

Corporate Governance in China: A 'Law' unto itself

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List of Abbreviations

ACFTU-All China Federation of Trade Unions

AGM-Annual General Meeting

BoD -Board of Directors

BSAM-Bureau of State Asset management

CBRC-China Banking Regulatory Commission

CCL 1994-Chinese Company Law 1994

CCL 2005-Chinese Company Law 2005

CCP-Chinese Communist Party

CEFs-Closed-end funds

CEO- Chief Executive Officer

CSR -Corporate social responsibility

CSRC-China Securities Regulatory Commission

IOSCO- International Organization of Securities Commissions

KMT-Kuomintang of China

LAC - Legislative Affairs Committee

NGOs -nongovernmental organizations

NSSF- National Social Security Fund

OECD- Organization for Economic Cooperation and Development

PBOC- People's Bank of China

PT- Particular Transfer

P/E- Price-earnings ratio

PRC-People's Republic of China

- QFII-Qualified Foreign Institutional Investors**
- SASAC-State-owned Asset Supervision and Administration Commission**
- SBR-Supervisory Board Report**
- SCNPC-National People’s Congress**
- SCSC-Securities Committee of the State Council**
- SHZSE-Shenzhen Stock Exchange**
- SOEs-State-owned enterprises**
- SPC-Supreme People’s Court**
- SSE -Shanghai Stock Exchange**
- ST- Special Treatment**
- U.S. SEC- United States Securities and Exchange Commission**

Contents

Corporate Governance in China: A ‘Law’ unto itself

Chapter 1 Introduction

1. Background	1
2. Understanding the characteristics of the Chinese corporate governance	7
2.1 Culture and tradition can play an important role	7
2.2 The largest shareholder is the state	10
2.3 The role of the CSRC	12
2.4 Different nature of the judiciary system in China	13
2.5 The role of investors	13
2.6 The principle of the corporation’s responsibility to society is a product from the era of planned economy	14
2.7 The Chinese supervisory board’s apparent resemblance to the German model is confined mostly to its name and the participation of workers	16
3. The objective of this research	17
4. The structure of this research	18

Chapter 2 Globalization and tradition: When East meets West

2.1. Introduction	21
2.2 Globalization means Americanization?	22
2.3 The U.S. style has shifted	29
2.4 Culture can thrive beneath the law	31
2.5 The culture beneath the law and behind economic and other institutions	34
2.6 Chinese culture and law	38
2.6.1 Confucianism and Chinese law	45

2.6.2 When the East meets the West	51
I The late Qing dynasty reform	51
II The continuing reform under the Kuomintang	53
III Reform under the Communist Party	60
IV The Company Law and securities market in China	68
2.7 Conclusion	71

Chapter 3 Internal corporate governance mechanisms

3.1 Introduction	74
3.2 Internal corporate governance mechanisms in China	79
3.3 The supervisory board in Germany	80
3.4 The supervisory board in China	83
3.4.1 The function of the supervisory board in China	83
3.4.2 The gap between reality and expectation of the law in the role and powers of the supervisory board	84
3.5 The independent director in the UK and US	87
3.6 The independent director in China	91
3.7 The gap between reality and expectation of the law in the role and powers of the independent directors	95
3.7.1 Chinese entrepreneurs do not trust outsiders	95
3.7.2 Difficulties in finding appropriately experienced and qualified independent directors	96
3.7.3 Independent directors do not have the really power	99
3.7.4 Independent directors do not have the financial incentive	103
3.8 Directors' duties	110
3.8.1 Duties of directors in the United Kingdom	110
3.8.2 Duties of the directors in China: the law on paper	115
I No-conflict rule	116

II Duty of care, skill and diligence	118
3.8.3 Duties of directors in China: the law in practice	119
I The largest shareholder is the state	119
II The relationship between the state and SOE managers	121
III The securities law and company law leaves much to be desired	123
3.9 Conclusion	128
Chapter 4 Institutional investors	
4.1 Introduction	132
4.2 Institutional investors and corporate governance: the theories in the West	133
4.3 Institutional shareholders and corporate governance: the practice in the UK	135
4.3.1 Criticism of institutional investors	141
I Lack of willingness and ability to actively monitor and intervene	141
II Institutional investors as short-term players?	144
III The free-rider problem	146
4.4 Institutional investors and corporate governance: the practice in China	149
4.5 Who are the institutional investors in China?	151
4.5.1 The insurance companies	152
4.5.2 Pension funds	153
4.5.3 Qualified foreign institutional investors	153
4.5.4 The emergence of investment funds in China	154
I Self regulate period	154
II The call for standardization	157
III Standardisation of old funds	158
IV The Preliminary Securities Investment Fund Act 1997	160
V The regulatory authorities	161
VI The Securities Funds Law 2003	163

4.6 Quis Custodiet Ipsos Custodies? (Who shall guard the guards?)	165
4.6.1 The problems of the fund manager	166
4.6.2 The problems of the fund custodians	167
4.6.3 The problems of fund holders	169
4.6.4 The problem of the investment funds activities	171
I The voting system	172
II Collective action and free-rider problems	174
III Conflict of interests	175
4.7 Conclusion	177
Chapter 5 Minority shareholder protection	
5.1 Protection of minority shareholders' rights and interests: the theory in the West	178
5.2 Protection of minority shareholders' rights and interests: law and practice in China	187
5.2.1 The role of the market	187
5.2.2 The structure of the ownership	188
I The problems of this ownership structure	192
II Reforming the split share structure	195
5.2.3 The role of the state	197
5.2.4 The role of the Securities Regulatory Commission	203
I The Listing system and regulatory corruption	203
II ST, PT Company and delisting system	210
5.2.5 The role of auditors	212
5.2.6 The choice for investors	216
5.3 Shareholders' protection: law and legal enforcement	219
5.3.1 Protection of minority shareholders' rights and interests under the Company Law 1994	220
5.3.2 Protection of minority shareholders' rights and interests under the Company Law 2005	222
5.3.3 Securities law offers another legal channel to protect the	

substantive rights of shareholders	224
I Article 42	224
II Article 63	225
5.4 Legal rules lose their teeth without enforcement	225
5.4.1 The role of the judiciary in China	230
5.4.2 The difficulties of bringing a minority shareholder action	233
I Civil Procedure Law	233
II The Supreme People's Court Guidelines 2003	234
III . Minority shareholder protection under the Company Law 2005	238
5.5 Conclusion	240
 Chapter 6 Co-determination/ Industrial democracy	
6.1 Introduction	243
6.2 Stakeholder theory in West	244
6.3 The development in the UK	252
6.3.1 The influence from the EU	256
6.3.2 The political impaction	257
6.3.3 The new development of the 2006 Companies Act	260
6.4 The German co-determination	264
6.5 Employee participation in corporation in China	271
6.5.1 The principle of the corporation's responsibility to society is a product from the era of the planned economy	271
6.5.2 The economic reform and the changing relationship between the SOE and employee	276
6.5.3 The adaptation of the corporate theory in China	277
6.5.4 Employee participation in corporate decision making-the law on paper	279
6.5.5 The employee participation in corporate affairs –the practice	283
I The Trade Union in China	283
II The Works Council in China	291

6.6 Conclusion	292
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Chapter 7 Conclusion	295
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Bibliography

Abstract

China has been in great transition since the end of the 1970s. It has gradually moved from a rigid planned economy with public ownership of the means of production toward a socialist market economy. The changes at the firm levels have called for a general reform of the legal system as a whole, with a particular focus on the reform of corporate governance. Chinese commentators' views on the concept of corporate governance have been substantially influenced by corporate governance theories in developed economies.

One main objective of this study is to analytically explore cultural, social, institutional, historical, economic and other factors affecting the resulting differences in implementation that have been observed in China.

Simply copying from the West without effective implementation and compliance of the standards to appease the international investors is unlikely to work in the long run. When learning from the West in finding appropriate measures, care needs to be taken to understand the background and reasoning to the measures adopted in the West and whether such measures are likely to work in China. China is engaging in selective adaptation of international norms and the success of that exercise depends also on institutional capacity building.

Corporate Governance in China: A 'Law' unto itself

Chapter 1 Introduction

1. Background

The rapid economic development of China over the last thirty years has been impressive.¹ Whilst the current slowdown due to the global credit crunch has presented a new set of challenges, the important debate concerning the governance of China's corporatized state owned enterprises (SOEs) remains a key element in understanding the success of that development. The governance processes at play during the journey from central planning to the emergence of what is officially termed a 'socialist market economy' have been complex and at times intricate with multiple layers of competing interests tugging in different directions.²

¹ The development of China since its opening up has led to a plethora of books on virtually every aspect of China's complex society. Ever since Clive Buttercup recounted his experiences as one of the first Western journalists allowed back into China after the Cultural Revolution, see Butterfield, F. (1982). China: Alive in the bitter sea. New York, N.Y. Times Books. There has been a great demand for books that offer insights into how the country is developing. A few useful examples include Schell, O. (1994). Mandate of heaven : a new generation of entrepreneurs, dissidents, bohemians and technocrats lays claim to China's future. New York ; London, Simon & Schuster.; Kristof, N. D. and S. WuDunn (1994). China wakes : the struggle for the soul of a rising power. New York, Times Books.; Child, J. (1994). Management in China during the age of reform. Cambridge, Cambridge University Press.; Nolan, P. (2001). China and the global economy. Basingstoke, Palgrave. ; Zweig, D. (2002). Internationalizing China : domestic interests and global linkages. Ithaca; London, Cornell University Press. ;Walter, C. E. and F. J. T. Howie (2006). Privatizing China : inside China's stock markets. Singapore ; Chichester, John Wiley & Sons (Asia).; Burgh, H. d. (2006). China : friend or foe? Thriplow, Icon.; Hutton, W. (2007), The Writing on the Wall; China and the West in the 21st Century, Little Brown.

² See for example Weideman, A., "Corporate Capitalism and Socialist China." in Gomez, E. T. and X. Xiao (2003). Chinese enterprise, transnationalism, and identity. London, Routledge.; and Pillion, S. E. (2009). Workers' democracy in China's transition from state socialism. New York ; London, Routledge.; Cao, L.(2000), "China's Privatisation: Between plan and market ." Law and Contemporary Problems (Autumn) 63.

Also, the continued absence of a privately held but publicly quoted sector remains a related issue.³ A consideration of this phenomenon helps to shed light on corporate governance in the context of China's almost miraculous economic achievements.

Corporate governance has developed as a major interdisciplinary field of study since the early 1990s with roots going back to the governance crisis in the USA during the 1970s⁴ and even earlier in the works of Berle and Means,⁵ and later Coase⁶ and others. Whilst various waves of scandals⁷ have led to renewed efforts in improving corporate governance and vigorous debates on the best ways forward, the major theories that have

³ Kirby, W. C. (1995). "China Unincorporated - Company Law and Business-Enterprise in 20th-Century China." *Journal of Asian Studies* 54(1).; Bowen, J. R. and D. C. Rose (1998). "On the absence of privately owned, publicly traded corporations in China: The Kirby puzzle." *Journal of Asian Studies* 57(2): 442-452.

⁴ Hamilton, R.W. (2000), "Corporate Governance in America 1950-2000, Major Changes but Uncertain Benefits." *Journal of Corporations Law*, 25.

⁵ Berle, A.A. and Means G. C. (1932), *The Modern Corporation and Private Property*. New York, Macmillan Co.

⁶ Coase, R.H. (1960), "The Problem of Social Costs." *Journal of Law and Economics* 3; Coase, R. H. (1988). *The firm, the market and the law*. Chicago ; London, University of Chicago Press. ; Posin, D.Q. (1990), "The Coase Theorem: If pigs could fly." *Wayne Law Review* 89; Campbell, D. (1994), "Ayers versus Coase: An attempt to recover the issue of equality in law and economics." *Journal of Law and Society*, 21.

⁷ Over the last 50 years corporate scandals have tended to come in waves, the 1970s bribery scandals in the USA following in the wake of the Watergate affair led to the Foreign Corrupt Practices Act. In the UK a number of scandals in the 1980s and early 1990s from Re Atlantic Computers, Queens Moat Hotels, Pollypeck, Bank of Credit and Commerce and the Mirror Newspaper Group are but a few in a long list which resulted in increased emphasis on corporate governance and through the deliberations of several committees, the evolution of the Combined Code on Corporate Governance. Barings Bank in the early 1990s was a forerunner of the recent Banking Scandals which have almost ruined the economies of the Western world and resulted in unprecedented government action and intervention, particularly in the USA and UK. In between these waves, the Enron Scandal and many others in the USA at the turn of the 21st Century had led to major changes with the Sarbanes-Oxley Act. They ought to lead to fundamental questioning of many of the assumptions underlying corporate governance practice, see generally Hamilton, S. and A. Micklethwait (2006). *Greed and corporate failure : the lessons from recent disasters*. Basingstoke, Palgrave Macmillan.; Clarke, F. L., G. W. Dean, et al. (2003). *Corporate collapse : accounting, regulatory, and ethical failure*. Cambridge ; New York, Cambridge University Press.; Jacoby, N. H., P. Neheimkis, et al. (1977). *Bribery and extortion in world business : a study of corporate political payments abroad*. New York, Macmillan ; London : Collier Macmillan.; Noonan, J.T. (1984), *Bribes: The Intellectual History of a Moral Idea*, Berkley, University of California Press.; Baker, R.W. (2005), *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System*, New Jersey, John Wiley. China too has had numerous corporate scandals during the reform period these will be dealt with later but for a consideration of the first 'overseas' Chinese corporate scandal see Jackson, K. T. (2009), 'The China Aviation Oil Scandal' in Matulich, S. and D. M. Currie (eds) *Handbook of Frauds, Scams, and Swindles: Failures of Ethics in Leadership*. Boca Raton, CRC Press.

tended to hold sway in terms of influence have been agency theory,⁸ the related nexus of contract⁹ and various other 'law and economics' influences.¹⁰ To these have been added the law matters thesis,¹¹ political determinants of corporate governance,¹² path dependency¹³ and others. From another perspective, but directly related to the central debate on corporate governance namely, the question of in whose interests are corporations managed? A number of theories are relevant. These include stewardship,¹⁴ stakeholder theory¹⁵ and corporate social responsibility.¹⁶

⁸ Jensen, M. C. and W. H. Meckling (1976). "Theory of Firm - Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3(4): 305-360.; Fama, E. F. (1980). "Agency Problems and the Theory of the Firm." *Journal of Political Economy* 88(2): 288-307.

⁹ Cheung, S. N. S. (1983). "The Contractual Nature of the Firm." *Journal of Law & Economics* 26(1): 1-21.; Easterbrook, F. H. and D. R. Fischel (1989). "The Corporate Contract." *Columbia Law Review* 89(7); Bratton, W. W. (1989). "The Nexus of Contracts Corporation - a Critical-Appraisal." *Cornell Law Review* 74(3); Bratton, W. W. (1989). "The New Economic-Theory of the Firm - Critical Perspectives from History." *Stanford Law Review* 41(6).; Ulen, T.S. (1993), "The Coasean firm in Law and Economics " *Journal of Corporate Law* 18 at 301

¹⁰ For a critique of the development of the law and economics approach see Ireland, P. (2000), 'Defending the Rentier: Corporate Theory and the Reprivatization of the Public Company' in Parkinson, J., A Gamble and G Kelly (eds) *The Political Economy of the Company*, Oxford, Hart Publishing.

¹¹ This is particularly relevant to the debate over concentration of share ownership. see La Porta, R., F. Lopez-de-Silanes, et al. (1999). "Corporate ownership around the world." *Journal of Finance* 54(2): 471-517. But is of wider significance in terms of law and development more generally, see in particular Dam, K. W. (2006). *The law-growth nexus : the rule of law and economic development*. Washington, D.C., Brookings Institution Press. and Milhaupt, C. J. and K. Pistor (2008). *Law and capitalism : what corporate crises reveal about legal systems and economic development around the world*. Chicago, London, University of Chicago Press at 140.

¹² The political determinants of corporate governance often go to the core of various corporate models, see Hadden, T. (1977). *Company law and capitalism*. London, Weidenfeld and Nicolson., Chapter 12; Roe, M. J. (1994). *Strong managers, weak owners : the political roots of American corporate finance*. Princeton, N.J., Princeton University Press.; Roe, M. J. (2003). *Political determinants of corporate governance : political context, corporate impact*. Oxford, Oxford University Press.; Roe, M. J. (2005). *Corporate governance : political and legal perspectives*. Cheltenham, Edward Elgar.; Gourevitch, P. A. and J. Shinn (2005). *Political power and corporate control : the new global politics of corporate governance*. Princeton, N.J. ; Woodstock, Princeton University Press.

¹³ Bebchuk, L. A. and M. J. Roe (1999). "A theory of path dependence in corporate ownership and governance." *Stanford Law Review* 52(1): 127-170.

¹⁴ See for example, Davis, J. H., F. D. Schoorman, et al. (1997). "Toward a stewardship theory of management." *Academy of Management Review* 22(1): 20-47.

¹⁵ The stakeholder debate concerns whose interests should be taken into account when making corporate decisions and the question of voice in the company in so far as some of those interests might have representation on the board or advisory board. see Goldenberg, P. (1998), "Shareholders versus stakeholders: The bogus argument" *The Company Lawyer* 19 (34); Clarke, T. (1998). "The stakeholder corporation: A business philosophy for the information age." *Long Range Planning* 31(2).; Letza, S., Sun, X. and Kirkbride, J. (2004) "Shareholding versus Stakeholding: A Critical Review of Corporate Governance" *Corporate Governance an International Review* 12, 239; for a more market fundamentalist critique of stakeholder theory see, Steinberg, E. (1999), "Stakeholder Theory Revisited; Defects of the Stakeholder Doctrine" *Corporate Governance International* 2(2).; Steinberg, E. (2004). *Corporate Governance: Accountability in the Marketplace*, London, Institute of Economic Affairs.

¹⁶ See for example, Morrissey D. J. (1989), "Toward a New/Old Theory of Corporate Social Responsibility" *Syracuse Law Review* 40; Pettet, B. (1997), "From Cakes and Ale to Corporate Social Responsibility" *Current Legal Problems* 50. The UK Companies Act 2006, s 172 gives broader scope to the board of directors in terms of considering the interests of a wider range of stakeholders rather than the shareholders only and possibly allowing

From a more international and comparative perspective of corporate governance are notions of convergence in corporate governance norms if not always forms and structures¹⁷ with related questions of the transplant effect.¹⁸ In short, the various theoretical lenses through which one might perceive and examine the development of corporate governance in China are potentially kaleidoscopic in nature as is the very subject of attention itself. As the title of this thesis suggests, the development of corporate governance in China has been a rather Chinese specific process with some Western influence, indeed a law unto itself.

In this thesis I will therefore draw on the various theoretical lenses of analysis as I think appropriate in order to cast as much light on the situation as is necessary to draw an understanding of the forces at play in corporate governance in China.

Since the founding of the People's Republic in 1949, the Chinese

for a activities that are more socially responsible, albeit that the company benefits by improving its corporate image in the long term. There is nothing to prevent a substantive philanthropic or charitable object, *Re Horsley & Weight Ltd* [1982] Ch 442. In China the overriding political bias is often in favour of preserving social cohesion and stability which inevitably entails the consideration of various stakeholder interests particularly at more local village and township enterprise level and often in larger towns and cities as well, see for example Chen, C. J. (2005), "The path of Chinese privatization: A case study of village enterprise in southern *Jiangsu*" *Corporate Governance an International Review*, 13.

¹⁷ See for example Clarke, T. (2004). *Theories of corporate governance : the philosophical foundations of corporate governance*. London, Routledge. Part 7.

¹⁸ See for example, Watson, A. (1993). *Legal transplants : an approach to comparative law*. Athens, Ga. ; London, University of Georgia Press. ; Watson, A. (1976), "Legal Transplants and Law Reforms" *Law Quarterly Review* 79; Legrand, P. (1997), "The Impossibility of Legal Transplants" *Maastricht Journal of European and Comparative Law* 4; for similar issues in relation to Malaysia, see Salim, M. R. (2006), "Legal Transplantation and Local Knowledge: Corporate Governance in Malaysia" *Australia Journal of Corporate Law* 20(55). See also Friedman, L. M. (1996). "Borders: On the emerging sociology of transnational law." *Stanford Journal of International Law* 32(1): 65-90.; for a consideration of the background to the debate, see Twining, W. (2005). "Social science and diffusion of law." *Journal of Law and Society* 32(2): 203-240. And for the start of the debate on the efficacy of transplantation, see Freund, O. K. (1974), "On Uses and Misuses of Comparative Law" *Modern Law Review* 37(1).

Government adopted a strict socialist planned economy, under which enterprises were owned and controlled by the state, “with all key decisions being made in accordance with State policy and objectives”¹⁹

The largest share of China's economy is the state-owned economy named “the all-people-owned economy.” China's Constitution provides that the all-people-ownership system is the primary component and the base of China's economy.²⁰ Chinese SOEs used to be production units as well as social and political organizations.²¹

Dengxiaoping broke the conventional boundaries of socialism and capitalism by claiming that “social practice (praxis) is the only criterion of seeking truth.”²² “No matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat.”²³ John Gittings in *The Changing Face of China* quotes Deng Xiaoping as stating: "Planning and market forces are not the essential difference between socialism and capitalism. A planned economy is not the definition of socialism, because there is planning under capitalism; the market economy happens under socialism,

¹⁹ Gul, F. A. and J. S. L. Tsui (2004). The governance of East Asian corporations : post Asian financial crisis. Basingstoke ; New York, Palgrave Macmillan, at 27.

²⁰ The Constitution of People's Republic of China, (1982), art. 7; the Constitution (2004) “The state-owned economy, namely, the socialist economy under ownership by the whole people, is the leading force in the national economy. The state ensures the consolidation and growth of the state-owned economy”. See the Constitution of Peoples' Republic of China (2004) art 7 .

²¹ Walder, A. G. (1986). Communist neo-traditionalism : work and authority in Chinese industry. Berkeley ; London, University of California Press.

²² See reports in the People's Daily, May 9, 1998:

²³ Deng ,1962. From a speech in a meeting of the Secretariat, actually a Sichuan proverb.

too. Planning and market forces are both ways of controlling economic activity." ²⁴

As a result of this change of policy at the top, China has been in great transition since the late 1970s. It has gradually moved from a rigid planned economy with public ownership of the means of production toward a socialist market economy. The changes at the firm levels have called for a general reform of the legal system as a whole, with a particular focus on the reform of corporate governance.

Broadly speaking, the Chinese company law system is a hybrid one, containing institutions borrowed from both common law systems, as practiced mainly in the United States, and the collection of continental civil law jurisdictions, in particular from Germany. The hybrid nature of the legal systems is reflected in the board structure of China's listed companies, which are mandated to have both a management board with independent directors and a supervisory board. However, the "transplant shock" i.e. the possibility that legal rules that work well in one nation may not work well, and ultimately may be rejected, in a nation with a different historical, political, or culture background is a concern. ²⁵

²⁴ Gittings, J. (2005). *The changing face of China : from Mao to market*. Oxford, Oxford University Press, at 253.

²⁵ Stout, L. A. (2002). "On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?" *UCLA School of Law Working Paper No. 02-11*; See also Milhaupt, C. J. (2001). "Creative norm destruction: The evolution of nonlegal rules in Japanese corporate governance." *University of Pennsylvania Law Review* 149(6): 2083-2129.

2. Understanding the characteristics of Chinese corporate governance

2.1 Culture and tradition can play an important role

Culture and ideology might influence a country's choice of corporate law. Law in traditional China was an instrument of the state. Its purpose was to enhance the power of the government and maintain imperial control. Rather than protecting the rights of individuals, legal codes focused on the individual's obligations toward the state.²⁶ The law traditionally focused on peoples' responsibilities rather than their rights.

China has continuing imperial history of over 2000 years, characterize throughout by its authoritarian Confucianism. Confucian governance was thus a matter of using moral teaching to shape people's behaviour. Chinese society is constructed of morally binding relationships connecting all. The individual is rather a 'connection', and the "totalness" of society is passed down from one binding relationship to the next, rather than by the Western mode of uniting loosely coupled and "free" individuals by their separate espousal of coordinating ideas and principles.

As such the law of the State was not very interested in social regulations

²⁶ In contrast to traditional China. 'The monarch (of medieval Europe), it is argued, may make law, but he may not make it arbitrarily, and until he has remade it-lawfully –he is bound by it.' See Berman, H. J. Law and revolution: The Formation of the Western Legal Tradition. Cambridge, Harvard University Press at 9.

among autonomous individuals, and least of all in defending individual rights against the state.²⁷ As a result, no independent legal system (as well as specialized legal practitioners) had ever been built to serve the interests of capitalist enterprises in Chinese history.²⁸ “So that, by default, the family and the relationships of trust became a more secure basis for business activity than formal bodies of law, such as company law.”²⁹

The Chinese way of life continues to affect how business is run in China.³⁰ For example, Chinese entrepreneurs do not trust outsiders. Secrets of the business and success are often kept “in the family.” This is one factor making it difficult for independent directors to function effectively in China.³¹ This is also the case in relation to former corporatized SOEs where the dominance of persons in authority acts in a similar way.

In this context legal reform is fraught with problems. Some commentators regard the recent wave of legal reform as statist in nature and represent an

²⁷ Bodde, D. and C. Morris (1967). Law in Imperial China: exemplified by 190 Ch'ing Dynasty cases, with historical, social, and juridical commentaries. Cambridge (Mass.): Harvard University Press; London: Oxford University Press, at 4.

²⁸ Ibid. See also Redding, S. G. (1990). The spirit of Chinese capitalism. Berlin, W. de Gruyter, at 48.

²⁹ Tomasic, R. and J. Fu (1999). “Company Law in China”, in Tomasic, R. (1999). Company law in East Asia. Aldershot, Ashgate at 135.

³⁰ “Ultimately, there is the issue of market culture and the general murkiness of the China business environment. Can we really expect former government workers (as red-chip employees are) to embrace a culture of shareholder value, or are they more likely to view corporatisation as an opportunity for personal enrichment?” said a commentator. Brooker, M. (2002). Tannery Stink Spoils Theory. South China Morning Post. August 27, at.2.

³¹ In 2005, the three independent directors in Guangdong Kelon Electrical Holdings who resigned stated in a resignation letter: “We think the company does not support our duty to protect shareholder rights,” alleging that the company did not listen to their advice or provide enough information when they looked into several “abnormal” transactions. See ‘Kelon gets fined for accounting fraud’, People’s daily, 2005, December 8, at 3.

attempt to rest the legitimacy of the post-Mao regime in part on an ideology that complements the government's attempts at economic reform.³² Whilst there are views that to some limited extent there has been an erosion of communist party control over law making in China³³ and attempts have been made to centralize power and rationalize the legal system, particularly in recent years, the legalization process remains primarily a relatively new means for the CCP to legitimize its regime and power control over the Chinese state. Nevertheless, the various processes of legalization remain inherently embedded with the characteristics of the Chinese legal tradition and their impact on the legal system remains dubious. The 'moral education' proposed by Jiang Zemin in 2001³⁴ was just one effort amongst several others to balance the rule of law with the rule of (socialist) morality and more recently President Hu Jintao called for 'building a socialist harmonious society'³⁵ clearly building on traditional Confucian elements in a socialist context. In such a cultural and political context the future of the legal system and the long march towards the rule of law remains speculative at best.³⁶

³² See for example Potter, P. B. (1994). "Riding the Tiger - Legitimacy and Legal Culture in Post-Mao China." China Quarterly(138): 325-358.; Potter, P. B. (1999). "The Chinese legal system: Continuing commitment to the primacy of state power." China Quarterly(159): 673-683.

³³ Tanner, M. S. (1994). "The Erosion of Communist-Party Control over Lawmaking in China." China Quarterly(138): 381-403.

³⁴ There were many reports in the Chinese press on Jiang's proposition of the moral education, see for example commentaries in *The People's Daily*, 1 and 22 February, 2001; 7 and 29 April, 2001.

³⁵ This call was made at the sixth plenary session of the 16th Central Committee in 2006. For a full report by Wu Bangguo, Chairman of the Standing Committee of the National Peoples Congress, see *The People's Daily*, 20 October, 2006.

³⁶ See for example Liang, B. (2009). The changing Chinese legal system, 1978-present : centralization of power and rationalization of the legal system. London, Routledge.; Peerenboom, R. P. (2002). China's long march toward rule of law. Cambridge, Cambridge University Press.; Lubman, S. (1995). "Introduction - the Future of Chinese Law." China Quarterly(141): 1-21.

Again, the cultural values of China³⁷ may indicate that the practice of auditing and behaviour of auditors as practiced and required in Western countries may not be easily transported to PR China. Guanxi (complex interpersonal relationships) and networking are important components of Chinese business behaviour. Regarding financial transparency, most listed companies in China are audited by local accounting firms but no reliable information exists to determine which accounting firms are more reputable.

2.2 The largest shareholder is the state

Most of the listed companies are SOEs, and mostly controlled by the state. The state has incentive to keep enough equity interest so it can achieve some policy goals easily through the listed firm vehicle, such as the maintenance of urban employment levels, direct control over sensitive industries, or politically motivated job placement.³⁸ Indeed, the Chinese

³⁷ In this context the greater cultural norms generally affecting a society, see Trompenaars, A. and C. Hampden-Turner (2000). Riding the waves of culture : understanding cultural diversity in business. London, Nicholas Brealey.; Hofstede, G. and G. J. Hofstede (2005). Cultures and Organisations: Software of the Mind New York, McGraw-Hill.; Hofstede, G. (2001). Culture's consequences : comparing values, behaviors, institutions, and organizations across nations. Thousand Oaks, Calif. ; London, SAGE.; Lewis, R. D. (2006). When cultures collide : leading across cultures. Boston ; London, Nicholas Brealey International. To some extent Psychological aspects are important, see Nisbett, R. E. (2003). The geography of thought : how Asians and Westerners think differently-- and why. London, Nicholas Brealey.

³⁸ Thus, we should understand as internally contradictory various proposals for the state to retain ownership of certain enterprises but to run them entirely on profit-oriented lines. Tenev and Zhang (2002) go even further by suggesting that the state's current equity stake be replaced by an interest akin to nonvoting preferred stock. See, Tenev, S., C. Zhang, et al. (2002). Corporate governance and enterprise reform in China : building the institutions of modern markets. Washington, D.C., World Bank : International Finance Corporation. The problem of continuing state ownership of enterprises cannot be finessed so easily. Nonvoting preferred stock might be a good investment in the right circumstances, but it is hard to see why a policy maker who believes that state ownership ought to mean something would be satisfied with it or why the state should commit itself never to sell it. Indeed, in replacing its equity stake with nonvoting preferred stock, the state would be giving up its ability to use control not just to pursue noneconomic goals, but also to defend itself from exploitation by management or controlling shareholders or even to exploit other shareholders for its own economic benefit.

Communist Party's role is central within most listed Chinese companies and Art 19 of the Company Law (as amended in 2005) provides that "In accordance with the Constitution of the Communist Party of China, the organization of the Communist Party of China shall be established in a company so as to carry out the activities of the Communist Party. The company shall provide its communist organization with conditions necessary for carrying out its activities." It is often the case that the Chairman of the company is also the Party Secretary of the local Communist Party branch within the company, effectively fusing managerial and political control in one office.

Secondly, the ownership structure makes it very difficult to establish an efficient takeover market and a primary stock market. "A prominent characteristic of Chinese listed companies is an overwhelmingly large percentage of non-tradeable shares, which represent about 2/3 of all the listed company's combined equity. The tradable shares represent the remaining 1/3"³⁹ The local office of the Bureau of State Asset management (BSAM) or its local subsidiaries, called state asset management companies, act as the largest shareholder. The chairman of the board of directors is usually a representative from the BSAM. This causes BSAM officials to align their interests with the local government,

³⁹ China Corporate Governance Report 2003 – Executive Summary, Shanghai Stock Exchange, at 8, available at <http://72.14.203.104/search?q=cache:ZzgLit8VlvOJ:rru.worldbank.org/Discussions/O>.

whose political interests may be to preserve employment rather than increase the efficiency of listed SOEs. This also has implications for minority shareholder actions since the ultimate majority shareholder is the state.⁴⁰

2.3 The role of the CSRC

In theory, the securities market principal watchdog-China Securities Regulatory Commission (CSRC), should assume the primary responsibility of supervising and monitoring the stock market by promoting good behaviour and truthful disclosure and by punishing wrongdoers. In practice, they have to face conflicting situations. On the one hand, the controlling shareholders of most listed companies are usually local governments or entities controlled by them. On the other hand, as a quasi-governmental agency, the CSRC lacks independence and is ultimately subject to government interference. Even worse, at times the CSRC is blamed for being unable to control the corruption cases that its own investigative efforts are increasingly bringing to light.

⁴⁰ See for example, Weideman, A., *supra* footnote 2; and McNeil, M. I. (2002). "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies." *Journal of Corporate Law Studies* 289: 308-312.

2.4 Different nature of the judicial system in China

The Chinese courts are widely perceived as lacking independence from government and as having insufficient experience to deal with corporate and securities disputes. The Chinese view their judicial system as merely another bureaucratic body. For example, Courts' loyalty to the Chinese Communist Party was re-emphasized in 2006 with the launching of a new campaign on "socialist rule of law theory". Thus, the judiciary in China has not played a dynamic role in developing a body of law to protect the interests of minority shareholders. Indeed, it is not unusual for courts to decide not to deal with a particular matter, regarding it as beyond their competence, and instead referring it to another branch of government.⁴¹

2.5 The role of investors

There are so many investors coming into the Chinese stock markets who do not understand the risks. Investors have very few alternatives for capital investment in China. Because of capital account controls, investors cannot easily remit financial assets out of the country to invest in equities overseas. Investing in equities has been a popular way to invest.

⁴¹ Tomasic, R. and A. Neil (2007). "Minority shareholder protection in China's top 100 listed companies." Australian journal of Asian law 9(1).

Only a third of the shares of a typical SOE are tradable in the market. The market is not very liquid in general. Thus, some investors view stock buying as a speculation tool for gains from short-term share trades in the secondary market rather than a long-term, value-based investment vehicle. Some even believed that as long as there was a ‘fool’ willing to buy shares from the previous holders, everybody can make gains in share trades until the last ‘fool’ is unable to find anyone else to sell the shares to, and bears all losses as the unlucky end chain of the ‘fool’s game’⁴². As a result, investing in the stock market has become one of the most risky investment activities in China.

2.6 The principle of the corporation’s responsibility to society is a product from the era of planned economy

In 1949 the Chinese Communist Party (CCP) came to power. The communist government assumed the responsibilities of protecting all worker interests. From the earliest days of communist rule, membership of a *Danwei* (a general term for a unit of production) as a SOE worker was of great value to workers not only because of the monetary benefits, but also because workers regarded their job as their lifetime employment

⁴² Leng, J. (2006). The interaction between domestic and overseas capital market and corporate governance of Chinese Listed companies. Corporate governance Post-Enron: Comparative and international Perspectives
J. J. Norton, J. Rickord and J. Kleinman, British Institute of International and comparative law at 293

position which also defined their social identity within society. During that period, China adopted a socialist planned economy, under which enterprises were owned and controlled by the state, “with all key decisions being made in accordance with State policy and objectives”⁴³ SOE employees usually enjoyed health services, housing, pensions, education, and entertainment provided by their enterprises. In every sense the system provided workers with what was colloquially called the ‘iron rice bowl’. This provides an interesting scope for the study of corporate governance in China in terms of the borrowings (or transplants) from Germany in the adaptation of the two tier board system and worker representation. The extent to which co-determination has been adopted in China in a context where party control remains central will provide insights into the political determinants of corporate governance in a system where independent trade unions simply do not exist.⁴⁴

Since 1978, China has chosen a route of evolutionary transformation from a central-planned economy to a free-market economy. Market reform has changed state–labour relations. The government abandoned all ideological, political and moral imperatives for job security in SOEs.

⁴³ Gul, F. A. and J. S. L. Tsui (2004). The governance of East Asian corporations : post Asian financial crisis. Basingstoke ; New York, Palgrave Macmillan, at 27.

⁴⁴ See Phillion, S. E. (2009). Workers' democracy in China's transition from state socialism. New York ; London, Routledge.; Blecher, M. J. (2002). "Hegemony and workers' politics in China." China Quarterly(170): 283-303.; Solinger, D. J. (2002). "Labour market reform and the plight of the laid-off proletariat." China Quarterly(170): 304-326. ; Cai, Y. S. (2002). "The resistance of Chinese laid-off workers in the reform period." China Quarterly(170): 327-344.

When workers relationship with the SOEs cease, they lose their high self-esteem as members of a leading class. This has led to a degree of resistance and arguments based on the former promises of the communist government.⁴⁵

2.7 The Chinese supervisory board's apparent resemblance to the German model is confined mostly to its name and the participation of workers

The law makers in China adopt the German model of a two-tier board system because the ideal of co-determination between capital and labour would seem to enhance internal unity and company performance. The Chinese Company Law expects that the board of supervisors will perform a supervisory role by simply saying that it will, without actually giving the board any significant powers⁴⁶ or providing structurally for its independence from those supervisors.⁴⁷

The establishment of the supervisory board in China is not based on the same social and philosophical considerations as for the setting up of supervisory boards in the German codetermination model of corporate

⁴⁵ See in particular Cai (2002) and Blecher (2002) *supra* note 44.

⁴⁶ See Wang, J. (2008). "The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies." *The Compliance and Regulatory Journal* 3: 49.

⁴⁷ *Ibid*, at 52.

governance. No broader social and historical issues seem to have been involved in designating the official functions⁴⁸ of the supervisory board in China, other than a desire to provide another organizational layer for a rather loosely defined monitoring role over the board of directors and managers.⁴⁹

3. The objective of this research

Chinese commentators' views on the concept of corporate governance have been substantially influenced by corporate governance theories in developed economies most of which have been referred to at the beginning of this introduction. There are clearly certain corporate governance practices and mechanisms, mostly from the European and Anglo-American models, that are adopted in China.

One main objective of this study is to analytically explore legal, cultural, social, institutional, historical, political, economic and other factors affecting the resulting differences in implementation that have been observed in China. Chapters in this research address these issues from various perspectives.

⁴⁸ The Company Law 2005, Articles 67, 81, 118. Only limited liability companies and joint stock companies with limited liabilities are to set up supervisory boards, wholly state-owned companies do not have supervisory boards.

⁴⁹ Tam, O. K. (1999). The development of corporate governance in China. Cheltenham, Edward Elgar, at 86.

The methodology used is a library based one. Given the wide range of issues which it is proposed to cover in this thesis it is proposed to draw together and integrate key aspects that influenced the unfolding story of corporate governance in China. By drawing on a wide range of factors (and therefore disciplines) which it is argued impact on the corporatization of SOEs it will be argued that China's path of corporate governance development is uniquely Chinese in nature. This is because the processes involved remain imbued with Chinese characteristics, particularly political and cultural ones which have impacted on the development of the legal regime and corporate governance practices. A library based methodology is therefore considered appropriate to draw together various strands of thought which help to illuminate and give some recognizable pattern to the kaleidoscopic nature of corporate governance in China.

4. The structure of this research

Globalization has had major impacts on business activities in countries throughout the world. Chapter 2 focuses on the questions of whether a transformation in the world business environment has [already] caused a convergence of corporate governance whereby cultural factors are losing their influence. Whether globalization is reducing the diversity in

corporate governance practices in China or not is an important question considered in this section of the thesis.

In order to understand China's current approach to enterprise reform and corporate sector development in its institutional and developmental context, it is important to consider the background and meaning of several key concepts and practices, some of which China has borrowed from mature market economies. Thus, Chapter 3 focuses on internal corporate governance mechanisms and corporate performance in China. This chapter evaluates the effectiveness of independent directors, directors' duties and the role of the supervisory board in China.

The purpose of chapter 4 is to assess the role currently and potentially performed by institutional investors in China. In exploring whether the rise in institutional shareholdings has had a measurable impact on corporate performance so far in China will help to examine whether this development has potential for enabling future improvements in practice.

Chapter 5 focuses on the legal infrastructure and minority shareholder protection in China. The Chinese regulatory body adopted policies based on Western theories on the positive link between capital market development and public shareholder protection. However, the real

situation in China is different. The issue of how to protect the rights of minority shareholders is an important one in China where the State is by far the largest majority shareholder of many listed companies, and where auditors and the judiciary lack independence from governance. Given that there is presently and for the foreseeable future no real market for corporate control and minority shareholder protection is in its infancy, China lacks mechanisms for the disciplining of management.

The social responsibility model of governance in China is a product from the era of planned economy. SOE employees usually enjoy health service, housing, pensions, education, and entertainment provided by their enterprises. Market reform has changed state-labour relations. Chapter 6 discusses the issues that have arisen as a result of the shift in the governance practices in China. Will similar institutions, trade unions or collective bargaining, be stable institutional responses to their circumstances? Will workers have voice in the company and are their interests a legitimate concern for those who direct and manage China's corporations?

Chapter 2 Globalization and tradition: When East meets West

2.1 Introduction

Globalization appears to be associated with a disjunction of space and time,¹ a shrinking of the world.² The global economy - driven by increasing technological scale, alliance between firms, and information flows³ is one “with the capacity to work as a unit in real time on a planetary scale”.⁴ It is also one in which national economies become more interdependent in terms of trade, finance, and macroeconomic policy.⁵ Some scholars argue that convergence in organizational patterns is taking place as result of globalization.⁶ Other researchers see globalization as promoting diversity in the world as opposed to homogeneity.⁷

However, one of the most frequent complaints about globalization is that it is equivalent to Americanization. There are widespread fears that in today's borderless, high tech world, national differences will be

¹ Giddens, A. (1990). The consequences of modernity. Cambridge, Polity in association with Blackwell. at 64.

² Mittelman, J. H. (1996). The Dynamics of Globalization. Globalization : critical reflections- International political economy year book. J. H. Mittelman. Boulder, Colo. ; London, Lynne Rienner Publishers, at 3: .

³ Kobrin, S. J. (1998). "Back to the Future: Neomedievalism and the Postmodern Digital World Economy." Journal of International Affairs 51.

⁴ Castells, M. (1996). The rise of the network society. Cambridge, Mass. ; Oxford, Blackwell Publishers. at 92.

⁵ Gilpin, R. (1987). The political economy of international relations, Princeton University Press.at 389

⁶ Hamel, G. and C. K. Prahalad (1996). "Competing in the new economy: Managing out of bounds." Strategic Management Journal 17(3): 237

⁷ Guillen, M. F. (2001). "Is globalization civilizing, destructive or feeble? A critique of five key debates in the social science literature." Annual Review of Sociology 27: 235-260., and Macey, J. R. and G. P. Miller (1995). "Corporate governance and commercial banking: A comparative examination of Germany, Japan, and the United States." Stanford Law Review 48(1): 73-112.

overwhelmed by American economic and cultural domination.⁸ Indeed, corporate law scholars debate whether a transformation in the world business environment has [already] caused a convergence of corporate governance whereby cultural factors are losing their influence.⁹ An often posited question has been whether the United States style of corporate governance practices and structures ultimately will prevail in China?

2.2 Globalization means Americanization?

Some scholars believe that the increase in foreign direct and portfolio investment---with the concomitant rise of powerful multinational corporations and institutional investors---are commonly cited as pressures tending toward convergence.¹⁰ Large multinational corporations such as Daimler-Chrysler list their shares both on European and United States stock exchanges.¹¹ The SEC (US Securities and Exchange Commission) had been working with the International Organization of Securities Commissions (IOSCO) to develop international standards for

⁸ Dale, R. (2000). "'Americanization' Has Its Limits " International Herald Tribune 25: 9.

⁹ Fanto, J. A. (1998). "The role of corporate law in French corporate governance." Cornell International Law Journal 31(1): 31-91.

¹⁰ Guillen, M. F. (2004). Corporate governance and globalization: is there convergence across countries. Theories of corporate governance : the philosophical foundations of corporate governance. T. Clarke. London, Routledge: 226.

¹¹ Cunningham, L. A. (1999). "Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance." Cornell Law Review, 84: 1194.

nonfinancial statement disclosure.¹²

The Economic Cooperation and Development (OECD) document highlights the increased profile that governance issues have attained around the world. The OECD's recommended principles of corporate governance cover five areas of concern (1) the rights of shareholders (2) the equitable treatment of shareholders, (3) the role of stakeholders in corporate governance, (4) disclosure and transparency, and (5) the responsibilities of the bourse.¹³

Most financial experts and money managers would prefer companies throughout the world to observe shareholder rights, maximize shareholder value, and be transparent in their reporting of corporate activities and results. The rise of globally diversified mutual funds seems to create pressures for the standardization of information on companies in major overseas institutional investors like *Calpers* (the California State Pension Fund) have required standards of disclosure and governance practices similar to those in their home jurisdictions.¹⁴ Given that evidence and its largely United States-European bias, it seems a stretch to conclude that

¹² Ibid, at 1194

¹³ Emmons, W.R. and Schmid F. A. (2000). "Corporate governance and corporate performance" in Cohen, S. S. and G. Boyd (2000). Corporate governance and globalization : long range planning issues. Cheltenham, Edward Elgar.

¹⁴ Ibbotson, R., G. and G. P. Brinson (1993). Global Investing: The Professional Guide to the World's Capital Markets. New York., McGrawHill.

“[c]ross border alliances among businesses are leading to the articulation of a new global corporate governance template which uses existing tools to build a new corporate world order.”¹⁵ Thus, two prominent specialists even proclaimed ‘The end of History for Corporate Law.’¹⁶ As a result of the pressures for convergence which they identify they argue that the last decade or so have brought strong evidence of a growing consensus on convergence issues among the academic, business, and governmental elites in leading jurisdictions.

Others believe that the globalization of the financial markets will, inevitably, lead to a convergence of corporate governance expectations and, thus, practices.¹⁷ Professor John Coffee predicts global convergence through “the backdoor”, so to speak, as foreign firms seek stock exchange listings in the United States and thus make themselves subject to United States style corporate governance norms.¹⁸ Foreign issuers arrive on United States shores because of the strength of United States capital markets. In turn, the strength of United States capital markets stems from the protection United States law extends to minority investors in United

¹⁵ Cunningham, L. A. (1999). "Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance." *Cornell Law Review*, **84**: 1194.

¹⁶ Hansmann, H. and R. Kraakman (2001). "The end of history for corporate law." *Georgetown Law Journal* **89**(2): 439-468.

¹⁷ Editorial (1999) "Corporate Governance-the global state of the art" *Corporate Governance-An international review* 7(2) at 118; Hansmann, H. and R. Kraakman (2002). *Toward a single Model of Corporate Law?* In *Corporate governance regimes : convergence and diversity*. J. McCahery. Oxford, Oxford University Press: 56.

¹⁸ Coffee, J. C. (1999). "The future as history: The prospects for global convergence in corporate governance and its implications." *Northwestern University Law Review* **93**(3): 641-707.

States enterprises.¹⁹ However, the China Aviation Oil (CAO) episode exemplifies the limits of strategies aimed at outsourcing law enforcement, for example by listing a Chinese company on a foreign stock exchange and thereby subjecting it to a more robust legal regime – in this case that of Singapore.²⁰ The basic theme of such outsourcing arguments is that firms located in weak corporate governance regimes, in particular those in developing countries and emerging markets, may counter these disadvantages by obtaining listings on foreign stock exchanges. Theoretically, the firm integrates into the governance and disclosure regime of the foreign country thereby signalling to investors that its management is capable of compliance with higher governance standards than those pertaining in the firm's home country.²¹ Whilst there is some empirical evidence in support of this thesis²² the CAO example is one example where the weak domestic corporate governance regime was exported to the foreign listing environment. As a result minority shareholders were victimized by a foreign parent company operating by very different rules whereby, in exploiting a gap in Singapore's listing rules the Chinese SOE parent company was able to privately place shares

¹⁹ Ibid. at 644 ,698

²⁰ Burton, J. (5 Jan 2005). CAO Seeks \$500m Debt Write-offs, Financial Times

²¹ Coffee, J. C. (2002). "Racing towards the top?: The impact of cross-listings, and stock market competition on international corporate governance." Columbia Law Review 102(7): 1757-1831.; Gilson, R. J. (2001).

"Globalizing corporate governance: Convergence of form or function." American Journal of Comparative Law 49(2): 329-357. For a contrary view, see Licht who argues that cultural factors often militate against the influence of the governance norms and practices of the host listing country, Licht A. N., "The Mother of All Path Dependencies: Towards a Cross-Cultural Theory of Corporate Governance" available at http://papers.ssrn.com/paper.taf?abstract_id=208489.

²² Reese, W. A. and M. S. Weisbach (2002). "Protection of minority shareholder interests, cross-listings in the United States, and subsequent equity offerings." Journal of Financial Economics 66(1): 65-104.

without full disclosure, in order to raise capital to cover its listed subsidiary's losses. All of this was done to save both the subsidiary and its parent from disgrace.²³

Foreign issuers go to the United States shores, however, because that is where the money is, not because of the protection United States law may once have given to minority shareholder interests. And the United States supply of capital is not inexhaustible and is not exclusive. There is a great deal of money elsewhere in the world, for example, in Dubai, Hong Kong, Singapore, Shanghai and Tokyo, to name a few international banking centres. In fact, in February 2000, perhaps aware of strong capital markets in East Asia, seven United States high tech firms listed their common shares on the Hong Kong Stock Exchange.²⁴ The growth of Asia's emerging economies will also shift the world's financial centre of gravity east. As a result: "Wall Street will no longer be the centre of the universe," according to Stephen Green, group chairman of HSBC Holdings Plc when he gave a speech at the Spruce Meadows Changing Fortunes roundtable in Calgary.²⁵ Today, Sovereign wealth funds are the investment funds established by governments in the Middle East and

²³ See Milhaupt, C. J. and K. Pistor (2008). Law and capitalism : what corporate crises reveal about legal systems and economic development around the world. Chicago, London, University of Chicago Press at 140.

²⁴ "International Developments: Seven NASDAQ Stocks to be available in Hong Kong In Pilot Program", available at http://english.peopledaily.com.cn/english/200005/29/eng20000529_41836.html

²⁵ "HSBC's Green says Asian demand to spur inflation", available at http://www.forbes.com/reuters/feeds/reuters/2008/09/05/2008-09-05T205619Z_01_N0584146_RTRIDST_0_CANADA-BANKS-HSBC-PIX.html.

China, with large surpluses of money. Indeed, after the recent banking crisis in the Western developed countries, this is increasingly the case. Recently, OECD Secretary General Angel Gurría even said that sovereign wealth funds were part of the solution to the current credit crunch.²⁶

Again, some United States scholars have a very one-sided view of what globalization is and what may be expected of it. They believe that “Global” convergence in corporate governance is that United States style corporate governance practices and structures ultimately will prevail in some world wide market-place of ideas. Instead, the recent globalization is, in part, a technological and telecommunications revolution, a phenomenon of the information age, which will not necessarily erase all differences and barriers between nations and cultures.²⁷ The previous age of globalization was brought to an end by the First World War and is not simply a modern phenomenon.²⁸ The process of globalization does not as yet seem to have changed national structures very much. As Scott has pointed out, from a sociological perspective, any comparative account of corporate control, whilst recognizing that there are common uniformities in all of the major capitalist economies such as the use of technologies and business practices there remain, however, equally important

²⁴ “Lifting the lid on sovereign wealth funds”, available at <http://news.bbc.co.uk/1/hi/business/7430641.stm>

²⁷ Guillen, M. F. (2004). Corporate governance and globalization: is there convergence across countries. Theories of corporate governance : the philosophical foundations of corporate governance. T. Clarke. London, Routledge: 226.

²⁸ Freguson, N. (2005). “Is Globalization Doomed.” Foreign Affairs 84.

divergences. These arise from different countries' and regions' specific historical experiences and various cultural and legal systems. As a result, he argues for example, that the pattern which taken by impersonal possession in Britain, the USA Australia, Canada and New Zealand is to be seen as the outcome of a specific convergence of national and international forces in the Anglo-American, English speaking world. The national variations referred to earlier shape the constraints which operate on the actions and orientation of business leaders. This results in a number of alternative patterns of capitalist development.²⁹ Whilst there considerable variations within the Anglo-American countries listed above³⁰ in other parts of the world, which are impacted by other forces, even greater differences in patterns of impersonal possession are apparent. In terms of convergence in corporate governance fundamental reforms must be enacted in individual countries in the face of what is likely to be strong resistance by parties well served by the current system.

²⁹ Scott, J. (1990). "Corporate-Control and Corporate Rule - Britain in an International Perspective." British Journal of Sociology 41(3): 351-373. ; See also Scott, J. (1997). Corporate business and capitalist classes. Oxford, Oxford University Press. For the literature on varieties of capitalism, see Hall, P. A. and D. W. Soskice (2001). Varieties of capitalism : the institutional foundations of comparative advantage. Oxford, Oxford University Press, at 387, 388.; Dore, R. P. (2000). Stock market capitalism, welfare capitalism : Japan and Germany versus the Anglo-Saxons. Oxford, Oxford University Press. ; and for business systems in Asia with particular reference to China, Japan and Korea, see Whitley, R. (1992). Business systems in East Asia : firms, markets and societies. London, Sage. ; Whitley, R. (1999). Divergent capitalisms : the social structuring and change of business systems. Oxford, Oxford University Press.

³⁰ See for example, Miller, G. P. (1998). "Political Structure and Corporate Governance: Some Points of Contrast between the United States and England." Columbia Business Law Review 52. Which argues that in the UK the market for corporate control is the real force disciplining management whereas in the USA it is shareholder (including minority shareholders) actions; Morck R. K, Percy M, Tian Gy and Yeung B, "The Rise and Fall of the Widely Held Firm: A History of Corporate Ownership in Canada" which outlines the failure of the 'Berle and Means' type corporation in Canada and Franks J., Mayer C. and Rossi S., "Spending Less Time With the Family: The Decline of Family Ownership in the United Kingdom" outlining the change in family control of corporate businesses in the UK, both in Morck, R. (2007). A history of corporate governance around the world : family business groups to professional managers. Chicago, Ill., University of Chicago Press ; Bristol : University Presses Marketing [distributor].

2.3 The U.S. style has shifted

The United States, so strongly identified with the Berle-Means pattern of separation of ownership and management control today, was not always thus. In the late nineteenth century, patterns of ownership of large firms looked far more like Germany than they do now. U.S. firms began with concentrated inside owners, the blockholding model, as have most firms around the world. At that time, large ‘trusts’ or oligopolies were controlled by shareholder blocks in the hands of individuals and banks; minority shareholder protection was weak, insider trader scandals common. The United States then began to create shareholder protections through listing requirements on stock exchanges. Legislation, stimulated in part by earlier scandals, produced financial separation of firms from insurance companies and banks.³¹

The laws were passed: the Sherman Antitrust Act in 1890, several laws following the 1905 Armstrong Commission on the insurance industry, the Glass-Steagall Act on banking in 1933, the Securities and Exchange Act of 1934, and now Sarbanes-Oxley of 2002. It is this legislation, regulatory structure, and their enforcement that changed corporate

³¹ Gourevitch, P. A. and J. Shinn (2005). Political power and corporate control : the new global politics of corporate governance. Princeton, N.J. ; Woodstock, Princeton University Press.

governance in the United States.³²

The United States has relatively low private blockholding ratios. However, there are still several old-line, family-controlled firms on U.S. exchanges, the American equivalent of Germany's Mittelstand, and even a family-controlled industrial giant, Ford Motor, controlled by the eponymous family through the mechanism of closely held preferred voting shares just like the Quandt family at BMW. Aside from this handful of old-line, family-controlled firms, most current private blockheld firms in the United States are in relatively young high-tech firms with a large market cap such as Microsoft, Oracle, and Google, whose founder-entrepreneurs continue to hold a stake in the firm above the 10 percent control threshold.³³ Nevertheless, family controlled firms have played a major part in the history of corporate America and remain an important contributor to the US economy.³⁴

³² Ibid. at 2

³³ Ibid, at 242

³⁴ Hall, P. D. (1988). "A Historical Overview of Family Business in the United States." Family Business Review 1(1). ; Astrachan, J. H. and M. C. Shanker (2003). "Family Businesses' Contribution to the US Economy: A Closer Look." Family Business Review September 1. ; and see Lamoreaux, N. R. "Partnerships, Corporations and the Limits on Contractual Freedom in US History: An Essay in Economics, Law and Culture" and Dunlavy A. C., "From Citizens to Plutocrats: Nineteenth-century Shareholder Voting Rights and Theories of the Corporation" both in Lipartito, K. and D. B. Sicilia (2004). Constructing corporate America : history, politics, culture. Oxford, Oxford University Press.

2.4 Culture can thrive beneath the law

The starting point for mapping the processes of legal change is the empirical view of law as an ‘aspect of society’.³⁵ It takes the view that law and the social context in which it operates need to be examined together.³⁶ This view emphasises the ways in which law and legal culture are embedded in broader social structures including history, politics, state and possibly non-state institutions.³⁷ To invoke Professor Alford:

“Legal doctrine cannot be understood simply as written, in isolation from other social phenomena. Implicit in this is the idea that law is contested and dynamic, even in our own legal system [the author is referring to the USA] and others that we might be inclined to think of as already largely ‘developed’”.³⁸

The legal argument against convergence in corporate governance notes that corporate law is intimately related not only to social custom but also

³⁵ Cotterrell, R. (1995). Law's community : legal theory in sociological perspective. Oxford, Clarendon., discussing empirical legal theory and contrasting it with normative legal theory. See also his idea of law as ‘institutionalised doctrine’ (at 4). Legal doctrine, he argues is shaped by ‘pre-existing patterns of power’ (at 8), as well as the practical and institutional contexts in which law is developed and used (at 4).

³⁶ Moore, S. F. (1978). Law as process : an anthropological approach. London, Routledge and Kegan Paul.

³⁷ See, generally Young, A. (2008). "Rethinking the fundamentals of corporate governance: the relevance of culture in the global age." The Company Lawyer; Zimmermann, R. O. and M. Reimann (2006). The Oxford handbook of comparative law. Oxford, Oxford University Press.

³⁸ Alford, W.P. (2003). "The more law, the more...? Measuring legal reform in the People's Republic of China." in Hope, N. C., D. T. Yang, et al. (2003). How far across the river? : Chinese policy reform at the millennium. Stanford, Calif., Stanford University Press at 56.

to other legal areas, such as banking, labour, tax, and competition law. Such complex systems of laws and regulations evolve in a path-dependent way and are resistant to change.³⁹ In most 'Western' free and democratic societies, the citizenry have, over time, insisted on a right to investigate and criticize lawmakers and place constraints on their behaviour.⁴⁰ When faced with international or "global" proposals akin to law, the nation state may view the proposals with a greater degree of scepticism. This is often because, even if the domestic decisionmaker is a bureaucrat, he still bears some political accountability for the government's choices. On the other hand, the international lawmaker rarely faces the same degree of political accountability. What often underlies the sceptical position is a belief that the more accountable decisionmaker should receive the benefit of the doubt.⁴¹ International unification and harmonization efforts also encounter scepticism because they lack the transparency of local lawmaking. This is because interest groups tend to incur lower costs of expressing their preferences to executives engaged in international lawmaking than in conveying their wishes to domestic legislators. In contrast the general public has higher monitoring costs with respect to international lawmaking.⁴²

³⁹ Guillen, M. F. (2004). Corporate governance and globalization: is there convergence across countries. Theories of corporate governance : the philosophical foundations of corporate governance. T. Clarke. London, Routledge: 226.

⁴⁰ Stephan, P. B. (1997). "Accountability and International Lawmaking: Rules, Rents and Legitimacy." NW. J. Int'l L. & BUS 17: 682.

⁴¹ Ibid. at 732.

⁴² Ibid. at 699

Again, bureaucrats will decrease transparency and engage in turf protection because they will feel threatened by harmonization-unification and the end of their ability to engage in rent seeking.⁴³ Zweig has particularly criticized this aspect of ambiguous laws in China which has allowed government officials at many levels from the various hierarchies of local government to industrial ministries and enterprise zone officials to earn fees for guiding the foreign investor through the regulatory maze.⁴⁴ In the context of corporate governance, foreign institutional investors may also be dubious of the laws for minority shareholder protection in relation to their investments in listed Chinese firms. However, they also factor into the equation the rapid growth in firms' aggregate revenues and in earnings which can offset many sins, including an expropriation "tax" to corrupt officials and venal managers.⁴⁵ These global investors can also reap the gains in portfolio diversification from holding in stock markets whose correlation with the NYSE are far lower than Europe or Japan, and for most emerging markets.⁴⁶ Some multinationals were hailed for introducing concepts of market-driven competition and business fair play, and for bringing in capital, but it

⁴³ Agrawal, A. and C. R. Knoeber (1996). "Firm performance and mechanisms to control agency problems between managers and shareholders." *Journal of Financial and Quantitative Analysis* 31(3): 377-397.

⁴⁴ Zweig, D. (2002). *Internationalizing China : domestic interests and global linkages*. Ithaca, N.Y. ; London, Cornell University Press at 264-7.

⁴⁵ Such as, Zhang Enzhao , the former head of Construction Bank of China , was given a 15-year sentence for corruption. But Zhang was not the only guilty party. The U.S. computer giant IBM is also embroiled in this scandal. Zhang, former chairman of the China Construction Bank, was accused of taking a 4.15 million yuan (520,000 U.S.dollars) bribe to arrange loans and facilitate contracts. IBM was only one of a number of foreign companies which had secret deals with Zhang. Available at http://english.people.com.cn/200611/17/eng20061117_322599.html

⁴⁶ Some of the less conflicted international institutional investors, such as CalPERS, have declined to participate in the Chinese Listed market.

seems that many of them have adapted to the local business environment in the wrong way.⁴⁷

2.5 The culture beneath the law and behind economic and other institutions

The culture beneath the law and behind economic and other institutions is as, or more important than, law itself, legal structures, and good governance practices. Licht asserts that culture does matter in corporate governance and notes:

"A nation's culture can be perceived as the mother of all path dependencies. Figuratively, it means that a nation's culture might be more persistent than other factors believed to induce path dependence. Substantively, a nation's unique set of cultural values might indeed affect--in a chain of causality--the development of that nation's laws in general and its corporate governance system in particular."⁴⁸

According to Tricker (somewhat reflecting Scott discussed earlier) the heart of the matter is the manner in which culture, as a process, tends, cultivates and regulates particular types of economic outcomes."⁴⁹ Lannoo

⁴⁷ See note 36. See also Companies international: Probes under foreign corruption law, Financial Times, Published on Feb 14, 2007.

⁴⁸ Licht, A. (2001). "The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems." *Delaware Journal of Corporate Law* 26(1): 149.

⁴⁹ Tricker, R. I. (1990). Corporate Governance: A Ripple on the Cultural Reflection., *Capitalism in contrasting*

observes that European legislators have fought considerable battles over the last 25 years to bring some harmonization to standards for corporate control in the EU, but that their efforts have been thwarted by “irresolvable disagreements among member states”.⁵⁰ Instead, he argues that either the private sector, industry or the European Commission should take the initiative to come up with a European-wide code of best practice. In his view it is improbable that any significant harmonization of corporate governance standards will occur at the European level.⁵¹ However, Susan Binns, of the European Commission, notes that researchers remain engaged in searching for economic evidence that one approach to corporate governance produces better results than another. She concludes that it is better to leave these issues for regulation at the national level, whilst avoiding “too much divergence in national rules and practices.”⁵²

Some debates from Asian countries suggest that many Asian administrations widely believed that ‘one size does not fit all.’ This is basically a metaphor for North American attempts to impose their standards on developing economies. From this Asian perspective an

cultures S. Clegg, S. G. Redding and M. Cartner. Berlin ; New York, W. de Gruyter: 32.

⁵⁰ Lammoo, K. (1999). "A European perspective on corporate governance." Journal of Common Market Studies 37(2): 270.

⁵¹ Ibid.

⁵² Gindin, S.E. (1998) As the cyber-world turns: the European Union's Data Protection Directive and Trans-border Flows of Personal Data, available <http://www.info-law.com/eupriv.html>

international code of best practice is unworkable.⁵³ For example, South Korea had recently undergone corporate governance reforms in the aftermath of the Asian financial crisis. Licht writes:

"The architects of corporate governance reforms may want to consider the idea of culturally compatible governance ... [t]he far reaching reliance on American models may bring about some improvement. But Korean reformers could devise better corporate governance that draws on the country's huge social capital that its cultural endowment embodies."⁵⁴

The former Prime Minister of Singapore, speaking of the potential twilight of Occidental style capitalism and the rise of Asia and the Pacific Rim as economic powers, described the uniqueness of Asian institutions:

“ for America to be displaced, not in the world, but only in the western Pacific...is emotionally very difficult [for American policy makers] to accept. The sense of cultural supremacy of the Americans will make this adjustment most difficult. Americans believe their ideas are universal-[for example] the supremacy of the individual and free, unfettered expression. But they are not-they never were.”⁵⁵

⁵³ Allen, J. (March 2000). "Code Convergence in Asia: Smoke or fire." Corporate Governance International 3(1): 154.

⁵⁴ Licht, A. (2004). "Legal Plug-in: Cultural Distance, Cross-Listing, and Corporate Governance Reform." Berkeley Journal of International Law 22(1): 232.

⁵⁵ Interview with Lee Kuan Yew (1996), 13 New Persp.Q.4.

United States economic success,⁵⁶ with its concomitant supremacy of the individual, is viewed in much of the world as destructive of social cohesion and to be avoided rather than emulated.⁵⁷ To observers and opinion makers in many countries, the United States's high divorce, murder, and incarceration rates, categories in which the United States leads the world,⁵⁸ together with the obscene rate of United States corporate executive compensation,⁵⁹ symbolize the abandonment of social cohesion and the ascendancy of market style individualism and unbridled greed. In fact, in much of the world the belief is that, by emulating the United States and copying its economic thoughts and institutions, a sort of Gresham's Law⁶⁰ will prevail: bad capitalism (United States style) will drive out good capitalism (family capitalism, bamboo capitalism, guided capitalism).⁶¹ Then, Gray in his criticism of Globalization has argued that the evidence suggests a logical chain that begins deep in the idiosyncratic national histories behind durable domestic institutions and ideologies and extends to firm-level structures of internal governance and long-term

⁵⁶ Unfortunately, the current financial crisis draws gloomy picture for the US economic growth.

⁵⁷ Gray, J. (2002). False dawn : the delusions of global capitalism. London, Granta, at 26.

⁵⁸ Ibid, at 116

⁵⁹ In 1989, US CEOs earned 160 times the pay of the average worker, while in Japan the figure was 16 and in Germany 21. See Graef, S. Crystal (1991), *In Search of Excess -The Overcompensation of American Executives*, W. W. Norton & Company, at 205-09. In 2000, compensation consultant Graef Crystal says "it is 'north of 400 times and heading rapidly to 500 times.'" Kathleen Day, Aug. 27, 2000, *Soldiers for the Shareholder*, Wash. Post, at H1.; In 2009, huge Bonuses paid to executives of the American Insurance Group (AIG) have caused widespread outrage in the US after the US government bailed out the insurer to the tune of \$170bn. See "AIG employee quits at 'betrayal'" available at <http://news.bbc.co.uk/2/hi/business/7964250.stm>.

⁶⁰ Sir Thomas Gresham explained that "bad money drives out good." Lipsey R. G. and Steiner P. O. (3rd ed. 1972), *Economics* 592.

⁶¹ Gray, J (2002), *supra* note 57, at 78-79

financing. In turn, those structures are linked to continuing diversity in patterns of corporate research and development operations in the complex connections between corporate foreign direct investment and intrafirm trading strategies. According to Gray, the basic linkage is that distinctive national institutions and ideologies shape corporate structure and vitally important policy environments in home markets. As a result, the external behaviour of firms continues to be marked by their idiosyncratic foundations.⁶²

“The Myth of Globalization” tells us what is, namely that “national roots remain a vital determinant” and that multinationals’ “corporate cores remain national in a meaningful sense.”⁶³

2.6 Chinese culture and law

Culture and ideology also influence a country’s choice of corporate law. Deresky notes that a society’s culture comprises the shared values, understandings, assumptions, and goals that are learned from earlier generations, imposed by the members of society, and passed on to succeeding generations. This in turn results in a shared outlook. People share to a considerable degree, common codes of conduct and attitudes, and expectations that subconsciously guide and control various norms of

⁶² Ibid. at 139

⁶³ Ibid. at 145

behaviour.⁶⁴

American culture, for example, resists hierarchy and centralized authority more than, for example, French culture.⁶⁵ German citizens are proud of their national codetermination. Italian family firm owners may get special utility from a longstanding family controlled business⁶⁶, while an American family might prefer to cash the company earlier and run the family scion for the U.S. Senate. In China, for example, the existence of Confucian and communist traditions has left deep impressions in the social fabric and the economic landscape⁶⁷.

In the popular view, Confucianism is presented as a deeply rooted despotic socio-political system and an unchanged state-run ideology.⁶⁸ Confucius lived between 551 and 479 B.C., and his ideas were adopted as state orthodoxy in the Han dynasty which lasted from 206B.C. to 220 A.D. For the next thousand years, they contributed to the stability of the state and to the flourishing of a very advanced civilization, clearly pre-

⁶⁴ Deresky, H. (2008). International management : managing across borders and cultures : text and cases. Harlow, Prentice Hall, at 91-92.

⁶⁵ Bebchuk, L. A. and M. J. Roe (1999). "A theory of path dependence in corporate ownership and governance." Stanford Law Review 52(1): 127-170.

⁶⁶ See Bohlen, C., A Delphic Oracle Has Seen the Future, and Likes It, N.Y. TIMES, Apr.14, 1998, at A4 (describing how Giovanni Agnelli's prestige is based on his family's control of Fiat, the Italian automobile maker).

⁶⁷ For a discussion of path dependence in China's economic transition, see Guthrie, D. (2002). Dragon in a three-piece suit : the emergence of capitalism in China. Princeton, N.J. ; Woodstock, Princeton University Press, at 24-41. Some of the distinctive features of Chinese corporate governance are discussed by Tam, O. K. (1999). The development of corporate governance in China. Cheltenham, Edward Elgar, at 86.

⁶⁸ You-Zheng Li, " Towards a Minimal Common Ground for Humanist Dialogue: A Comparative Analysis of Confucian Ethics and American Ethical Humanism", in Mou, B. (2003). Comparative approaches to Chinese philosophy. Aldershot ; Burlington, Vt., Ashgate, at 170.

eminent in world terms by the Sung period. During this same period however, alternative philosophies also flourished most notably Taoism and Buddhism. This synthesis became known as neo-Confucianism, and having developed the original ideas from an ethical code to a full philosophy, it has lasted until the present day.⁶⁹

Confucians emphasized the power of moral teaching as the way to cultivate *li* and to achieve order. They believed that human nature was basically good and that people were responsive to the moral examples of the king and the nobility. Confucian governance was thus a matter of using moral teaching to shape people's behaviour.⁷⁰

At the core of Confucian social order was a series of social relationships, most importantly the 'five basic relationships'-between father and child , husband and wife, elder and younger brother, ruler and subject, friend and friend. Human beings are differentiated and defined by the role each plays in these networks of social relations.⁷¹ In these circumstances, there is much to be said for a value system which places a constraint on the expression of individual desires and also sponsors group sharing of limited resources.⁷² The self-sufficiency of the family unit, based on its

⁶⁹ Redding, S. G. (1990). The spirit of Chinese capitalism. Berlin, W. de Gruyter, at 48.

⁷⁰ Ibid.

⁷¹ Wang, H. (2002). Weak states, strong networks : the institutional dynamics of foreign direct investment in China. New York, Oxford University Press, at 23.

⁷² Bond, M. H., & Hwang, K. K. (1986) The social psychology of the Chinese people. In Bond, M. H. (1997). The

ability to manage its affairs well, was its only insurance against disaster, and the common budgets and common property of the *chia* (family) formed a rational collective response to the surrounding circumstances.⁷³

Confucian society is constructed of morally binding relationships connecting all. The individual is instead a connection, and the “totalness” of society is passed down from one binding relationship to the next, rather than by the Western mode of uniting loosely coupled and “free” individuals by their separate espousal of coordinating ideas and principles. For the Chinese, fulfilment comes from the very structure and dynamics of the relationships and emphasis on belonging.⁷⁴

In terms of its manifest workings, there are three differences separating Confucianism from many other religions. Firstly, it contains no deity but is based instead on rules of conduct. Secondly, it is not promoted in such a way as to compete with other religions, living as it does in the minds of many alongside Buddhism, Taoism and even Christianity. Thirdly, it has no large-scale institutional “church,” with priests, ceremonial and laity.⁷⁵

Hamilton has provided a valuable distinction between Western and

Psychology of the Chinese people. Hong Kong ; Oxford, Oxford University Press, at 215.

⁷³ Cohen, M. L. (1976). *House united, house divided : the Chinese family in Taiwan*. New York ; London, Columbia University Press, at 22.

⁷⁴ Ketcham, R. (1987). *Individualism and public life : a modern dilemma*. Oxford, Basil Blackwell, at 111.

⁷⁵ *Ibid.* at 47

Confucian societies in saying that the Western system emerged via the institutionalizing of power, and thus of jurisdictions. The traditional Roman *Patria potestas* defined a field within which the head of the family could exercise personal discretion and control.⁷⁶ For Tang Junyi, the fundamental difference between Chinese and Western culture is that Chinese culture is oriented in humanism, while Western culture in materialism. This brings about further differences: Chinese culture puts more emphasis on morality and arts, human responsibilities and unity, while Western culture stresses science and religion, individuals' freedom and differentiation.⁷⁷ These different roots between the Chinese and Western (based on ancient Greece and Rome) ways of viewing the world have also been emphasized by Nisbett in his work on the geography of thought.⁷⁸

Although Confucianism lacks either a deity or an organized church, Confucian values permeate the lives of Chinese peoples everywhere.⁷⁹ Prior to the CCP's ascendancy in 1949, from a very early age, in the

⁷⁶ Hamilton, G. G. (1984). "Patriarchalism in Imperial China and Western-Europe - a Revision of Weber Sociology of Domination." *Theory and Society* 13(3): 441.

⁷⁷ Tang J. "Moral Idealism and Chinese Culture", in Cheng, Z.-y. and N. Bunnin (2002). *Contemporary Chinese philosophy*. Oxford, Blackwell Publishers.

⁷⁸ See Nisbett, R. E. (2003). *The geography of thought : how Asians and Westerners think differently-- and why*. London, Nicholas Brealey.

⁷⁹ Other nations such as Japan and Korean are said to be influenced by "post Confucian" values. The Post-Confucian thesis is attributed to Kahn, H. (1979). *World economic development : 1979 and beyond*. NY, Morrow. , Kahn proposed "that the success of organizations in Japan, Korea, Taiwan, Hong Kong and Singapore was due in large part to certain key traits shared by the majority of organization members which were attributable to an upbringing in the Confucian tradition." Clegg ,S. et al., " Post-Confucianism", *Social Democracy and Economic Culture*, in Clegg, S., S. G. Redding, et al. (1990). *Capitalism in contrasting cultures*. Berlin ; New York, W. de Gruyter, at 38. .

school context, Confucianism was taught by the study of the main writings and the discussion of their implications. Children were encouraged to memorize the classics and to build relationships based on the Confucian principles.⁸⁰ Central to those relationships is a high degree of abnegation of self and tolerance and patience for others.⁸¹ One has to question how a corporate governance model that entails a certain degree of confrontation and a high degree of individualistic behaviour fits with beliefs that an individual must fit into and conform to the basic social order of his surrounding world.⁸² The Confucian order is strongly hierarchical with each individual regarding himself not only as part of nature but also part of the natural order.

“One of the most important effects of Confucianism, and one of the principal determinants of social and economic behaviour...is the passivity induced by a system which places the individual in a powerfully maintained family order, itself inside a powerfully maintained stated order, itself seen as part of a natural cosmic order, and all dedicated to the maintenance of the status quo.”⁸³

⁸⁰ Redding, S. G. (1990). *The spirit of Chinese capitalism*. Berlin, W. de Gruyter, at 48.

⁸¹ “The Confucian ideal is that family, clan, and head of state take precedence over the individual.” Ibid. at 63. In a series of interviews with Chinese business men, a representative answer demonstrated the Chinese principle of tolerance: “[B]e tolerant-it creates less worries. Try to put the lawyers out of business.” Ibid. at 87

⁸² Ibid. at 58. In the Confucian context, “the individual has a built-in sense of the legitimacy of the superior-subordinate relationship...it is an extension of a natural order. The open challenge of formal authority is rare.”

⁸³ Ibid. at 52.

Core values in economic behaviour included a concern for reconciliation, harmony and balance coupled with a central focus on practicality.⁸⁴ It is doubtful whether individuals taught from an early age that “the shiny nail is the first to feel the sting of the hammer’ will confront and forcibly remove underperforming CEOs or step forward to file derivative or class action lawsuits.⁸⁵

The economy is embedded in the social order and social cohesion, not rugged individualism, is the value in the ascendancy.⁸⁶ For example, from the Asian perspective, life in a collectivist and group-dominated society means that the Chinese self is not isolated in the same sense as the Western one.⁸⁷ In some cultures, firms are independent legal entities which are well bounded and distinct from their environments.⁸⁸ By contrast, theorists have recognized Asian business firms’ form and operation as contingent, socially contextual phenomenon varying across

⁸⁴ Ibid. at 76

⁸⁵ In the United States model, by contrast, the 1990s witnessed an unprecedented number of forced removals of CEOs of major United States corporations. See Doremus, P. N. (1998). The myth of the global corporation. Princeton, N.J. ; Chichester, Princeton University Press, at 26.

⁸⁶ Gray, J. (2002). False dawn : the delusions of global capitalism. London, Granta, at 26. (“In the normal course of things markets come embedded in social life. They are circumscribed in their working by intermediary institutions [such as labor unions and professional associations] and encumbered by social conventions and tacit understandings”). 182 (‘As in other economic cultures, Chinese capitalism comes embedded in the networks and values of the larger society.’).

⁸⁷ Redding, S.G. (1990), The Spirit of Chinese Capitalism, Walter de Gruyter Inc, at 95; see also, Acton, T. A. Ethnicity and Religion in the Development of Family Capitalism: Seui-Seung-Yahn Immigrants from Hong Kong to Scotland, in Clegg, S. R. and Redding, S. G. (eds.) Capitalism in Contrasting Cultures, Walter de Gruyter , at 391 (“Economy’ and ‘culture’ have been seen by westerners as two great independent variables or value systems while Asian cultures see them as closely intertwined or one (economy) deeply embedded in the other”).

⁸⁸ Redding, S.G. and Whitley, R.D., "Beyond Bureaucracy. Towards a Comparative Analysis of Forms of Economic Resource Co-ordination an Control", in Clegg, S. R. and Redding, S. G. (1990) (eds.) Capitalism in Contrasting Cultures, Walter de Gruyter, at 95.

cultures and historical periods.⁸⁹ This view has been reinforced by the underlying norms of businesses in corporate form, for according to Ruskola, the Anglo-American norm is contract based whereas in the Chinese context the basic norm has always been a kinship, connectedness and *guanxi* norm.⁹⁰

2.6.1 Confucianism and Chinese Law

Confucians, believed that the ideal social order was one of harmony (*he*) and humanity (*ren*), and that it should be maintained by propriety (*li*). The word *Li* expressed a very comprehensive idea and had an extraordinarily wide range of meanings.⁹¹ It can be translated as ceremonies, rituals, or rules of social conduct.⁹² It regulated social relations, curbed the natural desires of man, and cultivated moral habits. In fact Confucianists called all rules which upheld moral habits and served to maintain social order by the generic name of *li*.⁹³ The Confucian philosophy took the view that without *li* it would be impossible to tell the difference between the position of a prince and that of his minister, between the position of a superior and that of an inferior,

⁸⁹ Ibid.

⁹⁰ Ruskola, T. (2000). "Conceptualizing corporations and kinship: Comparative law and development theory in a Chinese perspective." *Stanford Law Review* 52(6): 1599-1729.

⁹¹ Indeed, Confucianists saw it as their duty to dedicate their whole lives to studying and interpreting the meaning of *li*, which they believed was created by the ancient sage.

⁹² Fung, Y.-L. (1966). *A short history of Chinese philosophy*, N.Y. : London : Free Pr. ; Collier-Macmillan, at 147.; Qu, T. (1965). *Law and Society in traditional china*. Paris. Mouton, at 255.

⁹³ Cheng, C.-y. (1991). *New dimensions of Confucian and Neo-Confucian philosophy*. Albany, N.Y., State University of New York Press, at 4.

or between the position of an elder person and that of a younger one. Without *li* it would be impossible to fix the degrees of relationship between the sexes, between father and son, and between brothers,⁹⁴ and to be without these differences, ‘it is to be like the beasts’.⁹⁵ In other words, the final goal of good government was the correct operation of hierarchical human relationships.⁹⁶

Li was a set of general rules governing proper conduct and behaviour by which rulers could maintain an ideal social order.⁹⁷ It was never a body of detailed rules designed to deal with all situations, but a general instrument for training character and nourishing moral force.⁹⁸ When people understand and act according to *li*, a harmonious and humane order will prevail.⁹⁹

Similar to Western notions of natural law, Confucianism assumed the existence of a ‘natural’ order on which social order should be based.¹⁰⁰ But the content of Confucianism differed from that of Western natural law founded on individual rights. In the Western tradition, several

⁹⁴ Ibid. at 2

⁹⁵ Mencius cited in Fung, Y-L (1966), *supra* note 92, at 151.

⁹⁶ Qu, T. (1965) *supra* note 92, at 239.

⁹⁷ Ibid at 230.

⁹⁸ Schwartz, B., "On Attitudes Toward Law in China", reprinted in Cohen, J.A. (1968), The Criminal Process of the People's Republic of China 1949-1963: An Introduction, Harvard University Press, at 64.

⁹⁹ Ibid.

¹⁰⁰ This similarity as well as the similarity between legalism and positivism is noted in Needham, J. (1962). *Science and civilisation in China*. Cambridge, Cambridge University Press. pp.530-2. This analogy is, however, limited. Natural law has a super-human dimension that is incompatible with the secular nature of Confucianism.

principles have been associated with the idea that law should be autonomous from politics and therefore above government. In China, the state has not traditionally maintained order by jurisdiction. During the Imperial dynasties the ruling elite was small in number and scattered over a vast land. To govern a state was similar to regulating a family, which was achieved through the cultivation of individual morality, as the Confucian social formula suggested: cultivating the personality-regulating family life-ordering a state-ensuring world peace (*xiushen-qijia-zhiguo-pingtianxia*).¹⁰¹ The fusion of the concept of family with that of state thus provided a basis for elevating morality to the status of state law.¹⁰²

According to Confucianism, only a government based on virtue could truly win the hearts of men.¹⁰³ This idea is reflected in one of the most cited Confucian passages:

“Lead the people by regulations keep them in order by punishments (*Xing*), and they will flee from you and lose all self-respect. But lead them by virtue and keep them in order by the established morality (*li*),

¹⁰¹ It is stated in the Great Learning, one of the Confucian classics, that: “The ancients who wished to illustrate illustrious virtue through the Kingdom, first ordered well their own states. Wishing to order well their states, they regulated their families. Wishing to regulate their families, they first cultivated their persons” Cited in Qu (1965), *supra* note 92, at 255.

¹⁰² In fact, a great part of Confucianism is the rational justification or theoretical expression of the Chinese family system as a social system. See Fung Y-L. (1966), *Supra* note 92, at 147. ; Qu (1965), *supra* note 92, at 22-22.

¹⁰³ Bernhardt, K. E. and P. C. C. E. Huang (1994). *Civil law in Qing and Republican China* Stanford University Press, at 14.

and they will keep their self-respect and come to you.”¹⁰⁴

Thus, in reply to a question concerning the conduct of good government, Confucius said: ‘Set yourself as an example to the people both in conduct and in physical labour’.¹⁰⁵ As such the Confucian idea of government has been described as a government of ‘rule by man’.¹⁰⁶ But perhaps this should be understood to be ‘government lies in man’.¹⁰⁷ As Xun zi (d.ca. 210 B.C.) said:

“Laws cannot stand alone...for when they are implemented by the right person they survive, but if neglected they disappear... Law is essential for order, but the superior man is the source of law. So when there is a superior man, even incomplete laws can extend everywhere. But when there is no superior man, even comprehensive laws cannot apply to all situations or be flexible enough to respond to change.”¹⁰⁸

Indeed, law in traditional China was an instrument of the state. Its purpose was to enhance the power of the government and maintain imperial control. Rather than protecting the rights of individuals, legal codes focused on the individual’s obligations toward the state.¹⁰⁹ As such

¹⁰⁴ Ibid. at 21-22.

¹⁰⁵ For an English version, see Library of Chinese Classics-Analects, China Hunan Publishing House, 2000, at 189

¹⁰⁶ Yu Ronggen, ‘Questioning the Theory of Rule by Man in Confucianism and Rule of Law in Legalism’, (no.4, 1984) Law Science Quarterly (Faxue Jikan) 60.

¹⁰⁷ Qu (1965), *supra* note 92, at 230.

¹⁰⁸ For an English version see Library of Chinese Classics-Xunzi, China Hunan Publishing House, 2000, at 127

¹⁰⁹ In contrast to traditional China. ‘The monarch [of medieval Europe], it is argued, may make law, but he may not make it arbitrarily, and until he has remade it-lawfully –he is bound by it.’ See Berman, H. J. (1983). Law and

it was not very interested in social regulations among autonomous individuals, and least of all in defending individual rights against the state.¹¹⁰ As one of the early authorities on Chinese law Wang Chun-hui observed in 1917 that Anglo-American law emphasises the individual as against the family, while the Continental system inherits something of the old Roman *familia*. As the family was the basic unit of Chinese society reform in the early twentieth century naturally sought to preserve this

EndNote><Cite><Author>Hart</Author><Year>1995</Year><RecNum>

In his study, Weber paid close attention to Chinese traditions such as Confucianism and Taoism and tried to find something comparable to (or distinct from) the Western religious impact on the capitalist system.¹¹² He concluded that the incentive for economic rationalization appeared only briefly in Chinese history during the Warring States period (475-221 B.C.) and never established its dominance afterwards. Rather, patrimonialism and traditional clan (the kinship, or Zu) dominated Chinese society under the influence of Confucianism and strongly weakened the state's centralization of power and administration. As a result, no independent

revolution: the Formation of the Western Legal Tradition, Cambridge, at 93. .

¹¹⁰ Bodde, D. and C. Morris (1967). Law in Imperial China: exemplified by 190 Ch'ing Dynasty cases, with historical, social, and juridical commentaries Cambridge (Mass.): Harvard University Press; London: Oxford University Press, at 4.

¹¹¹ Wang Chung-hui, 'Legal Reform in China: A Sociological Analysis', in Chinese Social and Political Review, Jun 1917, quoted in Cameron, M. E. (1931). The reform movement in China 1898-1912. [S.I.], Stanford University Press.

¹¹² Weber, M. (1968). The Religion of China: Confucianism and Taoism, Free Press: New York; Collier-Macmillan: London. See also Weber, M. (1930). The protestant ethic and the spirit of capitalism. London, George Allen & Unwin Ltd.

legal system (as well as specialized legal practitioners) had ever been built to serve the interests of capitalist enterprises in Chinese history.¹¹³

In this sense the initial stimulus of traditional Chinese law was therefore also unrelated to economic development,¹¹⁴ although some contemporary Chinese scholars have argued that law was often used to implement 'economic reforms' in traditional China.¹¹⁵ Thus, civil law was not developed in China. Instead, a system grew up in which the social order could operate by itself, with the minimum of assistance from the formal political structure.¹¹⁶ Indeed, the Confucian order was in the final analysis more fundamentally moral than it was rational.¹¹⁷ Contrary to Weber's theory some scholars have argued that the success of the recent economic reforms was due to the decentralization of the planned economy. This gave more power both politically and economically to the local governments. There was, for example, a considerable increase in local laws and regulations as local governments gained room to manoeuvre to substantiate general laws and policies from the central government. Therefore the systemization of law was helped by the early

¹¹³ Ibid.

¹¹⁴ Bodde, D. and C. Morris (1967). Law in Imperial China: exemplified by 190 Ch'ing Dynasty cases, with historical, social, and juridical commentaries. Cambridge (Mass.): Harvard University Press; London: Oxford University Press, at 4.

¹¹⁵ See e.g. Zhang Jinfan, A Collection of Paper on legal History (Fashi Jianlue) (Beijing: Press of the Masses, 1988), at 12&42-43; Wang Qianghua, 'On the Role of Law in Reform and the Three Legal Reforms in Our History', (no.5, 1982) Studies in Law (Faxue Yanjiu) 58.

¹¹⁶ Yang, C.K., "Some Characteristics of Chinese Bureaucratic Behavior" in Wright, A (ed.) (1959), Confucianism in Action, Stanford, Stanford University Press, at 164.

¹¹⁷ Bary, D. and W. Theodore (1959). Approaches to the Oriental Classics: Asian Literature and Thought in General Education, Columbia University Press: New York, at 41.

decentralization of legislative power which went hand in hand with the first decade or so of the development of the economic reform.¹¹⁸ However, this lent itself to the type of ambiguity and rent seeking criticized by Zweig and others.

2.6.2 When the East meets the West

I The late Qing dynasty reform

In China, the late Qing reforms were a moderate attempt by the government to introduce legal, institutional, and educational reforms in order to satisfy popular demands for change and modernization while maintaining the political status quo of a conservative imperial monarchy.¹¹⁹ In May 1902, Shen Chia-pen (Shen Jiaben), Junior Vice-President of the Board of Punishments,¹²⁰ and W Ting-fang (Wu Tingfang), a former ambassador to the United States,¹²¹ were appointed by the Imperial Court to carefully examine and re-edit all the laws then in force,

¹¹⁸ Zhu, S. (2005). The change of law and its characteristics in the Peoples' Republic of China: 1978-present. Unpublished master's thesis. Tempe, Arizona, Arizona State University.; Lu, H. and T. D. Miethe (2007). " Provincial laws on the protection of women in China: A partial test of Black's theory." International Journal of Offender Therapy and Comparative Criminology 51: 25-39.

¹¹⁹ Goetzmann, W and Koll, E. (2005) , " The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control", in Morck R. K. (ed), A History of corporate governance around the world: Family Business Groups to Professional Managers, The University of Chicago Press at 161-162.

¹²⁰ For a brief biographical background on Shen Chia-pen, See Chinese Encyclopedia-Law (Zhongguo Dabaike Quanshu-Faxue) (Beijing/Shanghai: The Chinese Encyclopedia Press, 1984), at 525-526; and China University of Political Science and Law, A Study on the Legal Thought of ShenJia Ben (Shen Jiaben Falu Sixiang Yanjiu) (Beijing: Publishing House of Law, 1990).

¹²¹ For a brief biographical background on Wu Ting-fang, see Chinese Encyclopedia-Law (Zhongguo Dabaike Quanshu-Faxue) (Beijing/Shanghai: The Chinese Encyclopedia Press, 1984), at 627.

to bring them into accord with the conditions resulting from international commercial negotiations, to consult the laws of various countries, and to ensure that new laws would be commonly applicable to both Chinese and foreigners and for the benefit of the Government.¹²²

Finally, the Japanese model became the jurisdiction of choice. This choice was not an accident, Japan's success in reversing extra-territoriality and in becoming a mighty power in the Asian area was seen to be a result of its having a constitution and a legal system based on Western models. The similarity of the two countries in historical, ideological, and cultural features as well as in written language was seen as a further reason for the emulation of the Japanese model.¹²³ Also important is the fact that the Continental European, mainly German, system, which the Japanese legal system was modelled on, was seen as a form of Western jurisprudence that had been tested in an oriental society.¹²⁴ Within a few years several new codes were drafted and issued: the General Principles for Merchants, the Company Law, and the Bankruptcy Law were promulgated in 1903.¹²⁵

¹²² For a Chinese text of the Edict, See Yang Hunglieh, *A History of Chinese Legal Thought (Zhongguo Falu Sixiangshi)*, vol. II (Beijing Commercial Publishing House, 1937), reprinted by Shanghai Publishing House, 1984, at 305; for an English translation of the Edict, see Meijer, M. J. (1967). The Introduction of Modern Criminal Law in China, De Unie: Batavia.

¹²³ Foo, P.S. 'Introduction', in *The Civil Code of the Republic of China* (Shanghai: Kelly & Walsh, Ltd., 1930), at xi; Cheng, F.T. 'Law Codification in China', 1924 (6) *J. of Comp. Leg.* 283, at 285; Li Guilian, 'Legal Reforms in Modern China and the Japanese Influence', (no.1, 1994) *Studies in Comparative Law (Bijiaofa Yanjiu)* 24.

¹²⁴ Chang, H. C. (1973). A History of the Modern Chinese Legal System (Zhongguo Jindai Fazhishi) The Commercial Press, Taipei, at 285.

¹²⁵ Zhang, J. F. (1986). A Chinese Legal History (Zhongguo Fazhi Shi) Press of the Masses, Beijing, at 340.

It is therefore not surprising that the reforms met strong opposition. Between 1904 and 1908, some 272 companies registered with the Chinese government, over half of them as joint-stock companies with limited liability.¹²⁶ Although these numbers are impressive, they represent only a fraction of the unlisted Chinese enterprises operating in China at the time.¹²⁷ Many families opted not to register their firms for fear of losing control over management and equity. Family businesses have a long tradition in China and have been highly successful in the production or distribution of commercial goods, including long-distance trade.¹²⁸ Nevertheless, the reforms were seen as challenging the traditional institutions and structures, ignoring the traditional values as embodied in Confucian *li*, and undermining the social foundation built on centuries-old social morality and customs.¹²⁹

II The continuing reform under the Kuomintang

But by 1904 the government of the Qing dynasty was collapsing; it first

¹²⁶ Chan, W. K. K. (1977). Merchants, mandarins and modern enterprise in late Ch'ing China. [Cambridge, Mass.], East Asian Research Center, Harvard University ; Cambridge at 180-82.

¹²⁷ Goetzmann, W. and E. Koll (2005). The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control. A history of corporate governance around the world : family business groups to professional managers R. Morck. Chicago ; London, University of Chicago Press, at 163. See also Kirby, W. C. (1995). "China Unincorporated - Company Law and Business-Enterprise in 20th-Century China." Journal of Asian Studies 54(1); Bowen, J. R. and D. C. Rose (1998). "On the absence of privately owned, publicly traded corporations in China: The Kirby puzzle." Journal of Asian Studies 57(2): 442-452. ; Cochran, S. (2000). Encountering Chinese networks : Western, Japanese, and Chinese corporations in China, 1880-1937. Berkeley, Calif. ; London, University of California Press.

¹²⁸ Goetzmann and Koll (2005) *supra* note 127.

¹²⁹ Meijer, M. J. (1967). The Introduction of Modern Criminal Law in China, De Unie: Batavia. , chs.2 & 5; Guo, C. W. (1990). Legal Thought of Shen Jiaben and the Controversies during the Qing Legal Reform, Publishing House of Law, Beijing.

was replaced by a military government and then further disintegrated into what we now refer to as the warlord period. A Republic was established in 1912 by the revolutionaries led by Sun Yatsen.¹³⁰ Although it overthrew the Dynasty, the Republican government allowed the continued use of the Qing law: all imperial laws formerly in force were repeatedly declared to remain effective unless they were modified by new laws or were contrary to the principles of the Republic.¹³¹

During this period, certain specific writings of Sun Yatsen were declared to have the force of formal law.¹³² Law, seen as an instrument for social change, was used largely as a tool for implementing the Kuomintang (KMT) doctrines and goals.¹³³ Moreover, the KMT law and legal institutions were far from reaching the Chinese people and had no substantial impact on the society at large.¹³⁴ As a result, they broke down traditional systems, values and practices and separated private law from public law, civil law from criminal law, and the legal system from the administrative hierarchy. Most importantly, they laid down a foundation for Western law and legal systems to be further studied, developed and

¹³⁰ Established in 1912, the Republic of China encompassed much of mainland China. After 1949 when the Kuomintang lost the Chinese Civil War to the Chinese Communist Party and the People's Republic of China (PRC) was founded in mainland China.

¹³¹ Resolution of the Provisional Government of April 3, 1912, in Zhang J.F., et al. (eds.), *A Chinese Legal History* (Zhongguo Fazhi Shi) (Beijing: Press of the Masses, 1986), at 394; and Resolution of the Central Political Council (Zhongyan Zhengzhi Huiyi) of 1927, in Gilpatrick, M. P. (1950). "The status of Law and Law-making Procedures Under the Kuomintang 1925-46." *The Far Eastern Quarterly* 10(1): 45.

¹³² Marc, v. d. V. (1939). *An Outline of Modern Chinese Family Law*, Catholic University of Peking, at 165.

¹³³ The Kuomintang of China, also often translated as the Chinese Nationalist Party, is the founding and the ruling political party of the Republic of China. Starting in 1928, the Republic of China was ruled by the Kuomintang as an authoritarian one-party state.

¹³⁴ Tay, A. E.-S. (1969). "Law in Communist China-Part I." *Syd. L.Rev* 6(165).

adapted in China.¹³⁵ For instance, regarding the progress of legislation under the KMT, which clearly was a continuing process from the Qing reform, Pound has remarked:

“Thus in twenty-four years, from the overthrow of the Empire and setting up of the Republic, the work of providing a modern Constitution, modern codes, and a modern organisation of Courts was done, and well done. This would have been a remarkable achievement in any case, seeing that it had to be done with little to build on, by study of foreign institutions and laws and adaptation of new ideas to an old country in a time of profound changes, even if there had been propitious conditions of peace and stability. To do it under the actual conditions is an achievement without parallel.”¹³⁶

However, with the advantage of greater hindsight this view may be somewhat overstated. Legal reforms require more than changing a few laws. Prior to the Communist regime, China's former company laws were enacted in 1904, 1914, 1929 and 1946 respectively. Tomasic and Fu argue that all of these corporate legal regimes have reflected a considerable degree of central government control. Partly because of this, and family dislike of outside interference, they have had limited impact on the organisation of business activity in China. Throughout its history,

¹³⁵ Chen, J. (2008). *Chinese law : context and transformation*. Leiden, Martinus Nijhoff , at 37.

¹³⁶ Pound, R. (1948). "Law and Courts in China: Progress in the Administration of Justice." *A.B.A.J* 34: 274.

commerce has not been encouraged by Chinese governments. This is due to some extent to the long-standing policy of national isolation which has been broken only by relatively short and intermittent periods of exploration such as the early Ming voyages of the great admiral Zheng He.¹³⁷ At other times, eg the early Ching dynasty, monopolies were granted over certain trades in specific areas in return for various services in support of the government.¹³⁸ It is also a reflection of the Confucian disdain for the world of business. As a result the state provided minimal protection for private business. Merchants and businessmen were forced to fall back on the family and local and regional ties and kinship in which the relationships of trust became a more secure basis for business activity rather than formal bodies of law, such as company law.¹³⁹

The importance of the relational and networking system called *guanxi* in Chinese society including business dealings and politics cannot be underestimated. It is this system of personal relationships which has

¹³⁷ For a consideration of this period see Levathes, L. (1994). When China ruled the seas : the treasure fleet of the Dragon Throne, 1405-1433. New York ; London, Simon & Schuster.; for a more controversial version of events see Menzies G. (2002), 1421, The Year China Discovered the World London, Bantam Books.

¹³⁸ The background to the Chinese classic by Cao Xueqin, (1760), A Dream of Red Mansions (*Hong lou meng*) otherwise known as The Story of the Stone (*Shitouji*) is indicative of this in that the family had been textile commissioners in Nanking and Soochow for almost 80 years. This involved supervision of government owned textile factories. In addition to their duties as textile commissioners they were the Emperor's 'men on the spot' charged with observing and reporting on the high ranking officials in their area and keeping him privately informed on a variety of topics ranging from market fluctuations to the weather and amusing local scandal. After the death of the Emperor Kangxi in 1722, the Emperor Yongzheng came to the throne by means of a coup d'etat. Yongzhen had his own highly organised army of secret agents and did not trust his father's former intelligent network. In 1728 the Cao family lost their positions and had their wealth confiscated. Cao Xueqin was living in poverty near Beijing when he wrote his story. See Cao Xueqin (translated by David Hawkes) (1973) The Story of the Stone: Volume I The Golden Days (Penguin Classics) at 25-32.

¹³⁹ Tomasic, R. and Fu J. (1999). "Company law in China", in Tomasic, R. (1999). Company law in East Asia. Aldershot, Ashgate at 135.

played an important role in China for millennia. In China the Confucian concept of *renzhi* (a respect for peoples' feelings: *renqing*) mean't that in theory law should be in harmony with, or in the case of contradiction subordinate to, "the peoples feelings." Individuals are therefore more concerned about the feelings of those with whom closer personalistic ties (*guanxi*) exist. The combined influence of *renzhi* and its direct counterpart *guanxi* led to the "rule of the virtuous man" rather than to anything like the rule of law.¹⁴⁰ According to Yang the practice of *guanxi* has varied throughout Chinese history and had largely disappeared after 1949 as communist ideals and practice suppressed patronage but reasserted itself during the Cultural Revolution as society broke down and the collapse of production and distribution created the need to find food and other necessities. In these times of institutional chaos and uncertainty Chinese society drew upon its traditions to develop networks of interpersonal relationships.¹⁴¹ Williamson posits that the pace at which contracts and arms-length market transactions gain ground over *guanxi* arrangements within the PRC may depend upon security of both prosperity and the reliability of institutions.¹⁴² Whilst some argue that *guanxi* has played a diminishing role in China's economic development,

¹⁴⁰ See for example Lawton, P., (1996), "Berle and Means, Corporate Governance and the Chinese Family Firm" *Australian Journal of Corporate Law* 6, 348 at 354-6.

¹⁴¹ Yang, M. M.-h. (1994). *Gifts, favors, and banquets : the art of social relationships in China*. Ithaca, N.Y. ; London, Cornell University Press.

¹⁴² Williamson D. (2005), "A management control assurance in the different cultures and institutions of China and the UK " in Brown, D. H. and A. I. MacBean (2005). *Challenges for China's development : an enterprise perspective*. London, Routledge

particularly as China has developed administrative and bureaucratic processes,¹⁴³ others argue that *guanxi* is not a fixed essentialized phenomenon which can only wither away with the onslaught of new legal and fixed regimes. Rather, *guanxi* must be treated historically as a repertoire of cultural patterns and resources which are continuously transformed. This transformation takes place as the *guanxi* practice adapts as well as shapes new social institutions and structures. It is also affected by the particular Chinese experience with globalization. *Guanxi* may decline in some social domains but appears to be flourishing in others such as business transactions. In doing so it may display new ways of expression and new social forms. A historical approach to *guanxi* is more sensitive to the important issues of power both within the Chinese social order and in relation to power issues between China and the West.¹⁴⁴ The latter would include the transplantation and adaptation of certain corporate governance structures and norms such as the two tier board adapted from Germany and the independent non executive director concept seemingly bolted on from the Anglo-American system. According to the historical approach many recent arguments for the decline of *guanxi* tend to be embedded with unreflective positive methodology and the technology of modernization theory/narrative and

¹⁴³ See eg Guthrie, D. (1998), "The declining significance of Guanxi in China's economic transition," *China Quarterly* (154): 254-282.

¹⁴⁴ Yang, M. M. H. (2002), "The resilience of Guanxi and its new deployments: A critique of some new Guanxi scholarship." *Ibid.* (170): 459-476.

neo-liberal discourse.¹⁴⁵ Another perspective of the analysis of *guanxi* is the sociological one which admits of different possible market configurations in contrast to the economist view which tends to narrowly define the concept of the market as ideal typical transactions between legal equals in costless transactions institutionalized in private property rights defined and enforced by the state.¹⁴⁶ In China, where private property rights are at best ambiguous and until 2007 have received relatively scant recognition within the constitution and legal system¹⁴⁷ it is submitted that the economists' approach is seriously limited in its view of *guanxi* relationships. In recent years as the size of the family has been limited it has become increasingly important to extend *guanxi* networks and the impetus to do so has remained strong. *Guanxi* has important implications for organizational studies as well as marketing and corporate governance.¹⁴⁸ I will return to its importance and implications for corporate governance in later chapters.

Another major issue relevant to the role of *guanxi* in Chinese society is that of law and development. It has been argued that relationship

¹⁴⁵ Ibid.

¹⁴⁶ See for example Wank, D. L. (1996). "The institutional process of market clientelism: Guanxi and private business in a South China city." *China Quarterly* (147): 820-838.

¹⁴⁷ See for example, Mo Z, (2008) "From Public to Private: The Newly Enacted Chinese Property Law and the Protection of Property Rights in China" (Temple university, Beasley School of Law, Legal research paper series 2008-39); Rehm, G. H. and Juhns, H., (2008) "The New Chinese Property Rights Law: An Evaluation from a Continental European Perspective", available at <http://ssrn.com/abstract=1132343>.

¹⁴⁸ See for example Child, J. (1994). *Management in China during the age of reform*. Cambridge, Cambridge University Press. ; Li Y. Y., Parnell M. F. and Hawkins N., (2005) "*Guanxi*, relationship marketing and business strategy" and Williamson D., (2005) "A management control assurance in the different cultures and institutions of China and the UK" in Brown, D. H. and A. I. MacBean (2005). *Challenges for China's development : an enterprise perspective*. London, Routledge .

transactions diminish the need in Chinese society for universally enforceable contractual rights and other legal rights. This relates to arguments as to whether legal rights are a necessary precondition for economic development or whether it is economic development that stimulates the growth of enforceable legal rights.¹⁴⁹ Whilst China may enact laws such as contract law based on international models these appear to be impacting relatively slowly. More recent research has indicated that China's growth has been supported by non-legal substitutes such as the official bureaucratic supervision and sponsorship of enterprise. These models have considerable historical precedents.¹⁵⁰ This has important implications for corporate governance in that the system remains embedded to a large degree in such systems.¹⁵¹ Though, on the supply side, the development of formal law has developed into an important tool for the central government to use in managing the state owned sector.¹⁵²

III Reform under the Communist Party

After the Chinese Communist Party (CCP) came to power, the country's

¹⁴⁹ Clarke, D. (1996). "Power and politics in the Chinese court system: the enforcement of civil judgements." Columbia Journal of Asian Law **10**.

¹⁵⁰ See for example, Goetzman, W. and Koll, E., (2005), "The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control" in Morck, R. (2007). A history of corporate governance around the world : family business groups to professional managers. Chicago, Ill., University of Chicago Press ; Bristol : University Presses Marketing [distributor].

¹⁵¹ Milhaupt, C. J. and K. Pistor (2008). Law and capitalism : what corporate crises reveal about legal systems and economic development around the world. Chicago, London, University of Chicago Press at 140. See also Dam, K. W. (2006). The law-growth nexus : the rule of law and economic development. Washington, D.C., Brookings Institution Press. in particular Chapters 10 and 11.

¹⁵² Milhaupt and Pistor (2008), *supra* note 151, at 141.

connection with the outside world, especially economically advanced Western nations, was very limited (mainly due to ideological confrontations during the Cold War). Chinese legal institutions took yet another turn. Alongside the imperial traditions, the communist legacy has been a major source of influence on today's legal system in China.¹⁵³

From classical Marxism, the Chinese communists took over the notion of law as a tool of class struggle. From the Soviet Union, they learned the practical importance of law for revolutionary dictatorship. During this period, the function of Law and the legal system was reduced to serve the communist government as an instrument. The notion of an independent legal system governing all actors in a society was as alien to the Chinese communists as it was to the imperial mandarins.

From the “Anti-Rightists” campaign and the “Great Leap Forward” movement in the 1950s to the Cultural Revolution in the 1960s and 1970s, law and the legal system were used as tools for class struggle, and their existence and functions were subject to politicians’ discretions. As a result, China suffered significantly from the chaos caused by endless class struggle. This period of time was usually labeled as the “rule of

¹⁵³ The communist era is defined here as the era from the communist victory in 1949 to the beginning of the economic reforms in 1979. Although, the Chinese Communist Party continues to monopolize political power in China, gradual but substantial changes have taken place in China's economic and the political system. The complexity of the political system in China today is such that it is no longer appropriate to characterize the present regime as communist.

man.”

It should be noted that Chinese communist law was not a product of Marxism alone. It was also a product of Chinese traditions. Scholars have already pointed out some commonalities between Marxian practices and Chinese traditions. First, both emphasized moral and ideological education and internalization, and law and the legal system were only secondary as means to reach the ends.¹⁵⁴ Second, based on Marxism, the Chinese Communist Party (CCP) maintained that national and CCP's interests are by definition synonymous with those of the masses. Individuals' rights were granted from above and only so long as they may serve the overall societal good.¹⁵⁵ This practice was consistent with traditional Confucian views of individualism, in which one's value was realized through the fulfilment of one's duties and responsibilities in certain social groups.¹⁵⁶ Third, class distinctions in the new China were not unfamiliar to Chinese people because under Confucianism, traditional Chinese society was hierarchical and class-based.¹⁵⁷ All those seemingly common features to a large extent helped China's transition into a communist nation.

¹⁵⁴ Ren, X. (1997). Tradition of the law and law of the tradition : law, State, and social control in China. Westport, Conn. ; London, Greenwood Press, at 3.

¹⁵⁵ Polumbaum, J.(1994), "Striving for Predictability:The Bureaucratization of Media Management" in Li, J. (1994). China's media, media's China. Boulder ; Oxford, Westview.

¹⁵⁶ Ren, X. (1997), supra note 154, at 3

¹⁵⁷ Ibid.

The door was reopened after the economic reform initiated in 1978. In that year the Third Plenary Session of the Eleventh Central Committee of the CCP declared that large-scale nationwide mass political movements should be stopped and ‘the emphasis of the Party’s work should be shifted to socialist modernisation as of 1979’.¹⁵⁸

Further, Deng broke the conventional boundaries of socialism and capitalism by claiming that “social practice (praxis) is the only criterion of seeking truth.”¹⁵⁹ Under Deng’s theory, the market economy does not belong to capitalism any more, and it is consistent with the necessity of socialist economic division and productions.¹⁶⁰ This was summarised by Deng Xiaoping as a ‘Two-Hands’ policy: On the one hand, the economy must be developed; and on the other hand, the legal system must be strengthened.¹⁶¹

A legal system was declared a necessity for socialist modernisation.¹⁶²

Then the Party leaders also repeatedly emphasised the importance of law for providing a social order conducive to economic development.¹⁶³

¹⁵⁸ See the Communiqué of the Third Plenary Session of the Eleventh Central Committee of the CPC. An English translation of the Communiqué appears in Liu Suinian & Wu Qungan, (eds) *China’s Socialist Economy: An Outline History (1949-1984)* (Beijing: Beijing Review Press, 1986), at 564-577.

¹⁵⁹ “Social practice (praxis) is the only criterion of seeking truth” (Shijian Shi Jianyan Zhenli de Weiyi Biaojun); 5, *Guangming Daily*, November, 1978,

¹⁶⁰ *The People’s Daily*, June 8, 2000.

¹⁶¹ See Wang, J.F. et al., ‘On the Rule of Law’. (no.2, 1996) *Studies in Law (Faxue Yanjiu)* 3, at 7. See also Qiao, W., ‘Guidelines for Building Up a Legal System in the New Era-Comrade Deng Xiaoping’s Writings on Building a Legal System’, (no.2, 1984) *Legal Science in China (Zhongguo Faxue)* 67.

¹⁶² *Ibid.* at 573.

¹⁶³ See e.g. Jianying, then chairman of the Standing Committee of the NPC, ‘Opening Speech at the Second

Deng and other leaders have said that it is necessary to establish the authority of law.¹⁶⁴ It was announced after the Third Plenary Session of the Eleventh Central Committee of the Party in 1978 that the practice whereby the ‘Party decides the case’ would be abolished.¹⁶⁵

Under Deng’s leadership in the 1980s and 1990s, in sharp contrast, China witnessed the massive and rapid enactment of laws and regulations, particularly laws and administrative rules regulating economic and commercial relations.¹⁶⁶ A major ideological breakthrough was made during Deng Xiaoping’s surprise visit to Shenzhen and Zhuhai in January 1992 (now commonly referred to as the ‘Southern Tour’) During his visit, Deng was reported as saying that ‘reforms and greater openness are China’s only way out’ and that ‘if capitalism has something good, then socialism should bring it over and use it’.¹⁶⁷ Party Secretary-General Jiang Zemin then proclaimed that the market and planning were both means of regulating the economy, but not criteria for distinguishing between

Session of the Fifth National People’s Congress on June 18, 1979’. in *Main Documents of the Second Session of the Fifth National People’s Congress of the People’s Republic of China* (Beijing : Foreign Languages Press, 1979), at 3; and Hua Guofeng, then Chairman of the Party and Premier of the State Council, ‘Report on the work of the Government’, in *id.*, see particularly Part I (A Historical Turning Point) and Part III (Strengthening Socialist Democracy and the Socialist Legal system).

¹⁶⁴ See Deng Xiaoping, “zai zhongyang zhengzhijiu changweihui Shang de jianghua” (Speaking to the Standing Committee of the Political Bureau of the Central Committee of the Communist Party of China), Jan.17, 1986, in *Deng Xiaoping wenxuan* (The collected works of Deng Xiaoping) (Beijing: Renming press, 1993), 3:152-54.

¹⁶⁵ See “zhangguo Gongchandang di shiyijie zhongyang weiyuanhui di sanci quanti huiyi gongbao” (Communique of the Third Plenary session of the Eleventh Congress of the Communist Party-preamble), the People’s daily, Dec.24, 1978.

¹⁶⁶ By March 1998, the National People’s Congress (NPC) and its Standing Committee had promulgated 328 statutes and decisions. The State Council had issued more than 700 regulations and the local legislatures had adopted over 5,000 local rules. See *People’s Daily* (Renming Ribao), internet edition, 14 March 1998.

¹⁶⁷ The Sydney Morning herald, 31 January 1992, at 6. An edited version of Deng’s Speech was later published in the Chinese media: ‘Major Points of Speech Made in Wuchang, Shenzhen, Zhuhai and Shanghai (by Deng Xiaoping)’, *People’s Daily* (Renmin Ribao), 6 November 1993, at 1; and translated as ‘Gist of Speeches Made in Wuchang, Shenzhen, Zhuhai and Shanghai (by Deng Xiaoping)’, *Beijing Review*, 7-20 February 1994, at 9-20.

socialism and capitalism.¹⁶⁸ The Party's programme of reconstructing the legal system was further elevated in importance in 1996, as one eminent Chinese legal scholar has suggested, to the 'same theoretical level as the socialist market economy'¹⁶⁹ with adoption of the slogans 'Use law to rule the country, protect the long term peace and good order of the state'¹⁷⁰ and 'ruling the country according to law is the basic programme by which the Party leads the people in ruling the country'.¹⁷¹ Keith and Lin cite arguments put forward by Chinese scholars supporting an emphasis upon the concept of rule of law (fazhi) as it 'forms part of the progress from a traditional to a modern society'.¹⁷² In the primary stage of socialism, the task of law was to facilitate development of the market economy, to assist

¹⁶⁸ People's Daily (Renming Ribao), (Overseas edition), 14 March 1992, at 1. According to the People's Daily, the concept came directly from Deng Xiaoping: at the end of 1990 Deng Xiaoping pointed out that 'planning and markets are not criteria for distinguishing socialism from capitalism'. Deng re-stressed this point during his tour to Shenzhen and Zhuhai Special Economic Zones in February 1992. See 'Great Practice, Bright Chapter-the Birth of the Political Report of the 14th Congress of the Party', in People's Daily (Renmin Ribao) (Overseas edition) 24 October 1991, at 3. According to other scholars, Deng had in 1979 said that socialism could also practise a market economy. See Gao Lu, 'The Emergence of the Notion of "Socialist market Economy"' (no.1, 1993) Xinhua Digest (Xinhua Wenzhai) 40, at 40-41.

¹⁶⁹ Keith, R. and Lin, Z. (2001), Law and Justice in China's New Marketplace, Palgrave Macmillan, at 35, attributing this assertion to Professor Li Buyun, one of China's leading legal scholars. The decision to establish a 'Socialist market economy with Chinese characteristics' was adopted at the 14th CCP Congress held on 12-18 December 1992.

¹⁷⁰ (Yifa zhiguo, baozhan guojia Changzhi jiu'an) Jiang Zemin, former president of China, 'Hold High the Great Banner of Deng Xiaoping Theory for an All-round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21st Century', 12 September 1997, report delivered at the 15th National Congress of the CCP

¹⁷¹ This programme was incorporated into the Constitution in March 1999, amending art. 5 by adding: 'The People's Republic of China governs the country according to law and makes it a socialist rule of law country.' The proper translation of the last phrase is contested. An alternate interpretation could be 'make it a socialist country ruled by law'. This is the translation used in the English version of Jiang Zemin's speech, Hold high the great Banner of Deng Xiaoping Theory for an All-round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21st Century, 12 September 1997, in the Beijing Review. Keith, R. and Lin, Z. (2001), prefer an alternate translation: 'socialist rule of law state', supra note 171, at 33. The bases for different translations is discussed in Bill Brugger and Stephen Reglar (1994), *Politics Economy and Society in Contemporary China*, Stanford University Press, at 177-81.

¹⁷² Keith, R. and Lin, Z. (2001), supra note 171, at 33, citing Qiao Keyu. Ronald Keith argues that the earlier academic debates over 'rule of man' versus 'rule of law' were also, in fact, a debate about 'transition of Chinese legal culture from tradition to modernity'. See also Keith, R. C. (1994). China's struggle for the rule of law. Basingstoke, Macmillan.

maintaining public order and to eliminate political threats.¹⁷³

Thus as a consequence of the new policy Chinese scholars began to openly argue that a ‘market economy’ was a result of human wisdom; it was not a ‘privilege’ (*tequan*) for the West.¹⁷⁴ A socialist market economy, it was now often asserted, was an economy under rule of law (*fazhi jingji*).¹⁷⁵ The establishment and perfecting of a socialist market was thus said to be a process of establishing the rule of law.¹⁷⁶ To establish a market economy in China therefore demanded a revolution in legal theory and legal thought.¹⁷⁷

Nevertheless, many commentators saw legal developments in China as either statist in nature in that law is a mechanism to exercise state power in China rather than a limit on the state power.¹⁷⁸ Many aspects of the

¹⁷³ Wen jiabao, Prime Minister of China, “Our Historical Tasks at the Primary Stage of Socialism” Beijing review, 2007, 12, available at http://www.bjreview.com.cn/lianghui/txt/2007-03/12/content_58768.htm

¹⁷⁴ Liu Jinghua(1995), ‘Globalisation: An Historical Process Full of Paradoxes’, Pacific Studies (Taiping yan Xuebao) no.1, at 70.

¹⁷⁵ See.e.g.XiaoYang, Market Economy and Legal Construction (Shichang Jingji yu Fazhi Jianshe)(Beijing: Publishing House of Law, 1994); Chen Shixi, ‘Our Legislative Trend in the 1990s’, Guangming Daily (Guangming Ribao), 9 March 1994, at 5; “The Legislative Train is Speeding Up towards the Market Economy’, Legal Daily (Fazhi Ribao), 7 March 1994, at 1; and Min Xianwei, ‘A socialist Market Economy Is Naturally an Economy Under the Rule of Law’, (Special Issue, 1994) Journal of Shandong Normal University (Shandong Shifan Daxuebao) 93. Such an assertion is not without challenges (though rather isolated), See e.g. Lin Jie, A Question on the Proposition ‘A Market Economy Is an Economy Under the Rule of Law’ (no.1, 1994) Legal Science in China (Zhongguo Faxue) 68, at 68.

¹⁷⁶ See Wang Jiafu et al., ‘On the Rule of Law’, (no.2, 1996) Studies in Law (Faxue Yanjiu) 3, at 3.

¹⁷⁷ See Guo Daoxu, ‘The Market Economy and the Change in Legal Theory and Legal Thought’, (no.2,1994) Jurisprudence (Faxue)2; Xie Hui, ‘From a Planned Economy to a Market Economy: A Revolution in Legal Theory’, (no.4,1994) Gansu Journal of Theoretical Research (Gansu Lilun Xuekan)52; Wen Zhengbang, ‘Some Legal and Philosophical Thoughts on the Market Economy’, (no.4, 1995) Legal System and Social Development (Fazhi Yu Shehui Fazhang) 1;

¹⁷⁸ See for example, Potter, P. B. (1999). "The Chinese legal system: Continuing commitment to the primacy of state power." *China Quarterly*(159): 673-683. ; Potter, P. B. (2001). "The legal implications of China's accession to the WTO." *China Quarterly*(167): 592-609.

concept of a rule of law in the west are very inadequately developed in China. These include a number of important ideas and concepts such as supremacy of law, judicial independence, separation of powers, checks and balances and also equality before the law. Parliamentary systems and the protection of human rights (a concept of which the CCP is wary) are also part of the picture.¹⁷⁹ Also, Chinese judicial independence did not originate from the concept of separation of powers. The Chinese concept of judicial independence (*shenpan duli*) is more of a reference to the elimination of the CCP's political influence in actual judicial decisions as opposed to the party's influence over the general policy direction of the judicial process.¹⁸⁰ Other commentators have argued that China's legal system is more of a case of 'rule by law' rather than developing a 'rule of law.'¹⁸¹ The development of the legal system was described as rather like 'riding a tiger' as the development of due legal process in a society largely dependant on communist party fiat and the maze of *guanxi* relationships in which, even within the communist party, as well as society as a whole posed difficult political problems for as law developed as a system within China the question could be posed, and often was, is

¹⁷⁹ Chen, J. (1999). Chinese law : towards an understanding of Chinese law, its nature and development. The Hague ; London, Kluwer Law International.

¹⁸⁰ Brugger, B. and S. Reglar (1994). Politics, economy and society in contemporary China. London, Macmillan. ; see also Keith, R. C. and Z. Lin (2001), Supra note 171.

¹⁸¹ E J Epstein, (1992), "A Matter of Justice" in Kaun, H. and M. Brosseau (1992). China Review. Hong Kong, Chinese University Press.; Brugger and Reglar, (1994) supra.note 180; Zheng, Y. (1998). From rule by law to rule of law? A realistic view of China's legal development East Asian Institute, National University of Singapore. ; Peerenboom, R. P. (2002). China's long march toward rule of law. Cambridge, Cambridge University Press. ; Peerenboom, R. P. (2004). Asian discourses of rule of law : theories and implementation of rule of law in twelve Asian countries, France, and the U.S. London ; Routledge.

the CCP itself subject to those same laws?¹⁸² During the period of the first Emperor of China the legalist school of thought had been relatively triumphant but was swept away during the later Han dynasty.¹⁸³ However, it remains unlikely that systems of connectedness which are long fundamental to Chinese civilization will wither away as a socialist legal system with Chinese characteristics develops. On the contrary as that system has developed it has remained imbued with Chinese characteristics overlain with issues of political expediency.

IV The Company Law and securities market in China

The first Chinese Corporate Law was enacted in January 1904, during the late Qing Dynasty. When the People's Republic of China was founded in 1949, business corporations gradually disappeared. This was due to importation of the highly centralized economy model from the former Soviet Union. In the late 1970s, China started to introduce a market economy, SOEs were redefined as business corporations, and private businesses were incorporated.¹⁸⁴ However, China did not have a single law regulating business organizations, even though by the late 1980s as

¹⁸² Liang, B. (2009). The changing Chinese legal system, 1978-present : centralization of power and rationalization of the legal system. London, Routledge.

¹⁸³ Fung Y-L (Translated by Derk Bodde), (1952) A History of Chinese Philosophy (Vol. I) The Period of Classical Learning (2nd edn) Princeton, Princeton University Press. See Chapter XIII for a consideration of the legalists school of thought and Chapters XIV and XVI for a consideration of Confucianism under the Ch'in and Han dynasties and the eventual triumph of Confucianism respectively.

¹⁸⁴ Schipani, C. A. and J. Liu (2002). "Corporate Governance in China: Then and Now." Colum. Bus. L. Rev. 1(36).

many as five million companies had been established.¹⁸⁵

The need for a company law was soon recognised by law-makers, and thus efforts to draft a company law began to emerge in 1983, first jointly by the State Planning Commission and the State Commission for Economic structural Reform, and later by the Legislative Affairs Committee (LAC) of the Standing Committee of the National People's Congress (SCNPC).¹⁸⁶ On 29 December 1993 the SCNPC finally adopted the Company law of the PRC.¹⁸⁷ The event was seen by the Chinese press as a 'historical leap forward'.¹⁸⁸ The Company Law, according to the then Vice-chairman of the State Commission for Economics and Trade, ChenQingtai, was the 'most important' piece of legislation for regulating business entities.¹⁸⁹ It remains important to bear in mind that use of the law was to corporatize the SOEs and raise capital rather than encourage a large scale sell off of state businesses. The corporate form was a useful legal tool for the organization and modernization of the key sectors of the economy.

The reform of China's stock market systems began in 1990 with the

¹⁸⁵ Zhongguo baike nianjian 1990 ,(China encyclopaedic year book 1990), (Beijing: China Encyclopaedia Publishing house, 1990), at 315.

¹⁸⁶ See 'A Historical Leap Forward', Guangming Daily (Guangming Ribao), 18 January 1994, at 4.

¹⁸⁷ Promulgated by the president of the PRC on the same day. The Law became effective on 1 July 1994.

¹⁸⁸ See 'A Historical Leap Forward', supra note 186.

¹⁸⁹ See Daily of the Legal System (Fazhi Ribao), 19 January 1994, at 2.

redevelopment of the Shanghai and Shenzhen stock exchanges.¹⁹⁰ In the first year, only 15 companies dared to try the once forbidden apple with a total market capitalization of 10.9 billion Yuan.¹⁹¹ It took little time, however, before people accepted the new test, and China's stock market started expanding with incredible speed. By 2004, more than 1,300 companies had gone through public offerings, and the total market capitalization jumped to 4.8 trillion Yuan in 2000 before it cooled off to 3.7 trillion Yuan by 2004.

In October 1992 the State Council formed the Securities Committee (SCSC) and its executive arm, the China Securities Regulatory Commission (CSRC), to take charge of overall supervision and regulation of the securities market in China. In April of 1998, and as part of the State Council structural adjustment, the SCSC and CSRC were merged into one single authority- the China Securities Regulatory Commission-as the sole State Council securities regulatory authority responsible for the uniform administration and supervision of securities and futures markets throughout the country.

¹⁹⁰ See for example Walter, C. E. and F. J. T. Howie (2006). Privatizing China : inside China's stock markets. Singapore ; Chichester, John Wiley & Sons (Asia). According to this work the first business to issue shares to the public (despite there being no company law at that time) was Feile Acoustics in Shanghai in 1984 and was the first to be registered as a business operating under the 'shareholder system'. The business issued 10,000 shares at RMB50 each. See also F Hu, (2007) "The Effects of Stock Market Listing on the Financial Performance of Chinese Firms " in Calomiris, C. W. (2007). China's financial transition at a crossroads. New York ; Chichester, Columbia University Press.

¹⁹¹ For more detailed information on the first experience of China's stock market, see Green, S. (2003). China's stockmarket : a guide to its progress, players and prospects. London, Profile at 30.

Two decades of economic reforms have transformed China from a centrally planned system into a rapidly expanding economy with double-digit growth rates. But how to build a sound corporate governance system and improve the reputation of Chinese enterprises based on the concept of harmonious society, technically and practically speaking, has a long way to go. Undoubtedly, in my view China may combine its own traditions and needs with whatever is helpful from the German/Japanese and Anglo-American models of corporate governance. Though it remains debateable what exactly will work and the extent to which China ought to develop elements of governance which are particularly its own and which work best in the Chinese context.

2.7 Conclusion

The recent law reform is actually a continuation of many earlier efforts. In the late Qing dynasty, Chinese reformers grappled with models derived mainly from Germany as conveyed by the Japanese. China then adopted certain Soviet legal forms in the 1950s and Western models again in the 1980s. Unfortunately, none of these appear to have yielded much success. Indeed, within China's existing political structure and traditional culture, legal processes can never escape an embeddedness in Chinese characteristics and a susceptibility to political pressures.

The Chinese government indeed made no intention to hide the guidance (as one form of control) of the CCP over the building of the legal system. The official definition of “ruling the country in accordance with the law” (yifa zhiguo) was codified as follows:

“Under the lead of the Communist Party and based on the Constitution and laws, the people administer national affairs, economic, cultural, and social affairs via various means. It is to guarantee all national affairs to be accomplished according to laws, and to realize the systemization and legalization of the socialist democracy. The basic system and law will not be changed with changes of national leaders or changes of those leaders’ personal opinions.”¹⁹²

Too many reform initiatives have been partial and poorly conceived, undertaken without considering the fundamental interdependence between corporate law and corporate finance, and between corporate governance and the rest of the economic system.¹⁹³ Nor is it enough to know the ‘law on the books.’ Much depends on whether and how these laws are enforced. Many countries have extensive codes and shareholder protections-but these are not implemented well, particularly in terms of

¹⁹² The People’s Daily, June 20, 2001; November 1, 2002.

¹⁹³ Berglof, E.(2000) " Reforming corporate governance: Redirecting the European agenda", in Cohen, S. S. and G. Boyd (2000). Corporate governance and globalization : long range planning issues. Cheltenham, Edward Elgar.

being enforced. Or, if enforced, their interpretation can alter their meaning substantially. The actual application of law turns, again, on politics and choices. Despite the globalization of corporate activities, production and investment notwithstanding, corporations and investment funds remain very much rooted in their home countries and defined by their domestic political and legal environments.

Chapter 3 Internal corporate governance mechanisms

3.1 Introduction

The corporate governance literature typically distinguished two major corporate governance models, one based on equity finance and control primarily by capital markets, the other on debt finance and control by banks in the dual role of shareholders and major creditors.¹ The former is typically associated with the United States and the United Kingdom, the latter with Germany and Japan. The reasons for the major differences between these two major models are as much due to the accidents of history as they are to reasons of a political and cultural nature.²

Germany and Japan were heralded as the model economies that other countries should follow in the 1980s. Companies in both countries were believed to benefit from being controlled by stable, large shareholders

¹ Roe, M. J. (1993). "Some Differences in Corporate Structure in Germany, Japan, and the United-States." Yale Law Journal 102(8): 1927-2003.; Berglof, E. "Corporate Governance in Transition Economies: The Theory and Its Policy Implications", in Aoki, M. and H.-K. Kim (1995). Corporate governance in transitional economies : insider control and the role of banks. Washington, D.C., The World Bank, at 3-32.; Aoki, M., "Controlling Insider Control: Issues of Corporate Governance in Transition Economies", in Aoki, M. and H.-K. Kim (1995). Corporate governance in transitional economies : insider control and the role of banks. Washington, D.C., The World Bank, at 3-32.

² See for example Dore, R. P. (2000). Stock market capitalism, welfare capitalism : Japan and Germany versus the Anglo-Saxons. Oxford, Oxford University Press. Japan had looked to Prussia, the leading German State in the 19th Century as a model to follow because its martial spirit seemed most akin to its own Samurai past; Stewart, R., J.-L. Barsoux, et al. (1994). Managing in Britain and Germany. London, Macmillan. ; Charkham, J. P. (1994). Keeping good company : a study of corporate governance in five countries. Oxford, Clarendon Press.; Charkham, J. P., H. Ploix, et al. (2005). Keeping better company : corporate governance ten years on. Oxford, Oxford University Press.

who made long-term investments possible and were able to commit other stakeholders over the long run.³ However the circumstances have changed very quickly. Until the recent corporate scandals and credit crunch over the last nine years, many countries looked up to the UK and the US for their flexible labour markets, highly liquid stock exchanges and rapid growth in high-tech industries. Germany and Japan were no longer the models to follow.⁴ Today, the current credit crisis has led many people to re-examine the Anglo-American model.

Thus, Letza, Sun and Kirkbride note that "the so-called superiority and priority of any model is not permanent and universal, but rather temporary contextual".⁵ It is now generally accepted that there is no single system of corporate governance applicable to all countries although the globalization of the world economy has exerted some pressure on the need for convergence and harmonization in key areas of governance arrangement.⁶

Legal reforms in China have been comprehensive and have affected not only areas immediately relevant for the enterprise sector, but the entire

³ See, eg Da Silva, L. C., M. Goergen, et al. (2004). Dividend policy and corporate governance. Oxford, Oxford University Press. ; See also Miles, D. (1993). "Testing for Short Termism in the UK Stock-Market." Economic Journal **103**(421): 1379-1396.

⁴ Goergen, M. (April 2007). "What Do We Know About Different Systems of Corporate Governance?" Journal of Corporate Law Studies **7**.

⁵ Letza, S., Sun, X. and Kirkbride, J. (2004), "Shareholding versus Stakeholding: A Critical Review of Corporate Governance" **12**(3) Corporate Governance: An International Review 257.

⁶ Tricker, R. I. (1994). International corporate governance : text, readings and cases. New York ; London, Prentice Hall., ⁴⁴⁻⁴⁵.

legal system, ranging from constitutional, administrative, criminal, and civil law to the organization and procedural rules of the court system.⁷

Commentators have raised concerns about the relevant factor being not “law on the books” as much as the combination of law and its enforcement mechanisms.⁸ The “transplant shock” i.e. the possibility that legal rules that work well in one nation may not work well, and ultimately may be rejected, in a nation with a different historical, political, or culture background is a concern.⁹ Eastern European privatization experiences have shown that in order to be successful such programmes require complex regulations and specialized administrative skills, both of which are not readily available and cannot be easily created in sufficient quantity in these transforming economies.¹⁰ Again, the Russian experience, suggests that so many of these factors were lacking that they would not constitute sufficient conditions.¹¹

Thus, it is important to adapt selectively for China features from mature market economies on the basis of a clear theoretical and empirical

⁷ Pistor, K. (1995). Law Meets the Market: Matches and Mismatches in Transition Economies, The World Bank; Gray, C. (1993). Evolving Legal Framework for Private Sector Development in Central and Eastern Europe., The World Bank, Sachs, J. and K. Pistor (1997). The rule of law and economic reform in Russia. Boulder, Colo. ; Oxford, WestviewPress.

⁸ Berkowitz, D., K. Pistor, et al. (2003). "Economic development, legality, and the transplant effect." European Economic Review 47(1): 165-195.

⁹ Ibid.

¹⁰ Fox, M. B. and M. Heller (2006). Corporate governance lessons from transition economy reforms. Princeton, N.J. ; Oxford, Princeton University Press, at 38.

¹¹ Ibid, at 113, 116.

understanding of the evolution of such systems. The key question is what kind of corporate governance system would best suit China's economic and social developments in its quest to become a more competitive and prosperous economy.

In order to understand China's current approach to enterprise reform and corporate sector development in its institutional and developmental context, it is important to consider the background and meaning of several key concepts and practices, some of which China has borrowed from mature market economies.

Unlike most developed countries, corporate governance is a relatively new concept in China. Since the founding of the People's Republic in 1949, the Chinese Government adopted the public (state) ownership of all production means and the formal Soviet style planned economy.¹² In 1984, the Central Committee of the Communist Party adopted the Decisions to Reform the Economic System.¹³ The aim of the 1984 Decisions was to create an enterprise that was a relatively independent business entity. The *General Civic Law of the People's Republic of China*, which came into effect on 1 January 1987, stated that SOEs and collective-owned

¹² Zu, J. L., I. M. Liu, et al. (2007). "The development of corporate governance in China." *The Company Lawyer* 28(7): 200.

¹³ Jiang Qiangui, "Like Wading Across a Stream: Law, Reform and the State Enterprise", in Bachner, B. and Fu, H., (1995) (eds), *Commercial Laws in the People's Republic of China*, Butterworths Asia, at 3.

enterprises satisfying certain capital, organizational and approval requirements were to be turned into legal persons. Indeed, it was not until July 1994 when China's Company law came into effect that a national legal framework was introduced for formalizing the creation of the designated forms of companies¹⁴ as legal persons.

China's corporate governance reform began in the 1990s. The Chinese Communist Party (CCP) became increasingly aware that a good governance system for China's enterprises was of critical importance in delivering its goal of sustainable economic growth. Intense public interest on corporate governance was spurred in 2001 by the notorious YinGuangXia Scandal, which concerned unbridled fabrication of sales receipts and false disclosure by a company listed in the Shenzhen Stock Exchange under the leadership of a few "core" insiders, causing losses to thousands of minority shareholders.¹⁵ Since then, corporate governance "has become a high profile topic and has been made top priority of the (Chinese) regulator's agenda."¹⁶

Recently, the CSRS (China securities regulatory commission) has released a Code of Corporate Governance of Listed Companies to serve

¹⁴ China's Company Law covers two forms of companies: Companies with limited liabilities, and Joint stock companies with limited liabilities.

¹⁵ Wang, J. Y. (2004). "Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market " *Asian-Pacific Law & Policy Journal* 5: 40-42.

¹⁶ Ibid.

as a benchmark for evaluating whether a listed company has a good corporate governance structure.¹⁷

3.2 Internal corporate governance mechanisms in China

According to the PRC Company law, the basic organisational structure of listed companies comprises three tiers of control, namely the shareholders' meeting, the board of directors and the supervisory board. The shareholders' meeting in China is known as "the organ of power of the corporation"¹⁸ and it assumes supreme sovereignty in corporate governance. The boards of directors of Chinese listed companies enjoy the usual breadth of managerial powers of their Western counterparts.¹⁹ In August 2001, CSRC issued the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (hereinafter Independent directors Guidelines), mandating that by 30 June 2003 at least one-third of companies' board members should be independent.²⁰ The independent directors shall be independent from the company's management as well as its controlling shareholder. The supervisory board represents yet another watchdog over management. Pursuant to the PRC Company Law, the supervisors supervise the directors and managers for

¹⁷ Code of Corporate Governance for Listed Companies (Zhengjianfa) NO 1 of 2002, issued by the CSRC on 7 January 2002, preface (hereinafter CSRS Code of Corporate Governance).

¹⁸ Arts 37 and 99, PRC. Company Law 2005

¹⁹ Art 109, PRC. Company Law 2005

²⁰ Promulgated by the CSRC on 16 August 2001, Zhenghjianfa (2001) No 102, Art I:3.

any violation of laws, regulations or articles of association of the company during their performance of company duties.²¹ The members include shareholders' and employees' representatives, of which at least one-third shall comprise employees' representatives.²²

3.3 The supervisory board in Germany

Germany is classified as a "late developer," entering the game in the mid-nineteenth century at the iron-steel stage of economic development, when capital requirements were large and when Britain already dominated the scene. It embodied the features Gerschenkron ascribed to it,²³ namely an important role for banks and for the state, and interlocking relationships among firms - "organized capitalism", as it was called.²⁴

In contrast to many western economies, Germany has a two-tier board with a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*).²⁵ The supervisory board represents the shareholders and employees. Under the law of codetermination introduced in 1976,

²¹ Arts 54 and 118, PRC Company Law 2005

²² Art 118, PRC Company Law 2005

²³ Gerschenkron, A. (1962). *Economic Backwardness in Historical Perspective. A book of essays*, Belknap Press of Harvard University Press: Cambridge, at 456.

²⁴ Gourevitch, P. A. (1986). *Politics in hard times : comparative responses to international economic crises*. Ithaca ; London, Cornell University Press, at 267.

²⁵ The Netherlands also has a two-tier system with a Raad van Bestuur (management board) and a Raad van Commissarissen (supervisory board). In France, corporations have the choice between a one-tier board and a two-tier system; but more than 95% of the listed companies have opted for a unitary board. See Dherment-Ferere and Renneboog, "Share price reactions to CEO resignations and large shareholder monitoring in listed French companies " in McCahery, J., P. W. Moerland, et al. (2002). *Corporate governance regimes : convergence and diversity*. Oxford, Oxford University Press at 297-324.

employees are legally allocated control rights over all corporate decisions in the form of seats in the supervisory board. This is widely seen as one of the hallmarks of German corporatism.²⁶ Employees have the same rights to representation on the supervisory board as an owner of equity. This regulation also gives trade unions a foothold in the governance of firms entirely independent of the degree of organization (or lack thereof) among the company's employees. The general idea is that the suppliers of capital and suppliers of labour steer the firm 'cooperatively'.²⁷ The role of the supervisory board is that of overseeing the management of the company.²⁸ The functions of the supervisory board have been defined as appointing and removing the members of the management board,²⁹ representing the company in court and out of court in its relationship with the members of the management board, supervising and overseeing the management of the corporation; evaluating (studying) matters relating to the corporation; having insight into the corporation's books and cash; approving the corporation's financial statements; and reporting to the shareholders' meeting.³⁰

²⁶ A recent critical analysis can be found, eg, with du Plessis, J. J. and O. Sandrock (2005). "The Rise and Fall of Supervisory Codetermination in Germany?" International Company and Commercial Law Review 16: 67.; A study found that companies with equal representation of employees and shareholders on the supervisory board trade at a 31 percent stock market discount as compared with companies where employees representatives fill only one third of the supervisory board seats, see Gorton, G. and F. A. Schmid (2004). "Capital, Labor and the Firm: A study of German Codetermination." Journal of the European Economic Association 2.

²⁷ Siebert, H., "Corporatist versus market approaches to governance" in Hopt, K. J., W. Eddy, et al. (2005). Corporate governance in context : corporations, states, and markets in Europe, Japan, and the US, Oxford : Oxford University Press at 287.

²⁸ See Aktiengesellschaften (Law on stock corporations) § 111(1), translated in Commercial laws of the World: Germany (rev. ed. 1995).

²⁹ See Oppenhoff, W. and Verhoeven, T.O., 'Stock Corporations', in Bernd Rüster (eds)(2003) Business Transactions in Germany, Berlin, Matthew Bender, ch. 24, § 24.03

³⁰ Ibid.

However, the performance of companies with a supervisory board in an international comparison is a heavily debated issue. On the one hand, it can be argued that the advantage of this system is the cooperation between different groups of a company so the interests of the employees, the shareholders, and the firm are considered when important decisions are made.³¹ This gives labor control rights over corporate decisions and leads to a kind of negotiated management where - in the terms of Hirschman - labour has voice as an alternative to exit. The result is a willingness to practice long-term commitment.³²

On the other hand, many legal scholars have criticized that system: for example when difficult problems have to be solved within the company, the trilateral interdependence among members of the management board, the representatives of the shareholders and the representatives of the employees in the supervisory board often lead to agreements that burden the shareholders.³³ Employees working abroad are not entitled to participate in the elections of the representatives of the employees to serve on the supervisory boards of some large German companies.³⁴ The employees' representatives on supervisory boards are sometimes faced by

³¹ Siebert, H.(2005), supra note 27, at 288-289

³² Streeck, W. and Yamamura, K. "Introduction: Convergence or Diversity? Stability and Change in German and Japanese Capitalism" in Yamamura, K. o. o. and W. Streeck (2003). The end of diversity? : prospects for German and Japanese capitalism. Ithaca, Cornell University Press at 13.

³³ du Plessis, J. J. and O. Sandrock (2005). "The Rise and Fall of Supervisory Codetermination in Germany?" International Company and Commercial Law Review 16: 67.

³⁴ Ibid, at 70

serious conflicts of interest, e.g. when they call for a strike against the company on whose supervisory board they are sitting.³⁵ It has been argued that the German statutory regulations on codetermination have the effect of "poison pills" on foreign companies that consider taking them over peacefully. Certain investors keep away from Germany because they are afraid of German codetermination, which is largely an unknown factor to them.³⁶

3.4 The supervisory board in China

After studying the various available Western models, the law makers in China chose the German model of a two-tier board system because the ideal of co-determination between capital and labour would seem to enhance internal unity and company performance. Its ‘communitarian’ capitalist approach was more appealing to them than the theoretical shareholder dominance of the Anglo-American system.

3.4.1 The function of the supervisory board in China

Chinese company law provides for a two-tier board structure, with a board of supervisors (elected by shareholders) as well as a board of

³⁵ Ibid.

³⁶ Ibid.

directors, and contemplates a relatively active managerial role for the board of directors.³⁷ The responsibilities of the supervisory board include the following: (a) examining the company's financial affairs; (b) supervising directors and managers to see whether they violate laws, regulations or the company's articles of association in the performance of their duties; (c) if an act of a director or manager harms the interests of the company, to require him to correct such an act; (d) proposing to hold extraordinary shareholders' general meetings; and (e) other functions and powers provided for in the company's articles of association.³⁸

3.4.2 The gap between reality and expectation of the law in the role and powers of the supervisory board

Although Chinese commentators often compare China's two-tier model to Germany's, the Chinese structure differs in a crucial way: the Company Law expects that the board of supervisors will perform a supervisory role by simply saying that it will, without actually giving the board any significant powers³⁹ or providing structurally for its independence from

³⁷ See Tang X., *Zhongguo Shangshi Gongsi Zhili Huanjing De Xin Fazhan* [New Developments in the Governance Environment for Chinese Listed Companies](Paper for 21st Century Commercial Law Forum, Tsinghua Univ., Beijing, Nov. 18, 2001).

³⁸ See PRC Company Law 2005, art. 54

³⁹ Wang, J. (2008). "The Strange Role of Independent Directors in a Two-Tier Board Structure of China's Listed Companies." *The Compliance and Regulatory Journal* 3: 49.

those supervisors.⁴⁰ Indeed, a relatively recent study⁴¹ indicates that over half the companies surveyed maintained supervisory boards with only the legal minimum number of members suggesting that this institution plays no real role in corporate governance.

In China, a board of supervisors may lack independence as well. Under the Company Law, a board of supervisors must consist of members from the ranks of shareholders and employees.⁴² In most cases, shareholder board members are predominantly appointed by majority shareholders and therefore represent only majority interests.⁴³ Furthermore, since employee board members rely on top management for annual evaluations, promotions, and remuneration decisions, they find it difficult to play a totally independent role without considering their personal career interests.⁴⁴ Consequently, a board of supervisors in China is “merely a figurehead and not a monitor in [any] real sense.”⁴⁵

The establishment of the supervisory board in China is not based on the

⁴⁰ Ibid ,at 52.

⁴¹ Miles, L. and Z. Zhong (2006). "Improving corporate governance in state-owned corporations in China which way forward." Journal of corporate law studies: 229.

⁴² P.R.C. Company Law 2005, article 118

⁴³ Zu, J. L., I. M. Liu, et al. (2007). "The development of corporate governance in China." The Company Lawyer 28(7): 200.

⁴⁴ Tai, K. and C. Wong. (2003). "Corporate Governance in China." from [http:// www.acga-asia.org/loadfile.cfm?SITE_FILE_ID=187](http://www.acga-asia.org/loadfile.cfm?SITE_FILE_ID=187).

⁴⁵ Yang, P., "The two models of corporate governance and the institutional reform of Chinese enterprise " in Nakamura, M. (2008). Changing corporate governance practices in China and Japan : adaptations of Anglo-American practices. Basingstoke, Palgrave Macmillan at 20-23 , see also Xiao, Z. z., J. Dahya, et al. (2004). "A Ground Theory Exposition of the Role of the Supervisory Board in China." British Journal of Management 15: 39-45.

same social and philosophical considerations as for the setting up of supervisory boards in the German codetermination model of corporate governance. No broader social and historical issues seem to have been involved in designating the official functions⁴⁶ of the supervisory board in China, other than a desire to provide another organizational layer for a rather loosely defined monitoring role over the board of directors and managers.⁴⁷

The Chinese supervisory board's apparent resemblance to the German model is confined mostly to its name and the participation of workers.⁴⁸ In the Chinese case, however, the supervisory board consists of shareholders' and workers' representatives, but the mix is to be determined in each case by the company's articles of association. The number of supervisors could be just one or two for smaller limited liability companies, and greater than three in the case of joint stock limited liability companies. *A priori*, given its limited function and unclear mode of operation, the supervisory board cannot be expected to play an effective role.⁴⁹

⁴⁶ The PRC Company Law 2005, Articles 67, 81, 118. Only limited liability companies and joint stock companies with limited liabilities are to set up supervisory boards, wholly owned state-owned companies do not have supervisory boards.

⁴⁷ Tam, O. K. (1999). The development of corporate governance in China. Cheltenham, Edward Elgar, at 86.

⁴⁸ Ibid.

⁴⁹ Ibid.

The lack of motivation and resources certainly forms part of the explanation for the limited effectiveness of supervisory boards. However, it should be recognized that it has been common practice to have employees of the company acting as representatives of shareholders on the supervisory board, along with other employees who act as workers' representatives. Therefore, these employees cannot reasonably be expected to carry out effectively the primary supervisory board role as this would be likely to involve confrontation with their superiors in the company hierarchy for whom they work.⁵⁰

3.5 The independent director in the UK and US

Policymakers in several countries have turned to independent directors as an important element of legal and policy reform in the field of corporate governance. They are a monitoring tool put forward by agency theorists. Britain's own set of corporate scandals led to the Cadbury Report, which recommended, along with subsequent similar reports and studies, a greater role for outside and independent directors.⁵¹ The Combined Code

⁵⁰ Ibid.

⁵¹ As of 2001, outside directors were a board majority in 53% of companies on the London Stock Exchange. See Hashimoto, M. (May 2002), Commercial code revisions: Promoting the evolution of Japanese companies, Nomura Research Institute, NRI Papers, No.48; In 2004, however, Pensions Investment Research Consultants reported a board majority of independent directors in well under 15% of LSE-listed companies. See Pensions Investment Research Consultants Ltd. (PIRC), Presentation of Corporate Governance Annual Review 2004 (Nov. 18, 2004), available at <http://www.pirc.com>.

2008 clearly distinguishes them by stating: “The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the board’s decision taking.”⁵²

In theory, independent directors are free of management pressure and powerful enough to remove a CEO, so they can have a controlling influence. Independent directors have been claimed to provide a comparative advantage in that they are less dependant on the CEO and more sensitive to external assessments of their performance as directors, less worried about the disclosure of potentially competitively sensitive information. They also have credibility in the “checking” of market signals against intrinsic measures of the firm’s prospects. Thus, they can solve three different problems. First, they enhance the fidelity of managers to shareholder objectives, as opposed to managerial interests or stakeholder interests. Second, they enhance the reliability of the firm’s public disclosure, which makes stock market price a more reliable signal for capital allocation and for the monitoring of managers at other firms as well as their own. Third, and more controversially, they provide a mechanism that binds the responsiveness of firms to stock market signals but in a bounded way.⁵³

⁵² The Combined Code on Corporate Governance 2008, section 1 A.3

⁵³ Gordon, J. N. (2007). “The rise of independent directors in the United States, 1950-2005: Of shareholder value

To be sure, the evidence is mixed concerning whether director independence actually curbs agency problems and increases efficiency of board decision-making.⁵⁴ In general, the thrust of the empirical literature does not seem to support the common perception that board independence increase decision-making capacities of the board and the value of the firm.⁵⁵ The recent comprehensive study is that of Bhagat and Black, who in a review of other studies as well as with their own research find, among other things, that:

* There is no evidence that greater board independence leads to better firm performance. Poor performance is correlated with subsequent greater independence, but there is no evidence that this strategy works to improve performance.⁵⁶

* having insiders on the board can add value.⁵⁷

*independent directors with significant stock positions may add value, whereas others do not.⁵⁸

Evans and Evans found that the presence of independent directors on board or compensation committees had no effect on CEO pay levels.⁵⁹

and stock market prices." *Stanford Law Review* 59(6): 1469.

⁵⁸ Zhang, C., L. Renneboog, et al. (2008). "Do UK Institutional Shareholders Monitor Their Investee Firms?" *Journal of Corporate Law Studies* 8(1).; Romano, R. (2004). "The Sarbanes-Oxley Act and the Marking of Quack Corporate Governance." *Yale LJ* 114.

⁵⁵ Bhagat, S. and B. S. Black (2002). "The Non-Correlation Between Board Independence and Long-Term Firm Performance." *Journal of Corporation Law* 27: 231.

⁵⁶ Ibid, at 263

⁵⁷ Ibid

⁵⁸ Ibid, at 265-67

⁵⁹ Evans, R. T. a. E., John P. (2002). The Influence of Non-Executive Director Control and Rewards on CEO Remuneration: Australian Evidence. *EFMA 2002 London Meetings*.

As one commentator noted:

“[B]oard independence has done little to prevent past mismanagement and fraud. For example, thirty years ago the SEC cast much of the blame for the collapse of the Penn Central Company on the passive non management directors. No corporate boards could be much more independent than those of Amtrak, which have managed that company into chronic failure and government dependence. Enron had a fully functional audit committee operating under the SEC's expanded rules on audit committee disclosure.”⁶⁰

Independence is matter of objective judgment rather than definition. In practice, however, many independent directors do not have significant enough investments in the companies on whose boards they serve to really care about performance, and have difficulty following company operational details. Many are not experienced business executives, or if they are, they may be too busy to keep themselves well informed.⁶¹ And, of course, rational CEOs are inclined to get rid of troublesome, overly critical directors by arranging for them not to be reappointed.⁶²

⁶⁰ Ribstein, L. E. (2002). "Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002." *Journal of Corporation Law* 28(1). It is particularly noteworthy that Enron's audit committee "was headed by a widely respected accounting professor . . . and included another respected academic." Healy, P. M. and K. Palepu (2002). "Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron." *Harvard NOM, Working Paper No. 02-27*.

⁶¹ Smith, R. C. and I. Walter (2006). *Governing the modern corporation : capital markets, corporate control and economic performance*. New York ; Oxford, Oxford University Press, at 92.

⁶² Ibid.

In continental Europe, the creation of independent boards is problematic. In most member states, controlling shareholders retain the power to appoint and dismiss both the board and the management of the company. Thus, the effectiveness of adopting US-style board independence rules to ensure independent audit committees-where the board remains exposed to controlling shareholder influence- is likely yield few benefits.⁶³

3.6 The independent director in China

The Chinese literature and regulations contemplate a number of roles for independent directors. One sees generalities about how they will reduce corruption, bring an objective view to board meetings, dare to ask uncomfortable questions, criticize company management, and ensure good corporate governance practices.⁶⁴ Many Chinese commentators appear to view concentrated ownership as almost perverse and unnatural, and see the stereotypical Berle and Means Corporation as the ideal ownership structure.⁶⁵ Independent directors will, it is hoped, represent the interests of small shareholders and prevent the recurrence of corporate

⁶³ Coffee, J. C. (2005). "A theory of corporate scandals: Why the USA and Europe differ." *Oxford Review of Economic Policy* 21(2): 198.

⁶⁴ See, e.g., Li Yining: Shangshi Gongsì Duli Dongshi Zhi Shang Nan Fahui Zuoyong (Li Yining: It Is Still Difficult for the Listed Company Independent Director System to Play Its Proper Role), China News Agency, June 12, 2004.

⁶⁵ Some Chinese academics assert (incorrectly) that corporate law in the United States prevents large shareholders from dominating by prohibiting any person from exercising over 20% of shareholder voting rights. See, e.g., Gu Gongyun, Gongsì Fa Xiugai Ying Jiejue de Ruogan Shiji Wenti (Several Practical Problems that Should Be Solved in a Revision of the Company Law), (Falü Chubanshe 2004) .at 60

scandals.⁶⁶ The increasing worldwide interest in independent directors had not gone unnoticed by Chinese policymakers.

In November 2000, the Shanghai Securities Exchange issued a set of draft guidelines on corporate governance (SSE Guidelines) for companies listed on the exchange.⁶⁷ The SSE Guidelines stipulate that each listed company must have at least two independent directors, and that independent directors should constitute not less than 20% of the board of directors (30% where the chairman of the board and the general manager are the same person). Independent directors may be nominated by the board's nominating committee or by shareholders holding at least 5% of the stock. Controlling shareholders may not, however, nominate more than one director, indicating that the SSE Guidelines contemplate independent directors as a shield against dominant shareholder abuses as well as management abuses.⁶⁸

The SSE Guidelines contemplate a major role for independent directors.⁶⁹ All subcommittees of the board of directors—including those for compensation, nomination, and investment decisions, which are

⁶⁶ See Jiang Qiangui, *Gongsi Zhili yu Guoyou Qiye Gaige*, *Zhongguo Zhengquan Bao* (China SEC. News), Internet ed., June 12, 2005; Ye Xiangsong & Cao Zongping, *Tuixing Duli Dongshi Zhidu, Wanshan Faren Zhili Jiegou* (Promote the Independent Director System, Perfect the Legal-Person Governance Structure), *Qishi Zazhi* (Seeking Truth Magazine), No. 6, 2004, at 30-31.

⁶⁷ See *Shoufen Gongsi Zhili Zhiyin Chutai* (First Guide to Corporate Governance Appears), *Zhongguo Jingji Shibao* (China ECON. Times), Nov. 6, 2000.

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

specifically mentioned—are to be composed principally of, and chaired by, independent directors. In early 2001, the Securities Regulatory Office of Shenzhen promulgated the "Guidelines for the Implementation of an Independent Director System in Listed Companies" (*Shangshi Gongsì Duli Dongshi Zhidu Shishi Zhiyin*). These provided detailed rules respecting the qualifications and functions of independent directors and presumably applied to companies listed on the Shenzhen Stock Exchange.

The CSRC in August 2001 issued its "Guidance Opinion on the Establishment of an Independent Director System in Listed Companies" (Independent Director Opinion). The Opinion covers Chinese companies listed in China; it does not cover Chinese companies listed overseas, which stipulated that listed companies in China shall revise their constitutions and hire appropriate people as independent directors (including at least one professional accountant) so that there would be at least two independent directors prior to 30 June 2002 and that at least one-third of directors would be independent prior to June 2003.⁷⁰

To strengthen the powers of the independent directors, the Independent Director Guidelines provide that independent directors are required to approve major related party transactions (including loans to related parties) whose total value exceeds RMB 3 million or 5% of the

⁷⁰ Guanyu Zai Shangshi Gongsì Jianli Duli Dongshi Zhidu de Zhidao Yijian (Guidance Opinion on the Establishment of an Independent Director System in Listed Companies), CSRC, 2001, 5 (1)

company's net assets: may appoint and remove the company's auditors; may propose to call a meeting of the board of directors or a shareholders' interim meeting; and can appoint an outside auditing and consulting organisation independently.⁷¹ The opinions of the independent directors must also be sought in the nomination, appointment and removal of directors and senior managers, as well as in the remuneration of directors and senior managers.⁷²

On paper, the independent director institution in China looks poised to play an effective role in corporate governance, but the reality may be rather different.

As shown in the optimistic words of a CSRC official stated in the 2005 OECD Policy Dialogue on corporate Governance in China:

“As [the] Chinese independent director system has not been established too long and experienced independent directors are badly needed, we have to wait a longer time to witness the obvious effect of independent directors' impact on corporate governance; however, we are deeply convinced that the establishment of the independent director system is a big step in making the Chinese people and companies have a better

⁷¹ Ibid .

⁷² Ibid.

understanding of the idea of corporate governance.”⁷³ I now turn to the problems and difficulties connected with the introduction of independent directors in China.

3.7 The gap between reality and expectation of the law in the role and powers of independent directors

3.7.1 Chinese entrepreneurs do not trust outsiders

The Chinese way of life continues to affect how business is run in China.⁷⁴ Secrets of the business and success are often kept “in the family.” This makes it difficult for independent directors to function effectively in China.⁷⁵ The traditional kinship, which dominates the clan corporation, continues to affect and dominate contemporary Chinese society, even in Communist China.⁷⁶ In other words, Business operations are traditionally run like a family (for example, within a clan corporation) in Chinese society and the younger and lower-ranking members of the

⁷³ Yang, H. (May 2005), "Overview of governance of State-owned Listed Companies in China", OECD Proceedings of the Second Policy Dialogue on Corporate Governance in China, Beijing, 19, available at <http://www.oecd.org/dataoecd/14/6/34974067.pdf>.

⁷⁴ "Ultimately, there is the issue of market culture and the general murkiness of the China business environment. Can we really expect former government workers (as red-chip employees are) to embrace a culture of shareholder value, or are they more likely to view corporatisation as an opportunity for personal enrichment?" said a commentator. Brooker, M., "Tannery Stink Spoils Theory", South China Morning Post, August 27, 2002, p.2.

⁷⁵ In 2005, the three independent directors in Guangdong Kelon Electrical Holdings who resigned recently stated in a resignation letter: "We think the company does not support our duty to protect shareholder rights," alleging that the company did not listen to their advice or provide enough information when they looked into several "abnormal" transactions.

⁷⁶ Ruskola, T. (2000). "Conceptualizing corporations and kinship: Comparative law and development theory in a Chinese perspective." *Stanford Law Review* 52(6): 1599-1729.

family trust the older members of the family to look after them - a tradition of "high trust, low structure."⁷⁷

3.7.2 Difficulties in finding appropriately experienced and qualified independent directors

The Independent Director Guidelines state that independent directors should, before taking office, make a declaration to the board of directors and the board of supervisors guaranteeing that they have sufficient time and energy to carry out their duties, and promising that they will perform them with diligence.⁷⁸

The Opinion takes a positive approach and a negative approach to the qualifications of independent directors. On the positive side, an independent director must (1) be qualified to serve as a director pursuant to the Company Law and other regulations; (2) possess the independence required by the Opinion itself;⁷⁹ (3) possess basic knowledge relevant to the operations of the listed company, and be familiar with relevant laws

⁷⁷ Potter, P. (2004). "Legal Reform in China-Institutions, Culture, and Selective Adaptation." *Law & Social Inquiry* 2(4): 465-95., citing Eisenstadt, S. N. and L. Roniger (1984). *Patrons, clients and friends : interpersonal relations and the structure of trust in society*. Cambridge, Cambridge University Press. and Merton, R. K. (1967). *Social Theory & Social Structure*. [S.l.], Free Press. Macmillan.

⁷⁸ See *supra* note 70

⁷⁹ First, Section 1(2) states that independent directors "are not to be influenced by major shareholders, controlling persons, or others who have a relationship of interest with the company." Second, the negative requirements of Section 3 specify further elements of the definition. China Securities Regulatory Commission, *Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian* (Guidance Opinion on the Establishment of an Independent Director System in Listed Companies) issued Aug. 16, 2001, 1(2), 3.

and administrative rules and regulations; (4) possess at least five years' work experience in law, economics, or other fields necessary for the proper exercise of his functions as independent director; and (5) possess other qualifications stipulated in the company's articles of association.⁸⁰

In a later press release, the CSRC stated that independent directors must also undergo a training course organized by the CSRC in conjunction with Tsinghua University.⁸¹

On the negative side, the following persons may not serve as independent directors: (1) a person who holds a position in the listed company or its subordinate affiliates as well as the direct relatives of, and those with important social connections⁸² to, the former; (2) a person, or the direct relative of a person, who directly or indirectly holds at least 1%⁸³ of the company's stock or is among the top ten shareholders of the company;⁸⁴ (3) a person, or the direct relative of a person, who is employed by an entity that directly or indirectly holds at least 5%⁸⁵ of the company's stock or is among the top five non-natural person shareholders of the company;

⁸⁰ Ibid, 2.

⁸¹ See Zheng Jian Hui: Jiaqiang Peixun Duli Dongshi Houbei Rencai (CSRC: Strengthen Training of a Reserve of Qualified Candidates for Independent Director), Shanghai Zhengquan Bao Wangluo Ban (Shanghai Securities News, Web Edition), Oct. 8, 2001, available at <http://finance.sina.com.cn/y/20011008/113694.html>.

⁸² "Direct relatives" are defined as a "spouse, mother, father, son, daughter, etc. China Securities Regulatory Commission, Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian (Guidance Opinion on the Establishment of an Independent Director System in Listed Companies) 2, issued Aug. 16, 2001. It is not clear to me what the "etc." is intended to cover. "Important social connections" are defined as "brother, sister, father-in-law, mother-in-law, son-in-law, daughter-in-law, spouse of a brother or sister, brother or sister of a spouse, etc." Ibid. Again, it is not clear how far the "etc." is intended to reach.

⁸³ The Chinese here is ambiguous; it could be "over 1%." Ibid.

⁸⁴ "Natural person shareholders" may be meant here. Ibid.

⁸⁵ Ibid.

(4) a person about whom any of the above conditions have been met within the last year; (5) a person who supplies accounting, legal, consulting, or other similar services to the company or its subordinate affiliates; (6) any other person specified in the company's articles of association; and (7) any other person specified by the CSRC.

Commentators at the time expressed doubts that companies governed by the Opinion could find qualified persons in the time available.⁸⁶ The total number of independent directors nationwide was quite small - a survey by the Shanghai Securities Exchange showed that only 0.3% of directors surveyed could be classified as "independent"⁸⁷ (other sources suggest 0.99%⁸⁸ and 3%⁸⁹) and another claimed that only 314 existed in the whole country.⁹⁰ By the end of July 2004, 1382 out of 1386 listed companies had independent directors on the board (i.e., four companies still had no independent directors at all). There were 4559 independent directors in

⁸⁶ See, for example, the comments to this effect by Li Yining, the chief architect of the Securities Law, in Li Yining: Shangshi Gongsi Duli Dongshi Zhi Shang Nan Fahui Zuoyong (Li Yining: It Is Still Difficult for the Listed Company Independent Director System to Play Its Proper Role), CHINA NEWS AGENCY, June 12, 2001.. See also Ni, J. (2001), Gongsi Zhili Jiegou: Falv Yu Shijian, (The Structure of corporate governance: Law and Practice), (Fali Chubanshe), at 120-21.

⁸⁷ See McGregor, R. China Plans New Market Rules, FIN. TIMES, Apr. 19, 2001, at 25; Ni, J. (2001), supra note 86, at 125.

⁸⁸ See Touzizhe Repan Duli Dongshi (Investors Eagerly Look Forward to Independent Directors), Xinming Wanbao (New People's Evening News), June 23, 2001, available at http://www.pcpa.com.cn/ch/communicate/Item_content.asp?id=266

⁸⁹ See, for example, the figures cited in Xie C.B., Shangshi Gongsi Faren Zhili Jiegou Yu Gudong Quanyi Baohu [The Corporate Governance Structure of Listed Companies and the Protection of Shareholders' Rights] (Paper for 21st Century Commercial Law Forum, Tsinghua Univ., Beijing, Nov. 18, 2001).

⁹⁰ See Duli Dongshi yu Duli Jianshi (Independent Directors and Independent Supervisors), Guangming Ribao (Enlightenment Daily), Sept. 18, 2001. Citing annual reports for the year 2000, another source puts the number at 103. See Touzizhe Repan Duli Dongshi (Investors Eagerly Look Forward to Independent Directors), Xinming Wanbao (New People's Evening News), June 23, 2001.

total, yielding an average of just over three per company.⁹¹

3.7.3 Independent directors do not really have power

Independent directors are supposed to pay special attention to the interests of small and medium shareholders, but there is no mechanism to push them in this direction. The Independent Director Opinion seems to give special powers to independent directors by requiring that they constitute at least half of the members of a board's audit, nomination, and compensation committees.⁹² On the other hand, there is no requirement that these committees be established, so a company could keep inside director control over such matters by having them decided by the entire board.⁹³

The independent directors apparently do not have the power to actually call a meeting of shareholders or the board; they have only the power to recommend to the board that such a meeting be called. The

⁹¹ See Duli Dongshi Zhidu Wanshan Zhi Lu Reng Manchang (The Road to Perfecting the Independent Director System Is Still Long), Shichang Bao (MARKET NEWS), Sept. 14, 2004, at 11, available at <http://finance.sina.com.cn/roll/20040914/024010135.shtml>.

⁹² China Securities Regulatory Commission, Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian (Guidance Opinion on the Establishment of an Independent Director System in Listed Companies) issued Aug. 16, 2001, 1.3

⁹³ A survey of listed companies showed that as of mid-May 2003, about half had not established any of the board committees on which independent directors have a special role under the Independent Director Opinion. See Jin Xin Securities, Dui Woguo Shangshi Gongsi Duli Dongshi Zhidu Shishi Zhuangkuang de Fenxi ji Jianyi (Analysis and Suggestions Concerning the Situation of Implementation of the Independent Director System in China's Listed Companies), Aug. 8, 2003, at <http://news1.jrj.com.cn/news/2003-08-07/000000618234.html>. The information contained in this report is based on a survey of 69 listed companies.

powers listed above cannot be exercised by individual independent directors; their exercise must receive the consent of a majority⁹⁴ of the independent directors as a body. More importantly, the only real force pushing strongly for independent directors seems to be the CSRC, whose authority over internal corporate governance matters has been questioned and which in any case has not required companies to give independent directors real power.⁹⁵ The Opinion does not actually confer these powers on independent directors. It calls on companies to confer these powers, presumably through provisions in their articles of incorporation or other internal rules. A company that does not do so may encounter pressure from the CSRC to make appropriate changes, but it would not be acting illegally in failing to do so.⁹⁶

It is submitted that the early experience gathered by independent directors in China shows that the institution has long way to go before it can take an effective role in corporate governance. For instance, whilst the Independent Director Guidelines and the Code of Corporate Governance provide that independent directors shall not be related to the listed company's management and major shareholder, interviews with independent directors have found that an overwhelming majority of

⁹⁴ 2001 Guidance Opinion on the Establishment of an Independent Director System in Listed Companies, CSRC, 5.1

⁹⁵ Green, S. (2003). *China's Stock Market: Eight myths and some reasons to be optimistic*, Royal Institute of International Affairs and Cambridge University: 8-9.

⁹⁶ See Jin Xin Securities (2003), *supra* note 93.

independent directors are appointed by the largest shareholder, are relatively weak in appraising and supervising management, and are subject to interference by the largest shareholder and the management.⁹⁷

The Dean of the Changjiang School of Business, who serves as an independent director, was recently quoted as saying, "I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state."⁹⁸

Shi Xinghui's interviews with 104 independent directors in 52 Chinese listed companies revealed the following empirical results.⁹⁹ First, the Ability of the Independent Director to act as a Monitor of management is Low. Shi's interviews showed that the average number of independent directors in a listed company is two, in contrast with the rest of the directors, who may number as many as 19. How can we expect two or three independent directors to stand up against the dominant

⁹⁷ Lu, T. (2003), "Development of the System of Independent Directors and Chinese Experience", Institute of World Economics and Politics, Chinese Academy of Social Sciences, available at <http://old.iwep.org.cn/cccc/pdf/Development%20of%20System%20of%20Independent%20Directors%20and%20the%20Ch%20A%20AD.pdf>. A survey of the China Securities Daily shows that 67.5% of the independent directors were nominated by the board of directors, while 27.5% were directly nominate by the controlling shareholders, "Zhangguo Dudong Diaocha Ji Zhidu Fansi" ("Survey on China's Independent Directors and Reflections on the Institutions"), China Securities Daily, 28 July 2005, available online at http://www.cs.com.cn/syln/04/t20050728_723933.htm.

⁹⁸ Xiang Bing, quoted in Duli Dongshi Xiang Huaping? (Are Independent Directors Just Decorative?), Gang-ao Xinxi Ribao (Hong Kong-Macau News Daily), Jan. 1, 2003, available at <http://www.chinainfobank.com>.

⁹⁹ Shi, X. (2001). "Wei Duli Dongshi Diaocha Fenxi—Tamen Shi Shei? (An Investigation and Analysis of 104 Independent Directors: Who Are They?)." *Zhongguo Qiye Jia (The Chinese Entrepreneur)* 7: 17.

shareholder's nominees who comprise the majority of the board? They are simply outnumbered.¹⁰⁰

In another report by the Financial Times, it was found that independent directors of at least three listed firms were forced to resign after challenging management decisions, including requesting an audit of one's company's account.¹⁰¹ Again, Shi's interviews¹⁰² found that independent directors are generally old in age, with 30.7% of them in their sixties. In terms of their professional capabilities, 42.6% are technical experts, 22.8% are economists, 47.6% are college teachers or researchers, 15.5% are government functionaries and only 22.3% are entrepreneurs. A CSRC study in 2002 found a similar number, with accountants, lawyers, and other intermediaries making up another 30%. Only 10% were executives from other companies.¹⁰³ A more recent study based on a random sample of 500 listed companies found that 45% of independent directors were university professors or researchers from institutes, similar to the figure in previous studies. Other (presumably industrial) companies were the source for 28% of the independent directors, while lawyers, accountants,

¹⁰⁰ Shen, S. B. and J. Jia (2005). "Will the Independent Director Institution Work in China?" Loyola of Los Angeles International and Comparative Law Review 27,: 223.

¹⁰¹ "Director Loses Seat for Hiring Auditor" Financial Times, 18 August 2004.

¹⁰² Shi, X. (2001), *supra* note 99.

¹⁰³ See Du Dong Duiwu Jisu Kuorong (Ranks of Independent Directors Quickly Enlarged), Zhengquan Shibao (Securities Times), March 2003. A 2003 study put the number of professors at 39%; this is not necessarily inconsistent with the other studies, since the category "professors" may have been more narrowly defined than the category "professors and technical specialists." See Jin Xin Securities (2003), *supra* note 93.

and other service industry professionals accounted for 14%.¹⁰⁴

These data are disturbing as they confirm that independent directors in China cannot act as a counterbalance to the rest of the board. Independent directors cannot be expected to detect dishonesty hidden in the neat and professionally turned-out documents presented to him for board meetings, assuming he gets invited to the board meetings.¹⁰⁵ In some cases, the listed firm withheld negative information from the independent directors, and even refused to invite them to board meetings.¹⁰⁶

3.7.4 Independent directors do not have the financial incentive

There is no financial incentive to act impartially and professionally as an independent director. Evidenced by a survey of the China Securities Daily, which revealed that 52.5% of independent directors had their remuneration determined by the company's "senior managers" whilst 37.5% had theirs determined by the company's controlling shareholders.¹⁰⁷ So how can one expect the independent directors to be independent when their remuneration is decided by the very people they

¹⁰⁴ See, Yue Qingtang (2004), Dui 500 Jia Shangshi Gongsu Duli Dongshi Nianling Zhuanye Deng Goucheng de Shizheng Yanjiu (An Empirical Study of the Age and Occupational Composition of the Independent Directors in 500 Listed Companies), Jingjiye (ECON. World), No. 2, at 86-88.

¹⁰⁵ Shen, S. B. and J. Jia (2005). Supra note 100.

¹⁰⁶ Green, S. and J. Ho (2004). "Old Stocks, New Owners: Two Cases of Ownership Change in China's Stock Market." *Journal of Chinese Economic and Business Studies*.

¹⁰⁷ Lu, T. (2003), supra note 97.

are supposed to monitor?¹⁰⁸ The remuneration of independent directors in China is not linked to the performance of the director or the company, and is not high by Western standards.

One study reports annual director fees in the range of 5000 to 12,000 yuan.¹⁰⁹ This is between US\$730 and \$1,700 at current exchange rates. In view of other studies, however, this figure seems low. The recent study is based on data from the annual reports for 2002 of 81 listed companies that had independent directors since at least 2000.¹¹⁰ The authors found that over half the companies paid less than 30,000 annually to each independent director.

In 2002, Lu Jiahao, an independent director of Zhengbaiwen, was fined RMB 100,000 by the CSRS for failing to take action when the company submitted a false accounting report. Lu subsequently sued the CSRS for this decision, but the No 1 Intermediate People's Court of Beijing dismissed the lawsuit. Lu was the first independent director punished in China and his situation was deserving of sympathy. He was a retired professor with a monthly income of only RMB 1,500 (US\$181) and he

¹⁰⁸ Shen, S.B. and J.Jia (2005), *supra* note 100.

¹⁰⁹ Wu, J. et al., *Duli Dongshi Zenme Yangle—Shangshi Gongsi Tuixing Duli Dongshi Zhidu Xianzhuang Diaoyan Fenxi* (How Are Independent Directors Doing? An Investigation and Analysis of the Current Situation in the Implementation by Listed Companies of the Independent Director System), *Zhengquan Shibao* (Securities Times) Jan. 10, 2002.

¹¹⁰ See Luo Pinliang (2004) et al., *Duli Dongshi Zhidu yu Gongsi Yeji de Xiangguanxing Fenxi: Laizi Hushi A-Gu De Shizheng Yanjiu* (An Analysis of the Relationship Between Independent Directors and Corporate Performance: An Empirical Study of A-share Performance in the Shanghai Stock Market), *Shanghai Guanli Kexue* (Shanghai MGMT. SCI.), No. 2, at 20-23.

received no compensation from Zhengbaiwen for the directorship. Immediately after the incident, at least 66 independent directors resigned from listed companies.¹¹¹

Gao and Ma examined all 1151 reporting companies on the two Chinese exchanges (yielding an effective sample of 1018 companies), 83 of which had appointed independent directors in the previous three years.¹¹² They found no support for the hypotheses that (a) there is a clear difference in performance between companies with independent directors and those without, or that (b) there is a positive correlation between percentage of independent directors on the board and corporate performance.¹¹³ Indeed, the introduction of the independent director to China has many similarities noted by Lawton in relation its introduction to Hong Kong.¹¹⁴

I would submit that there are deeper reasons for the apparent failure of the institution of the Independent Non-executive Director in China. These reasons are to a degree also applicable in their countries of origin, but in the Chinese context are even culturally stronger. As Brudney pointed out

¹¹¹ Shen, S.B. and Jjia (2005), *supra* note 100.

¹¹² Gao, M. and S. Ma (2002). "Duli Dongshi Zhidu yu Gongsi Jixiao Guanxi de Shizheng Fenxi (An Empirical Analysis of the Relationship Between the Independent Director System and Corporate Results)." Nankai Jingji Yanjiu (Nankai University Economic Studies) 2: at 64-68.

¹¹³ *Ibid.*

¹¹⁴ Lawton P, (1995), "Directors' Remuneration, Benefits and Extractions, an Analysis of their uses, Abuses and Controls in the Corporate Governance Context of Hong Kong " Australian Journal of Corporate Law 4, 430 at 452-455; Lawton, P (1996), " Berle and Means, Corporate Governance and the Chinese Family Firm " Australian Journal of Corporate Law 6, 348 at 365-368. The large number of independent directors who are professionals rather than executives of other companies and the large number of friends and contacts who were appointed in the early stages is similar. Also the implications for director interlocks are similar.

as long ago as 1982:

“The institutionally generated disinclination to hold colleagues at arm’s length is furthered by other psychological and social considerations. Besides pressure to follow the leader in the boardroom along lines described in the learning on small group dynamics, other factors make independent directors particularly apt to view management’s demands congenially. If they are not themselves corporate executives, independent directors tend, nevertheless, to share common business and professional backgrounds with, and to live in the same social and economic milieu as does, management.”¹¹⁵

Similar findings in other jurisdictions supported this view of independent directors’ tendency to support management.¹¹⁶ More recently, Morck¹¹⁷ has pointed to the role of misplaced loyalty at the heart of every recent corporate scandal emphasising that, according to much work in empirical social psychology, loyalty is emotionally hardwired into human behavior. He refers, inter alia to the work of Milgram evidencing that an individual will suppress internal ethical standards quite readily if these conflict with loyalty to an authority figure such as a misguided or errant CEO.

¹¹⁵ Brudney, V. (1982). "The Independent Director - Heavenly City or Potemkin Village." Harvard Law Review 95(3): 633.

¹¹⁶ See for example, Udeni, H. (1997). "Power Dimensions in the Board and Outside Director Independence: Evidence from Large Industrial UK Firms." Corporate Governance: An International Review 7(62). ; Tomasic, R. and S. Bottomley (1993). Directing the Top 500: Corporate Governance and Accountability in Australian St Leonards, NSW, Australia : Allen & Unwin, at 17.

¹¹⁷ Morck, R. (2008). "Behavioral finance in corporate governance: economics and ethics of the devil's advocate." Journal of Management and Governance 12: 179-200.

However, according to Milgram, dissenting peers and rival authorities undermine a subject's loyalty, stimulating independent moral reasoning.¹¹⁸

Recent corporate governance reforms in the UK and the USA have sought to weaken this innate but errant response of loyalty in order to render corporate governance disasters less common. Along these lines the Sarbanes Oxley reforms in the USA require that boards of directors contain sufficient independent directors to staff key board committees, whilst the Higgs proposals in the UK recommended that listed companies have non-executive chairs and senior independent directors thereby providing for alternative authority figures on the board. These requirements were incorporated into the Combined Code in 2006.¹¹⁹ China has not yet gone so far in relation to these types of proposals. Nor is China likely to do so for the foreseeable future. There are a number of political and cultural reasons why this is unlikely.

The first reason is the very hierarchical nature of Chinese authority structures, particularly within government bureaucracies at both local and central government level and within certain government agencies such as

¹¹⁸ Milgram, S. (1963). "Behavioral-Study of Obedience." *Journal of Abnormal Psychology* 67(4): 371-378.;

Milgram, S. (1974). *Obedience to authority: an experimental view*, London: Tavistock Publications.

¹¹⁹ See Higgs, D. (2003) *Review of the role and effectiveness of non-executive directors* (The Higgs Report) (DTI). These recommendations were included in the *Combined Code* 2006, at A.3.2 and A.3.3.

the State Assets Management Bureau and the Ministry of Finance (Enterprise Division). This is in turn reflected in many corporate structures. Both those which are corporatized SOEs and most corporations within the private business sector are similar in this respect due to the usually patriarchal/patrimonial (less commonly matriarchal) authoritarian nature of the organisation.¹²⁰ Hamilton has contrasted western and Chinese society from the perspective of patriarchy, patrimonialism and filial piety. Building on Fei Xiatung's work¹²¹ by using his metaphors to explain the distinctive patterning in each society Hamilton takes the view that Western individuals fall under specific and distinct jurisdictions from the club, office or division of a corporation all the way up to the level of the State and take their rights and duties accordingly.¹²² In the context of Chinese society there are rarely clear social units and ambiguity is common. The metaphor used for Chinese society is that of concentric rings flowing out from the centre when a stone is thrown into a pond. In this contextual setting a Chinese person stands at the centre of the circles produced by his or her own social influence. The kinship rings are the closest to the centre and they are

¹²⁰ There are a number of studies indicating this, see for example Hui Y W, (1999), A Study of Authority and Relations in Chinese Governmental Agencies and Institutional Work Units: Neo Patrimonialism in Urban Work Units NY, Edwin Meller Press Ltd. Empirically examining issues of authority and human relations in Chinese Government organizations and other work units by tracing their development before and after Mao's era this work strongly indicates that the quasi charismatic patterns of authority under Mao have given way to more traditional patrimonial relationships at the micro level. However, CCP domination continues to prevail politically at the macro level.

¹²¹ Fei Xiatung, (1986) Xiangtu Zhongguo (Rural China) (Hong Kong, Joint Publishing Co) Chs 4 and 5.

¹²² Hamilton, G. G. (1990). "Patriarchy, Patrimonialism, and Filial Piety - a Comparison of China and Western-Europe," British Journal of Sociology 41(1): 77-104.

many and varied but they do not take precedence over more distant relationships. Everyone's circle of influences or circles of relationships are interrelated but no one person has exactly the same set. Nevertheless, they are ranked and the duties for each relationship are publicly known and to some extent codified. According to Fei, individuals calculate their actions by knowing with whom they are dealing and knowing the relationship that prevails rather than being aware of where those relationships fit organizationally. These patterns of behaviour persist and are often mirrored at board level in Chinese enterprises. The independent director, in the Chinese context, has to operate within them and therefore is arguably even more likely to be sympathetic to management proposals than his Western counterpart.¹²³ In the light of the above discussion Campbell's call for an ethical framework for cooperation within a company may not be that effective without both alternate authority figures and directors who are prepared to dissent within the board, even if those ethical codes/frameworks have been strongly internalized by board members.¹²⁴

¹²³ For a discussion of these factors in the context of corporate governance see Lawton P, (1996), "Berle and Means, Corporate Governance and the Chinese Family Firm" Australian Journal of Corporate Law 6(3), 348-379.

¹²⁴ Campbell D, (1997), "The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation" Australian Journal of Corporate Law 7, 343-365 at 362; see also Campbell D, (1997), "Towards a Less Irrelevant Socialism: Stakeholding as a 'Reform' of the Capitalist Economy" Journal of Law and Society 24, 65.

3.8 Directors' duties

3.8.1 Duties of directors in the United Kingdom

The general duties of directors are reinforced by specific statutory duties spelt out in Pt 10 Ch.2 of the Companies Act 2006. In addition to codifying the case law on directors' duties, these provisions replace complicated provisions under the 1985 Act, many of which were introduced as a result of financial scandals.¹²⁵ In addition to duties of care and skill at common law¹²⁶, the important fiduciary duties, derived from principles of equity as applied to directors include a number of important principles or rules of law requiring directors to act in good faith. Therefore, a director must exercise his powers entrusted to him under the company's constitution for their proper purpose and in good faith for the benefit of the company as a whole¹²⁷. He must act within his powers. A

¹²⁵ Craig, R. (2008). "The enormous turnip: a discussion on the companies act 2006 which like in the child's fairy tale is still growing." *The Company Lawyer* 29(12): 361.

¹²⁶ For a long time these were subjective in nature taking into account the skills and experience of the particular director or directors concerned, see for example *Dovey v Cory* [1901] AC 477; *Re Brazilian Rubber Plantation & Estates Ltd* [1911] 1 Ch 425; *Re City Equitable Fire Insurance Co* [1935] Ch 407; *Dorchester Finance v Stebbing* [1989] BCLC 498. Breach of the duty of care and skill was always ratifiable until recently unless the directors benefitted at the expense of the company from their breach of duty, see *Pavlides v Jensen* [1956] Ch 565; *Multinational Gas Ltd v Multinational Gas & Petrochemical Services Ltd* [1983] Ch 258 and *Daniels v Daniels* [1978] Ch 406. More recently the courts have tended to take a more objective approach to the standard of care, see *Norman v Theodore Goddard* [1991] BCLC 1028. This has been influenced by the combined subjective and objective test for wrongful trading in the insolvency Act 1986, s 214. Poor management is a normal risk of investment and may not give rise to an action for unfairly prejudicial conduct, *Re Elgindata Ltd* [1991] BCLC 1028, though a repeated course of poor actions amounting to specific negligence may do so, see *Re Macro (Ipswich) Ltd* [1994] 1 All ER 242. The Companies Act 2006, s 260 (3) now allows a derivative action to be brought for negligence. The duty to exercise reasonable care, skill and diligence is now contained in Companies Act 2006, s174.

¹²⁷ See for example, *Re Smith & Fawcett Ltd* [1942] Ch 304; *Punt v Symons & Co Ltd* [1903] 2 Ch 506; *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77; *Hogg v Cramphorn* [1966] 3 All ER 420; *Howard Smith v Amphol Ltd* [1974] AC 821. The duty of directors to act within their powers is now contained in Companies Act 2006, s 171. Of

director must not take into account irrelevant factors but rather he must act in the interests of the class of shareholders taken as a whole and he must not fetter his discretion¹²⁸. To fulfil his fiduciary duties a director must not allow his duty to the company and personal interests to conflict. He must not be in a position of conflict of interest or duty. Secret profits or otherwise unauthorized profits are not allowed. If a director is in a position of conflict of interest and/or duty he must make disclosure¹²⁹. Whilst a company's articles may waive duties, the duty to disclose is reinforced by statutory provisions and the company's articles of association.¹³⁰ In effect the duty to disclose a conflict of interest cannot be waived. Failure to disclose a conflict of interest or duty renders any affected contract voidable and any profit made is to be accounted for to the company and may be held on constructive trust¹³¹. Directors' duties may be enforced by the company, though often the company may be under the control of the wrongdoing directors in which case the law provides for remedies for minority shareholders¹³². These will be

significant importance is the statement of directors' duty to promote the success of the company which lists a wide range of factors which directors ought to take into account in promoting the success of the company for the benefit of the members as a whole contained in section 172.

¹²⁸ See *Selangor v Craddock No 3* [1968] 1 WLR 1555; *Thorby v Goldberg* (1964) 112 CLR 597; *Fulham Football Club v Cabra Estates plc* [1994] 1 BCLC 363. The duty to exercise independent judgment is now contained in Companies Act 2006, s 173.

¹²⁹ See *Aberdeen Railway v Blaikie Brothers* (1854) 1 Macq 461, HL; *Boston Deep Sea Fishing Co Ltd v Ansell* [1986] All ER Rep 65; *Movitex Ltd v Bullfield* [1988] BCLC 104. The statutory requirement to make full disclosure is now contained in Companies Act 2006, ss 177.

¹³⁰ See Companies Act, s 177 *supra* and see also *Guinness v Saunders* [1988] BCLC 607, CA; [1990] BCLC 402. Standard Articles of Association usually make waiver of the civil remedies subject to disclosure.

¹³¹ Companies Act 2006, s 178 maintains the common law principles of the civil consequences of a failure to make full disclosure, see also cases mentioned in fn 142 *ante*.

¹³² See the statutory derivative action contained in Companies Act 2006 ss 260 – 264 and unfairly prejudicial conduct contained in ss 994-999.

discussed in a later chapter¹³³. However, the duties of directors provide an important set of standards for directors and are replicated throughout the various jurisdictions of the common law world which have increasingly codified these duties in their company law legislation. Some problems do remain, particularly the potential conflict of interest of nominee directors. The often divergent norms of the law and commercial reality in this context have caused problems for the codification of duties of nominee directors¹³⁴.

There are a number of views concerning the efficacy of fiduciary duties. Many economists argue that the role of fiduciary duties should vary across the type of organizational form. Therefore, in the context of the closely held firm stricter fiduciary duties are justified in light of their organizational characteristics to prevent or cure opportunistic behavior as many case law examples show¹³⁵. There is a continuing debate on this subject. Some commentators defend and develop this approach in the context of closely held corporations. Others argue that even in closely

¹³³ See chapter 5 post.

¹³⁴ For a discussion of this problem, see Salim, M. R. and T. T. Yong (2008). "Market freedom or shareholder protection? A comparative analysis of the duties of nominee directors." International Journal of Law and Management 50: 168-188.; See also Boros, E. (1989). "The duties of nominee and multiple directors Part 1." The Company Lawyer 10(11): 211-219. ; Boros, E. (1990). "The duties of nominee and multiple directors Part 2." The Company Lawyer: 6-10. ; Crutchfield, C. (1991). "Nominee directors: the law and commercial reality." The Company Lawyer 12(7): 136. ; Redmond, P. (1987). "Nominee Directors." University of New South Wales Law Journal 10(194).

¹³⁵ Dickerson, C. M. (1997). "Cycles and Pendulums; Good Faith, Norms and the Commons." Washington and Lee Law Review 54. ; Dickerson C M, (2004), "Bracketed Flexibility: Standards of Performance Level the Playing Field" in McCahery, J., M. J. G. C. Raaijmakers, et al. (2004). The governance of close corporations and partnerships : US and European perspectives. Oxford, Oxford University Press.

held firms strict fiduciary duties are counter-productive in encouraging over monitoring at the expense of production¹³⁶. Agency theorist even claim that there is no moral basis for fiduciary duties and that they are simply an element of contractual tailoring of obligations allowing parties to waive fiduciary duties and allow them to signal their governance preferences¹³⁷. This is, in reality a common practice subject to the limitations concerning disclosure mentioned above. Waiver is different to a right to 'opt out' which is increasingly the case in some jurisdictions¹³⁸. This is arguably leading to an erosion of the underlying principles of fiduciary duties and could lead to a norm change in the long run. However, agency theory (and the nexus of contracts approach which agency theory embodies) has been heavily criticized in this respect. According to Campbell all that agency theory amounts to is a nexus of metaphors rather than any real nexus of contracts¹³⁹.

In the United Kingdom, the main function of the board is to be responsible for the strategy and management of the company. In general,

¹³⁶ See, for example, Ribstein, L. E. (1995). "Limited Liability and Theories of the Corporation." Maryland Law Review 50(80). ; Talley, E. (1999). "Taking the 'I' Out of 'Team': Intra-Firm Monitoring and the Content of Fiduciary Duties." Journal of Corporation Law 24.

¹³⁷ See Easterbrook, F. H. and D. R. Fischel (1993). "Contract and Fiduciary Duty." Journal of Law & Economics 36(1): 425-446.

¹³⁸ See for example, Mance, J. (2001). "Forecasting the Future: An Assessment of the New Delaware General Corporations Law, Section 122 (17)." Journal of Corporate Law Studies 1(2): 449. This provision enables corporations to renounce, in advance, any interest or expectancy the corporation may have in specified business opportunities or specified classes of opportunities that come to the corporation or its officers, directors or shareholders. In Mance's view this represents a sensible compromise between freedom of contract and mandatory rules.

¹³⁹ Campbell, D. (1997). "The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation." Australian Journal of Corporate Law 17: 343-365.

it is also responsible for overseeing the company's operations including ensuring an adequate system of internal control, competent management team, and compliance with statutory and legal requirements.¹⁴⁰

The Companies Act 2006 is a UK-wide piece of legislation. The 1985 legislation and Companies (NI) Order 1989 has been changed in order to meet four key objectives:

- to enhance shareholder engagement and a long-term investment culture;
- to ensure better regulation and a "Think Small First" approach as mentioned earlier;
- to make it easier to establish and manage a company;
- to provide flexibility for the future.

The Companies Act 2006 is not complete. It will be supplemented by a series of Regulations using powers given to the Secretary of State in certain parts of the Act. It will therefore be supplemented by Commencement Orders which bring the Act into force.¹⁴¹

¹⁴⁰ Important sections of the 2006 Act relating to directors' duties are noted. S 171 A director of a company must (a) act in accordance with the company's constitution, and (b) only exercise powers for the purpose for which they are conferred." Section 172: Duty to promote the success of the company. Section 173: Duty to exercise independent judgment. Section 174: Duty to exercise reasonable care, skill and diligence. Section 175: Duty to avoid conflicts of interest. Section 176: Duty not to accept benefits from third parties. Section 177: Duty to declare interest in proposed transactions or arrangements with the company.

¹⁴¹ Craig, R. (2008), Supra note 125.

3.8.2 Duties of the directors in China: the law on paper

China did not start developing a range of directors' duties until the early 1990s. Prior to 1990, there was little codification to regulate corporate directors and managers. In 1994, the first company code of the People's Republic of China - the Company Law - was introduced. The Company Law 1994 incorporated many principles and practices of both Anglo-American systems and civil law systems.¹⁴² With the promulgation of the Chinese Company Law 1994 ("the CCL 1994"), the legal underpinning for the concept of directors' duties was put into place.¹⁴³ Although the words "fiduciary duties" were not clearly expressed, certain concepts akin to these duties manifested themselves in the context of the CCL 1994.¹⁴⁴

The new People's Republic of China (PRC) Company Law (Company Law), which was adopted at the 18th meeting of Standing Committee of the Tenth National People's Congress on October 27, 2005, came into force on January 1, 2006. The new Company Law of the PRC is good in

¹⁴² One example is that it adopts a two-tier board system on the one hand, and requires listed companies to have independent executive directors on the other. See Company Law of the People's Republic of China 1994 ss.52, 71, 118 and 123

¹⁴³ Yang, J. Z. (2006). "The role of shareholders in enforcing director's duties: A comparative study of the UK and China: Part 1." *International company and commercial law review* 17(11): 318.

¹⁴⁴ For example, Art.59 of the CCL 1994 states that the directors, supervisors and managers shall abide by the company's articles of association, faithfully perform their duties and protect the interests of the company and shall not take advantage of their position, functions and powers in the company to seek personal gains which is akin to a fiduciary duty of loyalty under common law. Under this provision, it seems that directors, supervisors and general managers should act in a bona fide and diligent way in the interests of the company. However, the words "faithful" and "the interests of the company" employed in the context of the Art.59 of the CCL 1994 have not been clearly defined, so that they are not well understood by either the directors or shareholders.

theory and brings some encouraging changes, but how it will be put into practice is another matter.¹⁴⁵

I No-conflict rule

Article 61 of the CCL 1994 provides a mandatory context which regulates two distinct factual situations in which conflicts of duty and interests are likely to arise. First, directors and managers are prohibited from engaging in their own business or operating business for others in the same business category as the company which they are serving, or engaging in any acts which may damage the interests and benefits of the company, and any profits derived from such acts will be appropriated by the company.¹⁴⁶

Secondly, directors and managers are prohibited from entering into contracts or conducting transactions with the company unless they are authorised by the articles of association or approved by the shareholders' meeting.¹⁴⁷

¹⁴⁵ Krause, N. and C. Qin (2007). "An overview of China's new Company Law." The Company Lawyer 28(10): 316-320.

¹⁴⁶ Art.61 of the CCL 1994.

¹⁴⁷ Ibid., para.2.

In order to ensure that directors are precluded from entering into engagements in which they have, or can have, a personal interest conflicting, or which may conflict, with the interests of the company they serve, the Directive 1997 further provides that:

"[E]xcept as permitted by the articles of association or legally authorized by the board of directors, a director may not act on behalf of the company or the board of directors in his own name. If a third party reasonably believes that a director, who is acting in his own name, is acting on behalf of the company or the board of directors, such a director must clarify his position and status in advance".¹⁴⁸

In addition, if a director or an enterprise in which he/she assumes a position is interested, directly or indirectly, in any existing or proposed transaction, contract or arrangement of the company (other than a service contract), such a director must disclose his/her interests to the board of directors at the earliest opportunity. The interested director may not be counted in the quorum for or vote at the board meeting with respect to such matters. A related party transaction approved by the board of directors in violation of the above requirements may be avoided at the option of the company, unless the transaction is entered into between the company and a third party acting in good faith.¹⁴⁹

¹⁴⁸ Para.1 of Art.62 of the CCL 1994.

¹⁴⁹ Art.83 of the Directive 1997.

II Duty of care, skill and diligence

In China, the absence of the duty of care, skill and diligence of company directors is the weakest portion of the CCL 1994. The Directive 1997 clarified that directors must exercise their powers given by the company with care, conscientiousness and diligence¹⁵⁰ so as to ensure that: (1) the company's business activities comply with state laws, regulations and economic policies and do not exceed the business scope stipulated by its business licence;¹⁵¹ (2) directors treat all shareholders fairly;¹⁵² (3) directors read all commercial or financial reports of the company carefully and timely acquaint themselves with the business operation and management of the company;¹⁵³ (4) a director personally exercises the lawful powers to manage the company free from the control of others and shall not delegate his powers to others, except as permitted by laws, regulations or approved by informed shareholders in a shareholders' meeting;¹⁵⁴ and (5) directors accept the lawful supervision and reasonable suggestions on their performance of their duties provided by the supervisory committee.¹⁵⁵ In addition, Art.85 of the Directive 1997 provides that a director who fails to attend two successive board meetings, whether in person or through delegating his duties to others, is deemed

¹⁵⁰ Art.81 of the Directive 1997.

¹⁵¹ Ibid, Art.81 (1)

¹⁵² Ibid, Art.81(2) .

¹⁵³ Ibid, Art.81(3)

¹⁵⁴ Ibid, Art.81(4) .

¹⁵⁵ Ibid, Art.81(5)

incapable of performing his duties and the board of directors shall propose to the shareholders' meeting to remove that director.¹⁵⁶

3.8.3 Duties of directors in China: the law in practice

These strict rules seem to function against any director and manager who might misuse his or her power in a particular situation mentioned above. However, good law does not guarantee good practice. This provision is difficult to enforce because most listed companies in China are controlled by the majority or controlling shareholders.¹⁵⁷

I The largest shareholder is the state

The China Corporate Governance Report 2003 presented the picture of ownership concentration in China's listed SOEs: "Data in the 2002 annual reports of 734 companies listed on the Shanghai Stock Exchange (released as of June 20, 2003) suggests that, in the end of 2002, in 40.9% of all the companies (a total of 300 companies), the largest shareholders owned more than 50% of total shares... On average, in all 734 companies, each largest shareholder possessed 44.3% of its company's shares."¹⁵⁸

¹⁵⁶ Ibid, Art.85

¹⁵⁷ Yang, J. Z. (2007). "The Shareholder Meeting and Voting Rights in China: Some Empirical Evidence." *International Company and Commercial Law Review* 18(1): 4-16.

¹⁵⁸ Zhongguo Gongsi Zhili Baogao 2003 (China Corporate Governance Report 2003), Shanghai Stock Exchange Research Center, April 2003, at 46 (Shanghai, Fudan University Press) (hereinafter China Corporate Governance

The largest shareholder normally refers to the Chinese state, suggesting a state dominance of shareholding in listed SOEs. The high concentration of ownership is closely related to the control of the board of directors, which is regarded as the critical link between ownership and corporate governance.¹⁵⁹ For example, in some cases, listing companies and the controlling shareholder are often in the same business sector so that it is common for the controlling shareholder to take advantage of its privileged position to gain additional benefit through distributing products, supplying raw materials, sharing resources or other related business transactions.¹⁶⁰ In some cases, the listed companies help their controlling shareholders to gain additional benefit by offering loan guarantees or by leasing the controlling shareholder's facilities at a high price.¹⁶¹ Some listed companies are said to have become like "ATMs" of the controlling shareholders.¹⁶²

Report 2003).

¹⁵⁹ Green, S. (2003). The Economist China's stockmarket : a guide to progress, players and prospects. London, Profile.

¹⁶⁰ The associated trading between listed companies and large shareholders is popular in China. Statistics show that nearly 40 per cent of listed companies have associated trading with the top 10 large shareholders in sales, procurement, providing services, acquirement or leasing assets. Ma, J. (1997) "China's Economic Reform in the 1990s," available at www.members.aol.com/junmanew/chp5.htm.

¹⁶¹ For example, in November 2003, Xinjiang Hops, a barley and beer firm, announced that it had made guarantees worth RMB 1.8 billion (\$216 million) in loans to related parties. The firm's assets only total RMB600 million (\$72.3 million). See Green, S. (2004), "Enterprise Reform & Stock Market Development in Mainland China Special" Deutsche Bank Research, March 25. An investigation by the CSRC found that about 20 per cent of listed companies provide guarantees for the controlling shareholders and associated parties, see Ma, J. (1997), *supra* note 160.

¹⁶² Tong, D. (2006), "Current Conditions, Problem of Listed companies and How to Exercise Regulation: Positioning of the Responsibilities of Regulatory Department and Regulatory Measures, in Corporate Governance Reform: China and the World." Available at www.cipe.org/china/cg_book_toc.htm.

II The relationship between the state and SOE managers

The state, in the name of the people, is supposed to be the owner of all state property including SOEs of all sizes. The State Council is usually held to be the ultimate state organ holding state property. When an SOE is listed, the local office of the Bureau of State Asset management (BSAM) or its local subsidiaries, called state asset management companies (SAMs), act as the largest shareholder. The chairman of the board of directors is usually a representative from the BSAM. In consultation with the board, the chairman nominates the managers of the listed SOE and oversees the management.¹⁶³

The research by Chen, Fan and Wong finds that in China, politicians and state controlling owners occupy most board seats. They report that almost 50% of the directors are appointed by state controlling owners, and another 30% are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants, finance experts) on Chinese boards and almost no representative of minority shareholders.¹⁶⁴

This has led one writer to express the view that corporatisation of SOEs

¹⁶³ Ibid.

¹⁶⁴ Chen, D.-H., J. Fan, et al. (2004). Political Connected CEOs, Corporate Governance and Post-IPO Performance of China's Partially Privatized Firms, Chinese University of Hong Kong.

in China is “nothing different but the logo”¹⁶⁵ Studies have shown why BSAM officials are poor monitors of the listed SOE. First, BSAM officials are civil servants whose pay is not tied to the performance of the companies they oversee. Thus there is no incentive to increase the value of the listed SOE. Secondly, their bosses are the local governments, and again this causes them to align their interests with the local government, whose political interests may be to preserve employment rather than increase the efficiency of listed SOEs. The patrimonialism of many work unit relationships already referred to also plays an important role in this regard.¹⁶⁶ Thirdly, they are not industry experts who know which decisions made by the management are value-enhancing and which are not. In addition, they have to oversee hundreds of companies in which the state has an interest, not to mention that it is also difficult to improve the value by raising more capital through a rights issue as this will often be met with opposition from the BSAM because this would dilute state control.¹⁶⁷

Thus, the current Chinese situation is that the state is the major shareholder in the highly concentrated ownership pattern from the

¹⁶⁵ Huchet, J. F. and Richet, X.(1999), "China in search of an Efficient Corporate Governance System: international Comparisons and Lessons", Center for Economic Reform and Transformation, Heriot-Watt university, Edinburgh, discussion paper No 99/01; Xu, X. N. and Wang, Y.(1997) "Ownership structure, corporate governance and Firms" Performance: The Case of Chinese Stock Companies", The World bank Economic Development institute, policy Research Working Paper No 1794.

¹⁶⁶ Miles, L. and Z. Zhong (2006). "Improving corporate governance in state-owned corporations in China which way forward." *Journal of corporate law studies*: 229.

¹⁶⁷ Xu, L. X. C. L., T. Zhu, et al. (2005). "Politician control, agency problems and ownership reform - Evidence from China." *Economics of Transition* 13(1): 1-24.

country's partial privatization. However, despite its majority ownership, the state does not exercise effective control over their companies.¹⁶⁸

III The securities law and company law leaves much to be desired

There is no doubt that China has decided to encourage shareholders to use the statutory derivative action to improve the enforcement of directors' duties. But the main problem is the lack of an effective mechanism for shareholders to bring an action against directors for wrongdoing. For example, Liu points out that: "to make directors and managers accountable to the corporation and its stakeholders, it is urgent to deal with the loopholes in current legislation and enforce the responsibility of the directors and managers through various means, in particular the shareholders' derivative actions".¹⁶⁹ Lee argues that the lack of express remedies for the aggrieved shareholders in the Securities Law creates unnecessary ambiguity and confusion which is wholly inconsistent with other statutory remedies in Chinese law.¹⁷⁰

The Securities Law and company law leaves many gaps. It does not provide sufficient remedies to compensate securities investors, and does

¹⁶⁸ Tam, O. K. (2002). "Ethical issues in the evolution of corporate governance in China." *Journal of Business Ethics* 37(3): 305.

¹⁶⁹ Liu, J. (August 1999) "Legal Reforms in China", Discussion Papers on Development Policy 13, Centre of Development of Research, Bonn.

¹⁷⁰ Lee, S. M. (2001). "The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law." *New York International Law Review* 14(1).

not have sufficient regulation over securities companies and intermediaries. As a result, the CSRC, the Supreme Court and other authorities have introduced piecemeal legal documents to fill the gaps in the law. Supplementary regulations and provisional rules have been enacted to deal with some practical issues that are not stipulated in the major laws. Currently, securities activities are regulated by about 250 laws, regulations, standards and Supreme Court decrees.¹⁷¹

However, there is a lack of co-ordination and integration between these various enactments. This has typically reflected in the remedial aspects relating to securities market misconduct. Before 2002, there was not a single case where a victim of market misconduct received a remedy. During this time, China's courts made several unusual legal judgments relating to remedies. In 1999, for example, the Chengdu Gongguan company was found liable for making false statements and engaging in deceptive conduct, and the responsible directors and officers were sentenced and fined. The Court, however, rejected an investor's claim for damages on the ground that the Court lacked jurisdiction over such cases.¹⁷² Even more unusually, in September 2001, the Supreme Court of China decreed "Some Rules about Hearing False Statements on the

¹⁷¹ Wei, Y. (2006). "Volatility of Chinese Securities Markets and Corporate Governance." Suffolk Transnational L. Rev 29(2): 215, 217.

¹⁷² Huang, Z. Z. (2003). Meiguo Zhengquan Fa zhong Mingshi Susong (Civil Liability and Civil Litigation in US Securities Law), Falv (Law Press), Beijing, at 7.

Securities Market", which stated that because of legislative ambiguity and a lack of limited enforcement resources, the Court would not hear civil cases relating to insider trading, false or misleading statements, or market manipulation. The situation has improved since. Nevertheless, in many cases the misconduct of listed companies and responsible individuals only received lenient penalties.¹⁷³ This aspect of corporate governance in China will be analysed in more detail in Chapter 5.

It is important to bear in mind the general context of corporate governance reform in China. It ought to be understood that after the Contract Responsibility System introduced in the 1980s, the second wave of reform began as a corporatization of many SOEs and a liberalization of the private business sector. The SOE reform was a way of tapping into the savings of the Chinese people. As professor Zhang Weiying of Beijing University put it:

“Because the state controls the development of China’s stock markets, the guiding ideology is very important. I want to emphasize that up until today the guiding ideology in developing the stock markets is still to ‘help state enterprises resolve their problems.’ But I think we should change this wording to say ‘help the state enterprises realize management by the people.’. . . There is a big difference here.

¹⁷³ Hu, Xiaoke (2004), Preliminary Study on the Prohibition System of Securities Fraud, Economy and Technology Press, at 242, 243.

Helping SOEs resolve their problems means how to let the peoples' money flow into the SOEs with the worst problems. But helping SOEs realize management by the people means how to let SOEs flow into the hands of those best able to manage them.”¹⁷⁴

The shareholding system motivated local players, especially local cadres, enormously. As one enterprise boss put it, “It’s not who owns the money that’s important, it’s who gets to use the money.”¹⁷⁵ The promotion of town and village enterprises has influenced local cadres who want to maximize revenue. At the same time the rent seeking state is also seen as residuary of corrupt practices. This has created a political market where state assets and authorities are diverted into private interests.¹⁷⁶ Also the policy of reducing government interference in the running of SOEs, whilst developing a sense of enterprise and achieving cost reductions and production improvements, has been partially achieved within a climate of reform induced labour unrest and incipient political instability.¹⁷⁷ The convergence of the Chinese corporate governance system with those in Civil and common law systems has been at best a convergence of form

¹⁷⁴ Professor Zhang was responding to an article by Gao Xiqing, 3 January 2000, his response is quoted in Walter, C. E. and F. J. T. Howie (2006). Privatizing China : inside China's stock markets. Singapore ; Chichester, John Wiley & Sons (Asia).

¹⁷⁵ Walter and Howie (2006), *supra* note 174 at 233.

¹⁷⁶ Ngo, T. W. and Y. P. Wu (2008). Rent Seeking in China. London, Routledge. For a consideration of expropriation and corporate governance in Hong Kong and Asia, see Lang, L. H. P. (2005). Governance and expropriation. Cheltenham ; Northampton, MA, Edward Elgar.

¹⁷⁷ Hassard, J., J. Sheenan, et al. (2007). China's state enterprise reform : from Marx to the market. London, Routledge. This study of the steel industry in China charts the successes and failures of the reform policy in that industry.

rather than one of substance.¹⁷⁸ In many respects, at the end of the corporatization process, the state was that particular entity from a ministry, the latter's local bureau, or a local government in charge of that particular type of company or sector. In reality nothing had really changed except the form of the arrangement. The one important difference was that the company (more realistically its management) now had legal possession of its own assets.¹⁷⁹

Whilst these developments were unfolding, the debate over the recognition of private property slowly began and became embroiled in a number of ideological debates of a fundamentally political nature. Old communist attitudes were slow to retreat in the face of arguments for reform, fighting a long rear guard action.¹⁸⁰ Tied in with these factors is the resurgence of strong cultural elements such as guanxi and patrimonialism in changing and adaptive ways. These interact in various ways with the political elements at different levels. There is therefore a strong 'Chinese' element to the way corporate governance is conducted in China in addition to the role of the state as a strong path dependent

¹⁷⁸ MacNeil, M. I. (2002). "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies." *Journal of Corporate Law Studies* 2(1): 289-344. Macneil takes the view that there is considerable convergence in the legal framework of corporate governance in China. He identifies the main path dependent influence as the dominant role of the state, which had clearly influenced the 1994 company law in terms of the role of regulation and the legal position of the controlling shareholders. According to him corporate governance in China operates in a manner which is fundamentally different from that in West.

¹⁷⁹ See Walter and Howie(2006), *supra*, note 174 at 234-236.

¹⁸⁰ For a consideration of these political and jurisprudential debates in the slow legislative gestation of the Property Law of 2007, see Zhang, M. (2008). "From Public to Private: The Newly Enacted Chinese Property Law and the Protection of Property Rights in China." *Berkeley Business Law Journal* 5.

influence.

3.9 Conclusion

In the 1980s, the Chinese State's first objective was to promote greater production efficiency and the Contract Responsibility System was one key element of the structure designed to achieve this outcome.¹⁸¹ The major debates on reform centred round the adoption of market mechanisms in a gradual transition from the centrally planned economy. Deng's insights into the positive outcomes of the application of capital in large quantities saw a shift in objectives in the 1990s to the recapitalization of SOEs which in turn entailed their corporatization and the development of more sophisticated stock markets. According to MacNeil, the state had no real incentive to resist stronger convergence in securities law and listing rules towards international standards. This was because the process encouraged the development of a capital market in which some of its shareholdings could be sold without prejudicing its role as controlling shareholder. It allowed the government and to some degree the CCP to retain control over the direction of the reform process enabling appropriate policy shifts when necessary.¹⁸² As a result there has been a quite successful industry wide packaging and listing. As part of

¹⁸¹ For a consideration of the Contract Responsibility System see Hassard J, Sheenan et al(2007), *supra* note 177 at 115-128.

¹⁸² MacNeil, M.I.(2002), *supra* note 178, at 338-341.

this exercise the corporate governance reforms discussed above were enacted but not always successfully implemented within China's cultural and political milieu. However, the successful entrance into the WTO has again shifted the focus of China's policy. China is now concentrating on the creation of and support of internationally competitive national champions. These will be concentrated in those industries which China's leadership considers to be strategically important for China and the continued leadership of the CCP. This policy has focused on just under 200 major companies. Therefore china's government is less able to give attention to the other 150,000 plus SOEs. Given the state's financial needs, particularly in relation to the development of a welfare state, including a workable health service and social security system, it is slowly selling off its stakes in unwanted companies. This is China's slow path towards the privatization of many SOEs. However, this is not privatization in the true sense of the word as until 2007 this was politically unacceptable. But following the changes in 1998 when the original SAMB was eliminated to be replaced by the Ministry of Finance (Enterprise Division) exercising property rights is seen as different to exercising ownership rights. But the end result has been that local governments are enabled to make decisions affecting the restructuring of local enterprises without referring to the centre.¹⁸³ This has had its own

¹⁸³ Walter and Howie (2006), *supra* note 174, at 236-240.

set of problems as the political appointment of the key lead manager, who is himself a politician, usually means that profits are not his chief concern but rather political and social objectives, including survival of the enterprise and the employment opportunities it presents for local people.¹⁸⁴

The Chinese model has adopted the formal Anglo-American characteristics of independent directors but continues to mandate the two-tier board systems. However, it is unrealistic to expect improvements in China's current system of corporate governance simply by adopting the latest prescriptions that are being experimented with in Western countries. For instance, compared to the German two-tier board structure where supervisors have substantial authority to monitor directors by appointing and dismissing them, the supervisory board in China cannot be expected to play active role in supervising directors and managers due to their limited powers, resources, incentives, abilities, and low quality information. Measures such as raising the level and quality of information disclosure and setting up independent director system are normally desirable. They are unlikely to function effectively in China unless a more significant development of the accounting and legal professions and the administration of commercial law are achieved. But the argument is

¹⁸⁴ Tan, L. H. and J. G. Wang (2007). "Modelling an Effective Corporate Governance System for China's Listed State-owned Enterprises: Issues and Challenges in a Transition Economy." *The Journal of Corporate Law Studies* 7: 156.

often made neither the ‘outsider’ system of the Anglo-American world nor the ‘insider’ model of Germany and Japan are workable in China largely because of its cultural and political heritage and tendency to a familial and authoritarian system of governance.¹⁸⁵

¹⁸⁵ Tan and Wang (2007), *supra* note 184. Tan and Wang suggest that the best model for China would be one based on the Singaporean ‘Temasek’ model.

Chapter 4 Institutional investors

4.1 Introduction

Corporate governance issues, arising from the agency problems concerning the separation of ownership and control and the inability to write complete contracts for all possible future eventualities,¹ have been debated for many years. Since the early 1990s, there has been an increasing emphasis on the need for institutional shareholders to play an active role in corporate governance. Various commentators in fact have argued that institutional investor corporate governance activism could become an important constraint on agency costs in the corporation.²

Chinese government introduced a series of complementary reforms to build the institutional mechanisms for greater corporate accountability since the 1990s. However, these differences between various social and economic systems may sometimes be entrenched by the adoption of legal systems that are themselves built upon principles that may differ substantially, such as the different modes of thinking that have formed common law system that is found in many countries which part of the old

¹ See, e.g. Hart, O. D. (1995). Firms, contracts, and financial structure. Oxford, Clarendon Press.; Hart, O., Shleifer, A., Vishny, R.W. (1997). "The proper scope of government: theory and an application to prisons", *The Quarterly Journal of Economics*, 112(4) :1127-61.

² See, e.g., Roe, M. J. (1994). Strong managers, weak owners : the political roots of American corporate finance. Princeton, N.J., Princeton University Press.; Black, B. S. (1990). "Shareholder Passivity Reexamined." Michigan Law Review 89(3): 595-608.

British Empire and the USA and the forms of the European derived Civil Law system that are (to varying degrees) found in China.³ The purpose of this chapter is to assess the role currently and potentially performed by institutional investors in China.

4.2 Institutional investors and corporate governance: the theories in the West

The agency theorists argue that public corporations suffer from excessive costs as managers pursue their own interests rather than the interests of shareholders.⁴ The chief concern of Berle and Means was that "Where ownership is sufficiently sub-divided, the management can ... become a self-perpetuating body even though its share in the ownership is negligible."⁵ This gave rise to the famous expression "a separation of ownership and control": ownership resting with the myriad of small shareholders, and control residing in senior management.⁶ But this is not the case in China.

³ See further, Charkham, J. P. (1994). Keeping good company : a study of corporate governance in five countries. Oxford, Clarendon Press.; Charkham, J. P., H. Ploix, et al. (2005). Keeping better company : corporate governance ten years on. Oxford, Oxford University Press.; also see Kaplan, S.N. (1998), "Corporate Governance and Corporate Performance: A comparison of Germany, Japan and the US " in Chew, D. H. (1997). Studies in international corporate finance and governance systems : a comparison of the U.S., Japan, and Europe. New York ; Oxford, Oxford University Press.; Roe, M. J. (2003). Political determinants of corporate governance : political context, corporate impact. Oxford, Oxford University Press.; Hopt, K. J. (1998). Comparative corporate governance : the state of the art and emerging research. Oxford, Clarendon.

⁴ See Jensen, M. C. and W. H. Meckling (1976). "Theory of Firm - Managerial Behavior, Agency Costs and Ownership Structure." Journal of Financial Economics 3(4).; Jensen, M. C. (1986). "Agency Costs of Free Cash Flow, Corporate-Finance, and Takeovers." American Economic Review 76(2): 323-329.

⁵ Berle, A. A. and G. C. Means (1968). The modern corporation and private property. New York, Harcourt, Brace & World, at 82.

⁶ Ibid.

It is not surprising, therefore, that the rise in institutional shareholdings – with an accompanying increase in the concentration of shareholdings – has led many commentators optimistically to predict the end of the separation of ownership and control.⁷

As a result, there is a need for establishing mechanisms to make managers maximize shareholder wealth. These mechanisms include shareholding of managers, intermediaries and large block holder,⁸ outside directors,⁹ debt policy,¹⁰ the market for corporate control and incentive contracts¹¹.

In theory, as Stiglitz argues, individual shareholders with relatively small holdings have little incentive to gather and bear the relatively fixed costs of collecting information to enable them to monitor and control the behaviour of the board. Alternatively, large shareholders may have sufficient incentives to obtain the information necessary to effectively control management if the benefits of such monitoring outweigh the

⁷ See, for example Barnard, J. W. (1991). "Institutional investors and the new corporate governance." North Carolina Law Review 69: 1135-1187.

⁸ Morck, R., A. Shleifer, et al. (1988). "Management Ownership and Market Valuation - an Empirical-Analysis." Journal of Financial Economics 20(1-2): 293-315.; McConnell, J. J. and H. Servaes (1990). "Additional Evidence on Equity Ownership and Corporate Value." Journal of Financial Economics 27(2): 595-612.

⁹ Cotter, J. F., A. Shivdasani, et al. (1997). "Do independent directors enhance target shareholder wealth during tender offers?" Journal of Financial Economics 43(2): 195-218.

¹⁰ Lasfer, M. A. (1995). "Agency Costs, Taxes and Debt: The UK Evidence." European Financial Management 1(3): 265-285.; McConnell, J. J. and H. Servaes (1995). "Equity Ownership and the 2 Faces of Debt." Journal of Financial Economics 39(1): 131-157.

¹¹ Hart, O. (1995). "Corporate Governance - Some Theory and Implications." Economic Journal 105(430): 678-689.

associated costs.¹² Similarly, Shleifer and Vishny¹³ and Agrawal and Knoeber suggest that large investors, because of the relevance of the resource invested, have all the interest and the power to monitor and promote better governance of companies.¹⁴ The studies conducted by Smith and Nesbitt in which it is reported that firms targeted by CalPERS exhibit superior financial returns tend to support this view.¹⁵

The Wall Street Journal, the newspaper of record for executives, bankers, and investment professionals, calls hedge funds the “new leader” on the “list of bogeymen haunting the corporate boardroom.”¹⁶ And several European governments are weighing regulations designed to curb activist hedge funds.¹⁷ Has the rise in institutional shareholdings had a measurable impact on corporate performance so far?

4.3 Institutional shareholders and corporate governance: the practice in the UK

Unlike the relation-based corporate governance system of Japan and

¹² Stiglitz, J. E. (1985). "Credit Markets and the Control of Capital." *Journal of Money Credit and Banking* 17(2): 133-152.

¹³ Shleifer, A. and R. W. Vishny (1997). "A survey of corporate governance." *Journal of Finance* 52(2): 737-783.

¹⁴ Agrawal, A. and C. R. Knoeber (1996). "Firm performance and mechanisms to control agency problems between managers and shareholders." *Journal of Financial and Quantitative Analysis* 31(3): 377-397.

¹⁵ Smith, M. P. (1996). "Shareholder activism by institutional investors: Evidence from CalPERS." *Journal of Finance* 51(1): 227-252.; Nesbitt, S. L. (1994). "Long-term rewards from shareholder activism: a study of the 'CalPERS effect'." *Journal of Applied Corporate Finance* 6(4): 75-80.

¹⁶ Murray, A., "Hedge Funds Are New Sheriffs of Boardroom", Wall St. J., Dec. 14, 2005, at A2; see also Eisinger, J., (2006), Memo to Activists: Mind CEO Pay, Wall St. J., Jan. 11, at C1 ("The shareholder activists with the most clout these days are hedge-fund managers ...").

¹⁷ Taylor, E., and McDonald, A. (2006). Hedge Funds Face Europe's Clippers, Wall St. J., May 23, at C1 (regulations considered by Germany and the Netherlands).

Germany, where ownership is concentrated and markets are relatively illiquid, the UK is a market-based system characterized by liquid markets and non concentrated listed company ownership.¹⁸ Since 1990s external pressure such as institutional investors for greater corporate accountability has intensified in the UK. For example, the Cadbury Report stated that, “Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders’ Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code’¹⁹ - similar views were expressed by Greenbury , Hampel and Higgs. In their role as major shareholders, both the Cadbury and Hampel Reports²⁰ and the resulting Combined Code²¹ expected institutions to take on the role of the large shareholder, who will monitor company management on behalf of smaller shareholders. Hence, in this context, institutions are expected to take a long-term view of their shareholding positions, and where necessary, incur expense in intervening to correct mismanagement.

The most obvious course of action open to institutions is to exercise their

¹⁸ Chew D. H.(1997) for a collection of papers dealing with these two corporate governance systems. See Chew, D. H. (1997). Studies in international corporate finance and governance systems : a comparison of the U.S., Japan, and Europe. New York ; Oxford, Oxford University Press.; The UK government recently has nationalised or part-nationalised some leading UK banks struggling to survive the current crisis. For example, the UK taxpayer is taking a controlling share of 65% in Lloyds Banking Group, See “Treasury takes 65% Lloyds stake” BBC Business News , available at <http://news.bbc.co.uk/2/hi/business/7929957.stm>.

¹⁹ The Cadbury Report (Financial Aspects of Corporate Governance),1992, Para.6.16

²⁰ The Hampel Report (Committee on Corporate Governance), 1998, Para 5.7

²¹ The Combined Code (June 2008), Section 2, E.3; also see The Combined Code on Corporate Governance (2006) .Section 2, E.3:

right as shareholders to vote at a company's *Annual General Meeting* (AGM).²² The Institutional Shareholders' Committee recommended that institutional shareholders should make positive use of their voting rights.²³ Furthermore, the Cadbury Report stated that:

“Voting rights can be regarded as an asset and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend that institutional investors should disclose their policies on the use of voting rights.”²⁴

The Greenbury Committee stated that institutional shareholders should act to ensure the companies implemented the recommendations set out in their code of best practice regarding the determination of directors' remuneration. Increased pressures have been placed on institutional shareholders to exercise their right to vote since the election of the Labour government in 1997. Prior to their election, the Labour Party had signalled that it was considering proposals to include an obligation to vote in the fiduciary duties of pension funds and to require fund managers to justify their voting decisions to trustees.²⁵ One of the principles of the

²² Short, H. and K. Keasey (2005). *Institutional Shareholders and Corporate Governance in the UK. Corporate governance : accountability, enterprise and international comparisons*. K. Keasey, S. Thompson and M. Wright. Chichester, John Wiley & Sons: 81.

²³ Institutional Shareholders' Committee, *The responsibilities of institutional shareholders and agents-statement of principles*, updated June 2007.

²⁴ The Cadbury Report (Financial Aspects of Corporate Governance), 1992, Para.6.12

²⁵ See , "Harder Line From Labour ", *Accountancy*, October 1995, at12, reporting Dr Jack Cunningham's comments at a Fabian Society seminar on corporate governance and "Labour Attacks Investors' Secrecy", *Financial Time*, 5 June 1995, p.16.

Combined Code (1998) was that ‘institutional shareholders have a responsibility to make considered use of their votes’, and furthermore, the Code contained provisions stating that institutions should , on request, provide information to their clients on their voting behaviour and should take steps to ensure that their voting intentions were translated into practice.²⁶ The Institutional Shareholders’ Committee (2007) published a statement of principles which made clear that institutional shareholders have a responsibility to monitor and communicate with investee companies and, moreover, intervene where necessary.²⁷

Pound has claimed that personnel changes on the board and in policies pursued by companies were often brought about by the lobbying of large investors rather than by takeovers. Pound claimed that takeovers were an inefficient and a rather drastic means of correcting mismanagement.²⁸ Campbell has argued that the so called market for corporate control has yet to be shown to achieve the results claimed by agency theory stating that great deal of research still needs to be done to establish exactly what

²⁶ These code provisions in the Combined Code (1998) were translated into supporting principles in the Combined Code (2003), also see The Combined Code on Corporate Governance (2006), Section 2. E.3; The Combined Code (June 2008), Section 2 E.3

²⁷ Institutional Shareholders’ Committee, International Corporate Governance Network: Statement of Principles on Institutional Shareholder Responsibilities, July 2007.

²⁸ Pound, J. (1993). "The Rise of the Political Model of Corporate Governance and Corporate-Control." New York University Law Review 68(5): 1003-1071. Pounds view was criticized by Romano for failing to distinguish a conflicts of interest explanation from an equally plausible monitoring explanation. She argues that firms with high levels of institutional ownership experience proxy contests that are less credible because they effectively monitor managements’ performance. In her view Pound does not have data on how institutions voted in his sample proxy fights and therefore lacks any direct evidence of a significant difference in voting practices between private and public funds. See Romano R, "Public Pension Fund Activism in Corporate Governance Reconsidered" in Baums, T., R. M. Buxbaum, et al. (1994). Institutional investors and corporate governance. Berlin, de Gruyter.

the market for corporate control does in fact achieve.²⁹

Some pioneers of relational investing like Monk's LENS Corporation make money by selecting companies with intrinsic value and by pressing for changes in corporate governance often produced above market returns. They usually press for improvements that ensure that directors and managers have the appropriate ability and incentives to produce these results. However, a similar result may be produced by the role of banks and cross listings in 'internal systems' like those of Japan and Germany.³⁰

For example the German Hausbank has the capacity to provide all manner of financing. It often places its own executives on the Supervisory board of companies. The bank benefits in a number of ways not least of which is the payment of fees. In the context of the Japanese *kereitsu* members are financiers, suppliers and owners of each other leading to a more profound commercial relationship. Monitoring is a function of maintaining valuable commercial relationship rather than simply a function of ownership. But all of these types give rise to

²⁹ Campbell, D. (1997). "The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation." *Australian Journal of Corporate Law* 17: 343-365.; See also Campbell, D. (1990). "Adam Smith, Farrar on Company Law and the Economics of the Corporation." *Anglo-American Law Review* 19(3): 185.; Campbell, D., "Why Regulate the Modern Corporation? The Failure of 'Market Failure' " in McCahery, J., S. Picciotto, et al. (1993). *Corporate control and accountability : changing structure and the dynamics of regulation*. Oxford, Clarendon Press.

³⁰ See Monks, R. A. G. and N. Minow (2004). *Corporate governance*. Oxford, Blackwell at 174-187. For a consideration of these systems, see Aglietta, M and Breton R, "Financial Systems and Modes of Corporate Control" in Cobbaut, R. and J. Lenoble (2003). *Corporate governance : an institutionalist approach*. The Hague ; London, Kluwer Law International.

potential conflicts of interest. For example, when Warren Buffett became CEO of Salomon Brothers his obligations to his own shareholders at Berkshire Hathaway would not necessarily align with his priorities as CEO of Salomon Brothers. Put simply which one was given his primary time and attention? The German and Japanese block holders have similar conflicts of interest in their role as officers of their principal employer and as active owners of a portfolio investment.³¹ In the USA there remain a number of laws and regulations which cumulatively prevent the financial sector executive from being able to exercise control over commercial sector executives.³²

Buxbaum has also pointed to the different types of institutional investors each with its own form of governance structure and investment policy objectives which according to him are driven to a large extent by legal, institutional and even cultural specifics. In terms of the reasons for the existence of a particular institution, which differ to some degree, investment policy may vary for a number of reasons. In the case of pension funds, pension income is influenced by three main pillars, namely social security, firm level and the individual future pensioner. Each is dependent on the other and influences the flow of funds into these

³¹ See Monks and Minnow (2004), *supra* note 30 at 178.

³² Whilst the Glass-Steagall acts were substantially repealed in 1999 there remain a number of restrictions on commercial banks; the Investment Company Act 1940 places limitations on mutual funds whilst insurance companies are often limited by state law. Private pension funds are required to diversify as widely as possible by ERISA. The federal system is limited to equity investments through index funds under FERSA. See Monks and Minnow (2004), *supra* note 30 at 178-179.

institutions. Two other major factors also influence flow into the institution and its investment policies, namely, first the combined effect of public policies of taxation and subsidization of savings destined for pensions; and secondly, often overlooked at firm level, is whether the pension claims are capitalized through the collection and separate investment of premiums or whether they are unsecured general claims against the firm promising to provide the pension.³³

4.3.1 Criticism of institutional investors

I. Lack of willingness and ability to actively monitor and intervene

Perhaps the easiest way an institution can involve itself in the governance of a company in which it has invested its clients' funds is by actively voting on resolutions put to the general meeting. However, despite the increased pressure on institutions to exercise their voting rights, voting still remained low throughout the 1990s. Research by PIRC suggested that average voting at AGMs of the FTSE 350 companies had increased from approximately 38% in 1993 to 46% in 1998, two-thirds of companies still had a voting turn-out of less than 50%. In addition, the percentage of votes which oppose management resolutions or record an

³³ See Buxbaum R M. (1994) "Comparative Aspects of Institutional Investment and Corporate Governance" in Baums, T., R. M. Buxbaum, et al. (1994). Institutional investors and corporate governance. Berlin, de Gruyter.

explicit abstention is approximately 2%.³⁴ Although institutional shareholders control a large proportion of votes, they are often reported to abstain from voting at annual general meetings (AGMs) or rubber-stamp the management's motions.³⁵ As a result, managers are left with substantial levels of discretion as to how they run the firm.³⁶

The first criticism was that institutions may lack the will and ability to actively monitor and intervene. As Drucker argued:

“The pension funds are not ‘owners’, they are investors. They do not want control...The pension funds are trustees. It is their job to invest the beneficiaries’ money in the most profitable investment. They have no business trying to ‘manage’. If they do not like a company or its management, their duty is to sell the stock”.³⁷

From an alternative viewpoint, Hutton argued that some institutional investors such as pension funds have become classic absentee landlords, exerting power without responsibility and making exacting demands upon companies without recognizing their reciprocal obligation as owners.”³⁸

³⁴ Pensions Investment Research Consultants (1998), *Proxy Voting Trends at UK Companies*, December 1998, PIRC, London.

³⁵ See, eg Goergen, M. and L. Renneboog (2001). "Investment policy, internal financing and ownership concentration in the UK." *Journal of Corporate Finance* 7(3): 257-284.

³⁶ Zhang, C., L. Renneboog, et al. (2008). "Do UK Institutional Shareholders Monitor Their Investee Firms?" *Journal of Corporate Law Studies* 8(1).

³⁷ Drucker, P. F. (1976). *The unseen revolution : how pension fund socialism came to America*. London, Heinemann, at 82.

³⁸ Hutton, W. (1995). *The state we are in*, Vintage Press.

Murphy and Van Nuys argue that pension funds are run by individuals who do not have the proper incentives to maximize fund value.³⁹ Maug argues that while liquid markets make corporate governance more effective as it is cheaper and easier to acquire and hold large stakes, they also reduce large shareholders' incentive to monitor because they can sell their holdings easily.⁴⁰ Again, Plender argues that because fund managers will lose the mandate to manage their client's money if they do not perform well in comparison to their competitors they are no longer interested simply making money for their client. They have become overly preoccupied with their investment performance relative to their competitors.⁴¹

In their role as investors, institution investors need to be free to move funds around in order to find the best return for the beneficiaries of those funds. In this respect, it is difficult, certainly in a free market climate, to argue that institution investors should continue to hold equity positions in problem companies and incur additional expense intervening in management, particularly when there are no guarantees that intervention will be successful.⁴²

³⁹ Murphy, K., Van Nuys, K. (1994), State Pension Funds and Shareholder In-Activism, Working Paper, Harvard Business School.

⁴⁰ Large, M. E. (1998). "Shareholders as Monitors: Is There a Tradeoff between Liquidity and Control? ." Journal of Finance 53(1): 65-98.

⁴¹ Plender, J. (2003). Going off the rails : global capital and the crisis of legitimacy. Chichester, J. Wiley.

⁴² Short, H. and Keasey, K. (2005), supra note 22, at 67

A comprehensive survey found relatively little evidence that shareholder activism mattered.⁴³ Even the most active institutional investors spent only trifling amounts on corporate governance activism. Institutions devoted little effort to monitoring management; to the contrary, they typically disclaimed the ability or desire to decide company-specific policy questions. They rarely conducted proxy solicitations or put forward shareholder proposals. They did not seek to elect representatives to boards of directors. They rarely coordinated their activities. Most importantly, empirical studies of U.S. institutional investor activism found “no strong evidence of a correlation between firm performance and percentage of shares owned by institutions.”⁴⁴

II Institutional investors as short-term players?

Secondly, the criticism is that institutions are only interested in short-term gains. As Charkham argues that many fund managers are not equipped to act as long-term investors as their primary understanding is of short-term markets rather than industry. According to Charkham fund managers are

⁴³ Black, B.S. (2002), "Shareholder Activism and Corporate Governance " in Newman, P. (ed.) *The United States, in New Palgrave Dictionary of Economics and the Law*, Palgrave Macmillan, at 459. Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and technology stock bubble, the trend towards institutional domination stagnated. Large blocks held by a single investor remained rare. Few U.S. corporations had any institutional shareholders who owned more than 5-10% of their stock.

⁴⁴ Ibid, at 462.

not prevented by fear of dismissal from taking an interest in corporate governance. Rather they simply do not feel they are paid to do it. Nor are they measured by success in it. In the final analysis fund managers lack the skill and resources they would need to do it properly.⁴⁵ The Myners Review found that one-third of schemes had changed investment managers in 12 months prior to their survey. The debate over whether the focus in quarterly figures was a cause of short-termism was considered by the Myners Review.⁴⁶ From a survey carried out for the Review, it is clear that there is much debate over this issue. The Review stated that, although it was not possible to arrive at an objective answer to the question, there were three clear facts:

- * a large number of fund managers believe that their pension fund clients are very concerned about short-term performance.
- * a number of pension funds and their advisors insist that they are not so concerned; and
- * pension funds will inevitably look at quarterly performance figures.⁴⁷

The Myners Review of institutional investment in the UK found that the majority of pension fund trustees were not expert in investment - for example, 62% of trustees had no professional to assist them; and over

⁴⁵ Charkham, J. (2005), *Supra* note 3, at 272.

⁴⁶ See The Myners Review of Institutional Investment in the UK: Report March 2001, available at http://www.hm-treasury.gov.uk/documents/financial_services/securities_and_investments/fin_sec_mynfinal.cfm

⁴⁷ *Ibid*, para 5.69

50% of trustees received fewer than three days of training when they were appointed.⁴⁸ The Myners Review concluded that fund managers could assume rationally that they could be dismissed after any quarter's performance, and that this could lead to managers being unwilling to take a long-term perspective. Furthermore, the lack of clarity over timescales would weaken incentives for fund managers to actively intervene in underperforming companies.⁴⁹

III The free-rider problem

Thirdly, the free-rider problem facing institutional investors appear to be a real concern. Cadbury (1990) argued that while 'free riding' may be an option for individual institutional investors, for institutions collectively, this situation was becoming less tenable as the proportion of equity they own increased.⁵⁰ Hampel (1998) further stressed this point, arguing that the combination of their increased ownership and the growth of index tracking meant that many institutions were committed to (either explicitly or de facto) retaining substantial shareholdings in companies. In such circumstances, Hampel stated that the institution should 'share the board's interest in improving the company's performance.'⁵¹ It was

⁴⁸ Ibid.

⁴⁹ Ibid, para 5.70

⁵⁰ Cadbury Report (The Financial Aspects of Corporate Governance), 1992, para 6.9.

⁵¹ Hampel Report (Committee on Corporate Governance) , 1998, para.5.3

therefore argued by Hampel that institutions were effectively becoming locked into companies in which they invest and were, furthermore, becoming locked into the UK economy.

However, institutional investors are raising the question “*Quis Custodiet Ipsos Custodies?*”(Who shall guard the guards?). On the one hand, pension funds are perceived by the public to be short-termists, imposing their views on companies in which they invest by, for example, making them pay dividends and not invest in the long term.⁵² On the other hand, academic studies show that pension funds do not get involved in corporate monitoring because they find it easier and cheaper to sell their holdings , and that they do not want to sit on the board for fear of getting price sensitive information or because of the agency problems within the funds themselves.⁵³ As Stiglitz argues control by large shareholders may have a cost; if such shareholders are limited in terms of their

⁵² Hutton, W (1995) argues that ‘pension funds...have become classic absentee landlords, exerting power without responsibility and making exacting demands upon companies without recognizing their reciprocal obligations as owners’. See Hutton, W. (1995), *supra* note 38 at 304.

⁵³ For example, Drucker, P. F. (1976), stipulate that ‘pension funds are not ‘owners’, they are investors. They do not want control...If they do not like a company or its management, their duty is to sell the stock.’ Drucker, P. F. (1976). The unseen revolution : how pension fund socialism came to America. London, Heinemann, at 82.; Porter (1997) argues that institutional investors ,despite their substantial aggregate holdings, do not sit on corporate boards and have virtually no real influence on management’s behavior because they invest nearly all their assets in index funds rather than directly in companies, see Porter, M. E. (1992). "Capital choice changing the way American interests in industry " Journal of Applied Corporate Finance 5(2): 4-16.; Keasey (1997) suggest that once pension funds are locked in, it is costly to get involved in monitoring and they cannot exit in case they are considered to trade on insider information. See Keasey, K., S. Thompson, et al. (1997). Corporate governance : economic and financial issues. Oxford, Oxford University Press.; Murphy and Van Nuys (1994) argue that pension funds are run by individuals who do not have the proper incentives to maximize fund value. See Murphy, K. and Van Nuys, K. (1994), State Pension Fund shareholder activism. Working Paper, Harvard Business School.

diversification, then their interests may conflict with those of small shareholders.⁵⁴ Furthermore, Stiglitz suggests that large controlling shareholders and managers may cooperate in the diversion of resources from remaining shareholders.⁵⁵ As Ball noted there is a considerable amount of 'Voice' being exercised, but being behind closed doors it is not subject to any kind of monitoring and the whole process is therefore very unsatisfactory.⁵⁶

Furthermore, Coffee suggests that there are reasons to believe that some institutional investors are less accountable to their owners than are corporate managers to their shareholders and argues that the usual mechanisms of corporate accountability are limited or unavailable at the institutional level.⁵⁷ Indeed, Plender suggests that the claim that fund managers were engaged in an active dialogue with management behind the scenes was 'inherently unverifiable'.⁵⁸

Though, recent developments in corporate governance in the UK have put pressure on institutional investors to become more active. For example, the Institutional Shareholders' Committee, the association of the four

⁵⁴ Stiglitz, J. E. (1985). "Credit Markets and the Control of Capital." Journal of Money Credit and Banking 17(2): 133-152.

⁵⁵ Ibid.

⁵⁶ Ball, J. (1991). "Short-termism: Myth or reality?" National Westminster Bank Quarterly Review 24.

⁵⁷ Coffee, J. C. (1991). "Liquidity versus control: the institutional investors as corporate monitor." Columbia Law Review 91: 1277-1368.

⁵⁸ Wiley, J. (2003). Going Off The Rails - Global Capital And The Crisis Of Legitimacy, John Wiley & Sons, at 146.

major institutional shareholder associations in the UK, states “Responsible owners should make use of their voting rights. A high voting turnout at general meetings will help ensure that decisions are sound and representative.”⁵⁹ This suggests an interesting line of future research on the impact of the regulatory environment on monitoring by institutional investors.

4.4 Institutional investors and corporate governance: the practice in China

Comparative corporate governance, especially the difference between outsider systems of corporate governance as practiced in the market-dominated economies of the United States and the United Kingdom and insider systems as practiced in the bank-dominated economies of Germany and Japan, has received a lot of attention.⁶⁰ The tremendous growth in institutional shareholding over the last decade and the increasing role of institutions as relational investors and firm monitors is therefore an important issue.⁶¹ However, despite the sea change of the Chinese corporate sector and capital market during the last 18 years,⁶²

⁵⁹ Institutional Shareholders' Committee (July 2007), The Responsibilities of Institutional Shareholders and Agents—Statement of Principles, London, ISC, 4.4 II.

⁶⁰ Kose, J. and L. W. Senbet (October 1997). "Corporate Governance and Board Effectiveness." NYU Working Paper No. FIN-98-045, available at SSRN: <http://ssrn.com/abstract=1297747>; Shleifer, A. and R. W. Vishny (1997). "A survey of corporate governance." Journal of Finance 52(2): 737-783.

⁶¹ Chidambaram, N. K. and K. John (1997). Relationship Investing and Corporate Governance, Tulane University and New York University Working paper.

⁶² The Chinese stock market was established at the start of the 1990s, with the Shanghai Stock Exchange beginning

there is so far no systematic account of, and no serious exploration into, the dynamic aspect of institutional investors control, i.e. the evolution of ownership and control that has been intensively studied in the US, UK, and Germany,⁶³ though it has a large potential for throwing off its emerging status to become the biggest and most vibrant stock market in Asia'.⁶⁴ To understand these implications, one must go back into history.

China started its economic reform and open-door policies in 1978, and began to conduct experimental projects in "shareholding" vehicles in 1984. The Chinese stock market was established at the start of the 1990s, with the Shanghai Stock Exchange (SSE) beginning operation in December 1990 and the Shenzhen Stock Exchange (SZSE) in July 1991. In the spring of 1992, Deng Xiaoping made general speeches during his southern Mainland China inspection tour. In the speeches, Deng Xiaoping fully affirmed the experiments of reform to introduce the shareholding system and securities market. His speech was a powerful spur to speed up the progress of reforms.⁶⁵ Unlike reforms in other transitional economies,

operation in December 1990 and the Shenzhen Stock Exchange in July 1991. See Green, S. (2003). The Economist China's stockmarket : a guide to progress, players and prospects. London, Profile.

⁶³ Denis, D. J. and A. Sarin (1999). "Ownership and board structures in publicly traded corporations." Journal of Financial Economics 52(2): 187-223.; Goergen, M. and L. Renneboog (January 2003). Shareholder Wealth Effects of European Domestic and Cross-Border Takeover Bids, ECGI - Finance Working Paper, No. 08/2003., available at SSRN: <http://ssrn.com/abstract=372440>

⁶⁴ Walter, C. E. and F. J. T. Howie (2006). Privatizing China : inside China's stock markets. Singapore ; Chichester. John Wiley & Sons (Asia).

⁶⁵ This sentence was interpreted to mean economic growth is the ultimate target of the society. In 1984, the Third Plenary Session of the Twelfth Central Committee of the CCP adopted the Decision of the Chinese Communist Party Central Committee on Restructuring of the Economic System, encouraging 'flexible economic arrangements of various kinds' in order to enhance efficiency. A shareholding system in its primitive and embryonic form could

China's economic reform has proceeded with little political reform. The economic reform was undertaken under the central leadership of the Chinese Communist Party (CCP). The economic reform started from the four special economic zones, to coastal cities, then to capital cities of inland provinces and now it has reached an unprecedented stage of all-round opening demonstrated by China's accession to the World Trade Organization. Until the recent world economic downturn, China has maintained an annual growth rate of over 9.3% on average and has surpassed Britain to become the 4th largest economy in the world.⁶⁶ In 2005, the Chinese securities market is the 5th biggest securities market in the world.⁶⁷ In July 2009, China overtook Japan as the world's second-largest stock market by value for the first time.⁶⁸

4.5 Who are the institutional investors in China?

They are securities investment funds, insurance companies, pension funds, and securities companies, Qualified Foreign Institutional Investors (QFIIs) and commercial banks.

already be detected in those early 'flexible economic arrangements'. Walter, C. E., J. Franser, et al. (2001). To Get Rich is Glorious!: China's Stock Markets in the '80s and '90s. Hampshire, New York, PALGRAVE at 14.

⁶⁶ "China lifts annual growth figures", BBC news, available at <http://news.bbc.co.uk/1/hi/business/4594132.stm>

⁶⁷ Source from Dealogic: Global Equity Capital Markets 2005.

⁶⁸ China's Market Value Overtakes Japan as World's No. 2, after Chinese government stimulus spending and record bank lending boosted share prices in July 2009. Available at http://www.bloomberg.com/apps/news?pid=20601087&sid=a__84o9PPPGqk.

4.5.1 The insurance companies

Chinese insurers have been allowed to hold equity positions for their own account since October 2004.⁶⁹ Now insurance companies and their asset management arm may invest up to 5 per cent of the total assets into the A-share market. By October 2005, insurers' direct shareholding has grown to about RMB13.6 billion⁷⁰ (US\$1.7billion) or 1.3 per cent of tradable A-shares.⁷¹

In addition to their direct holdings, Chinese insurers have since October 1999 invested indirectly in the stock market through subscribing to securities investment funds, subject to a set of portfolio rules.⁷² It is estimated that the indirect investment in stocks by insurance companies has reached RMB 106 billion (US\$13.3 billion),⁷³ or 10.6 per cent of the tradable A-shares. Insurance companies have become the largest single type of investors in securities investment funds.⁷⁴

⁶⁹ Baoxian Jigou Touzizhe Gupiao Touzi Guanli Zanxing Banfa (Provisional Measures for the Administration of Stock Investment by Insurance Institutional Investors), jointly issued by the China Securities Regulatory Commission ("CSRC") and China Insurance Regulatory Commission on October 24, 2004.

⁷⁰ See "Dali Fazhan Jigou Touzizhe, Cujin Woguo Jinrong Tixi Xietiao Fazhan" (Vigorously Develop Institutional Investors, Promote the Harmonious Development of the Financial System in China), *Zhengquan Shibao* (Securities Times), December 3, 2005 ("Institutional Investors Vigorously Develop").

⁷¹ The calculation is based on the average market capitalisation of tradable A-shares in 2005, which was about RMB1,000 billion. Source: www.csrc.gov.cn.

⁷² China Knowledge Press (2005), *Financial Services in China: The Past, Present and Future of a Changing Industry*, China Knowledge Press, Singapore, p.p.402–403, ("Financial Services in China").

⁷³ Ibid.

⁷⁴ China Knowledge Press (2005), *Fund Management in China*, China Knowledge Press, Singapore, pp.129–131 ("Fund Management in China").

4.5.2 Pension funds

The National Social Security Fund (“NSSF”) was established in 2000. By October 2005, the total investment in the stock market by the NSSF has grown to RMB 20.5 billion (US\$2.6billion), up by 57 percent compared to the end of 2004.⁷⁵

4.5.3 Qualified foreign institutional investors

As part of China’s commitment to opening up the domestic securities market to foreign investment, Qualified foreign institutional investors (QFIIs) approved by the CSRC have been allowed to trade A-shares since May 2003,⁷⁶ but only within their investment quotas allocated by the State Administration of Foreign Exchange. The size of the total quotas increased in July 2005 from US\$4 billion to US\$10 billion.⁷⁷ As of October 2005, QFIIs held tradable A-shares worth RMB 17 billion (US\$2.1billion), and they invested another RMB 4.4 billion (US\$0.55 billion) in securities investment funds.⁷⁸

The focus of this chapter will be on securities investment funds, because

⁷⁵ Ibid.

⁷⁶ Financial Services in China, *supra* note 72.

⁷⁷ See, "Why Foreign Investors Are not Saviours", Financial Times, July 13, 2005.

⁷⁸ "Institutional Investors Vigorously Develop", Zhengquan Shibao (Securities Times), December 3, 2005.

they have been the principal players in the recent movement toward greater institutional activism. Other types of institution are either smaller in size, or have emerged as institutional shareholders only very recently.

4.5.4 The emergence of investment funds in China

I. Self regulation period

Since 1990s the government introduced a series of complementary reforms to build the institutional mechanisms for greater corporate accountability in China. Investment funds soon became one of the most important institutional investors in China. The Authorities believe that investment funds can improve investor structure and rationalize securities investment activities.

Retail investors have dominated China's securities market. Most of the retail investors lack specialized investment knowledge and are interested only in short-term speculation. Non-economic information and rumours, therefore, heavily influence the market, which often results in unusually sharp fluctuations of prices.⁷⁹ Investment funds, they argued, will

⁷⁹ See "Stock Market Changes Face of Finance", China Daily Bus. Wkly. Dec. 14, 1998, at 2.

approach corporate governance quite differently than individual investors. Because Investment funds typically own larger blocks than individuals, and have an incentive to develop specialized expertise in making and monitoring investments, the former should play a far more active role in corporate governance than dispersed shareholders. Their greater access to firm information, coupled with their concentrated voting power, should enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lagged.

The first closed-ended investment fund was Zhuxing investment funds. It was launched by Zhuhai International Trust & Investment Company and was authorized by the People's Bank of China, Zhuhai branch in August 1991.⁸⁰ Then, in October 1991, Wuhan investment funds and Nanshan investment funds were authorized by the local branch of the People's bank of China.⁸¹ From 1992 to 1997, 79 investment funds were launched; more than 1.2 million investors became involved, the total assets were more than 9000 million RMB.

⁸⁰ The origin of investment funds can be traced to the fund activities conducted by the Bank of China and China International Trust and Investment Co. In 1987, together with some overseas institutions, they have initiated an investment fund targeting overseas investors. See Woguo Laojijin De Fazhan Licheng Yu Shichang Guimo (Historical Development of China's Old Funds and Their Market Scale), Zhongguo Zhengquan Bao (China Securities), available at <http://www.cs.com.cn>; see also Chen, H.Q. (1995), Gongtong Juin Yunzuo Shiwu (Practicing Mutual Funds) 28 at 282.

⁸¹ See Kumar, A. (1997) (ed.), China's Non-Bank Financial Institutions: Trust and Investment Companies, World Bank Discussion Paper, at 47 (stating that the first fund was the Wuhan Securities Investment Fund); Touzi Jijin Zhoujin Niwota (Investment Funds Are Approaching Us), Renmin Ribao (People's Daily), Dec. 4, 1997, at 10 (stating that the first fund was the Shenzhen Nanshan Venture Investment Fund); Zhongguo Jijinye Lishi Huigu Yu Fazhan Sikao (History of China's Fund Industry and a Discussion of its Development), Zhongguo Zhengquan Bao (China Securities), available at <http://www.cs.com.cn> (stating that both were the earliest funds); but see Historical Development of China's Old Funds and Their Market Scale, (stating that the Zhuxin Fund, launched in Zhuhai municipality in July 1991, was the first fund in China).

The funds have developed in two stages demarcated by the national regulation promulgated in 1997. Before that time, funds were at the stage of self-development. There was even no official national legislation or regulation directly regulating investment funds before 1997.⁸² In the absence of national legislation, local regulations were formulated to cover investment funds. However, these local regulations are not uniform and are far from adequate.

For instance, the approval of investment funds was not unified. Most were approved by the provincial and municipal branches of the People's Bank of China ("PBOC"), and only a few funds were approved by the headquarters of the PBOC.⁸³ Many problems arose with these funds due to the absence of uniform regulation. Consequently the PBOC issued an Emergency Notice on May 19, 1993, announcing that approval to set up funds and fund management companies would only be given by the headquarters of the PBOC.⁸⁴ Since the Emergency Notice, the development of China's funds has slowed down. The headquarters of the PBOC has not formally approved the establishment of any domestic funds since then.⁸⁵ The number of funds, however, still increased slowly in subsequent years, reflecting the irregularities of the old funds. By the

⁸² See Kumar, A. (1997) (ed.), *supra* notes 81, at 47, 48.

⁸³ See Guifan Xianyou Jijin de Shexiang (A Vision for Standardizing Current Funds), *Zhongguo Zhengquan Bao* (China Securities), Nov. 17, 1997, at 7.

⁸⁴ See Kumar, A. (1997) *supra* note 81, at 47

⁸⁵ *Ibid.*

time the Provisional Measures were promulgated in November 1997, China had set up 75 funds and 47 fund-like certificates,⁸⁶ with a total capital of more than RMB 7 billion yuan.⁸⁷

II The call for standardization

In the early stages, investment funds operated in China on a self-regulating basis without much legal status. Thus, these funds ran into many problems due to a lack of uniformity. First, not only was the standard for approval of new funds lax, but different agencies had the power to approve. Thus, the headquarters of the PBOC, the local branches of PBOC, and local governments each separately approved different investment funds.⁸⁸

There was no department directly overseeing the operation of funds, allowing the local branches of the PBOC to assume such supervisory roles.⁸⁹ Nor was there a self-disciplinary body inside the industry.⁹⁰ Again,

⁸⁶ See Funds Can Curb Market Volatility, China Daily Bus. Wkly., Sept. 7, 1997, at 3; Historical Development of China's Old Funds and Their Market Scale, supra note 72; Zhongguo Jijinye Lishi Huigu Yu Fazhan Sikao (History of China's Fund Industry and a Discussion of its Development), Zhongguo Zhengquan Bao (China Securities), available [http:// www.cs.com.cn](http://www.cs.com.cn)

⁸⁷ Zhongguo Jijin Shichang 1998 Nian Huigu Yu 1999 Nian Zhanwang (An Overview of China's Investment Fund Market of 1998 and Prospects for 1999), Zhongguo Zhengquan Bao (China Securities), Mar. 30, 1999, available at [http:// www.cs.com.cn](http://www.cs.com.cn).(stating there is a total capital of RMB 7.6 billion yuan); Historical Development of China's Old Funds and Their Market Scale, (a total of RMB 7.196 billion yuan); Touzi Jijin Zhoujin Niwota (Investment Funds Are Approaching Us), Renmin Ribao (People's Daily), Dec. 4, 1997, at 10 (stating that the first fund was the Shenzhen Nanshan Venture Investment Fund)(a total of about RMB 8 billion yuan).

⁸⁸ See Zhengquanfa Lijie Shiyong Yu Anlie Pingxi (Understanding and Practice of Securities Law and Case Studies)276 (Yan Gao & Pingjun Yi eds., 1997) .see also see also Guifan Xianyou Jijin de Shexiang (A Vision for Standardizing Current Funds), Zhongguo Zhengquan Bao (China Securities), Nov. 17, 1997, at 7.

⁸⁹ See World Bank Discussion Paper, Supra note79; see also Funds Can Curb Market Volatility, China Daily Bus. Wkly, Sept. 7, 1997, at 3

it was not unusual for an old fund to have one company or department to act both as the fund manager and fund custodian. In some cases the roles of the fund promoter, fund manager and fund custodian were all assumed by one company.⁹¹ Furthermore, some funds invested heavily in real estate resulting in a low liquidity,⁹² some lent fund capital at high interests,⁹³ and some fund managers invested in the name of the investment funds with capital from other sources.⁹⁴

III Standardisation of old funds

In 1997 the first national regulation, the Preliminary Securities Investment Fund Act, was issued to regulate China's securities investment fund industry. China's standardised investment-fund industry began in March 1998 with the issue of two closed-end funds, Jintai and Kaiyuan, managed by the Guotai and Nanfang fund management companies (FMCs) respectively.⁹⁵ A total of 75 funds and 47 fund-like certificates had been launched with the accumulated capital of more than Renminbi

⁹⁰ See Funds Can Curb Market Volatility, China Daily Bus. Wkly., Sept. 7, 1997, at 3

⁹¹ Zhengquanfa Lijie Shiyong Yu Anlie Pingxi (Understanding and Practice of Securities Law and Case Studies) (Yan Gao & Pingjun Yi eds., 1997), at 281

⁹² See Funds Can Curb Market Volatility, China Daily Bus. Wkly., Sept. 7, 1997, at 3

⁹³ See Cong Touzi Yunzuo Kan Xianyou Jijin De Chulu (Looking at the Future of Current Funds from the Perspective of Investment Operation), Zhengquan Shibao (Securities Times), Nov. 24, 1997, at 11.

⁹⁴ Some listed companies entrusted fund managers to invest their capital in the securities market, which has seriously infringed upon the interests of investors of these companies. See *ibid*.

⁹⁵ Some 75 funds were issued in the early 1990s, and several were listed. However, these funds invested in real estate, industrial projects as well as securities, were issued by government-affiliated companies, and were poorly regulated by the People's Bank. In 1998, the CSRC took over regulation from the central bank and the government has since restructured or closed all of these 'old funds'. See Tao Tingting (1999), 'The burgeoning securities fund industry in China: its development and regulation', Columbia Journal of Asian Law 13 (2): 203-244 and Green, S.(2003), for an introduction to the fund industry in China. Green, S.(2003), China's stockmarket: A guide to its progress, players and prospects, The Economist, London.

("RMB") 7 billion yuan (approximately) US \$1 = RMB 8.3 yuan as of September 1999).⁹⁶

In order to boost investors' confidence and to attract more investors, especially institutional investors, to enter into the securities market, and to help the development of the investment fund industry, the legislative process for a national securities investment fund law was started in 1999. After four years of drafting, discussion and revision, the law of the People's Republic of China on Securities Investment funds was finally passed by China's top legislator on 28 October 2003.

Since then the growth of the sector has been rapid.⁹⁷ In the five years to year end 2002, total fund assets expanded some 13 times to Rmb138bn (\$16.6bn), as table one shows. By this time 71 funds (54 of which were closed-end funds, hereafter CEFs) were being run by 19 investment fund companies.⁹⁸ As of August 2004, there were 40 new fund management companies opening their businesses, together managing 146 funds, including 54 closed-end funds and 92 open-end funds. By the end of 2005 there were 54 closed-end funds and 154 open-ended funds under the

⁹⁶ See *Funds Can Curb Market Volatility*, China Daily Bus. Wkly., Sept. 7, 1997, at 3; Zhongguo Jijin Shichang 1998 Nian Huigu Yu 1999 Nian Zhanwang (An Overview of China's Investment Fund Market of 1998 and Prospects for 1999), Zhongguo Zhengquan Bao (China Securities), Mar. 30, 1999, available at <http://www.cs.com.cn>.

⁹⁷ In that same time, several thousand privately-raised funds have been raised from corporates and rich individuals by companies which are unregistered and unregulated by the PBoC and CSRC.

⁹⁸ The CSRC website provides basic data on fund issuance and trading (www.csrc.gov.cn). See also Zhang Kefeng et al., 'Fund Industry Review 2002', Taiyuan Securities Research, downloaded from www.homeway.com.cn.

management of 53 fund management companies. These funds held 44% and 17% respectively of the total tradable share capitalisation in China.⁹⁹

IV The Preliminary Securities Investment Fund Act 1997

However, because the authority has little knowledge of investment funds, the inefficient monitoring structure and the unstable market affects, during the funds development there are so many problems, there included funds manager wrong doing and bad quality of asset.¹⁰⁰ In order to change the situation, the Chinese State Council gave the Securities Regulatory Commission (CSRC) the power instead of the People's Bank of China to make regulations governing the establishment, carrying on, and regulation of investment funds in November 1997. The China Securities Regulatory Commission (CSRC) published new legislation, namely the Preliminary Securities Investment Fund Act (*Zhenquan Touzi Jijing Guanli Zanxing Banfa*) on 15th November 1997. This legislation contained 57 articles,¹⁰¹ and regulates securities investment funds, which invest in stocks, bonds, and other financial instruments.¹⁰²

⁹⁹ See China's Securities and Futures Markets (2006), available at www.CSRC.gov.cn/en/jsp/detail.jsp?infoid=1153810173100&type=CMS.STD, at 27.

¹⁰⁰ See Zhou, Z.Q. the Vice director of financial department of national congress Speech on Conference of the securities investment funds law in 2003.

¹⁰¹ These articles are divided into the following seven chapters: (1) general principles; (2) establishment, issuing and trading; (3) fund custodians and fund managers; (4) rights and duties of fund holders; (5) investment operation, and supervision and management of funds; (6) punishment; and (7) supplementary provisions.

¹⁰² 1997 Preliminary Securities Investment Fund Act. art. 2.

V The regulatory authorities

The Preliminary Securities Investment Fund Act 1997 is the first unified act to govern investment funds. The aim of this regulation is described as to strengthen investment funds supervision, to protect the investors, to develop a healthy and stable capital market in China. The new act gives the CSRC the power instead of the People's Bank of China to authorize investment funds¹⁰³.

The Act provides the CSRC with four categories of regulatory powers. First, the CSRC has the power to formulate rules and requirements to implement the Provisional Measures. The CSRC can specify the contents and format of fund contracts, custodian contracts and prospectuses,¹⁰⁴ Second, the CSRC has the power of approval. The establishment of funds is subject to the examination and approval by the CSRC,¹⁰⁵ as is the establishment of fund management companies.¹⁰⁶ Also, the CSRC is authorized to approve the enlargement or extension of closed-end funds,¹⁰⁷ the removal of fund managers,¹⁰⁸ the resolutions made in fund holders' meeting concerning certain matters,¹⁰⁹ and the results of

¹⁰³ 1997 Preliminary Securities Investment Fund Act, section 5

¹⁰⁴ Ibid, art. 8.

¹⁰⁵ Ibid, art. 5

¹⁰⁶ Ibid, art. 23

¹⁰⁷ Ibid, art. 11

¹⁰⁸ Ibid, art.27

¹⁰⁹ Ibid, art. 30. These matters are modification of fund contracts, termination of funds in advance, and change of fund custodians or fund managers.

liquidation.¹¹⁰

Third, the CSRC has the power to supervise and examine the operation of funds. Under their respective authority Article 39 of the Act states that the CSRC and the PBOC, at any time, may examine the issuing, trading, and operating of investment funds and other related activities. As a result, the CSRC can require the termination of a fund because of a serious violation of laws or regulations.¹¹¹ Additionally, if the CSRC has sufficient grounds to believe that a fund manager can no longer carry out his functions, it can require the fund manager to resign.¹¹²

Last, the CSRC has the power to impose legal sanctions. Violations of the Act would result in sanctions imposed by the CSRC according to Articles 43-54. The form of those funds can be open-ended investment funds and close-ended investment funds¹¹³ which can only invest in securities in China.¹¹⁴ In order to maintain independence, there should be no financial and administrative links between custodian and manger.¹¹⁵ If the custodian found any investment decision made by funds managers which is illegal they should reject it and report it to CSRC.¹¹⁶

¹¹⁰ Ibid, art. 41.

¹¹¹ Ibid, art. 40, section 3.

¹¹² Ibid, art. 27, section 4.

¹¹³ Ibid, section 6.

¹¹⁴ Ibid section 2.

¹¹⁵ Ibid, section 17.

¹¹⁶ Ibid, section 19 (3).

Another further development is investor protection, according to sections 21(3) and 27 (3) Investors have the right to attend an investors' general meeting which has authority to wind-up the investment funds ahead of schedule; remove the custodian and manger and make other decisions which the CSRC thinks should be made by the investors general meeting.¹¹⁷ Furthermore, the section itself is impractical. As it does not clearly outline the circumstances under which an action can be initiated.

Again, although the Preliminary Securities Investment Fund Act provides a basic framework for fund regulation, it is silent in some crucial issues concerning the legal nature of funds. The act fails to specify whether the legal form of investment funds in China is the contractual fund or the corporate fund. It is not clear whether both trust and contract principles would apply to China's investment funds, or whether contract principles alone are sufficient to govern the legal relationships of funds. The legislation leaves this issue open and avoids any mention of trusts.¹¹⁸

VI The Securities Funds Law 2003

Since 2001 the capital market went down sharply and investor

¹¹⁷ Ibid, section 30

¹¹⁸ The term "trust" does not appear anywhere in the Preliminary Securities Investment Fund Act 1997

participation in the Chinese capital market has fallen off.¹¹⁹ The CSRC have to face the investors claim to build market confidence.¹²⁰ At that time there was a significant change in the CSRCs' attitude.

The CSRC stressed that the securities investment funds law was vital for the healthy and fast development of China's funds industry, as well as its stock market.¹²¹ In addition, the CSRC also believe that investment funds can improve corporate governance of State Own Enterprises (SOEs). They insisted that, because the shares that the public holds are widely dispersed, individual investors have too small a stake to justify monitoring costs; thus, they cannot exert enough discipline for companies to improve their operation. Small investors are far more likely to sell their shares if they are not satisfied with a company's performance. They believe that investment funds can act as an important force in the shareholder structure of companies transformed from SOEs. Fund managers can represent investment funds in shareholders' meetings of the companies in which the funds are invested. As long-term shareholders, they have incentives to monitor the management of companies and give suggestions concerning their operation. Consequently, the participation of funds can theoretically exert more discipline on companies and improve

¹¹⁹ "China's Securities Market Begins Five-Faceted Reform", People's Daily, see the People daily website <http://cis2000.people.com.cn/gb/paper104>, on 27 Feb. 2001

¹²⁰ "Investors Expect Good Return", China Daily Bus. Wkly., 22 Mar. 1998, at 3.

¹²¹ Zhou D. J., member of the Financial and Economic Committee of the National People's Congress speech at the international funds law Conference 2002.

their management. Though, the reality is often different.

In addition, investment funds in China are not only tools for investment, but also possible tools for the state to coordinate the stable development of the securities market. Because publicly-owned fund management companies manage the funds, the state will be able to influence the securities market through the funds.¹²²

On 28 October, 2003, The Standing Committee of the National People's Congress published the securities investment funds law. The new Law regulates the functions and roles of securities investment funds, formally establishes the regulatory system, emphasises the protection of investors' rights and interests, sets the market entry threshold, specifies the liabilities of practitioners, and imposes penalties for violations of the law by fund managers and fund Custodian as well as securities administrative officials.

4.6 Quis Custodiet Ipsos Custodies? (Who shall guard the guards?)

The aims of the new law are to protect the investor's interests and related

¹²² See e.g., Li, Y.(1995) *Zhengquan Touzixue (Theories of Securities Investment)*, Beijing University, at 220.

parties' interests, to develop a healthy capital market in China¹²³. Therefore, investment funds themselves have been described as the guards of good corporate governance with their allegedly professional teams, rational investment behaviour and lower investment costs. These characteristics were expected to help stabilize the securities market, improve investment portfolios and help listed firms in their corporate governance.¹²⁴ However, can investment funds really achieve those kinds of goals under the new law? When we look at that question first we can focus on the investment funds structure to consider whether this is a balanced and efficient structure.

4.6.1 The problems of the fund manager

The fund manager is required to carry out the day to day management function of the investment funds. The law defines a fund manager's obligation and duties in more detail as to what are, and what are not, the obligations of the manager in sections 19 and 20. Section 19 goes on to enumerate a number of matters which regulations may cover: requiring the keeping of records with respect to the transactions and financial position of the scheme and for the inspection of those records; requiring the preparation of reports with respect to the scheme. Compared to the

¹²³ Securities Investment Funds Law 2003 ,Section I

¹²⁴ "China's Open-End Fund Helps Liberalizing Domestic Savings: Interview", available at the People's Daily website http://english.people.com.cn/english/200107/27/print20010727_75946.html

1997 act there are some significant changes. For example the manager has the right to initiate an investor's general meeting. In order to protect investor's interests, the securities investment funds law even offers the investor the right to sue for the funds custodian's or funds manager's wrongdoing which it is the first time the law to provide such a legal basis.

Yet it is still limited because it fails to specify any necessary substantive and procedural conditions of such an action. In addition, there are two basic duties placed on the fund manager. One is that as a normal company under the company law regulations, they have to increase returns for their company and its shareholders; on the other hand the managing company acts as a funds manger under the securities investment funds and contract law regulation, they have to take care of investment funds for the funds investor. This can give rise to a conflict or divergence of interests and requires cerebration of how the law deals with these issues.

4.6.2 The problems of the fund custodians

A fund custodian must be a commercial bank which has been authorized by CSRC and China Banking Regulatory Commission (CBRC) and has met the requirement of the securities investment funds law. According to

section 28 the fund custodian and the manager must be legal persons who are independent of each other. The main obligation of the fund custodian is safekeeping and supervision, compared to 1997 regulation the new law also provides the fund custodian with the right to initiate an investors' general meeting, if fund custodian finds an investment decision made by manager which is against the law or the investment deed, the fund custodian should suspend the action and deliver this information to the CSRC and the funds manger, if this decision has already become effective, the fund Custodian also should tell this to the CSRC and the funds manger immediately.¹²⁵

However, in practice, there are two main reasons which impact on those commercial banks to exercise such supervisions. First in China there are only a few major commercial banks which can satisfy the requirement to become fund custodians; however they have to face considerable market competition. An investment funds manager is an attractive customer for those banks. Because a fund manager has the right to choose a bank to hold a vast sum of funds that has been raised from the market. Under the increase market pressures, the fund custodians have to decide whether to lose those valuable customers or to 'accept' them. Secondly, fulfilling the role of funds custodians is a completely novel function for China's

¹²⁵ Preliminary Securities Investment Fund Act 1997, Section 30

commercial banks, it requires different professional knowledge to run it. As a result, the fund custodian has to develop a very good relationship with the fund manager. In the Chinese context this has strong guanxi implications. The fund custodian has no right to supervise the decision made by the fund manager, nor does it have the ability to understand whether or not the decision made by the fund manager has involved problems of related transactions, and whether or not the decision is in the interest of the funds investor. So far, there is no report on the fund custodian using his authority to fire the fund manager because of misconduct. However, given the inherited problem of the structures created by law, there is much room for negligence, incompetence and fraud.

4.6.3 The problems of fund holders

Generally speaking a fund holders' general meeting can play a very important role for investors to participate in investment as well as allowing them to exercise various supervisory functions. However, it is questionable whether this new law provides a practicable structure for those investment funds holders. Under section 71, a fund holders' general meeting can decide to close investment funds, change the investment funds type, and remove the funds custodians or funds manager. The

requirement for making those decisions is the agreement of more than two thirds of the attending fund holders which collectively represent above 50 percent of the total units. Although the new law provides the fund holders the right to initiate a fund holders' general meeting, however, according the CSRC new guidelines Administrative Measures for the Operation of Securities Investment Funds (*Zhengquan Touzi Jijing Yunzuo Guanli Banfa*) which was published by the CSRC in 2004, fund holders can not initiate a fund holders' general meeting directly. If they desire to do so, they have to apply to the fund manager to first decide whether to hold the meeting, but if the fund manager do not think it is necessary, then the fund holders have to apply to the fund custodians to decide. If the custodians still does not think it is necessary, then the fund holders can initiate a fund holders' general meeting under their own name. The custodian also has the right to initiate a fund holders' general meeting, but they also have to apply to the fund manager for approval, if the funds manager do not think it is necessary , but the custodian still insist that then the custodian can initiate a fund holders' general meeting. According section 43 of the Administrative Measures for the Operation of Securities Investment Funds (*Zhengquan Touzi Jijing Yunzuo Guanli Banfa*) the decision made by the investor's general meeting will not come to effect until the CSRC ratifies it.

Nevertheless, there is a problem with the process, if the fund holders plan to initiate a fund holders' general meeting and to discuss the removal of the funds manger or custodian, then the latter will not approve the general meeting. The manager or custodian will not allow this to happen. On the other hand even if the fund manager does not agree to initiate a fund holders' general meeting, but the fund holders or the custodian still insist, finally there will be a fund holders' general meeting. This is a tortuous journey to initiate a fund holders' general meeting requiring investors to waste time and money. Therefore, this section is not very supportive of investors' right. Additionally, it is a problem of not inconsiderable magnitude for the very large number of individual investors to initiate a general meeting. Even if this general meeting eventually takes place, the legal majority for a decision will be difficult to fulfil in the circumstance of most Chinese listed companies. As a result, in practice the fund holders' general meeting offers little protection to investors.

4.6.4 The problem of the investment funds activities

With the Chinese stock markets wracked with short term share churning and speculation, the government has hopes that investment funds will not only draw people's bank savings into equities, but also promote long-term

investment styles. Compared to individual investors, investment funds enjoy a major advantage as corporate monitors: they are large. They will tend to own a greater number of shares of an individual company than individual investors do.

The logic of these proposals is that investment funds will behave quite differently than dispersed individual investors. Because they own large blocks, and have an incentive to develop specialized expertise in making and monitoring investments, investment funds could play a far more active role in corporate governance than dispersed individual investors traditionally have done.

However, the sharpest accusation levelled against activist funds is that activism is designed to achieve a short-term payoff at the expense of long-term profitability.

I. The voting system

Perhaps the easiest way an institution can involve itself in the governance of a company in which it has invested its clients' funds is by actively voting on resolutions put to the general meeting. The 2005 Company Law

provided that shareholders representing not less than 3 per cent of the total voting rights may make proposals for resolutions. If the proposals relate to the issues that have already been contained in the notice of shareholders' meeting, the shareholders may choose to present the proposals at the meeting, dispensing with the need to submit the proposals to the board of directors ahead of the meetings.¹²⁶

Tradable shares amount to about one-third of all outstanding shares.¹²⁷ Of these tradable shares, securities investment funds hold an average of about 15 percent.¹²⁸ In a bunch of listed companies, the funds hold a larger proportion—in a few cases, as much as 50 to 70 percent—of tradable shares.¹²⁹ Though significant, institutional shareholding represents, therefore, only a relatively small stake in the portfolio companies.

Without minority protection mechanisms, the majority-voting rule will make it virtually meaningless for institutions to intervene on the issues

¹²⁶ The Company Law 2005, Art 103

¹²⁷ In China, about one-third of shares can be publicly issued, owned by individuals and legal persons, and freely traded. These shares are known as individual person shares. Non-tradable shares are legal person shares and state shares. The Legal Person category, roughly one-third of every listed firm's equity is owned by domestic shares institutions (stock companies, non-bank financial institutions and SOEs with at least one non-state owner) and cannot be openly traded. Transfer of shares needs special approval from the government. Legal person shares were created in 1980s when SOEs were first turned into shareholding companies. State shares another third of equity, is owned by the state (central and local government departments, as well as SOEs wholly owned by the state). The ultimate owner is the State Council. State shares cannot be traded, though they can be transferred to other market participants such as domestic and foreign investors, with permission from the CSRC.

¹²⁸ "Zhengjianhui Fuzeren jiu Gugai he IPO deng Wenti FabiaoTanhua" (CSRC's Responsible Officers Gave Talks on Issues of the Share Structure Reform and IPO), Shanghai Zhengquan Bao (Shanghai Securities News), April 28, 2006.

¹²⁹ China Knowledge Press, Fund Management in China (China Knowledge Press, Singapore, 2005), at 127-128 ("Fund Management in China").

that the majority shareholder supports. Again, institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. They are unlikely to be involved in day-to-day corporate matters. Thus investment funds lack the incentives to be active; they would be prone to follow the “Wall Street rule” of selling their stock when disappointed. Only in exceptional cases where investment funds are “locked in” and cannot sell their shares are they willing to intervene.¹³⁰

II Collective action and free-rider problems

Any positive share price effects from monitoring or intervening will be enjoyed by all shareholders regardless of whether or not they participate in (or contribute to) the monitoring. This means that if one or two investment funds spend resources intervening and (hopefully) increasing the value of a company’s shares, their competitors who also hold shares in that company can free-ride on their efforts – their performance will improve along with that of the intervening institutions but they will have spent nothing in the process. For this reason, a rational fund manager will only spend time and resources on detailed monitoring or intervening at an investee company in limited circumstances.¹³¹

¹³⁰ Wei, L., “Jigou Touzizhe Canyu Gongsi Zhili Wenti Yanjiu” (A Study on the Institutional Investors’ Participation in Corporate Governance), in Gongsi Falv Pinglun (Company Law Review), Gu Gongyun (ed.) 2003, Shanghai People’s Press, Shanghai, pp.113, 123–125.

¹³¹ Ibid.

III Conflict of interests

The main argument in the West which has been put forward to explain the under-use by the institutions of the corporate governance rights is the conflicts of interest that arise at the institutional investor level.¹³² The interests of institutional investors and their controllers would often lead them to act in their own best interest and sacrifice shareholder value.¹³³

Investment funds in China also suffer from conflicts of interests between fund managers and fund beneficiaries which inhibit their activities as monitors of portfolio companies. Many investment fund management companies are affiliated with – in effect subsidiaries of and controlled by – another financial institution, such as an investment bank or an insurance company. Managers in such funds may be reluctant to antagonize present or future clients of their parent company with their governance activities. Thus, the easiest and safest way to avoid any problems is for affiliated investment funds not to engage in governance activism at all.

¹³² Black, B. S. (1990). "Shareholder Passivity Reexamined." *Michigan Law Review* 89(3): 595-608.; Rock, E. B. (1991). "The Logic and (Uncertain) Significance of Institutional Shareholder Activism." *Georgetown Law Journal* 79(3): 469-472.

¹³³ Camara, K. A. D. (2005). "Classifying Institutional Investors." *Journal of Corporation Law* 30: 219.; Romano, R. (1993). "Public Pension Fund Activism in Corporate Governance Reconsidered." *Columbia Law Review* 93(4): 795

4.7 Conclusion

Institutional investors are expected to have a long term perspective and base investment decisions on the fundamental value of stocks. The authorities in China hope that with an enlarged institutional investor base and the increased professionalism of institutional investors, they will incur expense in intervening to correct mismanagement.

However, majority listed companies in China are mainly state-owned enterprises which are newly established shareholding companies upon transformation from the socialist enterprise system. Only about one-third of shares can be publicly issued, owned by individuals and legal persons, and freely traded. Though significant, institutional shareholding represents, therefore, only a relatively small stake in the portfolio companies. Without minority protection mechanisms, the majority-voting rule will make it virtually meaningless for institutions to intervene on the issues that the majority shareholder supports.

In addition institutional investors in China are asking the question “Who shall guard the guards?” The interests of institutional investors and their controllers would often lead them to act in their own best interest. Thus, institutions often devoted little effort to monitoring management. This is

because they lack the willingness and ability to actively monitor and intervene. When the micro *gaunxi* and overriding political issues at a macro level are added to the firmament of corporate governance in this context it can be seen how highly contingent and institutionally specific are the stock markets of China and even those of developed economies like Germany and Japan.¹³⁴ This has meant a number of varying problems in different jurisdictions for the role of institutional investors in corporate governance.¹³⁵ In China's case the problems are exacerbated by the political and cultural milieu in which the movement towards convergence with international norms in stock market regulation and listing rules has been introduced. Whilst, as MacNeil has asserted,¹³⁶ such regulation did not challenge the governments' role as controller of corporatized SOEs, the role of institutional investors in corporate governance could do. Only very recently has there been a slight increase in institutional shareholders bringing minority shareholder actions. This will be explored in Chapter 5.

¹³⁴ See Baums and Buxbaum (1994), *supra* note 33, at 8-10.

¹³⁵ See for example, Hadden T, "Corporate Governance by Institutional Investors? Some Problems from an International Perspective"; and Hauck M, "The Equity Market in Germany and its Dependency on the System of Old Age Provisions" both in Baums, Buxbaum (1994), *supra* note 33.

¹³⁶ MacNeil, M. I. (2002). "Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies." *Journal of Corporate Law Studies* 2(1): 289-344.

Chapter 5 Minority shareholder protection

5.1 Protection of minority shareholders' rights and interests: the theory in the West

From very early on in the corporate governance debate, some scholars¹ argued that "Many problems associated with the inadequacy of the theory of the firm can also be viewed as special cases of the theory of agency relationships"² An agency relationship can be defined as a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.³ Agency problems arise because contracts are not written and enforced without transaction costs. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests. Agency costs also include the value of output lost because the costs of full enforcement of contracts exceed the benefits.⁴ They argued that the central problem of corporate governance was a "principal-agent" problem: how to get

¹ Wilson, R. (1968). "Theory of Syndicates." *Econometrica* 36(1): 119-&; Ross, S. A. (1973). "Economic Theory of Agency - Principals Problem." *American Economic Review* 63(2): 134-139.; Ross, S.A. (1974). "The Economic Theory of Agency and the Principle of Similarity".in Balch, M., D. McFadden, et al. (1974). *Essays on economic behavior under uncertainty*. Amsterdam ; Oxford, North-Holland Publishing Co.; Heckennan (1975). "Motivating Managers to Make Investment Decision." *Journal of Financial Economics* 2.

² Jensen, M. C. and W. H. Meckling (1976). "Theory of Firm - Managerial Behavior, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3(4).

³ Ibid.

⁴ Berle, A. and G. C. Means (1933). *The Modern Corporation and Private Property*. New York, Macmillan.

corporate managers to act as loyal and committed “agents” for the shareholders or “owners” of corporations.⁵ Berle and Means’ theory contends that manager and the owners of a firm do not have the same interests and motivation to make full and efficient use of corporate assets. The purpose of corporate governance is thus to align the interests of managers with that of the owners.⁶ Proponents such as Ross argued that “examples of agency are universal.”⁷

In a fundamental paper, La Porta et al. argue that stock market development should be positively correlated with shareholder legal protection.⁸ Shleifer and Wolfenzon formalize this argument with a model in which controlling shareholders sell out to diversify if their rights as portfolio investors are legally protected. Otherwise, they remain undiversified block holders in the companies they manage and consume what private benefits they can extract from their public shareholders.⁹

La Porta et al. measure shareholder rights by focusing on six specific legal rights shareholders have in the United States and counting how many of them shareholders have in other countries.¹⁰ They find that in the

⁵ Jensen, M. C. and Meckling W. H. (1976), Supra note 2.

⁶ Berle, A. and Means G. C. (1933), Supra, note 4.

⁷ Ross, S.A. (1973) Supra note 1, at 134.

⁸ La Porta, R., F. LopezDeSilanes, et al. (1997). "Legal determinants of external finance." *Journal of Finance* 52(3): 1131-1150.

⁹ Shleifer, A. and D. Wolfenzon (2002). "Investor protection and equity markets." *Journal of Financial Economics* 66(1): 3-27.

¹⁰ This index adds one point if the country lets shareholders mail in proxy votes, does not require shares to be deposited prior to a general shareholders' meeting, allows cumulative voting or proportional representation of

1990s countries with stronger shareholder protection were characterized by larger stock markets and more diffusely held large corporations and that these countries tend to have legal systems derived from British common law. The common-law countries are Australia, Canada, England and Wales, Hong Kong, Ireland, New Zealand, Singapore, and the United States, and several African countries including Nigeria, and they clearly do have more widely held large firms than the other countries, all of which employ civil codes of one form or another. La Porta et al. conclude that diffuse ownership and shareholder capitalism require solid legal protection of public shareholders' property rights in their investments.¹¹

However, he fails to find any temporal correlation between changes in shareholder protection and ownership diffusion. Franks, Mayer, and Rossi argue that British shareholders had none of the legal rights La Porta et al, enumerate until 1948, and only attained their current level of protection in the final third of the twentieth century.¹² Yet they find that the ownership of new British firms dispersed as quickly early in the twentieth century and in its latter decades. Cheffins has argued that the historical record in the US does not support la Porta's thesis. At the turn of the 19/20th

minorities in the board, provides an oppressed minority remedy, lets an owner of 10 percent or less of the share capital call an extraordinary share holders' meeting, or lets shareholders' preemptive rights be voided only by a shareholders' vote. La Porta et al (1997). *Supra* note 8, at 1131.

¹¹ La Porta, R., F. Lopez-de-Silanes, et al. (1999). "Corporate ownership around the world." *Journal of Finance* 54(2): 471-517.

¹² *Ibid.*

centuries there were circa 500,000 equity investors and this rose to circa 5 million by the early 1920s despite the fact that the major securities and minority shareholder protections were introduced in the 1930's. This leaves open the question as to whether the introduction of minority remedies and investor protection today will help the diffusion of shareholdings along the US lines but he points to the German system which in the early 20th Century had far better minority shareholder and investor protection laws but where concentrated shareholdings remained the norm.¹³

Cheffins also argues that the UK experience casts doubt on the extent to which legal regulation matters in the corporate governance context. Rather, he argues that a highly specific set of laws governing companies and financial markets do not have to be in place for the development of dispersed ownership and strong securities markets. He argues that strong institutional structures can perform the function that the advocates of the 'law matters' thesis say the legal system needs to play.¹⁴ From another perspective he also argues that there is historical evidence supporting the role of mergers and takeovers in the march towards a US style of separation and ownership, which in recent times, is influenced by

¹³ Cheffins B R, (2003) "Law as bedrock: The Foundations of an Economy Dominated by Widely held Companies" *Oxford Journal of Legal Studies* 23(1), 1-23.

¹⁴ Cheffins, B. R. (2001). "Does law matter? The separation of ownership and control in the United Kingdom." *Journal of Legal Studies* 30(2): 459-484.

competition law in determining when such changing events occur¹⁵ and also that tax law has a part to play. According to Cheffins and Banks during the 20th century a system of outsider/arms length corporate governance took shape and became fully entrenched in the UK because taxation in terms of corporate profits, managerial income and investments and also inheritance taxes became burdensome for blockholders who sought to exit by selling their shares. Equally, tax incentives for institutional investors ensured that these other investors were willing to buy shares. For example, dividends were regarded as unearned income coming at the high end of tax rates for individual owner-directors whereas pension funds were tax exempt on their dividends¹⁶

Canadian shareholders had few of the shareholder rights until the 1960s, but Morck et al, find that Canadian corporate ownership grew widely dispersed by the middle of the twentieth century and that family-controlled pyramidal groups staged a roaring comeback at the century's end and under unprecedented strong shareholder rights laws.¹⁷ France, Germany, Italy, Japan, the Netherlands, and Sweden all had economically very important stock markets off and on through their history-especially at the beginning of the twentieth century, as noted by Rajan and

¹⁵ Cheffins, B. R. (2003). "Competition Law and Corporate Ownership Structure : A European Research Agenda." *European Business Organisation Law Review* 4: 3-30.

¹⁶ Cheffins, B. R. and S. A. Banks (2007). "Corporate Ownership and Control in the UK : The Tax Dimension." *Modern Law Review*: 778-811.

¹⁷ Morck, R., Percy, M. et al. (July 2004). " The Rise and Fall of the Widely Held Firm - A History of Corporate Ownership in Canada ". NBER Working Paper No. W10635. Available at SSRN: <http://ssrn.com/abstract=579782>

Zingales.¹⁸ Even today in the US, where private benefits of public companies is low,¹⁹ some notable large companies, including Microsoft, Walmart, Coco-Cola and Intel, have relatively high ownership concentration. Indeed there were many large family controlled companies in the US until the 1980s.²⁰

Again, Mark Roe has advocated political economy-based theories.²¹ According to Roe, political economy-based theories are better than the legal origins theory in explaining that politics affects whether policy makers want to, and can, build financial markets.²² With respect to ownership concentration, Roe argues that because social democracies prefer the interests of other constituencies to those of shareholders, they will pressure corporate managers to subordinate shareholder interests, and only concentrated large shareholders can effectively compel managers to resist these pressures.²³

In addition, the theory of asymmetric information provides a much more

¹⁸ Zingales, L. and R. G. Rajan (2003). "Banks and Markets: The Changing Character of European Finance." NBER Working Paper No. W9595. Available at SSRN: <http://ssrn.com/abstract=391131>

¹⁹ An indication is the low premium of 5.4% enjoyed by voting shares. See Lease, R. C., J. J. McConnell, et al. (1983). "The Market Value of Control in Publicly-traded Companies." *Journal of Financial Economics* 11: 439.

²⁰ Hall, P. D. (1988). "A Historical Overview of Family Business in the United States." *Family Business Review* 1(1); see also Astrakan, J. H. and M. C. Shanker (2003). "Myths and Realities: Family Businesses Contribution to the US Economy." *Family Business Review* 9(2): 107 - 123.

²¹ Roe, M. J. (2000). "Political preconditions to separating ownership from corporate control." *Stanford Law Review* 53(3): 539-606.; Roe, M.J., (2006), "Legal Origin and Modern Stock Markets", J Olin Centre for Law, Economics, and Business Discussion Paper, Harvard Law School, Available at SSRN: <http://ssrn.com/abstract=908972>.

²² Ibid.

²³ Roe, M.J., (2000), *supra* note 21, at 603.

plausible explanation of missing markets. This idea has found many applications in the financial markets over the last 30 years. Akerlof shows how this phenomenon can prevent a market from being established. The basic problem is that when individuals have access to private information that is known only to them or their close associates, they become information monopolist. Adverse selection can prevent a market becoming established or lead to a low-quality market. Moral hazard and other problems can also precipitate a suboptimal outcome.²⁴ After the Enron case and the WorldCom case, many scholars²⁵ considered that investors' trust in the securities markets is very important. La Porta, Rafael and Shleifer stress more fundamental legal system differences turning on judicial independence, disclosure, and securities laws.²⁶ Now, a global recession has now become the biggest threat to many companies all over world. The international financier George Soros blames this on what he calls "market fundamentalism".

"The economics profession has developed theories of "random walks" and "rational expectations" that are supposed to account for market movements. That's what you learn in college. Now, when

²⁴ Akerlof, G. A. (1970). "Market for Lemons - Quality Uncertainty and Market Mechanism." *Quarterly Journal of Economics* 84(3): 488-500.

²⁵ Stout, L. A., (2002) , "The Investor Confidence Game" . UCLA School of Law, Research Paper No. 02-18. Available at SSRN: <http://ssrn.com/abstract=322301>; Tamar Frankel (1999) ,Trusting And Non-Trusting: Comparing Benefits, Cost And Risk, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=214588; La Porta, R., F. Lopez-De-Silanes, et al. (2002). "Investor protection and corporate valuation." *Journal of Finance* 57(3): 1147-1170.

²⁶ La Porta, R., F. Lopez-De-Silanes, et al. (2008). "The economic consequences of legal origins." *Journal of Economic Literature* 46(2): 285-332.

you come into the market, you tend to forget it because you realize that that's not how the markets work.”²⁷

In addition to the question of whether the law matters in relation concentrated shareholdings and their effect on corporate governance is the question of to what extent, if any, minority shareholder protection laws discipline management behaviour. Coffee, for example, considers minority shareholder protection to be an effective weapon in this regard. According to Coffee and Swartz, the derivative action deters managerial misconduct and thereby reduces the agency costs inherent in corporate management.²⁸ However, Fischel and Bradley have doubted the effectiveness of litigation arguing that it is far from obvious that managerial liability in shareholder litigation will reduce agency costs. This is because other measures of corporate governance have already encouraged managers to act in shareholders' best interests. Additionally liability rules play little or no role in creating incentives for beneficial conduct.²⁹ Other commentators have pointed out that it is virtually impossible to empirically assess the benefits of deterrence of corporate wrongdoing because it does not result in positive actions for

²⁷ Schifferes, S. (2008) "Soros warns global boom is over", BBC Business News report, 19 May, available at <http://news.bbc.co.uk/2/hi/business/7408620.stm>.

²⁸ Coffee, J. C. and D. E. Schwartz (1981). "The Survival of the Derivative Suit - an Evaluation and a Proposal for Legislative Reform." *Columbia Law Review* 81(2): 261-336.

²⁹ Fischel, D. R. and M. Bradley (1986). "The Role of Liability Rules and the Derivative Suit in Corporate Law : A Theoretical and Empirical Analysis." *Cornell Law Review* 71(2): 262.

examination.³⁰ Romano, in particular, points out that for circa 200 such actions commenced in the Delaware courts, only one makes it to a full court hearing on the substantive issues thereby laying down legal guidelines for appropriate conduct. The rest are settled.³¹ Miller has argued that there are important differences in terms of disciplining management between the England and the US which are politically derived. According to him the differences in costs, traceable to the tort of champerty in England and the limits on the market for control in the US have resulted in minority shareholder litigation playing a more important role in the US whilst the market for corporate control is more effective in disciplining management in England. In the latter jurisdiction there have been very few derivative actions especially those involving listed companies.³² Whilst there have been a large number of minority shareholder actions based on the unfair prejudice remedy, except for a very few instances,³³ they have been concerned with smaller, usually private companies for which the provision was originally designed.³⁴

³⁰ See for example, Thompson, R. B. and R. S. Thomas (2004). "The Public and Private Face of Derivative Lawsuits." *Vanderbilt Law Review* 57(5): 1747-1793.

³¹ Romano, R. (1991). "The Shareholder Suit - Litigation without Foundation." *Journal of Law Economics & Organization* 7(1): 55-87.

³² Miller, G. (1998). "Political Structure and Corporate Governance: Some Points of Contrast between the United States and England." *Columbia Business Law Review* (1): 52. For an example of a major UK derivative action which was brought by an institutional investor, see *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] Ch 204, CA.

³³ See for example, *Re Blue Arrow plc* [1987] BCLC 585; *Re Tottenham Hotspur plc* [1994] 1 BCLC 655; *Re Astec (BSR) plc* [1998] 2 BCLC 556. In the latter case Jonathan Parker J explained that the concept of legitimate expectation has no place in the context of public companies.

³⁴ Although the unfair prejudice remedy was designed with the small company in mind several instances of its use in public companies have been made. Now the *Companies Act 2006*, s 995 allows for a petition by the Secretary of State in circumstances which could cover a public company. The vast majority of reported cases concern smaller private companies which is similar to the situation in Asian jurisdictions where similar provisions apply, see Lawton, P. (2007) "Modeling the Chinese Family Firm and Minority Shareholder Protection: The Hong Kong Experience 1980-1995" *Managerial Law* 49; Salim, M. R. and P. Lawton (2008). "Law in a Post-Colonial State:

In the context of the UK, Reisberg argues that the derivative action is not just another corporate asset in the context of serious breaches of directors' duties but is a mechanism of corporate accountability. The derivative action also has sufficient relevance to merit independent existence rather than moving towards a single form of action under the unfair prejudice remedy. That is if the central issue of costs can be tackled to make the action financially worthwhile. He proposes action on three complementary levels, first at the conceptual level a Functional and Focused model to govern derivative litigation, secondly, the strategic level whereby the employment of appropriate incentives and fee rules to advance the premise behind the conceptual model and thirdly, maintaining doctrinal consistency by clarifying the interaction between the derivative action and the unfair prejudice remedy.³⁵

5.2 Protection of minority shareholders' rights and interests: law and practice in China

5.2.1 The role of the market

The Chinese regulatory body adopted policies based on La Porta's scholarship on the positive link between capital market development and

The Shareholder Oppression Remedy in Malaysia." *Global Jurist Frontiers* 8(1): 1-21.

³⁵ See Reisberg, A. (2007). *Derivative actions and corporate governance : theory and operation*. Oxford, Oxford University Press.

public shareholder protection.³⁶ The reformers in China believe that stock market mechanisms are more efficient at rationalizing productive assets than the intermingling of government administration and enterprise management.³⁷ An active market for corporate control is considered to be essential for the efficient allocation of resources. This market allows able managers to gain control of sufficient shares in a short period of time to remove inefficient managers. However, the reality is very different in China. China's market suffers from a lack of liquidity and an active corporate control market does not exist in China.

5.2.2 The structure of the ownership

Basically, there are three categories of shares issued by China's A-share listed companies, each with different rights, benefits and prices: state shares, legal-person shares, and individual person shares.

About one-third of shares can be publicly issued, owned by individuals and legal persons, and freely traded. These shares are known as

³⁶ See generally La Porta, R., F. Lopez-De-Silanes, et al. (2000). "Investor protection and corporate governance." *Journal of Financial Economics* 58(1-2): 3-27. ; La Porta, R. et al. (1997), supra note 8, (postulating that poor investor protections result in capital markets that are both smaller and narrower). In a speech given at the International Seminar on Investor Protection in June 2002, Zhou Xiaochuan, then the Chairman of the CSRC, specifically mentioned that "foreign research proves that the better investor protections in a country or a region, the better developed the capital market (in that country or region), and the stronger its capability to resist financial risks." Zhou Xiaochuan, Baohu Touzizhe Quanyi Shuli Touzizhe Xinxin Guanxi Zhongda (To Protect Investors' Rights and Interests and to Build Up Investors' Confidence Are Critical), Zhegquan Shibao (Securities Times) (P.R.C.), June 26, 2002, available at http://news.xinhuanet.com/fortune/2002-06/26/content_457416.htm

³⁷ See Xu, J. (1987). "The state-share System: A New Avenue for China's Economic Reform." *Journal of Comparative Economics*, 11(3): 513.

individual person shares (*geren gu*).

About one-third of company's equity is made up of state shares (*guojia gu*). The ultimate owner is the State Council, but these shares are managed by bureaus of the Ministry of Finance (MOF, previously by the State Asset Management Administration), as well as by SOEs wholly owned by the state. Only representatives of the state can own them, and they are not freely tradable: authorisation is required from the MOF to transfer them.³⁸

Legal person shares (*faren gu*) make up the final third of the average listed firm's equity structure. Only legal persons can own them. The legal-person shares are usually held by state-owned or controlled enterprises. Some Legal person shares are also held by government bureaus (which has created much confusion over the exact difference with state shares). They cannot be traded on the stock market, although they can be transferred between legal persons subject to the agreement of the stock exchange where the firm is listed. It was only, however, after August 2000 that such transfers became popular. In 2003 the government set up an agency SASAC to act an investor on behalf of the state in 196 large SOEs. These own 6.9 trillion in assets and represent 2.5 trillion of

³⁸ Green, S. (2003). *China's stockmarket : a guide to its progress, players and prospects*. London, Profile at 30.

owners' equity. Those SOEs not owned by State-owned Assets Supervision and Administration Commission (SASAC) are subject to local government established bureaus- Bureau of state asset management (BSAM) to manage state assets. Over 32 such provincial agencies have approved so far. As indicated in chapter 3 this makes it more likely that the government will sell off those SOEs that are problematic, however, whilst these agencies are tasked with separating government function from enterprise management and thereby relieve themselves from social and public duty burdens, being staffed with bureaucrats and party officials government and political interference continues through SASAC and BSAMs.³⁹

It was not unusual for between 60% and 80% of the shares of Chinese listed companies to be state owned, especially in strategic areas. Often such control is exercised through a wholly state owned enterprise (SOE) out of which the listed company had been spun off. The Shanghai Stock Exchange in 2003 noted that:

“A prominent characteristic of Chinese listed companies is an overwhelmingly large percentage of non-tradeable shares, which represent about 2/3 of all the listed company's combined equity.

³⁹ Tan, L. H. and J. G. Wang (2007). "Modelling an Effective Corporate Governance System For China's Listed State-owned Enterprises: Issues and Challenges in a Transitional Economy." *Journal of Corporate Law Studies* 7(143): 175.

The tradeable shares represent the remaining 1/3. A majority of listed company's non-tradeable shares are 60%-80% of their total number of shares. A few companies have more than 90% shares not tradeable. About 6% of all the listed companies have more than 40% of their total equity in tradeable shares. Only 0.4% of all listed companies have only tradeable shares. On average, the larger the size of the company, the higher the percentage of state shares, which demonstrates that large listed companies are essentially state-owned.”⁴⁰

A survey by a group of scholars from the World Bank demonstrates that parent SOEs control the boards of listed SOEs.⁴¹ At the end of 2001, government agencies and state-owned enterprises, who owned 68% of the shares, occupied 69% of the board seats. On the other hand, tradable A-share holders, having ownership of 30%, appointed only 4% of the board seats.⁴² At the end of 2005, among the country's 1,400-plus listed companies, the number controlled or held by the state was near 900, accounting for 65% of the total. The State shares and Legal Person shares in these companies total more than 340 billion, accounting for 74% of the total non-tradable shares and making up 64% of the total share capital of

⁴⁰ Shanghai Stock Exchange, China Corporate Governance Report 2003 – Executive Summary, at 8, available at <http://72.14.203.104/search?q=cache:ZzgLI8V1vOJ:rru.worldbank.org/Discussions/O>.

⁴¹ Tenev, S., and Zhang, C. L. (with Brefour, L.) (2002). Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets, Washington DC: World Bank and the International Finance Corporation. 83–86.

⁴² Ibid at 83-84

companies listed on the Shanghai and Shenzhen Stock exchanges.⁴³

Despite the process of corporatisation, the state still holds the majority of shares across the 1,600 companies currently listed on the Chinese stock exchanges.

I. The problems of this ownership structure

The large proportion of non-traded state and legal-person shares has created a number of problems. The ownership structure makes it very difficult to establish an efficient takeover market and a primary stock market.

First, in the main movements in share price are caused by trading among individual shareholders, which is often conducted on a speculative and random basis. Much blame has been placed on the non-tradability of state shares.⁴⁴ Because state shares are not tradable, their prices remain constant and do not react to fluctuations in the market.⁴⁵

Secondly, the non-tradability of large blocks of shares means that

⁴³ "China's Transfer of State Shares to SSF Under Way", SinoCast China Business Daily News, 13 March 2006.

⁴⁴ See Qiu, X. (2004), "Eight Dangers in the Split between Tradable and Non-tradable Shares", China Securities, 12 January, available at <http://www.cs.com.cn/csnews/20040112/457126.asp> (in Chinese). See also article 1(2), Guiding Opinions Concerning the Reform of Non-Tradable Shares in Listed Companies (adopted by the CSRC, State-Owned Assets Supervision and Administration Commission, Fiscal Ministry, Central People's Bank and Ministry of Commerce on 23 August 2005).

⁴⁵ Tam, O. K. (2002). "Ethical issues in the evolution of corporate governance in China." *Journal of Business Ethics* 37(3): 305.

directors are insulated from market discipline. Controlling shareholders have monopolist position and influence so they can easily control or dominate the nomination and appointment of directors and senior management officers and virtually preclude other shareholders from participation in making operating decisions. Thus, directors have little need to account for their decisions or behave responsibly.⁴⁶ Why worry if there is no threat to their jobs? When State shares are non-transferable, management expects to be always in control and they see the making of good relations with government officers as being of first importance.

Third, as La Porta concludes, "... the central agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by controlling shareholders..."⁴⁷ The controlling large shareholders have frequently intervened in the operations of the listed firms to benefit their parent companies, using the listed firms to guarantee loans for related entities and exposing the listed firms to unnecessary financial and operating risks. They are frequently engaging in benefit transfer through misappropriation of funds or related-party transactions to expropriate listed companies and infringe upon the

⁴⁶ Miles, L. and Z. Zhong (2006). "Improving corporate governance in state-owned corporations in China which way forward." *Journal of corporate law studies*: 229.

⁴⁷ La Porta, R., F. Lopez-de-Silanes, et al. (1999). "Corporate ownership around the world." *Journal of Finance* 54(2): 471-517.

interests of other shareholders, the public investors in particular.⁴⁸ For example, in 2001, the largest shareholder of Meierya — a then profitable company — colluded with other insiders to embezzle US\$44.6 million, 41% of the company's total equity. In the same year, the largest shareholder of Sanjiu Pharma, a one-time blue chip in China, extracted US\$309.1 million, 96% of the listed company's total equity. In addition, in a 2003 report on China's corporate governance problems, the Shanghai Stock Exchange concluded that:

“[The]..shareholding structure of Chinese companies is problematic. First, the institution for implementing state shareholder's rights is unsatisfactory. Either the government exerts too much influence on listed companies and the company's objective is affected by political considerations, or there is a lack of monitoring on the shareholders, resulting in insider control in the form of misuse of company assets and [pursuit] of private objectives.”⁴⁹

Russell also reports that in early 2004 nearly two-thirds of companies'

⁴⁸ In addition, controlling large shareholders or parent companies have often manipulated the profits of the listed firms or transferred huge amounts of expenses or losses to the listed firms through relate-party transactions and arbitrary transfer pricing. As a result, quite a number of Chinese listed companies turned into operating losses shortly after their listing in the stock market and brought about significant losses to public investors. See, e.g. Zu, J. L., I. M. Liu, et al. (2007). "The development of corporate governance in China." *The Company Lawyer* 28(7): 200.

⁴⁹ Shanghai Stock Exchange, China Corporate Governance Report 2003 – Executive Summary, supra note 40.

issued shares were held by controlling shareholders in the form of state bodies and other legal persons in China, and this has had the effect of distorting share prices and creating a conflict of interest between the large and small shareholders.⁵⁰

II Reforming the split share structure

For the past several years, the government has made attempts to reform the split structure of the stock market. The latest reform was initiated in 2005. The move in reforming the split share structure was a pilot ‘full flotation’ scheme that is to be adopted with a limited number of listed companies which have a smaller size of state shareholding. It is stated in Article 3 of Measures for Administration of Split Share Structure Reform of Listed Companies that:

“split share structure reform of listed companies shall be subject to the principles of openness, equality and fairness, and conducted by the relevant shareholders of the A share market on the basis of equal consultation, good faith and mutual understanding and independent decision-making.”⁵¹

The first four companies selected to carry out the pilot program were

⁵⁰ Russell, M.E. (February 2004), "The People's Republic of China--Visit Report: Banking on Reform", available at www.citlon.co.uk/pdf/features/China_Report2.04.pdf.

⁵¹ 2005 Administrative Measures on the Split Share Structure Reform of Listed Companies, Chapter I, Article 3, CSRC, available at <http://www.csrc.gov.cn/n575458/n4001948/n4002120/4069846.html>

announced on May 9, 2005.⁵² The program rapidly expanded, and by early 2006 shareholders had approved the reform proposals of nearly a quarter of China's listed companies.⁵³

The split share structure reform was prompted by economic considerations.⁵⁴ An economic scholar who was head of the Chinese securities law amendment drafting team even went so far as to state that the "the split share structure is a problem of the legacy of Chinese policy and not a legal problem".⁵⁵

The program has three main features, first it attempts to be flexible rather than impose a one-size-fits-all solution; secondly it leaves the final decision to shareholders (especially the owners of tradable shares); and thirdly, it tries to deal with short-term market volatility.⁵⁶

However, China's stock exchanges were not established to promote privatization of the state-controlled economy, but were conversely designed to strengthen the state's ability to allocate capital. For example

⁵² Three of these four companies (Hebei Jinniu Energy Resources, Sany Heavy Industry, and Shanghai Zi Jiang) received approval from shareholders for their reform proposals, but one company (Tsinghua Tongfang)'s initial proposal was rejected. See Cooper, M. C. (2007). "New Thinking in Financial Market Regulation: Dismantling the "Split Share Structure" of Chinese Listed Companies." *Journal of Chinese Political Science* 13(1): 60.

⁵³ Cooper, M.C.(April 2008), Ibid.

⁵⁴ Lee, S. L. (2008). "From Non-Tradable to Tradable Shares: Split Share Structure Reform of China's Listed Companies." *Journal of Corporate Law Studies* 8(1).

⁵⁵ Tan Xiao, Gu quan fen zhi gai ge fa lu san lun (Legal Discussion of Split Share Structure Reform) (Chinalawinfo, 2005).

⁵⁶ Takeshi, I. (2005). "Reform of China's Split Share Structure Takes Shape." *Nomura Capital Market Review* 8(3).

Liuhongru, Vice Minister of State, Commission for Restructuring the Economic System, explained that “[w]hat we resolutely oppose is privatization. But we do not because of that oppose a stock-holding system”.⁵⁷

Thus, the key obstacle to implementing a ‘full flotation’ scheme is the controversy over pricing-while the Government wants to sell these shares at the market value at which the tradable shares now trade, the investors, concerned about the prospect that their current holdings will be diluted when flows of state shares pour into the market, expect huge discounts. These understandably, entail some difficult tasks in the short run.⁵⁸

5.2.3 The role of the state

The state has incentive to keep enough equity interest so it can achieve its policy goals easily through the listed firm vehicle. First, the role of raising equity capital for SOEs following conversion to the corporate form was important. The state does not only want the enterprises it owns

⁵⁷ Cao, L. (1995). "The Cat that Catches Mice:China's Challenge to the Dominant Privatization Model " Brooklyn Journal of International Law 21(97).

⁵⁸ Leng, J. (2006), The interaction between domestic and overseas capital markets and corporate governance of Chinese listed companies in Norton, J. J., J. Rickord, et al., Eds. (2006). Corporate governance Post-Enron: Comparative and international Perspectives, British Institute of International and comparative law, at 451.

to be run efficiently, but also serves role includes such as the maintenance of urban employment levels, direct control over sensitive industries, or politically motivated job placement.⁵⁹ The dominance of the Chinese Communist Party: The Central Committee of the Communist Party has declared that “[t]o meet the needs of a modern enterprise system and to survive and grow amidst fierce competition, SOEs must build a contingent of highly qualified managers and nurture a large number of skilled entrepreneurs. The Party must manage and supervise its SOE cadres.”⁶⁰ The Central Committee also highlighted the central role of the party in China’s socialist market economy by describing it as follows:

“Strengthening and improving the Party leadership is the fundamental guarantee for speeding up the reform and development of SOEs. To manage well SOEs in general, efforts must be made to establish a leadership system and organisational and managerial system in them that conforms to the law of the market economy and China’s actual situation, to strengthen the

⁵⁹ Thus, we should understand as internally contradictory various proposals for the state to retain ownership of certain enterprises but to run them entirely on profit-oriented lines. Tenev and Zhang (2002) *supra* note 40, go even further by suggesting that the state’s current equity stake be replaced by an interest akin to nonvoting preferred stock. The problem of continuing state ownership of enterprises cannot be finessed so easily. Nonvoting preferred stock might be a good investment in the right circumstances, but it is hard to see why a policy maker who believes that state ownership ought to mean something would be satisfied with it or why the state should commit itself never to sell it. Indeed, in replacing its equity stake with nonvoting preferred stock, the state would be giving up its ability to use control not just to pursue noneconomic goals, but also to defend itself from exploitation by management or controlling shareholders or even to exploit other shareholders for its own economic benefit.

⁶⁰ The Communist Party’s concern with increasing the quality of management personnel in state owned enterprises is well known and this concern clearly extends to majority state owned listed companies; see further, “The Decision of the Central Committee of the Communist Party of China on Major Issues Concerning the Reform and Development of State-Owned Enterprises”, Adopted at the Fourth Plenum of the 15th CPC Central Committee on September 22, 1999, at 9.

building of their leadership, and to adhere to the principle of relying on the working class wholeheartedly.”⁶¹

The central role of the Party in Chinese listed companies has recently been strengthened in the 2005 amendments to the PRC Company Law.⁶²

The emphasis on the import role of the Chinese Communist Party was stressed in answers to other questions. The Party’s role is central within most listed Chinese companies and Art 19 of the Company Law (as amended in 2005) provides that:

“In accordance with the Constitution of the Communist Party of China, the organization of the Communist Party of China shall be established in a company so as to carry out the activities of the Communist Party. The company shall provide its communist organization with conditions necessary for carrying out its activities.”

It is often the case that the Chairman of the company is also the Party Secretary of the local Communist Party branch within the company, effectively fusing managerial and political control in one office. Often the

⁶¹ Ibid. at p10. However, it has been said that the Party has long had difficulties in dealing with corrupt practices involving its members: see further, Lu, X. (2000). Cadres and corruption : the organizational involution of the Chinese Communist Party. Stanford, Calif. : [Great Britain], Stanford University Press. See also, Dickson, B. J. (2003). Red capitalists in China : the party, private entrepreneurs, and prospects for political change. Cambridge : New York, Cambridge University Press.

⁶² Art 19 of the 2005 version of the Company Law (amended in October 2005) is much stronger than the equivalent provision (Art 17) of the 1994 version

manager is also the trade union official.

Lack of capital is another biggest risk facing many China's state-owned enterprises (SOEs). Thus, the stock market in China was organized by the government as a vehicle for its SOEs to raise capital and improve operating performance.⁶³ As Wu, an eminent economist with the State Council put it: "In the eyes of some government officials and SOE leaders, the function of the stock market is to help enterprises raise cash and bail them out." ⁶⁴

In 1990 and 1991, China's two stock exchanges — the Shanghai and Shenzhen Stock Exchanges were opened with great fanfare. In slightly over seventeen years, China's stock market has grown to become one of the largest in Asia (second only to the Japanese market) with market capitalization of close to US\$500 billion. About 1,400 firms have gone IPO and raised close to 800 billion RMB (around US\$100 billion). Corporate China, especially the SOEs has benefited greatly from rapid equity issuance growth and public enthusiasm for the equity market due to a lack of other attractive investment vehicles. China now boasts 1,600 listed companies, more than 130 securities firms, over 100,000

⁶³ Su, D. (2004). "Leverage, insider ownership, and the underpricing of IPOs in China." *Journal of International Financial Markets, Institutions and Money* **14**(1).

⁶⁴ WU, J. L. (1994). *Xiandai Gongsi Yu Qiye Gaige* (Modern Companies and Enterprise Reform). Tianjin, Tianjin Renmin Chubanshe, at 185.

practitioners, and over 70 million investor accounts. The state therefore wants to continue to be involved in the build up of the Chinese stock market. However, such state involvement creates a conflict of interest between the state as controlling shareholders and minority shareholders. Even worse, the state is playing two roles at the same time — controlling shareholders and regulators.

Secondly, one other important use of the market has been to raise revenues for the government budget. China imposed a six rmb per thousand rmb stamp tax on stock transactions when its stock markets were created since 1990. Driven by the huge transaction volume, China's securities stamp tax revenue more than doubled in 2006 to 17.95 billion yuan (2.24 billion U.S. dollars) and skyrocketed 516 percent to 12.1 billion yuan in the first quarter of 2007.⁶⁵ The tax rate was later readjusted a couple of times. China has collected more than 100 billion yuan (some 12 billion US dollars) in stamp tax on stock transactions since then.⁶⁶ The then Primeminister Zhu had plans to offload more than 1 trillion yuan of state-held shares in listed SOEs in 2001 -- and much of the funds were to be used to finance an ambitious unemployment, medical and old-age insurance program. However, since June 2001, the

⁶⁵ See "China raises stamp tax on securities to cool stock market" available at http://English.peopledaily.com.cn/200705/30/eng20070530_379116.html.

⁶⁶ See "China lowers stamp tax imposed on securities transaction", available at http://English.peopledaily.com.cn/200501/24/eng20050124_171696.html.

share prices of China's stock market have been moving in the opposite direction to the strong growth trend of the country's economy. The Shanghai Composite Index, which covers yuan-denominated A-shares⁶⁷ and hard currency denominated B-shares,⁶⁸ fell 14 per cent in 2004 and experienced a free-fall to a six-year low on 1 February 2005. Meanwhile, the Shenzhen Composite Index has been at its lowest level since 1997.⁶⁹ Then, the government halved the tax rate from 0.2 percent to 0.1 percent in a bid to boost the depressed equity market in 2005.

Third, it is also important not to assume that the stockmarket has become the dominant source of funding for industry. Chinese listed companies prefer equity financing over debt financing. Issuing shares to raise capital has been an enduring favourable option for these firms, as compared to bank loans and corporate bonds. Many listed companies have regarded the stock exchanges as places for a 'money grab' ('QuanQian') and do not care about investor rights. Instead, they rarely pay dividends and often provide false information. The market remains dysfunctional as the mechanism for protecting investors' rights has yet to be fully established and enforced.⁷⁰

⁶⁷ Domestically listed shares, denominated in Renminbi, originally could only be owned by Chinese citizens. With the introduction of the QFII scheme in 2002 they can now be owned by approved foreign institutional investors.

⁶⁸ Domestically listed shares of China-incorporated companies, denominated in US\$ in Shanghai and HK\$ in Shenzhen. Initially reserved for foreign investors, starting from March 2001, mainlanders can trade B shares as well. However, they must trade with legal foreign currency accounts.

⁶⁹ Asia Pulse/XIC 'Shanghai Stock Market Hits Six-year Low' Asia Times Online (2 Feb 2005), available at Asia Times Online <http://www.atimes.com/atimes/China/GB02Ad08.html>.

⁷⁰ Asia Pulse/XIC 'China Moves to Cage its Rampaging Bears' Asia Times Online (20 Jan 2005), available at Asia

5.2.4 The role of the Securities Regulatory Commission

I The listing system and regulatory corruption

In October 1992 the State Council formed the Securities Committee and its executive arm, the China Securities Regulatory Commission (CSRC), to take charge of overall supervision and regulation of the securities market in China. In April of 1998, and as part of the State Council structural adjustment, the SCSC and CSRC were merged into one single authority - the China Securities Regulatory Commission - as the sole State Council securities regulatory authority responsible for the uniform administration and supervision of securities and futures markets throughout the country.

In theory, the securities market principal watchdog - China Securities Regulatory Commission (CSRC), should assume the primary responsibility of supervising and monitoring the stock market by promoting good behaviour and truthful disclosure and by punishing wrongdoers. The main duties, powers and functions of the CSRC are defined by the Securities Law,⁷¹ and include rule-making, regulations, supervision and administration, and investigation and imposition of

Times Online <http://atimes01.atimes.com/atimes/China/GA20Ad02.html>

⁷¹ See Article 179 of the Securities Law 2005.

penalties.

Initially, when performing the above duties, the CSRC had the power to investigate and to gather evidence; to question the parties to any case or other related units or individuals; to inspect and make copies of securities documents or seal them up for safekeeping; to investigate fund accounts and securities accounts of the parties to a case or other related units or individuals, and, where necessary, to apply to a court to have funds and securities frozen. These power are now expanded by the revised Securities Law to include the power to conduct on-site inspection of issuers, listed companies, securities companies, securities investment fund management companies, securities services organisations, stock exchanges and securities registration and settlement organisations, the power to freeze or seize corporate or individual capital, stocks, bank accounts any other property or evidential materials in cases of suspected illegal activity (without the need to go through a court, but in accordance with its own Implementation Measures on the Power to Freeze and Seize [Assets], issued by CSRC on 30 December 2005), and the power to suspend for 15 days the trading activity of persons suspected of stock manipulation or insider trading, with a permissible 15 day extension for complicated cases.⁷² No unit or individual under examination or

⁷² Ibid.

investigation may refuse to co-operated with the authority or obstruct the investigation or conceal information.⁷³ Further, the CSRC is authorised to share information with other financial supervision and administration authorities of the State Council, and all relevant state authorities are required to cooperate with the CSRC in its performance of its supervision, inspection and investigation functions.⁷⁴

In order to monitor compliance by listed companies with its Regulations, the CSRC introduced a “checkpoint system” in 2001. The “Rules on The Examination of Listed Companies 2001” provide that these checkpoints include an examination of the governance structure, the financial affairs, use of company funds and the disclosure of information by the company. The CSRC may also carry out special investigations on major issues highlighted by investors or exposed by the media.⁷⁵ It may impose sanctions against the company for non-compliance with its regulations. Lastly, it can, by virtue of a “quick response to information” system, review any information submitted by the media or other organisations about a company to verify its truth and tackle potential problems before

⁷³ See Articles 180& 183 of the Securities Law 2005.

⁷⁴ See Article 185 of the Securities Law 2005.

⁷⁵ Lu, T. (2003), Corporate Governance in China, Working paper, Chinese Academy of Social Sciences, available at <http://old.iwep.org.cn/cccg/pdf/Corporate%20Governance%20in%20China%20%20Prof.pdf>; In July 2001, for example, the Journal of Caijing disclosed the accounting fraud of Yinguangxia. The CSRC launched an immediate investigation. On September 6, it reported the results of the investigation to the public and the responsible directors were sued. The responsible accounting firm and its staff were also penalised and had their authorisation to conduct a business withdrawn.

they materialise.⁷⁶ However, in practice they have to face conflicting situations. On the one hand, the controlling shareholders of most listed companies are usually local governments or entities controlled by them. On the other hand, as a quasi-governmental agency, the CSRC lacks independence and is ultimately subject to government will.

Listing quota is one of the important characteristic of China's listed companies. Under the quota system, the CSRC assigns the listing quota to the planning commissions of various provinces, then to IPO candidates.⁷⁷

Pistor and Xu argue that the quota system served two important functions with respect to development of the Chinese stock market. It helps to mitigate the asymmetric information problems investors and regulators face. It also provides the local bureaucrats an incentive to choose viable companies to go IPO. Partly due to the quota system, China has achieved partial success in its stock market development.⁷⁸

However, the quota system has inherent weakness. The listing of a company is usually decided not on commercial merits but on political and sectional considerations. Clearly this aspect alone has created fertile

⁷⁶ Ibid.

⁷⁷ In most cases, the corporatization (or corporate restructuring) is organized based on the actual quota an IPO obtains. The local government, in order to boost the post-IPO performance of the listed firms, has incentive to inject quality assets into the listed companies, and divest low quality assets or debt.

⁷⁸ Pistor, K. and C. Xu (2005), "Governing Stock Markets in Transition Economies: Lessons from China." *American Law and Economics Review* 7(1): 184-210.

grounds for many forms of rent-seeking activities that could give rise to significant ethical issues. The local bureaucrats thus have incentives to select the firms (IPO candidates), through whom they can grab the largest rents. Similarly, they also choose the ownership structure by which their benefits can be maximized. The utility function of the local bureaucrats is definitely different from that of the minority shareholders.

The China Securities Regulatory Commission (CSRC) proclaimed early in 2001 that the year would be the “year of supervision.”⁷⁹ A wide-ranging effort has been made to follow through on the agenda of the year of supervision, and important progress has been made. The cancellation of the listing quota, the introduction of the sponsor and initial public offering pricing systems was one of the most important initiatives.⁸⁰

Under this system, the government has given up its power to control the number of share issuers. Enterprises intending to issue shares need to find a securities company to act as their sponsor (*baojian ren*) in applying for share issuance, and the sponsors become responsible for review of the issuer’s application documents an information disclosure, and for

⁷⁹ “Year of Supervision’ for China’s Stock Market: Roundup,” People’s Daily, December 30, 2001, available at http://english.peopledaily.com.cn/200112/30/eng20011230_87763.shtml.

⁸⁰ It was expected that companies launching IPOs would have to make inquiries about share prices among institutional investors, which would make prices more reasonable and let second market investors have more say in the price formation process. As the sponsors and the listing applicants were to take more liability for the correctness of financial figures and listing qualifications, it may help block bad and disqualified ones from the beginning. See ‘Sustainable growth needed for China’s stock market’ 07 October, 2004, available at http://english.peopledaily.com.cn/200410/07/eng20041007_159212.html

supervising the conduct of the issuer during the course of share issuance. The sponsor will bear joint liability for any wrongs on the part of the issuers that occur during the share issuance process. The sponsorship system is designed to assign a first gate-keeper to be in control of the quality of listed companies.⁸¹ This system is further formalised in the newly revised Securities Law.⁸² The CSRC hoped this move would provide the listing procedures to be administered by the stock exchanges were transparent and independent,⁸³ and remove much of the grounds for non-productive rent seeking activities and would have a positive effect on the quality of companies that would go public.

However, campaign-style supervision and control is not feasible. Despite the CSRC's efforts to promote regulatory transparency and accountability, there remain problems with the approval procedures for public offerings and new shares issues. Many financial analysts still believed that it was still an open secret that listing candidates and investment banks gave massive payments to public relations firms to lobby the Public Offering Review Committee members.⁸⁴

In fact, at times the CSRC even gets blamed for being unable to control

⁸¹ For more detailed examination of the sponsorship system, see Mao, B. and R. Sun (April 2004). "Upgrading the Sponsorship system: The CSRC Makes Moves to Enhance Market Quality." *China Law & Practice* **85**.

⁸² See Article 11 of the Securities Law 2005.

⁸³ China's two stock exchanges are supervised by and administratively accountable to the CSRC.

⁸⁴ 'Securities Official Held for Allegedly Taking Bribes' South China Morning Post, 17, Nov 2004, 6.

the corruption cases that its own investigative efforts are increasingly bringing to light. Although the corrupt practices predate the present CSRC administration, the public sees more cases of corruption and may blame the CSRC for not doing more.

The recent “Wang xiaoshi case’ and ‘Wang yi case’ are one of the latest manifestation of regulatory corruption at the CSRC. Wang xiaoshi, a deputy division director in the CSRC’s Department of Public Offering, has been arrested on corruption charges, including taking bribes from a businessman to facilitate the IPO application review of a favoured company. This case could lead to a more comprehensive probe into stock market listing approvals.⁸⁵

The other scandals at listed firms have put many high-ranking officials in an uncomfortable spotlight. Wang Yi, the former vice chairman of the CSRC and the vice president of the China Development Bank, who built up an extensive and strong network within the securities markets during his seven-year career with the stock markets watchdog agency, has been detained for alleged corruption, which facilitated the illegal listing of Pacific Securities.⁸⁶

⁸⁵ Ibid.

⁸⁶ “Missing Funds Spark Probe of Bank Vice President”, The economic observer online, 06 Jun 2008
<http://www.ceo.com.cn/ens/Politics/2008/06/26/104454.html>

II ST, PT Company and delisting system

It is interesting to note that the two stock exchanges in China have created a “ST” (Special Treatment) and later “PT” (Particular Transfer) for listed companies facing various degrees of financial difficulties that would have led to their suspension but were allowed to remain listed under some restrictions labels.

In 1998, China slapped trading curbs on companies with two straight years of losses, setting a 5 per cent daily price limit, up or down, instead of the usual 10 per cent for ordinary shares. The counters were classified as special-treatment shares. A year later, China's regulators put companies with three years of losses under PT status, and saddled them with a 5 per cent daily limit.⁸⁷ Most of the PT companies have little probability of escaping their labelling because of heavy debts and the inferior quality of their assets.

ST and PT firms are given time to restructure. However, because of the entirely rational expectation among investors that these firms are likely to be subject to a local government-led rescue bid, ST/PT firms are often the focus of much speculative trading activity. The share price of a firm will

⁸⁷ PT firms are only traded on Fridays on a separate market from the main board and are also subject to extensive CSRC monitoring.

more often than not rise, rather than fall, when it enters ST.

Thus, the moral hazard problem created by such concessions and special treatment for those poorly performing companies. The public, by and large, have expressly voiced the opinion that continually loss-making companies should be de-listed from the stock market. The former Premier Zhu, when interviewed by domestic and foreign journalists after the closing of the 4th Session of the 9th National People's Congress, pointed out that "clearing up the listing of companies is the key matter so far as strengthening the role of supervision is concerned. The CSRC is now invoking various kinds of measures to reinforce this work. De-listing will be one of them"

On 22 February 2001, the CSRC issued a circular to clarify rules on suspending and terminating the listing status of a loss-making company. Under these rules, a company which has recorded three years of consecutive losses can apply to the stock exchange for a 'grace period' to restructure its business.⁸⁸ Since 2002 the CSRC has moved to gradually eliminate the PT category altogether by introducing an automatic trigger for a de-listing once a company has recorded three years of losses. Following these rules, a Shanghai electronics company, Narcissus

⁸⁸ McGregor, R. (2001) "First Chinese Company to be Delisted Today", Financial Times 11. Apr. 24

Electric Appliances, was delisted on 24 April 2001, in a landmark event for China's stock exchanges, which had never lost an enterprise in their 11-year trading history as of that date.⁸⁹

However, in practice, it is still difficult to delist companies because both local governments and investors are unwilling to see this happen. For local government, delisting a local firm would mean losing a low-cost fund-raising tool; for the investors, exclusion of the company from the market would result in huge losses.⁹⁰ In an attempt to improve such incentives, since 2002 the CSRC has moved to gradually eliminate the PT category altogether by introducing an automatic trigger for a de-listing once a company has recorded three years of losses. But, these companies would then be likely to be prime targets for acquisition by competitors and some might be bought by companies hoping to gain a backdoor listing.

5.2.5 The role of auditors

One of the main objectives of the corporate governance structure is to 'ensure that minority shareholder receive reliable information about the value of firms and that a company's managers and large shareholders do

⁸⁹ Ibid.

⁹⁰ Leng, J. (2006), *supra* note 58, at 321

not cheat them out of the value of their investment...”⁹¹ Transparency in corporate financial statements is essential for public confidence in the capital market. A high level of financial disclosure and transparency will contribute to the establishment of confidence to the security market and direct resources to the entities that produce more wealth. To maintain the confidence of Chinese capital markets, there is a high demand for good corporate governance, and financial disclosure and transparency are essential characteristics of good corporate governance.

The history of accounting in China can be traced back 2000 years, but it was not until the early 1990s that a double-entry bookkeeping system was introduced.⁹² Business firms in China have long been small and dominated by family. In Chinese culture the merchants have been considered inferior to other professions and people of higher ability have not gone into business.⁹³ After 1949, in common with many countries in Central and Eastern Europe, accounting in China came under the Soviet influence. The approach developed by the Soviets emphasised the central plan and the role of the accounting function was to service the information needs of the central planners. Bailey describes the role of accounting in a socialist economy as one where the national economy

⁹¹ Bushman, R. M. and A. J. Smith (2003). "Transparency, Financial Accounting Information, and Corporate Governance." Economic Policy Review-Federal Reserve Bank of New York 9(1).

⁹² Leng, J. (2006), *supra* note 58

⁹³ Nakamura, M. (2008). Changing corporate governance practices in China and Japan : adaptations of Anglo-American practices. Basingstoke, Palgrave Macmillan at 20-23

becomes the accounting entity and the individual enterprise is represented as an accounting sub entity. The implementation of a national chart of account causes the accounting system of all enterprises to be interconnected. Therefore, the accounting in each and every enterprise is converted into an instrument of national economic administration for realisation of control over their activities. The central authorities in a socialist economy use the accounting system as a means for maintaining control over the activities of the state enterprise. Accountants are accordingly required to perform a state control function on behalf of the central authorities.⁹⁴

The Open Door policy of 1978 led to major changes in the economy, which have greatly affected the accounting function. As far back as 1980 it was suggested that it was time for accounting to become part of economic management rather than the traditional Chinese description, a tool of economic management. "The year 1993 may well represent the start of a new era in Chinese accounting history".⁹⁵ The introduction of China's first accounting standard, known as the Accounting Standard for Business Enterprises (Basic Standard), effective from July 1 1993, was the first of a series of steps which transformed Chinese accounting practices.

⁹⁴ Bailey, D. T. (1988). Accounting in Socialist countries. London, Routledge.

⁹⁵ Scapens, R.W. and Hao, Z.P. (1995). "Chinese accounting reform: reasons and effects", in Blake, J, Gao, S. (Eds), Perspectives on Accounting and Finance in China, London and New York. Routledge, at 261.

However, the cultural values of China may indicate that the practice of auditing and behaviour of auditors as practiced and required in Western countries may not be easily transported to PR China. Liu refers to the importance of networks (*guanxi*) in the conduct of business development in China as follows:

“Guanxi and networking are important components of Chinese business behaviour...[M]ost observers of Chinese business behaviour are well aware that the use of *guanxi* in business networking is strategic. It is the use of social relations and networks for business interests. However, it is equally important to note that most studies have also demonstrated the limits of *guanxi* and networking”.⁹⁶

Regarding financial transparency, most listed companies in China are audited by local accounting firms but no reliable information exists to determining which accounting firms are more reputable. The speech by former premier, ZhuRongji, at the 16th World congress of Accountants in November 2002 highlighted the issue of falsified accounts and the need for the highest ethical standards amongst accountants.⁹⁷

⁹⁶ Lui, T.(2001) "A Brief note on Guanxi" in Appelbaum, R. P., W. L. F. Felstiner, et al. (2001). Rules and networks : the legal culture of global business transactions. Oxford, Hart, at 390.

⁹⁷ See “Bu Zhuo jiazhang” (No falsified accounts), People’s Daily, 19 Nov. 2002, A3

5.2.6 The choice for investors

Another problem is that the price-earnings ratio in the primary market is set artificially high. In Western markets, a high price-earnings ratio (P/E) generally indicates that investors are expecting future growth in earnings (but it may also simply indicate low earnings). As a rule, P/Es in Western markets float between 10 and 20.⁹⁸ In market comparison, for much of the 1990s P/Es in Mainland China were above 40 and even by the end of 2002, after a sustained fall in prices, at the Shanghai Stock Exchange (SHGSE) prices averaged 35 times earnings and at the Shenzhen Stock Exchange (SHZSE). This means firms can raise equity capital at a very low cost, and that they provide investors with virtually no meaningful returns on assets. Given the fact most of China's listed companies do not pay dividends at all, the costs of raising equity capital for these companies are even lower than the average level.⁹⁹

But why in the first place would the investors want to buy these shares if returns are so low? Three factors are particularly important in helping to explain the irrational investment pattern: first, investors have very few alternatives for capital investment in China. Because of capital account

⁹⁸ Green, S. (2003). The Economist China's stockmarket : a guide to progress, players and prospects. London, Profile.

⁹⁹ Gu, Weiping (2001) 'Why Do Chinese Listed Companies Prefer Equity Financing to Debt Financing?' Shanghai Gongsi (Listed Companies), Jun, 8.

controls, investors cannot easily remit financial assets out the country to invest in equities overseas. Neither has the corporate bond market been developed much. Bank deposit interest rates are set low. Many small investors cannot afford to invest in real estate in China. Thus, investing in equities is such a popular way to invest in China.

Second, there are so many investors coming into stock market who do not understand the risks. Most of these individual investors are middle-aged individuals or senior citizens, with an average age of 43.01 years.¹⁰⁰ The majority of them (86%) are low- or middle-income, and 55.63% have an annual income below RMB 20,000 (\$2,418).¹⁰¹ In addition, many Chinese individual investors may lack basic financial or investment knowledge, as 43.81% of them have no higher education.¹⁰² Again, the Government has used editorials in the state run newspaper People's Daily to influence the trading of shares in the stock market, such as encouraging investors to trade when the market sentiment was low, and discouraging investors to trade when the market seemed 'excessively speculative.' In addition, some Chinese economists, who were then seen by investors as the government's 'think tanks' or policy advisors, had assured investors that '60-80 times price-earnings are absolutely normal' and 'the

¹⁰⁰ Chen Bing et al. (2002), Zhongguo Gushi Geren Touzizhe Zhuangkuang Diaocha (An Investigative Report on the Situation of Individual Investors in China's Securities Markets) 13 (Shenzhen Zhengquan Jiaoyisuo Zonghui Yanjiusuo (Research Inst. of the Shenzhen Stock Exch.) Paper No. 0055, available at <http://yjwk.cninfo.com.cn/finalpage/2002-05-10/571541.PDF>

¹⁰¹ Ibid. at 16.

¹⁰² Ibid. at 14

government will definitely not allow the market to decline,' which had misled small investors into buying shares at high prices, in the hope of making lucrative returns at a later time.¹⁰³

Third, there is too much speculation in Chinese stockmarket. Only a third of the shares of a typical SOE are tradable in the market. The market is not very liquid in general. Thus, some of investors view stock buying as a speculation tool for gains from short-term share trades in the secondary market rather than a long-term, value-based investment vehicle. They believed that as long as there was a 'fool' willing to buy shares from the previous holders, everybody can make gains in share trades until the last 'fool' is unable to find anyone else to sell the shares to, and bears all losses as the unlucky end chain of the 'fool's game'.¹⁰⁴ Therefore, they buy into these shares regardless of their long-term return prospects.¹⁰⁵

Indeed, some institutions such as banks, state-owned enterprises (SOEs), even the department of the central government breaking the law by using public funds and inside information to speculate in shares.¹⁰⁶ Soft controls over their budgets mean that any profits they make can be skimmed off

¹⁰³ " Forcing China's Stock Market Down to the Bottom: Tails of Robbing Wealth in China's Stock Market", Business Watch 24 (12 Dec 2003).

¹⁰⁴ See, Leng,J.(2006), supra note 58 at 293.

¹⁰⁵ Gu Weiping(2001), Supra note 99.

¹⁰⁶ The General Administration of Sports was reported to have appropriated 131 million yuan (US\$15.8 million) for the 2008 Beijing Olympic organizing committee since 1999. About 109 million yuan (US\$13.2 million) of the money was misused to invest in Chinese stockmarket. See "Auditor: Central government misuses US\$1.1b of funds," available at http://www.chinadaily.com.cn/english/doc/2005-06/29/content_455557.htm

into informal accounts and retained, while losses can be put through their books and replaced by budgetary transfers or loans from the state banks.¹⁰⁷ For example, there is the shocking story reported by the financial journal *Caijing*, in which a well-known broker confessed to having raised 2 billion Yuan from banks and other state units to "stir-fry" the market.¹⁰⁸

It is not surprising therefore that many small investors adopted investment strategies that are widely seen as being essentially short term and speculative in nature. As a result, investing in the stock market has become one of the most risky businesses in China, and there have been reported cases where retail investors, many of them pensioners, committed suicide upon losing all their savings in the stock market.

5.3 Shareholders' protection: law and legal enforcement

In China, the framework of civil liability on securities fraud is set up in the 1994 Company Law of China (as amended in October 2005, came into effect in 2006) and the 1998 Securities Law of China (as also amended in October 2005). In addition, the General Principles of Civil Law provide the bottom line for civil liability issues in general. With

¹⁰⁷ See Green, S. (2003), *supra* note 98.

¹⁰⁸ *Caijing Magazine* 2005, 3, 12 at 19.

these three layers of statutory provisions, the whole statutory framework is still too brief to execute, in strong contrast to that of the administrative and criminal liability.¹⁰⁹

5.3.1 Protection of minority shareholders' rights and interests under the Company Law 1994

Article 111 of the 1994 Company Law entitled a shareholder, in the case of the resolutions of shareholders meeting or the board of directors contravening laws and regulations and prejudicing the interests of shareholders, to apply to the court for an order banning such acts. Its full text reads:

In the event the resolutions of shareholders' meetings or the resolutions of the board of directors are in breach of laws and administrative regulations or infringe on shareholders' legal interests and rights, the shareholders shall have the right to initiate litigation to stop such breach or infringement.

However, this provision fails to specify any necessary substantive and

¹⁰⁹ Miles, L. and Z. Zhong (2006). "Improving corporate governance in state-owned corporations in China which way forward." *Journal of corporate law studies*: 229.

procedural conditions of such an action. First, the provision provides “excessively narrow”¹¹⁰ scope for shareholder actions. Article 111 requires the existence of both a “violation” (of laws or administrative regulations) and an “infringement” (upon shareholder rights) to justify a shareholder action.¹¹¹ By the operation of this provision, if resolutions violate laws or administrative regulations but do not immediately harm shareholder interests, shareholders are not permitted to sue.¹¹²

Secondly, this provision only provides that the shareholders have a right to bring an action to the court for an injunction to stop the illegal acts or infringing acts, but fails to guarantee any equitable remedies for injured shareholders.¹¹³ Therefore, even though shareholder interests are infringed upon by resolutions legally adopted at a shareholders' meeting or by a board of directors, Chinese shareholders may still be unable to apply for injunctions against such resolutions.¹¹⁴

¹¹⁰ Mi Xinli, Paisheng Susong-Xiaogudong Quanyi de Shihou Jiuji [Derivative Lawsuits--Ex Past Remedies of Minority Shareholders], *Fazhi Ribao* (Legal Daily) (P.R.C.), May 16, 2001, at 8.

¹¹¹ See Xianchu Zhang (1998), *Practical Demands to Update the Company Law*, 28 *Hong Kong L.J.* 248, 251, at 252 (suggesting two possible readings of Article 111: “the grammar of Art. 111, separating the two phrases (violation and infringement) by only a comma, makes the confusion even worse because it may suggest two reasonable readings: violation and infringement are two conditions that need to exist at the same time to justify a shareholders' action; or they are two separate conditions and each may independently constitute the ground of the action”).

¹¹² See Gu Gongyun, *Gongsifa Xiuding de Ruogan Jianyi* (Several Suggestions on the Amendment of the Company Law), *Shangshi Gongsi* (Listed Company) Vol. 5, 2000, available at <http://www.people.com.cn/GB/paper87/703/84318.html>; Apparently, Professor Gu's reading of Article 111 is consistent with the first reading suggested by Professor Zhang. See *id.* (claiming that “violation and infringement are two conditions that need to exist at the same time to justify a shareholders' action”).

¹¹³ See Zhang, X. C. (1998), “Practical Demands to Update the Company Law,” *Hong Kong Law Journal* 28: 248.

¹¹⁴ *Ibid.*

Finally, although this provision clearly provides the shareholder with a private right of action, the provision fails to indicate any procedural rule on shareholder litigation. It is far from clear that an action brought by shareholders under Art.111 of the CCL 1994 should be a direct action (personal action) or a derivative action.

5.3.2 Protection of minority shareholders' rights and interests under the Company Law 2005

Nevertheless, the Chinese Company Law 2005 ("the CCL 2005") envisages the foregoing problems. Article 150 of the CCL 2005 states that a director, a supervisor or any senior officer shall be liable for any losses of the company if he/she violates any provisions of laws, or administrative regulations, or the articles of association of the company in performance of his/her official duties.¹¹⁵

In addition, Art.152 of the CCL 2005 provides certain procedural rules, stating that shareholder(s) who have either individually or collectively held more than 1 per cent of the shares of the company for more than 180 consecutive days may petition in writing to the supervisory board to initiate legal proceedings against the wrongdoing director or senior

¹¹⁵ See Art.150 of the CCL 2005

officers in the people's court. If a supervisor commits any of the acts described in Art.150 of the CCL 2005, the aforementioned shareholders may petition in writing to the board of directors to initiate civil proceedings against the supervisor in the people's court.¹¹⁶ If the supervisory board or the board of directors refuses or fails to initiate any legal proceedings upon receipt of the written petition put forward by the shareholders, or fails to initiate any proceedings within 30 days of the receipt of the shareholders' petition, or the situation is so urgent that the company will suffer irreparable losses if legal proceedings are not initiated immediately, the shareholders as prescribed above shall have the right to directly initiate legal actions in the people's court in their own name for the benefits of the company.¹¹⁷ The CCL 2005 also extends the right for shareholders to sue any person who encroaches on the lawful rights and interests of the company, thus causing any loss to the company in accordance with the provisions of Art.152. Inevitably, the CCL 2005 has strengthened the position of both minority shareholders and the supervisory board.

Nevertheless, certain rules governing the derivative action, such as the threshold requirement and the demanding requirement under the CCL

¹¹⁶ CCL 2005, Art. 152.

¹¹⁷ See Art.150 of the CCL 2005.

2005, may still be quite expensive and burdensome, and could unduly deter the bringing of derivative actions by minority shareholders in China.¹¹⁸

5.3.3 Securities law offers another legal channel to protect the substantive rights of shareholders

I Article 42

Article 42 of the Securities Law provides that if a shareholder holding five percent or more of the issued shares of a corporation sells the shares in his possession within six months of purchase, or if he repurchases them within six months after selling them, the profits generated from such sale or repurchase shall be disgorged. Moreover, the corporation's board is responsible for collecting the profit from the shareholder.¹¹⁹ If the board fails to collect, other shareholders may demand that the board do so. If the board does not collect the profit from the shareholder and a loss to the corporation results, the responsible directors shall be held jointly and

¹¹⁸ See Art.150 of the CCL 2005, at 327. In China, on the one hand, 1% of company-issued share capital in most listed companies would mean hundreds of thousands of shares and a collective action by minority shareholders will be always necessary to satisfy the threshold requirement. On the other hand, most companies are controlled by the majority/controlling shareholders who have their representatives seating in the boards. Therefore both demands on shareholders based on a percentage and demands on the board of directors/supervisory board will make it difficult for minority shareholders to initiate a derivative action.

¹¹⁹ Securities Law 1998, Art. 42. This restriction does not apply to securities companies that acquire five percent or more of the shares in the corporation as part of an underwriting arrangement for the securities of the corporation.

severally liable to compensate the corporation for damages.

II Article 63

Article 63 of the Securities Law provides that issuers and underwriters are liable to investors for any financial losses in the course of trading in securities that resulted from any false or misleading statement or material omission in prospectuses, accounting reports, annual and interim reports, and other materials. Furthermore, the responsible directors, supervisors, and managers of the issuers or underwriters are jointly and severally liable for damages to investors. Article 63 is the only provision under the Securities Law that relates to civil remedies for misrepresentation made in securities transactions.¹²⁰

5.4 Legal rules lose their teeth without enforcement

The PRC Company Law goes on to provide various legal remedies that are available to shareholders who may have suffered at the hands of management, for example, Article 1 of the PRC Company Law (as amended in October 2005) provides that this Law was enacted in order to “protect the legitimate rights and interests of companies, shareholders

¹²⁰ Liu, H. (Mar 2003). "Halfway to Effective Shareholder Protection." China L. & Practice

and creditors...” Further, Art 4 of the Company Law provides that the “shareholders of a company shall, according to law, enjoy such rights of owners as benefiting from assets of the company, making major decisions and selecting managerial personnel.” The new Art 153 allows shareholders to bring group actions before the people’s court where damage has been caused “to the interests of any shareholders of the company” by any illegal action by a director or senior officer of the company.¹²¹ This provision follows Art 150, which states: “If the directors, supervisors and senior executives violate the laws, administrative regulations or the articles of association of the company in performance of their functions and thus cause loss to the company, they shall be liable for compensation.”

It should be noted that the 1998 PRC Securities Law was also amended in October 2005. It also contains some very general principles that seek to protect the interests of all investors in listed companies. For example, Art 4 of the Securities Law speaks of the parties involved in the issuing and trading in securities having “equal status” and having to adhere to “the principles of voluntariness, compensation and good faith.” Art 15 also provides that unless otherwise approved by the general meeting of

¹²¹ This has not worked well in the past and we have yet to see if these new provisions are any more effective; See further, PRC Supreme People’s Court, “Some Provisions of Supreme People’s Court on Trying Cases Involving False Statements Related to Securities Market”, (Effective 1 February 2003); B Hu, “On Civil Compensation in Securities Law Violations – in the perspective of the company law and the securities law”, available at <http://www.cipe.org/printerfriendly/printpage.php>.

shareholders, funds raised by the company through the issue of shares must be used for the purposes set out in the prospectus; this provision responds to a common practice of listed companies raising funds for a particular stated purpose and then using these shareholder funds for quite different purposes.

Art 20 of the Securities Law 2005 requires that any documents prepared for the issue of securities must be “truthful, accurate and complete.” One of the most common problems in the listing of Chinese companies has been the use of inaccurate or fabricated information to support the listing or share issue, such as the use of false company accounts. Public shareholders obviously suffer from practices such as these. The Securities Law also contains a number of provisions (Arts 73-76) regarding insider trading by such persons as directors and senior executives of the company; insider trading is obviously more likely to benefit corporate controllers and insiders and outsiders, such as public shareholders. The Law deals with other securities market offences; these include the manipulation of the securities market (Art 77), and the fabrication or dissemination of false information (Art 78). Securities Law penalties for manipulating the securities market include the disposal of the illegally gained securities and the confiscation of illegal gains as well as the giving of a disciplinary warning to the person directly in charge and the person responsible for

the manipulation (Art 203). No provision is made for the payment of damages to those who have suffered as a result of the securities manipulation (although, as we have seen, the Company Law does contain some compensation related provisions). A number of other provisions of the Securities Law refer to failures by controlling shareholders. (eg Art 71, Art 150(6) and Art 214).

Chapter 1 of the Code of Corporate Governance for Listed Companies in China issued in 2001 by the China Securities Regulatory Commission (CSRC) proclaims the following general principles regarding the protection of minority shareholders in listed companies:

- “1. A listed company shall establish a corporate governance structure sufficient for ensuring the full exercise of shareholders’ rights.
2. The corporate governance structure of a company shall ensure fair treatment toward all shareholders, especially minority shareholders. All shareholders are to enjoy equal rights and to bear the corresponding duties based on the shares they hold.
3. Shareholders shall have the right to know about and the right to participate in major matters of the company set forth in the laws...

4. Shareholders shall have the right to protect their interests and rights through civil litigation or other legal means in accordance with laws and administrative regulations...”

In regard to the dangers of abuse of power by dominant shareholders in China’s listed companies, the CSRC Code goes on to provide that: “The controlling shareholders owe a duty of good faith toward the listed company and other shareholders. The controlling shareholders of a listed company shall strictly comply with laws and regulations while exercising their rights as investors, and shall be prevented from damaging the listed company’s or other shareholders’ legal rights and interests, through means such as assets restructuring, or from taking advantage of their privileged position to gain additional benefit.”

However, the key question of whether the amended rules governing shareholder derivative action have any real “teeth” against the wrongdoing directors in China remains to be seen. Pistor and Xu argue that because the law is incomplete, law enforcement by courts cannot be expected effectively to deter violations.¹²² A leading corporate governance expert in China said that “[a]fter 20 years of exploring gradual reform, Chinese enterprises have come to realize the corporate

¹²² Pistor, K. and C. Xu (April 2003). Deterrence and Regulatory Failure in Emerging Financial Markets: Comparing China and Russia, Working paper available from www.wefia.harvard.edu.

governance is (at) the centre of the enterprises reform in China”. She is of the view that although “ a basic legal framework has been established, there is vast scope for further institution building to improve the corporate governance practice of Chinese enterprises.” She concludes that “[a]t present, China has not established a complete law enforcement system concerning securities markets. This is one of the important causes for the frequent occurrences of insider trading and market manipulation”.¹²³

5.4.1 The role of the judiciary in China

In the UK and US, judges can play an important role in corporate governance, for example by making and clarifying the law governing directors. But this is often a different story in China. As Donald Clarke has noted, “perhaps Chinese courts are not designed to do, and should not do, the things Western courts do.”¹²⁴

The Chinese view their judicial system as merely another bureaucratic body. For example, Courts’ loyalty to the Chinese Communist Party was re-emphasized in 2006 with the launching of a new campaign on “socialist

¹²³ See Lu T. (2004), "Corporate Governance in China", in Kala Anandarajah (Ed), Corporate Governance Compliance, Singapore, LexisNexis.

¹²⁴ Clarke, D.C. (2003), "Empirical research into the Chinese judicial system", in Jensen, E. G. and T. C. Heller (2003). Beyond common knowledge : empirical approaches to the rule of law. Stanford ; [Great Britain], Stanford Law and Politics, at 164-192.

rule of law theory”. In the speech Luo, head of the Party’s Central Political-Legal Committee, appeared to be drawing a distinction between “rule of law” and “socialist rule of law,” with the latter emphasizing the legal system’s obligation to follow Party leadership, and in particular Hu Jintao’s theory of a “harmonious society.”¹²⁵ In a follow-up speech, Cao Jianming, vice-president of the Supreme People’s Court, linked the campaign to the need to avoid the “negative influence of Western rule of law theory”¹²⁶-an apparent reference to those within and outside China advocating Western-style judicial independence for China.

Indeed, the Chinese courts are widely perceived to lack independence or experience in dealing with corporate and securities disputes. The judiciary in China has not played a dynamic role in developing a body of law to protect the interests of minority shareholders. It is not unusual for courts to decide not to deal with a particular matter, regarding it as

¹²⁵ “Luo Gan zai shehui zhuyi fazhi linian yantaoban shang qiangdiao: shenru kanzhan shehui zhuyi fazhi linian jiaoyu, qieshe jiaqiang zhengfa duiwu sixiang zhengzhi jianshe” (“Luogan emphasizes in a symposium on socialist rule of law theory; deepen education on socialist rule of law theory, enhance the ideological and political construction among workers in the political-legal system”), *Zhongguo fayuan wang* (China Court Web), 14 April 2006, available from <http://www.chinacourt.org/public/detail.php?id=201753>. In a speech in November 2006, Luogan again called for strengthening Party oversight of legal institutions. He also added a more direct critique of those advocating judicial independence and Western-style legal reforms. Luo warned against underestimating the influence of such arguments, in particular arguments that deny the Party’s leadership of legal and political institutions, on those working in the political-legal system. He also stated that “hostile forces” were trying to use legal institutions as an entry-point for Westernizing and splitting China. Luogan, “Zhangfa jiguan zai guojian hexie shehui zhong danfu zhongda lishi shiming he zhengzhi zeren” (“Political and legal institutions should an important historical mission and political responsibility in the construction of a harmonious society”), *Qiushi* (Seeking Truth), No.3 (2007), available at <http://www.qsjournal.com.cn/qs/20070201/GB/qs%5e448%5e0%5e1.htm>.

¹²⁶ “Cao Jianming zai shehui zhuyi fazhi linian yantaoban shang qiangdiao: renming fayuan yao laogu shuli shenhui zhuyi fazhi linian” (“Caojianming emphasizes in the symposium on socialist rule of law theory: the People’s courts must steadily establish socialist rule of law theory”), *Zhongguo fayuan wang*, 14 April 2006, available from <http://www.chinacourt.org/public/detail.php?id=201755>. Cao also spoke of the need to avoid “extreme ‘left’ thoughts” and the “remnants of feudalism.” His speech appeared primarily aimed at placing the courts in line with current Party ideology, and thus perhaps designed to insulate them from criticism for excessive reliance on Western models. But such comments also reflect the SPC’s move away from aggressively promoting court reform.

beyond their competence, and instead referring it to another branch of government.¹²⁷ Courts are also reluctant to implement or enforce their judgements (especially those involving coercive measures) against state-owned enterprises if they were responsible for the same locality, or if their judgments led to the closure of the enterprise and unemployment of workers.¹²⁸

To make things worse, the Supreme People's Court of China even banned temporarily lower courts hearing cases against corporate fraud in the middle of 2001. In September 2001, the Supreme Court of China issued a Circular to lower courts, directing them to stop temporarily accepting cases concerning three kinds of securities fraud: corporate misstatement, inside trading, and market manipulation.

The reason for the suspension was given one month later by an official in the Research Office of the Supreme Court in a China Central TV station interview.¹²⁹ The official claimed that both the Company Law and the Securities Law were very rough and hardly provided any guidance to judges. He also admitted the lack of competent judges familiar with securities market rules and the inability of procedural rules dealing with

¹²⁷ Tomasic, R. and A. Neil (2007). "Minority shareholder protection in China's top 100 listed companies." *Australian journal of Asian law* 9(1).

¹²⁸ Ibid.

¹²⁹ The content of the interview was summarized in 'Zhengquan Minshi peichang Zan BU shuoli' ('Sue for Damage in Securities Market is Temporarily Banned') *Caijing Zazhi* (Finance Magazine) (20 Oct 2001).

such novel matters as massive numbers of plaintiffs in one action. At the end, the Supreme Court official asked for the patience of the public in giving courts time to prepare for the securities fraud case.¹³⁰

This situation began to change after the Supreme People's Court (SPC) issued its first judicial interpretation in this regard to assert court jurisdiction over cases involving false disclosure on 15 January 2002.¹³¹ One year later, the SPC again released its second interpretation on private securities litigation, detailing the rules on damage calculation and the scope of compensation, which was an improvement on the first interpretation.

5.4.2 The difficulties of bringing a minority shareholder action

I Civil Procedure Law

Lee argues that the lack of express remedies for the aggrieved shareholders in the Securities Law creates unnecessary ambiguity and confusion which is wholly inconsistent with other statutory remedies in Chinese law.¹³² Hu argues that owing to the insufficient legal

¹³⁰ Ibid

¹³¹ McGregor, R.(2002) "China to Allow Investors to Sue Listed Companies" Financial Times 15 Jan , at 9

¹³² See Lee, S. M. (2001). "The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law." New York International Law Review 14(1).

infrastructure in China, it will be difficult to hold violators of the laws accountable for their wrongdoings¹³³

The Civil Procedure Law¹³⁴ provides that in order to institute a lawsuit, a plaintiff must have a “direct interest” (*zhijie lihai guanxi*) in the case.¹³⁵

In contrast, a derivative lawsuit initiated by a shareholder is usually for the benefit of a corporation. Therefore, in practice, the immediate impression of most courts when a shareholder files a derivative lawsuit is to assume “the shareholder is not qualified to be the plaintiff” and “the case should not be accepted.”¹³⁶

II The Supreme People's Court Guidelines 2003

In 2003, the Supreme People's Court introduced guidelines entitled “Several rules on adjudicating civil lawsuits against listed companies on the ground of false statements”¹³⁷ to allow local courts to hear actions

¹³³ Hu, R. (November 2002), “The Recent Development of Corporate Governance in Great China Area, Shareholder Rights and the Equitable Treatment of Shareholders”, Fourth Asian Roundtable on Corporate Governance.,

¹³⁴ Zhonghua Renmin Gongheguo Minshi Susong Fa (Civil Procedure Law of the P.R.C.) J, Apr. 9, 1991, available at <http://law.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=5110>

¹³⁵ Ibid, art. 108(1).

¹³⁶ See Sun, Y. (2000), Lun Gudong Daibiao Susong Zhidu (A Discussion of the Shareholder Derivative Lawsuit System), 5 Shandong Daxue Xuebao (Zhaxue Shehui Kexue Ban) [Journal of Shandong U. (Phil. & Soc. Sci. Version)] 99.

¹³⁷ This was to replace an earlier set of regulations “Notice regarding civil lawsuits against listed companies on the grounds of false statements 2002” which were practically unenforceable due to a lack of clarity as to when investors were entitled to compensation, how compensation was to be calculated, the difficulty in establishing a causal link between shareholder loss and the false statements and the reluctance of the court to hear class actions brought by shareholders. See Li, N. (2004), “Civil litigation against China's listed firms: Much ado about nothing?” Asia Programme Working Paper, No 13, February 1, at 1-5. This can be viewed at www.riia.org/pdf/research/asia/WPFeb04.pdf.

brought by individual shareholders for false statements issued by directors about the company, but the civil case shall not be accepted by the court, unless the cause of action is based on the conclusion reached by the CSRC or other state organs such as the Ministry of Finance.¹³⁸

First, requiring an enforceable administrative decision as the precondition for civil action stirred up big controversy. Investigation of securities fraud is often labour-intensive, time-consuming, expensive, and burdensome. The CSRC has long been criticized for its failure to react to and probe into the various blunt market abuses punctually, due to its lack of competent staff or some political concern. This requirement prevents shareholders from asserting their right to bring an action to protect their investment as soon as possible.

Second, the Rules provide that issuing false statements means falsely recording major events, making misleading statements, omitting to disclose certain information, or disclosing information in an inappropriate manner.¹³⁹ However, they only protect certain types of losses suffered by minority shareholders. According to the Rules, losses will not be recovered if investors sold their shares before the discovery of the false

¹³⁸ The Supreme People's Court guidelines 2003, Art 6

¹³⁹ The Supreme People's Court guidelines 2003, Art.17

statements. Article 18 provides:

“the court should presume a link between loss and the false statement if the following situations exist: (1) there is a direct relationship between these shares and the false statement; (2) the investor holds the shares between the date the false statement is issued and the date it is discovered, or buys them before the false statement is discovered; (3) the investor loses his investment because he sells these shares or holds on to them after the false statement is discovered.”

The Rules also provide for the joint and several liability of persons responsible for issuing the false statement. Articles 26-28 provide that persons other than the company who contributed to the making of the false statements, or who were aware of the false statements but had done nothing, would be jointly and severally liable to compensate shareholders. This increases the likelihood of compensation for minority shareholders who otherwise might lose out because the “proper” defendant had become bankrupt.

In fact, there are certain cases that have recently been initiated by injured

shareholders in China in which there appears to be reluctance on the part of the courts to hear a case through a derivative action because of a lack of detailed procedures applicable to derivative actions. Consequently, although many company directors have been punished by either administrative sanction or criminal prosecution as a result of making false disclosures, frauds and market manipulations, the injured shareholders have been left without proper remedies in respect of matters of illegal actions. Indeed, the limited scope for effective civil litigation against directors and controlling shareholders in securities fraud cases in China has been well documented.¹⁴⁰ For example, writing in 2004, Naomi Li and Stephen Green found that over 1000 civil actions have been filed against some 14 companies in China, but they noted “most remain in legal limbo with courts refusing to make judgement, and none having been settled by a court judgement in favour of the investors.”¹⁴¹

Wu, Xu and Yuan found that for the period from 1992 to 2003 find that the inverse relationship between ownership concentration and legal investor protection does not hold for state controlled firms. By way of contrast, for the less numerous, non state- controlled listed firms whose shareholders do not enjoy political power, legal investor protection is

¹⁴⁰ Li.N. (2004). "Civil litigation against China's listed firms: Much ado about nothing?" Asia Programme Working Paper, No 13 , February 1, at 1-5.

¹⁴¹ Ibid, at 25.

negatively related to ownership concentration. Accordingly they find that La Porta's thesis does not hold in all types of firm. The implication of this is that the nature of the controlling shareholder should be taken into account, especially if it is the state.¹⁴²

III Minority shareholder protection under the Company Law 2005

The Company law 2005 (brought into effect in January 2006) reinforces shareholders' right of taking direct action against wrongdoers in a company. Article 152 in particular gives guidance on bringing a derivative action. It specifies that a shareholder can bring an action against any director, supervisor or manager if he violates any law, administrative regulation or the articles of association during the course of performing his duties. The requirements are that a shareholder or shareholders should hold either separately or in aggregate 1% or more of the total shares of the company for a period of at least 180 days. The article also allows a derivative action against any third party who damages the company's interests. However, the provision also emphasizes the exhaustion of internal remedies by requiring shareholders to raise the issue complained of with the board of directors or the supervisory board and urge them to seek remedies before lodging a

¹⁴² Wu, S., N. H. Xu, et al. (2009). "State Control, Legal Investor Protection, and Ownership Concentration: Evidence From China." *Corporate Governance: An International Review* 17(2): 176.

derivative action. Only when the minority have evidence to prove that the company is controlled by the wrongdoers can they initiate a derivative action.

Cheng recently analysed 26 cases to show that 42% involve expropriation of assets, 34% relate to misstatements in annual reports, 4% relate to non payment of dividends, 8% relate to the use of the companies to provide guarantees to a third party without the authority of the board and 12% relate to improper alteration of the articles. She comments on the dogged perseverance of the shareholders who bring their actions against the odds. For example in the pre 2005 legislation case of *Wu & 11 other minority shareholders v Hong Guang*, the action was turned down several times by various people's courts in different cities. They waited until the Supreme people's Court issued the Notice on 'Acceptance of cases of Disputes over Civil Tort Arising from False Statements in the Securities Markets' in 2002 and filed the case again, eventually winning. Cheng notes that since the new company law the attitude of the judiciary to handling minority suits has changed for the better. Of her sample of 26 cases 11 had been decided under the new company law and shareholders had succeeded in 9 of them. Even those that were not successful had the effect of alerting the authorities resulting in a positive outcome. For example, the case of *Zhang Qiuju v Wuhan Petroleum* a minority shareholder

lodged a derivative action against Wuhan Petroleum for selling state assets at an under value in 2007. This was a politically sensitive case because the government and public opinion supported severe punishment for such behaviour. The defendant argued that the decision to sell was made by the board which had the assets valued by professional appraisers and due and proper process had been adhered to.

On consideration of all the facts, the judge turned down Zhang's claim on the basis of her failure to exhaust internal remedies. However, the publicity surrounding the case drew the sale of state assets to the attention of the CSRC which blocked the transaction. Overall Cheng reports that there is some improvement in the way the courts deal with this type of minority shareholder action in light of the clearer guidelines laid down in article 152. This is a small but important improvement in the context of China.¹⁴³

5.5 Conclusion

The issue of how to protect the rights of the minority shareholders of firms is an important one in China where the state is by far the largest

¹⁴³ Cheng, W. Q., (2008) "The Protection of Minority Shareholders after the New Company Law – Twenty-Six Case Studies" paper delivered at the Conference on economic and Legal Reform Beijing Institute of Business, October 2008.

majority shareholder of many listed companies. The formal framework of corporate governance adopted from the Anglo-American system is, based on competitive external markets with a strong role for the court system. This corporate governance system also relies on arms-length transactions and shareholder sovereignty that protects the small and diverse individual shareholders. However, some of these key conditions are the result of the social, political and legal evolutionary processes as well as the developments of the market mechanism. As indicated earlier in this chapter the role of minority shareholder and investor protection in terms of both influencing the concentration of shareholdings and its role in disciplining management - or least holding them to account for misbehaviour remains the subject of considerable debate in the West.

It is quite obvious that China does not have the accompanying economic conditions and social institutions for this stylized model to work. The important path dependency factor in China is clearly the role of the state in controlling state enterprises; and whilst in policy terms the government wishes to separate its role from management and ownership along with the consequential social and welfare burdens, the political make up of the SASAC and BSAMs continues to retain ties and influence over SOEs. It is now generally accepted that there is no single system of corporate governance applicable to all countries, although the globalization of the

world economy has exerted some pressure on the need for convergence and harmonization in some areas of governance arrangement.¹⁴⁴ The evolution of China's corporate governance system depends much on its economic, social and political conditions and their respective stages of development.

¹⁴⁴ Letza, S., X. P. Sun, Kirkbride, J. (2004). "Shareholding versus stakeholding: a critical review of corporate governance." *Corporate Governance-an International Review* 12(3).

Chapter 6 Co-determination/ Industrial democracy

6.1 Introduction

In China, a firm belief in the principle of the corporation's responsibility to society and stakeholder relationships as a necessity to hold the society together is a product from the era of planned economy. Since 1949 the communist government has assumed the responsibilities of protecting all worker interests. On that day, membership as a SOE worker was of great value to workers not only because of the monetary benefits, but also because they regard their job as their whole life position and their social identity within society. Most of them have worked on the same job for many years and have invested much time and energy to develop the particular skills required because they assumed that they would be there for life. Their promotions and wage increases, even their reputation and their families' reputation, are all decided by their job performance in their enterprise community. SOE workers regard themselves as the owners of the nation and the leaders of the Chinese people.

Since 1978, the state is not concerned so much with communist ideology, in the sense of a centrally planned economy, any more. China's pragmatic policy goals are economic development and a stable society. When

workers' relationship with the SOEs cease, they lose their high self-esteem as members of a leading class. Is the Chinese workforce doomed to repeat the experiences and responses of their counterparts in the European industrial revolution? Will similar institutions, trade unions or collective bargaining, be stable institutional responses to their circumstances? Do employee representatives—while seeking to govern the firm in a manner that protects their own interests—indirectly protect the interests of minority shareholders and thereby increase firm value? The important question considered in this chapter is the extent to which, if any, the values encapsulated in the co-determination model of the communitarian form of capitalism encountered in Germany, from which some elements of corporate governance have been copied, can successfully take root in modern China as the reform continues along an ideological path towards a socialist market with Chinese characteristics. Or, are the dominant factors in China such that a different trajectory is more likely?

6.2 Stakeholder theory in West

The classical theory is that corporate managers are only and exclusively responsible to their shareholder and that this responsibility includes a

duty to maximise the profits and the wealth of shareholders.¹ Many legal and finance scholars have focused on the relationship between shareholders and managers, particularly on the problem of getting managers to act as faithful agents for shareholders. Even in the early 1990s, it had become quite unfashionable for corporate executives to talk about their jobs in any terms other than maximizing shareholder value.

However, a classical theory that once was unchallengeable must yield to the facts of modern life. At the height of the economic depression in the United States in 1932 Dodd made a dramatic plea in the pages of the Harvard Law Review:

‘There is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfil these responsibilities.’²

This resonated with Berle and Mean’s insistence that large corporations serve not only the owners or the controllers, but all society.³ In the name of normal business activity, corporations were too often given a licence to

¹ See Dodd, E. M. (1932), "For Whom Are Corporate Managers Trustees?" HARV. L. REV. **45**: 1145.

² Dodd, E.M. (1932), *Ibid* at 1146.

³ *Ibid*.

destroy people's lives and damage the environment. According to Mitchell rather like the shark evolving into a perfect eating machine, the device of limited liability has allowed the corporation to perfect its function, namely that of permitting corporations to externalise the costs of stock price maximisation that is to push those costs onto others. According to Mitchell, the corporation has become the perfect externalizing machine.⁴ In the view of Deakin and Konzelmann corporate governance must no longer confine its analysis to the relationship between managers, boards and shareholders. This narrow focus was a major contributing factor to the 2000-1 round of corporate scandals of which Enron was the most emblematic.⁵

A firm should be run in the interests of all its stakeholders rather than just the shareholders. A business corporation is an economic institution which has a social service as well as a profit making function.⁶ As such, stakeholder theorists argue that corporations owe an obligation to society to act in a socially responsible manner even if such actions are not legally mandated.⁷ Employees, creditors, suppliers, customers and the local community are primary stakeholders often mentioned and emphasised

⁴ Mitchell, L. E. (2002). Corporate irresponsibility : America's newest export. New Haven ; London, Yale University Press, at 99.

⁵ Deakin, S. and S. J. Konzelmann (2003). "After Enron: An Age of Enlightenment?" Organization 10(3).

⁶ Dodd, E.M., (1932), *supra* note 1 at 1148.

⁷ Grossman, H. A. (2005). "Refining the Role of the Corporation: the impact of corporate social responsibility on shareholder primacy theory." Deakin Law Review 10(2): 575.

within a broad definition of stakeholding.⁸

Generally, a stakeholder model of corporate governance gives stakeholders a 'Voice' in firm management and seeks to accommodate their diverse interests in deciding upon corporate action.⁹ Freeman's initiative on stakeholder management as a business strategy also has an instrumental orientation.¹⁰ As Campbell explicitly posits, "I support stakeholder theory not from some left wing reason of equity, but because I believe it to be fundamental to understanding how to make money in business"¹¹

Again, according to *Stakeholder Capitalism* edited by Kelly et al., stakeholder theory is based on the grounds that individuals well endowed with economic and social capabilities will be more productive; companies which draw on the experience of all of their stakeholders will be more efficient; while social cohesion within a nation is increasingly seen as a requirement for international competitiveness.¹²

A case study from the worker/stakeholder cooperatives in Mondragon in

⁸ Freeman, R. E. and D. L. Reed (1983). "Stockholders and Stakeholders - a New Perspective on Corporate Governance." *California Management Review* 25(3): 88-106.

⁹ Sigurt, V. (1999) "Varieties of Corporate Governance: Comparing Germany and the UK" in Hall, P. A. and D. W. Soskice (2001). *Varieties of capitalism : the institutional foundations of comparative advantage*. Oxford, Oxford University Press, at 387, 388.

¹⁰ Freeman, E. R. (1984). *Strategic management : a stakeholder approach*. Boston, Mass., Pitman.

¹¹ Campbell, A. (1997), "Stakeholders: the case in favour", *Long Range Planning*, Vol. 30 No.3, at.446

¹² Kelly, G., D. Kelly, et al. (1997). *Stakeholder capitalism*. Macmillan, at 244.

the Basque area of Spain suggests that sensible balance can be achieved.¹³ In a survey in December 2005 by management consultants McKinsey, only 6 per cent of the 4,238 executives surveyed worldwide agreed with the Milton Friedman line that the sole purpose of business was to produce high returns for shareholders; 84 per cent thought high returns had to be balanced with contributions to the broader public good.¹⁴ The view classically summed up by Milton Friedman as '[t]he social responsibility of business is to make profits'.¹⁵ As a concept, CSR directly challenges the dominant Anglo-American paradigm of corporate governance, which emphasises profit maximisation for investors as the most efficient means of promoting wealth creation for society as a whole.

Employees, as one key stakeholder group, and their relationship with the corporations are often part of the debate about corporate stakeholder theory and social responsibility (CSR). This is only logical, as employees constitute the heart of every corporation. Through their jobs employees gain much information about how things are going within a corporation, and how they might go better. Employees often have a good sense of which managers are doing a good job, and which are not. On many

¹³ Turnbull, S. (1995). "Innovations in Corporate Governance: The Mondragon Experience." Corporate Governance: An International Review 3(3): 167-180.

¹⁴ McKinsey (2006). "Global Survey of Business Executives: Business and Society." The McKinsey Quarterly 2.

¹⁵ Friedman, M., "The Social Responsibility of Business is to Increase its Profits", The New York Times Magazine, September 13, 1970; see Henderson, D. (2001). Misguided virtue : false notions of corporate social responsibility, Institute of Economic Affairs.; Bakan, J. (2004). The corporation : the pathological pursuit of profit and power. New York, Free Press at 34.

matters employees are likely to be better informed than the scattered small shareholders of a public corporation. This may make employees more effective monitors of managers than shareholders.¹⁶ Employee governance may also be an effective commitment device to induce employees to invest in firm-specific human capital. Employees develop firm-specific human capital and, like the firm owner, make “investments” in the firm. These non transferable skills and knowledge may be critical to the competitiveness of the firm.

As Grant argues, if knowledge is the pre-eminent productive resource and most knowledge is created by and stored within individuals, then employees are the primary stakeholders. This creates a challenge for management to establishing mechanisms by which cooperating individuals can co-ordinate their activities in order to integrate their knowledge into productive activities.¹⁷ In *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288, a Canadian Court said:

If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if

¹⁶ See Stiglitz, J. E. (1985). "Credit Markets and the Control of Capital." *Journal of Money Credit and Banking* 17(2): 133-152.; Eugene Fama has argued that lower level managers are often good monitors of higher level managers. See Fama, E. F. (1980). "Agency Problems and the Theory of the Firm." *Journal of Political Economy* 88(2): 288, 293.

¹⁷ Grant, R. M. (1997). "The knowledge based view of the firm: Implications for management practice." *Long Range Planning* 30(3): 452.

the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.’¹⁸

In the UK the case law had always taken the view that there should be no charity at the board except such as is for the benefit of the company but even the classic case which laid down this test accepted that it would be for the company’s benefit to organise an event for the benefit of workers in order to foster loyalty to the company.¹⁹ Although more recent cases have accepted that there is nothing to prevent a commercial company having a substantive charitable or philanthropic object.²⁰

Again, it has been argued that good corporate citizenship can be used to attract, retain and motivate the best workers.²¹ McDonnell supports employee governance as a way to ensure that corporations are governed in part in the interests of employees.²² He identifies three approaches: employee share ownership; electing employee representatives to the

¹⁸ See *Teck Corp. v. Millar* (1972), 33 D.L.R. (3d) 288 at 291.

¹⁹ *Hutton v West Cork Railway Co* (1883) 23 ChD 654 at 658.

²⁰ *Re Horsley and Weight Ltd* [1982] Ch 442 at 450; for a consideration of these developments see Pettet B, (1997) ‘From Cakes and Ale to Corporate Social Responsibility’ *Current Legal Problems* 50, 289.

²¹ Benioff, M. and K. Southwick (2004). *Compassionate Capitalism: How Corporations Can make Doing Good an Integral Part of Doing Well*. The Career Press.

²² McDonnell, B. H. (October 15, 2002). “Corporate Constituency Statutes and Employee Governance.” *Minnesota Public Law Research Paper No. 02-13*. Available at SSRN: <http://ssrn.com/abstract=349642>

board of directors; and employee involvement in quality circles, work councils or the like. He believes that employee involvement in corporate governance can work as a potentially powerful additional mechanism to control managerial opportunism and to direct the corporation towards greater efficiency.²³ Thus, employee involvement in corporate governance works as a potentially powerful additional mechanism to control managerial opportunism and to direct the corporation toward greater efficiency. Employees have an abundance of information on the functioning of the corporation and managers, and incentives to use that information to improve the corporation's performance, if given a way to do so.²⁴

Parkinson also argued that employees are not merely one of several 'outside' groups but are in a special position with a claim to be regarded as 'insiders'. This claim is equal to that of the shareholders to demand that the company be run for their benefit. From his perspective he envisaged a function for worker participation that extends beyond the requirement of social responsibility. In his view the function of participation is not merely to restrain profit maximisation but to inculcate an open ended commitment to the furtherance of the interests of an employee in addition to those of the shareholder constituency. He viewed

²³ Ibid.

²⁴ See Stiglitz, J.E. (1985), *supra* note 16; Eugene Fama has argued that lower level managers are often good monitors of higher level managers. See Fama, E.F., (1980), *Supra* note 16, at 288, 293.

employee participation as a corrective to corporate power responding to the doubts concerning the legitimacy of the power exercised by companies over the lives of their employees. Employee participation would provide a practical means of broadening company goals for their benefit although the nature of these would be largely in relation to community concerns. Though the latter would not be free from conflicts of interest for which he suggests an alternative way of addressing that issue in this context. Parkinson's response to the issue of private power was to subject companies to a form of democratic control and not by subsuming them within the machinery of the state. Rather, he preferred countering private power through internal democratization by way of employee participation or control.²⁵

6.3 The development in the UK

Traditionally, corporate governance theory in the US as expressed in academic legal literature is clearly focused on shareholder wealth maximisation as the dominant corporate function. In contrast, the 'communitarian' or 'social responsibility' model of governance seems more dominant in many European countries.²⁶ This variety of capitalisms

²⁵ Parkinson, J. E. (1993) Corporate Power and Responsibility: Issues in the Theory of Company Law Oxford, Clarendon Press, Chapter 9, The Democratic Imperative: Beyond Social Responsibility.

²⁶ See generally Venanzi, Daniela and Fidanza, Barbara (2006), Corporate Social Responsibility and Value Creation - Determinants and Mutual Relationships in a Sample of European Listed Firms . Available at SSRN: <http://ssrn.com/abstract=939710>

reinforces the argument that there are differences in corporate governance systems that are determined largely by factors other than a particular model of economic thinking, among which are the historical, political and cultural influences at play.²⁷

The UK had flirted with the idea of 'industrial democracy' under a number of labour governments. The labour government of 1974-9 had a number of alternatives for economic strategy after the earlier post war labour governments had failed to deliver on their promises. The left had developed proposals for industrial democracy giving stronger rights to workers as an integral part of its strategy to transfer power from private firms. Support for this approach had come from both the Trade Union Congress (TUC) and the labour conferences in the early 1960s. Unfortunately, their proposals were uncertain and ambiguous. It was recognised that different decisions would be made by workers groups and would need to be reconciled with one another and with the objectives of national planning. Little progress was made on developing a solution to these potential conflicts in the party's policy development.²⁸

²⁷ See for example Whitley, R. (1999). Divergent capitalisms : the social structuring and change of business systems. Oxford, Oxford University Press. ; Thelen, K., "Varieties of Labour Politics in the Developed Democracies"; Wood, S., "Business, Government, and Patterns of Labour Market Policy in Britain and the Federal Republic of Germany" ; Vitols S. "Varieties of Corporate Governance: Comparing Germany and the UK" ; Teubner, G., " Legal Irritants: How Unifying Law Ends up in New Divergencies" in Hall, P. A. and D. W. Soskice (2001). Varieties of capitalism : the institutional foundations of comparative advantage. Oxford, Oxford University Press, at 387, 388.

²⁸ Wickham-Jones, M. (1996). Economic strategy and the Labour Party : politics and policy-making, 1970-83. Basingstoke, Macmillan Press Ltd.at 68-70 and 142-143

Following considerable prevarication the government set up a committee on industrial democracy under Sir Alan Bullock which failed to reach agreement. In 1977, the majority of the committee proposed that companies with over 2000 employees should be compelled to accept equal numbers of worker representatives to those appointed by the shareholders onto their boards. This amounted to a rejection of the German two tier board system. The employers' representatives on the committee expressed considerable hostility to these proposals producing their own minority report. The latter criticised the majority view as being aimed at control by and the exercise of increased power by trade unions.²⁹ The government proposed legislation based on a moderated version of the majority report. However, in the face of further opposition from the Confederation of British Industry, it was postponed to be followed by a white paper in 1978.³⁰ The government's attempt to promote worker co-operatives was also unsuccessful. The labour movement's flirtation with industrial democracy was all but dead. A Conservative government headed by Margaret Thatcher was elected in 1979.

Mrs. Thatcher launched a free market property rights counter revolution

²⁹ The Bullock Report, (1977) Report of the Committee of Inquiry on Industrial Democracy, Cmnd. 6706, HMSO. In addition to the Main (majority) Report at vii and the Minority Report at 167 there was a note of dissent relating to the number of employee representatives on the board by committee member Mr N. S. Wilson at 163. See also Hadden, T., (1977) Company Law and Capitalism (2nd Edn) London, Weidenfeld and Nicolson, Chapter 13 Industrial Democracy; Batstone E and Davies, P. L. (1976) Industrial Democracy, European Experience: Two reports prepared for the Industrial Democracy Committee HMSO.

³⁰ (1978) Industrial Democracy, Cmnd. 7231, London, HMSO.

upon the world which from 1979 has travelled in the opposite direction. The UK has stood apart from Europe as an influential exponent of the Anglo-American market based approach to corporate governance.³¹ The following decade saw a major change in the political and industrial landscape of the UK. The state retreated from the nationalised industries and the private sector stepped in. The aftermath of the miners' strike saw the retreat of the trade unions and a considerable decline in their membership.³²

The EC 5th Directive on industrial democracy was stalled and constantly negotiated down by the British government which saw it as an alien imposition.³³ The EC requirement to duty to show consultation with worker representatives in the form of trade unions was legislated for in a very mild form, though since 1995 this has changed.³⁴ Meanwhile the drive to extend the boundaries of the property owning democracy continued apace. Employee share schemes were encouraged and given

³¹ Because of the current financial crisis, huge amounts of money have been committed in financial support for many industries. The UK has spent £81bn to prop up Royal Bank of Scotland, HBOS and Lloyds TSB as well as nationalizing Northern Rock and parts of Bradford & Bingley. In US, a \$700bn scheme approved last year, known as the Troubled Asset Relief Programme, was used to help lenders like Citigroup and Bank of America as well as the automobile industry. See BBC Business report "Global downturn: In graphics" available at <http://news.bbc.co.uk/2/hi/business/7893317.stm>.

³² Deakin, S. and G. S. Morris (2005). *Labour Law* (4th edn). Oxford and Portland, Hart Publishing at 766.

³³ Du Plessis, J. J. and J. Dine (1997). "The Fate of the Draft Fifth Directive on Company Law: Accommodation Instead of Harmonisation." *Journal of Business Law* 23.

³⁴ Deakin, S. and Morris, G. S. (2005) *supra* note 32 at 822. In Case C-382/92 *EC Commission v United Kingdom* [1994] IRLR 292 and Case C-383/92 [1984] IRLR 412, ECJ held that the original position in the Trade Union and Labour Relations (Consolidation) Act 1992 making consultation subject to the voluntary act of the employer infringed obligations imposed by the directives relating to redundancies and transfer of undertakings. The legislation was therefore amended to require employers to consult, at their choice, either a recognised union or an elected representative of the affected employees.

tax advantages. The co-determination approach adopted in the company law harmonisation project was completely stalled. The change in political attitudes and relative demise of the trade unions which had their own tried and tested form of collective bargaining led to their turning away from any flirtation with the concept of industrial democracy.

6.3.1 The influence from the EU

The European Union, for example, acknowledged the importance of social and market pressures, noting that civil society must be recognised as playing a significant role in this new business governance. The United Kingdom has also implemented EU laws requiring at least partial adaptation of the shareholder primacy model, to reflect aspects of the European ‘stakeholder’ approach to corporate regulation-specifically, employee board representation.³⁵

John Armour and Simon Deakin have claimed that recent developments in the UK have significantly reduced the centrality of shareholder interests and, largely due to the implementation of EU Directives, have succeeded in moving the UK’s system of corporate governance closer to

³⁵ See Davies, P. (2003). "Workers on the Board of the European Company?" *Industrial Law Journal* 32.; Barnard, C. and S. Deakin (2003). "Reinventing the European Corporation: Corporate Governance, Social Policy and the Single Market." *Industrial Relations Journal* 33: 484.

that of Germany where debt-holders and employees already have a variety of formal decision rights that limit managerial discretion in several important areas relating to investment, financing and restructuring strategies.³⁶ However, for a market-oriented economy and system of governance such as the UK, formally entrenching debt holder and or employee representatives into corporate decision making would be a radical departure from existing practice.

6.3.2 The political impact

The British New Labour Party emphasis on stakeholding, with the further consideration that:

“We believe that in the appointment of non-executive directors companies should recognise that there are other stakeholders in the future of the company than shareholders.”³⁷

It was this critical distinction which let the Hampel committee on Corporate Governance in the UK off the hook of more formally recognising stakeholder interests among the duties of company directors:

‘A company must develop relationships relevant to its success. These will depend on the nature of the company’s business; but

³⁶ Armour, J., S. Deakin, et al. (2003). "Shareholder primacy and the trajectory of UK corporate governance." *British Journal of Industrial Relations* 41(3): 531-555.

³⁷ In October 1994, at the annual Labour party conference in Blackpool, Tony Blair gave his first platform speech as the leader of the Labour party. At the end of his speech he declared that the party needed a new statement of aims and a modern constitution. Later, Blair gave speeches about "stakeholding" on 18th and 29th of January and 11th of February, 1996. *The NSS*, 29 Mar 1996.

they will include those with employees, customers, suppliers, credit providers, local communities and governments. It is management's responsibility to develop policies which address these matters; in doing so they must have regard to the overriding objective to preserving and enhancing the shareholders' investment over time...'³⁸

The approach to CSR taken by the Hampel Committee is indicative of the consensus that had formed by the 1990s.³⁹ The committee insisted that good corporate governance should take into account the various stakeholders affected by the company's operations, but was unwilling to mandate particular management structures giving those stakeholders representation in decision-making processes or to impose legally enforceable duties benefiting those stakeholders.

The UK government's major review of company law, reporting in 2001,⁴⁰ underlined this approach by opting to retain CSR as a voluntary matter rather than making it a direct legal obligation, and the theme has been reiterated since, with Stephen Timms, Energy and Corporate Responsibility Minister, describing CSR as 'going beyond legal

³⁸ Hampel Report (1998), "Committee on Corporate Governance Final Report", London, para 1.16

³⁹ Ibid.

⁴⁰ Department of Trade and Industry, Company Law Review Report. 2001.

requirement’.⁴¹ The former Department of Trade and Industry’s (now BERR) line was to ‘see CSR as the voluntary actions that business can take, over and above compliance with legal requirements’.⁴² The CLR Steering Group indicated that it would not consider fundamental changes to the Anglo-American model of corporate governance:

“We interpret our terms of reference as requiring us to propose reforms which promote a competitive economy by facilitating the operations of companies so as to maximise wealth and welfare as a whole. We have not regarded it as our function to make proposals as to how such benefits should be shared or allocated between different participants in the economy on the grounds of fairness, social justice or any similar criteria.”⁴³

Approaches to reform such as those proposed by Parkinson in relation to employee participation were therefore regarded as beyond the scope of the review. In light of the UK’s historical flirtation with industrial democracy and its stalling of the 5th EC Directive on Co-determination this is not surprising.

The government identified the enhancement of shareholder engagement and a long term investment culture as one of the four key objectives of its

⁴¹ Webb, T. (2004). "What will the UK government do about its new reporting proposals?" Ethical Corporation September.

⁴² Corporate social responsibility: a government update, available at www.csr.gov.uk/whatiscsr.shtml.

⁴³ CLR Steering Group (1999), *Modern Law for a Competitive Economy: The Strategic Framework*, para.2.5.

Company Law Reform Bill, introduced to the House of Parliament in November 2005⁴⁴ and passed into law in November 2006 as the Companies Act 2006. The Act includes a section which gives the government authority to require institutional investors to disclose how they have exercised their voting rights on resolutions tabled at company meetings.

6.3.3 The new development of the 2006 Companies Act

In the United Kingdom, there are limited exceptions to this general rule: directors have a duty to consider the interests of employees in performing their functions. Section 309 of the Companies Act 1985, introduced in 1980, states that directors, as part of their duty to the company, are to have regard to the interests of the company's employees in general, in addition to the interests of its members. A generous interpretation of this provision is that it elevates the interests of employees to the same level as those of shareholders. It also leaves it to directors to decide how to balance those interests when they are in competition with each other. A more pessimistic interpretation is that the section 'does not compel the

⁴⁴ The other key objectives of the Company Law Reform Bill are: ensuring better regulation and a 'Think Small First' approach; making it easier to set up and run a company; and providing flexibility for the future. The Bill was introduced to the House of Lords in November 2005 and brought forward to the House of Commons in May 2006. It received Royal Assent in November 2006 as the Companies Act 2006. It is the longest Act ever to have been passed by Parliament as it repeals, and restates in plain English, almost all of the current Companies Acts, which it largely replaces. See Craig, R. (2008). "The enormous turnip: a discussion on the companies act 2006 which like in the child's fairy tale is still growing" *The Company Lawyer* 29(12): 361.

directors to do anything they would not otherwise have been inclined to do'.⁴⁵ Instead, it simply requires (and there is debate about its mandatory effect) directors to 'have regard to' employees' interests; that is, 'the duty is merely a procedural one, having no substantive content'. Perhaps this is what lies behind Len Sealy's observation that section 172 'is either one of the most incompetent or one of the most cynical pieces of drafting on record'.⁴⁶

The 2006 Companies Act also sets out a duty on directors to act in the way they consider 'in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole'.⁴⁷ Section 172 of the Companies Act 2006 introduces a 'duty to promote the success of the company'. The section has its origins in the recommendations of the Company Law Review Steering Group which reported in 2001.⁴⁸ The section begins by stating that a director must act in the way that would be most likely to promote the success of the company for the benefit of its members as a whole. The section then goes on to state that in fulfilling this duty, a director must have regard to a range of factors including the interests of the company's employees (thus

⁴⁵ Parkinson, J. E. (1993). Corporate power and responsibility : issues in the theory of company law. Oxford, Clarendon, at 84.

⁴⁶ Sealy, L. (1987). "Directors 'wider' Responsibilities-Problems Conceptual, Practical and Procedural " Monash Law Review 13: 177.

⁴⁷ Companies Act 2006, s. 172 (1) came into force in 2008.

⁴⁸ Company Law Review Steering Group, Modern Company Law For a Competitive Economy-Final Report (2001, Volume 1), Appendix C; see also Department of Trade and Industry, Company Law Reform White Paper (March 2005), pp. 20-1.

replacing the present section 309), its suppliers and customers, the impact of the company's operations on the community and the environment, and the desirability of the company maintaining a reputation for high standards of business conduct.⁴⁹ Other factors to be considered include the likely consequences of any decision in the long term.

These additional considerations reflect the government's acceptance of the 'enlightened shareholder value' approach to company law reform, which assumes that a company's relationship with its stakeholders affects the returns to shareholders, and that it is therefore in shareholders' interests that directors take account of broader stakeholder concerns.⁵⁰ But in reality the section goes no further than would normally be expected in terms of the considerations of a sensible board of directors determining what is in the interests of the company for the benefit of its shareholders as a whole. Boards have always had to balance the often competing interests of its primary and secondary stakeholders.

Labour rights commentators on the United Kingdom's 2006 codification of 'enlightened shareholder value' duties for directors, while welcoming their potential to enhance discussion of social issues at board-level, may

⁴⁹ Ibid.

⁵⁰ The government also considered, and rejected, an alternative approach identified by the CLR Steering Group—referred to as the 'pluralist' approach—in which the interests of a range of stake holders are accommodated without the interests of a single group (shareholders) being overriding. See House of Commons Library Research Paper 06/30, p.11.

also have been right to observe that their impact in practice will probably depend on the willingness of trade unions, nongovernmental organizations (NGOs) and socially oriented shareholders to query how boards have interpreted the “enlightened” part of their mandate.⁵¹

On the other hand, amendments to UK company legislation have seen the provision requiring directors to have regard to the interests of employees as well as shareholders⁵² replaced by a more general directors’ duty provision.⁵³ In addition to the criticisms of the former statutory provision discussed above, its effectiveness in protecting employee interests has been questioned on the basis that it does not require those interests to be given priority, and because the duty is owed to the company and therefore is enforceable only at the instance of shareholders.⁵⁴ However, the enshrinement of the concept of ‘enlightened shareholder value’ through the new statutory provision⁵⁵ means that employees will have to compete with a range of other stakeholders for legal recognition.⁵⁶

⁵¹ Ergon: Focus on Labour (7 December 2006), 6. available at http://www.ergononline.net/news_publications/newsletters/ergon_focus_on_labour_december_2006.html

⁵² Companies Act 1985 (UK), s. 309 (1)

⁵³ Companies Act 2006 (UK), s. 172.

⁵⁴ Villiers, C., “Section 309 of the Companies Act 1985: is it Time for a Reappraisal? ”, in Collins, H. C., P. Davies, et al. (2000). *Legal regulation of the employment relation*. London, Kluwer Law International. at 595-597.; Lord Wedderburn (2002). “Employees, Partnership and Company Law.” *Industrial Law Journal* 31: 106-8.

⁵⁵ See Davies, P., (2005), “Enlightened Shareholder Value and the New Responsibilities of Directors: What Does the Best Director Do for the Creditor?” (Inaugural W.E. Hearn Lecture, Law School, The University of Melbourne, 4). available at <http://celsr.law.unimelb.edu.au/download.cfm?DownloadFile=BC82395E-09AD-DB76-F1D0B2AFFB41CF9D>

⁵⁶ Wedderburn, B. (2004). *The Future of Company Law: Fat Cats, Corporate Governance and Workers*. London, The Institute of Employment Rights, at 43.

6.4 The German co-determination

In contrast, the German corporate governance system is frequently described as representing a stakeholder or pluralistic approach.⁵⁷ In Germany, there has been a long-standing policy that employees should share in the decision-making of their firms. The freedom under the German system available to company directors to consider purposes other than profit maximisation/shareholder value, e.g. employee interest or social interests, arises implicitly from the German legislative framework as a whole and the fact that the German constitution prescribes a "social" market economy.⁵⁸

In contrast to most Western economies, Germany has a two-tier board with a management board (Vorstand) and a supervisory board (Aufsichtsrat). The supervisory board represents the shareholders and employees. Through the Montanmitbestimmungsgesetz of 1951, Germany required mining, coal, and steel workers have the right to 50% representation on their company's boards with the remaining 50% representing shareholders. The Mitbestimmungsgesetz of 1976 extended this right to all firms with employees numbering in excess of 2,000. The

⁵⁷ Corfield, A. (1998). "The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis." *Bond Law Review* 10.

⁵⁸ Article 20 of the Federal Constitution (Grundgesetz) states: "The Federal Republic of Germany is a democratic and social republic." This is supplemented by Article 14(2) Federal Constitution (Grundgesetz): "Property commits. Its use should also serve the general public".

Betriebsverfassungsgesetz of 1952 required stock corporations with employees numbering between 500 and 2000 provide labor one-third representation on their boards. Exceptions to codetermination included firms of any size that are family controlled or are involved in media, religious, union, or political activities.⁵⁹ The interests of certain employee groups are considered through the co-determination provisions as those employees have the right to elect representatives on the supervisory board which supervises the board of directors of the respective companies. Nevertheless, the employee representatives within the Aufsichtsrat have the same rights and duties as the representatives nominated by the shareholders, they are all non-executive company directors.⁶⁰

Another form of labour representation in business decision-making in Germany is Work Councils Codetermination. Under these laws, plants must have councils elected by workers; firms with multiple plants must have aggregate councils; and holding companies (Konzerne) with multiple firms must have group councils. For example, German law gave Work Councils rights to co-determination with the Management Board in connection with dismissal, employee vocational training and grievances.

⁵⁹ Fauver, L. and M. E. Fuerst (2006). "Does good corporate governance include employee representation? Evidence from German corporate boards." *Journal of Financial Economics* 82(3): 676.

⁶⁰ Ibid.

The German co-determination system is particularly well suited for the investigation because it has demonstrated over the last 30 years that three apparently conflicting goals might be achieved at the same time.⁶¹ First, is the goal of enhanced economic performance of corporations and the integration of employees into the process of corporate decision making. Labour, with its operational knowledge, acts as a check on the private control benefits of large shareholders and the perquisite-related abuses by management. If only management proposes board members, then only management has access to the board. It is likely that embedded in project choices there are benefits to large shareholders or management that do not improve small shareholder wealth and hence firm value. Again, detailed knowledge of operations allows employees to act as a check on choices made for the benefit of large owners and management, but to the detriment of firm viability and hence labour interests.⁶²

As Prigge surmises:

“... at least as members of Wirtschaftsausschuss, work councillors can collect both a wide range of basic plant-level information as well as information on the business and financial situation. Conditions seem to be such that a works councillor sitting on the supervisory board has a solid information base at his disposal and,

⁶¹ A new German Corporate Governance Code was introduced in 2001 and now bears much closer resemblance to the Anglo-American model, although the core value remains the protection of the investor.

⁶² Supra note 59, at 684

equally important, his information base most likely is highly complementary to the information the shareholder representatives have...from a mere informational perspective the makeup of the supervisory board...is a good starting point for management board monitoring...This may be one main reason why internal employee representatives are generally highly appreciated supervisory board members of the capital side.⁶³

Secondly, advantages of the German co-determination system include reduced employee turnover, stronger corporate identification of employees and enhanced industrial peace.

As Freeman and Lazear discuss, codetermination provides a mechanism for the credible exchange of information between the board and the workers. During difficult times for the firm, the union will be well aware of the problems and forthcoming with concessions. Of course, during times with better firm performance, labour too will expect to benefit. At the very least, the probability of a costly strike when the firm truly cannot afford a wage increase is likely to decrease with codetermination. This free and credible exchange of information should also improve cooperation and lead to a team approach to management. Workers with

⁶³ Prigge, S., "A survey of German corporate governance", in Hopt, K. J. (1998). Comparative corporate governance : the state of the art and emerging research. Oxford, Clarendon.

operational expertise should now have a means to propose ideas to the highest levels of the firm and thereby improve efficiency. Employee representation may improve the coordination and flow of specific knowledge within the firm, i.e., create an information intermediary between management and other employees.⁶⁴

Third, this applies to companies which are subject to the co-determination system, the interests of shareholders and employees often coincide in practice.⁶⁵ A study by the renowned German Max Planck Institute examined the decision-making process of the 40 biggest German corporations during the 1990s and revealed that shareholders and employees in most cases have common rather than distinct objectives and interests.⁶⁶ Several observations might help to illustrate this phenomenon. First of all, employees, as well as shareholders, have a great interest that "their" particular company remains or becomes competitive and generates profit because only then it will be guaranteed that staff does not become redundant. Second, somewhat surprisingly, the study revealed that shareholders and employees often formed coalitions against the management in order to achieve common goals such as better and

⁶⁴ See Freeman, G. and Lazear, E. P. (1995), "An Economic Analysis of Works Councils", in Rogers, J. and Streeck, W. (eds) (1995). Works councils : consultation, representation, and cooperation in industrial relations. Chicago, London, University of Chicago Press at 27-52.

⁶⁵ See Max Planck Institute, *Arbeitsbeziehungen in Deutschland: Wandel durch Internationalisierung. Bericht über Forschung am MPIfG* (2002); a summary of the study can be accessed online, see Max Planck Institute, <http://www.mpg.de/english/portal/index.html>.

⁶⁶ Ibid.

expanded transparency or resistance against skyrocketing management remuneration.⁶⁷ Other areas of cooperation between employee and shareholder representatives included opposition against management plans to accumulate undisclosed reserves in order to reduce corporate profits.⁶⁸

The observation that the interests of employees and shareholders often coincide in practice is also supported by a representative study, which asked (non-employee) shareholders whether codetermination procedures on the supervisory board should be restricted. Only one per cent expressed the view that employee representation should be totally abolished, but 64 per cent of the private shareholders indicated that they are happy with the current state of employee representation on the supervisory board (31 per cent supported reforms).⁶⁹

Of course, there are also disadvantages of the German co-determination such as efficiency considerations or a conflicting duty situation on the supervisory board. However, as West Germany had been one of the fastest growing and strongest economies in Europe since the Second World War. The codetermination model had been partly responsible for

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Poll by TNS Emnid for the German Manager Magazin, January 2005.

decades of high productivity and robust economic growth⁷⁰ on balance and in the long term. It seems that the positive impacts of co-determination procedures, at least in the German context, outweigh any negative influences caused by the system.⁷¹ Roe has argued that co-determination influences managers and blockholders to retain their 'semi-private' blockholding structure therefore limiting the development of securities markets.⁷² Charkham, however, puts this down in part to the German public's agnosticism towards the cult of equity and reflects German managements' lack of enthusiasm for the stock market.⁷³ It is also important to note that the system of co-determination is an important part of the total system of corporate governance in Germany. It is one important piece of the jigsaw puzzle, fitting in with the other elements of the institutional structures.⁷⁴ According to Gerum and Wagner, the variety of regulations in those countries having a co-determination system reflects a variety of preference and culture on the one hand and on the other differences in development, thereby emphasizing the importance of historical development, path dependency and culture.⁷⁵

⁷⁰ Michel, G. (2003), "Corporate Governance, Employees, and the Focus on Core Competencies in France and Germany" in Milhaupt, C. J. (2003). Global markets, domestic institutions : corporate law and governance in a new era of cross-border deals. New York ; Chichester, Columbia University Press at 206.

⁷¹ FitzRoy, F. and K. Kraft (2005). "Co-determination, efficiency and productivity." British Journal of Industrial Relations 43(2): 233-247.

⁷² Roe, M. J., "German Co-determination and German Securities Markets" in Hopt, K. J. (1998). Comparative corporate governance : the state of the art and emerging research. Oxford, Clarendon.

⁷³ Charkham, J. P., H. Ploix, et al. (2005). Keeping better company : corporate governance ten years on. Oxford, Oxford University Press.

⁷⁴ Prigge, S., "A Survey of German Corporate Governance" in Hopt et al. supra note 72.

⁷⁵ Gerum, E. and Wagner, H., "Economics of Co-determination in View of Corporate Governance" in Hopt et al (1998) supra note 72.

6.5 Employee participation in corporate in China

6.5.1 The principle of the corporation's responsibility to society is a product from the era of the planned economy

In China during the Mao period, like the former Soviet Union, labour relations are claimed to be based on a "tacit agreement" or moral arrangement between the State and labour that protects workers' interests.⁷⁶ Where such contracts are fulfilled, labour movements are rare.⁷⁷ Cook describes state-labour relations in the former Soviet Union in this manner:

[T]he regime provided broad guarantees of full and secure employment, state-controlled and heavily subsidized prices for essential goods, fully socialized human service, and egalitarian wage policies. In exchange for such comprehensive state provision of economic and social security, Soviet workers consented to the party's extensive and monopolistic power, accepted state domination of the economy, and complied with authoritarian political norms. Maintenance of labour peace in this political

⁷⁶ Thompson, E. P. (1971). "Moral Economy of English Crowd in Eighteenth Century." *Past & Present*(50): 76-136.; Scott, J. C. (1976). *The moral economy of the peasant : rebellion and subsistence in Southeast Asia*. New Haven ; London, Yale University Press.

⁷⁷ Cook, L. J. (1993). *The Soviet social contract and why it failed : welfare policy and workers' politics from Brezhnev to Yeltsin*. Cambridge, Mass. ; London, Harvard University Press.; Ludlam, J. (1991). "Reform and the Redefinition of the Social Contract under Gorbachev." *World Politics* 43.

system thus required relatively little use of overt coercion.⁷⁸

During that period, China adopted a strict socialist planned economy, under which enterprises were owned and controlled by the state, “ with all key decisions being made in accordance with State policy and objectives”⁷⁹ In Chinese socialism, it was declared that because the state owned not only productive materials but also labour, the government should allocate labour resources. Therefore, SOE employees were recruited and allocated by the state according to labour and employment plans.

Communism produced a class of workers with strong emotional ties to and material interest in maintaining that system.⁸⁰ In Marxian labour theory, labour is a commodity when workers are separated from productive materials but own their labour. That is, because workers do not own productive materials, they have to sell their labour, which is under the workers' direct control, to capitalists at the price amounting to the cost of labour force reproduction. Only when labour and productive materials are controlled directly by workers is labour not a commodity.⁸¹

⁷⁸ Cook, L., (1993), *supra* note 77, at 1-2.

⁷⁹ Gul, F. A. and J. S. L. Tsui (2004). The governance of East Asian corporations : post Asian financial crisis. Basingstoke ; New York, Palgrave Macmillan, at 27.

⁸⁰ Linz, J. J. and A. Stepan (1996). Problems of democratic transition and consolidation : southern Europe, South America, and post-communist Europe. Baltimore ; London, Johns Hopkins University Press.

⁸¹ See Gu Kewu, *Guanyu Laodongli Suoyouzhì Wenti De Guandian Jieshao* [An Introduction to the Theories of Labor Ownership], in *Jianguo Yilai Laodongli Suoyouzhì Lunwenxuan* [Selection of Articles on Labour ownership since the Establishment of the People's Republic of China] (Xu Jiewen & Gu Kewu eds., 1982). Gongren Press, at

In Chinese socialist economics, workers can directly control their own labour. Chinese workers may sell their labour to the state or to others. However, they indirectly control and use productive materials through the state's management. Therefore labour is a commodity in China's socialist economy.⁸² The profits made by the state are put into the common pool of welfare for the people. Workers still own the surplus product they produce through the state-owned system that replaced "the all-people-ownership" system.⁸³ In theory, workers will benefit through China's long-run prosperity and the victory of socialism achieved by the economic reform.

The largest share of China's economy is the state-owned economy named "the all-people-owned economy." China's constitution provides that the all-people-ownership system is the primary component and the base of China's economy.⁸⁴ Chinese SOEs used to be production units as well as social and political organizations responsible for their employees' welfare.⁸⁵ Labour relations in SOEs in China were characterized as "organized dependence" of workers on firms. In this arrangement, workers depended on their work units or employers for highly secure jobs

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⁸² See Dai Yuanchen *Zhongguo Laodongli Shichang Peiyu Gongzi Gaige* (Development of Chinese labour market and wage reform) 1994, Beijing Press, at 10-13.

⁸³ See Hsu, R. C. (1991). *Economic theories in China, 1979-1988*. Cambridge, Cambridge University Press, at 31.

⁸⁴ 1982 Xianfa (1982 Constitution of the People's Republic of China), Art 7.

⁸⁵ Walder, A. G. (1986). *Communist neo-traditionalism : work and authority in Chinese industry*. Berkeley : London, University of California Press.

as well as cradle-to-grave welfare coverage, although provisions of welfare varied across firms.

SOE employees usually enjoy health services, housing, pensions, education, and entertainment provided by their enterprises. In many cases the cost of these benefits exceeds the total wage bill, no matter how poor the actual quality of these social services. A survey found that 70 percent of state enterprise workers felt that social benefits were as important as their cash incomes. In the same survey, workers reported that the most important social benefits were, in order of priority, health services, housing, and pensions.⁸⁶ For a Chinese worker, the loss of a position in a state-owned firm means loss of medical benefits, shelter, pensions, and entertainment. However, the reality was often rather different in that the benefits of the 'iron rice-bowl' were always deliberately limited to a minority of the industrial workforce as a whole. There were often much less generous benefits in the far more numerous small and medium sized SOEs. As a result these could not always count on the docility of their workforce.⁸⁷

As Walder suggests, "the extraordinary job security and benefits, the

⁸⁶ Asian Development Bank/Ministry of Labour PRC, Study of Social Welfare and Labour Adjustment for Enterprise Reform (Hewitt Associates, 1995) Cited in China & Mongolia DEP'T, World Bank, REP. NO. 14924-CHA, China Reform of State-Owned Enterprises, available at <http://www.worldbank.org/pics/eco/14924>

⁸⁷ Hassard, J., J. Sheenan, et al. (2007). *China's state enterprise reform : from Marx to the market*. London, Routledge at 153.

goods and services distributed directly by the state enterprise in a situation of scarcity that affects other sectors of the workplace more severely, is an important source of the acceptance of the system.”⁸⁸ In the pre-reform period, though SOE workers also have the right to participate in the enterprise’s democratic management. They participate in and supervise the management through the Employee Representative Conference (*zhigong daibiao dahui*).⁸⁹ However, they dependence on SOEs for almost all their basic needs and a lack of alternatives gave management powerful leverage over workers. Walder writes: “This complex web of personal loyalty, mutual support, and material interest creates a stable pattern of tacit acceptance and active co-operation for the regime that no amount of political terror, coercion, or indoctrination can even begin to provide.”⁹⁰ Membership as a SOE worker is of great value to workers not only because of the monetary benefits, but also because they regard their job as their whole life position and their social identity within society.

⁸⁸ Walder, A., (1986), *supra* note 85.

⁸⁹ *Zhonghua Renmin Quanmin Suoyou Zhigongye Qiye Fa* [State-Owned Industrial Enterprise Law of the People's Republic of China] (Apr. 13, 1988), *Zhongguo Renming Gonghuguo Falu Fenglei Zonglan, Jingjifa*, VOL. 2. [Classified Assemblage of the law of the People's Republic of China, Economic Law] 1209. art. 5, 45. See also 1994 *Zhonghua Renmin Gongsi Fa* [1994 Company Law of the People's Republic of China]

⁹⁰ Walder, A. (1986), *supra* note 85 at 249

6.5.2 The economic reform and the changing relationship between the SOE and employee

Since 1978, China has chosen a route of evolutionary transformation from a central-planned economy to a free-market economy. In the late 1980s, the economic developments following the Four Modernizations of 1979 produced workplaces that were increasingly regulated by labour contracts, displacing the "iron-rice bowl" model of earlier years.⁹¹ Market reform has changed state-labour relations. The theory of all-people-owned labour has been replaced step by step by the labour commodity theory, along with the establishment of the labour contract system that the growing market economy called for.

When the theory of labour commodity became the dominant official ideology in the early 1990s, the government abandoned all ideological, political and moral imperatives for job security in SOEs. The transition to a socialist market economy in the 1990s coincided with a growing assumption of managerial control for employers."⁹² SOEs and their employees are now equal parties to an employment contract. One side

⁹¹ Won, J. (2004). "Withering away of the iron rice bowl? The reemployment project of post-socialist China." *Studies in Comparative International Development* 39(2): 71-93.; See also Peerenboom, R. (2001). "Globalization, Path Dependency and the Limits of Law: Administrative Law Reform and Rule of Law in the People's Republic of China." *Berkeley Journal of International Law* 19: 161, 208.

⁹² Nee, V. and Y. Cao (2005). "Market Transition and the Firm: Institutional Change and Income Inequality in Urban China." *Management and Organization Review* 1(1): 23.; See also Jonathan, P. and D. Greenfield (2004). "The Importance of Core Labor Rights in World Development." *The Michigan Journal of International Law* 26(39): 40.

sells its labour for living materials and another side buys labour for profits. Both sides are free to choose with whom they make an employment contract or terminate an employment contract for their own benefit as long as they do not violate the law.

The 15th Congress of the Chinese Communist Party (1997) stated that large and medium-sized state-owned enterprises should be corporatized and that the process of creating a modern enterprise system should be sped up.⁹³ Reform of SOEs in China implies a possible end to traditional labour relations and welfare provisions. Workers who will be laid off no longer depend on their firms as before, and their collective action is thus less risky.⁹⁴ Today in China, even though workers are considered as the masters of the State and enjoy very high political status in society, it has never been made clear how that important political and legal status is guaranteed in practice, especially in employment relationships.⁹⁵

6.5.3 The adaptation of corporate theory in China

The Chinese corporate governance approach, as will be shown in this study, has essentially been modelled on selected organizational features

⁹³ Wei, Y. W. (2003). "An Overview of Corporate Governance in China." *Journal of International Law and Commerce* 30: 23.

⁹⁴ Cai, Y. (2006). *State and laid-off workers in reform China : the silence and collective action of the retrenched*.

London, Routledge, at 4.

⁹⁵ Ibid.

of German and Anglo-American systems.⁹⁶ The government has adopted a rather legalistic approach based on rules apparently borrowed from mature market economies.⁹⁷ Chinese economists also seem to have adopted a definition of corporate governance that is primarily influenced by the agency-cost theory.⁹⁸ As Wu has argued:

“Because a company does not have its own mind and consciousness, only through an organization system—namely managerial staff directed by its corporate governance—it can be governed...A check and balance relationship is formed within that structure, through which the owner entrusts its capital to the board of directors.”⁹⁹

Thus, corporate governance is often taken by Chinese economists and policy makers to mean the organisational structure consisting of the owner, board of directors and senior managers. Within this structure a check and balance relationship is formed. In this structure the owner (often the state as majority owner) entrusts its capital to the board of directors. The board of directors is the highest level of decision making of the company and has the power to appoint, reward and penalise, and dismiss senior managers.¹⁰⁰ However, as already pointed out, a considerable amount of political interference remains through SASAC

⁹⁶ Tam, O. K. (1999). The development of corporate governance in China. Cheltenham, Edward Elgar, at 86.

⁹⁷ Ibid, at 19

⁹⁸ Ibid.

⁹⁹ WU, J. L. (1994). Xiandai Gongsi Yu Qiye Gaige (Modern Companies and Enterprise Reform). Tianjin. Tianjin Renmin Chubanshe, at 185.

¹⁰⁰ Ibid at 184.

and local BSAMs.

A modern corporate system is generally understood among Chinese policy makers and commentators to possess the following attributes:¹⁰¹

- * clearly clarified property rights;
- * designated authorities and responsibilities;
- * separated functions between government and enterprise;
- * scientific management.

According to the CCL 2005, Article 4, the shareholders of a company shall be entitled to enjoy the capital proceeds, participate in making important decisions, choose managers, and so on.¹⁰² Directors are under a duty to act in the best interest of the corporation under Article 47 of the CCL 2005.

6.5.4 Employee participation in corporate decision making-the law on paper

China's legal system had its origin in continental Europe. Europe's emphasis on "social solidarity", its scepticism about the merits of unfettered competition, and the formal inclusion of labour in corporate

¹⁰¹ This definition was first adopted in the 1993 CCP Decisions and reaffirmed in the 1999 Decisions.

¹⁰² The Company Law of the People's of China 2005, Article 4

management in some European countries all reflect the greater importance that European culture attaches to the community, particularly as opposed to American culture.¹⁰³ American doctrines of ‘employment at will’ and ‘freedom of contract’, both reflections of strong individualistic values, contrast with German concepts of ‘Labour rights’ and ‘good faith’ in contracting.¹⁰⁴

In 1993, China promulgated its first Company Law to regulate the formation, organisation or dissolution of companies. The ultimate ideological goal of the CCL 1994 is to:

“... adapt to the needs to establish a modern enterprise system, standardize the organization and activities of companies, protect the legitimate rights and interest of companies, shareholders and creditors, safeguard social and economic order and promote the development of the socialist market economy.”¹⁰⁵

Article 5 of the CCL 2005:

“When undertaking business operations, a company shall comply with the laws and administrative regulations, social morality and

¹⁰³ See Salacuse, J.W. (2006), "The cultural Roots of Corporate Governance", in Norton, J. J., J. Rickord, et al., Eds. (2006). Corporate governance Post-Enron: Comparative and international Perspectives. British Institute of International and comparative law, at 451.

¹⁰⁴ See Casper, S., (1999) "The Legal Framework for Corporate Governance: the Influence of Contract Law on Companies Strategies in Germany and the United States" in Hall, P. A. and D. W. Soskice (2001). Varieties of capitalism : the institutional foundations of comparative advantage. Oxford, Oxford University Press, at 387, 388.

¹⁰⁵ The Company Law of the People's Republic of China 1993 (Company Law 1993) Art.1

business morality. It shall act in good faith, accept the supervision of the government and the general public, and bear social responsibilities.”¹⁰⁶

The Chinese government has made provisions in its Company Law for employee participation in the corporate governance of SOEs through representation on the supervisory board.¹⁰⁷ Articles 45 and 68 of the CCL 2005 stipulate that a proper proportion of workers’ representatives should be elected as board members in limited liability companies established with investment from two SOEs or two state investment holding entities, or in state-funded companies. According to articles 52 and 124 of the CCL 2005, the boards of supervisors in limited liability companies and joint stock companies should also contain a proper proportion of workers’ representatives. Employees are represented to a significant extent on the boards of directors and supervisors of companies that have corporatized and transformed their ownership.

Chinese Company law 2005 also requires listed companies to adopt a two-tier board structure composed of a Board of Directors (BOD) and a Supervisory Board. The BOD is defined as a decision-making unit¹⁰⁸ and

¹⁰⁶ The Company law of the People’s Republic of China 2005 (Company Law 2005) Article 5

¹⁰⁷ Tam, O.K. (1999), *supra* note 96, at 61

¹⁰⁸ Among other duties, the BoD is empowered to appoint the CEO and other senior managers, call shareholders’ meetings, determine internal management systems and undertake other necessary decisions, authorised by shareholders.

the Supervisory Board as the “monitoring organ”.¹⁰⁹ Members of both the BOD and the Supervisory Board are appointed by, and report to shareholders. Listed companies in China are required to include a supervisory Board Report (SBR) in their annual reports by the Chinese Securities Regulatory Commission (CSRC).¹¹⁰

Notwithstanding the effectiveness of the current arrangement, this formalized participation reflects a line of thinking among Chinese policy makers that suggests some acceptance and recognition of the role of employees in the development of corporate governance.¹¹¹ Therefore it seems worthwhile to investigate whether the German two-tier board structure, which establishes some form of employee representation on board level, provides a potential way for introducing CSR requirements into Chinese law. The reality of reform has meant that many large SOEs have had to rid themselves of a considerable proportion of their often bloated work force leading to a number of problems.

At the same time in the private sector, poor conditions have lead to activist workers and campaigning lawyers and eventually the introduction

¹⁰⁹ The responsibilities of the Supervisory Board include (I) financial review; (II) monitoring directors' and managers' compliance with law, regulations and Articles of Incorporation, (III) requesting directors and managers to alter and /or rectify any of their personal actions if they are in conflict with the firm's objectives; (iv) proposing temporary shareholder meetings, whenever they deem them to be necessary; (v) fulfilling any other duties that are stipulated in the articles of association for the firming (vi) attending the meetings of the BoD; and (vii) submitting a report to the shareholders at the AGM. This list of activities illustrates the statutory role of the Supervisory Board.

¹¹⁰ This requirement is stipulated in CSRC (1998) “Standards on the Content and Format of Information Disclosure by Public Issuing Companies, No.2: Annual Reports.”

¹¹¹ Ibid.

of a new labour law.¹¹²

6.5.5 The employee participation in corporate affairs –the practice

I The Trade Union in China

Trade Unions are important organizations for workers in capitalist systems, although their power varies. It is found that two important factors determine the power of a trade union: First, the extent to which unions, as a broad national pattern, are integrated into the process of managerial decision making, especially concerning work reorganization. Secondly, is the existence of laws or corporatist bargaining arrangements that regulate firm-level union practice from outside the firm.¹¹³

Workers want unions to speak for them but are dissatisfied with their performance. However, communist systems are characterized by weak mass associations like trade unions. In the former Soviet Union: Prior to a take-over, communists inside the trade union movement strive unceasingly and by all means available to generate hostility to the capitalist state. Once in power, with the state now supposedly on the side

¹¹² See for example, Harney, A. (2008). The China price : the true cost of Chinese competitive advantage. London, New York, Penguin Books., Chapter 5 "The stirring masses"; Hassard, J., Sheenan, J. (2007) note 87, Chapter 7 "State Capitalism, Labour unrest and worker representation"; Philion, S. E. (2009). Workers' democracy in China's transition from state socialism, New York ; London, Routledge.

¹¹³ Turner, I. (1991). Democracy at work : changing world markets and the future of labor unions. Ithaca, N.Y., Cornell University Press, at 12.

of worker, the relationship is totally changed. This apparently signifies the trade unions' almost total surrender of their position as independent institutions to promote and defend the workers' interests and welfare.¹¹⁴

What happened in the former Soviet Union also holds true in China.¹¹⁵

Workers' interests are represented industrially through the All China Federation of Trade Unions (ACFTU)-the only workers' organization with legal approval. ACFTU are used to counting nearly 90 percent of state enterprise workers as formally trade union members, as was also the case with other former socialist states.¹¹⁶

The ACFTU was founded in 1925. It has always been closely aligned with the CCP. In 1949, the government passed a law authorizing the creation of a national union which role was taken over by the ACFTU. In the early 1950s any union leaders who tried to assert a role for the union independent from the party were removed from their posts. Therefore, the ACFTU became what was known as a 'transmission belt' for party propaganda as well as an enforcer of labour discipline. Rather it was the *danwei* work unit that looked after workers interests. During the chaotic period of the Cultural Revolution 1966-1976 unions were labelled as

¹¹⁴ Godson, J. (1981), "The Role of the Trade Union", in Schapiro, L. and J. Godson (1981). The Soviet worker : illusions and realities. London. The Macmillan Press at 106-29.

¹¹⁵ Lee, L. T. (1984). The structure of the trade union system in China, 1949-1966. [Hong Kong], Centre of Asian Studies, University of Hong Kong.

¹¹⁶ Pravda, A. and Ruble, B. (1986) "Communist Trade Unions: Varieties of Dualism," in Pravda, A. and B. A. Ruble (1986). Trade unions in communist states. Boston ; London, Allen & Unwin.

‘economist’ and ‘welfarist’ and had their meetings suspended. By the time economic reforms began in 1979, the ACFTU had been marginalized.¹¹⁷ Indeed, as early as 1955, in a report to the central government, the ACFTU admitted that “the phenomenon that the trade union demands independence from the Party has largely disappeared. It is now focused on production matters.”¹¹⁸ Consequently, as defined in the trade union charter, the major task of the trade union is to help management fulfil production goals. Under the planned economy the main work of the trade union officials was to organize production campaigns and deal with welfare issues such as housing, or as some unionists put it at a National People’s congress meeting in April 1994, “issuing film tickets, managing meal coupons and collecting bathing tickets.”¹¹⁹ To avoid potential conflict in the past, it has tended to concentrate its work in non-industrial areas such as welfare and housing

At the enterprise level there was often a closer alliance between the union, Party and enterprise manager than between the union and workers. Indeed for many a position in the union was a career path.¹²⁰ The trade union is a

¹¹⁷ See Harney, A. (2008), *supra* note 112, at 131-2.

¹¹⁸ The General Office of the All China Federation of Trade Unions (1989) (ed.), *Jianguo yilai zhonggong zhongyang guanyu gongren yundong wenjian xuanbian* (Selected the Foundaing of the PRC), Beijing: Gongren chubanshe, (Workers Press), at 357.

¹¹⁹ See “Trade unionists on the ‘new role’ of unions in the modern enterprise system” in Summary of World Broadcasts, FE/ 1966 G/5,08.04.1994.

¹²⁰ Although Chinese law says that trade union officers must be elected by workers or their representatives, all too often in practice they are appointed by the government or party. Even when workers do elect their own union leader, more often than not the leader turns out to be the government’s or party’s nominee. Indeed the Institute of Industrial Relations in Beijing’s Haidian district trains cadres for such positions. see Harney ante n 111 at 131 -134.

weak bureaucracy compared to others, in particular those which play key roles in economic planning and development. All bureaucracies are subsumed under the Party's tutelage, but the potentially 'subversive' nature of the union's role accords it closer Party state supervision.¹²¹ As Walder points out in his work on the Chinese enterprise, informal, client list relations between management and workers operated both to guarantee production and ensure a relatively privileged position for workers in state-owned enterprises.¹²² As a result union officials of this older ilk were not accustomed either to confronting management or to raising issues concerned with employment conditions and were to a certain extent side-lined by the informal relationships between management and workers.

The state has, nonetheless continued to exercise strong political control. While it has allowed managers to adopt capitalist techniques of control, extraction of effort and rationalization, it has not allowed workers an independent voice to pursue their interests in the new dispensation. Nor, until the new labour law in 2008, has it provided institutional arrangements which reliably protect their wages and conditions. As wage levels, hours of work, benefits and so on were stipulated during the period of central economic planning by the state rather than the enterprise, trade

¹²¹ As an example, trade union staff members have more difficulty getting approval to go abroad for training (as opposed to investigation tours) than functionaries from other bureaucracies.

¹²² Walder, A.G., (1986), *supra* note 85.

union officials at enterprise level seldom had to negotiate the baselines or confront management on these issues. Chinese workers have long realized the weakness of trade unions. In the mid-1980s, some workers pointed out that “that trade union should be disbanded or at least reorganized.”¹²³ The revival of ‘workers congresses’ in the mid 1980s in the SOEs, ostensibly to promote industrial democracy, has not been effective in achieving this goal. Both Phillion and to a lesser extent Hassard et al¹²⁴ document the unrest amongst workforces brought about by the reforms and the arguments for industrial democracy that emerged partly to defend what they had been promised under Mao, namely the welfare security of the ‘iron-rice bowl’ and the job security of the ‘iron armchair’. The reform produced new forms of coercion that characterised social relations in Chinese industry and new mechanisms of resistance to that coercion. According to Phillion resistance to the new forms of labour coercion and its attendant ideologies sheds light on the nature of the economic transition. A great deal of SOE’s workers’ anger was inflamed by corruption amongst cadres and officials becoming not only more common but also more transparent as the assets of many *danwei* were sold off in less than appropriate circumstances by a string of officially appointed managers.¹²⁵ Government became adept at dealing with protest

¹²³ The ACFTU, *Zhongguo zhigong duiwu zhuangkuang diaocha 196* (An Investigation of Chinese Workers 196), Beijing: Gongren chubanshe, (Workers Press). 1987

¹²⁴ See supra note 87.

¹²⁵ Phillion, S.E. (2009), supra note 112 at 2, 53-54.

and adopted an increasingly ritualized form of negotiations and increasing smaller compensation to workers for loss of their rights. However, the ‘enterprise paternalism’ mindset has been a real barrier to the capacity of SOE workers to engage in a discourse of industrial democracy in a way that might effectively create an alternative to the neoliberal privatization and the loss of social rights and security that the policy of reform demands. Equally failure has been in part due to weaknesses at the organizational level where the discourses on industrial democracy were self limiting. The party had always been against the formation of independent unions or indeed any organization which might function as a base for political opposition.¹²⁶

However, under the pressure coming from below, the voice within the ACFTU that calls for representation is growing. “Without representative and defence functions,” as one top ACFTU official explicitly claimed, “the existence of the union is unnecessary.”¹²⁷ Union cadres from the ACFTU to its subsidiary branches have shown their desire to perform these functions. “We owe workers so much. If we do not represent them, what use does the union have?” said one union official in Shanghai. Gongyun yanjiu (Labour Movement Research), an ACFTU journal, now

¹²⁶ Philion, S.E.(2009), *supra* note 112 at 144-146.

¹²⁷ Zhang Junjiu(1999), "Gonghui Yaozai Guoqi Gaigezhong Shixian Wu Tupo Yi Jjiaqiang" ("The trade union should realize ‘five breakthroughs’ and ‘one enhancement’ in the reform of SOEs"). in *Gonghui ruhe canyu guoqi gaige* (How the Unions Participate in the Reform of SOEs), Gongyun ziliao bianqi bu (the editorial department of "Labour Movement Reference Materials"), at 183.

publishes more and more articles by union cadres and labour researchers that openly express their frustration and dissatisfaction with the current state of trade unions. They criticize unions' role as "ambiguous" and their status as "dependent," and complain that unions' rights stipulated in the Trade Union Law are "unenforceable" and "amount to nothing." Some even imply that the socio-economic basis for officially run unions (guanban gonghui) no longer exists with the abandonment of a planned economy, and call for "a redefinition of unions' status and role" in the market economy.¹²⁸

Although trade unions try to advance the economic interests of workers at both the central and local levels¹²⁹, their institutional weaknesses severely limit their effectiveness. Their operations are commonly either formalistic, co-opted by management or the Party or both. Hence in the reform period, although the trade union has tried to fight for workers and has become the "most important source" for negative news of high-level governments,¹³⁰ it can hardly function as an independent organization or assume the role of organizers for workers' collective action against the management, not to mention against the government.¹³¹ For example, the union chairman at

¹²⁸ Chen, F. (2003). "Between the State and Labour The Conflict of Chinese Trade Unions' Double Identity in Market Reform." *The China Quarterly* 176: 1011.

¹²⁹ Chan, A. (1993). "Revolution or Corporatism? Workers and Trade Unions in Post-Mao China." *The Australian Journal of Chinese Affairs* 29: 31-61.; Chen, F.(2003), supra note 127, at 1006-28.

¹³⁰ Gongren Ribao (Workers daily) August 10, 1998.

¹³¹ Weston , T. (2002). "'Learning from Daqing': More Dark Clouds for workers in State-Owned Enterprises." *Journal of Contemporary China* 11(33).; Chen, F.,(2003), supra note 127 at 1006-28.

an SOE in Xi'an opposed the manager's proposal that workers who failed to buy shares in the enterprise be arranged for *xiagang* (laid off). He was dismissed.¹³² The union chairman at another SOE in Jinan, Shangdong province accused the manager of corruption and extravagant spending of company funds for his private benefit that had caused wage arrears for workers for months. He was removed from his post by the management.¹³³

The ACFTU has tried to strengthen its representing role in industrial conflict. It's most recent effort was a push to have the Trade Union Law amended so that it might give unions some more muscle when it comes to representing labour. In addition to some revisions and new articles that define "defending workers' legitimate rights as unions' fundamental and only responsibility," and that make the Law more enforceable, a significant amendment to Article 27 is that unions are allowed to represent workers in the event of collective action in order to "talk things out" (*xieshang*) with management.¹³⁴ However, to what extent this article can translate into some real power for unions remains to be seen.

Lacking effective state protection as well as organizations of their own, workers have become increasingly vulnerable to the "whip of the market"

¹³² Gongren Ribao (Workers' Daily), 9 August 1999.

¹³³ Ibid. 10, July 1999.

¹³⁴ Gongren Ribao (Workers' Daily), 28 October 2001.

and to despotic managerial power.¹³⁵ As a result workers will be even less convinced of the utility of taking their grievances to the unions. With this channel of articulation becoming increasingly redundant, they are likely to seek other forms of self-expression, be that passive forms of resistance such as a lack of enthusiasm on the job or more active ways such as strikes and go-slows. But spontaneous contentions-no matter whether undertaken by workers in the private or state sectors or by those already laid off-do create a situation of "collective bargaining by riots"¹³⁶ that places pressure on management or governmental agencies

II The Works Council in China

Most SOEs have signed to strengthen workers' "democratic management" in enterprises. However, while the Enterprise Law empowers Works council to participate in enterprise administration, scrutinize policies advanced by the management, and supervise managers' performance,¹³⁷ their actual role is extremely limited. Few managers take the councils seriously. Asserting that they are the sole persons who have the legal right to make managerial decisions, managers either simply ignore Works

¹³⁵ Lee, C. K. (1999). "From organized dependence to disorganized despotism: changing labor regimes in Chinese factories." *The China Quarterly* 157.

¹³⁶ Tarrow, S. G. (1998). *Power in movement : social movements and contentious politics*. Cambridge, Cambridge University Press, at 34.

¹³⁷ Zhang, Y. Q. (1997). "An Intermediary: The Chinese Perception of Trade Unions since the 1980s." *Journal of Contemporary China* 6(14).

council or just treat their activities as a matter of formality or ritual.¹³⁸

Reform plans such as bankruptcy, merger, privatization, and layoffs are commonly carried out without the approval of the works council. Yet, despite its weak position, workers in China still look to the council to protect their interests. The reform period has seen a number of attempts by workers to prevent undesirable reform measures on grounds that the reform plan has not been approved by the works council.¹³⁹ But local governments may claim that SOEs belong to the state, so workers are not the legal owners and their approval is unnecessary. Thus, more often than not, workers' action fails.¹⁴⁰

6.6 Conclusion

The rapidity and scale of China's transformation requires that these developments are adopted quickly to avoid exacerbation of the severe social and political consequences which are already in evidence. The Kenan Working Group on CSR in China has published a new report which suggests that if policymakers and citizens want China's social and

¹³⁸ Gongren RiBao (*Workers' Daily*) 13 July 1998

¹³⁹ For example, when the Chongqing Knitting Factory was declared bankrupt in 1992, workers were greatly agitated. More than 200 workers forced their manager to go to the local court to withdraw the bankruptcy application because, as they claimed, the reform plans had not been approved by the workers' council. Xie Delu (1993), *Zhongguo zuida pochanan toushi* (A Comprehensive Perspective on China's Biggest Bankruptcy Case), Beijing Jingji guanli chubanshe (Economy and Management Press).

¹⁴⁰ Tian, Zehong (1999), "Guanyu dui pochan qiye zhaokai zhidaihui wenti de sikao" (Some Thoughts on the Convening of the Workers' Council in Bankrupt Enterprises), Beijing gongren (Beijing Workers Press), no.1,3-4.

environmental progress to run in line with its economic growth, they must develop and implement innovative ideas that encourage positive change.¹⁴¹

Again ,the decline and collapse of the socialist economies of the Soviet Union and Eastern Europe; the rapid development of East and Southeast Asian economies; and a gradual realization on the part of the Chinese leadership that economic development lay, not in developing an indigenous version of the Soviet model but in an indigenous version of the ‘Asian’ model.

The answer is by no means clear, but the experience for Chinese workers is so different from that of their European counterparts before them, that it is unlikely to be similar. For Chinese workers, the dominance of the state’s social control, not least as employer; the traditions of worker-management compliance; the vast labour reserve in the countryside and the extent of foreign investment will ensure that their response is significantly different.¹⁴² The role of the CCP and its political oversight limits and restricts any real potential for independent worker participation in business. The old enterprise paternalist mindset inculcated into SOE

¹⁴¹ Source: “Promoting CSR in China: Statement of Finding Released”, November 2004
<http://www.csrwire.com/News/3088.html>

¹⁴² O’Leary, G. (1998). *Adjusting to capitalism : Chinese workers and the state*. Armonk, N.Y. ; London, M.E. Sharpe, at xv.

workforces is continued in various new ways in both the state and private sectors. The historical progress of the reform, cultural mindset and continuing political oversight in a society now emphasizing a 'harmonious society' as its current leading norm has meant that the corporate governance elements of co-determination adopted from Germany will follow a particularly Chinese path.

And again, the scale of the Chinese transformation is so much greater than the whole of Europe's industrial revolution and its pace so much more rapid that the comparison with Europe's experience becomes tenuous.

143

¹⁴³ Ibid.

Chapter 7 Conclusion

In this study, I focus on the issue of the development of corporate governance in China including its selective adaptation of elements of governance structures from Western models of corporate governance. I have also explored whether China's political, social, cultural, and legal traditions will continue to influence the continuing developments in Chinese company law, or whether the evolution of China's corporate governance system must inevitably converge with Western models, particularly the Anglo-American system if it is to succeed economically in terms of the competition that exists between governance systems.

When learning from the West in finding appropriate measures, care needs to be taken to understand the background and reasoning to the measures adopted in the West and whether such measures are likely to work in China. Simply copying from the West without effective implementation and compliance of the standards to appease international investors is unlikely to work in the long run. I have considered in outline several theoretical frameworks, particularly agency theory, political determinants, stakeholder theory and corporate social responsibility as well as the law matters thesis and path dependency. In the context of China, all of these approaches have some insights to offer. However, as I hope I have

demonstrated, in the particular circumstances of China the historical development and strength of culture (which though it changes over time) combined with a strong centralization of power moderated by local political, social and economic imperatives have all impacted on the development of corporate governance. Adoption of new laws has been partially successful as they become embedded with Chinese legal characteristics.

Because each corporate governance system has within it political, social, economic, and cultural variations that play a greater or lesser role in how flexible and accommodating those investors will be towards those who act as their economic agents. Thus, the success of the convergence will depend not only on learning from the West and designing laws, rules, and regulations that are suitable to the Chinese social and economic developments and legal culture, but also on the supporting legal infrastructure such as the quality of judges and the independence and efficiency of the judiciary and the appropriate mix of government regulation and self-regulation. Indeed as already discussed the judiciary in China play a different role to those in a Western democracy. Most importantly, the effective enforcement of the law and the provision of appropriate remedies are lacking in China.¹ Pitman Potter argues that

¹ Shi, C. (March 22, 2004). How to Avoid Gangster Capitalism. South China Morning Post: 13.

China is engaging in selective adaptation of international norms and the success of that exercise depends also on institutional capacity building.²

First this study highlights the difference between the legal cultures and is an important factor in identifying how the Chinese tradition and the Western models can achieve consensus in what serves as the appropriate model for a modern Chinese corporate governance system. Corporate governance has been a globally debated topic. With multinational corporations entering new global market, it is clear that there are some differences in corporate governance rules among the various legal systems. China has quite a long history of trying to reform the organization of enterprise by introducing western style corporate forms since the late 19th century with varied success.³ The latest and most comprehensive revision took place in October 2005. As a continuation of many earlier efforts it remains to be seen how successful it will be over the medium term. In the late Qing dynasty, Chinese reformers grappled with models derived mainly from Germany as conveyed by the Japanese. The first Chinese Corporate Law was enacted in January 1904, during the late Qing Dynasty. China then adopted certain Soviet legal forms in the 1950s and Western models again in the 1980s. Unfortunately, none of these appear to have yielded much success. They appear to be examples

² Potter, P. (2004). "Legal Reform in China-Institutions, Culture, and Selective Adaptation." Law&Social Inquiry 2(4): 465-95.

³ Promulgated by the president of the PRC on the same day. The Law became effective on 1 July 1994.

of legal transplantation that have been at best only partially successful.

First, within China's existing political structure and traditional culture, legal processes can never escape political pressures. "At the heart of the matter is the manner in which culture, as a process, tends, cultivates and regulates particular types of economic outcomes."⁴ In China, the existence of Confucian and communist traditions has left deep impressions in the social fabric and the economic landscape.⁵

I have emphasized how the law was often limited in China and subservient to Confucian and Neo Confucian codes of conduct. Confucian governance was thus a matter of using moral teaching to shape people's behaviour. To some considerable extent these ideas of order, harmony and mediation have remained of considerable importance in Chinese society, despite the class struggle and chaos of the Cultural Revolution. Whilst the idea of rule of law gained popularity it has often been translated as rule by law as the legal process as part of the economic reforms became a means of policy implementation at various levels of government.

⁴ Tricker, R., I., "Corporate Governance: A Ripple on the Cultural Reflection", in Clegg, S., S. G. Redding, et al. (1990). *Capitalism in contrasting cultures*. Berlin ; New York, W. de Gruyter, at 38.

⁵ For a discussion of path dependence in China's economic transition, See Guthrie, D. (2002). *Dragon in a three-piece suit : the emergence of capitalism in China*. Princeton, N.J. ; Woodstock, Princeton University Press, at 24-41. Some of the distinctive features of Chinese corporate governance are discussed by Tam, O.K. (1999). *The Development of Corporate Governance in China*, Cheltenham, Edward Elgar.

Therefore, Chinese culture puts more emphasis on morality and arts, human responsibilities and unity, while Western culture stresses science and religion, individuals' freedom and differentiation.⁶ Core values in economic behavior include a "concern for reconciliation, harmony [and] balance" coupled with "practicality as a central focus."⁷ Culture, in the sense of basic societal norms has always been important.⁸ The fusion of the concept of family with that of state thus provided a basis for elevating morality to the status of state law.⁹ Law has always been an instrument of the state in China often focusing on responsibilities to the state.¹⁰ As such it was not very interested in social regulations among autonomous individuals, and least of all in defending individual rights against the state.¹¹ Whilst there has often been litigation in classical China it always had peculiarities of its own.¹² Whilst the role of law declined post 1949, alongside the imperial traditions, the communist legacy has been a major source of influence on today's legal system in China.¹³ During this period,

⁶ Tang, J.Y., "Moral Idealism and Chinese Culture", in Cheng, Z.-y. and N. Bunnin (2002). Contemporary Chinese philosophy. Oxford, Blackwell Publishers.

⁷ Ibid. at 76

⁸ It is stated in the Great Learning, one of the Confucian classics, that: 'The ancients who wished to illustrate illustrious virtue through the Kingdom, first ordered well their own states. Wishing to order well their states, they regulated their families. Wishing to regulate their families, they first cultivated their persons' Cited in Qu, T. (1965). Law and Society in traditional china. Paris, Mouton, at 255.

⁹ In fact, a great part of Confucianism is the rational justification or theoretical expression of the Chinese family system as a social system. See Fung, Y.-L. (1966). A short history of Chinese philosophy. N.Y. : London : Free Pr. : Collier-Macmillan, at 147.; Qu, T. (1965), Supra note 8, at 22-22.

¹⁰ In contrast to traditional China. 'The monarch (of medieval Europe), it is argued, may make law, but he may not make it arbitrarily, and until he has remade it-lawfully -he is bound by it.' See Berman, H. J. (1983). Law and revolution:the Formation of the Western Legal Tradition, Cambridge, at 93.

¹¹ Bodde, D. and C. Morris (1967). Law in Imperial China: exemplified by 190 Ch'ing Dynasty cases. with historical, social, and juridical commentaries. Cambridge (Mass.): Harvard University Press; London: Oxford University Press, at 4.

¹² Wang, C-H.,(1963), 'Legal Reform in China', in Chinese Social and Political Review, Jun 1917, quoted in Cameron,M. F., The Reform Movement in China 1898-1912 (New York: Octagon Books.), at 174.

¹³ The communist era is defined here as the era from the communist victory in 1949 to the beginning of the economic reforms in 1979. Although, the Chinese Communist Party continues to monopolize political power in

the function of Law and the legal system was reduced to serve the communist government as an instrument. The notion of an independent legal system governing all actors in a society was as alien to the Chinese communists as it was to the imperial mandarins.

China started its economic reform and open-door policies in 1978, and the Chinese communism party insisted that in the primary stage of socialism, the task of law was to facilitate development of the market economy, to assist maintaining public order and to eliminate political threats.¹⁴ Indeed, the Chinese government made no effort to hide the guidance (as one form of control) of the CCP over the building of the legal system. The central role of the Party in Chinese listed companies has in reality been strengthened in the 2005 amendments to the PRC Company Law.¹⁵

The Party's role is central within most listed Chinese companies and Art 19 of the Company Law (as amended in 2005) provides that the party shall be established in every company. As a result, it is often the case that the Chairman of the company is also the Party Secretary of the local Communist Party branch within the company, effectively fusing

China, gradual but substantial changes have taken place in China's economic and the political system. The complexity of the political system in China today is such that it is no longer appropriate to characterize the present regime as communist.

¹⁴ Wen Jiabao, Prime Minister of China, "Our Historical Tasks at the Primary Stage of Socialism" Beijing Review, 2007, 12, available at http://www.bjreview.com.cn/lianghui/txt/2007-03/12/content_58768.htm

¹⁵ Art 19 of the 2005 version of the Company Law (amended in October 2005) is much stronger than the equivalent provision (Art 17) of the 1994 version

managerial and political control in one office. Senior managers are often, in reality political appointees who have considerations of a political and social nature (as well as self interest) rather than maximizing shareholder wealth. The recent reforms in relation to BSAMs have only served to reinforce this trend.

The Chinese corporate governance approach, as shown in this study, has essentially been modelled on selected organizational features of German and Anglo-American systems.¹⁶ For example, the regulatory body adopted policies based on La Porta's scholarship on the positive link between capital market development and public shareholder protection.¹⁷ However, China's market suffers from a lack of liquidity and an active corporate control market does not exist in China. Similarly, I have shown how the internal elements of corporate governance, the two tier board and in particular the bolting on independent directors have raised more problems than it solves. This is because in the political and cultural context of China a different milieu applies which often exacerbates the type of problems encountered in the west, especially in relation to

¹⁶ Tam, O.K., (1999), *The development of Corporate Governance in China*, Edward Elgar, at24

¹⁷ See generally La Porta, R., F. Lopez-De-Silanes, et al. (2000). "Investor protection and corporate governance." *Journal of Financial Economics* 58(1-2): 3-27.; La Porta, R., F. LopezDeSilanes, et al. (1997). "Legal determinants of external finance." *Journal of Finance* 52(3): 1131-1150. (Postulating that poor investor protections result in capital markets that are both smaller and narrower). In a speech given at the International Seminar on Investor Protection in June 2002, Zhou Xiaochuan, then the Chairman of the CSRC, specifically mentioned that "foreign research proves that the better investor protections in a country or a region, the better developed the capital market [in that country or region], and the stronger its capability to resist financial risks." Zhou Xiaochuan, Baohu 'Touzizhe Quanyi Shuli Touzizhe Xinxin Guanxi Zhongda (To Protect Investors' Rights and Interests and to Build Up Investors' Confidence Are Critical), Zhengquan Shibao (Securities Times) (P.R.C.), June 26, 2002, available at http://news.xinhuanet.com/fortune/2002-06/26/content_457416.htm

independent non executive directors reinforcing the tendency to follow the leader irrespective of whether they are acting in an appropriate manner.

The securities market principal watchdog - the China Securities Regulatory Commission (CSRC), has, in practice, has long been criticized for its failure to react to and probe into the various blunt market abuses punctually, due to its lack of competent staff or some political concerns. Indeed, they have to face conflicting situations. On the one hand, the controlling shareholders of most listed companies are usually local governments or entities controlled by them. On the other hand, as a quasi-governmental agency, the CSRC lacks independence and is ultimately subject to government will. Its bureaucrats do not have the same rank as those from the relevant ministries controlling various sectors of the economy. In fact, at times the CSRC even gets blamed for being unable to control the corruption cases that its own investigative efforts are increasingly bringing to light. Investment funds speculation, using inside information, has been particularly problematic.¹⁸

Nor has the judiciary in China played a dynamic role in developing a

¹⁸ The General Administration of Sports was reported to have appropriated 131 million yuan (US\$15.8 million) for the 2008 Beijing Olympic Organizing Committee since 1999. About 109 million yuan (US\$13.2 million) of the money was misused to invest in Chinese stockmarket. See "Auditor: Central government misuses US\$1.1b of funds." http://www.chinadaily.com.cn/english/doc/2005-06/29/content_455557.htm

body of law to protect the interests of minority shareholders. Rather until very recently bureaucracy often suspended relevant cases or declared the courts ill equipped to deal with such cases. The Chinese view their judicial system as merely another bureaucratic body. The Chinese courts are widely perceived to lack independence or experience in dealing with corporate and securities disputes. Because it is not unusual for courts to decide not to deal with a particular matter, often regarding it as beyond their competence, and instead referring it to another branch of government major problems are swept under the carpet.¹⁹ Courts are also reluctant to implement or enforce their judgements (especially those involving coercive measures) against state-owned enterprises if they were responsible for the same locality, or if their judgments led to the closure of the enterprise and unemployment of workers.²⁰ To make things worse, the Supreme People's Court of China even banned temporarily lower courts hearing cases against corporate fraud in the middle of 2001, due to the lack of competent judges familiar with securities market rules and the inability of procedural rules dealing with such matters. In 2003, the Supreme People's Court introduced guidelines to allow local courts to hear actions brought by individual shareholders for false statements issued by directors about the company, but the civil case shall not be accepted by the court, unless the cause of action is based on the

¹⁹ Tomasic, R. and Andrews N., (2007) "Minority shareholder protection in China's top 100 listed companies", *Australian journal of Asian law*, 9 (1), at 141.

²⁰ *Ibid*, at 141.

conclusion reached by the CSRC or other state organs such as the Ministry of Finance.²¹ In practice, although many company directors have been punished by either administrative sanction or criminal prosecution as a result of making false disclosures, frauds and market manipulations, the injured shareholders have been left without proper remedies in respect of matters of illegal actions.

Institutional investors in China generally play an even less constructive role in China than they do in the Western context because of similar factors and the added complexity of the Chinese situation. This research focused on securities investment funds, because they have been the principal players in the recent movement toward greater institutional activism.

In theory, institutions are expected to take a long-term view of their shareholding positions, and where necessary, incur expense in intervening to correct mismanagement. Thus, the rise in institutional shareholdings has led many commentators optimistically to predict the end of the separation of ownership and control.²² Since 1990s the Chinese authority introduced a series of complementary reforms to build the institutional

²¹ The Supreme People's Court guidelines 2003 , Art.6

²² See, for example Barnard, J. W. (1991). "Institutional investors and the new corporate governance." North Carolina Law Review 69: 1135-1187.

mechanisms for greater corporate accountability. In the early stages, investment funds operated in China on a self-regulating basis without much legal status. Thus, these funds ran into many problems due to a lack of uniformity. Some funds invested heavily in real estate resulting in a low liquidity,²³ some lent fund capital at high interests,²⁴ and some fund managers invested in the name of the investment funds with capital from other sources.²⁵ On 28 October, 2003, The Standing Committee of the National People's Congress published the securities investment funds law.

The CSRC believe that investment funds can improve corporate governance of State Own Enterprises (SOEs). They insisted that, because the shares that the public holds are widely dispersed, individual investors have too small a stake to justify monitoring costs; thus, they cannot exert enough discipline for companies to improve their operation. They believe that investment funds can act as an important force in the shareholder structure of companies transformed from SOEs. As long-term shareholders, the investment funds have incentives to monitor the management of companies and give suggestions concerning their operation. Consequently, the participation of funds can exert more discipline on companies and improve their management.

²³ See "Funds Can Curb Market Volatility", *China Daily Bus. Wkly.*, Sept. 7, 1997, at 3

²⁴ See Cong Touzi Yunzuo Kan Xianyou Jijin De Chulu (Looking at the Future of Current Funds from the Perspective of Investment Operation), *Zhengquan Shibao* (Securities Times), Nov. 24, 1997, at 11.

²⁵ Some listed companies entrusted fund managers to invest their capital in the securities market, which has seriously infringed upon the interests of investors of these companies. See *ibid.*

However, investment funds can not really achieve those kinds of goals under the new law in China as examined in Chapter 4. The funds manager is required to carry out the day to day management function of the investment funds. There are two basic duties placed on the funds manager. One is that as a normal company under the company law regulations, they have to increase returns for their company and its shareholders; on the other hand the managing company acts as a funds manager under the securities investment funds and contract law regulation, they have to take care of investment funds for the funds investor. This can give rise to a conflict or divergence of interests and requires consideration of how the law deals with these issues. The main argument is that the interests of institutional investors and their controllers would often lead them to act in their own best interest and sacrifice shareholder value.

The main obligation of the fund custodian is safekeeping and supervision. A fund custodian must be a commercial bank which has been authorized by CSRC and China Banking Regulatory Commission (CBRC) and has met the requirement of the securities investment funds law. However, in practice, there are two main reasons which impact on those commercial banks to exercise such supervisions. An investment funds manager is an attractive customer for those banks. Because a funds manager has the

right to choose a bank to hold a vast sum of funds that has been raised from the market. Under the increase market pressures, the fund custodians have to decide whether to lose those valuable customers or to 'accept' them. The fund custodian has no right to supervise the decision made by the funds manager, nor does it have the ability to understand whether or not the decision made by the funds manager has involved problems of related transactions, and whether or not the decision is in the interest of the funds investor. So far, there is no report on the fund custodian using his authority to fire the fund manager because of misconduct.

Another accusation levelled against activist funds is that activism is designed to achieve a short-term payoff at the expense of long-term profit ability. In China, tradable shares amount to about one-third of all outstanding shares. Of these tradable shares, securities investment funds hold an average of about 15 percent.²⁶ Though significant, institutional shareholding represents, therefore, only a relatively small stake in the portfolio companies. Institutional investors generally are profit maximizers, they will not engage in an activity whose costs exceed its benefits. Institutions are unlikely to be involved in day-to-day corporate matters. Thus institutional investors lack the incentives to be active in

²⁶ "Zhengjianhui Fuzeren jiu Gugai he IPO deng Wenti Fabiao Tanhua" (CSRC's Responsible Officers Gave Talks on Issues of the Share Structure Reform and IPO), Shanghai Zhengquan Bao (Shanghai Securities News), April 28, 2006.

terms of monitoring they are prone to follow the Wall Street rule of selling their stock when disappointed.

In the chapter on Industrial democracy, which examined the issues that have arisen in relation to efforts in recent years to transplant German and Anglo-American corporate governance mechanisms to China, I explored corporate governance practices associated with shareholder value maximization versus stakeholder value maximization principles in China in the context of co-determination.

Managers as the agents of the shareholders of a firm are supposed to make decisions based on the shareholder value maximization principle; subject to the existing contractual relationships with others, such as employees. The current campaign of 'building a socialist harmonious society' has paved the way for Chinese corporate governance, especially in dealing with the relationship between shareholders, management and other stakeholders, such as the employee.

Since the communist government came to power in 1949, it has assumed the responsibilities of protecting all worker interests. Communism produced a class of workers with strong emotional ties to and material interest in maintaining that system.

At that day, Chinese SOEs used to be production units as well as social and political organizations responsible for their employees' welfare. Labour relations in SOEs in China were characterized as "organized dependence" of workers on firms. In this arrangement, workers depended on their work units or employers for highly secure jobs as well as cradle-to-grave welfare coverage, although provisions of welfare varied across firms. Membership as a SOE worker was of great value to workers not only because of the monetary benefits, but also because they regard their job as their whole life position and their social identity within society.²⁷

In the pre-reform period, though SOE workers also have the right to participate in the enterprise's democratic management, they participate in and supervise the management through the Employee Representative Conference (zhigong daibiao dahui).²⁸ However, their dependence on SOEs for almost all their basic needs and a lack of alternatives gave management powerful leverage over workers.

Since 1978, the state is appears less concerned with socialist ideology,

²⁷ Walder, A. G. (1986). *Communist neo-traditionalism: work and authority in Chinese industry*, Berkely, London. University of California Press

²⁸ Zhonghua Renmin Quanmin Suoyou Zhigongye Qiye Fa (State-Owned Industrial Enterprise Law of the People's Republic of China)(Apr. 13, 1988) 1994 Zhonghua Renmin Gohgheguo Falu Fenlei Zonglan, Jinji Fa, Vol. 2 (Classified Assemblage of the Law of the People's Republic of China, Economic Law) 1209, art. 5. See also Zhonghua Renmin Gongsi Fa (Company Law of the People's Republic of China) (Jul. 1, 1994) 1994 Zhonghua Renmin Gohgheguo Falu Fenlei Zonglan, Jinji Fa, Vol. 2 (Classified Assemblage of the Law of the People's Republic of China, Economic Law) 1034, art. 45, 55

rather China's pragmatic policy goals are economic development and a stable society. Market reform has changed state–labour relations. The theory of all-people-owned labour has been replaced step by step by the labour commodity theory, along with the establishment of the labour contract system that the growing market economy called for.

On paper, the Chinese government has made provisions in its Company Law for employee participation in the corporate governance of SOEs through representation on the supervisory board.²⁹ The system of a supervisory board was seemingly inspired by the German style of corporate governance. However, the Chinese supervisory board's apparent resemblance to the German model is confined mostly to its name and the participation of workers.

The number of supervisors could be just one or two for smaller limited liability companies, and greater than three in the case of joint stock limited liability companies. Therefore, these employees cannot reasonably be expected to carry out effectively the primary supervisory board role as this would be likely to involve confrontation with their superiors in the company hierarchy for whom they work. Given its limited function and unclear mode of operation, the supervisory board

²⁹ Tam, O.K.,(1999), *supra* note 16 , at 61

cannot be expected to play an effective role.

Again, the establishment of the supervisory board in China is not based on the same social and philosophical considerations as for the setting up of supervisory boards in the German codetermination model of corporate governance. In Germany, another form of labour representation in business decision-making is Work Councils Codetermination. German law gave Work Councils rights to co-determination with the Management Board in connection with dismissal, employee vocational training and grievances. But in China, that is a different story. Communist systems are characterized by weak mass associations like trade unions. The trade unions' had made an almost total surrender of their position as independent institutions to promote and defend the workers' interests and welfare.

It can hardly function as an independent organization or assume the role of organizers for workers' collective action against the management, not to mention against the government. Their operations are commonly either formalistic, co-opted by management or the Party or both.

Work Councils is another form of labor representation in business decision-making in China. Most SOEs have signed to strengthen workers'

"democratic management" in enterprises. The Enterprise Law empowers Works council to participate in enterprise administration. However, in practice few managers take the councils seriously. Asserting that they are the sole persons who have the legal right to make managerial decisions, managers either simply ignore Works council or just treat their activities as a matter of formality or ritual.

With this channel of articulation becoming increasingly redundant, they are likely to seek other forms of self-expression. This creates a situation of "collective bargaining by riots" that places pressure on management or governmental agencies. Whilst the reforms resulted in rationalization leading to mass layoffs there was some attempt by the workers to use arguments along co-determination lines to protect their interests but these were generally a failure in part to the lack of institutional strength on the part of workers organizations and the paternalist mentality of the workers themselves.

Since coming to power in 2003, facing serious social issues, the new generation of leaders in China has put forth a series of new guidelines and policies towards building a socialist harmonious society. These new guidelines and policies have pointed the way for corporate governance. The Chinese Communist Party in its 16th plenum raised the ideas of

‘respecting labour, respecting knowledge, respecting intellectuals, and respecting creativity,” and required the strengthening of the labour protection system in enterprise. How this approach will lead to any substantive change in relation to the role of employees in corporate governance remains to be seen.

To summarise the situation to date, the very different political, social and cultural context of China has resulted in a form of corporate governance which is still very Chinese in character once one looks beyond the form of governance structures adapted from Europe and Anglo-American model. The substance of the reality is largely determined by the political imperatives (and hence determinants), the culture and other factors particular to China, like the role of *guanxi*. In that sense corporate governance in China is truly a ‘law unto’ itself.

The future of China’s corporate governance reforms

Based on the above assessments, a reasonable order of reform measures at the next stage can be designed

First, the differentiated treatment of shares is a historical problem in China’s securities market: there are different policy treatments between

tradable and non-tradable shares upon the issuance of the stock. Non-tradable shares cannot be traded in the market, but the holders of these non-tradable shares control the company. For a long time, this differentiated treatment has caused many problems in corporate governance, such as the dominances by one majority shareholder. Many majority shareholders control all the assets in the company and therefore infringe upon the interests of the minority shareholders. The difficulty is in designing a selling plan that could be accepted by both the Government and the public investors. However, the removal of barriers in relation to these categories of shares would go some way to helping to create a more balanced market in relation to the many thousands of SOEs that the state is willing to let go.

A large shareholding by the state in the companies gives it economic power to exert administrative intervention and thus influence market rules. As discussed before, state-owned enterprises are more likely to pursue non-wealth maximizing goals. When the stock market is also used to achieve the political goal that the governments will maintain the control of the large SOEs in many sectors of the economy, it is unlikely that the Western style of corporate regulation will be strictly enforced. In addition, the high savings rate and lack of alternative investment channels explain why the stock market in China could develop quickly even though

investors were frequently cheated.

Recently, China's main stock exchange plans to launch an international board in 2010 that would allow foreign companies to sell shares denominated in Chinese currency for the first time.³⁰ Companies from the UK and other foreign countries will be able to have their shares traded on Chinese stock markets. Shanghai deputy Mayor Tu Guangshao, the former vice-chairman of the China Securities Regulatory Commission (CSRC), said in an interview that the international board is expected to be launched next year.

Indeed, a listing on a Chinese stock exchange could help foreign companies by allowing them to tap China's huge pool of savings and by raising their public profile. It is unknown so far to what extent this new plan will contribute to a good corporate governance practice. Clearly, it will change the picture that the SOE is the dominant player in the Chinese stock market. The other important development that could help many thousands of other privately held companies in China gain access to equity capital and again add diversity and investor choice to the stock markets would be to make it easier for privately owned corporate

³⁰ The Shanghai Stock Exchange is working on the board as part of efforts to promote the city as a regional financial center, the newspaper Shanghai Daily said, citing a Shanghai deputy mayor. "The board is expected to be launched next year," the deputy mayor, Tu Guangshao, said in comments Chinadaily 2009-08-07.

businesses in China to list on the stock exchange. Therefore a combination of privatisation of SOEs, more liquidity in the categories of shares, foreign listings in China and easing of opportunity for private corporate businesses to list on the Chinese exchanges would over time revolutionise the Chinese stock markets.

Second, the quality of the judiciary has improved tremendously over the last decade or so, but judicial independence and expertise needs to be further enhanced. A system of binding judicial precedents would also help to enable judges to develop principles of law in a predictable way to fill any legislative gaps. It is imperative that a case reporting system is developed in China. It is one of the greatest criticisms of both academic and practising lawyers in China that a reporting system does not yet exist. Such a system would slowly help in the training and practice of law and also the accountability of the judiciary.

Thirdly, the CSRC in China is currently too weak to curb serious securities fraud. In the meantime, the urgent task is reducing government intervention in the day-to-day workings of the stock market and making the CSRC independent of the Government and free from conflicting responsibilities. This will essentially strengthen the regulatory capacity of the CSRC and make it easier for the CSRC to punish violations, thereby

creating a favourable external environment for corporate governance reform of listed companies. As part of such a reform the ranking of the officials of the CSRC should be increased on par with those of leading industrial sector ministries. This would, in the cultural and political context of China do more to help them successfully carry out their allotted functions.

In addition, China still has not adopted international accounting standards. This, coupled with the common problems of fraud and false accounting, makes it hard for investors to be confident about the financial health of the companies. The next step is to deepen legal and regulatory reforms aimed at improving information disclosure and corporate transparency. Hand in hand with this development is the need to train accountants to high standards. In recent years there has been a phenomenal growth in Chinese students studying accounting and finance in Western universities – because they perceive both the need and demand for person with such knowledge and skill in China.

Again, as employees have a major role to play in corporate governance, it is necessary to take into consideration their interests and given them a proper position within the framework of corporate governance. In this sense, it is necessary to accomplish the transfer of state-owned enterprises

from administrative governance to economic governance, and construct of a framework under which all employees can make efforts in regard to governance. In addition, the Chinese government is willing to change the legal standing of workers to advance the political mantra of a more "harmonious society". Thus, China's trade unions should be transformed by law. Previously they only focused on social welfare; in the future they will be able to act more like Western trade unions, weighing in on discipline, safety, remuneration, and working hours. Though any such move is fraught with political difficulties as the CCP is reluctant, if not hostile to the idea of its retreating from control of the trade union movement and the party's role and representation within business units, to allow a more active role for worker and employee voice would do much to ease the frustration felt by many workers in China's rapid and often uncertain development.

The cause of the problems mentioned above is very complicated. As Mark Roe has pointed out, corporate governance depends on much more than simply getting the law right. The presence of other institutions is critical.³¹ Indeed, China was in transition from a state-owned economy to a market economy, and conflicts during the transition period have been

³¹ Roe, M. J. (2000). "Political preconditions to separating ownership from corporate control." Stanford Law Review 53(3): 539-606.

complex. “Crossing the River by Feeling Each Stone” refers to the pragmatic policy of the Chinese leader Deng Xiaoping, to move ahead with economic reforms slowly and pragmatically. The West has not got all the answers yet and is still searching for solutions to some of its corporate governance problems, as current financial crisis demonstrate. Chinese reformers, while learning from the successes and mistakes of the West, must also pay due regard to the circumstances of China and be confident enough to discuss, debate, and devise their own solutions which would work in China.

END

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