market. It also reveals that the CCP has strategically controlled the growth and influence of foreign institutional investors, allowing the CCP to rapidly develop a sizable and effective market for institutional investors, while ensuring that it reinforces the 'China Model' of corporate governance in which the CCP maintains ultimate control.

We collect and analyze a growing number of empirical studies in the business school literature that provide three valuable insights into the role played by institutional investors in Chinese corporate governance. First, the studies provide convincing evidence that different types of institutional investors have different impacts on Chinese corporate governance—confirming the value of our taxonomy of institutional investors. Second, several empirical studies find that the impact that institutional investors have on corporate governance is contingent on the extent to which the institutional investor is insulated from the CCP—highlighting the importance of distinguishing between State-Owned Institutional Investors (SOIIs), Private-Owned Institutional Investors (POIIs), and Foreign-Owned Institutional Investors (FOIIs). Third, several empirical studies find that the impact that institutional investors have on corporate governance is contingent on whether the investee company is a State-Owned Enterprise (SOE) or Private-Owned Enterprise (POE)—reinforcing the importance of understanding the role of the CCP in China's market for institutional investors.

However, we explain that as insightful as these empirical studies are, they suffer from some limitations in their currency, data, and analysis. To overcome these limitations, we hand-collect and analyze publicly reported cases in which institutional investors have been involved in activist campaigns in A-Shares Companies. Somewhat surprisingly, our analysis of these cases revealed that SOIIs have undertaken a significant portion of the activist campaigns and that POIIs have succeeded in half of their activist campaigns targeting SOEs. However, over the last decade the number of activist campaigns by POIIs, several of which have succeeded in SOEs, are on the rise. Moreover, FOIIs have undertaken only two activist campaigns, none of which were in the last decade. Finally, activist campaigns overall are clearly on the rise, with three times as many activist campaigns in the last decade compared to two decades ago. Taken together, this suggests that SOIIs and POIIs are developing into an important corporate governance mechanism to mitigate private benefits of control in China—while the role of FOIIs remains limited. It also suggests that the relationship between the CCP and institutional investors is important and complex.

We aim to make sense out of this complexity by mapping and analyzing the various government bodies, regulations, and tactics that the CCP has developed to control institutional investors formally and informally in China. Based on empirical, case study, and interview evidence, we explain how the CCP can—and has—used various mechanisms to engage in 'policy channeling' in SOIIs and POIIs, with foreign institutional investors being largely insulated from policy channeling. Equally important, however, is our evidence that the CCP uses its power to 'policy channel' in a targeted and limited way surrounding significant stock market and political events. However, on a day-to-day basis, absent these extraordinary events, institutional investors in China appear to often serve an important corporate governance function by acting as a check on corporate controllers in SOEs and POEs.

Ultimately, we conclude the rise of institutional investors in China has been done in a way to reinforce the CCP's ultimate control. However, contrary to what some conceptions of 'state capitalism' may suggest, the CCP does not micro-manage institutional investors on a day-to-day basis. Rather, institutional investors normally function according to free-market forces and increasingly perform an important corporate governance role—with the CCP using its policy channeling in a targeted way: what we coin the 'market within the state' for institutional investors in China.

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