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Legal Protection of Minority Shareholders in Chinese Listed Companies

Ziwei Zheng

**A Thesis submitted for degree of
Doctor of Philosophy**



Durham Law School

Durham University

April 2014

Legal Protection of Minority Shareholders in Chinese Listed Companies

Executive Summary

This thesis comprises comparative research, focusing on the legal design of minority shareholder protection and the effectiveness of this protection. Through comparison with similar legal arrangements in developed countries, this thesis aims to find ways to improve minority protection in Chinese listed companies. At the heart of this thesis are six main contributions.

Firstly, the thesis begins by investigating the possibility of and effectiveness of self-protection by shareholders. It is argued that activism by institutional investors, rather than individual minority shareholders, would eliminate misconduct by management and infringement by majority shareholders. In addition, in order to encourage and support minority shareholders to become more involved in corporate governance in China, this thesis suggests the reinforcement of specific legal institutions for minority protection, such as the cumulative voting system and the derivative claim. Moreover, the thesis notes that the newly introduced derivative claim could provide better protection of minorities if the *locus standi* requirement were lower, and the litigation procedure easier.

Second, this thesis argues that the board of directors is the most important participant in corporate governance. A professional and independent board of directors can guarantee that corporate decisions are made in the interests of all shareholders, including the minorities. With an effective board, majority shareholders would have less opportunity to obtain private

benefits by infringing the rights of minorities. Accordingly, the question of how to guarantee board independence is the most important concern in corporate legal design. This thesis reviews the law concerning independent directors in the US, and concludes that the institution of independent directors in Chinese listed companies is still immature. If current deficiencies were overcome, independent directors in Chinese listed companies could help to increase corporate transparency, providing minorities with timely and accurate information.

Thirdly, unlike Anglo-American countries, China uses a two-tier corporate governance structure, with a board of directors and a supervisory board. Although the effectiveness of the supervisory board in Chinese listed companies has frequently been challenged, this thesis argues that the supervisory board is and will remain the one of the most important internal monitors in the Chinese corporate governance structure. It will not be replaced easily. Therefore, this thesis suggests that legislators should clarify the function and responsibilities of the supervisory board and independent directors, and authorize more substantial powers to the supervisory board, for the purpose of increasing minority protection.

Fourth, with regard to that unique participant in Chinese corporate governance, the party committee of the Chinese Communist Party, this thesis argues that it cannot improve corporate efficiency or minority protection. Rather, owing mainly to the mismatch of rights and responsibilities in legislation, it has brought about problems related to corruption. Therefore, this thesis argues that legislators should restrict the involvement of the party committee in corporate affairs, so as to reduce the potential for infringement of minority shareholders' rights.

Fifth, this thesis also argues that, in order to protect minority shareholders,

the existence of a powerful external monitor is equally as important as that of an internal one. This study investigates the Chinese Securities Regulatory Commission (CSRC) and compares it to the Securities & Futures Commission in Hong Kong and the Securities and Exchange Commission in the US. The thesis highlights the efforts by the CSRC to improve the quality of governance in the Chinese market, and suggests that it should go further in increasing corporate transparency and investor education, in order to establish a better market environment for minority investors.

Finally, this thesis advances a new ideal model of corporate governance structure, based on the principle of board-centralization and with a higher level of minority protection. The thesis has proposed that listed companies be divided into two categories, the competitive area and the non-competitive area. In the competitive area, the state should begin by ensuring a fair competitive market, and eventually quit that market. In the non-competitive area, the state should operate companies in the interests of both shareholders and social welfare. Furthermore, a three-level structure should be established, in which one or more state-owned asset management companies are set up as an insulation layer, or alternatively a buffer, between the government and the listed companies, in order to eliminate undue government intervention. This would make it less likely that the rights of minorities would be infringed.

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List of Cases

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Barrett v Duckett [1995] 1BCLC 372
Foss v Harbottle [1843] 67 ER 189
Iesini & Ors v Westrip Holding Ltd & Ors [2009] EWHC 2526 (CH)
Johnson v Gore Woods & Co [2002] 2 AC 1
Re Smith & Fawcett Ltd [1942] Ch 304 (CA)
Re Stranton Iron and Steel Company [1873] LR 16 Eq 559
Shaw & Sons (Salford) Ltd v Shaw [1935] 2 KB 113
Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638 (CH)
Wallersteiner v Moir [1975] QB 373

Cases in the United States

Aronson v Lewis [1984] 473 A. 2d 805
Hawes v Oakland [1882] 104 US 450

Cases in Australia

ANZ Executors and Trustees Ltd v Humes Ltd [1990] VR 615
Re Direct Acceptance Ltd [1987] 5 ACLC

Cases in Hong Kong

Re PCCW Ltd [2008] HCMP 2382/2008
Re PCCW Ltd [2009] CAVA 85/2009

Case in China

Administrative Penalty Decision by the CSRC [2008] No.12

Case in Scotland

Wishart v Castlecroft Securities Ltd [2009] CSIH 65

List of Legislation

THE PEOPLE’S REPUBLIC OF CHINA

Administrative Measures on Information Disclosure by Listed Companies
Civil Procedure Law of the People’s Republic of China
Civil Procedure Rules 1998
Codes on Takeovers and Mergers (Hong Kong)
Companies Ordinance (Hong Kong)
Company Law of the People's Republic of China (1993)
Company Law of the People's Republic of China (2005)
Constitution of the People's Republic of China
Enterprise Bankruptcy Law of the People's Republic of China
Guidance Notes on the Split Share Structure Reform of Listed Companies
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Opinion on Strengthening and Improving Party Building in Central Enterprises
Opinions of the China Securities Regulatory Commission and the State-owned Assets Supervision and Administration Commission of the State Council on Performing the Work of Pilot Reform of Equity Division
Party Constitution of Chinese Communist Party
Provisional Measures on Raising Social Security Funds
Real Right Law of the People's Republic of China
Regulations for the Administration of Futures Trading
Securities Investment Fund Law of the People's Republic of China
Securities Law of the People's Republic of China (2005)
State-Owned Enterprise Law (1986)
The Code of Corporate Governance for Listed Companies in China (2002)
The Guideline of Articles of Association of Listed Companies

The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies

THE UNITED KINGDOM

Code of Best Practice

Combined Code

Companies Act 1948

Companies Act 1985

Companies Act 2006

THE UNITED STATES

American Law Institute's Principles of Corporate Governance

Delaware General Corporation Law

New York Stock Exchange Listed Company Manual

Sarbanes-Oxley Act

GERMANY

Aktiengesetz (AktG), German Company Law

German Corporate Governance Code

MALAYSIA

Malaysian Companies Act 1965

List of Abbreviations

AGM	Annual General Meeting
ALI	American Law Institute
Baosteel Group	Baosteel Group Corporation
Baosteel	Baoshan Iron & Steel Co., Ltd
CA 2006	Companies Act 2006
CCASS	Central Clearing And Settlement System
CCL 2005	Chinese Company Law 2005
CCP	Chinese Communist Party
CICC	China International Capital Corporation
CNC	China United Network Communications Group Company Ltd
CO	Companies Ordinance
CSRC	China Securities Regulatory Commission
FSA	Financial Services Authority
IPO	Initial Public Offering
JSC	Joint Stock Company
LLC	Limited Liability Company
LLSV	La Porta, Lopez-De-Silanes, Shleifer and Vishny
NPC	National People's Congress
NYSE	New York Stock Exchange
PCCW	Pacific Century CyberWorks Ltd
PCRD	Pacific Century Regional Developments
QFII	Qualified Foreign Institutional Investor
SASAC	Assets Supervisory and Administration Committee
SEC	Securities and Exchange Commission
SFC	Securities and Futures Commission
SHSE	Shanghai Stock Exchange
SOA	Sarbanes-Oxley Act
SOE	State-owned Enterprise
SZSE	Shenzhen Stock Exchange

Chapter One: Introduction

Given the persistent reduction in the demographic dividend, the traditional growth pattern, which takes advantage of low labour cost in the manufacturing industry, can no longer promote the growth of the national economy in China. The capital market, on the other hand, has become more and more important to Chinese economic development.

A report by the Shanghai Stock Exchange, dated December 31st, 2010, reports the total transaction volume on that exchange as RMB 30.4 trillion, placing it 3rd in the world. Financial products traded on the Shanghai Stock Exchange include corporate shares, corporate bonds, capital funds and warrants. With 894 listed companies, the total market value of shares in the Shanghai Stock Exchange amounts to RMB 17.9 trillion.¹

Accordingly, listed companies are the most important element in the Chinese capital market. However, most listed companies in China have a distinctive characteristic; unlike their Anglo-American counterparts, they are subject to state control, whereby the state holds all or the majority of corporate shares, and so dominates corporate decisions. Owing to the massive shareholding by the state, corporate governance in Chinese listed companies is more complex than is the case elsewhere. Rather than the agency cost problem, which is the core issue in the Anglo-American corporate governance regime, in Chinese corporate governance the problems concern conflicts of interest between the controlling shareholder, the state, and the many thousands of minority investors. Therefore, finding a means to increase minority protection is a core issue in Chinese corporate governance.

¹ Bloomberg, 'Shanghai Stock Exchange Composite Index' (*Bloomberg* 2012)
<<http://www.bloomberg.com/quote/SHCOMP:IND>> accessed 23-11-2012.

As evidenced by La Porta et al., the infringement of minority shareholder rights by controlling shareholders is a phenomenon that exists worldwide.² The difference between countries lies merely in the extent of infringement. Generally speaking, minority protection is better in developed countries than in those that are still developing.³ Therefore, this research examines the practical experience of minority protection in developed countries, in order to formulate some suggestions specifically tailored to the Chinese context, to inform the next stage of reform.

In order to provide a basic understanding of the complexity of Chinese corporate governance, this introductory chapter describes the shareholding structure of an existing listed company in China. The graduated history of Chinese corporate reform, and the problems remaining in the current corporate governance regime as highlighted by this thesis are introduced in Part 1.2. In Part 1.3, the importance of minority protection in the Chinese market is illustrated, while Part 1.4 provides a brief description of the legal framework in the corporate area. The structure of the main body of the thesis is presented in Part 1.5.

1.1 Example of a Chinese Listed Company

Most Chinese listed companies were originally state-owned enterprises. During the gradual reform state-owned enterprises partitioned some superior businesses to form new legal entities for listing purposes. Although those new entities are listed on the two stock markets in China, and issue corporate shares to private investors, the listed companies are still controlled by the parent enterprise, which hold the greatest proportion of corporate shares. Hence the connection between the listed company

² La Porta and others, 'Investor Protection and Corporate Valuation' (2002) 57 *Journal of Finance* 1147, 1148.

³ *Ibid.*

and the controlling shareholder is a historical problem, which cannot easily be changed.

As an example of a Chinese listed company, the corporate structure of Baoshan Iron & Steel Co., Ltd (Baosteel) and its parent enterprise Baosteel Group Corporation (Baosteel Group) is shown in Figure 1.

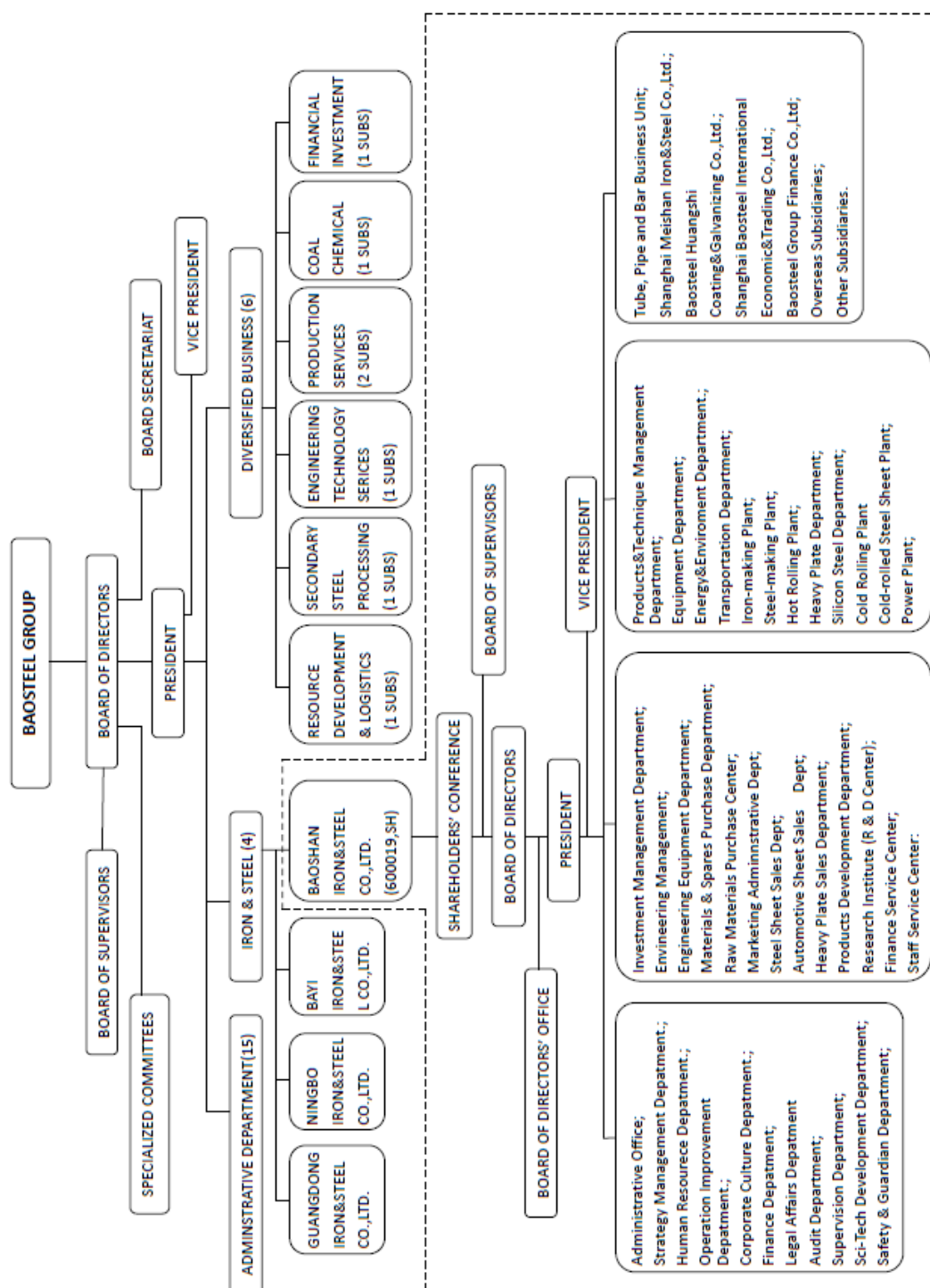


Figure 1: Corporate Structure of Baosteel Group and BaoShan Iron & Steel Co., Ltd (600019)⁴

⁴ Information collected from the website of Baosteel Group and structured by the author.
<http://www.baosteel.com/group_en/> accessed 22-10-2013.

The Baosteel Group is currently the largest iron and steel enterprise in China. With an operating income of \$40.327 billion, the Baosteel Group is placed 211th in the top 500 companies worldwide.⁵ It is a wholly state-owned company, controlling several subsidiary companies in the iron and steel industry, including Baosteel.

In order to develop its global competitive strategy, such as striving for overseas resources of ironstone, and in order to undertake mergers and acquisitions abroad, Baosteel Group has required huge amounts of funding. Consequently, in 2000, Baosteel Group separated its high-quality iron and steel business and formed a new stock limited company under the Chinese Company Law 1993.⁶ The new legal entity, named Baosteel, has successfully raised capital and been listed on the Shanghai Stock Exchange. Today, the iron and steel business is operated by Baosteel, while other relevant businesses remain under the management of Baosteel Group.

Over 74 per cent of corporate shares issued by Baosteel are held by its parent company, the Baosteel Group, and between them the top 10 shareholders hold a total of 76.68 per cent.⁷ As the most important subsidiary company, Baosteel contributes approximately 70 per cent of the total income of Baosteel Group.⁸

As an example of a Chinese listed company with relatively good corporate governance, Baosteel integrates many modern governance techniques, including external directors, independent directors, nomination committee, remuneration and assessment committee and audit committee.

⁵ Baosteel homepage, 'Corporate Introduction' <http://www.baosteel.com/group_en/> accessed 24-07-2013.

⁶ Ibid.

⁷ It is calculated by this thesis through the information disclosure in the website of the Shanghai Stock Exchange.

⁸ Baosteel homepage, 'Corporate Introduction' (n 5).

Nevertheless, this thesis will highlight some defects, including but not limited to: (1) there being too many related party transactions, which would work against minority protection; (2) as the actual controller, the government intervening in the corporate affairs too often, and (3) the decisive influence of the party committee of the Chinese Communist Party in personnel affairs hindering the effectiveness of the nomination committee.

Using the example of Baosteel, this thesis concludes that the complicated situation of corporate governance in Chinese listed companies is a result of state control. Control by the state leads to a number of crucial problems, specifically: (1) the real owner of shares held by the state is absent, which can lead to a serious problem of insider control; (2) corruption; (3) uncertainty of corporate goals because the companies take on undue public management functions, and (4) most importantly, conflicts of interest between the controller and minority shareholders.

According to the Chinese Corporate Governance Index, shown in Table 1, in 2011 the average score of corporate governance of 1,950 sample companies was 60.28, a slight improvement on the score in 2010, 59.09.⁹ However, this thesis notes that not a single company among the 1,950 achieved quality level of CCGI I or CCGI II, and only 8 reached CCGI III. The majority of listed companies scored CCGI IV and CCGI V.¹⁰

⁹ Wei-an Li, *Chinese Corporate Governance Index* (Corporate Governance Research Institution of Nankai University 2011), 6.

¹⁰ *Ibid* 13.

Corporate Governance Index Rank			
Corporate Governance Index Quality Level			
		Number	Proportion (%)
CCGI I	90-100	-	-
CCGI II	80-90	-	-
CCGI III	70-80	8	0.41
CCGI IV	60-70	1070	54.87
CCGI V	50-60	859	44.05
CCGI VI	50 and below	13	0.67
Amount		1950	100.00

Table 1: Corporate Governance Index Rank

While the quality of governance of Chinese listed companies has been improving over the past few years, the existing problems cannot be ignored. Instead, those defects make it crucial for China to seek further development. Among all the problems in Chinese corporate governance, this thesis contends that minority protection is the toughest issue to overcome. In order to establish a healthy and fair capital market to support the development of the national economy, it is essential that minority protection be improved. Therefore, this thesis will focus on this issue and attempt to find solutions for the next reform.

1.2 Chinese Corporate Reform

The gradual economic reform relating to the Chinese listed companies can be traced back to the 1990s. It had been realized already that tight control by the state would block the development of the Chinese national economy. However, the political concern for social stability discouraged the government from launching a radical reform scheme in the short term.

In this section, the history of Chinese corporate reform is reviewed, in order to establish a general understanding of how the state became the majority shareholder in modern listed companies in China. Specific emphasis is placed on the recent reform, namely the split share structure reform, which will have fundamental influence on future developments in the corporate governance regime in China.

1.2.1 The 1990s

Most of the listed companies on the two stock exchanges in mainland China, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, have been transformed from former state-owned enterprises (SOEs), which were set up before the Chinese economic reform. The SOEs undertook many public functions, which were fundamental for society at that time. Scholars argued that the SOE is not merely a legal-economic entity, but also a political entity which involves the political power of the Chinese Communist Party.¹¹ The government desired the SOEs to be operated with high efficiency, but not solely for the purpose of wealth maximization.¹² In other words, chasing profit was not the only goal of those SOEs. They should also provide benefits to employees, retired workers and their families.¹³

For example, in the 1990s, some traditional SOEs possessed subsidiary businesses or assets such as employees' accommodation, hospitals, schools and hotels, in addition to the core business. The subsidiary

¹¹ Haizheng Zhang, 'Bankruptcy of State-owned Enterprises and Planned Bankruptcy' in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ashgate 2010), 296.

¹² Donald C Clarke, 'Corporate Governance in China: An Overview' <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=424885> accessed 22-10-2013, 1.

¹³ Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 117.

businesses could cover almost every aspect of an employee's daily life. In this way, the SOEs could be seen as supporting and governing the whole society.

As such, it is not surprising that there existed an extremely close relationship between the SOEs and the government, at both central and local level. This relationship might include supervision and being supervised, supporting and being supported, and cooperation between the two counterparties. When the government made public policy, it would often delegate some tasks, such as providing funds or exercising subordinate management, to relevant SOEs; meanwhile the SOEs would seek political support from the government in its day-to-day operations.¹⁴ This support might take the form of tax-exemption, authorizing a special qualification for certain businesses or the granting of huge low-interest or even interest-free loans from the government-controlled banks.

However, far from creating the desired harmonious win-win situation, this cooperation between the SOEs and government actually led to serious social problems. As the government continued to add further public responsibilities to the SOEs, some public authorities became chaotic, and the social welfare system remained under-developed. Meanwhile, the SOEs relied too much on political support. The operators of the SOEs believed that, as long as they could fulfil the tasks assigned by the government, they would continue to enjoy political support and gain profits accordingly. Sometimes, these profits related to the personal interests of the operators.

As a result of this situation, the SOEs began to face many crises, such as

¹⁴ Enterprises with such a benefit-based relationship with government are known as "Red Hat" enterprises in the Chinese commercial field.

decreased operating efficiency, low competitive strength, and inadequate capability to undertake certain responsibilities of public governance. According to government statistics, at the beginning of the 1990s more than two-thirds of the SOEs were losing money in their operations.¹⁵ Meanwhile, without sufficient assistance from the SOEs, the government could no longer provide political support to SOEs. Therefore, a top-down reform of the SOEs was imperative.

1.2.2 State Owned Enterprises Reform

The first round of the SOEs reform, also referred to as 'stockholding reform', aimed to establish a joint stock system for SOEs under the Company Law 1993. The SOEs were restructured into Limited Stock Corporations, and the state became a shareholder of the new companies.

Furthermore, during this reform, China chose to strengthen its large state-owned enterprises and keep these under state control, whilst getting rid of some smaller firms by selling them off to private investors. This was known as the policy of 'Grasp the Large, Let Go of the Small', or 'zhua da, fang xiao'.¹⁶

However, the first round of reform was little more than a cosmetic exercise, and did not bring about any substantial changes. Although the modern corporate structure has been built up since that reform, which could be regarded as a milestone in the development of Chinese corporate governance, the key issue of the over-close relationship between the enterprises and government still remained. Independent legal personality

¹⁵ Clarke (n 12) 6.

¹⁶ Roman Tomasic, 'Looking at Corporate Governance in China's Large Companies: Is the Glass Half Full or Half Empty?' in Guanghua Yu (ed), *The Development of the Chinese Legal System Change and Challenges* (Routledge 2010), 8.

failed to bring about independent operation, and certainly not the modern corporate governance system based on the separation of ownership and management. In China, the government acted not only as owner of the company, but also as administrator and the regulator of businesses. Various governmental authorities intervened in the management of the SOEs, frequently and subjectively, which led to poor operating results for business entities.¹⁷

1.2.3 The Securities Market

During the 1990s, the Chinese government further promoted public listing of the stock companies and the development of the capital market. The Shanghai Stock Exchange (SHSE) was founded on November 26, 1990 and opened for trading on December 19, 1990.¹⁸ The Shenzhen Stock Exchange (SZSE) was founded in the same year on December 1 and formally opened for trading on July 3, 1991.¹⁹ A large number of SOEs went public after converting to limited stock companies to be listed both in China and overseas.

An interesting point to note here is that the Chinese capital market has a large number of individual investors. The number of investor accounts increased from 8.35 million in 1992 to nearly 138 million by the end of 2007.²⁰ Around 99 per cent of investors are individuals, with less than RMB 1 million in cash or shares equivalent.²¹ Those individual stock investors in China have been nicknamed 'stock-citizens', meaning citizens

¹⁷ Z Jun Lin, Ming Liu and Xu Zhang, 'The Development of Corporate Governance in China' (2007) 28 Company Lawyer 195, 199.

¹⁸ Official website of the SHSE, <<http://www.sse.com.cn>> accessed 22-10-2013.

¹⁹ Official website of the SZSE, <<http://www.szse.cn>> accessed 22-10-2013. Also see, Xiao Huang, 'Modernising the Chinese Capital Market: Old Problems and New Legal Responses' (2010) 21 International Company and Commercial Law Review 26, 27.

²⁰ CSRC, China Capital Market Development Report (Beijing: China Financial Publishing, 2008), <<http://www.csrc.gov.cn/pub/newsite/yjzx/cbwxz/201007/P020100714390847659848.pdf>> accessed 22-10-2013, 195.

²¹ Ibid 269.

in the stock market. Due to their limited experience of investment and lack of reliable information, these minority shareholders are usually silent investors, waiting for a free ride in corporate affairs. Hence it could be concluded that the Chinese individual minority shareholder is more like a speculator who seeks the premium income of share price, rather than a real corporate investor who looks forward to a long-term return. The average turnover ratio in China's stock market is nearly seven times higher than those in more mature markets.²²

A twenty-year period is not a long developing history for a securities market. The New York Stock Exchange was born in 1792,²³ and the history of the London security market can be traced back 300 years.²⁴ The Chinese security market, therefore, is still in its infancy, and much remains to be improved and perfected.

1.2.4 Split Share Structure Reform

Split share structure reform refers to measures to resolve the drawbacks caused by split share structure. More specifically, it is a design to transform non-tradable shares, listed in mainland China as A-shares, into tradable A-shares. Article 2 of the Measures for Administration of Split Share Scheme Reform of Listed Companies provides that:

Split share structure reform of listed companies shall refer to the processes to eliminate the systematic discrepancy of share

²² Ibid 271.

²³ The New York Stock Exchange traces its origins to 1792, when 24 New York City stockbrokers and merchants signed the Buttonwood Agreement. This agreement set in motion the NYSE's unwavering commitment to investors and issuers. See, <<http://www.nyse.com/about/history/1089312755484.html>> accessed 22-10-2013.

²⁴ For over 300 years, the London Stock Exchange has produced detailed market information for companies and investors. See, <<http://www.londonstockexchange.com/products-and-services/rns/history/history.htm>> accessed 22-10-2013.

transfer in the A share market through the consultation mechanism for balancing interests between shareholders of non-tradable shares and the shareholders of tradable shares.²⁵

The ideas of selling state-controlled shares for cash and withdrawing state funding from the market have long been among the aims of Chinese economic reform. As indicated by Cooper's research, China is pursuing a gradualist strategy, slowly but steadily expanding the role of the markets.²⁶

In this section, the reform of split share structure will be investigated in detail as a successful case of Chinese reform, in which the interests of minority shareholders have been properly considered. This thesis argues that it is possible to provide necessary protection for minorities as long as the state government approaches this issue in the right way.

(1) The Reasons for Split Share Structure

At the inception of the Chinese stock market, there was a common understanding that the purpose behind it was to raise capital for moribund state-owned enterprises.²⁷ At that time, many bank loans had become bad debts, due to the poor performance of SOEs. In order to minimize the risks to the banking system on one side and to diversify the channels of capital-raising on the other, the Chinese government was seeking a method other than bank loans to pour domestic savings into the SOEs. As reported above, Chinese domestic savings at that time represented a tremendous capital resource, constituting 40 per cent of China's GDP.²⁸ Therefore, if a platform designed for capital-raising could be established, for example, the

²⁵ Measures for Administration of Split Share Structure Reform of Listed Companies (2005), Article 2.

²⁶ Mary C Cooper, 'New Thinking in Financial Market Regulation: Dismantling the "Split Share Structure" of Chinese Listed Companies' (2008) 13 *Journal of Chinese Political Science* 53, 72.

²⁷ Ziqiao Chen, 'The Way to Invigorate Enterprises --- Joint Stock System in China' (1998) 3 *Fazhi Jianshe* [Legal Construction] 6, 6.

²⁸ Q Chen, *Securities* (China Machine Press 2003), 161.

stock market, SOEs in China would be able to gain a huge amount of funding for 'free'.²⁹

However, contrary to the views expressed by Chinese policy makers, some scholars question the main function of the capital market. Wu argues that in a mature financial environment, the core function of a capital market is not to raise extra funds for a company, but to re-allocate the existing resources of the company by merger and acquisition. A capital market cannot achieve the same efficiency as the commercial banks in terms of providing finance, while it does have unique advantages in the re-allocation of existing resources, because it can provide corporate resources with liquidity.³⁰ However, the split share structure took some liquidity away from the Chinese capital market and left raising capital as the only function. This is why, according to the viewpoint of this thesis, the Chinese economic reform has lasted for a decade while little improvement in corporate efficiency has been achieved.

While this thesis accepts that the original intention of establishing the Chinese stock market was to raise funds for SOEs,³¹ it must be acknowledged that such reform marked the first occasion on which Chinese government loosened the strict control over the state economy. Accordingly, the risk of losing control over those companies and the state economy was a matter of concern for politicians, who had to deal with the ideological issue of whether the re-structure of SOEs would undermine state control and ownership, before establishing the stock market.³²

²⁹ Compared with bank loans which the interests is compulsory to pay, capital raised from stock market belongs to the company and no money should be paid, if the company decides not to deliver a dividend.

³⁰ Xiaoqiu Wu, 'Guquan Fenzhi Gaige De Ruogan Lilun Wenti [A Certain Theoretical Issues Relating to Split Share Structure Reform]' (2006) 2 Finance & Trade Economics 24, 25.

³¹ Reviewed by this thesis, the main defect in operating the SOEs was not the inadequacy of funds, but the low efficiency owing to the poor corporate governance. Without the improvement of governance quality, attracting domestic savings to invest in those moribund SOEs would have no difference to misappropriation of minority shareholders' assets.

³² X Gao, 'The Perceived Unreasonable Man --- A Response to Fang Liufang' (1995) 5 Duke Journal of

To avoid political risks, government retained a majority of issued shares following corporate IPOs, in the form of state shares and legal person shares, which could not be traded on the open market. This was intended to ensure the state's continued dominant control of the listed companies and of the whole economy.³³ The co-existence of several different groups of shares formed the split share structure in the 1990s.

(2) Share-holding Status under the Split Share Structure

To maintain the state control over companies after listing on the open market, corporate shares were classified into different groups on the basis of the characteristics of the holders. Different groups of shares had different limitations in terms of trading on the stock market.

Split Share Structure		
Name of Group	Listing Place	Trading Currency
A-Share	China Mainland	RMB
B-Share	China Mainland	HK Dollar/ US Dollar
H-Share	Hong Kong	HK Dollar
N-Share	New York	US Dollar
S-Share	Singapore	Singapore Dollar

Table 2: Five different groups of shares issued by Chinese companies

Comparative and International Law 271, 271.

³³ Lee Suet Lin Joyce, 'From Non-tradable to Tradable Shares: Split Share Structure Reform of China's Listed Companies' (2008) 8 Journal of Corporate Law Studies 57, 62.

Sub Classification of A Shares		
Liquidity		Nature of Shareholders
Non-tradable Shares	State Shares	Central Government Other Levels of Government
	Legal Person Shares	State-owned Enterprises Government-Related Entities
Tradable Shares	Normal A-Shares	Domestic Individuals Domestic Institutional Investors Qualified Foreign Institutional Investors

Table 3: Sub-classification of A shares

As can be seen from Table 3, the non-tradable shares issued by companies had a close link with government. Hence these could be deemed 'state-controlled shares'. When approved by the state, non-tradable shares could be transferred only to other government-related entities, such as government agencies or strategic investing companies off market. The transfer price was normally based on net book value per share, return on equity, return on investment, recent market price, or a reasonable price-to-earnings ratio.³⁴

According to figures calculated by the 'China Stock Markets Web' facility at Hong Kong Exchanges and Clearing Limited, dated Oct 24th, 2008, the total market capitalization of the two mainland China stock exchanges, the Shanghai Stock Exchange and Shenzhen Stock Exchange, amounted at that time to RMB 11,874 billion,³⁵ while the capitalization of tradable A-shares was a mere RMB 3,994 billion.³⁶ That is to say, approximately two-

³⁴ Fei Lu, Maria Balabat and Robert Czerkowski, 'The Role of Consideration in China's Split Share Structure Reform' <SSRN: <http://ssrn.com/abstract=1284067> or <http://dx.doi.org/10.2139/ssrn.1284067>> accessed 16-05-2013, 4.

³⁵ The total market capitalization is calculated by imputing value to domestic, non-tradable shares, using the secondary market price for its tradable A-shares.

³⁶ Paul B McGuinness, 'An Overview and Assessment of the Reform of the Non-tradable Shares of Chinese State-owned Enterprise A-Share Issuers' (2009) 17 Journal of Financial Regulation and Compliance 41, 43.

thirds of the A-shares in the Chinese market were controlled by the state.

(3) Defects Caused by the Split Share Structure

It should be admitted that the Chinese stock market, established just two decades ago, has developed rapidly and is now the fifth largest market in the world. Nonetheless, the Chinese stock market still faces certain problems regarding further development, albeit that the total capitalization is tremendous. The split share structure has been widely regarded as the root of the problem. In this thesis, three of the main problems created by the split share structure will be highlighted, as follows:

- *Dysfunction of Pricing of the Stock Market*

The market price of corporate shares under a split share structure can be deemed only as the price of tradable shares, in circumstances where the majority of corporate shares are not allowed to be traded on the market. In other words, the share price on the market does not reflect the actual value of the company. This creates a disjunction between the price of corporate shares and real corporate performance. The market price of corporate shares depends largely on the relation of supply-and-demand, rather than the fundamental factors of corporate operation. In other words, minority shareholders, or the so-called public investors, who purchased the tradable shares could know little about the real operation of the company via the fluctuation of share price. As a consequence, without any essential changes, the stock market will eventually develop into a speculative playground, like a casino. In line with this hypothesis, scholars argue that the high turnover ratio for tradable shares before the reform, reported as 550%, was evidence of the speculative nature of the Chinese stock market, which in general lacked liquidity.³⁷

³⁷ Joyce (n 33) 64.

Furthermore, dysfunction of pricing of the stock market would lead to difficulty in evaluating the performance of corporate executives. In practice, due to the disjunction between the share price and corporate performance, term profitability has been used as the main criterion to evaluate the performance of corporate management. However, it is inappropriate. First, as an accounting index, term profitability is a flexible figure which can be adjusted in many ways.³⁸ Secondly, it is very hard to determine whether the profit earned now might be at the expense of corporate long-term development.

Therefore, the pricing function of the stock market should be restored in order to reflect the comprehensive factors of the company, including industrial growth ratio, productivity and profitability, as well as the value of the managerial team. Under such mature market conditions, the performance of corporate executives could be simply evaluated by share price on the market.

- *Blocking the Establishment of Market for Corporate Control*

The market for corporate control has been widely regarded as an important external monitoring institution in corporate governance. Listed companies with poor performance or low efficiency would become the target of a merger or acquisition. By changing the executive team and improving management, target companies might achieve a better performance. Moreover, the threat of merger would become an incentive for corporate managers to fulfil their duties better.³⁹

³⁸ Wu (n 30) 26.

³⁹ Market for corporate control has been defined as a market in which alternative managerial teams compete for the rights to manage corporate resources. In other words, the current managers may be substituted after takeover. See Michael C Jensen and Richard S Ruback, 'The Market for Corporate Control: The Scientific Evidence' (1983) 11 *Journal of Financial Economics* 5, 6.

However, as mentioned above, under the split share structure a dominant part of shares in Chinese listed companies could not be traded on the open market. Corporate mergers and acquisitions could be achieved only by agreement on transferring the shares off the market. In addition, such agreement would have to be approved by the government before it could be exercised. As such, the effectiveness of the market for corporate control as the external monitoring institution in China was totally restrained.

Because of such systemic problems, some scholars maintained that SOEs' reform under the split share structure could be deemed only a partial privatization, which would not be able to improve corporate performance in terms of profitability and efficiency.⁴⁰ Similarly, Cooper has argued that floating a minority of shares in the market can hardly help to improve the governance quality of those companies in practice.⁴¹

- *Conflict of Interests between the Controlling Shareholder and Minority*

The split share structure created conflicts of interest between the holders of non-tradable shares, usually the controlling shareholder, and holders of tradable shares, usually the minority investors of the listed companies. This is because the two parties held different expectations of corporate operations.

On the one side, holders of tradable shares were aware that they would have little say in corporate decision making, and could certainly not control the company, since the counterpart with the non-tradable shares accounted for the majority of corporate issuance. Hence, the most common way for tradable shareholders to maximise their returns was

⁴⁰ G Chen, M Firth and O Rui, 'Have China's Enterprise Reforms Led to Improved Efficiency and Profitability for Privatized SOEs?' (2006) 7 Emerging Market Review 82, 82.

⁴¹ Cooper (n 26) 58.

through share price inflation. In this way, the company's performance and profitability would be the most important concerns. However, these issues would not be considered so important by the controlling shareholder with a majority shareholding of non-tradable shares.⁴² In other words, only minority shareholders with tradable shares care about the relation between corporate performance and market price of corporate shares.

On the other side, holders of non-tradable shares would normally have a close relation with the government, a circumstance that has been criticized as the key problem, resulting in all sorts of inefficiencies in corporate operation.⁴³ Better corporate performance may not benefit the controlling shareholder any more than in a dividend acquired from the company. However, the majority holder may obtain benefits by taking advantage of corporate control, for example by tunnelling the corporate assets or through related-party transactions to deliver profits to their parent companies.

(4) Two Failures of Attempted Reform Schemes

The defects of split share structure were realized by policy makers very early on. The central government attempted two reform schemes, in 1999 and 2001 respectively, trying to convert non-tradable shares into tradable form and to sell a certain proportion of state-controlled shares for cash. Unfortunately, neither of these schemes succeeded. The key reason for the failure was the inevitable drop in market price when the quantity of tradable shares increased.

● *Reform Scheme in 1999*

In late 1999, two listed companies were selected by the government to sell

⁴² Joyce (n 33) 64.

⁴³ Andrei Shleifer, 'State Versus Private Ownership' (1998) 12 *Journal of Economic Perspectives* 133, 133.

their non-tradable state shares through the stock exchange. If the pilot scheme were to succeed, the government planned to attempt a larger sale of non-tradable shares, reducing the shareholding to just over 50 per cent of the total corporate issues. This would allow the government to raise tens of billions of Reminbi, the Chinese currency, which would be used to establish China's social security system.⁴⁴

Since the expectation of the government was to obtain more cash by selling the state-controlled shares, they wanted to take advantage of the market price for these shares. However, the owners of tradable shares insisted that the market price was based on the fact that a huge proportion of corporate shares could not be traded freely in the market.⁴⁵ If the supply of tradable shares increased, the market price of tradable shares would inevitably fall. Accordingly, the transaction price of non-tradable shares should be lower than the market price of tradable shares. Shareholders reacted negatively to this scheme. The share price fell dramatically in a short period, and therefore, the attempted scheme of reform had to be abandoned by the state.⁴⁶

● *Reform Scheme in 2001*

In July 2001, the government set out a new scheme to raise RMB 2.2 trillion by selling the non-tradable state shares in the market, at the market price of tradable shares. Reviewing the Provisional Measures on Raising Social Security Funds through Sales of the State-owned Shares, it is disappointing to note that no compensation to holders of tradable shares was suggested. As a result of negative market reaction, the two stock markets in mainland China collapsed, with falls of 43% and 53% on the

⁴⁴ Cooper (n 26) 58.

⁴⁵ Li Liao, Bibo Liu and Jinliang Li, 'Daode Fengxian, Xinxi Faxian Yu Shichang Youxiaoxing [On the Moral Hazards, Information Revelation and Market Efficiency: Evidence from the Split-share Reform in China]' (2008) 4 *Jinrong Yanjiu* [Journal of Financial Research] 146, 148.

⁴⁶ Cooper (n 26) 59.

Shanghai and Shenzhen composite indices respectively.⁴⁷ As a consequence, the scheme of reform had to be suspended for a second time.

(5) The Successful Reform in 2005

Having learned lessons from the former attempts, the state decided to implement a new pilot scheme intended to overcome the deficiencies caused by split share structure.

In May 2005, the CSRC announced a pilot scheme, involving four medium-sized companies for the first phase.⁴⁸ The companies were Tsinghua Tongfang, Hebei Jinniu Energy Resources, Shanghai Zi Jiang Enterprise Group and Sany Heavy Industry.⁴⁹ With the exception of Tsinghua Tongfang,⁵⁰ these companies completed reform with a compensation package in 35 days on average.⁵¹

One month later, in the second phase, another 46 issuers started to implement the scheme. Subsequently, all other listed companies were required to implement reforms to the split share structure. By the end of 2007, 1,254 listed companies, over 97% of the capitalization of A-shares, had completed the reform.⁵²

● *Approaches Adopted in the New Reform*

In order to implement the reform successfully, two new approaches were

⁴⁷ Chen (n 28) 148.

⁴⁸ M O'Neill, 'China State Share Sale Spooks Market: Regulator Names Four Companies to Start Revived Scheme' *South China Morning Post* (10-05-2005).

⁴⁹ Andrea Beltratti and Bernardo Bortolotti, 'The Nontradable Share Reform in the Chinese Stock Market' <<http://www.feem.it/userfiles/attach/Publication/NDL2006/NDL2006-131.pdf>> accessed 16-05-2013.

⁵⁰ Tsinghua Tongfang failed to pass its reform proposal the first time, since the compensation package was not passed by holders of tradable shares. See, *ibid* 3.

⁵¹ Yin-Hua Yeh and others, 'Non-Tradable Share Reform and Corporate Governance in the Chinese Stock Market' (2009) 17 *Corporate Governance: An International Review* 457, 460.

⁵² Kai Li and others, 'Privatization and Risk Sharing: Evidence from the Split Share Structure Reform in China' (2011) 24 *The Review of Financial Studies* 2499, 2501.

adopted by the CSRC in 2005.

First, with regard to the compensation paid by the non-tradable shareholders to those with tradable shares, the 2005 reform adopted a hands-off approach, rather than a one-size-fits-all solution. In fact, it would be impossible for the CSRC, a government department, to determine the compensation packages for listed companies with varied corporate backgrounds. A hands-off approach left this issue to the listed companies themselves, so that they could establish the most suitable compensation package.

Secondly, the principle of protecting the interests of tradable shareholders was applied. That is to say, the CSRC put more emphasis on minority shareholder protection during the reform. As reported by SinoCast China Business Daily News, a total of 340 billion non-tradable shares would be involved in the new reform scheme, accounting for 64% of the total capitalization of the Shanghai and Shenzhen stock exchanges.⁵³ If this amount of shares were to pour into the market, the price of tradable shares would come under enormous pressure, and the owners of tradable shares would inevitably suffer economic loss.

With political concern that the stability of the stock market was linked to the stability of society, and therefore a top priority for the central government in China,⁵⁴ the CSRC confirmed the necessity of compensation paid by non-tradable shareholder to owners of tradable shares.

The amount of compensation and methods of payment were to be

⁵³ Lei Ni, 'China's Transfer of State Shares to SSF Under Way' *SinoCast China Business Daily News* (13-03-2006).

⁵⁴ Joyce (n 33) 65.

negotiated between the two parties. Companies could use various forms of compensation packages, such as bonus shares, cash, warrants and share splits.⁵⁵ Among these, the offering of bonus shares proved the most popular method chosen throughout the reform. An empirical study involving 476 companies shows that 436 compensated tradable shareholders by offering bonus shares.⁵⁶

To ensure that the individual investors, who were the minority shareholders in most cases, had access to corporate information regarding the reform, when issuing the notice of shareholders' meeting with regard to split share structure reform, boards of directors were required to publish an announcement including a letter of opinion from the independent directors, an investment bank's recommendation, and legal opinion.⁵⁷ In addition, the board of directors was required to establish good communication with tradable shareholders by various methods, such as conducting conferences or roadshows, within 10 days of issuing the notice of shareholders' meeting.⁵⁸

Furthermore, in order to encourage a widespread involvement of minority investors, two extra responsibilities were imposed upon the companies: (a) the announcement of shareholders' meeting should be published at least three times; and (b) internet ballot for independent directors to collect proxies from tradable shareholders would last not less than five days.⁵⁹

● *Reform Process of a Listed Company*

⁵⁵ Yeh and others (n 51) 458.

⁵⁶ Beltratti and Bortolotti (n 49) 7.

⁵⁷ Measures for Administration of Split Share Structure Reform of Listed Companies (2005), Article 9.

⁵⁸ Ibid, Article 10.

⁵⁹ Takeshi Inoue, 'Reform of China's Split-Share Structure Takes Shape' (2005) 8 Nomura Capital Market Review 42, 49.

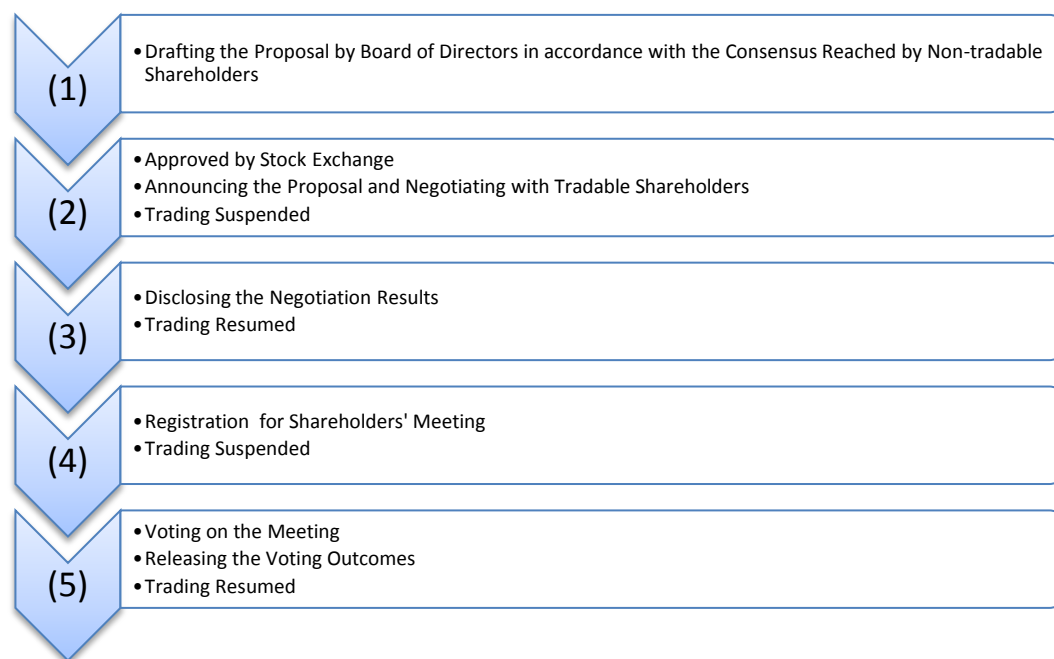


Figure 2: The Timetable for a Company to Implement the Reform

According to Article 5 of the Measures for Administration of Split Share Structure Reform of Listed Companies:

all non-tradable shareholders of a listed company shall in principle reach a consensus before they propose a motion on the split share structure reform. In case a consensus cannot be accomplished, such a motion may be proposed by a shareholder/shareholders holding individually/collectively two-thirds of the non-tradable shares of the listed company.⁶⁰

Once drafted, the reform proposal would be sent to the stock exchange to check the feasibility of the scheme.⁶¹ Share trading would be suspended on the day of the reform proposal and disclosure of the shareholders' meeting.

⁶⁰ Measures for Administration of Split Share Structure Reform of Listed Companies (2005), Article 5.

⁶¹ Yeh and others (n 51) 459.

During the following 10 days, non-tradable shareholders and the board members would communicate with tradable shareholders in order to reach consensus. If the proposal obtained acceptance by both parties, an announcement would be made and share trading would be resumed.⁶²

The share trading would be suspended for a second time when registration for the shareholders' meeting began. With regard to that meeting, the proposal of reform, including the compensation package, would need to satisfy the requirements in the Measures for Administration of Split Share Structure Reform of Listed Companies, whereby:

The reform plan of a listed company shall be approved by shareholders with at least two-thirds of voting shares at the relevant shareholders' meeting. Such a reform plan shall also be approved by the tradable shareholders owning at least two-thirds of tradable voting shares at the relevant shareholders' meeting.⁶³

If the proposal were to be vetoed in the shareholders' meeting, no new proposal could be presented for voting within 3 months.

Even after the reform proposal had been approved by tradable shareholders, a 12-month lock-up would be imposed before those new tradable shares, converted from former non-tradable shares, could be traded freely in the market. In addition, no more than 5 per cent of corporate shares could be traded on the open market within the first year after the lock-up period by those holders of formerly non-tradable shares holding more than 5 per cent of corporate shares. Another 5 per cent

⁶² Ibid. Once the proposal had been accepted by both parties, it could not be modified before voting in the shareholders' meeting. Anyone opposed to such a proposal could only vote against it in the meeting.

⁶³ Measures for Administration of Split Share Structure Reform of Listed Companies (2005), Article 16.

limitation would be applied within the second year after the lock-up period.⁶⁴

(6) The Significance of Split Share Structure Reform

Some scholars believe that the success of many other reforms in the Chinese capital market depends to a large extent on the achievement of split share structure reform.⁶⁵ The success of this reform could help to achieve four major improvements: (a) perfecting the pricing mechanism of the capital market; (b) establishing the market for corporate control over listed companies; (c) promoting the further reform of state-owned or state-controlled enterprises in terms of corporate governance structure; and (d) achieving the corporate target of maximizing the shareholder value.⁶⁶

To complete treatment of this issue, it is worth mentioning the following points.

First, like many other reforms in Chinese corporate governance, the split share structure reform is an example of top-down policy change. The state, in particular the central government, played a decisive role in the process. In order to achieve the success of the proposed reform, central government brought pressure to bear on different sectors, including:

- (a) Pressure on the listed companies through the administrative powers of the CSRC. Listed companies which had not implemented the reform successfully would not be allowed to raise capital or participate in any of the new derivatives pilot schemes,⁶⁷ while those that had

⁶⁴ Ibid, Article 27.

⁶⁵ Joyce (n 33) 58.

⁶⁶ Opinions of the China Securities Regulatory Commission and the State-owned Assets Supervision and Administration Commission of the State Council on Performing the Work of Pilot Reform of Equity Division <<http://www.sasac.gov.cn/n1180/n1566/n258222/n259203/11661185.html>> accessed 13-12-2013.

⁶⁷ Joyce (n 33) 68.

implemented reform successfully would be given priority by the CSRC to raise new capital in the stock market.⁶⁸ In other words, losing the support of the government would lead to an even bigger financial cost in business operations.

- (b) Direct or indirect influence on corporate leaders in companies holding non-tradable shares, which are normally formed as wholly state-owned companies or state-controlled companies. Owing to the tight relation between the business entities and the state, government usually has a big say in the companies' personnel issues. Therefore, it would not be sensible for corporate leaders to act against the will of their patron. Instead, they would complete the reform at all costs so as to gain political credit. As evidenced by scholars, state-controlled owners of non-tradable shares offered a relatively high compensation ratio to tradable-share holders, so that negotiations could be completed smoothly and speedily.⁶⁹
- (c) Pressure on the institutional shareholders. Reviewing the administrative document issued by the state, it is evident that direct or indirect pressure was placed on institutional shareholders in the Chinese market to promote the success of split share structure reform.⁷⁰ This would impact negatively on the development of a fair market and, in particular, minority protection.⁷¹ The threshold of

⁶⁸ Beltratti and Bortolotti (n 49) 3.

⁶⁹ Michael Firth, Chen Lin and Hong Zou, 'Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China' (2010) 45 *Journal of Financial and Quantitative Analysis* 685, 687.

⁷⁰ Opinion VI of Opinions of the China Securities Regulatory Commission of the State Council on Performing the Work of Pilot Reform of Split Share Structure provides that 'the institutional investors shall play positive roles in the reform...with respect to those who manipulate the voting result as a result of shareholders' meeting with other shareholders by right of shareholding preponderance and disturb the normal decision-making of other shareholders, the CSRC shall investigate'.

⁷¹ Although the institutional shareholder is one of the minority shareholders based on their shareholding percentage, however, it is different from other individual minority shareholders. Institutional shareholders noticed here refer to those mutual funds, pension funds, insurance companies, banks and QFIIs, who invested in the Chinese capital market. More details could be found in Chapter Two of this thesis. The individual minority shareholders refer to those so-called "stock-citizens", mentioned on page 11 of this thesis. The

approval by two-thirds of shareholding of the tradable shares would be easy to achieve with the help of institutional investors of the company, and therefore, the minority individual investors would be denied any say on the compensation issue. Indeed, most institutional investors chose to stand with the government,⁷² thus avoiding likely indirect cost, including but not limited to the possibility of losing access to crucial insider information, and the negative impact on their relationship with the government.

Secondly, some scholars have argued that the listed companies in the Chinese market have achieved full liquidity of corporate shares and completed privatization entirely through the split share structure reform.⁷³ This thesis takes a contrary view. The Chinese capital market, as defined in this thesis and elsewhere, was not established to promote privatization of the state-controlled economy, but to reinforce the ability of the state to allocate capital.⁷⁴

Although the state announced that the reform of split share structure had been implemented successfully, it is disappointing that there was no large scale privatization. McGuinness has confirmed this in his research, which found little evidence of significant disposals amongst the largest and most strategic of the former holders of non-tradable shares.⁷⁵ The majority shareholders kept their dominant position of corporate control with a relatively lower shareholding (51.7 per cent), compared with the figure before the reform (62.4 per cent).⁷⁶ However, given the liquidity of their

difference between the institutional shareholders and individual shareholders will also be investigated in detail in Chapter Two of this thesis.

⁷² Theoretically, institutional investors, such as mutual funds, should align with the interest of individual shareholders with regard to the compensation package. However, recent research has found that this was not the case. See, Firth, Lin and Zou (n 69) 686.

⁷³ Joyce (n 33) 60.

⁷⁴ Cooper (n 26) 54.

⁷⁵ McGuinness (n 36) 41.

⁷⁶ Yeh and others (n 51) 458.

shares, controlling shareholders would be able to choose a diverse investment portfolio and to acquire more benefits. What should be noted here is that the market administrator would face new challenges owing to the increased possibility of inside trading or manipulation of share price by controlling shareholders.⁷⁷

Nonetheless, the split share reform did at least reflect the attitude of policymakers that state control over the market-oriented economy would be more or less relaxed.⁷⁸ Jiang et al. affirm this conclusion with their research finding that the increase in the tradable share proportion and decrease in the government-owned share proportion, regardless of the size of those changes, have influenced corporate performance positively.⁷⁹

Thirdly, this thesis notes that in this third attempt at reform, proper attention was paid to the interests of minority shareholders. Scholars estimate that through the split share structure reform, total shareholder wealth has been increased by approximately 8%.⁸⁰ Given the bear market that prevailed for almost a decade, it was, at least, a good opportunity for individual minority investors to realize their investment in the Chinese stock market. Research by Lu et al. provides comprehensive evidence on the impact of the split share structure reform, and indicates that the consideration paid by the former non-tradable shareholders to the tradable shareholders was usually fair and reasonable.⁸¹ At least, there is no evidence to show that the interests of the minority shareholders were harmed by the arrangements in the implementation of the split share structure reform.

⁷⁷ Ibid 460.

⁷⁸ Cooper (n 26) 54.

⁷⁹ Bing-Bing Jiang, James Laurenceson and Kam Ki Tang, 'Share Reform and the Performance of China's Listed Companies' (2008) 19 *China Economic Review* 489, 491.

⁸⁰ Beltratti and Bortolotti (n 49) 15.

⁸¹ Lu, Balabat and Czernkowski (n 34) 2.

According to Wu, in the long run this reform provides the possibility of eliminating the conflict of interest between the majority shareholder and minorities, by sweeping away the problematic system design.⁸² He believes that all shareholders would have similar interests, pursuing better corporate performance, based on the greater liquidity of corporate shares. The controlling shareholder would put more emphasis on corporate competitiveness in the market, rather than tunnelling corporate assets or infringing the rights of minority counterparts. Therefore, improper related-party transactions would reduce in both amount and scale, since the loss of the listed company has a direct link to the asset value of the controlling shareholder.⁸³

Nevertheless, other researchers have expressed some doubts. They question whether the holders of tradable shares, especially the individual minority investors, have the capability to calculate the negative impact on their share price of floating such a large amount of non-tradable shares.⁸⁴ Therefore, minorities should have been provided with more reliable advice by consultants.

Furthermore, disappointing cases have been exposed in which non-tradable shareholders failed to fulfil their commitments in the reform proposals. For example, some controlling shareholders promised to buy back shares if the market price dropped to a certain level, but failed to do so. Shanghai's Baoshan Iron & Steel Co. was an example.⁸⁵ Even worse, administrative bodies, such as the CSRC, did nothing to protect the

⁸² Wu (n 30) 27.

⁸³ Ibid 30.

⁸⁴ Joyce (n 33) 70.

⁸⁵ , 'Guquan Fenzhi Gaige: 2006 Nian Jiang Yinglai Juezhuan [Split Share Reform: 2006 Will Greet an All-Decisive Battle]' <http://news3.xinhuanet.com/mrdx/2006-01/08/content_4024114.htm> accessed 18-05-2013.

interest of minorities involved in the reform, although the relevant administrative documents had granted them power to do so.⁸⁶ Therefore, in line with the conclusion of an empirical research by Yeh et al., the split share structure reform did not entirely resolve the conflict of interest between controlling shareholders and the vast number of minorities.⁸⁷

Notwithstanding these critical concerns, this thesis still defines the 2005 reform as an important example of a win-win situation which benefited the state while also protecting the interests of minorities. Providing better protection to minority shareholders need not inevitably be at the expense of the state economy, as long as a proper approach is chosen.

1.3 Legal Protection of Minority Shareholders in China

As has been mentioned, the key issue of corporate governance in Chinese listed companies is the conflict of interest between the controlling shareholder and minorities, rather than the agency cost problem as in the Anglo-American countries. The problem is mainly a result of the concentrated shareholding structure. Listed companies in mainland China are normally controlled by the state, which holds the majority of corporate shares, leaving little say to the minority shareholders.

In research on minority shareholder protection in China's top 100 listed companies, Tomasic and Andrews point out that the actual situation of the minority shareholder is much weaker than it should be, according to the law and announcements made by the government.⁸⁸ In addition, among all

⁸⁶ Article 50 of the Measures for Administration of Split Share Structure Reform of Listed Companies provides that: 'In the event that any shareholder who has made commitments in the split share structure reform fails to fulfill his commitments, any stock exchange shall condemn and adopt relevant administrative and regulatory measures; if such shareholder causes damages and losses to the legitimate rights and interests of any other shareholder, he shall bear the relevant legal liabilities according to law.'

⁸⁷ Yeh and others (n 51) 472.

⁸⁸ Roman Tomasic and Neil Andrews, 'Minority Shareholder Protection in China's Top 100 Listed

kinds of stakeholders in Chinese listed companies, including all the shareholders, the state-owned majority shareholder, or the government, receives the top priority in the corporate decision-making context. Consideration of the interests of banks, creditors, and employers sometimes is given prior to consideration of the minority shareholders.⁸⁹

Minority shareholders are in a weak position in the Chinese corporate governance structure. Compared with the majority shareholder or controlling shareholder, this thesis notes that minorities suffer or might suffer from three kinds of disadvantage in current market circumstances:

First, minorities have little access to crucial corporate information. While the controlling shareholder can keep himself updated through corporate executives appointed by him, with the exception of institutional investors most minority shareholders are unable to acquire timely and accurate information on how the company is running.

In recent years, the CSRC has put great emphasis on information disclosure in Chinese listed companies. Yet, while the accuracy of disclosed information has improved, this thesis believes what has not been disclosed might be more important. Thus, ensuring minorities have access to all important corporate information, information that is both timely and accurate, is one of the key issues of minority protection addressed by this thesis.

Secondly, it is difficult for minority shareholders to participate in corporate operations. In line with the traditional majority rule, majority shareholders in Chinese listed companies are able to influence any corporate proposals

Companies' (2007) 9 The Australian Journal of Asian Law 88, 88.

⁸⁹ Ibid 111.

in favour of their private interests by voting in the shareholders' meeting, especially on the issue of electing directors. In contrast, minority investors have little say during the decision-making process, even if they act jointly.

Therefore, finding a means by which the law can provide special powers regarding corporate operations to minorities, for example by introducing a special voting mechanism or providing particular rights, becomes another important issue for this thesis. Under such reforms, corporate decisions would be no longer at the cost of minorities' interests, but in the interests of shareholders as a whole.

Thirdly, minorities in Chinese listed companies are not likely to receive as much investment return as the majority shareholder. As argued by this thesis, there are two main methods for shareholders to realize their investment: dividends paid by the company, and increases in share premiums. In theory, these two kinds of benefit depend on a good corporate performance. However, the interests of majority shareholders in Chinese listed companies are not exactly the same as those of minorities. More specifically, a controlling shareholder may not always rely on better corporate performance to satisfy his interests, including financial benefits and non-financial benefits such as public governance targets. Accordingly, the benefits which should be acquired by minorities might be denied.

Hence, the question of how legislation regarding corporate governance can prohibit the controlling shareholder from abusing corporate control to pursue private benefits, and exclude those concerns not necessary for business operation (in the interests of all shareholders),⁹⁰ will be another

⁹⁰ This thesis argues that most Chinese listed companies in competitive areas should not bear any unnecessary operation target, for example, taking responsibility for public management. The interests of other stakeholders, such as employees or creditors, would be regarded as a part of shareholders' interests in the long term.

key issue in this research.

In addition, two questions need to be discussed: (1) why the interests of the controlling shareholder differ from those of minorities; and (2) why policy makers should have special concern for minority protection, especially when listed companies are controlled by the state.

1.3.1 Conflict of Interest between Controlling Shareholder and Minorities

The issue here is to identify the reason why the interest of the majority shareholder can deviate from that of minority shareholders. Generally speaking, there are two approaches of investment return for both the majority and minority shareholders: dividend from the company and share.⁹¹ If this is the case, both the majority shareholder and the minority ones, regardless of how many shares they actually hold, should have the same underlying interest, even where each is in pursuit of his own ends. This is because each shareholder can benefit when the company receives more income and when the price of shares increases in the stock market, while if the company performs poorly, fewer dividends will be paid to shareholders and the share price will drop accordingly.

Unfortunately, however, deviation between the shareholders certainly does exist. In this thesis, three main reasons for this situation will be highlighted, as follows:

(1) The natural motivation for the majority shareholder to infringe the rights of minority shareholders.

⁹¹ Shaobo Liu, 'The Paradox of Private Benefits of Control and Excessive Benefits of Control: A New Theoretical Explanation of Large Shareholders' Expropriation of Small Ones' (2007) 2 Economic Research Journal 85, 86.

According to the research of Shleifer and Vishny in 1997,⁹² and that of Pagano and Roell in 1995,⁹³ the controlling shareholder would be able to take advantage of the controlling power to infringe the rights of dispersed minority investors. This might be done via legal means, or by means that could hardly be called illegal. La Porta, Lopez-De-Silanes, Shleifer and Vishny (LLSV) argued in 1998 that the most important problem had been changed from one of agency to how to constrain the majority shareholder from exploiting the interests of the minority shareholders.⁹⁴ One year later, LLSV published further research of ownership structure of large companies in 27 countries or areas around the world. After identifying every ultimate controller, they reached the conclusion that, except in those countries whose legal protection of minority shareholders was already developed, such as the UK and the US, in general there was a pyramidal ownership structure.⁹⁵ Such an ownership structure, this thesis argues, would provide the controller with a natural motivation to infringe the rights of minorities.

It is not difficult to see the difference between the majority's control and dividend rights. The following example illustrates the situation: X holds 100% of the shares in company A, and company A holds 51% of the shares in company B. Theoretically speaking, when a shareholder owns over 50% of the shares of a certain company, he would be able to control this company completely. So in the above case, X would be able to control company A and company A would be able to control company B entirely.

⁹² Andrei Shleifer and Robert W Vishny, 'A Survey of Corporate Governance' (1997) 52 *The Journal of Finance* 737.

⁹³ Marco Pagano and Ailsa Roell, 'The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public' (1998) 113 *The Quarterly Journal of Economics* 187.

⁹⁴ Florencio López de Silanes and others, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113, 1151.

⁹⁵ Pyramidal Ownership Structure is talking about the controller behind the controlling shareholder. One of the aims of this research is to identify the ultimate power of control and cash flow right. See, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Corporate Ownership around the World' (1999) 54 *The Journal of Finance* 471, 511.

As such, company B is actually controlled by X. However, if we focus on the X's control rights and dividend rights in company B, we see that with 51% of the shares, X has 100% control. That is to say, X receives complete control through a 51% investment. This is what this thesis refers to as the natural motivation of infringement by the majority shareholder.

Furthermore, under the pyramidal ownership structure, this deviation could be even more skewed. Using the above example, if company B holds 51% of shares in company C, we can conclude that X would be able to fully control company C with $(100\% \times 51\% \times 51\% =) 26\%$ of the shares. Some further empirical researches by LLSV in 1999 showed that the higher the deviation that exists, the greater the possibility that the majority shareholder will infringe the rights of minorities, and the more serious will be the level of infringement.⁹⁶

This deviation between control rights and dividend rights can explain why the majority shareholder sometimes takes a different view from that of the minority shareholders. However, it should be mentioned here that legal protection of the minority shareholders reduces the natural motivation of the majority shareholder to infringe the rights of the remainder.⁹⁷

(2) Benefits of corporate control

Corporate control refers to the right to influence the day-to-day operation of the company. It could be acquired either based on the ownership on some other basis. In either case, the controlling power could have effect on the structure and the effectiveness of corporate governance, and then impact upon the market value of the company. The benefits derived from such determinant controlling power can be termed the benefits of

⁹⁶ Ibid.

⁹⁷ Ibid.

corporate control.⁹⁸

Benefits of corporate control can be classified into two kinds. On the one hand, if the controlling power is beneficial to all the shareholders of the company, such benefits can be termed 'Public Benefits of Control'.⁹⁹ All shareholders are capable of sharing these benefits according to the shareholding proportion they own. However, if the controlling power benefits only the majority shareholder, such benefits can be termed 'Private Benefits of Corporate Control'.¹⁰⁰

In the Chinese context, the majority shareholder exercises his controlling power only for the purpose of maximizing his self-interest, rather than the interests of company members as a whole. This can be achieved, for example, by tunnelling or related-party transactions.¹⁰¹ The minority shareholders in the company are not capable of sharing such interests with the majority. In some cases, the reasonable interests of the minority shareholders would be sacrificed or infringed by the majority shareholder on account of his profit maximizing.

Nevertheless, some scholars argue that it is acceptable for the controlling shareholder to enjoy the benefits of corporate control, to some extent.¹⁰² They assert that the cost borne by the majority shareholder of acquiring and maintaining corporate control cannot be ignored or taken for granted. Indeed, there exist some costs, including paying a premium to the former

⁹⁸ Alexander Dyck and Luigi Zingales, 'Private Benefits of Control: An International Comparison' (2004) 59 *The Journal of Finance* 537, 537.

⁹⁹ Research Centre of Shanghai Stock Exchange, 'Zhongguo Gongsi Zhili Baogao (2009): Kongzhiquan Shichang he Gongsi Zhili [China Corporate Governance Report (2009): Market for Corporate Control and Corporate Governance]' <<http://doc.mbalib.com/view/034fe9d78734449baae3a2d74de62972.html>> accessed 22-10-2013, 67.

¹⁰⁰ *Ibid.*

¹⁰¹ Tunnelling is defined as the transfer of assets and profits out of firms for the benefit of their controlling shareholders. Simon Johnson and others, 'Tunnelling' <http://www.nber.org/papers/w7523.pdf?new_window=1> accessed 22-10-2013, 1.

¹⁰² Liu (n 91) 86.

controller, facing more risks than the minority shareholders owing to relatively concentrated investment,¹⁰³ bearing more responsibilities of supervision and social concerns and/or losing the opportunity for multiple investments.¹⁰⁴ On the basis of these costs, it has been argued that the benefit of corporate control is an appropriate consideration for the majority shareholder. In other words, it can be regarded as a profit return of investing in a controlling stake.

However, this thesis argues that such a defence cannot sufficiently justify the benefits of corporate control. Acquiring a controlling stake in the company enables the majority shareholder to determine the decision making in the interest of the shareholders rather than the directors or the other stakeholders. Consequently, the risks of investment could be controlled at a lower level and the profit-returns could be maximized for the shareholders as a whole. Therefore, a further conclusion would be that the public benefits of corporate control could be regarded as a kind of reasonable investment return for the controlling shareholder, whereas the so-called private benefits of corporate control should be prohibited by law, in order to protect the interests of the minority shareholders and the other stakeholders.

The facts show, however, that the private benefit of corporate control exists widely among Chinese listed companies, due to the imperfections of legal regulations and insufficient supervision by the government. Taking related-party transactions as an example, during the financial year 2006 to 2007 there were 6,114 transactions defined as related-party transactions, 496 of which were classified as potentially beneficial for the listed company because it received cash, loans or guarantees from the related

¹⁰³ Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences' (1985) 93 *Journal of Political Economy* 1155, 1159.

¹⁰⁴ Oliver Hart, *Firms, Contracts, and Financial Structure* (Oxford University Press 1995), 95.

party, whereas 5,618 of these transactions were considered as potentially harmful.¹⁰⁵ In other words, infringements of the minority shareholders by the majority, via use of the controlling power, are frequent and serious in Chinese listed companies.

(3) The absence of the real owner of the listed companies controlled by the state

Another reason for the current contradiction between the majority shareholder and the minority ones is the absence of the real owner where the owner is the state. As argued by this thesis, this issue is the distinctive agency cost problem in the Chinese political and economic environment.

It will not be difficult to find that the real investor of Chinese state-controlled companies is absent for extended periods. According to Article 7 of the Constitution of the People's Republic of China:

The state economy is the sector of socialist economy under ownership by the whole people; it is the leading force in the national economy. The state ensures the consolidation and growth of the state economy.¹⁰⁶

Meanwhile, the Real Right Law of the People's Republic of China states that 'as regards the properties that shall be owned by the state as provided for by law, they shall be in the ownership of the state, that is, owned by all the people'.¹⁰⁷

However, the term 'all the people' is an ambiguous one when trying to

¹⁰⁵ Henk Berkman, Rebel A Cole and Lawrence J Fu, 'Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China' (2011) 45 Journal of Financial and Quantitative Analysis 1391, 1403.

¹⁰⁶ Constitution of the People's Republic of China, Article 7.

¹⁰⁷ Real Right Law of the People's Republic of China, Article 45.

determine the real investor or the real subject to exercise the rights as a shareholder, since it is obviously impossible for all the citizens of China to be involved in corporate operations. The only official representative of all Chinese people is the state, the People's Republic of China.¹⁰⁸ Nevertheless, from the point of view of the jurisprudence of International Public Law, the state is an abstract concept, comprising three elements: territory, sovereignty and residents. Hence, there must be another agent below the state, to perform the rights and obligations on behalf of the state.¹⁰⁹

In 2009, the State-owned Asset Law of the People's Republic of China came into force, clarifying that the State Council of China is the general agent of state ownership.¹¹⁰ However, the State Council is just one link in the chain of agents of those listed companies controlled by the state. Figure 3 gives an example to show the whole agent chain from the beginning, a normal citizen A, to the end of the chain, the director in a listed company controlled by the government.

¹⁰⁸ Article 2 of Constitution of the People's Republic of China ensures the right for people to exercise state power via the National People's Congress and the local people's congresses at different levels.

¹⁰⁹ Research Group of East China University of Political Science and Law, 'Research of Optimizing the Management of the State Assets and Corporate Governance of Listed Companies Controlled by State-owned Companies (2010)', available on the website of Shanghai Stock Exchange <<http://www.sse.com.cn/sseportal/en/home/home.shtml>> accessed 27-01-2012.

¹¹⁰ Article 3 states that the State Council shall exercise the ownership of state-owned properties on behalf of the state. Law of the People's Republic of China on the State-Owned Assets of Enterprises, Article 3.

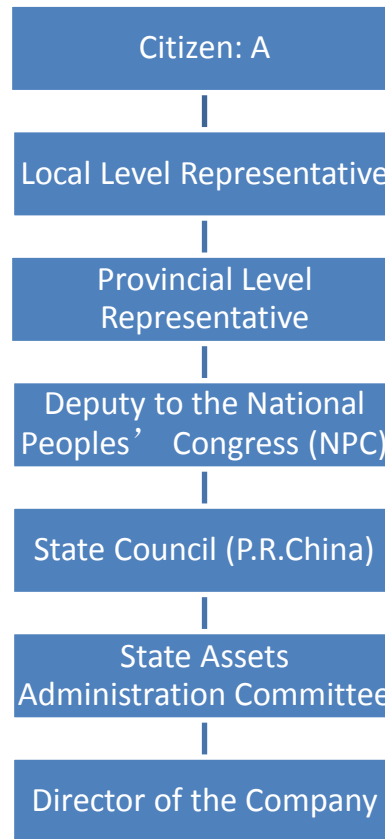


Figure 3: Agent Chain in China

When investigating each link of the agent chain, it should be noted that except for the director of the company, none of the interim agents, whether a deputy to a certain level of People's Congress or the State Assets Administration Committee, is able to gain any personal interest in the light of legal regulations. Such agents without direct claims on the company will not be sufficiently motivated to maximize the interests of the principals, because they will not be able to obtain any further profits on the basis of their performance. As such, a national majority shareholder, the State Assets Administration Committee for example, may not act as an ordinary shareholder, seeking better performance and profits, in the decision making of the company. Instead, public interests of concern to the government sometimes take priority over the benefits of the shareholders, thus causing inevitable contradiction between the majority and minority

shareholders.

1.3.2 Reasons to Improve Minority Protection

Since most listed companies are controlled by the state, what is the rationale to reinforce minority protection, which might negatively affect the vested interests acquired by the state? In the view of this thesis, improving minority protection is a necessary requirement of the gradual reform to maintain the sustainable development of the national economy and finally achieve the transformation to a market-oriented economy.

According to LLSV, the level of investors' protection can determine the capacity of the financial market, especially in developed countries such as the USA or the UK.¹¹¹ This finding has been widely cited and approved over the past decade. If the legal protection of investors could be engineered and maintained at a higher level, such investors would suffer less anxiety, and more capital would be introduced into the financial market. Meanwhile, the blooming of investment would lead to diversification of financial products and promote the economy as a whole. In this way, the national economy would develop further.

On the other hand, corporate stock ownership is based on a private contract. Compared with an explicit contract between parties, it is more difficult for the shareholders to seek remedies for the rights implied. Therefore, to some extent, the value of the stock should include an evaluation of legal protection and political supervision.¹¹² On this basis, if China intends to increase the value of its capital stock and securities market, improving and perfecting its legal protection of minority

¹¹¹ Porta, Lopez-de-Silanes and Shleifer (n 95) 472.

¹¹² Xianping Lang, *Text Book of Corporate Governance* (Social Sciences Academic Press 2003), preface.

shareholders will be necessary.

1.4 Legal Framework

China is a jurisdiction with a preference for Statutory Law. According to the Chinese legal framework, there are four levels of regulation in corporate government: (1) Laws; (2) Administrative Regulations; (3) Regulations issued by the departments of central government; and (4) Self-regulatory Rules.

Each level of regulation has different legal effect. The top level laws have the highest priority. Lower level regulations can only supplement the ones in the higher levels. Any lower-level rule violating higher-level rules is deemed as invalid.

(1) Laws

The laws in China refer to the legislation passed and issued by the National People's Congress and can only be amended or abolished by the National People's Congress or its Standing Committee. With regard to the corporate governance field, the relevant legislation includes Company Law of the P.R.C (Revised in 2005), Securities Law of the P.R.C (Revised in 2005), Criminal Law of the P.R.C, Law of the P.R.C. on the State-Owned Assets of Enterprises, and Accounting Law of the P.R.C (Revised in 1999).

(2) Administrative Regulations

Administrative regulations are those issued under the name of the State Council of China. The most important in terms of minority protection are

‘Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets’,¹¹³ and the ‘Notice of the State Council on Approving and Forwarding the Opinions of China Securities Regulatory Commission on Improving the Quality of Listed Companies’.¹¹⁴

(3) Regulations Issued by the Departments of Central Government

In relation to corporate governance, the departments of central government such as the State Assets Administration Committee, the China Securities Regulatory Commission, The People’s Bank of China and the National Audit Office of the P.R.C can be authorized to issue certain regulations. These regulations cover most of the practices in the realm of corporate governance, and include: the Code of Corporate Governance for Listed Companies, the Administrative Measures on Information Disclosure by Listed Companies, the Guidelines for the Articles of Association of Listed Companies (Revised in 2006), the Administration of the Takeover of Listed Companies Procedures, the Measures for Administration of Material Assets Reorganization of Listed Companies, the Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation), the Circular of China Securities Regulatory Commission on Distributing the Measures for the Administration of the Share-trading Reform of Listed Companies, and the Measures for the Administration of Securities Registration and Clearing.

(4) Self-regulatory Rules

¹¹³ English version available on <<http://www.asianlii.org/cn/legis/cen/laws/sootscoptroasgocm970/>> accessed 22-10-2013.

¹¹⁴ English version available on <<http://www.lawinfochina.com/display.aspx?lib=law&id=6117&CGid=>>> accessed 22-10-2013.

The lowest level rule in the corporate governance area is the self-regulatory rule, which is usually issued by the stock exchange. These rules include the Rules Governing the Listing of Stocks on the Shanghai Stock Exchange and the Notice of Shanghai Stock Exchange on Promulgating the Trading Rules for the Shanghai Stock Exchange. Although such rules lack the highest level of legal effect, breaches can carry serious punishment, such as trade suspension or delisting.

In order to illustrate the current corporate governance structure with the four levels of regulation, Figure 4 provides a simple representation of the formal structure of a Chinese listed company.¹¹⁵

¹¹⁵ On Kit Tam, 'Models of Corporate Governance for Chinese Companies' (2000) 8 Corporate Governance 52, 54.

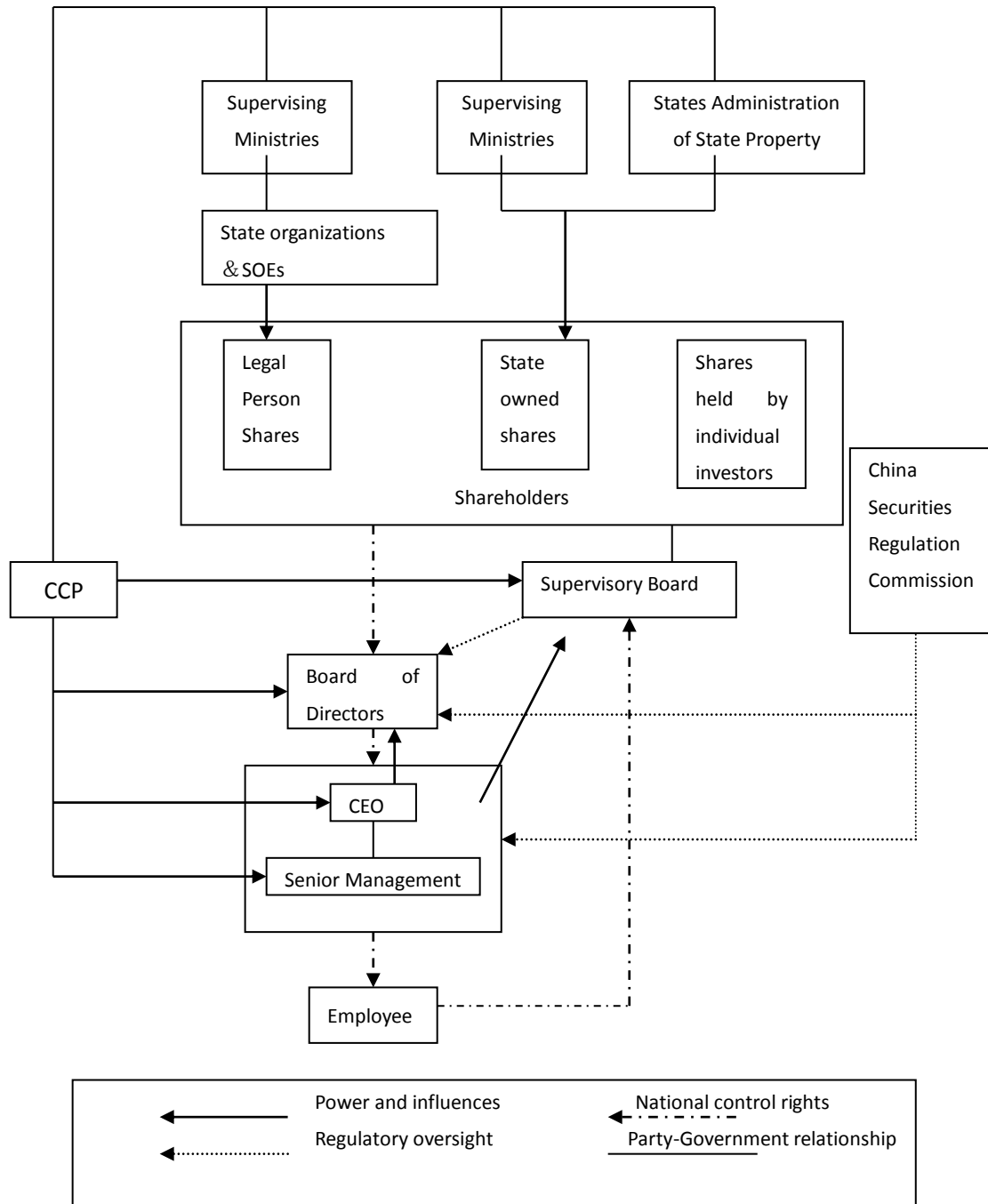


Figure 4: Legal Rights and Actual Influence of Powers in Chinese Corporate Governance

1.5 Methodology and Thesis Structure

1.5.1 Methodology

This thesis uses the methodology of comparative research. The

effectiveness of legal rules promoting to minority protection both in mainland China and in other jurisdictions is investigated and evaluated. Through comparative analysis a good understanding of those institutions, both in their original jurisdictions and in the Chinese context, is established.

As has been argued elsewhere, comparative research can provide important suggestions for legal amendment.¹¹⁶ Legislators in western countries would prefer to select jurisdictions with similar language and cultural background as the comparative object.¹¹⁷ However, in spite of the differences in language and social background between China and western countries, this thesis maintains that legal rules for minority protection in developed countries, such as the UK and the US, are proper comparative objects.

There are two main reasons for this view. First, during the gradual corporate reform that has been taking place since the 1990s, China has learnt a lot from those developed countries. For example, it has adopted the company form, established stock markets, and adjusted board governance. Reviewing such legal rules in its birthplace would help Chinese researchers and legislators to understand fully their pros and cons. Secondly, the globalization of business has caused the commercial environment in China to change in order to meet the needs of international trading. Hence, this thesis argues that comparative research on the legislation on minority protection in China and that in developed countries may be helpful to improve the quality of minority protection upon further corporate reform in China.

¹¹⁶ Helen Xanthaki, 'Legal Transplants in Legislation: Defusing the Trap' (2008) 57 *International & Comparative Law Quarterly* 659, 660.

¹¹⁷ *Ibid.* Those comparative researches argue that like must be compared with like.

Nevertheless, in comparative research it is more important to investigate divergences rather than convergences between cases. Comparative researchers cannot conclude that one jurisdiction is better than another simply because the former incorporates a certain design into its legal structure; nor can they evaluate a particular jurisdiction by the criteria of their home historic, social, cultural, and economic background.¹¹⁸

Without localization, even if the legal transplant has been completed, the original legislative intention would still be inapplicable.¹¹⁹ Even worse, such a transplant could bring about an illusion that the problem issue has been resolved.¹²⁰ In that case, the original problem could become more complicated due to delays in correction.

Therefore, this thesis places special emphasis on the social and business environment in which the legal rules for minority protection are rooted. Based on such research, the thesis puts forward some suggestions for the further improvement of minority protection in Chinese listed companies.

The literature on current corporate governance status in China comprises diverse studies. However, most of these are introductory in nature, highlighting the special characteristics in Chinese corporate governance practice: for example, how the relatively concentrated shareholding structure affects governance quality or what may result from the tight connection between listed companies and the government.

This thesis has found that there remain gaps in the literature. This is partly because the Chinese economy has developed rapidly in the last two

¹¹⁸ Mathias M Siems, 'What Does Not Work in Comparing Securities Laws: A Critique on La Porta et al's Methodology' (2005) 16 International Company and Commercial Law Review 300, 303.

¹¹⁹ Xanthaki (n 116) 659.

¹²⁰ Ibid.

decades. Commercial environment and social status are subject to continuous and tremendous change and research should keep up to date with the latest developments. In addition, there has been little research focusing in particular on minority protection.

This thesis comprises comprehensive research on minority shareholder protection in Chinese listed companies, based on the latest corporate governance legislation. It fills the gap in the literature by putting forward a detailed model for further Chinese legal reform, which provides better protection for the interests of minority shareholders.

1.5.2 Thesis Structure

The rest parts of this thesis will be organised as follows:

Chapter Two focuses on shareholder self-help by shareholders themselves. Minority shareholders may safeguard their own interests either by participating in corporate management or by initiating lawsuits as remedies. Shareholder activism, especially when exercised by institutional investors, has been regarded as one of the most important methods to reduce agency costs, and therefore prevent the interests of minorities from being infringed. Will such activism be effective in Chinese listed companies? If not, what blocks it from being effective? In terms of the remedies which minority shareholders could seek if damage occurs, this thesis places special emphasis on the derivative claim, incorporated into Chinese Company Law in 2005, to see whether this new litigation technique could help to improve minority protection.

In Chapter Three, the board of directors, as the locus of corporate

management, is analysed. By reviewing the duties owed by directors and the powers authorized to the board, the thesis argues that the board of directors should be and is able to become the key institution to balance different interests relating to corporate operations, including the interests of minority shareholders. This chapter also investigates in detail the institution of independent directors. As a mechanism of internal monitoring, the independent directors in Western countries bear high expectations. Will this institution succeed in the Chinese context? What is the relationship between the independent directors and the existing internal monitoring body, the supervisory board?

Chapter Four reviews the development of the supervisory board in China. Although often criticized as useless, the supervisory board was not abandoned in the revision of Chinese Company Law in 2005. Instead, the power of this internal monitoring body was reinforced. By analysing its shortcomings, this thesis suggests that the supervisory board could co-exist with the independent directors and the two could work effectively if their responsibilities were clearly defined.

Chapter Five introduces a special participant in corporate governance in China, the party committee of the Chinese Communist Party (CCP). This thesis finds that the CCP has decisive influence over many corporate affairs, including personnel, corporate strategy-making, and internal supervision. However, the thesis notes that there is little legal accountability to regulate this powerful actor. The party committee of the CCP is unaccountable to shareholders, especially minority shareholders. Taking into account the political concern, this thesis suggests that the party committee of the CCP could remain as part of the corporate structure after any further reform, but only for the purposes of political propaganda.

Chapter Six focuses on the external mechanisms which may increase minority protection. Starting with a case study, this chapter argues that the market administrator could be a key body to prevent the interests of minorities from being infringed by either the executives or the controlling shareholder. The case of PCCW in Hong Kong is a good example of such an external helper. Following the case study, the market regulator, the Chinese Securities Regulatory Committee (CSRC) is investigated and evaluated in comparison with its counterpart in the United States, the Securities and Exchange Commission (SEC).

In Chapter Seven, the thesis proposes a fundamental change in the corporate governance regime in China. After reviewing all the institutions relating to minority protection, it insists that state control is still the key obstacle to the improvement of minority protection, despite many institutions having been transplanted or reinforced. Only by cutting off undue intervention by the state can the protection of minority investors be increased. With this in mind, the thesis creates an ideal model with a three-level structure, based on the principle of board centralization. With such an ideal model, minority protection in China could be substantially improved.

Finally, the concluding chapter brings together the suggestions from each of the previous chapters. It is submitted that, taken together, these suggestions could substantially improve the level of protection of minorities' interests in Chinese listed companies.

Chapter Two: Self-help by Minority Shareholders

Executive Summary

As an effective method to reduce agency costs, ultimate supervision by shareholders has been encouraged in Anglo-American countries in recent years. The more the shareholders participate in corporate operations, the less misconduct by management will occur. However, this thesis argues that only activism by institutional investors will improve the legal protection of minorities. This is because individual minority shareholders lack the professional knowledge and skills needed to participate in business operations, while the institutional investors have both the motivation and the ability to become active.

However, institutional investors in China face a different market environment from that in the Anglo-American countries. Owing to the concentrated shareholding structure, institutional shareholders must fight against infringements by the majority shareholder, rather than just the misconduct of managers. Therefore, further governance mechanisms should be introduced, for example a cumulative voting system to support activism by institutional investors.

When damage occurs or is likely to occur to the company, minority shareholders need some special legal mechanism as their remedy to protect their investment. The derivative claim is such a mechanism, whereby a shareholder in the name of the company can initiate a claim against wrongdoers who harmed or may harm the company's interests. Through comparative research on the practice of derivative claim in the UK and in China, this thesis concludes that, in spite of some need for

clarification, the systematic design of the derivative claim in the UK puts more weight on minority protection, which should be instructive to China.

At the moment, however, the Chinese derivative claim is too restrictive, so that few minority shareholders could satisfy the *locus standi* requirement. As to litigation proceedings, the demand rule under the Chinese Company Law not only fails to eliminate unmeritorious and speculative claims, but also increases the difficulty for minority shareholders in initiating a reasonable derivative claim. Hence, this thesis suggests that the demand rule should be abolished in the next legal reform. Nevertheless, the thesis does conclude that the Chinese derivative claim, if it could be improved, would provide better minority protection in China.

2.0 Introduction

The separation of ownership and management is widely recognized in the modern corporate field.¹²¹ However, as the capital providers or the owners of the company, shareholders in different countries have been granted certain rights. These include not only the right to acquire the corporate profits, but also the decisive rights to determine crucial corporate affairs, such as electing directors and merger and acquisition issues. Even the minority shareholders are entitled to exercise such rights. Therefore, in terms of minority protection in Chinese listed companies, it is necessary first to review whether current corporate laws include any specific legal mechanisms to protect the interests of minority shareholders. If such mechanisms exist, then how do they work? In which aspects can they be improved in the future?

¹²¹ Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (Reprint edn, Transaction Publishers 1991), Book I, Chapter VI.

In this thesis, the legal mechanisms of self-protection by minority shareholders are divided into two groups according to the time at which they may be used in corporate governance. The first group contains the influential powers on the corporate operation, while the second consists of remedies which could be sought when damage occurs. In terms of minority protection, this thesis will suggest that legislators should authorize more effective powers to minorities, and that when damage occurs, the legal remedies should be improved.

In terms of corporate efficiency, it has to be admitted that leaving the day-to-day operation to professional managers and simply enjoying the investment return is a good choice for shareholders. This is because, in general, shareholders are not business experts, so they might make some poor decisions in corporate strategies and management.¹²² Prior research has concluded that weaker shareholder rights may increase corporate efficiency, since the executives would have greater security of position and incentives to engage in long-term projects.¹²³

Nevertheless, the separation of ownership and management leads to a core problem in corporate governance, known as the agency cost problem.¹²⁴ Corporate scandals in the last two decades have underlined the importance of the ultimate monitoring role of shareholders. Shareholders have been called on to become more actively involved in corporate operation and to fulfil their supervisory responsibility over the

¹²² Ataollah Rahmani, 'Shareholder Control and Its Nemesis' (2012) 23 *International Company and Commercial Law Review* 12, 12.

¹²³ For advanced research see L Bebchuk and L Stole, 'Do Short-term Managerial Objectives Lead to Under- or-overinvestment in Long-term Projects?' (1993) 48 *Journal of Finance* 719; M Harris, 'Anti-takeover Measures, Golden Parachutes, and Target Firm Shareholder Welfare' (1990) 21 *Journal of Economics* 614; and J C Stein, 'Takeover Threats and Managerial Myopia' (1988) 96 *Journal of Political Economy* 61.

¹²⁴ Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288, 288.

management. This can also be referred to as shareholder activism.

Owing to the huge cost of activism and the difficulty of exerting effective influence on corporate decisions, individual minority shareholders are not likely to be capable of participating in corporate governance or, consequently, of protecting their interest by their activities. Hence, institutional shareholders, minority investors which normally hold relatively more corporate shares than individuals, have been regarded as the major driving force of shareholder activism. In 2009, the increase in the intensity and quality of institutional shareholder activism was cited in certain documents in the UK, such as the UK Treasury White Paper and the Walker Review.¹²⁵ This thesis will confirm that institutional shareholders have both the motivations and the abilities to become active in corporate governance so as to reduce the agency cost and to safeguard their investment.

However, the question remains as to whether shareholder activism, or institutional shareholder activism in particular, could have the same effect in the Chinese context, because the positive function of shareholder activism pertains particularly to jurisdictions with dispersed shareholding structure. China, in contrast, has a concentrated shareholding structure, which results in the appropriation of value from minorities by the majority shareholder as the core issue of Chinese corporate governance. Thus, it cannot necessarily be concluded that institutional investor activism can help to provide better protection of minority shareholders' interests in China. This position arises as a result of various factors. For example, the shareholding of institutional investors is inadequate to achieve effective influence, and the dominant type of institutional shareholder is different

¹²⁵ Iris H-Y Chiu, 'Stewardship as Investment Management for Institutional Shareholders' (2011) 32 Company Lawyer 65, 65.

from that in the UK or the US. Yet, this thesis holds the view that encouraging institutional shareholder activism in China is the right direction for further development. If China were to learn from the experience of the West, and amend current regulations, it could be rational to expect that institutional shareholder activism would improve the quality of Chinese corporate governance.

If damages occur, either to the company or to shareholders, there are certain remedies available under the law. Generally speaking, shareholder individual claims and derivative claims, brought by shareholders rather than the company, are the two main legal mechanisms for ex post compensation. The former is a traditional form of litigation based on direct damage to shareholders, whereas the latter has been newly introduced into Chinese corporate regulations, although there is no action in the case of merely reflective losses.¹²⁶ This thesis will pay special attention to the relatively new mechanism of the derivative claim.

The derivative claim is a type of litigation initiated by shareholders in the name of the company, based on wrongs done to the company, against the wrongdoers. In most cases, the alleged wrongdoer is a director, the majority shareholder or a certain related third party. Any compensation from the lawsuit belongs directly to the company. The ultimate aim of such litigation is to control the agency costs and protect the interests of shareholders. If the actual controller, director or majority shareholder has not taken any action against the wrongdoer or has acted improperly in an existing lawsuit, the shareholders of the company are permitted to initiate a claim or take over the existing proceeding¹²⁷ in the name of the company

¹²⁶ For Chinese Law, see Company Law of the People's Republic of China (Revised in 2005), Article 152; for English law, see *Johnson v Gore Woods & Co* [2002] 2 AC 1.

¹²⁷ To date, there is no provision confirming that existing litigation could be taken over in current Chinese Company Law 2005. More details will be discussed later in this chapter.

to protect the company's interests.

The derivative claim is widely prescribed by law. It originated in the United States and received broad acceptance owing to its positive effect on the quality of corporate governance. The UK courts endeavoured to encourage derivative claims under the common law until 2006, when the Companies Act 2006 was passed (hereafter the CA 2006). In China, the derivative claim was introduced by the Chinese Company Law 2005 (hereafter the CCL 2005). Using comparative methodology, this thesis investigates certain specific issues in respect of derivative claim systems in the UK and in China. Although this litigation mechanism has been transplanted from the US to China, it is argued that given the similar conservative attitude towards such litigation in both jurisdictions, the UK experience of broadening the use of derivative claims could be a good example for China in order to improve the legal protection of shareholders, especially the minority shareholders. Therefore, this chapter also evaluates how the derivative claim system has balanced the interests between the shareholder on the one hand, providing a judicial remedy to the owners to prevent the company from wrongs, and the company itself on the other, establishing a judicial proceeding to avoid improper actions in order to maintain day-to-day operations.

The rest of this chapter is structured as follows. The investigation focuses first on shareholder activism, to review how minority shareholders can protect their own interests using the powers authorized by law. Part 2.1.1 provides a brief introduction to shareholder activism, reviewing the methods which minority shareholders could use to improve corporate governance. In Part 2.1.2, institutional investors are differentiated from individual minority shareholders according to two factors: motivation and

ability. Moreover, an evaluation of institutional shareholder activism is provided, with special concern paid to its deficiencies. Part 2.1.3 focuses on the Chinese context, and discusses three questions: (1) Can institutional investor activism improve Chinese corporate governance just as it has done in the US and the UK? (2) How do institutional investors perform in the Chinese market in terms of minority protection? (3) What blocks institutional investor activism from being effective under current conditions?

The derivative claim is then discussed in detail, beginning with a definition. Part 2.2.2 compares the *locus standi* requirements in the UK and in China. The subject matter of litigation is considered in Part 2.2.3, followed by an analysis of litigation procedures. In Part 2.2.5, the financial issues of litigation are investigated, with emphasis upon motivation and incentives.

2.1 Shareholder Activism

2.1.1 Brief Introduction to Shareholder Activism

In this part, two questions will be addressed: (1) What is shareholder activism? (2) How can shareholders become involved in corporate operations?

(1) The Concept of Shareholder Activism

As defined by Ryan and Schneider, shareholder activism refers to the 'use of power by an investor either to influence the processes or outcomes of a given portfolio firm or to evoke large-scale change in processes or outcomes across multiple firms through the symbolic targeting of one or more portfolio firms'.¹²⁸ Sparkes and Cowton clarify the concept of

¹²⁸ Lori V Ryan and Marguerite Schneider, 'The Antecedents of Institutional Investor Activism' (2002) 27 *Academy of Management Review* 554, 555.

shareholders' power, suggesting that shareholders' rights should include not just the usage of voting and resolutions, but also activities such as seeking publicity for the group's objectives or informal dialogue with corporate executives.¹²⁹

Shuangge Wen argues that the encouragement of shareholder activism could be beneficial to the capital market in a macro sense.¹³⁰ He asserts that investors would prefer to invest where they can have a say in the running of the business. Therefore, jurisdictions which advocate shareholder activism would attract more capital for investment, both from domestic investors and from abroad.¹³¹

(2) The Methods of Activism

The main methods available for shareholder activism are voting and presenting a proposal in the shareholders' general meeting. It has been recognized that the general meeting is a key mechanism whereby shareholders have an opportunity to participate in corporate operations and hold the board members to account.¹³²

For minority shareholders in particular, it is not often possible to participate in corporate governance by presenting proposals in the general meeting. They are unlikely to know the company's business well enough to put forward any governance proposal, or to be sufficiently professional to give proper guidance in terms of corporate operations. Accordingly, some have argued that exercising the right to vote is the only way they can get

¹²⁹ R Sparkes and C Cowton, 'The Maturing of Socially Responsible Investment: A Review of the Development Link With Corporate Social Responsibility' (2004) 52 *Journal of Business Ethics* 45, 51.

¹³⁰ Shuangge Wen, 'Institutional Investor Activism on Socially Responsible Investment: Effects and Expectations' (2009) 18 *Business Ethics: A European Review* 308, 312.

¹³¹ *Ibid.*

¹³² John H Farrar, Nigel Furey and Brenda Hannigan, *Farrar's Company Law* (4th edn, Butterworths Law 1998), 308.

involved in corporate governance.¹³³ However, due to their low shareholdings, the minority shareholders are usually not in a good position to bargain with the controlling shareholder or the management. As suggested by scholars, a new balance should be considered, imposed by law, so that the majority rule can prevail but not at the expense of the minority's interests.¹³⁴ Therefore, in this part, two legal mechanisms relating to the voting process, the cumulative voting system and proxy voting, are discussed, along with other special methods such as 'Just vote no' campaigns and releasing a focus list, to investigate whether such mechanisms would help minority shareholders in their activism.

- *Cumulative Voting System*

Cumulative voting is a special voting mechanism to balance the disadvantage of minority shareholdings.¹³⁵ Originating in North America, it has not been adopted by British law.¹³⁶ In contrast to the 'one share one vote' principle, in cumulative voting shareholders are given extra votes based on the number of nominees to the board. Shareholders can allocate all their votes to any of the candidates,¹³⁷ this increasing the possibility for minority shareholders to elect directors who stand for their interests.

However, the cumulative voting system has limitations. It can only strengthen the voice of large minority shareholders and is of little direct help to individuals.¹³⁸ To illustrate, if a board consists of 11 members, shareholders would need more than 9.09 per cent of shareholding,

¹³³ Burton Rothber and Steven Lilien, 'Mutual Funds and Proxy Voting: New Evidence on Corporate Governance' (2006) 1 *Journal of Business & Technology Law* 157, 158.

¹³⁴ Mohammad Rizal Salim and Ong Yee Shyun, 'The Law on Shareholders' Meetings in Malaysia' (2009) 20 *International Company and Commercial Law Review* 436, 436.

¹³⁵ Jeffery N Gorden, 'Institutions as Relational Investors: A New Look at Cumulative Voting' (1994) 94 *Columbia Law Review* 124, 124.

¹³⁶ David Milman, 'Ascertaining Shareholder Wishes in UK Company Law in the 21st Century' (2010) 280 *Company Law Newsletter* 1, 3.

¹³⁷ Salim and Shyun (n 134) 446.

¹³⁸ *Ibid.*

individually or collectively, to win a seat on the board.¹³⁹ Thus, only if minority shareholders reach a consensus and vote collectively, can the cumulative voting mechanism help them to elect more directors on behalf of their interests than would be possible using the normal voting method.

- *Proxy Voting*

Generally speaking, most company laws allow shareholders to vote either in person or by proxy. Indeed, while a proxy was originally considered as the representative of the appointer with the right to vote on their behalf, nowadays these rights extend to the right to speak and to demand a poll.¹⁴⁰

The law relating to voting by proxy can be traced back to the mid-19th century.¹⁴¹ In the UK, reviewing the Companies Act 1929, the Cohen Committee investigated proxy voting and suggested that the right of shareholders of the company to appoint someone as a proxy, even if the proxy was not a member of the company, should be set down in statute.¹⁴² Taking up this suggestion, the legislature passed s.136 of the Companies Act 1948 which provided that:

any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him, and a proxy appointed to attend and vote instead of a member of a private company shall also have the same right as the member

¹³⁹ Bo Gong, 'The Role of Institutional Shareholder Activism in Corporate Governance: A Comparative Analysis of China and the United Kingdom' (2012) 33 *Company Lawyer* 171, 176.

¹⁴⁰ Deirdre Ahern and Karen Maher, 'The Continuing Evolution of Proxy Representation' (2011) 2 *Journal of Business Law* 125, 136.

¹⁴¹ *Ibid* 125.

¹⁴² Cohen Committee, *Report of the Committee on Company Law Amendment* (Cmd 6659, 1945), para 133

to speak at the meeting.¹⁴³

With the development of technology, in the early 21st century CREST introduced an automated proxy voting service, by which proxy appointment and voting instructions could be presented online.¹⁴⁴ This has been considered an important milestone in the development of proxy voting, because it has made the proxy voting system more convenient and widely available.

Despite the formal acceptance of proxy voting in statute law in the UK, there are no provisions regulating the formalities attached to the appointment of proxies. In the light of business tradition, a written document, normally with 'wet signatures', is required for proxy appointment.¹⁴⁵ However, corporate law has not explicitly prohibited other methods of appointing a proxy. Since 2000, there has been statutory permission for appointment of a proxy by way of an electronic communication.¹⁴⁶ So far, the formality of proxy appointment has been left to the companies themselves, through regulations in their articles.

According to UK law, any individual can be appointed as proxy, even if he is not a member of the firm. However, it is worth noting the practice in Malaysia, where a proxy of any shareholder must be 'an advocate, an approved company auditor or a person approved by the Registrar in a particular case'.¹⁴⁷ In the view of this thesis, there is a good rationale for this requirement, especially for emerging markets such as Malaysia and

¹⁴³ Companies Act 1948, s 136(1).

¹⁴⁴ J Tuckley and T Lewis, 'CREST Settlement System: New Proxy Voting Service' <<http://uk.practicallaw.com/7-102-2583?sd=plc>> accessed 22-10-2013, 15.

¹⁴⁵ R C Nolan, 'The Continuing Evolution of Shareholder Governance' (2006) 65 The Cambridge Law Journal 92, 108.

¹⁴⁶ The Companies Act 1985, s 372(A) It is an inserted article, amending the Companies Act 1985 (Electronic Communications) Order 2000.

¹⁴⁷ Malaysian Companies Act 1965, s 149(1)(b) The articles of the company can exclude such a requirement by agreement among shareholders.

China, since it ensures that the proxy has a good understanding and experience to act professionally as an appropriate representative of shareholders.¹⁴⁸

Under the Companies Act 2006, multiple proxy appointment is also acceptable. In other words, a shareholder is allowed to appoint more than one proxy to attend the meeting and vote, and each proxy is 'appointed to exercise the rights attaching to a different share or shares held by him, or (as the case may be) to a different 10 pounds, or multiple of 10 pounds, of stock held by him'.¹⁴⁹ Accordingly, those nominee shareholders who hold shares on behalf of no less than two beneficial owners can separate the votes by appointing different proxies.¹⁵⁰ In addition, the Act makes it permissible for a proxy to represent more than one shareholder at a meeting. Section 285(2) provides that, on a show of hands, every proxy present has one vote for and one vote against a resolution if 'the proxy has been instructed by one or more of those members to vote for the resolution and by one or more other of those members to vote against it'.¹⁵¹

However, some scholars have noted that the importance of proxy voting will be challenged by the increasing involvement of institutional shareholders at the meeting.¹⁵² They argue that discussion on proxy voting is normally focused on the individual shareholders, because those individuals might benefit from the ability of the proxy to speak at the meeting, whereas this is of little importance to the institutional investors.¹⁵³

Furthermore, in the case of the United States, the SEC issued new rules in

¹⁴⁸ For more explanations, see Corporate Law Reform Committee, 'A Consultative Document on Engagement with Shareholders' <<http://library.oum.edu.my/oumlib/content/catalog/587152>> accessed 27-10-2013, 47.

¹⁴⁹ The Companies Act 2006, s 324(2).

¹⁵⁰ Ahern and Maher (n 140) 129.

¹⁵¹ The Companies Act 2006, s 285(2).

¹⁵² Ahern and Maher (n 140) 142.

¹⁵³ Ibid.

1992 which allowed direct communication among shareholders. As a consequence, the institutional shareholders no longer need a high-cost intermediary, a proxy, to communicate with others.¹⁵⁴

- *'Just vote no' Campaigns*

'Just vote no' campaigns, proposed by Joseph Grundfest, have been considered a useful tool for active shareholders.¹⁵⁵ The term refers to organized attempts by activists to convince their fellow shareholders via letters, press releases, and internet communications to withhold their vote from one or more directors in an effort to communicate a message of shareholder dissatisfaction to the board.¹⁵⁶ Similar to the shareholders' proposal, 'just vote no' campaigns are not legally binding on board members, but are deemed an effective method by activists, with very low cost.¹⁵⁷

Why is it that such a cheap tool can be effective? In the view of this thesis, the campaign gives rise to public attention, which may negatively affect the personal reputation of the directors involved. For a professional manager, personal reputation is extremely important, because to an extent, his career depends upon it. Therefore, the 'just vote no' campaign becomes an external monitoring mechanism, similar to the market for corporate control, which could force directors to perform better in management.

- *Releasing a Focus List*

CalPERS, one of the largest public pension funds in the United States,

¹⁵⁴ Stuart L Gillan and Laura T Starks, 'Corporate Governance Proposals and Shareholder Activism: the Role of Institutional Investors' (2000) 57 *Journal of Financial Economics* 275, 279.

¹⁵⁵ J A Grundfest, 'Just Vote No: A Minimalist Strategy for Dealing With Barbarians Inside the Gates' (1993) 45 *Stanford Law Review* 857, 857.

¹⁵⁶ Diane Gel Guercio, Laura Seery and Tracie Woidtke, 'Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?' (2008) 90 *Journal of Financial Economics* 84, 85.

¹⁵⁷ *Ibid* 86.

has been organizing shareholder activism campaigns since 1986.¹⁵⁸ CalPERS publish an annual 'focus list' of companies it will actively engage with in order to improve their governance quality and share performance. In fact, therefore, it is a list of poorly performing companies. Researchers have found that inclusion in the list would lead to positive abnormal stock returns of companies. That is to say, it is an effective method of shareholder activism which increases shareholder value.¹⁵⁹

2.1.2 Institutional Shareholder Activism

In spite of the existence of several active methods provided for in law by which minority shareholders might safeguard their interests, this thesis contends that in practice, due to low shareholding and lack of necessary knowledge, individual minority shareholders are rarely able to use those means to participate in corporate operations. As confirmed by the Hampel Report, the discussion of the role of shareholders in corporate governance has mainly concerned institutional investors.¹⁶⁰ Undoubtedly, institutions have greater motivation to perform actively and are also equipped with the proper knowledge and influential powers.

In this section, both the motivations and capability of institutional investors are investigated. A review of the effectiveness of institutional shareholder activism leads this thesis to conclude that institutional investors could and should participate more actively in order to improve corporate governance and provide better minority protection.

¹⁵⁸ Michael P Smith, 'Shareholder Activism by Institutional Investors: Evidence from CalPERS' (1996) 51 *The Journal of Finance* 227, 231.

¹⁵⁹ Eun-Hee Kim and Thomas Lyon, 'When Does Institutional Investor Activism Increase Shareholder Value?: The Carbon Disclosure Project' (2011) 11 *The BE Journal of Economic Analysis & Policy* 1, 1.

¹⁶⁰ Hampel, *Committee on Corporate Governance --- Final Report* (HMSO 1998).

(1) Motivation

Under a dispersed shareholding structure, almost all shareholders are minority members. Holding a small bulk of corporate shares, minority shareholders, especially individuals, cannot decide corporate affairs exactly as they wish. Therefore, it will be no surprise to find shareholder apathy, with no motivation to get involved in corporate operations, in the modern company model. The only option available to disappointed shareholders is the 'Wall Street Walk'; that is, to leave by selling the shares they hold.

However, the situation has been changed with the development of institutional shareholding. In contrast to the minority individuals, this thesis argues that for a number of reasons institutional investors have much more incentive to take part in the corporate decision-making process and fulfil their internal monitoring responsibility.

First, the dramatic increase of shareholding would push institutional investors to perform more actively in corporate governance than before. Figures show that, in the 1960s, institutional shareholders held only 16 per cent of the United States' corporate equity; by 2000 this figure had climbed to 57 per cent.¹⁶¹ At the end of 2003, institutional ownership accounted for approximately 60 per cent of listed US equities and over 70 per cent of listed UK equities.¹⁶² To safeguard such large investments, institutional shareholders are obliged to pay more attention to corporate performance. And the best way to ensure a better corporate performance is to get involved.

Secondly, it is not so easy for institutional investors to exit the company by

¹⁶¹ Ryan and Schneider (n 128) 554.

¹⁶² Wen (n 130) 310.

choosing the 'Wall Street Walk', owing to their relatively large shareholdings. The share price of the company will drop rapidly if large amounts of shares are sold in the market, and in that circumstance institutional investors may face considerable financial losses. Hence, compared with the huge loss caused by poor management, active involvement in corporate operation and monitoring is much cheaper and may become a better choice for institutional investors.¹⁶³

Thirdly, sometimes, legal regulations may require institutional shareholders to be active. Since 2000, all trustees of occupational and local government pension funds are required to pay more attention to socially responsible investment and to disclose their relevant policies.¹⁶⁴ As a consequence, those institutional investors have to become more involved in their portfolio companies, to ensure that their investments are in accordance with the requirement of social responsibility.

In addition, as noted by Jensen, the institutional shareholder has more motivation if the market for corporate control is inactive.¹⁶⁵ The market for corporate control has been recognized as an effective external monitoring mechanism over corporate management. Takeovers may occur if managerial performance is poor. In other words, in order to avoid being taken over, executives have to perform well in operating the business and achieving high investment return. However, when the market for corporate control is subdued, the external threat becomes weaker. Accordingly, institutional shareholders are unable to rely on such an external monitoring system, but have to act positively to safeguard their own interests, by participating in corporate issues more actively.

¹⁶³ Gillan and Starks (n 154) 278; See also, Ryan and Schneider (n 128) 556.

¹⁶⁴ Wen (n 130) 309.

¹⁶⁵ M C Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 *Journal of Finance* 831, 867.

(2) Capability

As mentioned above, participating in corporate operations may be too complicated for individual minority shareholders. They are not business experts, but capital providers who bet their future on investment return. However, this is not the case for institutional investors. Normally, institutional shareholders are either financial service companies or investment companies, which have the ability to participate in corporate governance.

First of all, as participants in the market, institutional investors are equipped with professional knowledge of corporate management, especially corporate financial affairs. Empirical research by R. Chung et al. concludes that the presence of large institutional shareholdings can deter managers from using opportunistic earnings management to pursue self-serving objectives.¹⁶⁶ It has been found that corporate managers have some scope to decide reported profits by using discretionary accruals. Put simply, the executives can move profits from one year to the next, which may result in financial loss for shareholders. However, such opportunistic behaviour could be constrained by effective monitoring by investors with professional knowledge. According to Chung et al., large institutional shareholders have both greater incentive and the professional knowledge to undertake internal monitoring.¹⁶⁷

Secondly, institutional investors have more weight in the corporate decision-making process based on their shareholding percentage. If several institutional investors vote collectively, it might be possible for them to obtain a majority vote on corporate issues.

¹⁶⁶ Richard Chung, Michael Firth and Jeong-Bon Kim, 'Institutional Monitoring and Opportunistic Earnings Management' (2002) 8 *Journal of Corporate Finance* 29, 30.

¹⁶⁷ *Ibid* 31.

Moreover, institutional shareholders may take advantage of their public influence to affect corporate operations, in order to protect their interests. For example, by expressing an opinion or suggestion on the operation of a certain listed company through the media, an institutional investor could influence decisions by other shareholders.

(3) Different Institutional Shareholders

In the US and the UK, institutional shareholders can be classified into several main types as follows: (a) Pension Funds; (b) Mutual Funds; (c) Insurance Companies, and (d) Banks.¹⁶⁸

It has been widely recognized that different characteristics of institutional investors would lead to different contributions to shareholder activism. Generally speaking, pension funds prefer long-term investment, so they would tend to keep a better relationship with corporate management. Hence, they may have less motivation to get involved in corporate affairs against management. In an examination of the natural role of the public pension fund, Monks finds that it could be a valuable ally for activism with other institutional shareholders, rather than perform actively alone.¹⁶⁹

In contrast, mutual funds normally have less conflict of interest with their portfolio companies, but more concern about corporate performance, that is in seeking higher profits. Therefore, mutual funds have been deemed as the best potential activist to monitor corporate management.¹⁷⁰

As for insurance companies, in most cases they pay more attention to

¹⁶⁸ Ryan and Schneider (n 128) 556.

¹⁶⁹ R Monks, 'Corporate Governance and Pension Plans: If One Cannot Sell, One Must Care' <<http://www.lens-library.com/info/whar5.html>> accessed 30-01-2013.

¹⁷⁰ Rothber and Lilien (n 133) 158.

corporate bonds and mortgages than to company shares.¹⁷¹ Hence, it is rare to see insurance companies become very involved in corporate operations.

Some scholars classify institutional shareholders into two categories based on the interest link between the institutional investors and their portfolio companies.¹⁷² Those institutional shareholders that have existing or potential business relations with the portfolio companies, such as insurance companies and banks, are labelled Pressure-sensitive investors. Conversely, institutional investors such as mutual funds, whose business with the firm is limited to investing in corporate shares, are classified as Pressure-insensitive institutional shareholders. It has been argued by scholars that the Pressure-insensitive investors have greater incentive to get involved in corporate monitoring and operations than their Pressure-sensitive counterparts, who would be reluctant to challenge the management owing to concerns about their other businesses.¹⁷³

(4) Evaluation of Institutional Shareholder Activism

This subsection reports evidence to support the effectiveness of institutional shareholder activism. It also notes certain deficiencies.

- *Positive Evidence*

Empirical research by Gillan and Starks examined voting outcomes and short-term market reactions conditioned on proposal type and sponsor identity to measure the success of shareholder activism.¹⁷⁴ The findings show that, in general, shareholder activism has a positive effect, and those proposals sponsored by institutional shareholders receive significantly

¹⁷¹ R J Fabozzi and J Frank, *Investment Management* (2nd edn, Prentice Hall 1998), 124.

¹⁷² Marica Millon Cornett and others, 'The Impact of Institutional Ownership on Corporate Operating Performance' (2007) 31 *Journal of Banking & Finance* 1771, 1772.

¹⁷³ *Ibid.*

¹⁷⁴ Gillan and Starks (n 154) 277.

more favourable votes than those sponsored by individuals.¹⁷⁵ Similarly, Smith finds that shareholder activism is largely successful in changing governance structures, with a consequent increase in shareholder value.¹⁷⁶ McConnell and Servaes find that the amount of institutional shareholding is positively related to a company's Tobin's Q Index.¹⁷⁷ Hence, institutional shareholder activism has been proved effective on some extent.

Almazan et al. conclude in their research that greater shareholding ownership by Pressure-insensitive investors is associated with greater discipline on executive remuneration.¹⁷⁸ Furthermore, empirical study has shown that on the issues of takeover defences, board independence and executive remuneration, institutional shareholders play a positive role in monitoring the management, and eventually achieve better governance quality.¹⁷⁹ Chen et al. find evidence that intervention by institutional investors has positive influence on the quality of corporate decision making in relation to acquisition.¹⁸⁰ More specific research shows that pension fund involvement can encourage corporate management to select a long-term strategy.¹⁸¹

In addition to monitoring management, it has been noted that institutional shareholder activism can achieve further positive influence in corporate governance in the United States, by issuing certain practice recommendations.¹⁸² Institutional investors such as CalPERS, TIAA-CREF

¹⁷⁵ Ibid.

¹⁷⁶ Smith (n 158) 251.

¹⁷⁷ J J McConnell and H Servaes, 'Additional Evidence on Equity Ownership and Corporate Value' (1990) 27 *Journal of Financial and Economics* 595, 595.

¹⁷⁸ A Almazan, J Hartzell and L T Starks, 'Active Institutional Shareholders and Cost of Monitoring: Evidence from Managerial Compensation' (2005) 34 *Financial Management* 5, 7.

¹⁷⁹ Rothber and Lilien (n 133) 171.

¹⁸⁰ X Chen, J Harford and K Li, 'Monitoring: Which Institutions Matter?' (2005) 86 *Journal of Financial Economics* 279, 304.

¹⁸¹ Gillan and Starks (n 154) 280.

¹⁸² Jin Zhu Yang, 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (2005) 16

and AFL-CIO have been deemed an important sector in corporate governance in the US.¹⁸³

- *Deficiencies*

In spite of the support given by this thesis to institutional shareholder activism, it cannot be ignored that the effectiveness of institutional shareholder activism has been challenged. For instance, empirical results show little evidence that activism exerted any positive influence on the major decisions made by corporate boards before 1993.¹⁸⁴ In this thesis, three of the main deficiencies are investigated, as follows:

(a) Free Rider Issue

One of the most important deterrents to shareholder activism is the free rider issue. Easterbrook and Fischel illustrate this problem as follows:

Most shareholders are passive investors seeking liquid holding. They have little interest in managing the firm and less incentive to learn the details of management. No one shareholder can collect all or even a little of the gains available from monitoring the firm's managers. The benefits would be dispersed among all stockholders according to their investment, not according to their monitoring efforts. Because other shareholders take a free ride on any one shareholder's monitoring, each shareholder finds it in his self-interest to be passive. He simply sells his shares if he is dissatisfied.¹⁸⁵

International Company and Commercial Law Review 8, 11.

¹⁸³ Ibid.

¹⁸⁴ Guercio, Seery and Woidtke (n 156) 84.

¹⁸⁵ F H Easterbrook and D R Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1980) 94 Harvard Law Review 1161, 1171.

Based on such a concern, shareholder apathy has been widely acknowledged. Low attendance at the Annual General Meeting (AGM) could be evidence of apathy among institutional shareholders in the UK.¹⁸⁶ Many institutional investors consider attendance at the AGM and voting as a waste of time and money. They prefer other methods to exercise their influence,¹⁸⁷ for example, by meeting with the executives to express their concerns. However, as concluded by the Myners Report, meeting directly with executives is not obviously effective in practice.¹⁸⁸

It has been mentioned above that only large institutional investors with a certain amount of company shares have the incentive to become active, since the sake of a large amount of shares would cause a drop in their price and thus lead to a potential financial loss. However, in the 1990s, there was a welcome shift in attitude by some institutional investors towards activism. Some public pension funds started to choose target companies based on their performance in particular.¹⁸⁹ Therefore, there appeared more active involvement by institutional shareholders in corporate operations.

(b) Inadequacy of Power

Some scholars claim that lack of power is the shortcoming in the nature of institutional shareholder activism. The expectation that shareholders may influence the management by their instructions may not be achieved easily. Zhao argues that the voting right is reserved for limited occasions only. Proposals asking for shareholder approval have usually been agreed

¹⁸⁶ Jin Zhu Yang, 'Shareholder Meetings and Voting Rights in China: Some Empirical Evidence' (2007) 18 International Company and Commercial Law Review 4, 8.

¹⁸⁷ J F Solomon and others, 'Institutional Investors' View on Corporate Governance Reform: Policy Recommendations for the 21st Century' (2000) 8 Corporate Governance: An International Review 215, 224.

¹⁸⁸ P Myners, 'Institutional Investment in the United Kingdom: A Review (Myners Report)' <<http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf>> accessed 29-10-2013, 90.

¹⁸⁹ Gillan and Starks (n 154) 278.

by the executives in advance.¹⁹⁰

In addition, scholars note that the limited influence of voting rights held by institutional shareholders is partly caused by legal constraints.¹⁹¹ In some jurisdictions, such as the US, institutional investors are prohibited from holding a large proportion of corporate shares, in order to prevent market manipulation.¹⁹² In the Chinese context, the legal requirement of disclosure discourages institutional investors from holding more than 5 per cent of corporate shares.¹⁹³ Therefore, votes by institutional shareholders on corporate issues are unlikely to have decisive influence on the outcomes.

(c) Sub-Agency Cost Problem in Institutional Investors

Because an institutional investor is also a company, it may suffer from its own agency cost problem. Some institutional investors have a multiple role, performing both as shareholders in portfolio companies, and as investment intermediaries, who may have conflicting interests with the portfolio companies.¹⁹⁴ Under some circumstances, a fund manager may support management at the expense of the fund-holders, in order to further his own interests. Even in the case of the mutual fund, which has been regarded as having most potential for activism, independence is an issue. In the real business world, a mutual fund is usually one of the divisions of a huge financial service company which holds a set of other businesses with the portfolio company. Embarrassing the management may have negative impact on those other businesses.¹⁹⁵ Moreover,

¹⁹⁰ Yuan Zhao, 'Nomination and Election of Independent Directors: from Anglo-Saxon Style to Chinese Practice' (2011) 32 *Company Lawyer* 89, 91.

¹⁹¹ Chao Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 2' (2006) 17 *International Company and Commercial Law Review* 287, 289.

¹⁹² *Ibid.*

¹⁹³ *Securities Law of the People's Republic of China* (Revised in 2005), Article 79.

¹⁹⁴ Wen (n 130) 309.

¹⁹⁵ Rothber and Lilien (n 133) 160.

scholars have noted two interesting points which impede fund managers from performing actively: (i) Competition among fund managers may hinder collective performance in activism, because they may worry about the better performance achieved by others; and (ii) By standing with the management, fund managers may acquire important corporate information only known by the executives. Using such information could help the fund managers to achieve better personal performance.¹⁹⁶

Moreover, in practice, it is difficult to keep funds managers accountable with regard to their performance as shareholders in portfolio companies. Three key problems have been noted, namely: (i) the wide acceptance of the business judgment rule can help the fund manager to immunise his liability, unless an obvious breach of duty occurs; (ii) the necessary causative link between the failure to exercise shareholder's right and any financial loss is extremely difficult to establish; and (iii) the fund investors may not have a cause of action provided by law.¹⁹⁷ Thus, the question arises of how to ensure the vote by fund managers is in the interest of fund investors.

In response, some scholars have suggested that information about fund proxy vote should be disclosed, so that fund investors could better monitor the fund managers in order to avoid conflicts of interest.¹⁹⁸ In 2003, the SEC implemented two new rules relating to proxy information disclosure. One requires the funds to publish the policies on how they will make decisions on proxy votes, and the other requires them to disclose how they actually voted.¹⁹⁹

¹⁹⁶ Xi (n 191) 287.

¹⁹⁷ Chao Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 1' (2006) 17 *International Company and Commercial Law Review* 251, 261.

¹⁹⁸ Martijn Cremers and Roberta Romano, 'Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation' *American Law & Economics Association Annual Meetings* <<http://law.bepress.com/alea/17th/art41>> accessed 29-10-2013, 2.

¹⁹⁹ Rothber and Lilien (n 133) 159.

(5) Summary

Despite some lingering problems, it is still rational to believe that encouraging greater shareholder activism, especially by institutional shareholders, is the right direction to improve corporate governance and achieve legal protection of minority investors.

As a result of lessons from the recent financial crisis in the UK banking sector, there is a new emphasis on greater involvement of institutional shareholders in corporate governance.²⁰⁰ In 2009 the UK amended its Companies Act 2006 to implement the EC Shareholder Rights Directive (2007/36),²⁰¹ which adopts some modern information technologies, requires more information disclosure²⁰² and clarifies the responsibility of the proxy in voting. As a result, scholars believe that shareholders, especially institutions, will be encouraged to become more active in corporate operations and monitoring,²⁰³ although the culture cannot be changed easily in a short period.²⁰⁴

2.1.3 Institutional Shareholder Activism in China

After a late start, institutional shareholding developed rapidly in the Chinese market. This section investigates whether institutional shareholder activism could have the same positive influence on minority protection in China as it does in the Anglo-American countries. The section does so by addressing the following three questions:

²⁰⁰ Gong (n 139) 171.

²⁰¹ David Milman, 'Shareholder Rights: Analysing the Latest Developments in UK Law' (2010) 266 Company Law Newsletter 1, 2.

²⁰² Peter Bateman and Simon Howley, 'Legislative Comment: Shareholder Rights Directive: New General Meeting Requirements For Traded Companies' (2009) 256 Company Law Newsletter 1, 1.

²⁰³ Ahern and Maher (n 140) 143.

²⁰⁴ Milman, 'Ascertaining Shareholder Wishes in UK Company Law in the 21st Century' (n 136) 5.

(1) Can institutional investor activism improve Chinese corporate governance just as it has done in the US and the UK?

To answer this question it is necessary to note two main differences between China and the Anglo-American countries, to establish a basic understanding of the current situation institutional investors may face in Chinese corporate governance.

First, the shareholding structure in China is different. Under a concentrated shareholding structure, the core issue of corporate governance is not the agency cost problem between shareholders and management, but the infringement of minority shareholders by the majority shareholder. In other words, the main target of institutional shareholder activism in China is not monitoring the executives, but keeping the controlling shareholder accountable.²⁰⁵

Secondly, it is important to notice that companies in Anglo-American countries are controlled by pension funds and insurance companies,²⁰⁶ while in China, the dominant institutional investors are mutual funds.²⁰⁷ Theoretically, the dominance of mutual funds should bring about better internal monitoring, since, as discussed above, the mutual funds are the most active institutional investors. However, the practical problem for Chinese mutual funds is how they can fight against the majority shareholder, who may control more than half of corporate equities.

In addition to the differences mentioned above, Yang points out that the weak enforcement of the law on minority protection may deter the success

²⁰⁵ Gong (n 139) 174.

²⁰⁶ Wen (n 130) 310.

²⁰⁷ Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 1' (n 197) 252.

of institutional shareholder activism in China.²⁰⁸ He lists four reasons for the weakness of legal enforcement: (a) government control remains, both in business operations and in regulation enforcement; (b) the courts lack experience to assess breaches of directors' duties; (c) the courts can rarely establish causality between the alleged wrongdoings and the financial losses of shareholders; and (d) the majority of company lawyers are not equipped with knowledge and experience of derivative claims in China.²⁰⁹

However, difficulty does not equate to impossibility. The dramatic increase of institutional shareholding and support from legislators have made institutional shareholder activism one of the most important sectors in the further development of the Chinese securities market. Compared with individual minority shareholders, who have less professional knowledge and weaker decision power, institutional shareholders could achieve better outcomes in terms of preventing the majority shareholder from abusing its controlling position. As such, better legal protection of minority shareholders could be realized.

(2) How do the institutional investors perform in the Chinese market in terms of minority protection?

The two stock exchanges in China, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, were established only relatively recently, in the early 1990s. Accordingly, the development of institutional shareholding also had a late start. However, with political support from the Chinese government, institutional investors have blossomed in the last decade. The investment threshold for institutional shareholders is continually being

²⁰⁸ Yang, 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (n 182) 15.

²⁰⁹ Ibid.

lowered, and some state-owned shares have been transferred to the national social security pension fund at the IPO stage. As reported by the CSRC, by 2009, institutional investors held more than half of Chinese equities which were trading in the stock market.²¹⁰

Furthermore, it has been expected that institutional shareholder activism could positively support the adoption of some significant legal mechanisms for minority protection. Such support could include the introduction of advanced corporate governance regulations, and shaping the evolution of standards of Chinese corporate governance.²¹¹ A few successful cases have been reported. For example, shareholders in China Vanke, one of the largest real estate developers in the Chinese market, passed a proposal raised by institutional investors to tighten shareholders' control over the provision of guarantees, which ran against the proposal presented by the majority shareholder.²¹²

However, in the view of scholars, institutional shareholder activism in China is still at a preliminary stage, with little participation in corporate governance.²¹³ Furthermore, the Shanghai Stock Exchange has reported that it is rare to see institutional shareholders contributing to corporate internal monitoring.²¹⁴

In comparative research, Gong reviews the increasing importance of institutional shareholders in the United Kingdom, and concludes that they will form a growing sector in the Chinese capital market. They could at

²¹⁰ In China, there still exist Non-tradable Shares of listed companies. Gong (n 139) 172.

²¹¹ Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 1' (n 197) 251.

²¹² , 'Jinjin Gaodiao Banyan "Jiji Touzizhe" [Mutual Funds Acted as "Active Investors"]' *Zhongguo Zhengquan Bao [China Securities News]* (May 9, 2005).

²¹³ Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 2' (n 191) 294.

²¹⁴ SSE, 'China Corporate Governance Report 2007'

<<http://static.sse.com.cn/sseportal/webapp/datapresent/SSedisquisitionAndPublicationAct>> accessed 04-04-2012, 36.

least play 'a greater role in the appointment of company directors, the compensation and supervision of management and major decision-making processes to ensure good corporate governance in Chinese listed companies'.²¹⁵ However, it is rare to see successful examples in practice. As Xi concludes in his study, many obstacles to institutional shareholder activism still remain.²¹⁶

With further reform of the split-share structure, it will not be surprising to see more non-tradable shares being transferred to institutional investors. As such, the importance of institutional investors in corporate governance will be enhanced. The attitude towards institutional shareholder activism can be seen in the recent reform of the split share structure, which requires institutional investors to ensure a fair compensation scheme for existing shareholders with tradable shares, who are normally minority individuals. A CSRC administrative document states that 'institutional shareholders are urged to take active part in the share reform, and defend the rights of investors, especially public investors, as well as sustained development of the market'.²¹⁷

Moreover, it is worth mentioning the development in the last decade of Qualified Foreign Institutional Investors (QFIs). Before opening up to foreign investors in 2003, the A-share market, as the domestic stock market, was reserved for domestic investors only.²¹⁸ The investment quotas of QFIs are allocated by the State Administration of Foreign Exchange, and by July 2005 had increased from \$4 billion to a total of \$10 billion.²¹⁹ This thesis holds the view that greater involvement of QFIs

²¹⁵ Gong (n 139) 171.

²¹⁶ Xi, 'Institutional Shareholder Activism in China: Law and Practice: Part 2' (n 191) 294.

²¹⁷ CSRC, Guidance Notes on the Split Share Structure Reform of Listed Companies, Article 14.

²¹⁸ X Tong, *Financial Services in China: The Past, Present and Future of A Changing Industry* (China Knowledge Press 2005), 308.

²¹⁹ Florian Gimbel and Geoff Dyer, 'Why Foreign Investors Are Not Saviours' *Financial Times* (July 13, 2005) <<http://www.ft.com/cms/s/0/4c940adc-f404-11d9-af32-00000e2511c8.html#axzz2Jwv2485B>>

could help to improve the governance quality of Chinese listed companies, as they will endeavour to implement the advanced corporate governance mechanisms evident in developed western countries.

(3) What blocks institutional investor activism from being effective under current conditions?

This thesis identifies two main obstacles to institutional shareholder activism in the Chinese market. These are the shareholding structure and the absence of effective legal mechanism to enhance activism.

- *Shareholding Structure*

As stated above, in China, the majority shareholder usually controls the company by holding more than half of corporate equities. In such a case, even if all the institutional minority shareholders perform collectively, it is still not possible for them to challenge the controller. For example, Lushan Laojiao (000568), a listed company, has the highest shareholding by institutional shareholders in the Chinese market; 41.50 per cent of its tradable shares are collectively controlled by mutual funds. However, these institutions still fail to challenge the controlling shareholder on corporate issues, since the controlling shareholder holds 53.53 per cent of total shares.²²⁰ A similar huge gap in shareholding exists in many other listed companies. The controlling shareholder of the Bank of China holds 67.49 per cent of total company shares, while a mere 0.19 per cent of shares is controlled by all levels of institutional investors.²²¹

Under such circumstances, institutional investors can neither decide managerial affairs nor act as monitors. Hence, it will not be surprising to

accessed 30-01-2013.

²²⁰ Gong (n 139) 174.

²²¹ Ibid 175.

see institutional investors stand with the controller. Any other course of action would lead to limited access to crucial corporate information, and consequently to a poor trading performance.²²²

- *Inadequacy of Effective Legal Mechanisms to Enhance Activism*

Where there is a controlling shareholder in the company, the voting process may be the easiest way to infringe the rights of minority shareholders.²²³ By voting, the will of the majority shareholder can be transferred to corporate decisions. According to the principles of 'one share one vote' and majority rule, minority shareholders, including institutions, would have almost no chance to prevail against the controller. Although the cumulative voting system has been introduced into Chinese company law, its effectiveness in practice is still in doubt.

The earliest provision relating to cumulative voting can be found in the Code of Corporate Governance for Listed Companies in China, 2002. Article 31 provides:

The election of directors shall fully reflect the opinions of minority shareholders. A cumulative voting system shall be earnestly advanced in shareholders' meetings for the election of directors. Listed companies that are more than 30% owned by controlling shareholders shall adopt a cumulative voting system, and the companies that do adopt such system shall stipulate the implementing rules for such cumulative system in their articles of

²²² Rothber and Lilien (n 133) 160.

²²³ Lilian Miles and Miao He, 'Protecting the Rights and Interests of Minority Shareholders in Listed Companies in China: Challenges for the Future' (2005) 16 International Company and Commercial Law Review 275, 276.

association.²²⁴

A regulation has been adopted in the revised Chinese Company Law 2005, whereby a cumulative voting system can be introduced to elect the members of the board of directors and supervisory board in accordance with the corporate articles.²²⁵ However, the implementation of cumulative voting design is not compulsory. Shareholders can reach any agreement on this issue in the company's articles of association.

As mentioned above, the cumulative voting system can help minorities to have a say only when they control a certain proportion of company shares. In order to investigate whether such a voting design is likely to be effective, Gong randomly selected 10 samples from the top 100 Chinese listed companies.²²⁶ The result shows that the average shareholding by institutional investors in this sample is less than the minimum requirement (9.09 per cent), which means, disappointingly, that institutional shareholders will be unable to use cumulative voting to win a seat on the board.

Moreover, Zhao notes that cumulative voting may result in disharmony within the board, because directors elected by cumulative votes would be separated into different groups. The corporate operation may suffer from serious disputes and endless debate.²²⁷ Consequently, corporate efficiency will be negatively affected and the interests of minority shareholders may be harmed.

As evidenced by empirical study, the voting system in China has not

²²⁴ CSRC, The Code of Corporate Governance for Listed Companies in China (2002), Article 31.

²²⁵ Company Law of the People's Republic of China (Revised in 2005), Article 106.

²²⁶ Gong (n 139) 176.

²²⁷ Zhao (n 190) 94.

functioned as well as legislators expected, so that minority shareholders still have little say through the voting process.²²⁸ By 2010, there had not been a single case relating to the application of cumulative voting rights.²²⁹

Apart from the uselessness of the cumulative voting system, this thesis holds the view that more specific mechanisms should be designed to compensate for the weakness of minority shareholders in participating in corporate operations. Detailed suggestions will be put forward in the concluding part of this chapter.

2.2 Remedies by Shareholders

2.2.1 Derivative Claim vs Shareholder Individual Claim

As mentioned earlier, derivative claims are initiated by a shareholder but in the name of the company against the wrongdoers to the company. It should be noted that the derivative claim differs from individual claims raised by shareholders (Table 1). First, the claims are initiated under different names. In an individual shareholder claim, the claimant shareholder acts on his own behalf, whereas under a derivative claim the claimant is the company and the shareholder is just the instigator of the litigation. In other words, the claimant shareholder is a company representative when raising a derivative claim. Second, the subject matter of the two kinds of claim is different. An infringement of individual interests can only be litigated in court by an individual shareholder action. Personal interests or reflective loss cannot be compensated through a derivative claim. Finally, compensation obtained as a result of the lawsuit belongs to different entities under the two different types of claim. This difference

²²⁸ Yang, 'Shareholder Meetings and Voting Rights in China: Some Empirical Evidence' (n 186) 6.

²²⁹ Wei-Qi Cheng, 'Protection of Minority Shareholders after the New Company Law: 26 Case Studies' (2010) 52 *International Journal of Law and Management* 283, 296.

might be one of the most important factors which the shareholder and his lawyer would take into consideration when deciding which claim to pursue. A claimant shareholder can receive compensation directly in an individual claim, while under a derivative claim, only the company can benefit directly. Following the success of such a claim, the shareholder, as an agent of the company bringing the litigation, can realize his interest via an increase in the share price or in extra dividends. Regarding this last point, it is still debatable whether the derivative claim mechanism is sufficient to motivate shareholders to intervene in corporate governance by monitoring the directors' activities.

Items	Derivative Claims	Other Individual Claims initiated by shareholders
Claimant	The company with the shareholder as representative	Shareholder
Subject Matter of Litigation	Wrongs done to the company	Personal interest or reflective loss
Allocation of Legal Compensation	The company	The claimant shareholder

Table 1: Derivative Claims vs. Other Individual Claims Initiated by Shareholders

It should be noted that, although the derivative claim provides a remedy for shareholders against wrongdoers, it inevitably carries the risk of abuse of rights of action for personal interests. Hence, a soundly-designed derivative claim should balance protection of shareholders' interest on the one hand and the stability of corporate operations on the other. In this section, attention is focused on this newly-transplanted legal mechanism,

the derivative claim, as it applies in China. The expectation of legislators is that the derivative claim should improve protection for shareholders, especially minority shareholders, in Chinese corporate practice.

Looking back at the history of derivative claims around the world, it is obvious that there have been changes in attitude toward such litigation. More specifically, the issues of the *locus standi* requirement, the subject matter of litigation and the litigation procedure remain controversial.

Generally speaking, UK courts have been conservative in relation to treating derivative claims, compared to their counterparts in the United States. The UK courts have strictly insisted on two fundamental principles set out in *Foss v Harbottle*.²³⁰ the independence of corporate personality and majority rule. Prior to the Companies Act 2006 (CA 2006), in common law the *locus standi* requirement meant that individuals could not bring lawsuits on behalf of the company for wrongs done to a company. Moreover, if corporate actions had been ratified by the shareholders under majority rule, a minority shareholder was not permitted to initiate a derivative claim unless he could successfully establish the existence of a 'prejudicial operation' and 'wrongdoer control'. Once CA 2006 came into force, statute replaced common law in regulating derivative claims (Table 2). According to the Secretary of State Alistair Darling: 'This Act will help ensure Britain remains one of the best places in the world to set up and run a business. It makes sure the regulatory burden on business is "light-touch", promotes shareholder engagement and will help encourage a long-term investment culture in the UK.'²³¹

²³⁰ (1843) 67 ER 189.

²³¹ A Darling, 'Consultation on Secondary Legislation' <<http://www.dti.gov.uk/bbf/co-act-2006/index.html>> accessed 16-07-2011.

	Common Law	Statute (the CA 2006)
Subject Matter of Litigation	Exceptions to <i>Foss</i>	s 260
Conditions	Establishing the existence of both 'fraud on minority' and 'control of the wrongdoer'	Comply with the two-stage proceeding
Comments	The statutory derivative claim extends the range of actions and increases the possibility of success by the claimant shareholder.	

Table 2: Derivative Claim under Common Law vs. Statute Derivative Claim

The statutory derivative claim extends the subject matter of litigation. It also removes some restrictive conditions which were present in the common law. As such, it can be concluded that the possibility of a shareholder initiating a derivative claim was increased by CA 2006. Additionally, in order to prevent litigation rights being abused, CA 2006 provides a two-stage proceeding as a safeguard. This two-stage proceeding can be briefly described as follows: at the first stage, if the claimant shareholder cannot establish a *prima facie* case, the application to continue the derivative claim will be dismissed by the court. If the claimant successfully passes the first stage, in the second stage the wrongdoer and the company will be asked to present their defences against the wrongs complained of. Consequently, the court decides whether the derivative claim should proceed to determination.

However, in practice, the provisions relating to this two-stage procedure fail to provide clear criteria. For example, what is the exact requirement for establishing a *prima facie* case? In the second stage, how should the court

weigh all the matters listed under s.172 of CA 2006 to determine whether the director has breached the duty owed to the company?²³² The uncertainty of such criteria can ultimately result in doubt about the likely outcome of derivative claim. This appears to be a negative aspect of the remedy, which was designed to help shareholders to protect their companies' interests and was presumed to be efficient. Overall, this thesis agrees that the derivative claim under the CA 2006 provides the best remedy so far for shareholders to protect corporate interests against those who commit wrongs against the company. Therefore, it attempts to determine what aspects of the procedure could be used for the further reform of the Chinese corporate regime.

In China, the derivative claim was introduced into the legal system under Art.152 of the CCL 2005, and has not yet been widely used in practice. Owing to the concentrated shareholding structure, the core issue of corporate governance in China is not the agency cost problem between the management and shareholders, but the conflict of interests between majority shareholder and minority counterparts. Thus, a soundly designed Chinese derivative claim should place greater emphasis on minority protection.

Art.152 states:

Where a director or a senior manager falls within the circumstances as mentioned in Article 150 of this Law,

²³² S.172(1) of CA 2006 formulates several matters the director should also have regard to: (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

shareholder(s) of a limited liability company, or those of a joint stock limited company separately or aggregately holding 1% or more of the total shares of the company for 180 consecutive days or more, may make a written demand to the board of supervisors or the supervisor in a limited liability company with no board of supervisors to initiate a lawsuit in the People's Court. Where a supervisor falls within the circumstances as mentioned in Article 150 of this Law, the aforesaid shareholder(s) may make a written demand to the board of directors or the executive director in a limited liability company with no board of directors to initiate a lawsuit in the People's Court. If the board of supervisors, the supervisor in the limited liability company with no board of supervisors, the board of directors, or the executive director in the limited liability company with no board of directors refuse(s) to initiate a lawsuit after receiving the shareholder's written demand as mentioned in the preceding paragraph, or fail(s) to initiate a lawsuit within 30 days after receiving such a demand, or if, in an emergency, the failure to initiate a lawsuit immediately will cause irrecoverable damage to the interests of the company, the aforesaid shareholder(s) may, on his/their own behalf, directly initiate a lawsuit for the interests of the company in the People's Court. Where the legal rights and interests of the company are impaired by a third party and any loss is caused to the company, the aforesaid shareholder(s) may initiate a lawsuit in the People's Court in accordance with the preceding two paragraphs.

Compared with the statutory derivative claim under CA 2006 in the UK, there remains an obvious difference in the Chinese provision. According to the CCL 2005, the claimant in a derivative claim is restricted not only by a *locus standi* requirement but also by a procedure, named demand rule, which ensures the shareholder has exhausted internal remedies before bringing the claim to the court. In other words, according to current regulations, it is not easy for Chinese shareholders, especially minority shareholders, to initiate such action before the court.

2.2.2 The *Locus Standi* Requirement

In this section, the key issue to be discussed is who qualifies to bring a derivative claim, or, alternatively, what is the *locus standi* requirement for a derivative claim in the two jurisdictions. As previously mentioned, it must be remembered that the derivative claim is a special litigation mechanism to protect shareholders' interests. However, business should not be inhibited by unmeritorious claims and speculative claims. Therefore, certain safeguards need to be established. One of these is the *locus standi* requirement. The 'proper claimant rule' ensures that the litigation is pursued on behalf of, and any damages are awarded to, the company, rather than shareholders.

(1) The *Locus Standi* Requirement in the UK

There is almost no qualification necessary for the initiation of a derivative claim according under UK law, as long as the requirement of being a member of the company is fulfilled. No additional restriction, such as holding a minimum proportion of shares or a minimum shareholding period, is required.

Indeed, somebody who becomes a member of the company after the wrong has occurred is still able to initiate a derivative claim as long as he retains his membership when he brings the claim to court. In contrast, a derivative claim initiated by somebody who is no longer a member of the company will not be permitted to continue, even if the wrong complained of occurred when he was a member. Therefore, being a member can be concluded as the only *locus standi* requirement for initiating a derivative claim in the UK.

(2) The *Locus Standi* Requirements in China

Regarding derivative claims, CCL 2005 lists a series of *locus standi* requirements as one of the safeguards to prevent unmeritorious suits. These safeguards are formulated in two categories: (a) minimum shareholding percentage; and (b) minimum shareholding period.

Moreover, these *locus standi* requirements are divided into different standards for different company types. Shareholder(s) of a Joint Stock Company (hereafter JSC) must hold separately or aggregately no less than 1% of the total shares for a minimum of 180 days,²³³ whereas there is no such limitation on the shareholder(s) in a Limited Liability Company (hereafter LLC). In other words, any shareholder in a LLC is capable of bringing a derivative claim under Art.152 of CCL 2005. However, all the listed companies focused upon in this thesis are formed as JSCs. Therefore, minority shareholders in listed companies are bound by this legal requirement.

One important reason for these requirements is that legislators have

²³³ Company Law of the People's Republic of China (Revised in 2005), Article 152(1).

considered the fact that the shareholders in JSCs have the choice and flexibility to leave the company by selling the shares they hold on a stock exchange. Shareholders in LLCs, in most cases, are bound by the constitution of the company and need the agreement of other shareholders to leave the company, either by transferring their shares to others or by asking the company to buy out their shares.²³⁴

However, this thesis argues that selling company shares in order to leave is not an appropriate choice for shareholders of a JSC as an alternative to a derivative claim when wrong has been done to the company, because the contested wrong would normally result in an infringement of the company's interests and be accompanied afterwards by a drop in the share price. Therefore, selling shares at this point would probably incur a financial loss. In addition, such a financial loss would be defined as a failure of investment, which cannot be compensated via any claims. Seen from this viewpoint, the possibility of transferring shares in a stock exchange should not become a reason for setting a higher *locus standi* requirement for shareholders in JSCs. It is suggested here that the real rationale could be consideration of the political aim to stabilize the financial market. In China, stability, or so-called 'harmony', is one of the most important targets of social development, and a key factor in promoting development. Preventing companies from too many speculative or unmeritorious claims by raising the *locus standi* requirements could ensure the stability of the day-to-day operations of JSCs. Accordingly, the company would be able to concentrate more on its business operations, achieving better profits; and consequently shareholders could earn a relatively higher premium on the stock market to realize their investment. As such, it could ultimately achieve harmony in society as a whole.

²³⁴ Ibid, Article 72; Also see, Z Y Zhang, 'The Rule of Derivative Actions in the Company Law Reform Proposal Draft 2005' (2005) 5 Company Lawyer 52, 52.

- *Shareholding Percentage*

The *locus standi* requirement for a percentage shareholding, which as mentioned above sets a threshold of holding separately or aggregately not less than one per cent of the company's shares, could be problematic in practice. As argued by this thesis, it might be too restrictive for minority shareholders to permit them to exercise their rights.

First of all, the statutory minimum shareholding of one per cent might be too high in the Chinese context. Apart from the top three shareholders, hardly any individual shareholder can meet the one per cent requirement.²³⁵ According to a survey of the ownership structure of listed companies in China conducted by Yang in 2006, the average proportion of shares held by the largest shareholder is in excess of 45%, the second largest holding is about five per cent and the third about three per cent; after that, no individual shareholder holds more than one per cent.²³⁶ In listed companies with a relatively dispersed shareholding structure,²³⁷ it is especially uncommon to find individual shareholders who meet such minimum requirement. The tremendous expense and cost in time also dissuades minority shareholders from acting collectively. Therefore, in the real business world the minimum requirement lacks practicability.

Secondly, the one per cent requirement is fixed, regardless of size or scale, which creates inequity between the shareholders in large JSCs and those in small ones. In some large JSCs, hundreds of millions of shares might be needed to meet the one per cent requirement, whereas in small

²³⁵ F Ma, 'The Deficiencies of Derivative Actions in China' (2010) 31 *Company Lawyer* 150, 152.

²³⁶ Ibid. Also see, Jinzhu Yang, 'The Role of Shareholders in Enforcing Director's Duties: A Comparative Study of the United Kingdom and China (Part 2)' (2006) 17 *International Company and Commercial Law Review* 381, 390.

²³⁷ Such listed companies are normally those reformed from State Owned Enterprises.

JSCs, the figure could be only a few million. This means that minority shareholders in large listed companies may face greater obstacles against initiating a derivative claim under the same regulation.²³⁸

When evaluating the statutory *locus standi* requirement of a percentage shareholding in China, it could be concluded that such a restriction precludes not only unmeritorious and speculative claims, but also a certain number of reasonable claims, due to the difficulty for minority shareholders to fulfil the requirement.

- *Shareholding Period*

To initiate a derivative claim, a shareholder in a JSC has to meet not only the minimum shareholding percentage, but also the statutory shareholding period requirement. Art.152 of the CCL 2005 stipulates a minimum period of 180 days before the day when the litigation is initiated.²³⁹ This design clearly aims to avoid abuse of the litigation right and to promote long-term investment. For example, with no such limitation on the shareholding period, a business competitor would be able to bring a derivative claim immediately after purchasing an adequate percentage of the company's shares for the purpose of achieving a negative impact on the company's reputation.

However, it might be argued that the length of the shareholding requirement, 180 days, is inappropriate. Research by a Chinese scholar has shown that the average shareholding period on the stock market is less than four months: that is, 120 days.²⁴⁰ In other words, *ex facto*, most

²³⁸ Bin Hu and Shunming Cao, 'Gudong Paisheng Susong de Helixing Jichu Yu Zhidu Sheji [The Reasonable Basis and Design of Rules on Shareholders' Derivative Actions]' (2004) 4 Faxue Yanjiu [Cass Journal of Law] 92, 93.

²³⁹ Company Law of the People's Republic of China (Revised in 2005), Article 152(1).

²⁴⁰ J Xin, *Shareholding Structure and Corporate Governance in Listed Companies* (CFP 2005), 143-144.

shareholders of Chinese listed companies would not meet the shareholding period requirement of 180 days.

Taking into account both the shareholding percentage and shareholding period requirements, few shareholders of Chinese listed companies would be able to initiate a derivative claim in the light of Art.152, even if the claim would indeed be in the interests of the company. However, it can also be argued that lowering or abolishing these requirements would mean that the current Chinese derivative claim procedure would face harder challenges from the abuse of litigation rights. One possible solution to this dilemma might be the introduction of a floating limitation. Simply put, this would mean that the greater the shareholding, the shorter the holding period should be. For example, if a shareholder owns five per cent of a company's shares, far more than the statutory minimum requirement of one per cent, he would be allowed to satisfy the *locus standi* requirement with a relatively short shareholding period, less than the current statutory minimum of 180 days. In fact, the flexible floating requirement would lower the *locus standi* requirement to initiate a derivative claim in China and could, consequently, result in a higher rate of litigation under the derivative claim, following wrongdoing to the company.²⁴¹

2.2.3 Subject Matter of Litigation

(1) The Subject Matter of Litigation in the UK

Under CA 2006, the common law conceptions of 'fraud on the minority' and 'control of the wrongdoer' have been discarded and replaced by judicial discretion to grant leave to bring a derivative claim, which is to be

²⁴¹ More detailed investigation of floating requirement could see, Zhong Zhang, 'Making Shareholder Derivative Actions Happen in China: How Should Lawsuits Be Funded?' (2008) 38 Hong Kong LJ 523, 529; and James Kirkbride, Steve Letza and Clive Smallman, 'Minority Shareholders and Corporate Governance: Reflections on the Derivative Action in the UK, the USA and in China' (2009) 51 International Journal of Law and Management 206, 215.

exercised by reference to statutory criteria set out in ss. 261-263 of the CA 2006.²⁴² More importantly, under the CA 2006, a defendant director does not have to gain individual benefits from the wrong of which the claimant complains. Some lawyers are concerned that if directors fail to have regard to one of the factors in s.172, or place undue weight on others, they might be brought before a court under a derivative claim.²⁴³ In other words, breach of almost any duty, or 'mere negligence', is potentially actionable, and the statutory codification of directors' duties expands the scope for derivative claims.²⁴⁴ To some extent, this was designed for more effective shareholder control of the directors' activities.

Moreover, in common law, *Ultraframe (UK) Ltd v Fielding*²⁴⁵ provides that, generally speaking, a shadow director has no duties unless a special responsibility is assumed regarding a particular asset in the case, while he would bear the same responsibility as an ordinary director under CA 2006.

The conclusion could be drawn that, as regards subject matters of litigation in the UK, with the passage of the CA 2006, shareholders now have fewer limitations on bringing a derivative claim. In the view of this thesis, this should have a positive impact on promoting better corporate governance.

(2) Subject Matter of Litigation in China

The subject matter of derivative claims under CCL 2005 in China is similar

²⁴² Andrew Keay and Joan Loughrey, 'Something Old, Something New, Something Borrowed: an Analysis of the New Derivative Action under the Companies Act 2006' (2008) 124 Law Quarterly Review 469, 469.

²⁴³ Gary Milner-Moore and Rupert Lewis, "'In the Line of Fire' - Directors' Duties under the Companies Act 2006' <<http://uk.practicallaw.com/9-213-2952?source=relatedcontent>> accessed 12-03-2012, 11.

²⁴⁴ J P Sykes, 'The Continuing Paradox: A Critique of Minority Shareholder and Derivative Claims Under the Companies Act 2006' (2010) 29 Civil Justice Quarterly 205, 215.

²⁴⁵ [2005] EWHC 1638 (CH).

to that regulated by CA 2006, with a broader scope of action. A shareholder can bring a derivative claim against any director, supervisor or senior manager for the reason that their conduct violates laws, administrative regulations or the articles of association of the company, and thereby has caused damage to the company.²⁴⁶ Moreover, the CCL 2005 provides that such derivative claims can also be initiated against any other person who has infringed the interests of the company and caused damage to it.²⁴⁷

The problem here is in the definitions of some key concepts; for example, 'the duty of diligence' and 'any other person', which have not been tested or interpreted by law. Consequently, the current subject matter of litigation remains uncertain.

Taking the breach of the duty of diligence as an example, the uncertainty of legal concepts could be problematic in practice. Art.148 of the CCL 2005 stipulates that directors owe a duty of diligence to the company, but fails to specify either a definition or any criteria for this. As such, it could be hard to distinguish a breach of diligence from a mere bad business decision. As a result, day-to-day operations may suffer, because directors may be reluctant to take some risky decisions, even though these may be profitable. In order to overcome the uncertainty relating to the issue of breach of the duty of diligence, it is highly recommended that the Chinese legal system adopt the concept of business judgment rule, which originated in the United States.²⁴⁸ According to this rule, which has the intention of 'stimulating risk taking, innovation and other creative

²⁴⁶ Company Law of the People's Republic of China (Revised in 2005), Article 150.

²⁴⁷ Ibid, Article 152(3).

²⁴⁸ Ma (n 235) 157.

entrepreneurial activities',²⁴⁹ if a director is found to have acted without self-interest, in an informed manner and with the rational belief that the decision was in the best interests of the company in a business matter, he will not be found to be negligent.²⁵⁰

However, in common with the UK, the current regulations defining the subject matter of litigation in China could be considered as satisfactory overall, given that it improves the legal protections of shareholders.

2.2.4 Litigation Procedure of Derivative Claims

In this section, the litigation procedures for derivative claims in the two jurisdictions are investigated separately. There are two key issues to consider here: (1) whether the litigation procedure makes it practicable for shareholders, especially minority shareholders, to achieve the legislative aim of providing them with an efficient remedy to protect their interests; and (2) whether the litigation procedure effectively precludes unmeritorious and speculative claims so as to maintain the stable operation of the company.

(1) The Two-stage Procedure in the UK

The CA 2006 introduced a new two-stage procedure for a claimant to obtain leave to pursue a derivative action.²⁵¹ In the first stage, an *ex parte* application is made to the court for consideration of the shareholder's evidence only; the claim should be struck out if a *prima facie* case is not

²⁴⁹ American Law Institute, 'Principles of Corporate Governance: Analysis and Recommendations' (Publication Catalog 2008) <http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=88> accessed 15-08-2011, 76.

²⁵⁰ *Aronson v Lewis* (1984) 473 A. 2d 805.

²⁵¹ Civil Procedure Rules 1998, r.19.9.

established, and the court can make an appropriate order for costs.²⁵² If it succeeds in passing the first stage, the application moves to the second stage, in which the court has discretion as to whether to allow the claim to proceed.²⁵³ Certain aspects should be considered by the court here, in particular:

- (a) Whether the member is acting in good faith in seeking to continue the claim;
- (b) The importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
- (c) Where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be:
 - (i) Authorised by the company before it occurs, or
 - (ii) Ratified by the company after it occurs;
- (d) Where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
- (e) Whether the company has decided not to pursue the claim;
- (f) Whether the act or omission in respect of which the claim is brought gives rise to a course of action that the member could pursue in his own right rather than on behalf of the company.²⁵⁴

²⁵² The Companies Act 2006, s.261(2).

²⁵³ Ibid, s.261(3).

²⁵⁴ Ibid, s.263(3).

The criteria formulated by the legislation are not exhaustive; for example the views of disinterested members should also be considered as a whole.²⁵⁵ However, permission (or leave) must be refused if the court believes a person under the duty to promote the success of the company would not seek to continue the claim or if the wrong complained of has been authorized or ratified.²⁵⁶

The two main controversial issues relating to this two-stage procedure are (a) how to judge whether the claimant has established a *prima facie* case; and (b) how to weigh the matters listed in the second stage under s.263 (3).

- *Prima Facie Case*

Generally speaking, the court would prefer to allow derivative claims to proceed at this initial stage. The evidence which the court decision is based on is provided by the claimant, *ex parte*. According to recent research, there is little evidence from the UK case law that the test has presented a significant obstacle to minority shareholders.²⁵⁷ The total number of reported judgments on derivative claims is small, but among them there have been few cases in which a shareholder has failed to establish a *prima facie* case.²⁵⁸ However, Reed has criticized this fact, stating that, 'obliged to decide the issue on inadequate evidence, the Courts have been much too willing to permit the continuation of derivative claims in circumstances that are far from exceptional'.²⁵⁹

²⁵⁵ Ibid, s.263(4).

²⁵⁶ Ibid, s.263(2).

²⁵⁷ Keay and Loughrey (n 241) 482.

²⁵⁸ Ibid.

²⁵⁹ Rupert Reed, 'Derivative Claims: the Application for Permission to Continue' (2000) 21 Company Lawyer 156, 156.

So far, there remains uncertainty as to what exactly the first stage of the proceeding requires. In common law, the requirements for establishing a *prima facie* case on its merits are not set at a high level; 'all the courts will require is for the applicant to demonstrate: a credible case; a substantive claim; a genuine triable issue; and that his case is worthy of being heard in full'.²⁶⁰ On appeal in the Scottish case of *Wishart v Castlecroft Securities Ltd*,²⁶¹ the court demonstrated a liberal view of the *prima facie* case requirement, by stating that:

...[T]he question is not whether the application and supporting evidence disclose a *prima facie* case against the defenders to the proposed derivative proceedings, but whether there is no *prima facie* case disclosed for granting the application for leave [permission in England].

Put simply, according to the viewpoint of the Scottish judges, it is not compulsory for shareholders to prove that they have established a *prima facie* case, but if the court is satisfied that there is not a *prima facie* case, there should be refusal. In addition, the judgment specifies the matters which must be taken into account.²⁶²

To determine whether the applicant has established a *prima facie* case, some factors in s.263 (2) (3) and (4) can be taken into account. However, the consequent question is whether considering those factors under s.263 might lead to a 'mini-trial' in the first stage, which would be time consuming and expensive.²⁶³ This would deviate from the model of the derivative

²⁶⁰ Keay and Loughrey (n 241) 484.

²⁶¹ [2009] CSIH 65.

²⁶² Ibid.

²⁶³ Law Commission, 'Shareholder Remedies: Report' (Law Com No 142, 1997) [6.71].

claim favoured by legislators. Furthermore, taking into account that there is no great difference between establishing a *prima facie* case and s.263 (2) (a), some scholars have argued that there is little need to establish a *prima facie* case.²⁶⁴

As such, if the two-stage procedure for derivative claims is still to be considered as the most important safeguard against unmeritorious and speculative claims, the criterion of having established a *prima facie* case needs more clarity, whether by case law or by amendment to the statute.

- *Good Faith*

In common law, the claimant shareholder must be acting in good faith when initiating a derivative claim, although this requirement has been criticized as uncertain and unworkable.²⁶⁵ Unlike 'wrongdoer control' and 'fraud on minority', the legal concept of 'good faith' has been inherited by CA 2006, under s.263(3)(a). However, the good faith requirement under s.263(3)(a) of CA 2006 is also controversial. Hannigan has pointed out that 'the vulture hedge fund and opportunistic shareholder may have difficulty in meeting this good faith requirement', to some extent, but they do qualify to initiate a derivative claim in practice.²⁶⁶

It should be remembered that, sometimes, it is quite hard to distinguish between the personal interest of a shareholder and his interest in promoting the success of the company. For example, taking into account the fact that the legal concept of 'success of the company' has not been defined explicitly, it would be hard to conclude that an expectation of

²⁶⁴ David Gibbs, 'Has the Statutory Derivative Claim Fulfilled Its Objectives? A Prima Facie Case and the Mandatory Bar: Part 1' (2011) 32 Company Lawyer 41, 43.

²⁶⁵ Arad Reisberg, 'Theoretical Reflections on Derivative Actions in English Law: The Representative Problem' (2006) 3 European Company & Financial Law Review 69, 101.

²⁶⁶ Brenda Hannigan, *The Derivative Claim: An Invitation to Litigate?* (Butterworths 2009) para.4.69.

making more profit is merely an individual interest of the shareholder. Therefore, the question arising from Hannigan's statement is whether the permission would be definitely refused on the ground of a lack of good faith if the claimant shareholder holds any individual interest or a collateral motivation for initiating a derivative claim.

So far, the case law indicates that the existence of such ulterior motivation would not definitely be regarded as a lack of good faith, as long as the litigation could consequently benefit the company.²⁶⁷ In *Mission Capital v Sinclair*,²⁶⁸ it was argued that the claimant shareholders were seeking to bring a derivative claim simply to obtain the benefit of a costs indemnity,²⁶⁹ while in *Iesini & Ors v Westrip Holding Ltd & Ors*²⁷⁰ it was argued that the shareholders brought the claim for the benefit of a third party instead of the company, since they were funded by that party. However, in neither case were these collateral motivations considered relevant, since the claim had also been brought in the interests of the company. As such, the conclusion can be drawn that a personal motivation attached to the willingness to benefit the company is sometimes acceptable by the court. Nevertheless, it cannot be assumed that the good faith requirement is without doubt fulfilled if the company could be ultimately benefited by the litigation. Good faith could still be absent if the shareholder is found to conduct the action in an abusive or unreasonable manner.²⁷¹

In regard to this issue, the practice in Australia indicates that the courts may consider two sides of the same coin in examining 'good faith': first,

²⁶⁷ Andrew Keay and Joan Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' (2010) *The Journal of Business Law* 151, 165.

²⁶⁸ [2008] EWHC 1339 (Ch).

²⁶⁹ *Ibid* 875.

²⁷⁰ [2009] EWHC 2526 (CH), 114 and 200.

²⁷¹ *Barrett v Duckett* [1995] 1BCLC 372.

the claimant's genuine belief that there are good grounds for suing should be examined; and secondly, the court should consider whether the claimant has a selfish interest in bringing an action that would constitute an abuse of process.²⁷² It should be pointed out that the requirement of acting in good faith on behalf of the company is quite similar to that formulated under s.263(3)(b), that is, whether a hypothetical director would continue the action. Some scholars argue that, if the action could benefit the company, it is less likely that the court will find that good faith is absent, whereas if it is not in the company's interests the contrary conclusion is more likely to be drawn.²⁷³

- *The Duties Under s.172 of CA 2006*

Hitherto, directors' duties were set out in 250 years' of accumulated case law, leading to 'considerable confusion amongst director [because] three quarters thought that directors' duties were difficult to understand'.²⁷⁴ However, under the CA 2006, for the first time part of directors' duties were codified in statute law. Under CA 2006 s.172, a duty is imposed on directors to promote the success of the company and to take an array of considerations into account during its daily operation.²⁷⁵ Any purported failure of directors to 'have regard' to such factors or to give them

²⁷² Ian M Ramsay and Benjamin B Saunders, 'Litigation by Shareholders and Directors: an Empirical Study of the Australian Statutory Derivative Action' (2006) 6 *Journal of Corporate Law Studies* 397, 427.

²⁷³ Keay and Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' (n 267) 167.

²⁷⁴ Patricia Hewitt, 'Patricia Hewitt's Speech (Speech to the Cambridge Faculty of Law 5 July 2002)' <<http://www.theguardian.com/business/2002/jul/05/politics.economicpolicy1>> accessed 30-10-2013.

²⁷⁵ Section 172 of Companies Act 2006 formulates: '(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to – (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.'

appropriate weight might result in a derivative claim initiated by a shareholder who is 'seeking judicial review, in effect, of a commercial decision of management'.²⁷⁶

The key issue in the second stage of the procedure is that the court must decide whether or not the defendant director has breached the duties he owes to the company. Hence, the question of which test the court uses to determine this, a subjective one or an objective one, becomes crucial in practice. Hannigan has suggested that the hypothetical test is for the court 'to look at the matter from a subjective perspective of the hypothetical director acting to promote the success of the company'.²⁷⁷ However, Reisberg holds the same view as Lord Goldsmith, that:

[T]he test of whether a claim is a sensible one to bring, which is what s.263 (3) (b) deals with, is objective, since, by definition, what is at issue is whether the director acted properly. It is coupled with a series of tests which are designed to look at what the company actually wants.²⁷⁸

According to the two statements above, even Lord Goldsmith, who supports the objective test, also admits that the company's actual wants need to be investigated. In other words, each derivative claim should be considered on the basis of the actual situation of the company involved, not that of some abstract company.

In short, what the judge will do in this stage, as understood by this thesis, is to act as a hypothetical director who has equal professional capability

²⁷⁶ Hannigan (n 266), para.4.13.

²⁷⁷ Brenda Hannigan, *Company Law* (2nd edn, OUP 2009), 156.

²⁷⁸ Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP 2007), 156.

and owes the same duty to the company, as the real director, to make a decision based on evidence presented by both parties in the litigation. During such decision making, corporate social responsibility, the interests of employees, the interests of creditors and so on should also be taken into account in order to promote the success of the company. If the decision made by the judge, alternatively named a hypothetical director, is in accordance with what the real director did, there should be no violation of directors' duties under s.172 of CA 2006; if not, the real director should take responsibility for breach of his duties.

- *Independent Shareholders*

Another issue to be cleared up about the second stage is the concept of 'independent member'. Under s.263(4), the court is asked to consider the views of members of the company who have no personal interest, direct or indirect, in the matter.²⁷⁹ The question here is who, in practice, should be considered as independent members.

Generally speaking, derivative claims affect the interests of every member of a company. For a listed company, derivative claims are likely to have some influence on the share price. Hence, the interests of members of the company suffer a collateral impact of the litigation. As to private companies, derivative claims have influence on the business's reputation and corporate management, so as a consequence such claims also impact indirectly on the members. According to such concerns, only by defining the concept of 'independent member' more explicitly can provision s.263 (4) be made more practicable.

Justice Lewison underlines the difficulty of understanding the meaning of

²⁷⁹ The Companies Act 2006, s.263(4).

s.263 (4). In *Iesini*, he stated that:

[I] am of the opinion that it was referring to those members who were not implicated in the alleged wrongdoing and who did not stand to benefit otherwise than in their capacity as members of the company.²⁸⁰

This is undeniably a practicable way to understand the provision. However, according to the understanding of this thesis, it is not necessary to give specific concern to the views of these independent members. The reason is that the viewpoints of such members could be fully taken into account via voting in relation to the wrongs complained of, such as voting to authorize or ratify. Even if they have not been fully presented, their interests should be considered by the hypothetical director as a part of the interests of the company as a whole.

- *Summary of the Two-stage Procedure in the UK*

Although there remain some uncertainties in the regulations under CA 2006, it is clear that the two-stage procedure has not become an obvious obstacle to a shareholder bringing a derivative claim. Instead, those uncertainties mainly result in a failure to effectively prohibit unmeritorious and speculative claims. In the context of the UK, where shareholder activism is valued, such regulations could be regarded as a kind of encouragement for shareholders to get involved in corporate governance.

(2) The Procedure in China under Article 152 of CCL 2005

In the Chinese legal system, there is no special litigation procedure with regard to derivative claims comparable to the two-stage procedure in the

²⁸⁰ [2009] EWHC 2526 (Ch), [129].

UK. However, Art.152 of the CCL 2005 stipulates a demand rule for the shareholder to be able to bring the claim to the court.²⁸¹ Put simply, it is compulsory to exhaust the possibility of internal remedy before bringing the lawsuit.

The demand rule originated from relevant law in the United States.²⁸² The rule reflects a preference for leaving to the directors the decision whether to bring a claim for the wrongs done to the company, because the directors know the company's exact situation better than anybody else. Of course, it might also reflect judicial reluctance to intervene in the company's affairs.

Several issues relating to the current Chinese demand rule need to be raised. First of all, Art.152 of the CCL 2005 fails to formulate the necessary content of the demand to be sent by shareholders to the board of supervisors or the board of directors, for example whether the shareholder should identify the wrongdoer and provide some evidence to prove his allegation, and whether he should put forward the remedial relief in the demand. Without such detailed requirements on the content of the demand, it may be very difficult for the board of supervisors or the board of directors to determine whether the wrong complained of should be litigated in the interests of the company. Moreover, if the boards make the decision not to initiate a claim against the wrongdoer on the ground of inadequate information provided by the shareholders, the latter are still capable of bringing the claim to court in the name of the company in the light of Art.152. As such, it is pointless to require shareholders to exhaust internal remedies before initiating a derivative claim.

²⁸¹ Company Law of the People's Republic of China (Revised in 2005), Article 152.

²⁸² The demand rule was transplanted from the United States Supreme Court decision in *Hawes v Oakland* (1882) 104 US 450. See, Deborah A DeMott, 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1987) 11 Sydney Law Review 259, 262.

Secondly, in China there is no clear mechanism for shareholders to take over existing litigation. Deadlock is likely to be the result if the wrongdoing director or the actual controlling shareholder has brought a claim for wrongdoing but with no positive actions in the litigation: under the CCL 2005 other shareholders who do act in the interest of the company can do nothing besides wait. Under this legal system, a wrongdoing director or the majority shareholder would be able to evade legal punishment by bringing a claim against themselves or looking for some qualified shareholder to initiate a derivative claim against them before sitting on the claim. For example, when a claim has been brought to court, the claimant might fail to provide effective evidence so that the defendant director might consequently avoid legal scrutiny. This legal loophole could be a crucial defect of derivative claims in China. In the UK, the problem does not arise because shareholders are allowed by law to take over ineffective actions.²⁸³

Thirdly, it could be problematic that the board of supervisors or the board of directors is given a maximum of 30 days by statute law to consider the allegation of wrongdoing made by shareholders. Apart from the loophole concerning requirements for the content of the demand mentioned above, it should be noted that the time needed for such consideration is different for companies of different sizes. Generally speaking, listed companies are bigger than LLCs and therefore they are given a longer period for the decision-making process. The principle behind setting limitations on the duration of decision making would seem to be ‘the sooner the better’, but with the condition that the duration should also be adequate for the board to investigate the factors involved in detail and make a rational decision.

²⁸³ The Companies Act 2006, s.262(2).

However, the 30-day limitation under current Chinese company law might be too long for most small LLCs. As a result, the company may incur irreversible loss due to the delay in the shareholders' bringing of a claim on behalf of the company. On the other hand, for big companies, such as listed companies, the maximum of 30 days may be inadequate for boards to investigate the wrong complained of. Although Art.152 (2) stipulates that the demand requirement can be avoided in 'emergency situations' or 'when the damage to the company will be irrecoverable if shareholders do not bring proceedings immediately',²⁸⁴ it has never been applied in practice without uncertainty. The reason for this is that the law fails to give a definition of 'emergency situations' or to clarify in what situation 'the damage will be irrecoverable if shareholders do not bring proceedings immediately'. As a consequence of such uncertainty, it can be difficult to estimate the possibility of exemption from the 30-day limitation based on the facts of a specific case.

Last but not least, it has been argued that the demand rule is an unnecessary procedure. Overall, reviewing the provisions relating to it, it will be seen that as long as the board of supervisors or directors decides not to sue the wrongdoer, or alternatively, the shareholders simply wait for the expiration of the 30-day time limitation after sending the demand to the board, they will be capable of initiating a derivative claim under the name of the company. That is to say, the demand rule does not preclude unmeritorious or speculative claims. Contrary to expectation, unfortunately, the demand rule might improperly delay the bringing of claims, thereby causing irreversible loss. As a short conclusion to this section, this thesis suggests that the 30-day time limitation should be deleted in the next reform of Chinese company law.

²⁸⁴ Company Law of the People's Republic of China (Revised in 2005), Article 152(2).

2.2.5 Selected Financial Issues

This section discusses the costs to the claimant shareholder of bringing a derivative claim, in both the UK and China. There is a consensus that financial concerns are one of the key issues related to the practicability of derivative claims. It is hard to encourage shareholders to participate in corporate governance without any financial support.

(1) Indemnity Orders in the UK

In the UK, the position on costs in relation to statutory derivative claims remains unchanged from common law, by which a minority shareholder with a reasonable bona fide claim may be indemnified as to costs by the company where the company would benefit from the claim.²⁸⁵ In *Wallersteiner v Moir (No.2)*, Buckley L.J. held that:

where a shareholder has in good faith and on reasonable grounds sued as a plaintiff in a minority shareholder's action, the benefit of which, if successful, will accrue to the company and only indirectly to the plaintiff as a member of the company, and which it would have been reasonable for an independent board of directors to bring in the company's name, it would, I think, clearly be a proper exercise of judicial discretion to order the company to pay the plaintiff's costs.²⁸⁶

The reason for providing such an indemnity order to minority shareholders, whether or not they are successful, is that they have little to gain but much

²⁸⁵ *Wallersteiner v Moir* [1975] QB 373; Also see, Sykes (n 244) 226.

²⁸⁶ *Ibid* 403.

to lose. As mentioned above, a derivative claim is initiated by a shareholder on behalf of the company and the legal outcome accrues to the company directly. Briefly put, the claimant shareholder will not achieve any individual interest directly via litigation, whereas if he loses the claim he has to pay the cost of litigation. Clearly, such an allocation of risks is unfair to the claimant shareholder.

However, an analysis of how the indemnity cost order operates shows the serious flaws in the operation of such orders:

- (a) Obtaining an indemnity order does not completely suppress the funding problem;
- (b) It does not provide a positive inducement to litigate; and
- (c) There is also little likelihood that this will encourage shareholders to opt for the derivative action in lieu of s.459 proceedings.²⁸⁷

Reisberg also argues that without any individual reward or element of compensation, the claimant shareholder would not have any substantive incentive to initiate a derivative claim.²⁸⁸ Yet, the defendant director whose conduct is complained of would not have any concerns about litigation costs because they are paid by the company. Although, according to CA 2006 s.205(1), the defendant director has to repay the cost if the derivative claim against him is successful, he may still have some advantages during the action. For example, he may receive better legal assistance, being able to hire the best lawyers at the expense of the company. Nevertheless, in the view of this thesis, implementation of the indemnity cost order is

²⁸⁷ Arad Reisberg, 'Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commerce Litigation' (2004) 4 Journal of Corporate Law Studies 345, 383.

²⁸⁸ Ibid 355.

better than nothing.

(2) Financial Issues in China

In general, litigation costs in China consist of two main parts: the payment to the court, such as filing fees, application fees for enforcement of the court's judgments and other statutory fees;²⁸⁹ and payment to the lawyers. The filing fees are based on a percentage with no upper limit and calculated on a sliding scale according to the amount of the claim.²⁹⁰ The principle of cost allocation is that the loser has to bear the payment to the court and each party pays its lawyers' fees separately.²⁹¹ Accordingly, in China, a shareholder who plans to initiate a derivative claim has to undertake not only the financial risk of losing the litigation, normally involving the filing fees of the court, but also the payment to his lawyer, even if the claim is successful.

In addition, the filing fees and other statutory fees must be paid at the moment when the claimant brings an action. Due to the high filing fees, many individual minority shareholders are restricted from seeking large amounts of compensation for their company. Although the law allows the claimant shareholder to apply for a reduction of or exemption from the filing fees,²⁹² in practice lawyers advise against this on the grounds that such a request may be viewed unfavourably, since the courts rely heavily on these fees for their operation.²⁹³

²⁸⁹ Civil Procedure Law of the People's Republic of China, Article 107(1).

²⁹⁰ More specifically, for claims of no more than RMB 10,000, RMB 50 is charged, for claims between RMB 10,000 and 100,000, fees are charged at the rate of 2.5 per cent; and for claims between RMB 100,000 to 200,000, the rate is 2 per cent. Measures on Payment of Litigation Fees 2006, Article 13(1)(2); Civil Procedure Law of the People's Republic of China, Article 107; Also see, Ma (n 235) 154.

²⁹¹ Measures on Payment of Litigation Fees 2006, Article 29. It was passed by the State Council in December 2006 and became effective on April 1, 2007.

²⁹² Civil Procedure Law of the People's Republic of China, Article 107(2).

²⁹³ B Liebman, 'Class Action Litigation in China' (1998) 111 Harvard Law Review 1523, 1534.

As such, the financial issue is one of the key problems behind the ineffectiveness in practice of derivative claims in China. Few minority shareholders can afford the financial cost to initiate a derivative claim. Accordingly, this thesis suggests that in the next legal reform Chinese legislators follow the UK example and introduce the cost indemnity order.

2.3 Conclusion and Suggestions

According to Bainbridge, the system of corporate governance is designed to function largely without shareholder input.²⁹⁴ However, with the separation of ownership and management, it is inevitable, sometimes, that the shareholder will intervene in the day-to-day operations in order to reduce agency costs.

After reviewing the development of institutional shareholder activism in the Anglo-American countries, this thesis takes the view that such activism would help to improve the quality of corporate governance. Taking into account the special characteristics of the Chinese context, institutional shareholder activism may also be helpful in achieving better governance, especially regarding minority protection, if the shareholding requirement could be lowered and further improvements in the procedure could be implemented by law.

This thesis puts forward the following suggestions for further reforms in corporate governance in China in terms of shareholder activism.

²⁹⁴ Stephen M. Bainbridge, 'Shareholder Activism and Institutional Investors' <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227> accessed 30-10-2013, 18.

(1) With reference to shareholding structure, it is worth noting the suggestion by Tenev et al., that the Chinese government transform state-held shares into non-voting shares or restrained-voting shares.²⁹⁵ In this way, the voting process could become the real instrument of shareholder democracy and the weight of the votes of minority shareholders could be increased.

(2) In spite of the shortcomings of the cumulative voting system in Chinese law, this thesis maintains that improving voting mechanisms is the right direction for the further development of Chinese corporate governance. Relevant to this argument is the fact that in Malaysia, a jurisdiction with the same concentrated shareholding structure, scholars are calling for the introduction of a cumulative voting mechanism to protect its minority shareholders.²⁹⁶

In order to improve the cumulative voting mechanism for minority protection in practice, Zhao proposes an upgraded model, the 'Threshold Voting' system.²⁹⁷ Under this mechanism, a 'minimum supporting rate' is required in the first round of voting for election to the board. If the candidate satisfies the minimum condition, there is no need to vote again; but if the candidate fails to reach the minimum supporting rate in the first round, a second round of voting, implemented under the cumulative voting system, takes place. Using such a voting mechanism, the likelihood that majority shareholders will win all the seats on the board will be decreased, since the controlling shareholder is forced to nominate those candidates who will also receive the support of minority shareholders. Otherwise, the candidate may fail to obtain the minimum supporting rate in the first round,

²⁹⁵ S Tenev, C Zhang and L Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (International Finance Corporation of World Bank 2002), 144.

²⁹⁶ Salim and Shyun (n 134) 447.

²⁹⁷ Zhao (n 190) 94.

and then lose in the subsequent cumulative round. On the other hand, each member of the board will balance the interests of majority and minority shareholders, since he needs the support of both. Hence, under this mechanism, both the interests of minority shareholders and the prosperity of the company can be ensured simultaneously.

(3) Chinese company law should be revised to be more detailed in terms of shareholders' rights. Based on empirical research, Huang and Wu argue that it is hard to determine the benefit of granting shareholders' rights in law, given the concern of long-term corporate development. Therefore, they suggest that it should be left to the company's articles to decide the range of shareholders' rights, rather than having these formulated in law.²⁹⁸ They further note that in China there is too much stipulation of shareholder rights in law and administrative regulations, leaving little room for companies to decide their own levels of shareholder rights.²⁹⁹

Admittedly, corporate autonomy could be the best model. However, in a jurisdiction such as China, where corporate governance has been introduced only relatively recently, more detailed regulations are necessary to promote further development and avoid unnecessary problems. In addition, this thesis argues that, while current Chinese company law does have many provisions relating to shareholders' rights, they are not sufficiently detailed. More guidance is needed; otherwise, shareholders, especially the minorities who are normally not professional market participants, may find their rights difficult to exercise.

For instance, the right to appoint a proxy has been introduced in Chinese

²⁹⁸ Henry He Huang and Shengwu Wu, 'Individual Shareholder Rights Provisions and Cost of Capital' (2010) 52 *International Journal of Law and Management* 415, 425.

²⁹⁹ *Ibid.*

company law, but no detailed guidance is provided, such as how to appoint a proxy and who can be appointed as a proxy. Accordingly, minority shareholders, with little knowledge of the proxy voting system and inadequate corporate information, are unlikely in practice to exercise their right to proxy voting.³⁰⁰ To date, proxy voting designed for shareholder activism has not been widely used in China.

Another example relates to the notice of shareholder meeting. In the UK, especially since implementation of the Shareholder Rights Directive (2007/36) via changes to the Companies Act 2006, certain information has been required in the notice, including how to appoint a proxy electronically and a reminder of the right to ask questions.³⁰¹ However, Chinese company law does not stipulate what information should be included in the notice.

Therefore, this thesis suggests that more detailed regulations should be put into the next revision of Chinese company law.³⁰²

(4) The use of modern technology in corporate governance should be explicitly encouraged by law. It has been mentioned above that in the UK, electronic documents have been widely facilitated by statutes, for example for the notice of company meetings, proxy appointment, instruction of voting and meeting results. This follows from Directive 2007/36, which concerns cross-border voting issues.³⁰³ Additionally, the legislation in Austria allows companies to hold a satellite meeting simultaneously with the general meeting.³⁰⁴ China should learn from the experience of these

³⁰⁰ Yang, 'Comparative Corporate Governance: Reforming Chinese Corporate Governance' (n 182) 10.

³⁰¹ Bateman and Howley (n 202) 4.

³⁰² The Chinese company laws here refer to all legal regulations in the corporate area, including but not limited to the Company Law of the PRC.

³⁰³ , 'DBERR Consults on Implementing Shareholder Rights Directive' (2008) 241 Company Law Newsletter 1.

³⁰⁴ Albert Birkner, 'Legislative Comment: Power to the People' (2009) 91 European Lawyer 47, 47.

jurisdictions because modern technologies can provide convenient methods for shareholders to perform actively, which would lead in turn to better governance.

In terms of remedies which minority shareholders could seek when damage occurs, among other remedies such as individual lawsuits or quitting the company, this thesis puts special emphasis on the derivative claim, a litigation mechanism which allows shareholders to initiate a claim on behalf of the company. With better regulation, such a remedy would improve the protection level of minority shareholders in listed companies. As commented by Bu, the derivative action is a procedural device to enable the court to do justice to the company.³⁰⁵

As noted, in theory, such a litigation mechanism should carry a low threshold so that shareholders, especially minority shareholders, are able to use it as an effective instrument to protect the company's interests, and consequently benefit from their investment in the company. However, at the same time, sufficient judicial control should be in place to safeguard the interests of the company against both shareholders' malicious suits and out-of-court settlements for improper reasons.³⁰⁶

In this thesis, the regulations on derivative claims under UK law and in China have been investigated comparatively (Table 3).

Items	UK	China
<i>Locus Standi</i> requirement	Company Member	(1) Holding individually or aggregately no less than one per cent of the company's

³⁰⁵ Quigxiu Bu, 'The Indemnity Order in a Derivative Action' (2006) 27 Company Lawyer 2, 2.

³⁰⁶ Ma (n 235) 157.

		shares; (2) Holding shares no less than 180 days before the date of litigation
Subject matter of litigation	All kinds of breaches of duty	All kinds of breaches of duty
Litigation procedure	Two-stage procedure	(1) Satisfying the Demand Rule before initiating a derivative claim; (2) Normal civil procedure
Financial support	Indemnity order	None

Table 3: Comparison of Derivative Claims in China and the UK

It can be seen that, since the common law rules have been surpassed by the statutory derivative claim under CA 2006, the subject matter of litigation has become much wider in practice. This change would seem to be a reflection of a preference by legislators for promoting shareholder activism. To the UK's two-stage procedure for derivative claims, should be applauded, despite the fact that there remain some uncertainties, such as the requirement to establish 'a *prima facie* case', the definition of 'good faith', the approach to weighing the duties under s.172 of CA 2006 and the understanding of 'independent member'. It is reasonable to expect that minority protection could be improved by using derivative claims, if such uncertainties can be resolved.

In comparison, the derivative claim system in China appears more problematic in terms of practicability. First, the *locus standi* requirement

regarding minimum shareholding percentage and shareholding period is less rational, because few shareholders would be able to meet it. Hence, it is suggested that the *locus standi* requirement should be lowered in the next legal reform. Secondly, there exist certain problems concerning the special procedure of the demand rule, under CCL 2005. In practice this demand rule is unable to preclude unmeritorious or speculative claims, but rather it might lead to irreversible loss by delaying claims. Hence, it is suggested that the problem be resolved by abolishing the demand rule.

As argued by Ma, if the derivative claim can be made more practicable, it is likely that it will become much more widely used in the Chinese legal system, owing to its broad scope and simple procedure, and the lack of alternative remedies.³⁰⁷ Comparative study of the systems in the UK and in China suggests that the UK derivative claim, in terms of its low *locus standi* requirement, two-stage procedure and indemnity order for resolving the financial burden on the plaintiff shareholder, is weighted more heavily towards shareholders' protection. Thus, the UK example should be followed by Chinese legislators.

As for the issue of precluding unreasonable claims, it should be mentioned that the special feature of Chinese corporate governance is not that there are too many unmeritorious and speculative claims, but that there is a lack of participation by minority shareholders in corporate operations. It is proposed, therefore, that the balance between the two aspects should be tilted towards the latter. Even if a claim has been raised vexatiously, the court will eventually be able to dismiss it.

³⁰⁷ Ibid.

Chapter Three: Directors' Role in Minority Shareholder Protection

Executive Summary

This thesis argues that, in modern corporate governance, the board of directors is the core participant. The board is the decision maker on most corporate issues, as well as the internal monitor of management. Despite some shortcomings, this thesis maintains that the board of directors could be the most important safeguard of minorities' interests.

Important elements in the design of the board of directors include board size, board composition, director duties and director rights. The most important concern for legislators is to ensure the independence of the board. More specifically, the board of directors should be independent not only from the executive managers, but also from the majority shareholder. In the Chinese context, the latter is more important for minority protection.

Through comparative research, this thesis finds that Chinese legislation regarding directors' duties is too general. As a result, minority shareholders in Chinese listed companies face difficulties in judging whether a director has breached his duty. Even worse, where a director has done something wrong, current legislation offers few remedies to minority shareholders.

This chapter discusses the following four shortcomings which block the board from performing effectively: (1) directors lack sufficient working hours and professional abilities; (2) directors have little motivation to

discharge their duties; (3) more substantial powers are needed; and (4) the board cannot be guaranteed timely and accurate information.

In order to increase board independence, and fulfil the internal monitoring mission, the institution of independent directors has been introduced into the corporate governance structure. This thesis proposes an ideal model, the 'All-Right Model', which advocates putting the right person in the right position, armed with the right powers. More specifically, the majority of members of a board of directors should be independent, and board sub-committees, such as the audit committee, should consist entirely of independent directors. Furthermore, this thesis argues that legislators should grant some special powers to independent directors, for example, in the need to approve related-party transactions, in order to protect minorities' interests.

With specific reference to the institution of independent directors in Chinese listed companies, this thesis argues that it is still immature. The percentage of independent directors on the board is too low to guarantee that board decisions will be in the interests of all shareholders, rather than the private interests of the majority shareholder. However, this thesis still believes that, with improvement, the institution of independent directors could benefit the minorities by improving the quality of board decisions and corporate transparency.

3.0 Introduction

According to the theory of separation of ownership and management, the interests of shareholders are threatened by misappropriation by the executives who actually control the company. This is the so-called agency

cost problem. Minority shareholders with an insignificant shareholding may be helpless to act against executives by themselves, simply because the voting power attached to their shareholding is too weak to make any change. Accordingly, the board of directors, as the intermediary between shareholders and managers, takes an important role in corporate governance, especially in terms of minority protection.

On the one hand, as experienced businessman, directors are obligated to set out variety strategies and core decisions for the company; on the other hand, they have been defined as internal monitors to ensure that management is running the company in the interests of shareholders. In addition, directors should be accountable to shareholders in terms of their duties. For example, in most cases, managers wish to pursue the maximal expansion of the company using all corporate resources.³⁰⁸ In this case, the directors should first determine whether such expansion is for the benefit of shareholders, and then estimate both investment costs and risks. If it is in the interests of shareholders, directors should guide the executives in performing their duties.

It has been argued that executive remuneration is higher when the board is weak.³⁰⁹ In other words, if the board works effectively, executive remuneration would be lower, which may benefit shareholders' return. Therefore, in theory, a sound board of directors will reduce agency costs and protect the interests of shareholders.

Moreover, this thesis argues that in Anglo-American countries, protection of shareholders' interests by directors is practically equal to protection of

³⁰⁸ Dujuan Yuan, 'Inefficient American Corporate Governance Under the Financial Crisis and China's Reflections' (2009) 51 *International Journal of Law and Management* 139, 149.

³⁰⁹ L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004), 15.

minority shareholders, who are in a weaker position in the company's operation. This point of view is based on the fact that in countries such as the UK and the USA, there is usually no controlling shareholder. Most corporate shares are dispersed in the hands of thousands of minority investors. These investors are not able to be involved in the day-to-day operation, but simply hope the company performs well.³¹⁰ Therefore, if the board of directors could promote better protection for all shareholders, it would thereby provide legal protection of minority shareholders.

Theoretically, a well-designed board of directors starts with clear director duties, in order to bind and guide directors' activities. Meanwhile, directors should be equipped with powerful and practical rights, granted by law or authorized by articles of association, to assist them in fulfilling their responsibilities. Other factors influencing the effectiveness of the board of directors include board size, composition of board members, and terms.

Finally, the independence of board of directors has been regarded as the key factor in determining whether directors can fulfil their roles, in preventing the interests of shareholders, minorities in particular, from being infringed by executives. Principle requires board of directors to act independently from management, so that directors are able to monitor and evaluate the performance of executives. Equally, directors should perform independently from the shareholders who nominated and elected them to become corporate directors. It is worth noting that, despite the fact that directors are elected by shareholders, in most cases their duties are owed to the company, rather than the shareholders. In other words, directors should not stand for the interests of a certain individual or group of shareholders, but for all shareholders as a whole. Board independence

³¹⁰ Indeed, in Anglo-American countries, institutional shareholders collectively hold a high proportion of corporate securities. However, counted separately, most institutional shareholders are still defined as minority shareholders, few of which can place decisive influence on corporate matters by acting alone.

from the controlling shareholder is more important in those jurisdictions with relatively concentrated shareholding structure, such as China. Otherwise, directors may become watchdogs of the controlling shareholder at the expense of minorities.

In practice, however, the effectiveness of the board of directors has long been criticized, given its failure fulfil achieve its duties as expected. Bebchuk, a Harvard scholar of corporate governance, claims that one of the central flaws of corporate governance in the United States is that 'boards of directors frequently are ornamental and provide negligible oversight'.³¹¹ Others claim that the board is often controlled by executives, especially the CEO.³¹² A company CEO may have the decisive say when nominating candidates for directors. Sometimes, the CEO is also capable of determining what the board does and what it does not do.

As mentioned, Chinese listed companies have their unique governance issues owing to the existence of a controlling shareholder. Can minority shareholders seek protection from the board of directors? If so, will there be any differences in legal design of board of directors with a special emphasis on minority protection? This chapter focuses on the effectiveness of the board of directors, both in the UK and in China. Through comparative study, the chapter attempts to identify a better legal arrangement for this institution, for the purpose of improving minority protection in China.

The rest of this chapter is organized as follows. In Part 3.1, directors duties and their roles in corporate operation, formulated by law, are investigated. This part explains what directors should and should not do

³¹¹ Bebchuk and Fried (n 309) 304.

³¹² O E Williamson, 'Corporate Boards of Directors: In Principle and In Practice' (2008) 24 *The Journal of Law, Economics & Organization* 247, 252.

according to the regulations in both jurisdictions. Part 3.2 reviews the power of the board of directors, authorized by law or shareholders' meeting. With reference to minority protection, it is noted that the UK board enjoys more powers in operating the company than its Chinese counterpart. Hence, it may be reasonable to conclude that the UK board is capable of providing better protection for the interests of minorities. Part 3.3 focuses on the effectiveness of the board in four aspects: (a) board size; (b) terms; (c) composition of the board; and (d) independence of the board. Board independence and the institution of independent directors will be investigated in detail in Part 3.4. The concluding part presents an ideal model of the board of directors, and offers some suggestions for further corporate reform in China.

3.1 Directors' Duties in Law

As mentioned, theoretically the board of directors is designed to protect shareholders' investment by reducing agency costs. According to Monks and Minow, directors are 'the middlemen who provide balance and mediate the conflicts of interest between a small group of key managers based in corporate headquarters and a vast group of shareholders spread all over the world'.³¹³ It is extremely important to review the directors' duties formulated by legislation before drawing a conclusion on whether directors could help in terms of protection for minority shareholders. This thesis holds the view that, as a sound legal arrangement with the purpose of minority protection, the duties of the board of directors should be explicitly laid out in law, so as to ensure accountability of the directors to shareholders.

³¹³ R A G Monks and Nell Minow, *Corporate Governance* (5th edn, John Wiley & Sons 2011), 252.

3.1.1 Traditional Directors' Duties in the UK

Traditionally, a director, as a fiduciary of the company, has a fiduciary duty whereby he should act *bona fide* in the interests of the company. Meanwhile, he must also fulfil the common law duties of care and skill.³¹⁴ However, it is worth noting that, in practice, it is rare for directors to be challenged based on breach of directors' duties. One reason is the difficulty for claimant shareholders of proving that the director in question has not acted in good faith. It has been confirmed by the court in *Re Smith & Fawcett Ltd* that a director is to act in what he or she genuinely believes to be the best interests of the company, rather than what the court may decide to be the best interests of the company.³¹⁵ In addition, it is similarly difficult successfully to accuse a director based on his breach of common law duties of care and skill. According to a US business judgment rule, unless it can be made clear that a diligent person with similar knowledge and skills and sitting in the same position would not act in the same way, a court would be reluctant to second guess what could have been done by the director, since it is the business of shareholders and directors to manage the company, not the court's.

Accordingly, this thesis holds the view that shareholders, minorities in particular, cannot keep directors accountable to them under traditional legal regulations.

3.1.2 Statutory Duties of Directors

With the implementation of the Companies Act 2006 (CA 2006), directors' duties from the common law and equity were codified into seven statutory

³¹⁴ Jonathan Mukwiri, 'Directors' Duties in Takeover Bids and English Company Law' (2008) 19 International Company and Commercial Law Review 281, 281.

³¹⁵ [1942] Ch 304 (CA).

duties. The rationale of codification is mainly to improve comprehensibility, since the relevant case law was quite complex.³¹⁶ Generally speaking, the statutory duties are not significantly different from those under common law, except in two respects. First, the statutory duty requires a director to promote the success of the company for the benefit of its members instead of the interests of the company; and secondly, there is now a requirement for directors to consider the interests of stakeholders.³¹⁷

(1) Duty to Act within the Company's Powers

This duty echoes the common law rules, requiring the directors to act in accordance with the articles of association of the company and exercise powers only for the purposes for which they were conferred.³¹⁸

(2) Duty to Promote the Success of the Company

CA2006, section 172 is one of the core developments of directors' duties. Under common law, a director was required to act in good faith in the company's interest. By contrast, the new statute provides that a director must 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'.³¹⁹

Rose has questioned how directors can balance the two targets of profit maximization and shareholder equality, in terms of promoting the success of the company.³²⁰ Such concern originates from real business practice, where profit maximization will not unconditionally benefit all parties. Therefore, the question could be put another way, asking which should be

³¹⁶ Davy Ka Chee Wu, 'Managerial Behaviour, Company Law, and The Problem of Enlightened Shareholder Value' (2010) 31 *Company Lawyer* 53, 53.

³¹⁷ *Ibid.*

³¹⁸ The Companies Act 2006, s 171.

³¹⁹ *Ibid.*, s 172.

³²⁰ Caspar Rose, 'Director's Liability and Investor Protection: A Law and Finance Perspective' (2011) 31 *European Journal of Law & Economics* 287, 298.

the priority of directors in order to achieve success for the company: to pursue maximal profit or to ensure that all shareholders are treated equally with regard to corporate benefits?

This is, indeed, a tough question to answer, since both targets fall within the remit to be fulfilled by directors. In the view of this thesis, the target of achieving shareholder equality requires more input from directors. There is little doubt that executives would pursue corporate profits in order to bargain for better positions and remuneration packages. Shareholders, whether majority or minority, would act in concert to put pressure on the managers or even to discharge them if their performance were really poor. However, it is necessary to have a monitor to ensure the interest of all the shareholders in day-to-day operations, because minority shareholders would have little ability to dismiss executives. Shareholders who enjoy corporate benefits might not stand with the infringed minority to challenge executives. Therefore, this thesis insists that directors ought to put more emphasis on the equality of shareholders than on maximization of corporate profits. Only in this way could minority shareholders receive adequate protection from internal monitors, and consequently the quality of corporate governance could be improved.

The question remains as to whether the test to be applied to determine whether the director has promoted the success of the company should be a subjective or an objective one. Again, similar to the common law duty to act in good faith, what is important is what the director, rather than the court, believes to be in the best interests of the company. Consequently, it is still difficult for shareholders to successfully establish a breach of director duty.

To fully discharge their duty, directors must have regard to certain factors, provided by CA 2006, including:³²¹

- a) The likely consequences of any decision in the long term;
- b) The interests of the company's employees;
- c) The need to foster the company's business relationships with suppliers, customers and others;
- d) The impact of the company's operations on the community and the environment;
- e) The desirability of the company maintaining a reputation for high standards of business conduct; and
- f) The need to act fairly as between the members of the company.

The list is not exhaustive, and it remains open for directors to determine what other factors should be taken into account. However, there is no guidance to show how to weigh these factors if an inherent conflict of interest occurs. Moreover, Mukwiri claims that this list may limit good judgment by directors, because they would define it as a rule book, with points to be ticked off.³²²

(3) Duty to Exercise Independent Judgment

This duty requires the directors to exercise their judgment independently, which reflects the common law principle that directors should not be fettered in exercising their discretion.³²³ Directors, especially the non-executive directors, may not claim the defence that they relied upon the judgment of others in areas in which they were not expert, and cannot

³²¹ The Companies Act 2006, s 172.

³²² Mukwiri (n 314) 285.

³²³ The Companies Act 2006, s 173; Also see, Bill Perry and Lynne Gregory, 'The European Panorama: Directors' Economic and Social Responsibilities' (2009) 20 International Company and Commercial Law Review 25, 28.

absolve themselves of responsibility by delegating matters to committees or appropriate individuals.³²⁴

(4) Duty to Exercise Reasonable Care, Skill, and Diligence

Another statutory duty which restates the common law is the duty to act with reasonable care, skill and diligence.³²⁵ This means the care, skill and diligence that would be exercised by a reasonably diligent person with: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and (b) the general knowledge, skill and experience that the director has.³²⁶

(5) Duty to Avoid Conflicts of Interest

A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.³²⁷ The interests of the company refer to any property, information or opportunity, regardless of whether the company could take advantage of them.³²⁸

In addition, section 175 provides three situations in which directors could be indemnified for breach of duty: (a) if the matter has been authorised by members of the company; (b) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or (c) if the matter has been authorised by disinterested directors where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or where the company is a public company and its constitution

³²⁴ Perry and Gregory (n 323) 28.

³²⁵ The Companies Act 2006, s 174.

³²⁶ Ibid.

³²⁷ Ibid, s 175.

³²⁸ Ibid.

includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.³²⁹

(6) Duty Not to Accept Benefits from Third Parties

The duty not to accept benefits from third parties derives from the duty to avoid conflicts of interest. It is not infringed only if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.³³⁰

(7) Duty to Declare Any Interest in Proposed Transactions or Arrangement

If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors before the company enters into the transaction or arrangement.³³¹ However, he does not need to do so: (a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest; or (b) to the extent that the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware); or (c) to the extent that it concerns terms of his service contract that have been or are to be considered by a meeting of the directors or by a committee of the directors appointed for the purpose under the company's constitution.³³²

3.1.3 Director Duties under Chinese Law

The directors of Chinese listed companies shall comply with laws,

³²⁹ Ibid.

³³⁰ Ibid, s 176.

³³¹ Ibid, s 177.

³³² Ibid.

administrative regulations and the company articles of association. They shall bear the obligations of loyalty and diligence to the company as well. Accepting bribes or any other illegal gains by taking advantage of their authority or expropriating the properties of the company is prohibited.³³³ Furthermore, a list of forbidden activities is provided in Article 149, as follows:³³⁴

- (1) To misappropriate any funds of the company;
- (2) To deposit funds of the company in bank accounts opened in their own names or in the names of others;
- (3) To lend funds of the company to others or put up assets of the company as security for others in violation of the articles of association of the company or without approval of the shareholders' meeting, the shareholders' general meeting or the board of directors;
- (4) To enter into any contract or transaction with the company in violation of the articles of association of the company or without approval of the shareholders' meeting or the shareholders' general meeting;
- (5) To take advantage of their positions to obtain for their own benefit or the benefit of others any business opportunities that belong to the company or to engage in the same type of business as that of the company for their own account or for the account of others without approval of the shareholders' meeting or the shareholders' general meeting;
- (6) To accept commissions on transactions between others and the company and keep such commissions as their own;
- (7) To disclose any secret of the company without authorisation;

³³³ Company Law of the People's Republic of China (Revised in 2005), Article 148.

³³⁴ Ibid, Article 149.

or

- (8) To commit any other act that is in violation of their duty of loyalty to the company.

According to the provisions, directors' duties in Chinese company law can be summarized as the duties of loyalty and diligence, which resembles a hybrid of fiduciary duty to act in good faith and common law duty of care and diligence. However, in China, a jurisdiction with no case law tradition, there remains uncertainty about the operation of directors' fiduciary duties in practice. Consequently, it is difficult for shareholders in China, especially minorities, to determine whether a director has breached his duties so that they would be able to bring a lawsuit against him. Even courts in the UK are reluctant to second guess directors' activities and decisions if there has been no apparent self-interested activity or obvious breach of duty of care and diligence. How then can we expect the Chinese courts to properly balance the personal business judgment of the director and the accountability of directors to the shareholders?

Moreover, to what extent can shareholders keep directors accountable if they indeed breach their duties? Legal remedies are inadequate in practice. Only when actual loss occurs can a shareholder bring individual litigation against a problem director. Otherwise, the derivative claim could be the only option. Although the derivative claim was introduced into Chinese corporate legislation in 2005, and this thesis argues that this mechanism could be helpful for minority protection if improved (as argued in Chapter Two) its present defects mean that it is hard to find a case in which claimant shareholders have successfully established breach of duty by directors through a derivative claim.

In short, as the Corporate Governance Assessment Report of the 100 Top Chinese Listed Companies (2006) makes clear, legal regulations relating to director duties are generally inadequate in China.³³⁵

3.2 Powers of the Board of Directors

In Anglo-American countries, powers authorised to the board of directors, either by law or by constitution of the company, can be classified into two categories: (a) decision-making powers relating to corporate operations; and (b) managerial powers towards executives, including electing and appointing managers or dismissing them, determining managers' compensation, and evaluating the performance of managers. By exercising such powers, the board of directors could, in theory, ensure that the company is run in the interests of shareholders and keep the executives accountable, urging them to operate the business in accordance with board strategies. Accordingly, the board of directors can be regarded as the core institution of the corporate structure in those jurisdictions, and this will also become the key mechanism in the ideal model provided by this thesis.

However, currently in China, the powers granted to the boards of listed companies are relatively limited. According to Article 47 of the Chinese Company Law, the board of directors shall be responsible for the shareholders' meeting and exercise the following authority:³³⁶

- (1) Convening shareholders' meetings and reporting the status on work thereto;

³³⁵ Jingchen Zhao and Shuangge Wen, 'Promoting Stakeholders' Interests in the Unique Chinese Corporate Governance Model: More Socially Responsible Corporations?' (2010) 21 *International Company and Commercial Law Review* 373, 378.

³³⁶ Company Law of the People's Republic of China (Revised in 2005), Article 47.

- (2) Carrying out the resolutions made at the shareholders' meetings;
- (3) Determining operating plans and investment plans;
- (4) Formulating the company's annual financial budget plans and final account plans;
- (5) Formulating the company's profit distribution plans and loss recovery plans;
- (6) Formulating the company's plans on the increase or decrease of registered capital, as well as on the issuance of corporate bonds;
- (7) Formulating the company's plans on merger, split-up, change of company form, dissolution, etc.;
- (8) Making decisions on the establishment of the company's internal management departments;
- (9) Making decisions on hiring or dismissing the company's manager and on his remuneration, and, according to the nomination of the manager, deciding on the hiring or dismissing of vice manager(s) and the person in charge of finance, as well as their remuneration;
- (10) Establishing the company's basic management system; and
- (11) Other functions as prescribed in the articles of association.

It can be seen that, in China, material decision-making powers are still held by shareholders, through the general meeting. Consequently, those who hold majority voting rights can control the operation of the company directly. In order to provide better protection of minorities, this thesis urges Chinese legislators to reinforce the powers held by the board of directors to prevent wrongs to minority shareholders being committed by the

controlling shareholder. This would be possible if the independence of the board could be guaranteed, although it remains one of the toughest issues in Chinese corporate governance.

3.3 The Effectiveness of the Board of Directors

In this section, four aspects which may influence the effectiveness of the board of directors are investigated, namely: (1) board size; (2) terms; (3) composition of the board; and (4) the independence of the board. Finally, several factors which may result in ineffectiveness of the board are summarised.

3.3.1 Board Size

The size of the board has long been an important issue for corporate scholars. It can exert a crucial impact on board effectiveness. In theory, a small board would be easily controlled by insiders and be unable to provide appropriate professional guidance and internal supervision; while a large board may be better able to exercise the monitoring role, due to the reduced likelihood of the CEO controlling every single director.³³⁷ However, a large board may be inefficient. It has been suggested by the Higgs Report that 'an effective board should not be so large as to become unwieldy. It should be of sufficient size that the balance of skills and experience is appropriate for the requirement of the business and that changes in the board's composition can be managed without undue disruption'.³³⁸

³³⁷ S A Zahra and J A PearceII, 'Boards of Directors and Corporate Financial Performance: A Review and Integrative Model' (1989) 15 *Journal of Management* 291, 311.

³³⁸ Derek Higgs, *Review of the Effectiveness of Non-Executive Directors* (Department of Trade and Industry 2003), para 4.10.

Therefore, many empirical studies have been carried out with the intention of finding the optimal size of the board of directors. According to Koontz's research, a range from five to 13 members is desirable.³³⁹ In his view, boards with fewer than five members could not cover all the duties formulated by law; but where there are more than 13 members it may not be possible to provide every member with an adequate chance to participate. Similarly, Rebeiz finds that a relatively small board of directors would bring about better internal monitoring and corporate strategies in favour of all shareholders.³⁴⁰ Some scholars have suggested that the ideal board size should be eight or nine members, so that directors can know each other and communicate effectively.³⁴¹

Research by Stuart shows that the average board size in the United States dropped from 15 members in 1988 to 10.9 members in 2002.³⁴² According to Yang's empirical research, the average size of UK board was 7.5 members in the fiscal year 2002-2003, with a range from four to 15.³⁴³ By contrast, during the same period more than 80 per cent of Chinese listed companies had a board comprising more than 9 members, and the average size was 10 directors.³⁴⁴ At this point, this thesis suggests that more specific empirical research focusing on the best board size for Chinese listed companies should be carried out, in order to improve the effectiveness of the board of directors.

3.3.2 Terms

³³⁹ H Koontz, *The Board of Directors and Effective Management* (McGraw-Hill Book Co 1967), 121.

³⁴⁰ Rebeiz concluded in his survey that a small board size of about seven or eight directors is more likely to be active and efficient. See K S Rebeiz, 'Strategies for Corporate Governance in Engineering Corporations' (2002) 49 IEEE Transactions on Engineering Management 398, 405.

³⁴¹ M Lipton and J W Lorsch, 'A Modest Proposal for Improved Corporate Governance' (1992) 48 Business Lawyer 59, 67.

³⁴² Spencer Stuart, '13th Annual Survey of Board Practices in Large US Companies' <<https://www.spencerstuart.com/>> accessed 01-11-2013; also see, Monks and Minow (n 313) 256.

³⁴³ Jin Zhu Yang, 'The Anatomy of Boards of Directors: An Empirical Comparison of UK and Chinese Corporate Governance Practices' (2007) 28 Company Lawyer 24, 25.

³⁴⁴ Ibid.

The terms offered to directors, together with financial incentives, can influence the effectiveness of the board. A short service term, such as a one-year contract, may generate short-term activities in order to obtain as much compensation as possible. By contrast, a long-term contract may encourage the directors to promote long-term strategies in the boardroom; however, it would also increase the possibility of insider control. Scholars have noted that, after the Enron scandal, many large companies in the US switched the service term back to an annual basis to reduce the risk of insider control.³⁴⁵

3.3.3 Composition of the Board

In most companies, the board of directors consists of current or retired executives, academics, leaders of non-profits organisations, and former government officials or military leaders.³⁴⁶ In China, the board may include some other special members, such as employee representatives and members of the party committee of the company.

The most controversial concerns with regard to the composition of the board are how to guarantee those professional outsiders will devote enough time and attention to board issues, and how to ensure those members who have never run a company have adequate business knowledge and skills. As Monks and Minow suggest, 'not every director has to come from a business background but everyone has to be willing to learn what is necessary'.³⁴⁷ In practice however, unfortunately, they may not have the time to learn due to their having full-time jobs.

³⁴⁵ Monks and Minow (n 313) 256.

³⁴⁶ Ibid 261.

³⁴⁷ Ibid.

Therefore, it is extremely important to put highly qualified candidates on the board of directors, to make the board as effective as possible.

3.3.4 Independence of the Board

One of the most important issues to determine the effectiveness of the board of directors is its independence. Only an independent board can appropriately fulfil the monitoring role over the management and challenge them when necessary, in order to protect the interests of the company and all shareholders. Moreover, an ideal board should be independent from the controlling shareholder of the company to prevent the infringement of minorities' rights. In other words, to discharge their duties properly, directors should not exercise them on behalf of the majority shareholder only. Instead, the board must put special emphasis on whether minorities have been treated fairly in corporate operations.

It should be noted that the independence of the board is not the same as the institution of independent directors. The latter is a method to increase the board independence which has been widely used in different jurisdictions around the world, although there remain some criticisms. For example, despite the uncertainty of the criterion of 'independence', Monks and Minow point out that interlocks and network links among shared directors would decrease the independence of the board.³⁴⁸ This might be the case when a company allows its executive directors to serve for another company as independent directors, or when several companies share the same independent director. Despite the difficulty in identifying what interests may become conflicted, this situation is not in accordance with the intention of the rule on 'independence'. The institution of

³⁴⁸ Ibid 258.

independent directors will be discussed in detail later in this chapter.

Another important issue with regard to improving board independence is the separation of the CEO and Chairman of the Board. The activities of the Chairman are crucial to the effectiveness of the board. Although his voting power is the same as that of other board members, he has an important power to decide the topics and agenda of board meetings. In other words, it is the chairman of the board who determines what the board will and will not do. As Dalton and Kesner note, the real threat to the independence of the board of directors is 'the dual role of the CEO as board chairman'.³⁴⁹ It could be unrealistic to expect that the outside board members could challenge the executives if the CEO controls the information and agenda of the board, because those issues which need to be investigated and discussed would not be presented at the board meetings. As pointed out by Nadler et al., 'in truth, the humble agenda constitutes the single most important tool for either empowering or emasculating the board. Simply stated, whoever controls the agenda controls the board's ability to do meaningful work.'³⁵⁰

Therefore, it is now widely acknowledged that the separation of the CEO and Chairman of the Board could increase the independence of the board by limiting the controlling power of the CEO, and eventually improve the protection of shareholders' interests.

In the United Kingdom, since the release of the Cadbury Report in 1990,³⁵¹ many large companies have brought about a separation of the

³⁴⁹ D R Dalton and I F Kesner, 'Composition and Duality of Boards of Directors: An International Perspective' (1987) 18 *Journal of International Business Studies* 33, 35.

³⁵⁰ D A Nadler, B A Behan and M A Nadler (eds), *Building Better Boards: A Blueprint for Effective Governance* (Jossey-Bass 2006), 94.

³⁵¹ Yang, 'The Anatomy of Boards of Directors: An Empirical Comparison of UK and Chinese Corporate Governance Practices' (n 343) 28.

CEO and Chairman, while in the United States it is still quite common to see the combination of CEO and Chairman. In China, surprisingly, more than 80 per cent of the listed companies separate the role of CEO and Chairman of the Board, in spite of the fact that there is no legal requirement to do so.³⁵² However, this does not mean that Chinese boards of directors have a higher level of independence. This is because, first of all, most chairmen of the board in Chinese listed companies serve as full-time members of staff, which means that the Chairman is, in fact, an executive of the company.³⁵³ Furthermore, most chairmen in Chinese listed companies are nominated and appointed by the controlling shareholder. Accordingly, those powerful chairmen may challenge the management, but only on behalf of the majority shareholder rather than all shareholders as a whole.³⁵⁴ Hence, in short, the independence of Chinese boards is still in question.

3.3.5 Challenges to the Effectiveness of the Board

Much has been expected of the board of directors in terms of resolving the agency cost problem. However, there have also been critical challenges. Some critics have focused on the defects of institutional design in jurisprudence, while others have pointed to the practical failures to realize its role as intended. According to Williams, 'a few boards of directors establish company objectives, strategies and broad policies; but most do not. A few boards ask discerning questions; but most do not. A few boards evaluate the measure and the performance of the CEO and select and deselect the CEO; but most do not.'³⁵⁵

³⁵² Ibid.

³⁵³ Juyin Zhong, 'Who Is the CEO of the Chinese Companies?' *Chinese Securities* (31-01-2002).

³⁵⁴ Zhao and Wen (n 335) 378.

³⁵⁵ Williamson (n 312) 252.

There are a number of factors which may exert a negative influence on the effectiveness of the board of directors. According to research carried out for this thesis, these can be divided into four main categories: (1) the incapability of board members; (2) low motivation to perform well; (3) limited working hours; and (4) insufficient necessary information.

(1) The Incapability of Board Members

Warren Buffett, one of the most successful investors of the 20th century, served as outside director in several giant companies. However, he holds a less than optimistic attitude towards the effectiveness of the board, admitting that many directors he worked with lacked the necessary abilities to perform as well as they should, even though they would have qualified as 'independent' as defined by today's rules.³⁵⁶

In theory, the board of directors should not only make strategies to guide management, but should also investigate and evaluate the performance of management on behalf of shareholders as a whole. Therefore, it is important for directors to understand the market well in order to make strategies, and to be equipped with managerial knowledge and experience, especially professional knowledge of corporate finance, in order to determine whether the executives are performing in accordance with the interests of the company and its owners.

As mentioned above, in current corporate practice, many Chinese board members have no business background. It could be rational to have them on the board because they may extend the professional scope of the board. As such, the board may be able to make better corporate decisions. For instance, academics may provide theoretical support for corporate

³⁵⁶ Monks and Minow (n 313) 254.

practice and government officials may help the company to perform better in terms of fulfilling its social responsibility. However, the use of outside directors for the monitoring function is open to question. It could be difficult for them to identify inappropriate management behaviours which may negatively affect. Hence, the intention behind having the board in the corporate structure may not be realised.

Therefore, this thesis will suggest that it is crucial to set a rational proportion of outside directors with no business background on the board, and equally important to provide them with relevant professional training, including the knowledge and skills of management and corporate finance. A board consisting of both types of director, with and without a business background, would be able to formulate the most appropriate strategies for the company, while also guaranteeing professional supervision over company operations to safeguard the interests of all shareholders, and the minority in particular.

(2) Low Motivation to Perform Well

In practice, while some directors are capable of fulfilling their roles, some do not perform as well as they should. Even Warren Buffett, whose professional reputation is undoubtedly high, once admitted that he sometimes failed to fulfil all the directors' duties, stating that '...too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence.'³⁵⁷ Such collegiality is just one of the elements which may influence the motivation of directors to perform well. Others include benefits, incentives and accountability to shareholders.

³⁵⁷ Ibid.

First, some argue that the reason directors lack motivation to monitor the management is that they themselves are not the capital providers, but the representatives of the investors. Accordingly, they can hardly be expected to protect others' investment as if it were their own money. In order to resolve this problem, a corporate-shares scheme has been widely used in directors' remuneration packages, especially in the US and the UK. Making corporate shares a major part of the remuneration package could bind the interests of board members with the interests of shareholders, and help to promote directors' motivation to discharge all their duties appropriately.³⁵⁸

It worth noting, however, that in order to improve the effectiveness of the board of directors, directors' remuneration packages with corporate shares should be designed based on empirical results. This is because the corporate-shares scheme is just one part of the remuneration package. If this part is too small, the aim of binding board members' interest with that of shareholders will not be realised; if it is too large, it may result in the manipulation of the corporate share price by the directors. This is why the government is moving towards share option schemes for banks in which shares can be paid as a part of the remuneration package only many years later.

Secondly, the desire to maintain the position as director may drive the board member to compromise with the management by not challenging their activities. As mentioned, in most cases the executives, especially the CEO, have decisive power over the nomination and appointment of directors. To retain the tangible or intangible benefits of being a director, for instance a six-figure payment, complimentary services based on the

³⁵⁸ Anu Arora, 'Remuneration Practices in Banks and Other Financial Institutions: Part 1' (2012) 33 Company Lawyer 67, 69.

position, prestigious reputation, and a network of business contacts, some board members would choose to stand with the executives, ignoring problems in corporate operations.³⁵⁹

Last but not least, it is still difficult for shareholders to keep the directors accountable. In theory, shareholders could control the board members by three methods: (a) selection and appointment; (b) good contract writing, including terms and remuneration; and (c) possible dismissal.³⁶⁰ However, in practice, the first two methods are normally influenced by the board of directors or the CEO; while the last option can only be exercised by those shareholders with a large voting power. Moreover, Okoli argues that dismissing a director is not a wise choice for shareholders, because it may bring about an extra cost. The dismissed director may 'go home with three years' remuneration for work undone or badly done'.³⁶¹ That is to say, board members will not be punished even if they do not discharge their duties, except in cases of corporate scandal, such as Enron. Hence shareholders, minority shareholders in particular, cannot keep directors accountable by these methods.

In short, how to motivate the board members to perform as well as expected is still an important issue with regard to improving the effectiveness of the board of directors.

(3) Limited Working Hours

The limited working hours of directors have been criticised as a significant obstacle to board effectiveness. Board members, particularly the non-executive outsiders, have to spend most of their time and energy on their

³⁵⁹ Yuan (n 308) 145.

³⁶⁰ Pontian Okoli, 'Controlling Directors in A Troubled Economy --- A UK Perspective' (2012) 23 International Company and Commercial Law Review 234, 234.

³⁶¹ Ibid 236.

own full-time jobs, so that less attention is paid to their work as directors. As a result, the effectiveness of the board is diminished.

Lipton and Lorsch argue that lack of time is the most widely shared problem for directors in fulfilling their duties.³⁶² They further note:

The typical board meets less than eight times annually. Even with committee meetings and informal gatherings before or after the formal board meeting, directors rarely spend as much as a working day together in and around each meeting. Further, in many boardrooms too much of this limited time is occupied with reports from management and various formalities. In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors.³⁶³

Some scholars also note that directors, especially the non-executive outside directors, will only get involved in corporate affairs when crisis occurs. They do not exercise constant monitoring of management to safeguard the interests of shareholders. Supporting this point, Judge William T. Allen stated in a speech that ‘the view of the responsibilities of membership of the board of directors of public companies is, in my opinion, badly deficient... Directors should function as active monitors of corporate management, not just in crisis, but continually.’³⁶⁴

Therefore, this thesis will suggest that legislation should set out minimum working hours and a requirement of keeping a diary, in order to improve

³⁶² Lipton and Lorsch (n 341) 64.

³⁶³ Ibid.

³⁶⁴ Monks and Minow (n 313) 292.

the effectiveness of the board.

(4) Insufficient Information

To fulfil their monitoring role, directors have to rely on the information given to them. In practice, such information is usually prepared by the executives, in particular the CEO, because no one knows the company better than the executives. Hence, it could be understood that the executives control the eye of the board of directors, unless the board members collect the valuable information by themselves.

Sarah A.B. Teslik points out that:

there isn't much point in fussing over the definition of an independent director, or the existence or makeup of board committees, or the procedures for electing directors if the information they get is inadequate. What can even the most brilliant and properly motivated director do if he or she lacks needed, accurate, or timely information?³⁶⁵

Walter Salmon, an experienced director, has provided the following checklist of the necessary information for board members to discharge their duties appropriately:³⁶⁶

- (a) Operating statements, balance sheets, and statements of cash flow that compare current period and year-to-date results to plan and last year. Management comments about the foregoing that explain the reasons for variations from

³⁶⁵ CII Central, *The Governance of Oozcskbhny: Newsletter for Members of the Council of Institutional Investors* (1993), 8.

³⁶⁶ Walter Salmon, 'Crisis Prevention: How to Gear Up Your Board' (1993) Jan-Feb Harvard Law Review 68, 69.

plan and provide a revised forecast of results for the remainder of the year;

- (b) Share of market information;
- (c) Minutes of management committee meetings;
- (d) Key media articles on the company and competition;
- (e) Financial analysts' reports for the company and major competitors, plus consumer preference surveys; and
- (f) Employee attitude surveys.

According to the viewpoint of this thesis, it will be suggested that a stricter standard of timely provision of accurate and complete information to board members should be introduced into current legislation. If the executives, including the CEO, failed to achieve this, they would be penalized personally. At the same time, the responsibility of directors to equip themselves with accurate, complete and timely information should also be reinforced. Board members could use various methods to collect corporate information, such as implementing surveys in retail stores or interviewing line managers or other employees. Lack of sufficient information should not be accepted as an excuse for directors to be exempt from discharging their duties, unless they are able to prove that acquisition of such information is impossible in the circumstances.

3.4 Board Independence and Independent Directors

With the exposure of financial scandals such as Enron, the inefficiency of internal supervision has become a matter of increasing attention. Executives, especially the executive directors, are so powerful that they can use the controlling power inappropriately in their own self-interest, taking advantage of information asymmetry. Such activities misappropriate

the interests of the company and the shareholders.

To resolve this agency cost problem, it has been suggested that shareholders should take on the role of internal monitoring. However, in the view of this thesis, an independent board should be the most important institution to improve internal supervision. This is because, first of all, the board of directors knows the company better than any shareholder. Traditionally, in business, the board of directors is the command headquarters of corporate decision making. It drafts and decides commercial strategies, determines corporate culture and resolves company financial issues. According to the 'team production' theory proposed by Blair and Stout, the directors are the mediators of the team.³⁶⁷ On the one side, the director is the agent of capital providers, namely the shareholders, managing the investment of those providers. On the other side, the director is an advisor to the professional skill providers, namely the managers, and the labour providers, namely the employees.

If we compare the company to an item of PC software, the shareholder, as the user, neither needs nor wishes to familiarise himself with the internal programming or running methods of that software. All he needs to do is waiting for the outcome of using the software and update it regularly.³⁶⁸ The board of directors is like the command centre of the software.

Moreover, legislators are not willing to allow shareholders to have too much decisive influence in day-to-day corporate operations. Greer L.J. claimed in *Shaw & Sons (Salford) Ltd v Shaw*:

³⁶⁷ Margaret M Blair and Lynn A Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 247, 249.

³⁶⁸ Yuan Zhao, 'Competing Mechanisms in Corporate Governance: Independent Directors, Institutional Investors and Market Forces' (2010) 21 International Company and Commercial Law Review 338, 341.

A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other power may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers... [Shareholders] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders.³⁶⁹

It can be seen from this statement that the court itself is reluctant to be involved in the assessment of business decisions. It is not the court's job to judge how bad a commercial decision is, as long as that decision is not a suspected breach of fiduciary duty.

Therefore, there has been much heated debate on the matter of improving the independence of the board so as to improve the internal monitoring function. An independent board could ensure that each decision made by the board is rooted in the aim of maximising corporate interests and shareholders' investment return.

In seeking ways to improve board independence, different jurisdictions have introduced various legal mechanisms.

An empirical development in the US corporate governance over the past half century has been the shift in board composition away from insiders (and affiliated directors) toward independent directors.³⁷⁰ In 2002, the

³⁶⁹ [1935] 2 KB 113, [134].

³⁷⁰ J N Gordon, 'The rise of independent directors in the United States, 1950-2005: Of shareholder value and

Sarbanes-Oxley Act (hereinafter the SOA) adopted the concept of independent directors, in order to rectify the systematic defects reflected by financial scandals such as Enron and WorldCom. One of the SOA reforms is that audit committees should be composed entirely of independent directors, and these independent directors are completely independent, receiving no financial benefits from the company other than their payment as directors.³⁷¹

In accordance with the SOA, the listing rules of the New York Stock Exchange (hereinafter the NYSE) and NASDAQ require a board with a majority of independent directors.³⁷² In addition, the sub-committees such as the audit committee, the nomination committee and the remuneration committee should be composed entirely of independent directors.³⁷³

In the United Kingdom, the suggestions relating to non-executive directors first appeared in the Cadbury Report of December 1992, which recommended a Code of Best Practice with which the boards of all listed companies registered in the UK should comply, and utilized a 'comply or explain' mechanism.³⁷⁴ According to the Code of Best Practice, non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, key appointments, and standards of conduct.³⁷⁵ The Report expressed high expectations of non-executive directors, stating that 'the Committee believes that the calibre of the non-executive members of the board is of special importance in setting and maintaining standards of corporate governance'.³⁷⁶

stock market prices' (2007) 59 Stanford Law Review 1465, 1473.

³⁷¹ C W Huang, 'Worldwide Corporate Convergence Within A Pluralistic Business Legal Order: Company Law and the Independent Director System in Contemporary China' (2008) 31 Hastings International and Comparative Law Review 361, 401.

³⁷² New York Stock Exchange Listed Company Manual, Section 303A.01.

³⁷³ Ibid, Section 303A.04, 303A.05, and 303A.07.

³⁷⁴ C A Mallin, *Corporate Governance* (3rd edn, Oxford University Press 2010), 35.

³⁷⁵ The Code of Best Practice, Section 2.1; also see Cadbury Code (1992).

³⁷⁶ Mallin (n 374) 174.

More recently, the Combined Code has amended the regulations referring to non-executive directors in more detail. It suggests that (1) at least half of the seats on the board should be taken by independent non-executive directors; (2) a nomination committee should consist of a majority of independent directors; and (3) the position of Chairman and CEO should be separated.³⁷⁷

In a jurisdiction such as China, which has a concentrated shareholding structure, the core issue of corporate governance is not the conflict of interests between the executives and shareholders, simply because the controlling shareholder has the final say on the appointment of executives. In this circumstance, the executives are performing in accordance with the will of the controlling shareholder. Therefore, the primary concern of Chinese corporate governance is that the majority shareholder, who in most cases is the controlling shareholder, is too powerful to intervene in the day-to-day operation of the company. As the consequence, he would be able to make corporate decisions at the expense of the interests of the minorities, in order to purchase his private benefits.

To improve the independence of the board and consequently the quality of Chinese corporate governance, Chinese legislators have adopted the institution of independent directors from the USA. Moreover, in addition to the supervisory function as exercised in the US, Chinese independent directors have been charged with another important target, standing for the interests of minority shareholders. It is claimed in the Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies that 'an Independent Director should, pursuant to the

³⁷⁷ A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized Should Non-executive Directors Be? An Empirical Investigation of Good Governance Codes' (2010) 21 *British Journal of Management* 63, 64.

requirements of the relevant laws and regulations, these Guiding Opinions and the company's articles of association, conscientiously perform his duties and responsibilities, safeguard the company's overall interests and, in particular, pay attention that the lawful rights and interests of small and medium shareholders are not prejudiced'.³⁷⁸

The first regulatory document concerning the concept of independent director in China was the Guideline of Articles of Association of Listed Companies, issued by the China Securities Regulatory Commission (hereinafter 'CSRC') in 1997. Under Article 112: 'A listed company has the option to appoint independent directors into the board.'³⁷⁹

A few years later, in 2001, the CSRC issued the Guiding Opinion on the Establishment of an Independent Director System in Listed Companies (hereinafter the 'Opinion'), which has been widely acknowledged as the formal legal implantation of such an institution to improve the quality of Chinese corporate governance. Under the timetable set by the Opinion, no fewer than two independent directors, including at least one accounting professional, were to be nominated to the board before June 30th, 2002; and the proportion of independent directors was to be increased to no less than one third before June 30th, 2003.³⁸⁰

In this section, mechanisms for improving the independence of the board of directors, both in the Anglo-Saxon system and in the Chinese context, are investigated in detail. Through comparative study, this thesis concludes that independent directors, despite current defects, would be a proper institution to improve the quality of corporate governance of

³⁷⁸ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, issued by the China Securities Regulatory Commission on 16th August, 2001, Section 1(2).

³⁷⁹ The Guideline of Articles of Association of Listed Companies, Article 112.

³⁸⁰ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies (n 378), Section 1(3).

Chinese listed companies, especially those that are state-controlled. An ideal theoretical model of such institution is established and illustrated in part 3.4.1. The provisional name, 'All-Right model', refers to putting the Right Person in the Right Position, authorised with the Right Power under the Right Supervisory System. In part 3.4.2, the current defects of corporate governance which lead to a lack of board independence are noted, followed by some discussion about specific issues, including why China transplanted the institution of independent directors into its corporate governance regime.

3.4.1 The Ideal: The 'All-Right Model'

Informed by comparative study of laws relating to the institution of independent directors, this research concludes with the ideal design of such a legal institution. To improve the board independence so as to fulfil the internal monitoring mission in the interests of shareholders, the Right Person should be put in the Right Position armed with the Right Power.

(1) Right Person

Responses to the question of who should serve on the board of a large public company have varied over the years. Circa 1950, the consensus was that such boards should be composed of senior officers, affiliated outsiders such as bankers, audit consultants or legal consultants, and a few independent directors.³⁸¹ Langevoort, using his tripartite board structure, suggests that a functional board should consist of independent monitors, 'grey' mediators,³⁸² and managers.³⁸³

³⁸¹ Gordon (n 367) 1468.

³⁸² 'Grey' mediators are those board members holding good relationships with different interest groups. See, D C Langevoort, 'Beyond "Independent" Directors: A Functional Approach to Board Independence' (2006) 119 Harvard Law Review 1553, 1566.

³⁸³ Ibid.

Nevertheless, half a century later, the consensus is that the board should comprise only independent directors, whose independence is buttressed by a range of rule-based and structural mechanisms.³⁸⁴

The reason for such a change in attitude is the change in the board's function. The major role of a modern board is as a safeguard on behalf of shareholders' interests. Therefore, it seems clear that a director with independence de facto could be deemed as the Right Person in the All-Right Model.

However, this raises the more difficult question of who can be defined as an independent director? In other words, what is the test of independence?

Rules around the world use different terms to name such independent persons, for example, independent director, disinterested director, or independent non-executive director. Commentators and courts in different countries also talk about 'independence', but it has been argued that they use this term to mean different things at different times for different reasons.³⁸⁵

- *The Sarbanes-Oxley Corporate Reform Act (2002)*

The Sarbanes-Oxley Corporate Reform Act is a set of changes embodied in the Accounting Industry Reform Act 2002, which followed directly from the financial scandals of Enron and WorldCom.

The Act marked the first use in US statute of the concept of independent director. Under the SOA, an independent director receives no financial

³⁸⁴ Gordon (n 370) 1468.

³⁸⁵ Langevoort (n 382) 1555.

benefits from the company other than his payment as director.³⁸⁶

With reference to the independent directors sitting on the company's audit committee, Section 301 of the SOA provides that:

In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee - (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.³⁸⁷

Such provision became the original script of the listing rule of the NYSE.

- *Delaware General Corporation Law*

In order to deal with 'conflicts of interest', Article 144 of the Delaware General Corporation Law, relating to interested directors, provides that no transaction between the corporation and its directors, or between the corporation and any other corporation in which its directors are directors, or have a financial interest, shall be void or voidable solely for the reason of conflict of interest if one of the following conditions is fulfilled.³⁸⁸

- (a) the material facts of such transaction are disclosed to the board of directors and a majority of disinterested directors authorize it in good faith; or
- (b) the material facts of such transaction are disclosed to the stockholders entitled to vote thereon, and an approval has

³⁸⁶ Huang (n 371) 401.

³⁸⁷ Sarbanes-Oxley Act of 2002, Section 301.

³⁸⁸ Delaware General Corporation Law, Article 144.

- been reached in good faith by vote of stockholders; or
- (c) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.

It should be mentioned that the Delaware General Corporation Law does not provide a definition of independence, nor does it set up a detailed independent director system by law. Instead, it requires scrutiny, transaction by transaction, on transparency or disinterest in a particular dealing involving conflict of interest.³⁸⁹

- *American Law Institute's Principles of Corporate Governance*

One of the most important contributions of the American Law Institute's Principles of Corporate Governance (hereinafter 'Principles') to the institution of the 'independent director' is that it provides the first interpretation of 'significant relationship'. According to Article 1.34 of the Principles, 'significant relationship' refers to a situation where: (i) the director has been under the corporation's employment within the two preceding years; (ii) the director is an immediate family member of someone who has been an officer or a senior executive within the two preceding years; (iii) the director has engaged in certain monetary activities which exceeded \$200,000 during the two preceding years; or (iv) the director is affiliated in a professional capacity with a law firm or an investment banking firm to the corporation or has acted as a managing underwriter in an issue of the corporation's securities within the two preceding years.³⁹⁰

Although it cannot be stated definitively that these significant relationships

³⁸⁹ Huang (n 371) 395.

³⁹⁰ ALI, Principles of Corporate Governance (1994), Article 1.34.

would be bound to involve self-interested activities, ruling them out makes it easier to improve the independence of directors.

- *Rules of the New York Stock Exchange*

The New York Stock Exchange is one of the leading equities markets around the world, with approximately 8000 issuers.³⁹¹ Thus, the listing rule of the NYSE has been deemed as an advanced corporate model for listed companies.

Consistent with the NYSE's traditional approach, in addition to the requirements of the Sarbanes-Oxley Act of 2002, the NYSE regulates a set of rules relating to independent directors. The NYSE Listed Company Manual establishes certain tests of independence. Generally speaking, an independent director should have no material relationship with the listed company, either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company.³⁹²

This raises the question of the definition of 'material relationships'. Based on business common sense, material relationships can include familial, financial, commercial, consulting (legal, accounting or corporate strategy) and industrial relationships, among others. Because of the existence of complicated social relationships, it seems impossible for regulators to formulate explicitly all circumstances that might lead to potential conflicts of interest. Consequently, smart legislators provided the board of directors with the power to determine what constitutes 'independence', taking broad consideration of all relevant facts and circumstances.³⁹³

³⁹¹ New York Stock Exchange, 'Company Overview' <<http://corporate.nyx.com/en/who-we-are/company-overview>> accessed 10-12-2011.

³⁹² New York Stock Exchange Listed Company Manual, Section 303A.02 (a).

³⁹³ Ibid.

To provide detailed guidance to the board of directors, in addition to the general independence test, the NYSE also stipulates several circumstances in which a director is not independent, specifically if:

(i) the director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company; (ii) the director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service; (iii) (A) the director is a current partner or employee of a firm that is the listed company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time; (iv) the director or an intermediary is or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.³⁹⁴

³⁹⁴ Ibid, Section 303A.02 (b).

- *Combined Code*

The Combined Code draws together the recommendations of the Cadbury, Greenbury, and Hampel reports.³⁹⁵ The Combined Code (2008) states that:

The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment.³⁹⁶

Such an independence requirement could be deemed as a mirror to the proposal in the Cadbury Report that independent directors should be 'free from any business or other relationship which could materially interfere with the exercise of their independent judgment'.

- *Guideline of Articles of Association of Listed Companies*

In 1997, the CSRC issued the Guideline of Articles of Association of Listed Companies, which is the first formal document relating to independent directors in China. Notwithstanding its failure to set out a detailed institution of independent directors, this document does provide a negative independence test whereby certain persons are banned from serving as independent directors: (a) shareholders or those employed by shareholding entities; (b) 'internal personnel' of the company (e.g. the executive director, senior manager or employees); and (c) persons with

³⁹⁵ Mallin (n 374) 29.

³⁹⁶ Combined Code (2008), Para A.3.1.

ties with the company's affiliates or managers.³⁹⁷

- *Guiding Opinion on the Establishment of an Independent Director System in Listed Companies*

The landmark document in the development of Chinese corporate governance, the Opinion, provides the first definition of 'independent director'. An independent director in a listed company is one who does not take up any other position than that of director, and has no relationship with the company or its major shareholders, which may interfere with his offering independent objective judgment.³⁹⁸ Moreover, independent directors must have a basic knowledge of operating a company and no less than five years' professional experience.

In addition to the positive requirement, the Opinion also puts forward a set of negative independence tests to disqualify certain persons from becoming an independent director:³⁹⁹

- (a) employees of the listed company or its subsidiary corporations as well as their direct relatives (such as spouses, parents and children) and major social relations (such as brothers or sisters, parents-in-law, children-in-law);
- (b) a natural person or a direct relative of a natural person who directly or indirectly holds more than one per cent of the company's shares, or a natural person who is one of the top 10 largest shareholders of a listed company;
- (c) an employee or a direct relative of an employee of a company which is a corporate shareholder of the listed

³⁹⁷ Donald C Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125, 183.

³⁹⁸ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, Section 1(1).

³⁹⁹ Ibid, Section 3 (author's translation).

company, directly or indirectly holding more than five per cent of the company's shares, or of a company that is one of the top five largest corporate shareholders of a listed company;

- (d) a person who has fulfilled any of the three conditions above in the last year;
- (e) a person who provides financial, legal or consultant services to the listed company or its subsidiary corporations;
- (f) other individuals regulated by the articles of association of the listed company; and
- (g) other individuals designated by CSRC.

Taking account of the regulations in different jurisdictions, it can be found that legislators in different countries have chosen to attempt to list and rule out those relationships which may influence directors' independence. Zattoni and Cuomo collected corporate governance codes developed worldwide by the end of 2005, and identified several relationships that must be avoided for the purpose of keeping directors' independence. Details are shown in Chart 1 below.⁴⁰⁰

⁴⁰⁰ Zattoni and Cuomo (n 377) 70.

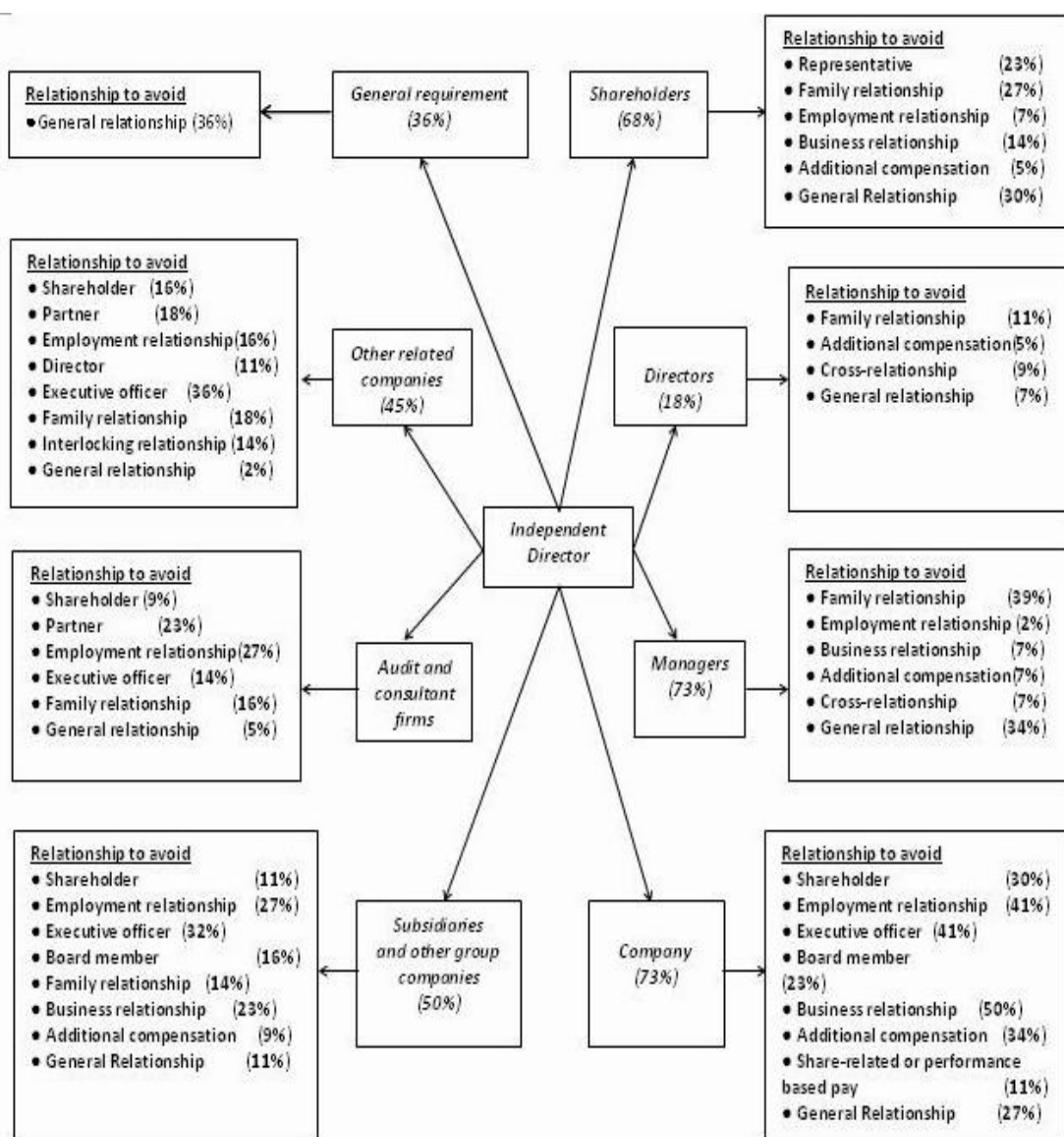


Chart 1: Relationships to Avoid for Independent Directors

Given the very many different relationships mentioned by various corporate codes, it is unrealistic to expect any one country to rule out all of them. Moreover, a recent study offers important empirical evidence that existing definitions of independence might not cover all the potential influences that may affect directors' independent judgment.⁴⁰¹ Some potential benefits-related considerations, for example, friendship, reputation or personal relationship, would not be expressed via

⁴⁰¹ Frederick Tung, 'The Puzzle of Independent Directors: New Learning' (2011) 91 Boston University Law Review 1175, 1185.

employment or economic ties. However, it is quite obvious that the relationships between the independent directors and the managers, company and shareholders are the top three most important concerns, which should be cut off by legislations. In terms of the relationships to avoid, the business relationship, family relationship and general relationship listed on the top.

As a partial conclusion, in order to ensure the independence of directors, emphasis should be put on improving the independence test. In addition, the transactions involving a conflict of interest should be investigated, case by case, to ensure the business decisions made by the board are in the interests of the company, and ultimately benefit the shareholders.

(2) Right Position

Corporate affairs can be divided into two classes: the general issues which are decided in the board meeting; and specific issues which are handed to specific professional committees to determine. Generally speaking, the position of independent director is an ideal position for a person to safeguard the interests of shareholders as a whole. This is because, in most countries, the board of directors is the most powerful governance mechanism in modern corporate governance structure. (China sits in a different group, which will be discussed in detail later.)

In addition to normal functions of the board, discussing and voting upon issues in the board meeting, there are also board sub-committees, which can have great influence on corporate operations. Examples of such committees include the audit committee, nomination committee, remuneration committee and special litigation committee.

Among all the sub-committees, the audit committee is the most important. According to Smith, 'while all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control'.⁴⁰² An empirical study by Chan and Li, in 2008, indicates that expert independence of the audit committee with a majority of independent experts results in positive firm value.⁴⁰³

The remuneration committee determines the remuneration packages of executives or senior managers, including pension rights and any other compensation.⁴⁰⁴ Meanwhile, the nomination committee, as the name suggests, is designed to lead the process for board appointments and make recommendations to the board.

Reviewing various corporate governance codes in both the Anglo-Saxon and Chinese systems, certain rules can be suggested to introduce or strengthen such board sub-committees.

One of the important objectives of the Sarbanes-Oxley Act is to reinforce the company's audit committee. The audit committee stipulated by the SOA should comprise only independent members, and the company must also disclose whether it has at least one 'audit committee financial expert' on the audit committee.⁴⁰⁵

Section 303A.01 of the NYSE Listed Company Manual sets out the

⁴⁰² Sir Smith Robert, 'Audit Committee Combined Code Guidance' (2003) Financial Reporting Council, para 1.5.

⁴⁰³ Kam C Chan and Joanne Li, 'Audit Committee and Firm Value: Evidence on Outside Top Executives as Expert-Independent Directors' (2008) 16 Corporate Governance 16, 17.

⁴⁰⁴ Mallin (n 374) 170.

⁴⁰⁵ Ibid 45.

general requirement of board independence that listed companies, with the exception of controlled companies,⁴⁰⁶ must have a majority of independent directors.⁴⁰⁷ Moreover, the nominating/corporate governance committee, compensation committee and the audit committee are required to be composed entirely of independent directors.⁴⁰⁸

Under the UK Combined Code, the board should establish an audit committee and a remuneration committee of at least three, or in the case of smaller companies, two, independent non-executive directors.⁴⁰⁹ For the nomination committee, a majority of independent non-executive directors is required.⁴¹⁰ Moreover, the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.⁴¹¹

In China, the proportion of seats on the board for independent directors required by the Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies is not less than one third. If a board sets up any sub-committee, for example, an audit committee or a nomination committee, that committee must have a majority of independent directors.⁴¹²

In addition, since empirical evidence shows that the integration of CEO and Chairman of the Board significantly negatively impacts firm value,⁴¹³ it has been argued that an independent director should chair the board of

⁴⁰⁶ A controlled company is a listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company. According to Section 303A.00 of the NYSE Listed Company Manual, such a controlled company is not required to comply with the requirements of Sections 303A.01, 303A.04 or 303A.05, but must comply with the remaining provisions of Section 303A.

⁴⁰⁷ New York Stock Exchange Listed Company Manual, Section 303A.01.

⁴⁰⁸ Ibid, Section 303A.04, 303A.05, and 303A.07.

⁴⁰⁹ The Combined Code (2008), para C.3.1, B.2.1.

⁴¹⁰ Ibid, para A.4.1.

⁴¹¹ Ibid, para C.3.1.

⁴¹² The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, Section 1.3 and Section 5.1.

⁴¹³ Chan and Li (n 403) 29.

directors.⁴¹⁴

To conclude, nominating more independent directors to the board, especially the board sub-committees, would improve the efficiency of internal monitoring by the board. As a consequence, better corporate governance would ensue, and the likelihood of misappropriation of shareholders' interests by executives would be reduced.

(3) Right Power

The independent director is not a new creation of company law, but a director with the additional characteristic of independence. The voting rights of independent directors are no different from those of normal directors. In most cases in Anglo-American companies, the weapon held by independent directors to challenge the executives is their right to vote in the board meeting; while in China, independent directors are granted more powers.

The question raised here is, given that the independent directors have been charged with higher expectation of improving governance quality and a requirement of independence, how can they achieve governance targets in Anglo-American companies without more powerful rights or privileges? Research for this thesis suggests that it could make sense in theory. As mentioned above, the US and the UK rules require the company to have a board with a majority of independent directors or independent non-executive directors. Therefore, a consensus among independent shareholders would become the decision of the board by voting, under a majority rule. Although there will inevitably be differences between independent directors, it is clear that the institution of director, even with

⁴¹⁴ The UK and China have similar regulations to avoid integration of CEO and Chairman of the Board.

normal voting power, can also fulfil the monitoring mission, as long as each independent director can exercise independent judgment in accordance with the company's interests or shareholders' will.

On board sub-committees, the proportions of independent directors are normally even higher. In Anglo-American countries, the audit committee, nomination committee, and remuneration committee are usually required to be composed entirely of independent directors.⁴¹⁵ Therefore, there can be no doubt that decisions made by such committees comply with the interests of the company.

Nevertheless, merely authorising voting rights for independent directors seems inadequate to improve board independence in China. In contrast to the board structure in the US and the UK, in Chinese listed companies the only requirement is that independent directors make up no less than one third of the board.⁴¹⁶ Moreover, under Chinese Company Law 2005, the method of decision making on the board is based on a conditional majority rule whereby a decision should be approved by more than half of the vote in the board meeting, and the number of board members who attend the meeting should be over half of the total.⁴¹⁷ As a result, there is little possibility that independent directors could influence corporate decision making without any other support. Therefore, increasing board independence cannot achieve the aim of improving internal monitoring, even if those independent directors are the right people in the right position. Hence, it is necessary to increase the minimum proportion of independent directors on the boards of Chinese companies.

⁴¹⁵ Specific rules are discussed in the previous section (Right Position).

⁴¹⁶ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, Section 1.3.

⁴¹⁷ Company Law of the People's Republic of China (Revised in 2005), Article 112.

According to the Opinion, Chinese legislators have created some special powers for independent directors. Independent directors in Chinese listed companies can provide suggestions to the board on the issues of appointing or dismissing an accounting firm and convening an extraordinary shareholders' meeting; suggest a board meeting be convened; and appoint an external audit institution and consultants.⁴¹⁸ More importantly, important related-party transactions should be approved by independent directors before discussion by the board.⁴¹⁹

However, this thesis does not believe that the Chinese independent director system is better than its western counterparts on account of these simple requirements. It should be noted that most special powers authorized to independent directors are no more than a set of recommended rights, having no direct effect on corporate operations. Furthermore, the approval right regarding related party transactions is also impractical, owing to the absence of remedies if the views of the independent directors are ignored.

From the discussion above, power of voting could be deemed as the fairest and most practical mechanism for independent directors to fulfil the ideal monitoring function. Of course, this should be assisted by a helpful board structure. It is suggested that the board should have a majority of independent directors. Alternatively, some more effective powers could be granted to independent directors in China, for example, the power of dismissing executives. It may bring about a substantial effect in improving the monitoring quality.

⁴¹⁸ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, Section 1.3 and Section 5.1.

⁴¹⁹ Important related party transactions refer to any amount over three million RMB or over 5% of the listed company's latest audited net asset value. Ibid.

As a brief conclusion, according to the All-Right Model, the board should comprise a majority of independent directors, as should the board sub-committees, to improve the independence of the board as a whole. Meanwhile, in terms of the powers granted to the board of directors to fulfil its internal monitoring duty, this thesis suggests that more substantial rights are required. However, equally important is the point that the board of directors should be accountable to shareholders.

3.4.2 Current Deficiencies of the Institution of Independent Directors

As has been mentioned, many empirical researchers have questioned the effect of the system of independent directors. Bhagat and Black survey the literature of independent directors and conclude that 'studies of overall performance have found no convincing evidence that firms with majority-independent boards perform better than firms without such boards'.⁴²⁰ Furthermore, Tan regards the presence of independent directors as 'a smokescreen and a snare for the unwary investor who may pay a higher price for the equity on the basis of a supposedly better corporate governance structure'.⁴²¹

Such challenges to the effectiveness of non-executive directors have been raised not only in the US, but also in the UK. The Treasury Committee looking into the failure of Northern Rock noted that:

the non-executive members of the Board, and in particular
the Chairman of the Board, the Chairman of the Risk
Committee and the Senior non-executive director, failed in

⁴²⁰ Sanjai Bhagat and Bernard Black, 'The Uncertain Relationship Between Board Composition and Firm Performance' (1999) 54 *The Business Lawyer* 921, 922.

⁴²¹ Cheng Han Tan, 'Corporate Governance and Independent Directors' (2003) 15 *Singapore Academy of Law Journal* 355, 378; also see, JiangYu Wang, 'The Strange Role of Independent Directors in a Two-tier Board Structure of China's Listed Companies' (2008) 3 *Compliance & Regulatory Journal* 47, 51.

the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.⁴²²

Reviewing corporate governance in the UK banking industry in the wake of the financial crisis in 2009, Lord Turner indicated that the levels of skill and time commitment of non-executive directors should be raised.⁴²³

However, this thesis wishes to defend the institution of independent directors by stating that such empirical studies may not give enough weight to the change in the board's function from consulting to monitoring. In other words, the institution of independent directors is designed specifically to increase board independence. Hence its success may not be directly reflected in corporate performance, at least not in the short term. However, it could still be regarded as effective if it has fulfilled the internal monitoring role.

Of course, the defects of the institution of independent directors should also be investigated in detail, so as to find strategies for improvement.

(1) Absence of Incentives

Appointment as an independent director does not mean that the candidate would successfully meet the supervision target. There should be some positive incentives, for example economic and reputation incentives, and even some negative incentives, such as the threat of being dismissed or sued. However, in practice it is difficult to assess how an independent

⁴²² House of Commons Treasury Committee, *The Run on the Rock* < <http://www.parliament.the-stationery-office.com/pa/cm200708/cmselect/cmtreasy/56/56i.pdf> > accessed 23-01-2014; also see, Anu Arora, 'The Corporate Governance Failings in Financial Institutions and Directors' Legal Liability' (2011) 32 Company Lawyer 3, 4.

⁴²³ Ibid.

director works without exploring recent financial scandals. In the view of this thesis, lack of incentives is one of the key defects which results in the ineffectiveness of the current independent director mechanism.

There are two reasons leading to low incentives among independent directors to devote themselves to the monitoring mission. First, their relationships with the executives or controlling shareholders make them unwilling to act as hostile colleagues. Second, the economic incentives are not sufficiently attractive to encourage them to do their best.

- *Relationships*

While it is true that the corporate codes in different countries have attempted to eradicate improper relationships between independent directors and the company, executives or the company's controlling shareholders, especially through financial or family ties, as argued above it is impossible to cover all possible relationships. Therefore, to ensure the independence and the efficiency of independent directors, in addition to the independence test, the rules on nomination and election are crucial. Furthermore, the power to decide the remuneration of independent directors is also an important concern.

With regard to nomination and election, independent directors must first be nominated by someone before being placed before shareholders. It has been argued that the management traditionally had a great influence on the nomination and selection of directors. If this scenario were repeated in relation to independent directors, the reform would become nonsense.⁴²⁴

Executives and majority shareholders continue to have an influential say

⁴²⁴ Zhao, 'Nomination and Election of Independent Directors: from Anglo-Saxon Style to Chinese Practice' (n 190), 91.

at the nomination stage, especially in China. In 2003, ninety per cent of independent directors in China were found to be nominated by the controlling shareholder or by executives.⁴²⁵ Other research has found that 63% of independent candidates were nominated by the board, and 36% directly by the controlling shareholder.⁴²⁶

In 2003, a famous TV producer was appointed as independent director of an entertainment company based in Xi'An province. When questioned as to his qualification to fill that position, the producer declared publicly that the manager was his good friend.⁴²⁷ This brief illustration is perhaps representative of the way in which many 'independent' directors are chosen.

The reason behind this unsatisfactory situation is the problematic nomination and election system. According to the Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, an independent director can be nominated by the board of directors, the supervisory board, or by a shareholder or shareholders who individually or collectively hold at least one per cent of the shares of the company,⁴²⁸ and be elected at the general meeting, normally under a simple majority rule.⁴²⁹ As such, it is hardly surprising to see the independent directors affiliated with the executives or controlling shareholders who nominated

⁴²⁵ Anonymous Author, '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]' *Jin Xin Securities Newspaper* (08-08-2003).

⁴²⁶ Ying Tong, 'Zhongguo Dudong Shengcun Xianzhuang [The Status Quo of Independent Directors in China]', (2004) *May Shanghai Zhengquan Bao* [Shanghai Securities Newspaper]; also see Jie Yuan, 'Formal Convergence or Substantial Divergence? Evidence from Adoption of the Independent Director System in China' (2007) 9 *Asian-Pacific Law & Policy Journal* 71, 104.

⁴²⁷ Sibao Shen and Jing Jia, 'Will the Independent Director Institution Work in China?' (2005) 27 *Loyola of Los Angeles International and Comparative Law Review* 223, 238.

⁴²⁸ The Guiding Opinion on the Establishment of an Independent Directors System in Listed Companies, Section 1.3 and Section 4.1.

⁴²⁹ The Cumulative Voting System is recommended to Chinese listed companies by the Company Law (2005) and several administrative regulations. However, it is not compulsory for the company to introduce such a voting system into their shareholders' meeting. Shareholders can vote to adopt such a system by amending the articles of association.

them and for their independence to be questioned. As Xie has noted, 'it is inevitable that an independent director would be very reluctant to offend his friend, namely the chairman or CEO of the company, although the chairman or CEO has [done] something which is detrimental to the interest of the company and its shareholders'.⁴³⁰

In order to change this situation, first of all a nomination committee led by independent directors should be required by law, and the independence of those committee members should be guaranteed. In addition, it is recommended that an external search consultancy or open advertising should be used.

Next, with regard to remuneration, it has been observed that the executives or controlling shareholders have a great say in the payment of independent directors in practice. According to a report by China Securities Daily, in 2005 '52.5% of the independent directors under survey said that their remuneration was determined by the company's "senior managers", while 37.5% of those revealed that it was the "controlling shareholders" who decided their remuneration'.⁴³¹

It is not reasonable to expect people to do their best when they are called upon to challenge those who decide their pay. In order to ensure good remuneration and avoid the difficulty of being called to account, an independent director might act in favour of the executives or controlling shareholder, leaving the monitoring mission aside.

Therefore, this thesis calls for a truly independent remuneration committee, to cut the financial tie between the monitors and the executives

⁴³⁰ C Xie, *Duli Dongshi Falv Zhidu Yanjiu [A Study of the Independent Director System]* (Law Press China 2004), 320.

⁴³¹ Wang (n 421) 52.

or controlling shareholders, in order to ensure the monitors' independence.

- *Economic Incentives*

In order to fulfil their monitoring role, the independent directors must invest considerable time and effort. Therefore it is rational and inevitable for independent directors to take account of their economic incentive. This will be decisive not only with respect to their willingness to become independent directors, but also with respect to how the directors fulfil their monitoring roles.

However, there is a paradox whereby, if the economic incentive is too high, the independence of directors would be eroded; in contrast, if it is too low, directors would lack motivation to challenge the executives.

Facing this tough issue, legislators around the world continue to seek ways to find a better balance. One appropriate solution would be to link the economic incentive to certain other incentives as an incentive package, to attract and encourage independent directors to fulfil their monitoring role.

(2) Deficiency of Time and Experience

For those independent directors who do have the intention to act as a safeguard of shareholders' interests, it is important that they have sufficient working time and necessary experience of operating a company.

- *Working Hours*

Seeney-Baird points out that the monitoring function of the independent director is time-consuming and creates an essential conflict.⁴³² As a part-

⁴³² Margarita Seeney-Baird, 'The Role of the Non-executive Director in Modern Corporate Governance' (2006) 27 *Company Lawyer* 67, 70.

time director, such an independent member would have only limited time to serve on the board, so that he could not ensure the company is properly managed all the time. Conversely, if the independent director were full-time, with ample time to spend on overseeing the corporate operation, his independence would be questioned because of the close connection with the executives.

Research has shown that, even in the US, the average working time of an independent director on supervisory affairs is only 123 hours a year, approximately equal to 1.5 working days per month, or less than 3 hours per week.⁴³³

Although the monitoring role of an independent director is not a 24/7 mission, it could still be argued that, if the hours of work are too few, the monitor would not be able to establish an overall understanding of the business. As a result, his judgment might be questioned, even if it were independent.

- *Experience*

Notwithstanding that legislators vest the internal monitoring function in the independent directors, there remain some companies which do not fully understand the monitoring role of independent directors, and place the expectation of good monitoring on technical advisors. A survey has shown that in Chinese listed companies, more than 40% of independent directors are technical experts.⁴³⁴ While it could be argued that technical experts are capable of advising on corporate technical innovation and strategy, their monitoring skills and experience of corporate operations cannot be guaranteed.

⁴³³ D S Lewis (ed), *Corporations Law and Policy* (3rd edn, West Publishing Corporation 1994), 656-667.

⁴³⁴ Shen and Jia (n 427) 233.

Apart from technical experts, the other main group of independent directors in Chinese listed companies are scholars. Further recent research based on a random sample of 500 Chinese listed companies has found that 45% of independent directors are university professors or academics.⁴³⁵ Facing the same difficulty as technical experts, scholars may be capable of giving advice from a theoretical point of view, but may not be competent to monitor corporate operations, since they lack experience in practice.

● *Shortage of Information*

One of the most important obstacles for shareholders to monitor the executives by themselves is the asymmetry of information between insiders and outsiders. However, it is not necessarily the case that the independent directors can get more corporate information than shareholders.

Although the monitoring role has been placed upon independent directors, it is undertaken on the basis of information provided by the executives. In other words, the quality of judgment made by independent directors is dependent on the quality and volume of the flow of information which the executives make available to them.⁴³⁶ Research has shown that, in practice, the independent directors have much less information than insiders.⁴³⁷ As such, if the executives want to conceal inappropriate activities, they can simply keep the crucial information away from the

⁴³⁵ Qingtang Yue, 'Dui 500 Jia Shangshi Gongsi 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]' (2004) 2 Jingji Jie [Economic World] 80, 86-88; Also see Clarke, 'The Independent Director in Chinese Corporate Governance' (n 397) 207.

⁴³⁶ M J Nowak and M McCabe, 'Information Costs and the Role of the Independent Corporate Director' (2003) 11 Corporate Governance-an International Review 300, 303.

⁴³⁷ E Ravina and P Sapienza, 'What Do Independent Directors Know? Evidence from Their Trading' (2010) 23 Review of Financial Studies 962, 963.

independent directors.

However, in an interesting research, Ravina and Sapienza compared the profits earned by independent directors and the average profit on the market in relation to company shares. They found that, although independent directors complained of insufficient information to discharge their monitoring role, they did earn significantly higher returns than the market.⁴³⁸ This might prompt the question of whether the independent directors know something that the public do not.

Of course, as this thesis argues, the empirical research mentioned above may not be sufficient evidence to conclude that independent directors have enough information to fulfil their monitoring role. But, at least, compared with the market or minority shareholders, it could be concluded that independent directors know the company better. Such a conclusion will become a logical foundation of my final suggestion in relation to Chinese corporate governance reform, that Chinese listed companies should change to a board-centralised structure and the institution of independent directors should be further improved to protect the interests of minority shareholders.

To conclude this section, the main defects of the current institution of independent directors are: (1) lack of independence due to the concealed relationships with executives or controlling shareholders; (2) lack of incentives, especially economic incentives, to encourage independent directors to challenge the executives; (3) lack of time or essential experience to monitor corporate operations; and (4) lack of necessary information to reach independent judgments.

⁴³⁸ Ibid.

3.4.3 Specific Issues Relating to the Institution of Independent Directors in China

In common with many scholars, this thesis holds the view that legal transplantation of the institution of independent directors into China would be helpful to improve corporate governance quality, if the defects mentioned above could be overcome.

However, it should be pointed out again that the core issue of Chinese corporate governance is not agency costs as between the executives and shareholders, but the conflict of interests between the controlling shareholder and minority shareholders. Most listed companies in China have a concentrated shareholding structure and are under the control of the state. An empirical study has indicated that 81.6% of companies are directly or indirectly controlled by the state, and, on average among all listed companies the single largest owner holds 36% of shares.⁴³⁹

Although the institution of independent directors originated as a specific legal mechanism to reduce agency costs as between executives and shareholders, independent directors in China not only have to fight against the executives, as do their Anglo-American counterparts, but also face challenges in improving legal protection for minority shareholders.

Moreover, in an empirical study Kim has demonstrated that ownership concentration and board independence are negatively related.⁴⁴⁰ In other words, the more concentrated the shareholding structure is, the less

⁴³⁹ Min Yan, 'Obstacles in China's Corporate Governance' (2011) 32 *Company Lawyer* 311, 312.

⁴⁴⁰ Kenneth A Kim, P Kitsabunnarat-Chatjuthamard and John R Nofsinger, 'Large Shareholders, Board Independence, and Minority Shareholder Rights: Evidence from Europe' (2007) 13 *Journal of Corporate Finance* 859, 860.

independent the monitors are.

Hence, before providing any suggestions for the next reform of Chinese corporate governance, two questions should be addressed: (1) Can anyone challenge the will of the controlling shareholder in Chinese listed companies? (2) If not, what can independent directors provide in terms of minority protection?

(1) Can Anyone Challenge the Will of the Controlling Shareholder in Chinese Listed Companies?

Under the current corporate governance structure in China, there is no doubt that the controlling shareholder has decisive influence over corporate affairs. In other words, the company is operated in accordance with the will of the controlling shareholder, the state.

According to Chinese Company Law, appointment of directors, important corporate decision making and directors' remuneration are all determined by the voting outcome in the shareholders' general meeting.⁴⁴¹ Therefore, the controlling shareholder can have a final say on most corporate decisions, both by voting and through a corporate decision-making body elected by him and acting in his interests.

The situation is not substantially different when an independent director acts as monitor of the company. Such a director may be affected, to a large extent, by the will of the controlling shareholder. Although independent directors are apparently more 'independent' than executive insiders, they are still not as independent as they should be. In a survey by

⁴⁴¹ Company Law of the People's Republic of China (Revised in 2005), Article 38(2).

Wang, 65% of the independent directors never said 'no' in the board meeting, and all admitted that they did, at least 'occasionally', vote yes when they should have voted no based on the merits of the proposal.⁴⁴² Moreover, as indicated by Andrews and Tomasic, independent directors need support from the controlling shareholder in order to be elected and to remain as directors.⁴⁴³

A Dean of the Changjiang School of Business, also appointed as an independent director, has stated that:

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.⁴⁴⁴

To conclude, current independent directors in Chinese listed companies are not likely to challenge the will of the controller shareholder. The reasons for this include, but are not limited to: (a) The standard of 'independence' is still imperfect; (b) The proportion of such directors on the board is too low; and (c) the attitudes and deference towards the perceived wishes of the state are still in question. This thesis holds that, if those defects could be overcome, the institution of independent directors would be one of the most important mechanisms to ensure the decisions made by the board are on behalf of all shareholders rather than just the majority shareholder. The suggestions for reform will be illustrated later in this thesis.

⁴⁴² Wang (n 421) 52.

⁴⁴³ Neil Andrews and Roman A Tomasic, 'Directing China's Top 100 Listed Companies: Corporate Governance in an Emerging Market Economy' (2006) 2 Corporate Governance Law Review 245, 291.

⁴⁴⁴ Clarke (n 397) 172.

(2) What Can Independent Directors Provide in Terms of Minority Protection?

Minority shareholders in China are normally institutional and individual investors, with little experience of participating in corporate governance. Individual stock investors in China are nicknamed 'stock-citizens', meaning citizens in the stock market. Due to their limited investment experience and lack of reliable information, the minority shareholders usually play the role of silent investors, who wait for a free ride on complicated corporate affairs. Therefore, although it might be better if the minorities could be more involved in running the business, they would also be happy to see higher corporate transparency. By knowing more about the company, minority investors would be able to make better investment decisions.

Therefore, this thesis suggests that, independent directors could be an appropriate institution to improve the accuracy and timeliness of corporate information published to all shareholders, even though they would not be in a position to challenge the corporate controller at this stage.

3.5 Conclusion

Upon an overall review of corporate governance issues in Chinese listed companies, this thesis concludes that the board of directors should be the core of corporate operations as well as the key institution in terms of legal protection of minorities. Although it is argued in Chapter Two that minority shareholders, especially institutional shareholders, should participate more in corporate management to safeguard their own interests, the board of directors should also take on a more important role.

A well-designed board of directors could balance all the interests relating to the company in the boardroom, including the interests of the majority shareholder, minority investors, employees, creditors and other stakeholders. As such, decisions made by the board would be more likely to be in the best interests of the company.

In order to realise this expectation, scholars around the world have offered ideas which could be used by Chinese policy makers. Smerdon suggests that a new body, named 'observers', should be introduced into the board structure in non-profit organisations.⁴⁴⁵ According to his suggestion, observers should be granted the right to attend and speak at board meetings.⁴⁴⁶ This thesis suggests that such a mechanism could be applied for the purpose of minority protection. Observers, selected by different groups of shareholders according to their shareholding, could be granted, either by law or by the articles of association of the company, the right to attend and speak at the board meeting on behalf of the interests of his group. Although such observers would have no right to vote in decision making, they could at least voice the interests of a certain group of shareholders, in particular the minorities, to the board, and provide feedback relating to the actual board meeting to the shareholders who appointed him. As a consequence, the transparency and independence of the board may be increased. However, there should be careful attention here to the issue of confidentiality, so that business secrets remain protected by suitable undertakings.

Lipton and Lorsch's suggestion from 1992, that a lead director should be

⁴⁴⁵ R Smerdon, *A Practical Guide to Corporate Governance* (2nd edn, Sweet & Maxwell Ltd 2004), 322.

⁴⁴⁶ Ibid.

introduced into a modern board of directors,⁴⁴⁷ could also be useful. In their conception, such a lead director should be consulted by the CEO or the Chairman of the Board on 'the selection of board committee members and chairpersons; the board's meeting agendas; the adequacy of information directors receive; and the effectiveness of the board meeting process'.⁴⁴⁸ Accordingly, the introduction of a lead director would be expected to make a significant contribution to corporate governance quality, through: (a) taking responsibility for improving board performance: (b) building a productive relationship with the CEO: and (c) providing leadership in crisis situations.⁴⁴⁹

Indeed, in practice, the institution of lead director has been proved effective. A survey by PricewaterhouseCoopers in 2010 shows that lead directors have improved the quality of corporate governance in listed companies, particularly by 'focusing the board's talent and wisdom when difficult situations arise: management performance and succession, risk management, mergers and acquisitions, and a host of other internal and external matters'.⁴⁵⁰

This thesis will put forward an ideal model of corporate structure in the concluding chapter, based on a key ingredient of board-centralization. In terms of the reform of the board of directors, two aspects should be improved in particular: decision powers and board independence. As argued by this thesis, more decisive rights relating to corporate operations should be moved from the shareholders' meeting to the boardroom. More importantly, the independence of the board should be increased. Certainly, this would be a tough project, which would require a restructuring to

⁴⁴⁷ Monks and Minow (n 313) 262.

⁴⁴⁸ Ibid.

⁴⁴⁹ Ibid.

⁴⁵⁰ Ibid.

increase the proportion of independent directors on the board. However, as a result, the interests of minority shareholders would be weighted more fairly in decision making, and the transparency of listed companies could be improved.

Chapter Four: The Supervisory Board in China

Executive Summary

This thesis argues that the internal monitoring mechanism is crucial in modern corporate governance. The two main institutions of internal monitoring currently in operation are the supervisory board, which originated in Germany, and independent directors, an idea adopted from the US. Although the Chinese capital market was established only relatively recently, both these internal monitoring mechanisms have been transplanted into Chinese company law. However, this thesis argues that their operation has not brought about better internal monitoring in Chinese listed companies, because the relevant legislation fails to clarify the duties and responsibilities of each institution.

Through comparative research of the design of the supervisory board in Germany and in China, this thesis identifies a fundamental divergence, which means that the Chinese supervisory board cannot achieve the same effectiveness as its German counterpart. The supervisory board in Germany is an intermediary between shareholders and the management board, and represents the company. In that conception, management should be accountable to the supervisory board. However, the Chinese supervisory board is at the same level in the corporate structure as the board of directors. There is no direct accountability between the two. Hence, the board of directors in a Chinese listed company will be unconcerned about supervision by the supervisory board, as long as it can satisfy the controlling shareholder.

This thesis argues that, there are four main defects leading to the

ineffectiveness of the supervisory board: (1) the insufficiency of substantial rights; (2) low motivation; (3) the absence of independence; and (4) the lack of professional knowledge and skills.

Nevertheless, this thesis argues that the supervisory board cannot simply be replaced, either by independent directors or by the party committee of the CCP. Theoretically, the co-existence of supervisory board and independent directors could improve minority protection, if legislation could clarify the duties and responsibilities of both institutions. In addition, the accountability of the supervisory board should be reinforced. Finally, but equally importantly, compulsory training to provide supervisors with professional knowledge and skills could improve the effectiveness of the supervisory board.

4.0 Introduction

To achieve good corporate governance in practice, a mature market is both an invigorating factor and an effective internal monitoring system. Since minority shareholders are unable to get involved in day-to-day corporate operations, internal monitoring could be the first line of defence to prevent the infringement of minority interests by executives. Internal monitoring mechanisms vary from one jurisdiction to another in accordance with commercial practice, legal system and culture.

Most common law countries, such as the US and the UK, have a dispersed shareholding structure, which means that almost all shareholders in a company are minority shareholders.⁴⁵¹ Consequently, the agency cost problem between shareholders and executives, or

⁴⁵¹ Therefore, the institution which may protect the interests of shareholders as a whole is the one providing specific protection for minorities.

alternatively, the capital providers and professional knowledge providers, has been considered the core issue of corporate governance.⁴⁵² In this context, the institution of the independent director has been introduced in order to improve the independence of the board, minimise the negative effect of information asymmetry and, eventually, achieve better protection of shareholders' interests.

However, in civil law countries such as Germany, the shareholding structure is relatively more concentrated. In contrast to Anglo-American countries, where the success of the company is widely equated with maximizing shareholders' interests, much more attention in Germany is paid to the interests of other stakeholders, including banks, institutional investors, employees, suppliers, customers and the public.⁴⁵³ Therefore, a legal mechanism has been introduced to protect the interests of all stakeholders. Specifically, there is a two-tier board structure, usually a board of directors and a supervisory board, where the latter acts as an internal safeguard to monitor the former.

The case of China is quite special. Its market-oriented economy started relatively late, but has experienced dramatic development over the last two decades. To fit the flourishing market, Chinese legislators have transplanted certain institutions into the Chinese corporate governance regime. In terms of the internal monitoring mechanism, both the supervisory board and the institution of independent directors have been integrated into the Chinese legal system. Ironically, however, despite the co-existence of those two institutions as safeguards, China has experienced numerous corporate scandals, in which the rights of minority shareholders have been expropriated by the majority shareholders and

⁴⁵² It has been discussed above in Chapter Two.

⁴⁵³ Thomas J Schoenbaum and Joachim Lieser, 'Reform of the Structure of the American Corporation: The "Two-Tier" Board Model' (1973) 62 Kentucky Law Journal 91, 92.

executives.⁴⁵⁴

This chapter investigates and evaluates the institution of the supervisory board in China. Through the analysis, this thesis concludes that supervisory boards in Chinese listed companies have not fulfilled their function as expected, and the co-existence of supervisory board and independent directors results in an overlap and ambiguity in rights and responsibilities. Therefore, the internal monitoring mechanism is not likely to be effective in the future without fundamental improvement.

This chapter begins by giving a brief theoretical introduction to the supervisory board and how it has been transplanted into the Chinese corporate governance structure. Part 4.2 investigates the current performance of supervisory boards in practice. The third part analyses the reasons for the failure of the supervisory board as an internal monitor. Part 4.4 focuses on the problematic co-existence of supervisory board and independent directors. The chapter concludes by discussing several issues, in an attempt to find a solution to improve currently inefficient internal monitoring mechanism that includes both supervisory board and independent directors.⁴⁵⁵

4.1 The Transplantation of the Institution of Supervisory Board

4.1.1 Proposal to Establish a Supervisory Board

It has been noted that a ‘third party’ should be put in place as an internal monitoring mechanism of a company, to oversee the corporate business operated by potentially opportunistic agents, the executives, and to

⁴⁵⁴ Shujun Ding and others, 'Executive Compensation, Supervisory Board, and China's Governance Reform: A Legal Approach Perspective' (2010) 35 *Review of Quantitative Finance and Accounting* 445, 446.

⁴⁵⁵ The issues concerning independent directors are discussed in Chapter Three of this thesis.

mitigate the vulnerability of the principals, the shareholders.⁴⁵⁶ Since such a third party normally has no obvious conflict of interest with either the shareholders or the executives, it is expected to fulfil the monitoring function more fairly, so as to reduce the agency cost problem. In accordance with this concern, civil law countries such as Germany have adopted the institution of the supervisory board,⁴⁵⁷ whereas common law countries have introduced independent directors as internal watchdogs.

It is not only very difficult to compare the two internal monitoring mechanisms to try to establish which is better; it is also pointless. They are rooted in different environments. However, it is worth noting that, whichever internal monitoring mechanism is chosen, a sound corporate structure design must separate decision management and decision control.⁴⁵⁸ Decision management refers to the activities of initiating and implementing corporate decisions, which are normally exercised by the board of directors. Decision control, on the other hand, refers to ratification and supervision of corporate decisions and operation. In a one-tier board, such decision control is allotted to independent directors, while in a two-tier board it becomes the job of the supervisory board.

As pointed out by Maassen and van den Bosch, reformers in the United States emphasise strongly that a one-tier board is not sufficiently independent.⁴⁵⁹ The so-called independent director mechanism has been criticised on the grounds that 'there is an uncomfortable untidiness in

⁴⁵⁶ S H Goo and Fidy Xiangxing Hong, 'The Curious Model of Internal Monitoring Mechanisms of Listed Corporations in China: The Sinonisation Process' (2011) 12 *European Business Organization Law Review* 470, 470.

⁴⁵⁷ The institution of supervisory board originated with the incorporation of the Dutch East India Company. Shenshi Mei, *Xiandai Gongsi Jiguan Quanli Gouzao Lun [Studies on the Structures of the Modern Corporate Organs' Powers]* (China University of Political Science and Law Press 2000), 556.

⁴⁵⁸ E F Fama and M C Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 301, 301.

⁴⁵⁹ Gregory F Maassen and Frans A J Van Den Bosch, 'On the Supposed Independence of Two-tier Boards: Formal Structure and Reality in the Netherlands' (1999) 7 *Scholarly Research and Theory Papers* 31, 31.

having one group of directors supervising or controlling another group on the same board, which is meant to be the collective for managing the company'.⁴⁶⁰ From this point of view, investigation by another board may be more reasonable, since, in that case, the atmosphere of the management board would be more collegiate. In addition, some scholars believe that a supervisory board could help to improve earnings' informativeness, so increasing the likelihood that minority shareholders would receive reliable investment information to protect their own interests.⁴⁶¹

Mintz illustrates an ideal conception of functional distribution of a two-tier board, as shown in Table 1 below:

An Ideal Two-tier Board		
	Supervisory Board	Executive Board
Composition	Representatives of Shareholders and Employees	(1) Top managers including CEO, CFO and COO (2) Other members should be independent directors ⁴⁶²
Responsibilities	(1) Evaluate executives' performance and decide their remuneration; (2) Review and approve the corporate governance compliance report;	(1) Review and approve the financial statements and management's report on internal controls; (2) Monitor the internal

⁴⁶⁰ Sheridan Thomas and Kendall Nigel, *Corporate Governance: An Action Plan for Profitability and Business Success* (Pitman Publishing 1992), 161.

⁴⁶¹ M Firth, P Fung and O Rui, 'Ownership, Two-tier Board Structure, and The Informativeness of Earnings: Evidence From China' (2007) 26 *Journal of Accounting and Public Policy* 463, 493.

⁴⁶² Mintz suggests that in an ideal board structure, an independent director should serve as the chair of the executive board. Steven M Mintz, 'Corporate Governance in an International Context: Legal Systems, Financing Patterns and Cultural Variables' (2005) 13 *Corporate Governance* 582, 594.

	<p>(3) Review and approve accounting and financial statement;</p> <p>(4) Hire external auditors; and</p> <p>(5) Establish specific committees including audit committee, nomination committee and remuneration committee.</p>	<p>control system including risk assessment;</p> <p>(3) Report to the supervisory board on operational strategies and major questions about corporate planning, financial and investment activities, and human resource issues;</p> <p>(4) Report to the supervisory board on the profitability of the business, particularly the return on equity; and</p> <p>(5) Report to the supervisory board on business development.</p>
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Table 1: An Ideal Two-tier Board

(Resource from: Minz)⁴⁶³

However, other scholars have reviewed the role of the supervisory board and concluded that this internal monitoring institution is also dysfunctional in some respects.⁴⁶⁴ Similarly, Xiao et al. define the members of the supervisory board as honoured guests, friendly advisors or censored

⁴⁶³ Ibid.⁴⁶⁴ Chao Xi, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China' (2006) 22 Connecticut Journal of International Law 1, 2.

watchdogs.⁴⁶⁵

With specific reference to the supervisory board in Germany, which is based on the concept of codetermination,⁴⁶⁶ some critics have claimed that it would result in a less efficient or at least delayed decision-making.⁴⁶⁷ Jensen and Meckling argue that if such codetermination were beneficial to the company, it would be introduced voluntarily into corporate governance. In fact, however, in those countries which have no codetermination laws, very few companies choose to adopt a supervisory board as an element of codetermination in the corporate structure.⁴⁶⁸

In short, despite some shortcomings, in theory at least the supervisory board is expected to provide a fair investigation of executives' performance, and better protection for stakeholders.

4.1.2 The Systematic Design of the Supervisory Board in Germany

The institution of the supervisory board originated in Germany. The German *Aktiengesellschaft*, a corporation limited by shares that may be traded on the stock market, has a two-tier board. Power is vested in three separate bodies: the shareholders' meeting (*Hauptversammlung*), the supervisory board (*Aufsichtsrat*) and the management board (*Vorstand*). The rights and responsibilities of all three bodies are interrelated.⁴⁶⁹

⁴⁶⁵ Jason Zezhong Xiao, Jay Dahya and Z Jun Lin, 'A Grounded Theory Exposition of the Role of the Supervisory Board in China' (2004) 15 *British Journal of Management* 39, 42.

⁴⁶⁶ Codetermination is based upon the theory that workers in an enterprise should be provided with the opportunity to 'co-decide' questions which affect them individually and the work-force of the enterprise as a whole. For more detail see Schoenbaum and Lieser (n 453) 100.

⁴⁶⁷ Simon Renaud, 'Dynamic Efficiency of Supervisory Board Codetermination in Germany' (2007) 21 *Labour* 689, 691.

⁴⁶⁸ M C Jensen and W H Meckling, 'Rights and Production Functions: An Application to Labour-managed Firms and Codetermination' (1979) 52 *Journal of Business* 469, 474.

⁴⁶⁹ Schoenbaum and Lieser (n 453) 95.

- (1) General meeting of shareholders elects the members of the supervisory board;
- (2) Supervisory board appoints and removes if necessary the members of the management board;
- (3) Management board reports to and is accountable to supervisory board; and
- (4) Supervisory board reports to and is accountable to shareholders' meeting.

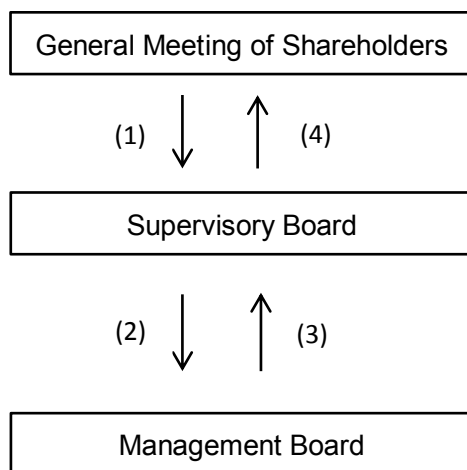


Chart 1: Corporate Structure in German Companies

As shown in Chart 1 above, the two-tier board in Germany is a structure with a supervisory board between the shareholders' meeting and executive board. As such, the management board has no direct link to the shareholders, which should help them to focus on business operations. In practice, shareholders may participate in corporate decisions at the request of the management board, but their decision would not be binding on the executives.⁴⁷⁰ According to the German Company Law, *Aktiengesetz* (AktG), the supervisory board in this structure is the

⁴⁷⁰ Ibid 107.

representative of the company in dealing with the management board.⁴⁷¹ In other words, it is the monitor which investigates the performance of the management board. It may appoint and dismiss members of the management board and enter into employment agreements with its members.

The members of the supervisory board should be elected by shareholders.⁴⁷² Members totalling two-thirds of the board may be freely chosen by the shareholders, while the remaining one-third should come from the labour force of the company, determined by the shareholders.⁴⁷³ There should be no fewer than two company employee representatives.⁴⁷⁴

As set out in para.90 (3) of AktG, the supervisory board may request a report from the executives on any matter to do with the company, including business decisions, legal relationships with connected undertakings, and circumstances concerning the business of such undertakings that may have a significant influence on the company's condition.⁴⁷⁵ Furthermore, the profitability of the company and, in particular, the return on its equity capital, should be reported to the supervisory board.⁴⁷⁶

Section 3 of the German Corporate Governance Code regulates the co-operation between the management board and supervisory board. It provides that the supervisory board is responsible for ensuring that the executives fulfil their duty to provide information and make reports to it.⁴⁷⁷

In addition, the Code requires each executive on a board of directors to

⁴⁷¹ Aktiengesetz (AktG), German Company Law, Para 84(1).

⁴⁷² Ibid, Para 101(1).

⁴⁷³ Schoenbaum and Lieser (n 453) 99.

⁴⁷⁴ Ibid.

⁴⁷⁵ Aktiengesetz (AktG), German Company Law (n 471), Para 90(3).

⁴⁷⁶ Ibid, Para 90(1).

⁴⁷⁷ German Corporate Governance Code, Section 3.4.

inform other directors and the supervisory board without delay when a conflict of interests between himself and the company occurs.⁴⁷⁸

Moreover, significant transactions require the consent of the supervisory board.⁴⁷⁹

Section 5 of the Code formulates the position and powers of the supervisory board in detail. To summarise, the supervisory board in German companies should (1) act as a regular consultant of the executive board in terms of corporate operations, especially in long-term planning; (2) supervise the performance of executives; (3) appoint or discharge the members of the executive board;⁴⁸⁰ and (4) set up the remuneration of members of the executive board.⁴⁸¹

Although it needs certain revisions, the operation of the supervisory board system in Germany has been deemed satisfactory in general, in terms of allocation of powers and responsibilities. Moreover, employee participation and harmony of the management board can be encouraged and achieved under this arrangement.

4.1.3 The Supervisory Board in the Context of the Chinese Legal System

Following the establishment of the stock exchanges in Shanghai and Shenzhen, in 1990 and 1991 respectively, in 1993 the Chinese Company Law conferred the internal monitoring function on the supervisory board.⁴⁸²

⁴⁷⁸ Ibid, Section 4.3.4.

⁴⁷⁹ Ibid.

⁴⁸⁰ Ibid, Section 5.1.

⁴⁸¹ Jean J du Plessis and others, *German Corporate Governance in International and European Context* (2nd edn, Springer 2007), 81.

⁴⁸² Company Law of the People's Republic of China (1993), Article 54.

Given the particular political concerns in China, it is not difficult to understand the choice of the supervisory board as internal monitor. First of all, the legal system in China is to a large extent inherited from continental law. Therefore, it would be relatively easy to transplant the supervisory board by statute into the Chinese system. Furthermore, and perhaps more importantly, the philosophy behind this institution, for example, the system of codetermination that allows employees to take part in corporate decision making, is conducive to that of the CCP, the Chinese political governor self-defined as a vanguard of the Chinese working class. According to socialist ideals, the working class is deemed the owner of the means of production.⁴⁸³ Therefore, its interests in particular should be protected.

Under the Company Law 1993, the supervisory board became compulsory for all joint stock companies, including all listed companies.⁴⁸⁴ With regard to the internal monitoring functions performed by the supervisory board, the Law stipulates four main tasks:⁴⁸⁵

- (1) To scrutinise the financial affairs of the company;
 - (2) To oversee the executives' actions with regard to compliance with the laws, administrative regulations and articles of association of the company. If any violation is found that would be detrimental to the company's interest, the supervisory board may request the executive to rectify his acts;
 - (3) To propose a provisional shareholders' general meeting;
- and

⁴⁸³ Z Jun Lin, Ming Liu and Xu Zhang, 'The Development of Corporate Governance in China' (2006) 1 Asia-Pacific Management Accounting Journal 29, 31.

⁴⁸⁴ Company Law of the People's Republic of China (1993), Article 124.

⁴⁸⁵ Ibid, Article 126.

- (4) To attend the meeting of board of directors.⁴⁸⁶

With regard to the composition of the supervisory board, there should be no fewer than three supervisors, and the members should include representatives of both the shareholders and the employees.⁴⁸⁷ Therefore, the institution of the supervisory board established a new channel for employees to participate in corporate operations, in addition to the already existing trade unions.

The Company Law was revised in 2005. However, despite evidence of supervisory board inefficiency, the institution was not replaced by independent directors as the internal monitor. On the contrary, the Company Law 2005 reinforced the supervisory board by conferring upon it several new rights.

- (1) Supervisors can bring forward proposals on the removal of any director or senior manager who violates any law, administrative regulation, the articles of association or any resolution of the shareholders' meeting.⁴⁸⁸
- (2) Supervisors can bring forward proposals at shareholders' meetings.⁴⁸⁹
- (3) Supervisors can initiate derivative actions against directors or senior managers at the request of shareholders.⁴⁹⁰
- (4) Supervisors can raise questions or suggestions on the matters to be decided by the board of directors.⁴⁹¹
- (5) Where necessary, supervisors may hire an accounting firm

⁴⁸⁶ The right to attend the meeting of board of directors does not imply any voting right, nor the right of inquiry as to the affairs being discussed.

⁴⁸⁷ Company Law of the People's Republic of China (1993), Article 124.

⁴⁸⁸ Company Law of the People's Republic of China (Revised in 2005), Article 54(2).

⁴⁸⁹ Ibid, Article 54(5).

⁴⁹⁰ Ibid, Article 54(6).

⁴⁹¹ Ibid, Article 55.

to help them, at the expense of the company.⁴⁹²

It should be noted that, despite the clear improvement in the monitoring powers held by the supervisory board, its effectiveness in practice is still in doubt. This is because the powers newly authorised to the supervisory board could be defined as soft powers, which pose no direct threat to the executives. The most powerful right conferred upon the supervisory board under the Company Law 2005 is that of bringing a proposal on the removal of a director to the shareholders' meeting.⁴⁹³ In this case, shareholders will have the final say by voting; hence, a director who has not satisfied the supervisory board will not be affected, as long as he can guarantee support by a majority of shareholders.

It is important to note that legal transplantation is not simply copying another jurisdiction. Indeed, as Mintz argues, any attempt to establish a global corporate governance structure would be a mistake.⁴⁹⁴ Although China learnt a great deal from Germany in terms of the supervisory board design, there remain clear differences, due to the different cultures and backgrounds. Goo and Hong term this divergence 'sinonisation'.⁴⁹⁵ According to their research, they assert that it stems from differences present at the very beginning, when Chinese legislators integrated the internal monitoring mechanisms into the Chinese corporate structure, and applies not only to the supervisory board system but also to the institution of independent directors.⁴⁹⁶

Among these differences, it is necessary to note that the governance structure of Chinese companies in accordance with the Company Law

⁴⁹² Ibid.

⁴⁹³ Ibid, Article 54(2).

⁴⁹⁴ Mintz (n 463) 595.

⁴⁹⁵ Goo and Hong (n 456) 471.

⁴⁹⁶ Ibid.

1993 is quite different from the German system. In Germany, the supervisory board stands between the shareholders and executives, as shown in the chart above. The management board is accountable to the supervisory board, while the supervisory board reports to shareholders. Holding the power of appointment and dismissal, as well as the right to determine remuneration, the supervisory board in Germany is equipped to discharge its monitoring function effectively.

However, the structure in China is different, as shown in Chart 2 below:

- (1) General Meeting of Shareholders elects the members of Board of Directors;
- (2) Board of Directors reports to and is accountable to General Meeting of Shareholders;
- (3) General Meeting of Shareholders elects the members of Supervisory Board;
- (4) Supervisory Board reports to and is accountable to General Meeting of Shareholders; and
- (5) Supervisory Board investigates the performance of Board of Directors.

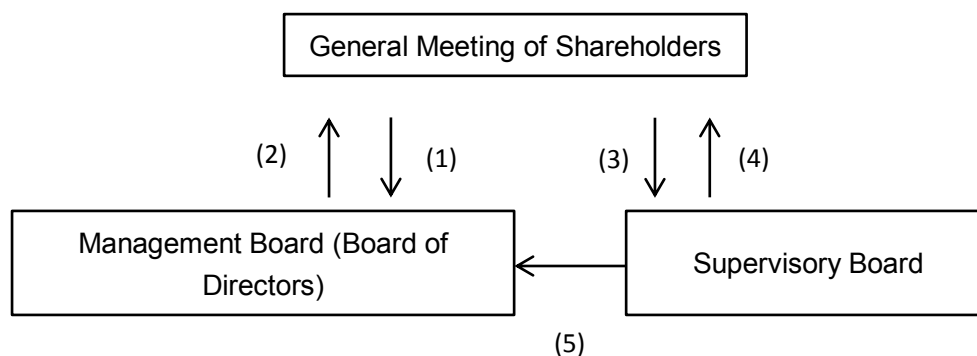


Chart 2: Corporate Structure in Chinese Companies

As shown, both the supervisory board and the board of directors are responsible to shareholders. The board of directors has no accountability to the supervisory board. Moreover, lack of substantial powers would inevitably result in inefficient monitoring in practice. These problems are investigated in detail in the remaining sections of this chapter.

4.2 How Does the Supervisory Board Work in China?

Since 1993, the supervisory board has been the compulsory monitoring body in the Chinese corporate structure. Despite certain criticisms, the institution of the supervisory board has not been abolished but has instead been reinforced. In 2008, the average size of supervisory board was 4.95.⁴⁹⁷ In the same year the average number of external supervisors, introduced in order to improve the independence and professional capability of the supervisory board, was 1.97.⁴⁹⁸ Based on these figures alone, it might be concluded that the supervisory board in China has developed to become capable of internal investigation. However, this remains in doubt.

Some scholars continue to question the effectiveness of the supervisory board in China.⁴⁹⁹ It has been claimed that the supervisory board is more decorative than functional in practice.⁵⁰⁰ Dehya et al. classify supervisory boards into four categories: (1) honoured guest; (2) friendly advisor; (3) censored watchdog; and (4) independent watchdog.⁵⁰¹ Among these, only an independent watchdog could fulfil the internal monitoring function as

⁴⁹⁷ Tong Lu, Jiyin Zhong and Jie Kong, 'How Good Is Corporate Governance in China?' (2009) 17 *China & World Economy* 83, 96.

⁴⁹⁸ *Ibid.*

⁴⁹⁹ J Z Xiao, J Dahya and Z Lin, 'A Grounded Theory Exposition of the Role of the Supervisory Board in China' (2004) 15 *British Journal of Management* 39, 53.

⁵⁰⁰ Lin, Liu and Zhang, 'The Development of Corporate Governance in China' (n 483) 39.

⁵⁰¹ Jay Dahya and others, 'The Usefulness of the Supervisory Board Report in China' (2003) 11 *Corporate Governance* 308, 313.

theory would expect. However, unfortunately, the researchers find that most supervisory boards in China tend to be of the other three types.

According to a survey by the Shanghai Stock Exchange in early 2000, the performance of supervisory boards in listed companies was disappointing. Only 3.4% of the respondents believed the supervisory board had achieved its monitoring function.⁵⁰²

A series of corporate scandals in the Chinese market offers more evidence of the ineffectiveness of the supervisory board. As a watchdog, the supervisory board is expected to discover the problems of the company and expose these to shareholders and the public when necessary. However, in almost all cases of corporate scandal, the supervisory boards have failed to do so.

More ironically, although the design of the supervisory board takes particular account of the interests of stakeholders, including creditors and employees, it has been reported that in the years since the introduction of supervisory boards in China, there has been no improvement in employees' benefits or corporate social responsibility. According to research by Lu et al. examining the quality of supervisory boards, 50% of the companies involved made no mention of employees' safety and benefits in their supervisory board report, and 47% had not introduced employee share schemes or other long-term employee incentive compensation plans.⁵⁰³ In other words, the establishment of supervisory board failed both to provide special protection for employee's interests and to establish a channel for employees' participation.

⁵⁰² Shanghai Stock Exchange, 'Shanghai Gongsì Zhìlì Wénjuàn Diào chá Jiéguó Yú Fēnxi [Results and Analysis of the Survey of Corporate Governance of Listed Companies]' (2000) Shangshì Gongsì [Listed Company], 25.

⁵⁰³ Lu, Zhong and Kong (n 497) 93.

Conversely, certain empirical studies have shown that the supervisory board in China has had some positive effects. For example, Dahya et al. conclude that lack of a supervisory board report in a company's annual report would lead to a negative market reaction.⁵⁰⁴ Firth et al. find that the existence of the supervisory board improves the quality of corporate accounting information so as to increase corporate transparency.⁵⁰⁵ More recently, a study has shown that the size of supervisory board can affect the remuneration of the board of directors.⁵⁰⁶ Additionally, Li and Hao conclude in their empirical research that the monitoring function carried out by the supervisory board cannot be replaced easily by any other institution.⁵⁰⁷

A survey by the CFA Institute in Hong Kong in 2006 focused on the practice of corporate governance in mainland China and showed that the performance of the supervisory board has improved since the Company Law reform in 2005.⁵⁰⁸ The rating of effectiveness of supervisory board reached 3.85, the historical high point, on a scale of one (extremely unimportant) to five (important).⁵⁰⁹

While the number of cases showing that the supervisory board has positive influence on corporate operations are few, it is worth mentioning some of them. For example, the supervisory board of Jiabao Group (600622) initiated a proposal to withdraw two decisions concerning related-party transactions, which were approved by the board of

⁵⁰⁴ Dahya and others (n 501) 309.

⁵⁰⁵ Firth, Fung and Rui (n 461) 493.

⁵⁰⁶ The study concludes that the larger the size of supervisory board, the lower the remuneration of board of directors. See, Ding and others (n 455) 469.

⁵⁰⁷ Wei-an Li and Chen Hao, 'Zhongguo Shangshi Gongsi Jianshihui Zhili Pingjia Shizheng Yanjiu [An Empirical Research of Supervisory Board Governance in China's Listed Companies]' (2006) 8 *Journal of Shanghai University of Finance and Economics* 78, 84.

⁵⁰⁸ Ding and others (n 455) 447.

⁵⁰⁹ Ibid.

directors,⁵¹⁰ while the shareholders' meeting of ST Kaidi upheld a supervisory board proposal to dismiss a director. In another case, three of the five supervisors of Sisha Stock (000611), representing the second largest majority shareholder and employees, took the lead in fighting against the majority shareholder and successfully protected the interests of employees and public minority investors.⁵¹¹

Certainly, no structural design can balance perfectly the various interests in a company, and nor can a supervisory board achieve this. Even in Germany, the institution is subject to challenge. For example, critics have questioned the independence of supervisors and the shortness of working time over a year.⁵¹² Therefore, it is more important to discuss how to improve the internal monitoring mechanism rather than to evaluate it further. The remaining sections of this chapter will focus on the causes of failure and possible solutions in the Chinese context.

4.3 Analysis of Supervisory Board Failure to Perform Well in China

This part investigates in detail the failure of the supervisory board in China, and highlights several problems in this corporate governance mechanism.

4.3.1 The Insufficiency of Substantial Rights

To become an effective monitor, the supervisory board should be equipped with a set of important powers: (1) the power to threaten any complacency on the part of the executives; and (2) the substantial ability to influence

⁵¹⁰ Weiguo Xu, *Zhongguo Gufenzhi Qiye Jianshi Shidian [The Supervisor Dictionary of Chinese Stock Companies]* (Hunan People's Publishing House 2000), 62-74.

⁵¹¹ Ibid 67.

⁵¹² Schoenbaum and Lieser (n 453) 103.

corporate decisions.

Sufficient supervisory power would guarantee that executives would not easily ignore or challenge these monitoring activities. Such power would include the right to appoint and remove executives, and the right to determine their remuneration. If executives were unable to satisfy the supervisory board, they might suffer reduced remuneration or even immediate dismissal.

Substantial ability to influence corporate decisions could improve the efficiency of supervision so as to provide better protection of corporate interests. Such ability could be exercised through a voting right on corporate decisions or a right to veto decisions. It should be pointed out that this thesis does not support giving voting rights to the supervisory board, owing to concerns regarding separation of decision management and decision control. The board of directors should be authorised to deal with corporate affairs independently. However, this thesis suggests that the supervisory board be granted a right of veto under a set of conditions. In this way, the risks of wrong-doing could be reduced and the interests of the company could be better protected.

With regard to the veto right, China could draw upon the German experience. In Germany, the company articles of association or the supervisory board itself may determine that certain transactions be conducted with the consent of the supervisory board, or if the supervisory board refused to grant such consent, these transactions could be proposed to the shareholders' meeting, seeking a majority vote.⁵¹³ Such power is similar to a right of veto, whereby the supervisory board would be

⁵¹³ Normally, it should be passed by no fewer than three-quarters of the votes cast. Frank Wooldridge, 'The Composition and Functions of German Supervisory Boards' (2011) 32 Company Lawyer 190, 192.

able to exert substantial influence when it considered the company's day-to-day operations were being compromised. Consequently, the interests of shareholders, especially minority ones, could be protected.

Despite reinforcement under the Company Law 2005, the Chinese supervisory board is still weak. It has little say on the issues of nomination and appointment of directors, or of their removal. It is not always possible to remove the executive in question from his position. All the supervisory board can do is to bring a proposal for dismissal to the shareholders' meeting and seek approval under the majority rule.⁵¹⁴ As a result, executives tend to show respect to shareholders rather than monitors, and even ignore requests from the supervisory board.

It might be asked why, if the performance of management can satisfy the shareholders who appointed the managers, it might not satisfy the supervisory board? The key issue here is the concentrated shareholding structure in China. In most cases, it is the majority shareholder who holds the majority voting right to determine the appointment and removal of executives, not the shareholders as a whole. However, the interests represented by the supervisory board are not limited to majority shareholders, but should also include the interests of minority shareholders and other stakeholders. Therefore, the supervisory board may challenge the managers when corporate operations only benefit the majority shareholder.

As to the remuneration of directors, once again this is determined by shareholders voting in the general meeting.⁵¹⁵ Therefore, the assessment of management performance by the supervisory board cannot threaten the

⁵¹⁴ Company Law of the People's Republic of China (Revised in 2005), Article 54.

⁵¹⁵ Ibid, Article 38(2).

directors' individual income.

In addition to the lack of real power, it is important to note that currently the powers granted to the Chinese supervisory board should be exercised collectively. While apparently in accord with corporate internal democracy, in practice this would limit the internal monitoring function. Goo and Hong argue that it could be better to allow the supervisors to act individually rather than collectively, especially on the issue of financial auditing, which requires significant time and energy.⁵¹⁶ It would be impossible to exercise such monitoring power collectively in the supervisory meeting, which only convenes a few times a year.⁵¹⁷

4.3.2 Low Motivation

Although, in China, the supervisory board and the board of directors are at the same level in the corporate structure, as shown in Chart 2 above, and both report to the shareholders, their status and influence are entirely different.

Under Chinese company law, the general meeting of shareholders is the most powerful body in the corporate governance structure. Corporate decisions that should be approved by shareholders' vote⁵¹⁸ include: (1) the company's operating guidelines and investment plans; (2) appointment and removal of directors and supervisors; (3) remuneration of the board; (4) the reports of both boards; (5) annual financial budget plans and final accounting plans of the company; (6) profit distribution plans and loss recovery plans; (7) increases or reductions in registered capital; (8) issuing of corporate bonds; (9) issues of assignment, split-up, change of form,

⁵¹⁶ Goo and Hong (n 456) 480.

⁵¹⁷ Ibid.

⁵¹⁸ Company Law of the People's Republic of China (Revised in 2005), Article 38.

dissolution, liquidation of the company; and (10) revision of articles of association.

The management, including directors and senior managers such as the CFO or the COO, are placed second in terms of influence over corporate operations. They are entitled to a substantial remuneration package, including annual salary, stock option incentives and other benefits. Meanwhile, because of their decisive position, they also enjoy high status within the company.

Supervisors, on the other hand, have far less incentive to perform well compared with the two bodies above. As mentioned, on the one hand, they have not been granted sufficient powers to influence corporate decisions, nor can they encourage the executives to perform well through their supervision. Hence the importance and effectiveness of their function is in doubt. On the other hand, there is no specific provision on payment for supervisors. Article 57 states merely that the cost of supervisory board activities should be paid by the company.⁵¹⁹ In practice, supervisors are normally paid a small allowance for their part-time monitoring job. Therefore, with little individual benefit, supervisors lack motivation.

Another important reason why supervisors fail to act energetically is the lack of any legal penalties for poor performance under Chinese company law. So far, there have been few cases in which a supervisor has been held responsible for corporate failure due to his inefficient supervision. As a consequence, supervisors might feel that they do not have to perform well.

⁵¹⁹ Ibid, Article 57.

To overcome this problem, Li and Hao suggest that an effective assessment of the performance of the supervisory board in China should be established.⁵²⁰ Such an assessment or ranking should include: (1) operation of the supervisory board; (2) composition and size; and (3) capability of supervisors. Furthermore, a set of regulations should be added to current company law to keep supervisors accountable in the same way as directors.

4.3.3 The Absence of Independence

Under statute, members of the supervisory board are elected either by general meeting of shareholders or by general meeting of employees.⁵²¹ Given the current shareholding structure, it is likely that the supervisors elected by shareholders will be dominated by the majority shareholder(s), while the members elected by employees of the company will be influenced to a large extent by the executives, the leading company employees. Therefore, lack of independence has been argued by this thesis as one of the most important reasons for the failure of the supervisory board mechanism in China.

Recent data show that Chinese state-controlled companies, especially the listed companies, retain a highly concentrated shareholding structure. In 94 of the top 100 listed companies in China, the five largest shareholdings make up more than 30% of the total.⁵²² Indeed, in 78 of these companies the five largest shareholdings make up over 50% of the total.⁵²³ A survey in 2002 showed that 72% of the listed companies on the Shanghai Stock

⁵²⁰ Li and Hao (n 507) 79.

⁵²¹ Company Law of the People's Republic of China (Revised in 2005), Article 52.

⁵²² Lu, Zhong and Kong (n 497) 92.

⁵²³ Ibid.

Exchange had no supervisor nominated by minority shareholders.⁵²⁴ Further empirical evidence shows that in 2004, 60% of supervisors were appointed by non-tradable shareholders, usually the majority shareholders in the company, and 38.38% were representatives of employees.⁵²⁵ Inevitably, in such a shareholding structure, supervisors appointed by shareholders represent the interests of the majority shareholder, rather than the interests of the company as a whole. Hence the independence of the institution is open to challenge.

In fact, it has been noted by German scholars that the supervisory board system may not suit all kinds of companies, especially small or medium-size companies, because it is too easy for the majority shareholder to dominate and control the board.⁵²⁶ The problem is almost the same in Chinese state-controlled companies, where the state takes the dominant position.

In practice, however, the supervisory board in China is dominated not only by the company's majority shareholder, but also by the executives and party committee. The issues relating to the CCP are illustrated in detail in Chapter Five of this thesis. With regard to the influence of executives, especially the chairman of the board of directors, it should be noted that in most cases, supervisors are either employees of the companies or close friends of the chair.⁵²⁷ In the former situation, supervisors might worry about losing their employment if they were to challenge their leader to fulfil the supervisory function; in the latter case, concerns about the personal

⁵²⁴ Xuebin Zhao and Lijie Wang, 'Woguo Shangshi Gongsì Jianshihui Ruogan Wenti Fenxi [Several Issues on the Supervisory Board System of Listed Companies]' (2003) 10 *Jingji Yu Guanli* [Economy and Management] 30, 35.

⁵²⁵ Denian Yao, *Woguo Shangshi Gongsì Jianshihui Zhidu Yanjiu [Research on the Supervisory Board of China's Listed Companies]* (China Legal Publishing House 2006), 208.

⁵²⁶ Schoenbaum and Lieser (n 453) 115.

⁵²⁷ Jay Dahya, Yusuf Karbhari and Jason Zezong Xiao, 'The Supervisory Board in Chinese Listed Companies: Problems, Causes, Consequences and Remedies' (2002) 9 *Asia Pacific Business Review* 118, 127.

relationship would inhibit full effectiveness in the role.

4.3.4 Inadequate of Professional Knowledge

To fulfil the statutory requirements, most supervisors are the representatives of shareholders and employees. This raises the question of whether they are competent to carry out their monitoring task, which requires certain professional knowledge and skills. The answer, unfortunately, is in the negative.

A survey in 2004, focusing on the 40 composite index companies on the Shenzhen Stock Exchange, showed that a mere 3.24% of supervisors had a legal background, and only 23.78% had professional accounting knowledge.⁵²⁸ The same survey revealed that 85% of the companies involved had no supervisor with a legal background, and 32.5% had no supervisor with an accounting background.⁵²⁹

A financial controller of a large state-controlled company in China enlarged upon these defects in an interview, stating that:

the supervisory board generally does nothing. Even with the annual report, I was the one who briefed them. They don't understand anything. The supervisory board meets twice a year, once before the interim report is issued and the other [time] before the annual report is published. Each meeting lasts about half an hour. It is basically a formality. They cannot discuss serious issues. Our secretary to the board of directors, after all, drafts the supervisory board

⁵²⁸ Yao (n 525) 215-219.

⁵²⁹ Ibid.

report.⁵³⁰

Moreover, Lu et al. note that out of 100 companies surveyed, only two provided training to supervisors.⁵³¹

As a means to improve the capability of supervisors in China, this thesis draws attention to some experience in practice in the Netherlands. Maassen and van der Bosch report that 74% of the chairmen interviewed for their research approve of the appointment of a former executive director as supervisor.⁵³² The clear rationale is that such a supervisor would know more about the company, in particular about the financial affairs and long-term corporate strategy.

As a partial conclusion to this section, the failure of the supervisory board is caused by a number of reasons, including but not limited to lack of substantial powers, motivation, independence and professional knowledge. Some of these defects could be overcome via legal reform, by granting to the supervisory board the power of veto or by reinforcing the accountability of supervisors. Evidence could be found in other researches.⁵³³ And more importantly, the reinforcement of the power of supervisory board in the revised Company Law 2005 shows the attitude and expectation of the state to improve such institution. However, some of the shortcomings will be more difficult to deal with. For example, it will not be easy to guarantee the independence of supervisors appointed by the majority shareholder.

⁵³⁰ Dahya, Karbhari and Xiao (n 527) 129.

⁵³¹ Lu, Zhong and Kong (n 497) 97.

⁵³² Maassen and Bosch (n 459) 36.

⁵³³ Shujun Ding and others, 'Executive Compensation, Supervisory Board, and China's Governance Reform: A Legal Approach Perspective' (2010) 35 Rev Quant Finan Acc 445, 469; and Xi, 'In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China' (n 466) 9.

4.4 The Co-existence of Supervisory Board and Independent Directors

As mentioned in Part 4.1, the Chinese corporate structure has a dual internal monitoring mechanism, including both supervisory board and independent directors. Generally speaking, the monitoring functions of both institutions are the same: checking corporate financial affairs, the legitimacy of corporate decisions and the rationality of such decisions.⁵³⁴ In other words, the introduction of independent directors has resulted in an overlap between the two internal monitors.

The question of why a company should have two internal monitoring institutions at the same time is extremely difficult to answer. To date, there has been no official explanation. However, it is worth noting that the independent director system was promoted by the China Securities Regulatory Commission (CSRC) based on certain concerns.⁵³⁵ Until the second draft of the Company Law 2005, companies could choose whether or not to adopt independent directors.⁵³⁶ To a certain extent, this fact casts doubt upon the necessity of establishing the independent director system in China.

The most common explanation for the dual monitoring system is based on the inefficiency of the supervisory board. Accordingly, the independent directors could supplement internal monitoring.⁵³⁷ Zhang adds that the co-

⁵³⁴ Ciyun Zhu, Ji Yang and Jianyong Ding, *Gongsi Neibu Jiandu Jizhi: Butong Moshi Zai Biange Yu Jiaorong Zhong Yanjin [Inner Supervision Mechanism of Corporations]* (Law Press 2007), 2.

⁵³⁵ There are several reasons to explain the legal transplant of such a common law institution into a civil law country: (a) most developed capital markets are in common law countries, so it is necessary to follow the leading trends from them; (b) coincidentally or not, officials of the CSRC have educational backgrounds in common law jurisdictions; and (c) it is part of a power struggle, aimed at helping the CSRC to have a bigger say as a market administrator.

⁵³⁶ CSRC, 'Opinions on Improving the Quality of Listed Companies'

<http://www.csrc.gov.cn/pub/newsite/ssb/ssflfg/bmgzjwj/ssgszl/200911/t20091110_167758.htm>, Article 3.

⁵³⁷ Yuan Zhao, 'Independent Directors in China: the Path in Which Direction?' (2011) 22 International Company and Commercial Law Review 352, 355.

existence of the two institutions provides a second check, which may work better than reliance on either one of them.⁵³⁸

However, this thesis cannot agree entirely with such explanations. The question remains as to why the supervisory board cannot be made more effective by revising the statutes. Alternatively, if the supervisory board has failed to fulfil its mission, why is it not simply abolished and replaced by the independent director system? The co-existence of the two institutions may be nothing more than a costly waste to the company.

In the next section, the two institutions are compared in detail in Table 2, and the problems resulting from their co-existence are highlighted.

4.4.1 Supervisory Board vs. Independent Directors

Comparison of Supervisory Board and Independent Directors		
	Supervisory Board	Independent Director
Composition	Representatives of shareholders and workers	Specialist experts
Remuneration	No extra payment has been mentioned for being a member of supervisory board	Same as directors or managers at the same level
Attends meetings of board of directors	√	√
Votes in the meetings of board of directors	×	√

⁵³⁸ Yihe Zhang, 'Review and Reconstruction: Functional Complement between Systems of Supervisory Board and Independent Directors' (2003) 5 Contemporary Law Review 20, 22.

Inquiry right on the matters to be decided by board of directors	√	Not necessary
Scrutinises corporate financial affairs	√	√
Engages external auditor	√	√
Engages external consultant	√	√
Brings proposal on the removal of director or senior manager under certain conditions	√	×
Brings proposal to shareholders' general meeting	√	×
Initiates derivative actions at the request of shareholders	√	×
Relationship to the Annual Report	It has to be approved by the supervisory board and the supervisory board should make its own report in relation to company affairs	Involved in drafting the Annual Report; Can issue independent statements if necessary.
Relationship to Related-party Transaction	N/A	It has to be approved by independent directors

Table 2: Comparison between Supervisory Board and Independent Directors

To summarise, the four main differences between the two monitoring

bodies, the supervisory board and independent directors, are as follows:

- (1) The independent directors are more professional.
- (2) Independent directors may help to improve the quality of corporate decisions via voting rights in the board meeting. However, the supervisory board can only investigate corporate decisions after they have been made.
- (3) Certain rights have been granted to the supervisory board only; for example, the right to initiate a derivative claim, the right to bring a proposal to the shareholders' general meeting and, more importantly, the right to bring a proposal on the removal of executives to the general meeting.
- (4) The operation of the supervisory board is by collective action, whereas the independent directors may perform their monitoring function individually.

4.4.2 Defects in Co-existence

As stated earlier, although in theory the co-existence of the supervisory board and independent directors establishes a double-check internal monitoring design, in practice it does not work well. The main reason is that legislators in China have failed to integrate the two mechanisms, so that some functions are ambiguous and overlap.

In practice, it is not unusual to find the supervisory board waiting for independent directors to undertake the monitoring activities, while the independent directors expect the supervisory board to act. Neither performs their function, although both should do so. In such situations, the so-called double-check monitoring becomes no monitoring at all. On the other hand, if both bodies do take action at the same time, this might not

represent good governance. For example, according to the Company Law 2005, both the supervisory board and the independent directors may hire external auditors or consultants at the expense of the company, when they consider it necessary.⁵³⁹ A duplication of cost may occur if both the institutions exercise their powers. Although the monitoring function might be achieved in this way, it is still wasteful for the company, which pays twice for the same service.

If the co-existence of the supervisory board and independent directors is to continue, this thesis suggests two methods to overcome the core defect. First, the Company Law should be revised to clarify the supervisory activities of each body, in order to avoid overlap and ambiguity of rights and responsibilities. A second, alternative, approach would be via internal agreement on the allocation of supervisory powers and responsibilities. Comparing the two methods of reform, this thesis would prefer such responsibility allocation should be regulated by law. It is because the most important concern for an immature jurisdiction is not the corporate democracy but minimization of uncertainty in law. Therefore, clarifying the supervisory activities of both the supervisory board and independent directors by the Company Law would be more effective in practise in China.

4.5 Conclusion

In concluding, this section seeks to answer the following three questions:

- (1) What are the core targets of the supervisory board in China?
- (2) Is there any institution that can perform better than the supervisory board in terms of internal monitoring?

⁵³⁹ Company Law of the People's Republic of China (Revised in 2005), Article 55 and 57.

(3) If not, how can the mechanism be revised so as to achieve a sound internal monitoring function?

(1) What are the core targets of the supervisory board in China?

The establishment of the supervisory board in China dates back to the corporate reform of the 1990s, when state-owned enterprises were transformed into modern companies. The supervisory board undertakes three main kinds of responsibilities.

(a) To provide legal protection of shareholders' interests

More specifically, the supervisory board is charged with safeguarding state assets. Under the corporate reform, the state has been re-defined as a company investor rather than company manager. Theoretically, its investments face the problem of agency cost in the same way as counterparts in western countries.

According to the National Audit Department, in the year 2000 the loss of state assets amounted to RMB 22,900 million.⁵⁴⁰ The reasons included avoidance of bank debt payment, extracorporeal circulation of capital and other violations. It has been reported that the price of state assets in a public auction is normally 10 per cent higher on average than asset valuation, whereas the price of state assets through private transaction or appointing transfer is 30 per cent lower than asset valuation.⁵⁴¹ Yet, the latter method was exercised widely during the reform. Indeed, the World Bank estimates that the loss of state assets accounted for approximately 8

⁵⁴⁰ Jiaxiao Lei, 'Guoyou Zichan Liushi Weixie Guoyou Jingji Anquan [The Threat to Safety of State-owned Economy by the Erosion of State Assets]' *People* (<<http://www.people.com.cn/GB/paper2515/8536/801394.html>> accessed 20-08-2012.

⁵⁴¹ Ibid.

to 12 per cent of GDP.⁵⁴²

Therefore, as the guardian of shareholders' interests, the supervisory board has been expected to supervise corporate finances as well as crucial business decisions, and to, prevent the misuse of state assets.

(b) To reduce mis-information

False financial statements are a common feature of corporate scandals, perhaps most famously in the collapse of Enron. The problem is a familiar one in China. According to a survey focusing on the financial reports of 152 companies in 2002, the under-valuing of assets reached RMB 8,588 million. Of this total, RMB 4,138 million related to shareholders' equity while RMB 2,872 million related to profit. More worryingly, for more than half of the companies involved the inaccuracy information of profit exceeded 10 per cent.⁵⁴³

To improve this situation, the supervisory board has been expected to explore the distortion of financial reports and to increase company transparency.

However, according to interviews conducted by Dayha et al.,⁵⁴⁴ sometimes supervisors are forced to pass the annual report without any correction, under pressure from executives or majority shareholders. Therefore, as mentioned by the Head of the Market Development Division in a top Chinese securities company, it does not matter what is written in the supervisory board report, because while that is all 'true', the problems lie in 'what is missing'.

⁵⁴² Minghui Li, 'Lun Guoyou Qiye Jianshihui Zhidu [On the Institution of Supervisory Board in State-Owned Enterprises]' (2005) 27 Journal of ShanXi Finance and Economics University 88, 89.

⁵⁴³ Baichuan Sang, 'Guoyou Zichan Liushi Mengyuhu, Jiada Shehui Pinfu Chaju, Jiaju Fubai [Warning of the Erosion of State Assets]' (2004) 3 Huanqiu [Globe] 31, 36.

⁵⁴⁴ Dahya and others (n 501) 315-316.

(c) To represent the interests of minority shareholders and other stakeholders

As mentioned above, China is a jurisdiction significantly influenced by civil law traditions. Therefore, the interests of stakeholders such as creditors and employees receive special attention in Chinese law. Moreover, given the political context of China, some scholars insist that the participation of workers should be enhanced, since this would be a good way to preserve the leading role of the working class and China's political status as a socialist country.⁵⁴⁵ Furthermore, with the development of the stock market in China, an increasing number of citizens now gamble their futures on corporate stocks. Therefore, preventing infringement of their interests, and thus achieving social harmony, becomes a new target for the supervisory board. Hence, the supervisory board is a corporate body that is expected to investigate the management on behalf of the interests of creditors, employees and the public.

(2) Is there any institution that can perform better than the supervisory board in terms of internal monitoring?

In some developed countries, such as Japan and France, there can be found a tendency to weaken or even abolish the supervisory board.⁵⁴⁶ However, despite the globalisation of corporate governance, supporters of the supervisory board in China believe this institution can be made to work and will eventually be widely accepted by Chinese citizens.⁵⁴⁷

To properly address this issue, it would be necessary to review whether

⁵⁴⁵ Goo and Hong (n 456) 504.

⁵⁴⁶ Shiquan Wang and Jinyan Liu, 'The Market for Controlling Rights, Independent Directors System and Supervisory Board Governance ----- A New View Based on Comparative Institutional Analysis ' (International Conference on Management Science and Engineering, Lille, 5th-7th Oct, 2006), 736.

⁵⁴⁷ Ibid 738.

there exists an institution equipped with all the rights held by the supervisory board. Only through exercising those legal rights can the supervisory board achieve its current monitoring function. If any institution has the same rights, it is rational to believe that it would not perform worse than the supervisory board. If such an institution were granted more powerful rights than the supervisory board, it may perform better than the supervisory board.

However, the comparison between the supervisory board and independent directors in Part 3.4.1 of this thesis reveals that some crucial rights, for example the right to initiate a proposal of removal and the right to bring a derivative claim, are granted to the supervisory board only. Therefore, under the current system, the independent directors are not equipped to take over all the functions of the supervisory board.

With regard to the monitoring function exercised by the party committee of the CCP, it is pointed out in Chapter Five of this thesis that the committee has a crucial problem in the mismatch between its powers and responsibilities. As such, replacing the supervisory board by the party committee would lead to an even worse mismatch. Furthermore, as a political institution, the CCP could not be expected to stand for minority shareholders against the majority one, the state.

Therefore, according to the research so far, this thesis concludes that the supervisory board in China cannot easily be replaced. At the moment, there is no other institution better able to perform the internal monitoring function.

(3) How can the supervisory board be reformed so as to achieve a

sound internal monitoring function?

Before answering this question, we should keep in mind that there is no 'one size fits all' model in today's diverse business world. With regard to internal monitoring, neither the supervisory board originating in Germany nor the independent directors created in the US can be perfect for all Chinese companies. Clearly, the co-existence regime in current Chinese company law needs to be revised, to reduce the overlap of rights and responsibilities and to minimise corporate costs, as suggested in Part 4.4.2. Alternatively, as suggested by Zhao, the statute could be changed to allow the company to choose either of the institutions in accordance with its own demands and situation.⁵⁴⁸

Focusing on the Chinese supervisory board in particular, this thesis puts forward the following suggestions:

- (a) The supervisory board should be granted with more substantial rights, including but not limited to the right to dismiss executives immediately under certain conditions, and the right to veto corporate decisions.
- (b) Regulations on the accountability of the supervisory board should be reinforced to enhance members' motivation.
- (c) Professional training should be provided for supervisors, and should be compulsory.

⁵⁴⁸ Zhao, 'Independent Directors in China: the Path in Which Direction?' (n 537) 356.

Chapter Five: The Chinese Communist Party: A Key Participant in Chinese Corporate Governance

Executive Summary

Corporate governance in Chinese listed companies is unique in having as a participant the party committee of the Chinese Communist Party (CCP). The CCP shares administrative rights with the government, and sometimes has an even more powerful influence on corporate management. This thesis argues that, notwithstanding the political concern to maintain the party committee's dominance in corporate operations, this two-track governance regime is actually a waste of management resources.

The dominance of the party committee extends to three main areas: (1) decisive power over personnel; (2) participation in corporate decision making via interlocking appointments; and (3) supervision of corporate management.

However, the involvement of the party committee in corporate operation has no legal ground in Chinese company law. The party committee is guided by party documents, known as circulars, which in practice are as influential as laws. This thesis argues that, without legal authorisation, there is a mismatch between the rights and duties of the party committee in Chinese listed companies, because party circulars only formulate what the party committee should do, but never prohibit what it should not do.

This thesis uncovers five main problems caused by the participation of the

party committee in corporate governance: (1) The mismatch of the rights and duties of the party committee is inconsistent with ideal corporate governance methods; (2) The criterion of manager appointment used by the party committee is based not on performance, but on political concerns, which would negatively impact corporate efficiency and the development of managers; (3) Participation of the party committee in management supervision must result in greater complexity and low efficiency of internal monitoring, because Chinese listed companies already have two internal monitors; (4) The ideological work of the CCP cannot be guaranteed if the party committee puts too much emphasis on corporate operations; (5) In the absence of any legal responsibility, participation by the party committee may bring about problems of corruption and rent seeking, infringing the interests of minority shareholders.

Therefore, this thesis argues that participation by the party committee in corporate operations does not improve minority protection. Instead, it decreases corporate efficiency, and ultimately harms the interests of shareholders. Of course, it would not be possible to exclude the party committee entirely from corporate governance in the current political environment. Nevertheless, if intervention by the party committee could be reduced, minority shareholders might suffer fewer problems as a consequence. Accordingly, this thesis advances two suggestions: (1) The CCP should be distinguished from the government, prohibiting direct influence by the CCP on administrative management; (2) The appointment of managers should be decided by the board of directors.

5.0 Introduction

Modern corporate governance was introduced into China with the corporatisation reforms of the 1990s, and was formalised in the Company Law 2005. A unique feature in Chinese listed company is the reservation of a seat in corporate governance structure for an important and powerful participant, the Chinese Communist Party (CCP), enabling it to participant in the business operation. The rationale for such reservation is rooted in the national strategy for economic transition, opening the market to promote the state economy while at the same time de-emphasising and limiting political liberalisation to maintain the governance of the CCP.⁵⁴⁹

Under the current Chinese legal system, the CCP committee has a tight connection with both the board of directors and the supervisory board, and has been authorised with power over corporate decision making. However, sound corporate governance is not only about power; it should also include accountability: who takes the blame for corruption, misuse of funds, or poor performance.⁵⁵⁰ By measure, Chinese corporate legislation is deficient in that it fails to clarify the role the CCP should play in companies and the liabilities it should bear, a failure that could lead to infringement of the interests of minorities.

The only provision relating to the CCP in the Company Law 2005 is Article 19, which states that 'the Chinese Communist Party may, according to the Constitution of the Chinese Communist Party, establish its branches in companies to carry out activities of the Chinese Communist Party. The company shall provide necessary conditions to facilitate the activities of the Party'.⁵⁵¹ More regulations are found in party documents, called circulars, issued by the National Congress of the CCP. Nevertheless, all

⁵⁴⁹ David M Lampton, 'The Faces of Chinese Power' (2007) 86 Foreign Affairs 115, 117.

⁵⁵⁰ Peter A Gourevitch and James Shinn, *Political Power and Corporate Control* (Princeton University Press 2005), 1.

⁵⁵¹ Company Law of the People's Republic of China (Revised in 2005), Article 19.

these circulars put emphasis on what the CCP committee should do; there are almost no restrictions stating what it should not do, nor any regulations to make the CCP accountable for the wrongs it has done already.

In practice, the CCP's position within the corporate governance structure is an ambiguous one. It is not the regulator, as that role is taken by the state;⁵⁵² nor is it the supervisor, because that is the job of the supervisory board and independent directors.⁵⁵³ It is not the decision maker on operations, nor is it accountable to the shareholders. However, it is charged with certain political tasks, such as being the 'political core' and leading the corporate executives, and is empowered to intervene in business decision making. This causes the key problem, discussed later in this chapter, whereby the existence of any participant who is equipped with powers and does not take any responsibility will eventually erode accountability.

It argued that the legal status of the CCP in the current Chinese context originated in the history and reform of politics, economy and law. As noted by Gourevitch and Shinn, a corporate governance system reflects political attitudes, shaped by a mixture of laws, rules and regulations.⁵⁵⁴ Similarly, Lubman points out that, in China, legislation satisfies the needs of politics and the economy.⁵⁵⁵ He notes that China needs a more developed legal system to match its market economy, because such an economy should be governed by law.⁵⁵⁶ McNally concludes that many problems in today's China triangulate between managerial autonomy, political interests, and market demands.⁵⁵⁷

⁵⁵² Lance L P Gore, *The Chinese Communist Party and China's Capitalist Revolution: The Political Impact of the Market* (Routledge 2011), 85.

⁵⁵³ Discussed in Chapters Three and Four of this thesis.

⁵⁵⁴ Gourevitch and Shinn (n 550) 3.

⁵⁵⁵ Stanley Lubman, 'Introduction: The Future of Chinese Law' (1995) 141 *The China Quarterly* 1, 12.

⁵⁵⁶ *Ibid.*

⁵⁵⁷ Christopher A McNally, 'Strange Bedfellow: Communist Party Institutions and New Governance

Indeed, direct involvement of the CCP in corporate governance would unite corporate executives to ensure party control over the company. Nevertheless, communist institutions are seen as a weakness in promoting market-economic development.⁵⁵⁸ As Adam Smith argued in *The Wealth of Nations*, as far back as 1776, 'the government monitors and enforces the regulatory environment in which firms compete for survival and profits, but should not directly be involved in a firm's decisions and transactions'.⁵⁵⁹

The question of what role the CCP should play in the Chinese legal system is a difficult one to answer. It is apparent that the CCP, as a political actor, is not in keeping with the needs of modern corporate governance and business concerns. However, political considerations mean that it cannot simply be removed from the system. Just as the reform undertaken by China is proceeding gradually,⁵⁶⁰ participation by the CCP will not be changed in the short term.

Accordingly, ensuring that the control exercised by the CCP has a proper legal basis is one of most important tasks for the legislature. As argued by western observers, the main problem is how to set the legal balance to maintain social cohesion amid the vast development of a socialist market economy in the long term,⁵⁶¹ although they find it hard to understand how the Chinese can hold on simultaneously to both socialism and capitalism

Mechanisms in Chinese State Holding Corporations' (2002) 4 Business and Politics 91, 94.

⁵⁵⁸ Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry' (2005) 181 The China Quarterly 1, 2.

⁵⁵⁹ Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* (University of Chicago Press 1976), 208.

⁵⁶⁰ Economic reforms in China can be characterized as gradual rather than revolutionary. Therefore, it is argued that Chinese political institutions remain unaffected. Shujun Ding and Cameron Graham, 'Accounting and the Reduction of State-owned Stock in China' (2007) 18 Critical Perspectives on Accounting 559, 565.

⁵⁶¹ Robert Skidelsky, 'The Chinese Shadow' (2005) 52 The New York Review of Books 1, 3.

with no contradiction at all.⁵⁶²

This chapter aims to analyse and evaluate the methods used by the CCP to implement its political interest in company operations. By doing so, it is hoped that this research might find a balance between achieving CCP control in accordance with political concerns on the one hand, and improving corporate autonomy on the other. Because in most cases the state is the majority shareholder, it will be further concluded that increasing corporate autonomy, pursuing the success of the company, is an important means to provide better legal protection for minority shareholders.

The chapter begins by discussing the relationship between the state and the CCP, which is often confusing to western researchers. The CCP circulars, which are not laws but share the same legal effect, are introduced in the second part. Part 5.3 gives a brief history of Chinese economic reform and legislative changes relating to the CCP in corporate governance. Part 5.4 focuses on the two key methods used by the CCP to intervene in corporate operations. The negative influences of such intervention are illustrated in Part 5.5. The final section offers suggestions on how to achieve the required balance.

5.1 The Communist Party and the State

In this section, the relationship between the state and the CCP is investigated, before further discussion of the CCP's role in corporate governance.

Compared with many western countries, the relationship between the

⁵⁶² Ibid.

People's Republic of China and its governing party, the CCP, is unique. The CCP is one of the most powerful parties in its territory anywhere in the world. For example, it is written into the Constitution of China that the country should be under the leadership of the CCP.⁵⁶³ When analysing the economic issues of China, there is a strong tendency to treat the CCP as something irregular and exogenous to state bureaucracies.⁵⁶⁴ However, as Gore points out: 'Never before has a Leninist Party attempted to preserve an organizational structure designed for a planned economy while pushing for marketization and embracing globalization.'⁵⁶⁵

As noted by many scholars, the Chinese reforms, whether economic, legal or political, are exercised under a 'Top-Down' model. Yet, the 'Top' in this model does not always refer to the state council, the supreme executive body. In most cases, it refers to the CCP. It is the CCP, in fact, that revived China by implementing the 'Open Door' policy and various social reforms. Under its leadership, China has experienced great economic development and attracted attention from other countries, including developed countries such as the UK and the US. Even so, it cannot be ignored that direct leadership by the CCP blurs the distinction between the CCP and the state, especially in terms of rights and responsibilities.

According to the Constitution, the National People's Congress (NPC) is the highest organ of state power;⁵⁶⁶ it exercises the legislative power of the state.⁵⁶⁷ The State Council, also referred to as central government, is the executive body of the highest organ of state power and the highest organ of state administration.⁵⁶⁸ Those two, together with the local governments,

⁵⁶³ Constitution of the People's Republic of China, Preamble.

⁵⁶⁴ Heilmann (n 558) 4.

⁵⁶⁵ Gore (n 552) 5.

⁵⁶⁶ Constitution of the People's Republic of China, Article 57.

⁵⁶⁷ Ibid, Article 58.

⁵⁶⁸ Ibid, Article 85.

are usually regarded as 'the state'. The CCP, as the governing party, is the vanguard of the Chinese working class, the Chinese people and the Chinese nation, as formulated in its Party Constitution.⁵⁶⁹ Its three historical tasks are to advance the modernisation drive, to achieve national reunification, and to safeguard world peace and promote common development.⁵⁷⁰ The members of the NPC and State Council can be, but are not limited to, CCP members. That is to say, it is for the NPC or the State Council, not the CCP, to decide national affairs and to govern. The interests of the CCP should be realised by the voting power or administrative power exercised by its members with a position in the state organs.

However, in reality, the CCP holds final decision power and direct influence over the government organs. Even the NPC remains heavily influenced by the party. Evidence for this influence can be found in the removal of Qiao Shi, who disagreed with Jiang Zemin, then Party Secretary and State President, over party leadership of law making and legal enforcement.⁵⁷¹

The organisation of the CCP mirrors that of the state. For example, the State Council is the top administrative body, with 28 ministries and commissions, 18 special organisations and several related institutions,⁵⁷² while the CCP central committee has 15 affiliated departments, in charge of different national affairs. Moreover, although there is no connection between state ministries or commissions and the party departments in law, in practice, the state organs are under the leadership of CCP departments.

⁵⁶⁹ Party Constitution of Chinese Communist Party, General Program, <http://news.xinhuanet.com/18cpnc/2012-11/18/c_113714762.htm> accessed 18-12-2013.

⁵⁷⁰ Ibid.

⁵⁷¹ Pitman B Potter, 'The Chinese Legal System: Continuing Commitment to the Primacy of State Power' (1999) 159 *The China Quarterly* 673, 676.

⁵⁷² State Council, 'State Council of PRC' (2012) <<http://english.gov.cn/links/statecouncil.htm>> accessed 03-05-2012.

Hence, in terms of corporate governance, in addition to the classical bureaucratic channel of intervention common in the East Asian developing states, in China party committees provide a second channel of state involvement in corporate governance,⁵⁷³ one that usually displays a stronger influence in the company than government bureaus.⁵⁷⁴ In fact, the relationship between the CCP and the state has sometimes been deemed a 'delegation relationship', in which the party is the principal and the government departments are the agents.⁵⁷⁵

This thesis defines the organizational structure just outlined as a two-track governing organisation. However, the two-track organisation raises certain problems in both politics and corporate governance.

First, the ultra vires actions of the CCP may impact the ordinary operation of companies. As mentioned above, it is the state that is authorised by law to exercise administrative powers over national affairs, including those in the commercial area, for example by being the representative investor of state assets owned by all citizens as a whole. In theory, such powers should not be exercised by the CCP. However, over the past few decades, there have been many cases in which the CCP not only participated in, but dominated, public management. For instance, the reform of state-owned shares should be decided by the shareholders' representative, the state, in accordance with the theory of corporate governance.⁵⁷⁶ However, the reform that began in China in 1999 was initiated by a document issued by the CCP. 'The Decision Regarding Several Important Issues Related to the Reform and Development of State-Owned-Enterprises' set the tone for

⁵⁷³ Victor Nee, Sonja Opper and Sonia Wong, 'Developmental State and Corporate Governance in China' (2007) 3 *Management and Organization Review* 19, 27.

⁵⁷⁴ Ibid.

⁵⁷⁵ S L Shirk, *The Political Logic of Economic Reform in China* (University of California Press 1993), 53.

⁵⁷⁶ In the design of corporate governance, the shareholders should have the final say about their shareholding.

reforming state-owned assets.⁵⁷⁷ Another example, relating to legal practice, is that many judges report directly to district party committees and discuss major cases, including business cases, before they come to court.⁵⁷⁸ As such, day-to-day operations of the company could be influenced by CCP activities beyond its legal authority. A later part of this chapter will identify in detail how such intervention may take place.

Secondly, the ultra vires activities of the CCP lead to dual leadership by the state and the CCP. Since the organisation of the state mirrors the organisational structure of the CCP central committee, it would appear that there are two organs in charge of the same matters. Although, as noted above, these two organs may have an inherent connection, de jure they are two different bodies. Such practice is not only a waste of administrative resources, it also results in some inevitable uncertainties, which make it more difficult for the company to forecast and plan its business activities.

Furthermore, the two-track governing organisation has been regarded as the core reason for the ill-defined status of accountabilities, and the basis for the existence of CCP committees in the modern corporate governance structure. This thesis argues that, unless the rights and responsibilities of the state and the CCP can be clarified in law, the CCP will remain trapped in an ambiguous situation. Consequently, the quality of corporate governance will be affected negatively, and finally the interests of minority shareholders will be infringed.

During the past decade, there has been a welcome transfer of power from the CCP organs to state agencies.⁵⁷⁹ However, this change is not based on legislative reform, and more time is needed for China to clarify the

⁵⁷⁷ Ding and Graham (n 560) 567.

⁵⁷⁸ K T Liou, *Managing Economic Reforms in Post-Mao China* (Praeger 1998), 13.

⁵⁷⁹ Heilmann (n 558) 16.

accountability of the CCP in law. For ease of explanation, in this thesis the CCP and the state will be integrated into the same interest group.

5.2 Laws, Administrative Regulations and Circulars

It has been noted earlier in this thesis that the Chinese legal system features several levels of law-making. Laws are at the top, while administrative regulations issued by central government are placed second, followed by administrative regulations issued by state ministries and local governments. Clearly, the party circular issued by the CCP is not a part of the legal system. Theoretically, these circulars should refer only to party affairs, and be binding only on party members.

However, it has been pointed out that, in China's political context, party documents enjoy de facto authority, even if this is not supported in law.⁵⁸⁰ For example, the 'Party-control-cadres Policy', which will be illustrated below, has impacted business operations on a wide scale in China, despite having no basis in Chinese company law.

The wide use of circulars in national governance can be seen as connected to the transitional economy. Although China has implemented certain reforms in order to boost the national economy, this is a gradual process. As the Chinese saying goes, it is like crossing the river by touching the stones. There is no optimal model or legislation for reference; indeed, it has been suggested that, for China, it could be more workable to carry out second-best policies, rather than implement an optimal model directly.⁵⁸¹ In addition, Tomasic and Fu argue that 'legal reform in China may not have been an essential precondition to economic reform, as

⁵⁸⁰ Gore (n 552) 87.

⁵⁸¹ Jing Leng, *Corporate Governance and Financial Reform in China's Transition Economy* (Hong Kong University Press 2009), 1.

evidenced by the fact that these reforms actually occurred after economic reform gained momentum'.⁵⁸²

Certainly, legislation usually requires a complicated procedure before becoming effective, whereas CCP documents can be passed easily by a group of the party elite. It is also simple to revise or abolish the circulars, so that the cost of error correction is relatively low. During the reform process, this could be a wise choice to achieve large-scale social development. However, in the long run, it is the stability and credibility of law that can promote stable growth. Accordingly, this chapter would urge the Chinese government to decrease the influence of the circulars on national governance; alternatively, it should implement the idea of 'Rule of Law' rather than 'Rule by Law'.

5.3 Brief Introduction to CCP Strategies in Chinese Economic Reform

This section provides an introduction to the changing role played by the CCP in the Chinese commercial area, in order to establish an overall understanding of CCP political concerns in different periods. It is argued that the CCP recognises the massive opportunity offered by the flourishing market economy, although it retains control over certain products such as oil and gas, electricity, railways, banking, telecommunications, and foreign exchange.⁵⁸³ Therefore, the CCP has tried to find the right balance to ensure both the growth of the national economy and its own control over the state and commercial entities.

Ever since the 1950s, the CCP committee had been the most powerful

⁵⁸² Roman Tomasic and Jian Fu, 'Legal Regulation and Corporate Governance in China's Top 100 Listed Companies' (2006) 27 *The Company Lawyer* 278, 279.

⁵⁸³ Gore (n 552) 80.

management body in China.⁵⁸⁴ With the implementation of the 'Open Door' policy, a modern management body comprising managers and supervisors took its place in corporate operations. During this stage, the CCP central committee attempted to reduce its direct influence over companies, and to leave business affairs to executives who held more experience of productive activities and management thereof.

Nevertheless, such delegation of power did not mean that the CCP gave up control of companies in China. It still adopted a prudential role in the market economy. According to McKerra, 'on the one side were those who feared that over-hasty and excessive reform and modernization would lead China to capitalism... On the other side stood those who emphasized the rise in the standard of living produced by reform and modernization.'⁵⁸⁵ Therefore, the power to appoint executives was retained by the CCP as a key safeguard.

The State-Owned Enterprise Law,⁵⁸⁶ passed in 1986, states:

It must be made clear that enterprises are not government organs and the role of enterprise Party organizations is different from that of political leadership of central and local Party committees. It no longer performs single-pole leadership role (*Yiyuanhua lingdao*); instead, its role is to ensure and monitor business operation. Its energy should be concentrated on enterprise Party building, on fully utilizing Party organizations as the fighting fortress in fulfilling tasks, and on mobilizing Party members to serve as

⁵⁸⁴ Martin Lockett, 'Culture and the Problems of Chinese Management' (1988) 9 *Organization Studies* 475, 481.

⁵⁸⁵ Colin McKerra, Pradeep Taneja and Graham Young, *China Since 1978* (2nd edn, Longman 1998), 27.

⁵⁸⁶ It was replaced in 2009 by the Law of the People's Republic of China on the State-Owned Assets of Enterprises.

role models for workers... It should also support the manager or CEO in order for them to fully exercise their power in accordance with the State-Owned Enterprise Law, and offer suggestions on major issues and decisions of the enterprise.⁵⁸⁷

In accordance with this legislation, on April 28th 1986 the CCP central committee issued a circular urging the downsizing of party committees in enterprises, whereby only large enterprises should have a full-time party secretary and a simple party bureaucracy.⁵⁸⁸

However, the trend towards improving corporate autonomy did not last for long. After the Tiananmen incident in 1989, the new General Secretary of the CCP, Jiangze Min, reinforced party building, especially in the grass-roots units. He put forward the 'Party-control-cadres Policy' (*Dang Guan Ganbu*), requiring the party committee in the company to act as a political core, in order to increase the CCP's control over enterprises once again.

The rationale for such strategic change, according to Jiang and Zhu Rongji,⁵⁸⁹ is that most economic problems, especially in the financial industry, are caused by ignorance of CCP directives and a general neglect of 'party construction' within supervisory organs and financial firms.⁵⁹⁰ A circular issued by the CCP Central Committee in August 1989 formally stipulated the roles that party committees should play in the corporate governance structure: (1) to participate in making major business decisions; (2) to appoint middle-level management personnel jointly with the CEO or top manager; (3) to maintain a team of full-time party affairs

⁵⁸⁷ CCPCC, 'Circular on Strengthening Party-Building' in, *Qiye Dangjian Dashiji [Chronicle of Major Events in Enterprise Party-Building]* (Beijing: Dangjianduwu Chubanshe 1996), 40.

⁵⁸⁸ Gore (n 552) 80.

⁵⁸⁹ The latter was the Premier of the PRC at that time.

⁵⁹⁰ Heilmann (n 558) 6.

workers.⁵⁹¹ It also made clear that the remuneration of party cadres should be comparable with that of management cadres of the same rank.⁵⁹²

Although the party document emphasised the importance of the CCP committee in corporate operations, the Company Law that came into force in 1993 did not touch upon what rights would be granted to the CCP committee, nor did it clarify the responsibilities of the CCP. Therefore, the participation of the party committee in major business decisions, as urged by the circular mentioned above, still lacks a legal basis in company law.

With the implementation of the Company Law 1993, most SOEs in China restructured themselves into modern companies, a development known as 'corporatisation reform'. Under this reform, a western style corporate governance structure was introduced into the Chinese legal system. Corporatisation reform was expected to separate state ownership from state control, and consequently, companies would have complete autonomy in day-to-day business operation. Unfortunately, however, it has been noted that corporatisation did not bring any such autonomy of corporate operations, but enabled the state to maintain the same level of control it had before, over an even larger pool of assets.⁵⁹³

In 2001, the CCP updated its strategy in corporate governance by changing the role of the enterprise party committee from political core to business helper. It held that 'the party committee should utilise its "comparative advantage" in mobilisation to boost workers' morale, to mediate conflicts and mend fences, to mobilise mass campaigns to improve efficiency and expand sales, to build up the "spiritual

⁵⁹¹ The number of such party affairs workers should normally not exceed one per cent of the total workforce.

⁵⁹² CCPCC (n587) 52.

⁵⁹³ Modern corporate structure enables the State to control a company with a shareholding of less than 100 per cent. See Clarke, 'Corporate Governance in China: An Overview' (n 12) 5.

civilisation”'.⁵⁹⁴ In the same year, to make the strategy more specific, the Organisational Department of the CCP Central Committee issued an Opinion on the party work in 100 pilot modern enterprises. This circular required the party committee to assist the shareholders' meeting, board of directors and supervisory board to fulfil their tasks by establishing a sound connection with employees and by providing internal monitoring, with the ultimate aim of achieving the development of a socialist market economy.⁵⁹⁵ However, this thesis argues that such guidelines cannot help the party committee to know exactly what it should do in practice, nor do they have any binding force over the committee.

In 2004, in order to resolve the ambiguous position of the CCP in the corporate governance structure and to obtain controlling power over corporate decision making, the Organisational Department of the CCP Central Committee and the State Assets Administration Committee jointly issued an 'Opinion on Strengthening and Improving Party Building in Central Enterprises'.⁵⁹⁶ In this political document, the CCP reaffirmed the importance of acting as the political core, and further urged the establishment of a path to help the party committee get involved in decision making on major affairs. The path refers mainly to an interlocking of roles: for example, appointing the secretary of the party committee as CEO or top executive, and appointing an influential director as vice-secretary of the party committee. As such, party members would be able to exercise decision-making power or operation power legally in the interests of the CCP. Such a strategy has been upheld by the Shanghai government as follows:

⁵⁹⁴ Gore (n 552) 87.

⁵⁹⁵ Ibid.

⁵⁹⁶ CCP, 'Opinions on Strengthening and Improving Party Building in Central Enterprises.'
<http://www.jxccc.com/jtdj/xjjy/xjjy_sjjs_08.htm> accessed 24-04-2012.

Where possible, the party secretary of state holding corporations should act as the chair of the board of directors. If this requirement cannot be fulfilled, then the chair should act as vice-secretary and the secretary as vice-chair of the board of directors.⁵⁹⁷

However, the system is still not perfect. In practice, the interlocking strategy inevitably results in a confusion of decision maker, decision executive and monitor. It has been commented that interlocking appointments provide the opportunity for the CCP to join the management in 'insider control'.⁵⁹⁸

Although since 2004 there has been little further change, this does not imply that all problems have been resolved. The main issues caused by CCP intervention will be discussed in detail in Part 5.5 of this chapter.

5.4 Current Situation of CCP Control over Corporate Operation

According to an empirical survey by Tam, both the board of directors and the supervisory board lack the conditions and resources to carry out their nominal functions.⁵⁹⁹ He further points out that, more significantly, the process of corporate governance is dominated by a variety of government departments and the CCP.⁶⁰⁰ Similarly, a survey of the Shanghai Stock Exchange in 1999 found that more than 95 per cent of listed companies were under control of the state, directly or indirectly.⁶⁰¹

⁵⁹⁷ Internal materials, from Shanghai State-owned Asset Management Commission.

⁵⁹⁸ Peng Liu, 'Dangdai Guoqi Chongzu he Dangjian suo Mianlin de Wenti [The Current Restructuring of SOEs and the Challenges Party-building Faces]' (2004) 12 Zhongguo Gongchandang [Chinese Communist Party] 104, 111.

⁵⁹⁹ Tam (n 115) 54.

⁶⁰⁰ Ibid.

⁶⁰¹ Tenev, Zhang and Brefort (n 295) 76.

Currently, the CCP exercises ultimate control over three aspects in the company: decisions on personnel, business decision making and the supervisory function. The power to control can be classified into three types: (1) legal rights granted by law; (2) powers mentioned by circular; and (3) decisive impact power based on inherent connection. Owing to different shareholding structures within companies, these CCP controls differ from one company to another (Table 1).

Table 1: CCP Control Over Companies			
	Wholly State-Owned Companies	Partly State-Owned Companies	Private Companies With No State Shareholding
Personnel at Director Level	Rights Authorised by Law ⁶⁰²	Decisive Impact Power	Decisive Impact Power
Personnel at Manager Level	Decisive Impact Power	Decisive Impact Power	Decisive Impact Power
Business Operations	Rights Authorised by Law ⁶⁰³	Powers Mentioned in Circulars	Power Mentioned in Circulars
Supervision	Rights Authorised by Law ⁶⁰⁴	Powers Mentioned in Circulars	Decisive Impact Power

Through the table, it can be concluded that the CCP committee is one of the key participant in corporate operation in all kinds of companies in China. However, only the party committee in wholly state-owned company has the legal rights to get it involved in personnel issue at director level,

⁶⁰² Company Law of the People's Republic of China (Revised in 2005), Article 68.

⁶⁰³ Ibid, Article 67.

⁶⁰⁴ Ibid, Article 71.

business operation and internal supervision. The rest influential powers, hold by the CCP committee, are lack of legal ground.

5.4.1 Personnel Decisions

It is argued that, facing the challenges of a transition economy, the CCP is not a passive player awaiting the onslaught of new market forces, but a continuous controller, keeping power over executive appointments.⁶⁰⁵ In most cases, the party committees possess key knowledge regarding suitable candidates and will suggest potential appointees to leadership positions.⁶⁰⁶ For example, research by Heilmann shows how the CCP controlled the appointments of senior executives in China's financial system in 2003⁶⁰⁷ (Table 2).

⁶⁰⁵ Heilmann (n 558) 6.

⁶⁰⁶ McNally (n 557) 101.

⁶⁰⁷ Heilmann (n 558) 18.

Division of Labour in Centralised Cadre Management in March 2003
<p>CCP Central Organisation Department</p> <ul style="list-style-type: none"> ● National state supervisory organs (Central Bank, Banking Regulatory Commission, Securities Regulatory Commission, Insurance Regulatory Commission) ● Ten national financial companies under central administration (big four national commercial banks, three policy banks, Bank of Communications, Everbright Group, CITIC Group) <p>Central Bank Party Committee/Organisation Department</p> <ul style="list-style-type: none"> ● Regional branch offices of the Central Bank <p>China Banking Regulatory Commission Party Committee/Organisation Department</p> <ul style="list-style-type: none"> ● Four asset management corporations (Huarong, Changcheng, Dongfang, Xinda) ● Merchants Bank and Minsheng Bank ● Chung Mei Trust & Investment and Government Securities Depository Trust & Clearing Co. <p>China Securities Regulatory Commission Party Committee/Organisation Department</p> <ul style="list-style-type: none"> ● Three securities companies (Galaxy, Minzu, Sci-Tech) ● Individual securities companies undergoing investigation and restructuring ● Stock exchanges; future exchanges <p>China Insurance Regulatory Commission Party Committee/Organisation Department</p> <ul style="list-style-type: none"> ● Six insurance companies (People's Insurance, China Life Insurance, China Reinsurance, China Export & Credit Insurance, China Insurance Group, Minsheng Life Insurance)
<p>Source: Zhongguo Zhengquan Bao (Chinese Securities Press, April 8th, 2003)</p>

Table 2: CCP Control over Senior Executives in China's Financial System

The CCP not only decides the appointments of directors, but also has the final say on the nomination of executive managers, either directly or indirectly. This important but often indirect link among executives, the

CCP, and the government departments, through majority shareholdings, has been considered a special characteristic of the insider problem in China.⁶⁰⁸

Hence, the nomination and election procedures found in the Company Law 2005 cannot achieve corporate autonomy in practice in China. Instead, most personnel decisions are made by party committees at different levels, then ratified and announced by state organs or corporate institutions, such as the shareholders' meeting or board of directors.

5.4.2 Decision Making

A study by Tam in 1999, on the internal decision and operating processes of China's listed companies, found party influence at the enterprise level.⁶⁰⁹ Further empirical studies have shown evidence that local party committees continue to wield significant influence in the corporate decision-making process.⁶¹⁰

It should be reiterated that there is no provision under the Company Law 2005 authorising any kind of corporate decision-making power to the party committee in the company, nor does the Law identify any situation in which the CCP committee could be involved in business operations. However, a series of party documents have urged CCP intervention in the decision making on major issues, albeit that not one of these circulars has outlined the methods the party committee could adopt in the decision-making process.⁶¹¹

⁶⁰⁸ Tam (n 115) 55.

⁶⁰⁹ On Kit Tam, *The Development of Corporate Governance in China* (Edward Elgar 1999), 39.

⁶¹⁰ Sonja Oppen, Sonia M L Wong and Ruyin Hu, 'Party Power, Markets and Private Power: Chinese Communist Party Persistence in China's Listed Companies' (2002) 19 *The Future of Market Transition* 103, 104.

⁶¹¹ Such circulars have been introduced above in this Chapter. See CCPCC (n 587).

In practice, the decision-making process in China is clearly a result of cultural influences.⁶¹² Lockett indicates that a key feature of the Chinese organisational structure is the tendency to pass decisions to higher levels in the hierarchy, based on respect for age and hierarchical position.⁶¹³ This is also explained in terms of giving 'face' to those higher in the hierarchy.⁶¹⁴ Accordingly, in corporate operations, decision making is usually pushed up to the highest level, namely the party committee, which holds administrative power and the final say on personnel issues.

In order to clarify this further, Figure 1 below demonstrates the typical decision-making process in most Chinese companies, especially large enterprises with state assets:

⁶¹² Lockett (n 584) 475.

⁶¹³ Ibid 476.

⁶¹⁴ 'Face' is defined as the respect, pride, and dignity of an individual as a consequence of his/her social achievement: T K P Leung and Ricky Yee-kwong Chan, 'Face, Favour and Positioning - A Chinese Power Game' (2003) 37 *European Journal of Marketing* 1575, 1575.

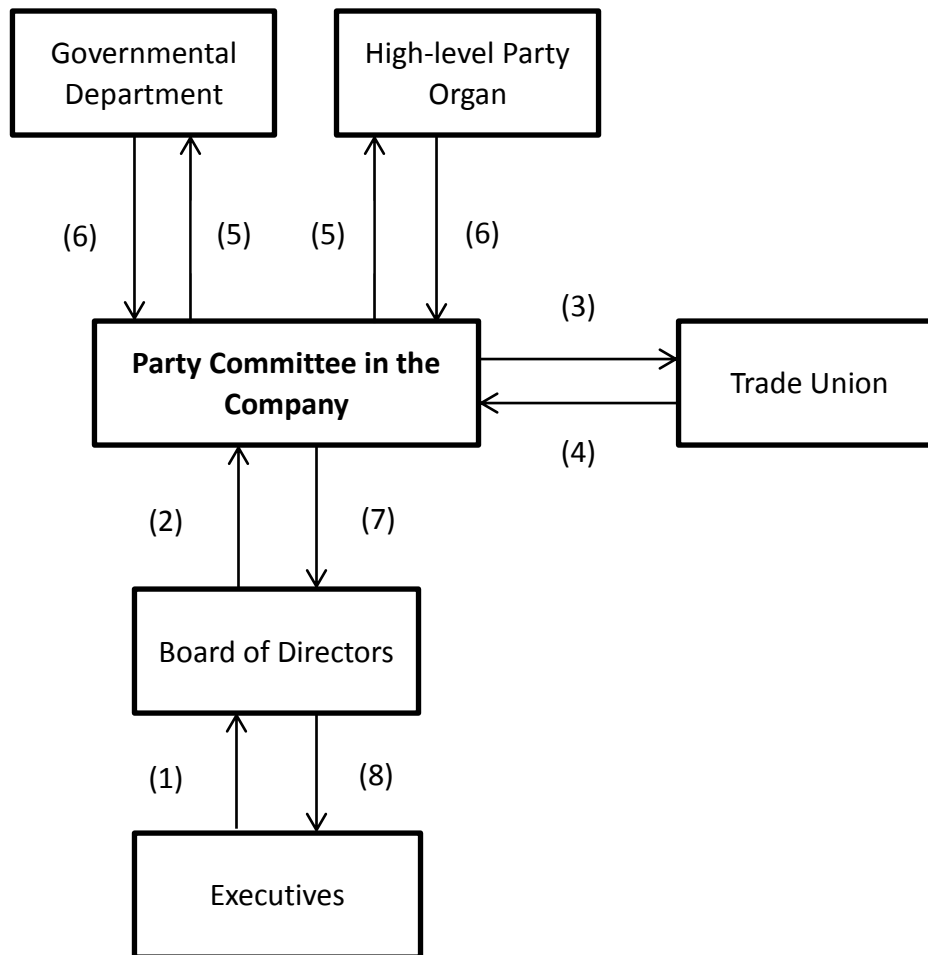


Figure 1: Decision-making Process in Chinese Large Companies

- (1) Executives find out the major issues to decide in day-to-day operations and report to board of directors.
- (2) Board of directors passes the issues to party committee in the company.
- (3) Party committee seeks the opinion of the trade union.
- (4) Party committee drafts a decision, taking into account the opinions of the trade union.
- (5) Party committee reports the decision proposal to relevant governmental departments and to high-level party organs, seeking views.
- (6) Party committee revises the proposal and reaches the final decision based on views at stage (5). (It should be

noted that view at stage (5) usually have more weight than views from the trade union in stage (3).)

- (7) Inform the board of directors of the decision.
- (8) Board of directors ratifies the decision and discloses it to executives.

5.4.3 Supervisory Function

According to the corporate governance structure stipulated by the Company Law 2005, internal supervision power should be authorised to the supervisory board.⁶¹⁵ However, de facto, the party committee in the company acts as a supervisory body, but with more power than the former.

The rationale for this may be, according to various party documents and statements issued by party leaders,⁶¹⁶ that the CCP needs more reliable safeguards for state assets, which are the foundation of a socialist public-ownership economy.

Nevertheless, once again, the problem here is not whether the party committee in the company should or should not share the supervision power, but rather that such power should be authorised by law with clarified rights and responsibilities.

5.5 The Negative Impacts of Intervention by CCP Committee

Although an empirical study has found that companies with government links provide higher investment returns and do better in many performance

⁶¹⁵ Company Law of the People's Republic of China (Revised in 2005), Article 52 and 54.

⁶¹⁶ Guorong Fan, 'Dangwei Zai Guoyou Qiye Neibu Jiandu Zhong Yingqi Zhudao Zuoyong [The CCP committee in the SOEs Should Have Dominant Influence over the Internal Supervision]' <<http://www.sasac.gov.cn/n1180/n1271/n20515/n2697175/14853001.html>> accessed 04-11-2013.

measures, compared with companies without such links,⁶¹⁷ it should be noted that government-linked companies are distinct from government-controlled companies.⁶¹⁸ A government-linked company is an independent business entity which aims to maximise shareholders' interests, whereas a government-controlled company is more like a political tool to achieve some business aims along with more public aims. Unfortunately, many Chinese companies, especially most of the listed companies, fall into the second category.

It is argued in this thesis that control by the government/CCP leads to several defects in Chinese corporate governance, which will block the further development of the corporate legal system, and of the national economy.

First of all, corporate governance mechanisms transplanted from the west has failed in practice due to the intervention of the CCP. The shareholders' power of determining appointments at director level, the directors' of appointment at manager level, and supervisory power, have all been shared by the party committee. In other words, the existence of the party committee replicates the corporate governance structure in practice. As such, it has been argued that the party committee is an additional cost to the company, and such cost is unlikely to be counter-balanced by any benefit that the party committee may bring to the company.⁶¹⁹

Taking over the decision power on personnel from the shareholders' meeting is a direct infringement of minority shareholders' rights. Clarke points out that the policy of continued state involvement brings about a

⁶¹⁷ James S Ang and David K Ding, 'Government Ownership and the Performance of Government-linked Companies: The case of Singapore' (2006) 16 *Journal of Multinational Financial Management* 64, 86.

⁶¹⁸ As mentioned in this chapter, government-controlled means party-controlled.

⁶¹⁹ Gore (n 552) 98.

conflict of interest between the state as controlling shareholder and other shareholders.⁶²⁰ Minority shareholders invest in the company in exchange for voting power that will help them to realise their investment later on. CCP intervention makes that voting power worthless.⁶²¹ As such, the capital market in China will lack the necessary support from individuals for its further development.

In terms of CCP involvement in corporate decision making, Ma concludes that the management power in practice is often 'concentrated in a few cadres who do not really understand technology, economics, and management, and who are not even prepared to be bothered about these issues'.⁶²² Consequently, it is questionable whether the company is operating with the purpose of achieving success, and in the interests of shareholders as a whole.

Secondly, the CCP's decisive influence on personnel decisions is an obstacle to the establishment of a market for managerial talent. Such a market is rooted in performance-linked evaluation, which is different from the criterion used by the party to select managers.⁶²³ For the party, political standpoint and public support are more crucial considerations.

Furthermore, the CCP's concern with political considerations undermines the incentive mechanism of directors and managers in the western-style corporate governance system.⁶²⁴ As long as the directors or managers can fulfil the tasks allocated by the party, their employment will not be affected by bad corporate results. In fact, it has been reported that most executives

⁶²⁰ Clarke, 'Corporate Governance in China: An Overview' (n 12) 12.

⁶²¹ Ibid.

⁶²² Hong Ma, 'Guanyu Gaige Gongye Qiye Lingdao Zhidu de Tanta [Enquiry into the reform of the leadership system of industrial enterprises]' *People's Daily* (20-11-1980) 5; also see, Lockett (n 584) 482.

⁶²³ Gore (n 552) 81.

⁶²⁴ McNally (n 557) 93.

can be assured renewal of their contracts until retirement.⁶²⁵

Thirdly, rather than helping the supervisory board or the independent directors to fulfil supervisory functions, the party committee precludes the possibility of internal supervision, since it is the party itself that is involved in the decision-making process.⁶²⁶ McNally notes that:

Since all corporate decisions are either made by a corporation's party committee or handed down through party channels, the system of internal checks and balances within a corporation envisaged by China's Company Law has failed to take root.⁶²⁷

Clearly, it is not easy to contradict a decision made by oneself, especially for a ruling party. In addition, the supervisory cadres of party committees are usually party organisational specialists, not professional staff. For example, Zhu Rongji, a former Premier of China, set up the Communist Party Central Financial Work Commission (CFWC), a monitoring agency to combat any covert actions of party-appointed managers.⁶²⁸ Most of its key cadres were not financial professionals, but party organisational elites.⁶²⁹ The rationale for such a system is to cut the connection between the monitor and professional executives. However, this thesis questions the effect on governance efficiency.

Moreover, asymmetry of information and lack of transparency of corporate

⁶²⁵ Ibid 102.

⁶²⁶ Lockett (n 584) 482.

⁶²⁷ McNally (n 557) 303.

⁶²⁸ Heilmann (n 558) 2.

⁶²⁹ Ibid, 3; Also see research on background of top leaders of the CCP, which argues that, over a long period, the CCP and the state were led by a group of technocrats: Cheng Li and Lynn White, 'The Fifteenth Central Committee of the Chinese Communist Party: Full-Fledged Technocratic Leadership with Partial Control by Jiang Zemin' (1998) 38 *Asian Survey* 231, 231.

operations restrict the effectiveness of coordination of economic activity at firm level by the CCP.⁶³⁰

Fourthly, it has also been questioned whether the party committee has achieved its ideological task. Ye and Shao argue that, in practice, the party committees in many companies have been criticised as dumping grounds for old cadres, because the younger cadres with better capability have been assigned to management positions.⁶³¹

To root out incompetent party staff, the CCP top elite introduced the interlocking appointment strategy mentioned above. A survey by the *People's Daily* showed that 57 per cent of all SOEs in China have interlocking appointments, for example, the party secretary of the listed companies is often appointed as the of corporate executive.⁶³² Yet, while this might seem to give the CCP better control over corporate affairs, it has been argued that, in fact, those cadres with a dual position in the company usually ignore party building owing to preoccupation with business affairs.⁶³³

Finally, but most importantly, CCP intervention results in ambiguity regarding accountability, or a mismatch of rights and responsibilities. As mentioned in a World Bank report, accountability is deemed a considerable challenge for China in the current stage of development.⁶³⁴

In accordance with company law and sound corporate governance design,

⁶³⁰ Nee, Oppen and Wong (n 573) 22.

⁶³¹ Wuxi Ye and Yunduan Shao, *Xiandai Qiye Dang de Jianshe [Party Building in Modern Enterprises]* (Beijing: Zhongguo Fangzhen Chubanshe 1996), 53.

⁶³² Xinhua She, 'Guanyu Guoqi Lingdao de Diaoyan Baogao [A Survey Report of Leaders in SOEs in China]' *The People's Daily* (20-10-2002).

⁶³³ Gore (n 552) 82.

⁶³⁴ The World Bank, *China 2030: Building a Modern, Harmonious, Creative High-Income Society* (2012), 109.

when legal powers are conferred upon directors, managers and supervisors, they are also bound with a set of responsibilities, albeit that such responsibilities have not been formulated well enough.⁶³⁵ However, the law places no responsibilities upon the party committee. Accordingly, there is a mismatch of rights and responsibilities in Chinese corporate operations. While it is clearly unfair to hold directors or managers accountable for what the party committee has done, there is no legislation regulating the liabilities of the CCP for decisions made de facto by its organs.

Moreover, lack of accountability results in abuse of power, self-interested activities and corruption. As argued by a Chinese scholar in the Guangxi Provincial Party School, many party secretaries do not participate on behalf of party organisations; rather, they do so as individuals.⁶³⁶ The same is true of members of local committees. In order to secure both their former political and social status and economic rent-seeking possibilities, allowing them to pursue individual utility maximisation and opportunistic activities, CCP cadres tend to exercise a power-preserving strategy.⁶³⁷ That is to say, they would try any possibility to maintain current status and corruption might still occur.

On the other side of the coin, Chen found that most companies and their executives had not severed their political connections; instead, they used such connections to gain a competitive edge.⁶³⁸ For example, they would seek to maximise their own budgets,⁶³⁹ or give priority to securing political

⁶³⁵ The inadequacies of legislation relating to the responsibilities of both directors and supervisors have been argued in the earlier chapters of this thesis.

⁶³⁶ Shaofu Wei, 'Xiandai Qiye Zhidu dui Guoqi Dangjian de Yanjun Tiaozhan yu Yingdui Cuoshi [Party Building in SOEs Meeting Severe Challenges from the Modern Enterprise System]' (2002) 1 *Journal of Guangxi College of Education* 11, 20.

⁶³⁷ J Fewsmith, *Elite Politics in Contemporary China* (M.E. Sharpe 2001), 86-97.

⁶³⁸ Min Chen, *Asian Management* (2nd edn, Thomson 2005), 106-108.

⁶³⁹ W A Niskanen, *Bureaucracy and Representative Government* (University of Chicago Press 1971), 111.

support to increase executives' chances of staying in power.⁶⁴⁰

It is further argued by this thesis that the problems caused by CCP intervention could be even worse than the breach of duty by directors, managers or supervisors in terms of minority shareholder protection. This is because, while minority shareholders may seek legal remedies in response to wrongdoing by directors, managers or supervisors, there is no recourse open to them if the infringement is caused by the party committee.

5.6 Solutions and Conclusion

It has been pointed out that, ironically, the current situation is one in which the government is seeking various solutions to problems caused by political concerns, while at the same time being unwilling to reduce their continuing power over commercial enterprises.⁶⁴¹

It has been argued that western corporate law and the western governance model are inappropriate for China, 'because of some basic flaws in the assumptions of those advocating "Western-style" corporate governance in China... They are based on assumptions about the purposes and functions of business enterprises that are not shared by most Chinese policy makers'.⁶⁴²

It is true that the quality of corporate governance could be improved if China were to move further towards a market-oriented economy. For

⁶⁴⁰ J M Buchanan, R D Tollison and G Tullock, *Toward a Theory of The Rent-Seeking Society* (Texas A&M University Press 1980); also see, Nee, Oppen and Wong (n 573) 22.

⁶⁴¹ Leng (n 581) 6.

⁶⁴² Colin Hawes and Thomas Chiu, 'Flogging a Dead Horse? Why Western-style Corporate Governance Reform will Fail in China and What Should be Done Instead' (2006) 20 *Australian Journal of Corporate Law* 25, 28.

example, greater liquidity would attract more investors.⁶⁴³ According to an advisory report made by the World Bank to the Chinese government, going forward, China will need to determine the relative role of the state as against the market and the private sector in economic activity.⁶⁴⁴ One solution provided by the World Bank to sustain economic growth is to introduce more competition, enabling more private actors, especially minority investors, to get involved in the market.⁶⁴⁵

Similarly, Tam argues that China should put more emphasis on developing market economics, in order to match the precocious corporate legislation.⁶⁴⁶ A successful example in practice is that of the joint-venture investment bank, China International Capital Corporation (CICC), which has little influence by the state or the CCP due to the existence of large private and foreign shareholders, but has very good governance quality and investment returns.⁶⁴⁷ It can, therefore, be concluded that the accelerating entry of private and foreign investors can lead to 'de-partyisation' or 'de-politicisation' in the business sector.

Meanwhile, various institutions should also be established, such as the market for corporate control, a human resource market for managers, and sound protection for minority shareholders.⁶⁴⁸

Certainly, while it could be easy to solve all the problems discussed in Part 5.5 if either the party or the market were powerful enough to convince the other,⁶⁴⁹ the facts force us to seek a difficult balance. As argued by Chen,

⁶⁴³ Tam, 'Models of Corporate Governance for Chinese Companies' (n 115) 53.

⁶⁴⁴ Bank (n 634) 110.

⁶⁴⁵ Ibid.

⁶⁴⁶ Tam, 'Models of Corporate Governance for Chinese Companies' (n 115) 62.

⁶⁴⁷ Heilmann (n 558) 13.

⁶⁴⁸ Tam, 'Models of Corporate Governance for Chinese Companies' (n 115) 62.

⁶⁴⁹ Gore (n 552) 87. The author believes that the overall trend is the decline of the party in corporate governance due to its lack of an appropriate and legitimate role.

transplanting the western corporate governance structure without any adjustments may not be the appropriate solution in the Chinese context. Chen claims that:

It is unrealistic to expect that in the next twenty years China will become like Japan – which has thrived through its adoption of American-led Western capitalism. Instead, it is likely that the PRC will take a few decades to find a balance between Western free-market enterprise and the historical influences of communism, nationalism and Confucianism.⁶⁵⁰

In concluding this chapter, it is argued that simply driving the party out of commercial practice is neither a possible nor the optimal solution. First, it could be beneficial to maintain the connection with the CCP in business operations. For example, this could facilitate access to scarce resources,⁶⁵¹ or reduce the uncertainty caused by institutional weaknesses.⁶⁵² Nevertheless, it should be noted that empirical results show that government-enterprise ties are necessary, but not sufficient, for improved performance.⁶⁵³

Secondly, CCP involvement would be helpful to achieve a more efficient and reasonable social allocation. Indeed, a market-oriented economy would improve productive efficiency. However, a harmonious social environment, which is urged by the CCP and the state, needs not only better productive efficiency, but also, and perhaps more importantly, a sound social allocation system,⁶⁵⁴ which the political ideological education

⁶⁵⁰ Ming-er Chen, *Inside Chinese Business: A Guide for Managers Worldwide* (HBS Press 2001), 180.

⁶⁵¹ J Oi, 'Communism and Clientelism: Rural Politics in China' (1985) 37 *World Politics* 238, 244.

⁶⁵² M M Pearson, *China's New Business Elite: The Political Consequences of Economic Reform* (University of California Press 1997), 21.

⁶⁵³ M W Peng and Y Luo, 'Managerial Ties and Firm Performance in a Transition Economy: The Nature of a Micro-Macro Link' (2000) 43 *Academy of Management Journal* 486, 486.

⁶⁵⁴ Richard E Caves, 'Lessons From Privatization in Britain State Enterprise Behavior, Public Choice, and

may help to advance.

Accordingly, the suggestions put forward below are based on a consensus that the participation of the CCP and its ultimate control over the national governance should be assured. In addition, the proposals take into account a specific concern regarding legal protection of minority shareholders.

First of all, there should be a separation of the state from the CCP. It is outside the scope of this thesis to discuss how the CCP can guarantee its status as governing party, but it is argued here that, from the jurisprudential perspective, separation of the state from the CCP would help to solve the mismatch of powers and accountabilities.

Ultimate control by the CCP could be achieved by a firm control over state government. Consequently, the CCP would be able to guide corporate operations and the direction of economic development through regulatory power, administrative power and supervisory power of different state organs.

Under such a regime, the CCP's political concerns would be taken into account, while at the same time the activities of state organs could be bound by law. In the view of this thesis, keeping power holders in the company accountable is the core basis of legal protection of minority shareholders in China.

Secondly, according to the different businesses they operate, listed companies with state assets should be divided into two categories: the

non-competitive sector and the competitive sector.⁶⁵⁵ Non-competitive sector refers to those monopoly industries created because of concerns of politics or national safety, such as natural resources and the military, or those which otherwise need massive investment with only little return but that have an important connection to public welfare.⁶⁵⁶ Competitive sector refers to business areas with a relatively higher extent of openness to private companies.⁶⁵⁷ Companies in the competitive sector are more like the modern companies in western countries, seeking maximum profits.

This thesis proposes that in the non-competitive sector, the state could continue to maintain its influence by introducing the institution of governmental directors.⁶⁵⁸ CCP political concerns could be taken account of through the voting power of governmental directors on the board. However, in the competitive sector, companies with national assets should be gradually privatised or phased out. In an analysis on the state-controlled companies in Singapore, Ang and Ding argue that, beyond the transition period of development, when the economy is developed and other institutions and mechanisms for control are in place, the state-controlled companies may outlive their usefulness and be phased out.⁶⁵⁹ Then, the role of the state or the CCP will be to build a more open and fair market environment, in which shareholders will benefit from their investment in such companies.

More importantly, the decision power on personnel should be returned to

⁶⁵⁵ Being a part of the solution suggested by this thesis, distinguishing the non-competitive sector from the competitive sector is the foundation of further reform of Chinese state-controlled economy. For more details see Chapter Seven of this thesis.

⁶⁵⁶ Gairong Hu, *Legal System of Board of Directors in State-owned Company* (Peking University Press 2010), 8.

⁶⁵⁷ Ibid.

⁶⁵⁸ A governmental director is one who has tight links with the government, for example, has another position in an administrative department. As an ideal structure, the board of directors of companies in the non-competitive sector would comprise governmental directors, individual directors and executive directors. For more details see the Chapter Seven of this thesis.

⁶⁵⁹ Ang and Ding (n 617) 66.

the power holders under the Company Law. Directors, including the governmental directors mentioned above, should be nominated and elected through a specified legal mechanism. Decisive influence on personnel decisions by party committee should be forbidden by law. Nevertheless, Gu argues that at the current stage a temporary veto power could be authorised to the party committee so that it can stop the appointment of a director if the candidate concerned has been exposed as involved in a major political problem.⁶⁶⁰ With respect to the appointment of managers, this chapter argues that this should be decided entirely by the board of directors via a specified legal mechanism. It is because, in the modern corporate governance, the board of directors is the internal monitor over the managers. It could be very difficult for board of directors to keep the managers accountable to the board if they are appointed and dismissed only by the controlling shareholder.⁶⁶¹

The ideal role of the party committee in the company, as suggested by this thesis, is to concentrate on ideological affairs. There is no need for involvement in corporate decision making or monitoring, because all these institutions have delegates working on behalf of the CCP in ways prescribed by law.

There are two further points to be made here in regard to the suggestions put forward by this chapter. First, such reform would be introduced gradually on a macro level. In terms of organisational behaviour, Chinese commercial and political exercises can be seen as a set of core values

⁶⁶⁰ Gongyun Gu, *Legal System of the State-owned Assets* (Peking University Press 2010), 159.

⁶⁶¹ Similar arguments could be found in other researches. See, Xiao Tan, 'Who Can Appoint the Managers' <<http://www.cgchina.org/cn/UploadFiles/200691216718350.pdf>> accessed 22-04-2014; Xiaochen Xu, 'Wo Guo Gongsi Jingli Falv Zhidu Yanjiu [Legal Research on Corporate Managers in China]' <<http://cdmd.cnki.com.cn/Article/CDMD-10422-1012465597.htm>> accessed 22-04-2014; and Feng Luo and Zhun Zhang, 'Guoyou Konggu Shangshi Gongsi Zhili Jiegou Cunzai de Wenti Ji Duice [The Problems and Solutions of Corporate Governance Structure of State-controlled Listed Companies in China]' (2013) 8 People's Tribune 45, 52.

which underlie social interaction among Chinese people.⁶⁶² Such core values are not eternal, but change only gradually, over generations rather than years.⁶⁶³ Any attempt at revolution may only bring about more social problems.

Secondly, equally as important as the new design of corporate structure, Chinese leaders must pay more attention to how to withdraw powers from groups with vested interests. Pearson highlights the difficulty of withdrawing power under Chinese multiple leadership. Focusing in particular on the telecommunication industry in China,⁶⁶⁴ she finds that companies are regulated by the Ministry of Information Industry (the formal regulator), the People's Liberation Army (which is responsible for information security concerns), the Ministry of Finance (which oversees accounting), the State Administration of Radio, Film and TV, the Ministry of Public Security, the Ministry of Commerce, and the State Administration for Industry and Commerce. Each power group strives to keep its power for further interest exchange. Accordingly, reform will not be an easy task.

To conclude, reform according to the suggestions made in this chapter will not be able to re-define the party committee as a catalyst minority protection. However, it could at least remove one potential wrongdoer. As mentioned above, owing to the mismatch of power and accountability, the party committee is a key element of the Chinese 'insider control' problem, which tunnels the company at the expense of the interests of minority shareholders. Cutting off its direct intervention is a suboptimal change, but better than nothing.

⁶⁶² Lockett (n 584) 486.

⁶⁶³ Ibid.

⁶⁶⁴ Margaret M Pearson, 'Governing the Chinese Economy: Regulatory Reform in the Service of the State' (2007) *Public Administration Review* 718, 723.

Chapter Six: The Chinese Securities Regulatory Committee - An External Helping Hand for Minority Protection

Executive Summary

It is argued by this thesis that a sound market environment would promote better corporate governance quality. In other words, if the market administrator were to fulfil its obligation well, minority shareholders would receive better protection of their interests.

Through a case study examining how the Securities and Futures Commission (SFC), the market administrator in Hong Kong, has prevented infringement of minorities' interests by majority shareholders, this thesis identifies three lessons for China in its further reform: (1) The head count test could be transplanted into Chinese company regulations, in order to reinforce the voice of minorities; (2) Substantial rights and independence of the market administrator in China should be guaranteed; and (3) Political intervention should be banned, even when state-owned assets are involved.

This thesis has also investigated and evaluated the performance of the US Securities and Exchange Commission (SEC). In order to achieve its core mission of investor protection, the SEC pursues two main strategies: (1) improving market regulations; and (2) developing investor education.

The China Securities Regulatory Commission (CSRC), the market administrator in China, has put great effort into increasing the governance

quality of Chinese listed companies. It has done so through: (1) developing awareness of minority protection; (2) increasing the quality of IPOs; (3) reducing insider trading; (4) fighting against commercial bribes; (5) promoting the split share structure reform; and (6) improving corporate information disclosure of listed companies.

However, this thesis argues that, although the CSRC is developing in the correct direction, it still has some defects to overcome, in terms of providing better minority protection. The main shortcomings are: (1) shortage of professional staff; (2) immaturity of regulatory activities; (3) absence of powerful rights; and (4) compromised position as a market regulator.

Therefore, with the proposal that the CSRC be developed to become the external safeguard of minorities' interests, this thesis suggests that it can learn from its American counterpart, the SEC, in the following three aspects: (1) improving independence from government intervention; (2) continuing efforts to increase corporate transparency; and (3) developing investor education.

6.0 Introduction

A well-designed corporate governance system requires not only a sound internal monitor to relieve or avoid agency costs, but also a mature and fair market. With its own discipline, also called market rules, the market would improve the development of corporate governance, in terms of pattern and quality. As concluded by Wei, a well-functioning securities market and a sound corporate governance system are inter dependent: good corporate governance quality is the basis of a mature securities

market, while a market with well-designed regulations could become an external monitoring mechanism of corporate governance.⁶⁶⁵ Therefore, as the regulator of the market, administrative bodies such as the CSRC in China, the SEC in the US, the SFC in Hong Kong and the Financial Services Authority (FSA) in the United Kingdom, could be deemed important external helpers, particularly in the legal protection of minority shareholders.

This chapter begins with a case study of Pacific Century CyberWorks Ltd (hereinafter, 'PCCW') in Hong Kong, to highlight how the market administrator, the SFC, is able to prevent infringement of minorities' interests by the controlling shareholder.

The recent decision by the Hong Kong Court of Appeal on privatisation of PCCW has been deemed a significant victory of legal protection for minority shareholders in Hong Kong. After a 170-day fight, the privatisation scheme set out under s.166 of the Companies Ordinance failed, thanks to the intervention of the SFC.⁶⁶⁶

PCCW is a Hong Kong-based company with businesses in telecommunications, media, IT solutions, property development and investment.⁶⁶⁷ It controls HKT Ltd, which is the dominant provider of telecom services in Hong Kong. Among the shareholders of PCCW, China Netcom BVI, a wholly owned subsidiary of China United Network

⁶⁶⁵ Yuwa Wei, 'Maximising the External Governance Function of the Securities Market: A Chinese Experience' (2008) 19 *International Company and Commercial Law Review* 111, 111.

⁶⁶⁶ Jie Wang, 'Xianggang Jianguan dui Neimu Jiaoyi Shuo Bu [Administrator in Hong Kong Says No to Insider Trading]' *Beijing Chen Bao [Beijing Morning Express]* (27-04-2009) <<http://finance.sina.com.cn/stock/hkstock/hkstocknews/20090427/09196153104.shtml>> accessed 07-11-2013.

⁶⁶⁷ Company Profile on the homepage of PCCW, <http://www.pccw.com/About+PCCW/Company+Profile/The+Group?language=en_US> accessed 16-02-2012.

Communications Group Company Ltd (hereinafter, 'CNC'),⁶⁶⁸ is listed in the top three, with a shareholding of approximately 20 per cent.⁶⁶⁹ The reason for mentioning this is a comparative concern with the differences in litigation outcomes between mainland China and Hong Kong, when a state-related enterprise is involved.

The rationale for this case study is threefold:

First, the shareholding structure of a listed company in Hong Kong is similar to that in mainland China. One or several majority shareholders have a decisive impact on corporate operations. Such a similarity is the basis of comparative study. In each case the conflict of interests between the majority and minority parties is a key issue. However, the key difference between the two, that of who holds the majority shares, leads to different corporate situations in the two jurisdictions. In most cases, a Hong Kong-based listed company is controlled by a powerful private family,⁶⁷⁰ whereas a listed company in China mainland usually maintains a government-related majority shareholder.

Secondly, the PCCW case could be a positive example of an external monitor making a crucial contribution to minority shareholder protection. In the privatisation case examined here, the intervention of the SFC is regarded as the turning point. In this case study, it will be argued that a set of clear and definite powers should be granted to the CSRC, in order to achieve the role of minority shareholders' protector.

⁶⁶⁸ Unicom is one of the biggest telecommunications service providers in mainland China. It is also a listed company with a large state shareholding.

⁶⁶⁹ Angus Young, Grace Li and Tina Chu, 'Case Comment: In the Interest of Minority Shareholders in Hong Kong: Case Study on the Privatisation of PCCW via a Scheme of Arrangement: Part 1' (2011) 32 Company Lawyer 28, 30.

⁶⁷⁰ Ibid 28. The author points out two kinds of dominant shareholding in Hong Kong companies: holding by family-owned business and holding by block shareholders.

Finally, the case illustrates a good lesson given by the Hong Kong Court of Appeal. In the PCCW decision, all three judges placed special emphasis on 'fairness' concerning the business facts and the interests of minority shareholders. Unfortunately, the courts in mainland China still lack appropriate experience on corporate issues; moreover, judicial independence needs to be strengthened.

The second part of this chapter focuses on comparative research between the US SEC and the CSRC, in order to find out how the market regulator can help in terms of minority investor protection. There are two reasons for choosing the SEC as a body for comparative study. First, it is the market regulator in the United States, the most developed market in the world. With the globalisation of corporate governance, SEC practice has been learnt from or transplanted into other jurisdictions. Even though the first corporate legislation in China copied the German model, the legal reforms in the twenty-first century have followed the US model. Several of the institutions introduced into the Chinese corporate governance regime, such as independent directors and disclosure requirements, were originally designed for the Anglo-American system. Hence, choosing the SEC as a subject of study could bring a certain reference value.

In the US, the main mission of the SEC is investor protection. Although it has no explicit preferences, SEC documents suggest that the position of public minority investors attract most of its attention. The shareholding structure in the US market is relatively dispersed, so that it is rare to see a shareholder holding more than 50 per cent of a company's shares. Even institutional investors, such as hedge funds or pension funds are minority shareholders in terms of the shareholding percentage. Furthermore, the SEC notes on its website that an increasing number of first-time investors

are turning to the market with different purposes, such as to secure their future financial well-being, to pay for real estate or to send their children to college.⁶⁷¹ Therefore, it can be concluded that the SEC, as the market regulator, plays a crucial role in minority protection in the US.

In China, the CSRC was formed in 1992. Research into its development leads this chapter to argue that the CSRC is an important market regulator in national economic reform, especially since the establishment of the financial market. It has bridged the gaps between the Company Law and Securities Law by providing detailed provisions to guide corporate operations in practice.⁶⁷² Moreover, with the rapid development of the securities market, corporate scandals caused by imperfect regulation and information asymmetry are appearing more frequently. As a result, the CSRC is making great efforts to enhance market regulation, while noting explicitly its mission to protect minority shareholders in particular.⁶⁷³ Therefore, the disadvantages of minority shareholders as market participants, for example lack of professional knowledge and reliable information, should be taken into account by the CSRC in any regulatory reforms. Rules and policies should favour minority protection. Eventually, this will improve the quality of corporate governance.

However, although these market regulators have put special emphasis on minority protection, the outcomes of their activities are still in question. What have they done? Can the minority shareholders benefit from their activities? How can they perform better? This chapter investigates these concerns via a comparative study of the SEC and the CSRC, in order to find out the best way to improve the minority protection in the Chinese

⁶⁷¹ SEC, 'The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation' <<http://www.sec.gov/about/whatwedo.shtml>> accessed 01-11-2012.

⁶⁷² Wei (n 656) 113.

⁶⁷³ CSRC <http://www.csrc.gov.cn/pub/csrc_en/about/who/intro/> accessed 28-09-2013.

securities market.

The rest of this chapter is organised as follows. Part 6.1.1 describes the PCCW privatisation case. In Part 6.1.2, three key issues that determined the outcome of this case are highlighted and discussed. Part 6.1.3 offers some comments from the case study, relating to legal protection of minority shareholders in mainland China. In Part 6.2.1, the strategic goals and effectiveness of the SEC with regard to its mission of investor protection are reviewed. Part 6.2.2 describes the development of the CSRC in China, while Part 6.2.3 identifies some specific problems in terms of minority protection. Part 6.2.4 notes several points where the CSRC could learn from its American counterpart, to improve the legal protection of minority shareholders and the quality of corporate governance.

6.1 PCCW Case Study

6.1.1 Summary of the PCCW Case

The *Financial Times* described the PCCW privatisation as ‘a house built by Richard’,⁶⁷⁴ an infringement of the minority shareholders by the controller. To illustrate the complete blueprint of such a house, this section provides a detailed description of the case.

The majority shareholder of PCCW, tycoon Richard Li, son of Li Ka-shing, the richest man in Hong Kong, along with his Singapore-listed holding company, Pacific Century Regional Developments (hereinafter, ‘PCRD’), controlled 28 per cent of the company’s shares.⁶⁷⁵ The second largest

⁶⁷⁴ Lex Team, ‘PCCW’s Privatisation’ *Financial Times* (05-11-2008) <<http://www.ft.com/cms/s/3/11940ec6-ab1e-11dd-b9e1-000077b07658.html>> accessed 17-02-2012.

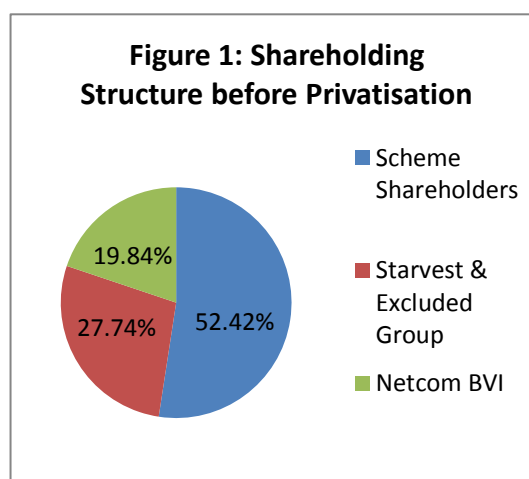
⁶⁷⁵ Lina Saigol, ‘PCCW’s Small Investors Should Make a Stand’ *Financial Times* (09-11-2008) <<http://www.ft.com/cms/s/0/0385c940-ae8a-11dd-b621-000077b07658.html>> accessed 17-02-2012.

shareholder, CNC, held approximately 20 per cent of PCCW via its wholly-owned subsidiary, China Netcom BVI.⁶⁷⁶

Based on high expectations of its corporate future, the share price of PCCW in the Hong Kong Stock Exchange climbed from HK\$6.00 to HK\$19.50 from December 1999, and reached a peak in 2000.⁶⁷⁷ However, the bull market did not continue for long. The share price of PCCW fell by around 95 per cent, from HK\$28.5 to a mere HK\$0.88 in 2003.⁶⁷⁸ In the four years before 2008, when the privatisation scheme commenced, PCCW's shares were trading below HK\$5.00.⁶⁷⁹

On 3rd November, 2008, a scheme of arrangement to privatise PCCW was announced by PCRD, jointly with China Netcom BVI.⁶⁸⁰ According to the Joint Announcement, the Joint Offerors would pay Scheme Shareholders, including individual shareholders, a cancellation fee of HK\$4.20 in cash for each Scheme Share.⁶⁸¹ Starvest, a wholly-owned subsidiary of PCRD, was to provide 74.27% of this cash consideration, while Netcom BVI would pay the other 25.73%.⁶⁸²

According to the Joint Announcement, the shareholding structure of the PCCW before privatisation was as illustrated in Figure 1 and Figure 2.



⁶⁷⁶ Justine Lau, Tom Mitchell and Sundeep Tucker, 'Li Risks veto by Minority Investors in PCCW' *Financial Times* (05-11-2008) <<http://www.ft.com/cms/s/0/6887772c-ab55-11dd-b9e1-000077b07658.html>> accessed 17-02-2012.

⁶⁷⁷ Team (n 674).

⁶⁷⁸ Young, Li and Chu (n 669) 29.

⁶⁷⁹ Team (n 674).

⁶⁸⁰ PCCW, 'Joint Announcement (November 4, 2008)' <<http://202.66.146.82/listco/hk/pccw/announcement/a081104a.pdf>> accessed 20-02-2012.

⁶⁸¹ Ibid 2 and 7.

⁶⁸² Ibid 4.

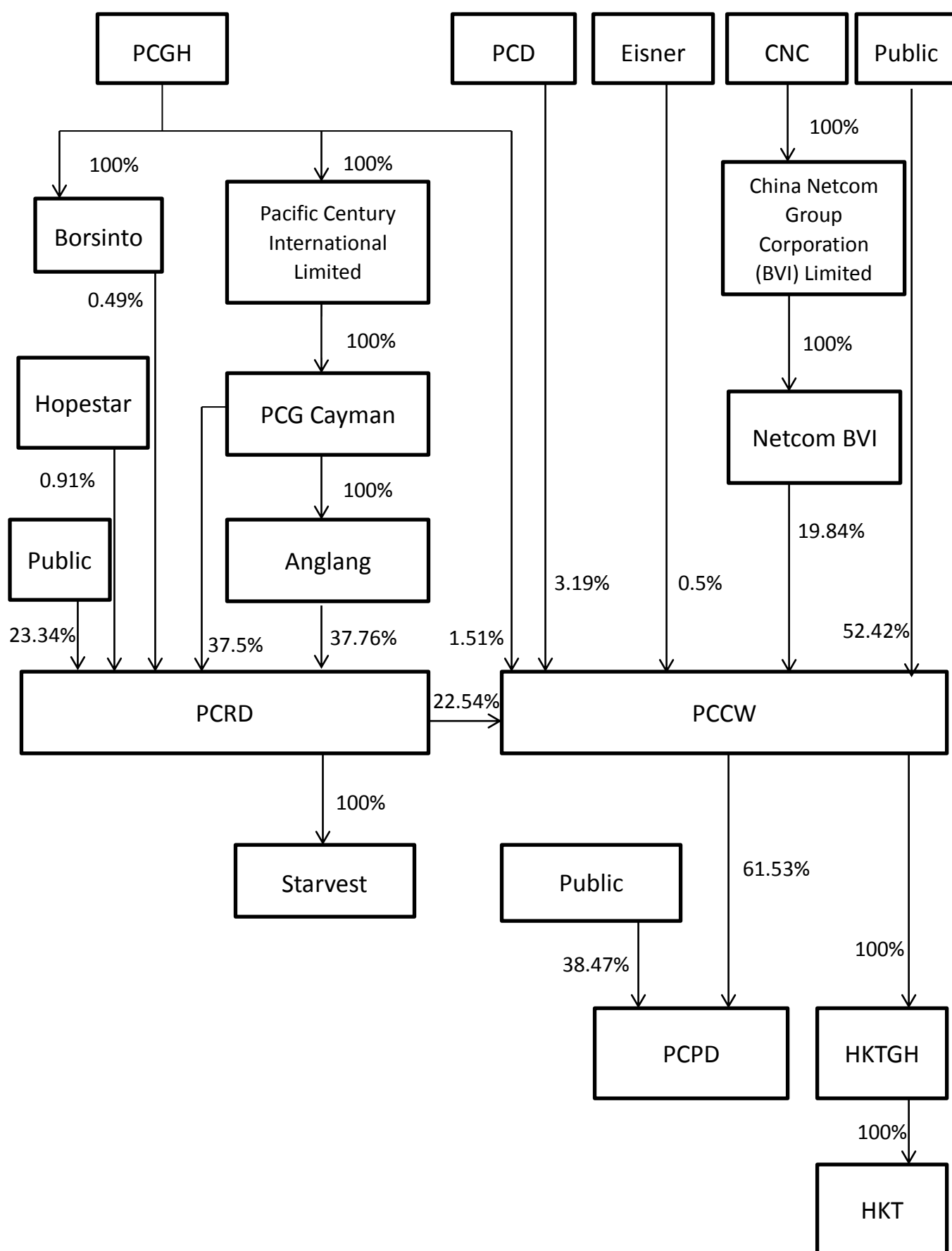


Figure 2: Shareholding Structure of PCCW and PCRD before the Scheme of Arrangement

If the Scheme of Arrangement were to be approved by the independent shareholders, the listing of PCCW shares on the Stock Exchange would be withdrawn,⁶⁸³ so that the company would then be classified as a closed or private company in law. The shareholding structure after privatisation would be as illustrated in Figure 3.

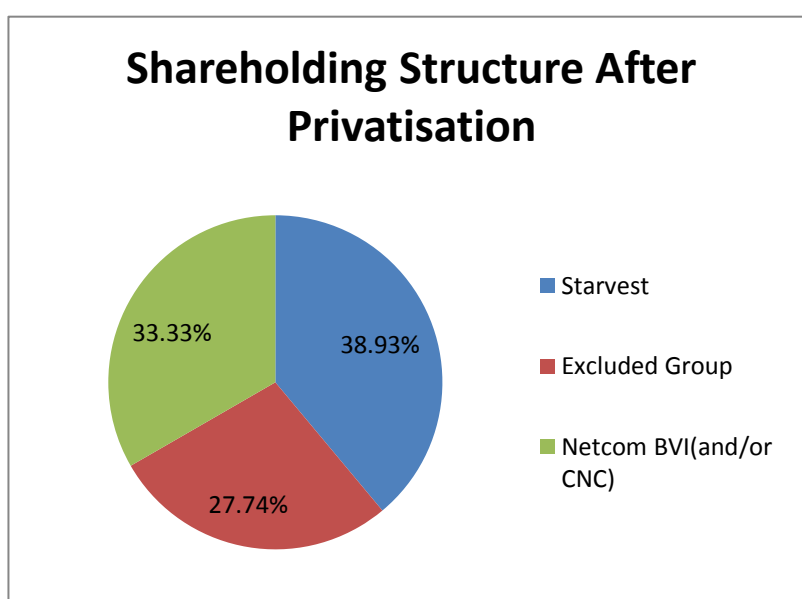


Figure 3: Shareholding Structure after the Scheme of Arrangement

By way of a scheme of arrangement under s.166 of the Hong Kong Companies Ordinance, which would bind all shareholders if approved, a proposal must achieve both the following statutory requirements: (1) At least a majority in number of the members, or the relevant class, present and voting in person or by proxy should be in favour of the scheme; and (2) The number must hold at least three-fourths in value of the holdings of those present and voting in person or by proxy.⁶⁸⁴ Moreover, those voting

⁶⁸³ Ibid 5.

⁶⁸⁴ Companies Ordinance (Hong Kong), Section 166.

against must account for less than 10 per cent of eligible voters.⁶⁸⁵

According to s.166, the procedure must be in three stages: (1) an application to the court for the meeting to be convened; (2) convening the meeting and voting; and (3) a petition to the court to sanction the scheme.⁶⁸⁶

According to Michael Todd, counsel to PCCW, this scheme of arrangement provided an opportunity for the minority shareholders to realise their investment.⁶⁸⁷ Meanwhile, the executive directors of the PCCW believed the proposal was a fair and reasonable offer and in the interest of shareholders as a whole.⁶⁸⁸

However, the public reaction told a different story. It was pointed out that, while the proposal appeared at first to represent a 53 per cent premium to the last trading date and approximately 6 times enterprise value, in fact, on a 180-day average, the 'premium' was equal to a 9.5 per cent discount.⁶⁸⁹

In addition, it was reported that a special dividend in cash would be paid to PCCW's three major shareholders if the proposal completed.⁶⁹⁰ The total amount of such cash dividend would be HK\$17bn, HK\$2bn more than all the expenses the Joint Offerors would pay.⁶⁹¹

Relatively early on, an anonymous journalist exposed a share-splitting scandal, in which it was alleged:

⁶⁸⁵ Ibid.

⁶⁸⁶ Young, Li and Chu (n 669) 32.

⁶⁸⁷ Benjamin Scent, 'It's Outrageous' *The Standard (China's Business Newspaper)* (21-04-2009) <http://www.thestandard.com.hk/news_print.asp?art_id=81081&sid=23531732> accessed 18-02-2012.

⁶⁸⁸ Young, Li and Chu (n 669) 30.

⁶⁸⁹ Team (n 674).

⁶⁹⁰ Saigol (n 675) 1.

⁶⁹¹ Ibid.

There was a scheme in which hundreds of Fortis insurance sales agents would each receive one lot (of 1,000) PCCW Limited shares, and that in return, they would sign a proxy form (which would allow the holdings to count in favour of the deal). If the proposed privatisation succeeds, then of course they would each get HK\$4,500 for the shares.⁶⁹²

This allegation resulted in SFC intervention in the proceedings.

On 11th February, 2009, a petition was presented for court sanction of the scheme.⁶⁹³

6.1.2 Key Issues before the Court

This part discusses in detail three key issues, which proved to be both controversial and critical for drawing a conclusion, at first instance and on appeal. The issues are: (1) differences between the scheme of arrangement under s.166 and compulsory acquisition under s.168; (2) the attitude to share-splitting before the vote in the Extraordinary Shareholder Meeting (ESM); and (3) the concerns of the court with regard to sanctioning the scheme of arrangement.

(1) The Scheme of Arrangement versus Compulsory Acquisition

There are two main ways to privatise a listed company in Hong Kong, namely a scheme of arrangement or a general offer, which may result in a compulsory acquisition.⁶⁹⁴ Both of these should fulfil the statutory

⁶⁹² Anonymous Journalist, 'Vote-rigging Plan for PCCW Meeting' 01-02-2009 <<http://www.webb-site.com/articles/pccwrig.asp>> accessed 20-02-2012.

⁶⁹³ *Re PCCW Ltd* (2008) HCMP 2382/2008, [1].

⁶⁹⁴ Young, Li and Chu (n 669) 31.

requirements laid down by the Companies Ordinance (hereinafter 'CO') and by the Codes on Takeovers and Mergers (hereinafter 'Codes') issued by the SFC under the Securities and Futures Ordinance, which contains specific tests to protect minority shareholders.⁶⁹⁵

- *Compulsory Acquisition*

Section 168 of the CO means a possibility for those majority shareholders who pursue total control of the company to squeeze out the rest, by way of a general offer. It provides that once an offeror has obtained acceptances which in aggregate represent no less than 90 per cent in value of shares within four months of submitting the initial offering documents, he will be able to acquire the remaining shares compulsorily.⁶⁹⁶ Pursuant to r.2.11 of the Codes, the shares acquired by the offeror, including those purchased by his concert parties, should amount to 90 per cent of the disinterested shares.⁶⁹⁷

- *A Scheme of Arrangement*

In the alternative, a privatisation of a listed company may take place by a scheme of arrangement, under s.166 of the CO. The statute provides that if, a majority in number representing three-fourths in value of the members or class of members, present and voting either in person or by proxy at the meeting, are in favour of the scheme of arrangement, the proposal shall, if sanctioned by the court, be binding on all the members.⁶⁹⁸

In addition, the Codes provide a set of supplementary requirements, whereby such a scheme of arrangement should be approved by no less than 75 per cent of votes of independent shareholders that are cast either

⁶⁹⁵ S H Goo, 'Should the Headcount Test for a Scheme of Arrangement Be Abolished?' (2011) 32 Company Lawyer 185, 186.

⁶⁹⁶ Young, Li and Chu (n 669) 31.

⁶⁹⁷ Codes on Takeovers and Mergers (Hong Kong), r.2.11.

⁶⁹⁸ Companies Ordinance (Hong Kong), Section 166.

in person or by proxy at the court meeting of the holders of the disinterested shares.⁶⁹⁹ Furthermore, the proposal may still be dismissed if more than 10 per cent of the voting rights attached to all disinterested shares oppose it.⁷⁰⁰

Comparison of the statutory requirements of the two methods mentioned above suggests that it might be relatively easier for the offeror to privatise a listed company via a scheme of arrangement, due to the lower threshold of votes required for approval.

Having taken into account the opposition by minority shareholders, the Joint Offerors of PCCW opted for scheme of arrangement, with its relatively lower requirement in terms of voting. As such, the proposal could fulfil all the statutory requirements before being sanctioned by the court if (i) it obtained approval by those holding at least 75 per cent in value of the shareholding present and voting in person or by proxy at the court meeting; (ii) it obtained approval by at least a majority in number of the independent shareholders present and voting in person or by proxy; and (iii) the number of votes cast against the proposal amounted to no more than 10 per cent of voting rights attached to all disinterested shares.

Without the consideration of share-splitting, which will be discussed in detail later, it was confirmed by the court at the first instance that: (i) The total number of independent shareholders who attended and voted at the court meeting, in person or by proxy, was 2,256.⁷⁰¹ Among these, 1,404 independent shareholders, holding approximately 83 per cent of shares held by all the independent shareholders present and voting either in person or by proxy, voted in favour of the scheme; while 859 independent

⁶⁹⁹ Codes on Takeovers and Mergers (Hong Kong), r.2.2a.

⁷⁰⁰ Ibid, r.2.2b.

⁷⁰¹ *Re PCCW Ltd* (n 693), [23].

shareholders, holding approximately 17 per cent of such shares, but approximately 8 per cent of the number of shares held by all the independent shareholders whether or not present and voting,⁷⁰² voted against.

Based solely on the voting result, the scheme of arrangement satisfied the statutory requirements under s.166 of the CO and r.2.2b of the Codes. However, questions remain as to whether, in sanctioning a scheme, weight should be given to share-splitting, and exactly what should be taken into account by the court in order to sanction a proper scheme.

(2) The Attitude to Share-splitting Before the Vote in the Extraordinary Shareholder Meeting (ESM)

With the intervention of the SFC, the allegation of improper share transfers, termed share-splitting by the public media, became the decisive issue for the court's decision on whether to sanction the scheme.

At the first instance, Mr Steward, the executive director, enforcement, of the SFC, exhibited 32 bundles containing the records of interviews conducted by the SFC and transcripts of audio-taped interviews.⁷⁰³ The investigation by the SFC focused on 726 persons who became members of the company between 30 December, 2008, the day the court meeting was adjourned, and 30 January, 2009. Each held one lot of shares, the amount stated by an anonymous journalist before the first instance, as mentioned above, and voted in favour of the scheme.⁷⁰⁴

The SFC investigation highlighted the abnormal share-transferring activities. However, unfortunately, Kwan J ruled that such activities were

⁷⁰² Ibid, [25].

⁷⁰³ Ibid, [59].

⁷⁰⁴ Ibid, [61].

merely a matter of conjecture.⁷⁰⁵ In response to the allegations, Kwan J held that such a serious allegation should be proved by strong and cogent evidence before the court.⁷⁰⁶

Moreover, Kwan J held that the splitting of shares is not a prohibited activity in Hong Kong, where arbitrageurs are very active.⁷⁰⁷ Quoting an earlier case, she noted that a shareholder is entitled in common law to transfer some of his share to nominees to increase his voting power at meetings.⁷⁰⁸

In a similar case, *Re Direct Acceptance Ltd.*,⁷⁰⁹ McLelland J claimed:

Regardless of the purpose of these transfers, it is quite clear that the transferees were members of the company at the time of the meeting and entitled to vote. Accordingly their votes had to be counted...

As a result, Kwan J was reluctant to denigrate the unusual share transfers as a manipulation to boost the head count. In addition, she agreed that it would be unfair and wrong for the court to lay down, for the first time, a policy on share-splitting in a scheme.⁷¹⁰

However, on appeal, Rogers VP took the view that the conclusion was inescapable that, by buying shares and distributing them to individuals to increase the number of supporters of the scheme, Mr Lam's actions were a manipulation of voting.⁷¹¹ It was, indeed, a successful operation, which

⁷⁰⁵ Ibid, [90].

⁷⁰⁶ Ibid, [163].

⁷⁰⁷ Ibid, [142].

⁷⁰⁸ *Re Stranton Iron and Steel Company* [1873] LR 16 Eq 559.

⁷⁰⁹ [1987] 5 ACLC [1041].

⁷¹⁰ *Re PCCW Ltd* (n 693), [151].

⁷¹¹ *Re PCCW Ltd* (2009) CAVA 85/2009 [43].

created 494 individual shareholders to vote in favour of the scheme in a very short space of time.

Unlike Kwan J, who refused to reach a conclusion of manipulation of voting in response to a set of abnormal coincidences, Rogers VP pointed out that the multiple series of coincidences, of both timing and the collection of proxy forms, provided evidence that Mr Yuen had been involved with the activities of share-splitting operated by Mr Lam.⁷¹²

According to Rogers VP, it was impossible for the court to give its sanction to the proposal given its knowledge of some form of manipulation of the vote, and the fact that it could not be satisfied that the result of the vote had not been achieved by manipulation.⁷¹³ Moreover, Rogers VP noted that if such manipulation of voting were to be accepted by the court, any vote would be meaningless.⁷¹⁴

Lam J took a similar attitude to share-splitting, stating that the court should accord less weight to the voting result at a court meeting when there has been any form of manipulation.⁷¹⁵ His viewpoint was rooted in the legislative intent of the dual majority requirements in s.166 of the CO. He noted that the threshold settled by the provision requires a scheme to satisfy the majority in value as well as the majority in number.⁷¹⁶ Theoretically, these are two separate requirements. Condoning manipulation of the vote, such as by share-splitting, would make the threshold of majority in number meaningless. Those who hold the majority in value could easily achieve the majority in number by simply splitting their shares to any number they wished, to fulfil the statutory requirement.

⁷¹² Ibid, [60].

⁷¹³ Ibid, [70].

⁷¹⁴ Ibid, [75].

⁷¹⁵ Ibid, [142].

⁷¹⁶ Ibid, [136].

In this manner, the special mechanism for legal protection of minority shareholders would be diminished.

Accordingly, in respect of share-splitting, three judges on the appeal reached a consensus that such activity is a form of manipulation of the vote, and thus should be rebuked when the court exercised its discretion to sanction a scheme of arrangement.

(3) The Concerns of the Court with Regard to Sanctioning the Scheme of Arrangement

To some extent, Kwan J, at the instance, reached her conclusion on the attitude to the functions of the court in relation to the proceeding under s.166 of the CO. She pointed out that the function of the court in petition for the sanction of a scheme of arrangement contains three aspects, as illustrated by Buckley:

In exercising its power of sanction the court will see, first that the provisions of the statute have been complied with, second that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent, and thirdly, that the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve.⁷¹⁷

This was also the consensus among the three judges on the Court of

⁷¹⁷ *Re PCCW Ltd* (n 693); also see, Thomas Stockdale and others, *Buckley on the Companies Acts* (14th edn, 2000), 473.

Appeal.

However, based on her attitude to share-splitting mentioned above, Kwan J rejected the submission that the court should exclude all votes in favour of the scheme as a result of share-splitting in the wide sense.⁷¹⁸ She concluded that there were no procedural irregularities,⁷¹⁹ and her honour was finally satisfied that ‘the scheme is one as to which an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve’.⁷²⁰ Therefore, the scheme was sanctioned by her.⁷²¹

On appeal, Rogers VP mentioned that there were many cases reflecting the two major functions of the court to exercise its discretion to sanction a scheme: first of all determining that the statutory provisions had been complied with, and secondly asking whether the class had been fairly represented by those who attended the meeting.⁷²²

As to the PCCW case, Rogers VP confirmed that the scheme involved had satisfied the first part of the inquiry, since all those who voted at the court meeting, whether in favour of or against the scheme, were registered shareholders.⁷²³

However, it could not be so easily concluded that the required threshold had been achieved, because the existence of a clear manipulation of the vote should not be ignored by the court. Rogers VP agreed Lindley LJ’s view in *Re Alabama, New Orleans, Texas and Pacific Junction Railway*

⁷¹⁸ *Re PCCW Ltd* (n 693), [153].

⁷¹⁹ *Ibid*, [173].

⁷²⁰ *Ibid*, [80].

⁷²¹ *Ibid*, [81].

⁷²² *Re PCCW Ltd* (n 711), [38].

⁷²³ *Ibid*, [66].

Company,⁷²⁴ that:

...although on a meeting which is to be held under this section it is perfectly fair for every man to do that which is best for himself, yet the Court, which has to see what is reasonable and just as regards the interests of the whole class, would certainly be very much influenced in its decision, if it turned out that the majority was composed of persons who had not really the interests of that class at stake.⁷²⁵

When Rogers VP investigated the nature of the scheme in question, to consider whether it could be one in which an intelligent and honest man, a member of the class concerned and acting in respect of his interest might reasonably approve, he noted that, although the explanatory statement in the first document issued by the company described the scheme as an opportunity to realise the investment in PCCW with a significant premium to the market price prevailing on the last trading date, the price on that day, in fact, was at an almost historic low.⁷²⁶ According to the figures provided by the IFA, in the three-year period before the offer, the highest value for the shares of PCCW had been \$5.75 and the average closing price had been \$4.83, significantly higher than the offer price.⁷²⁷

Rogers VP agreed with the view expressed by proxy advisors, similar to that of many independent shareholders, stating that he failed to find any reason why PCCW, as a standalone company, could not to continue. Moreover, according to the scheme document, the Joint Offerors would

⁷²⁴ *Re Alabama, New Orleans, Texas and Pacific Junction Railway Company* (1891) 1 Ch 213, 243.

⁷²⁵ *Re PCCW Ltd* (n 711), [36].

⁷²⁶ *Ibid*, [79].

⁷²⁷ *Ibid*, [80].

maintain the existing business and no significant change would be introduced to the company after the privatisation.⁷²⁸ In other words, the Joint Offerors, who were the major shareholders of PCCW, were confident of the future of the company. Therefore, the key question arose as to why independent shareholders should decide to realise their investment and accept the scheme of arrangement at this time.

In addition, referring to the special dividend in the scheme document, Rogers VP noted that ‘not only are they [the independent shareholders] being treated inequitably and being bought out when the share price has reached an historical low, but the Joint Offerors would receive a dividend which should be payable to all shareholders’.⁷²⁹

Accordingly, Rogers VP concluded that such a scheme should not be sanctioned by the court, not only because the court could not be satisfied that the vote had been reflective of the proper majority, in view of the manipulation of voting, but also because the scheme itself would not be approved by any intelligent and honest member. Instead, in the view of Rogers VP, such a scheme would have the effect of forcing those shareholders out of the company and depriving them of the opportunity to benefit from any potential increase in value and share price.⁷³⁰

In a similar judgment, Lam J noted that the proceeding to seek the court’s sanction for a scheme of arrangement is summary in nature.⁷³¹ Unlike other ordinary civil litigation, it is the petitioner who should satisfy the court that the scheme is rational before being approved.

⁷²⁸ Ibid, [95].

⁷²⁹ Ibid, [94].

⁷³⁰ Ibid, [97].

⁷³¹ Ibid, [106].

With a special concern of legal protection of minority shareholders, the court can only sanction those schemes that are legally correct, since once the scheme has been sanctioned by the court, it will bind all members, even the dissenting shareholders. The importance of this process is pointed out by Buckley, and consequently the court cannot simply look at whether a statutory majority has been achieved. Rather, the court will 'have regard to the amount and quality of information which has been supplied and conduct of the meeting'.⁷³²

In *Re BTR Ltd*,⁷³³ Chadwick LJ, on appeal, claimed:

Minority shareholders are protected in this class of case by the fact that the court has discretion whether or not to approve the scheme having regard to all the circumstances of the case.⁷³⁴

Therefore, Lam J held to his view in respect of the summary nature that the court in such a case should investigate the scheme with a wide lens and that the petitioner must satisfy the court that the application is one which, as an intelligent and honest man, a member of the class concerned and acting in respect of his interest might reasonably approve of.⁷³⁵

Considering the protection given to the minority shareholders under s.168, Lam J held that good reason should be provided by the petitioner for the acquisition, rather than simply relying on the majority approval.⁷³⁶ However, in common with Rogers VP, Lam J concluded that: 'I do not see any good rationale for the scheme as far as those shareholders whose

⁷³² Stockdale and others (n 717) 425.

⁷³³ *Re BTR Ltd* (2000) 1 BCLC [740].

⁷³⁴ *Ibid*, [749].

⁷³⁵ *Re PCCW Ltd* (n 711), [107].

⁷³⁶ *Ibid*, [161].

shares are to be compulsorily acquired are concerned.’⁷³⁷

Barma J agreed with the judgments of Rogers VP and Lam J, especially in the concern that the voting result of the court meeting could not fairly represent the class of scheme shareholders as a whole. He further pointed out, in particular, that if a class member is a mere nominee, it is difficult to see how such a nominee could vote in the interests of the class as a whole. Rather, he represents his principal and the interests of his principal.⁷³⁸

Thus, in such circumstances, Barma J held that: ‘It would be entirely proper for the court, when considering whether or not to give its sanction to a proposed scheme of arrangement, to discount the votes of members of the class who are shown to be nominees for other members of the class, with a view to seeing whether or not there is truly a majority of members of the class favouring the scheme.’⁷³⁹

His Honour ultimately had not been satisfied that such scheme was a rational and reasonable arrangement, which the court should sanction.

6.1.3 Summary

The PCCW case has been deemed a successful example of protection of minority shareholders in Hong Kong. Despite some differences in legislation between the two jurisdictions, it provides a good lesson for the practice in mainland China.

Based on the PCCW case study, this thesis makes three

⁷³⁷ Ibid, [162].

⁷³⁸ Ibid, [190].

⁷³⁹ Ibid.

recommendations for practice in mainland China: (1) The head count test should be introduced into Chinese Company Law; (2) The CSRC should be granted the power to protect public minority investors; and (3) The independence of the court should be guaranteed when an interest of the state is involved.

(1) Head Count Test

The heated discussion as to whether the head count test involved in s.166 of CO should continue to be used has had a profound impact on the legal system of Hong Kong.

The head count test was originally adopted in the 1870 legislation, along with the share value test, and applied only to compromises or arrangements with creditors, to help small creditors fight against their large counterparts to carry the day.⁷⁴⁰ In 1900, when the compromises or arrangements were extended to members, the test was retained.⁷⁴¹

The combination of the head count test and share value test had been deemed an effective design for specific protection of minority shareholders for a hundred years or so before the PCCW privatization case. In *ANZ Executors and Trustees Ltd. v. Humes Ltd.*,⁷⁴² Brooking J in the Supreme Court of Victoria stated:

A balance is struck between the notion that one is simply to count heads and the notion that one is simply to tot up the amounts invested. When the vote is taken, there must be both a preponderance of investors and a preponderance in the case of the former and a three-fourths preponderance in

⁷⁴⁰ *Re PCCW Ltd* (n 711) [132]; also see, Goo (n 695) 185.

⁷⁴¹ *Ibid.*

⁷⁴² *ANZ Executors and Trustees Ltd. v. Humes Ltd.* (1990) VR 615, [622].

the case of the latter. This is, as I say, a fair and sensible formula, and one well known in company and insolvency law.

However, the effectiveness of the safeguard established by s.166 has since been challenged, and it has been argued that this requirement should be abolished. The opposing concerns are discussed in detail below.

First, opponents question whether the voting result through a head count test could truthfully represent the will of the voting group because, especially in Hong Kong, a majority of shareholders in public listed companies hold their shares through the Central Clearing And Settlement System (CCASS).⁷⁴³ Because they are not registered shareholders, those nominees are not qualified to vote for or against the scheme. That is to say, the real disinterested shareholders may not exercise their rights to block a scheme using the head count test, a fact that favours the majority members.

In the PCCW case, the total number of shares held by the independent shareholders who attended and voted at the court meeting, in person or by proxy, was 1,628,013,122, approximately 98% of which were held in CCASS.⁷⁴⁴ Although it seems there was nothing controversial in the share value test, since CCASS voted both in favour of and against the scheme on behalf of different ultimate beneficial independent shareholders, according to their instructions (if any), an issue arose when counting heads. In terms of head count, CCASS would be counted on both sides, once as supporter and once as opponent, consequently cancelling itself

⁷⁴³ Goo (n 695) 187.

⁷⁴⁴ *Re PCCW Ltd* (n 693), [23].

out.⁷⁴⁵ In other words, nominees represented by CCASS, either for or against the scheme, had not effectively voted according to the head count requirement.

However, Kwan J in PCCW did not take this issue into account at all, as she concluded that ‘the statutory majority who voted for the scheme were acting bona fide and were not coercing the minority in order to promote interests adverse to those of the class whom they represented’.⁷⁴⁶ From a similar viewpoint, Goo has argued that such concern cannot be considered a strong reason for abolishing this special protection for minority shareholders. He points out that shareholders who want to have their vote counted could take steps to bring the shares registered under their own names; otherwise, they could be deemed to have given up their individual vote.⁷⁴⁷

Secondly, the requirement of a majority of members accompanied with a share value test is inconsistent with the majority rule.

Some scholars have argued that the threshold of majority in number places significant veto power in the hands of minority shareholders. As a result, a speculative situation may occur, whereby a certain number of small shareholders, who have contributed only a small part of the company’s equity capital, hold the power to block a scheme that is supported by the majority of shareholders, who have invested much more.⁷⁴⁸

⁷⁴⁵ Goo (n 695) 188.

⁷⁴⁶ *Re PCCW Ltd* (n 693), [177].

⁷⁴⁷ Goo (n 695) 188.

⁷⁴⁸ FSTB, ‘Consultation Paper--Draft Companies Bill First Phase Consultation’
<http://www.gov.hk/en/residents/government/publication/consultation/docs/2010/CompaniesBill_PhaseI.pdf>
accessed 07-11-2013, Para 6.18.

That the risk a shareholder takes should be connected to the amount he has invested is undeniable. However, the issue covered by s.166 is not one of ordinary business decision making, but a scheme that would bind all members if sanctioned by the court. In other words, minority shareholders might be squeezed out of the company compulsorily without the legal protection provided by s.168 that the offeror should obtain approval by not less than 90% of share value of the company. Therefore, as argued by this thesis, it is reasonable to give a specific veto power to minority shareholders to defend themselves to remain members of the company.

Thirdly, owing to the use of different yardsticks in the Takeover Code to supplement the threshold of majority in number, a weakness arises in respect of the head count test in practice. The PCCW case is one of the best examples to illustrate this defect. As mentioned above, there were 3,473 million or so shares held by independent shareholders who were eligible to vote under the Code. Among those shares, approximately 1,628 million were involved in the voting at the court meeting. The 1,348 million shares voting in favour of the scheme represented 83 per cent of the shares held by independent shareholders present and voting either in person or by proxy, but only 38 per cent of the shares held by all the independent shareholders whether or not present and voting.⁷⁴⁹ Meanwhile, the 859 independent shareholders who voted against the scheme held shares representing approximately 17 per cent of the number of shares held by all the independent shareholders present and voting either in person or by proxy, but approximately 8 per cent of the number of shares held by all the independent shareholders whether or not present and voting.⁷⁵⁰

⁷⁴⁹ Goo (n 695) 186.

⁷⁵⁰ *Re PCCW Ltd* (n 693), [25].

This situation clearly satisfied the statutory requirements under the Code in that (i) there was approval by 83 per cent of the number of shares held by those independent shareholders present and voting either in person or by proxy; and (ii) only 8 per cent of the number of the shares held by all independent shareholders whether or not present and voting opposed the scheme.

Yet this dual requirement involved the use of a dual yardstick. On the one hand, the number of shares in value voting in favour of the scheme was counted based on the independent shareholders present and voting in person or by proxy at the meeting; while on the other hand, the number of shares in value voting against the scheme was calculated based on the independent shareholders as a whole, whether or not present and voting. In the view of this thesis, neither calculation method is rational.

If just one of these methods had been used in the PCCW, that is, either (i) based on the persons present or voting in person or by proxy at the meeting, or (ii) based on the independent shareholders as a whole, the scheme of arrangement would not have satisfied the statutory threshold at all.

- (i) By using the independent shareholders present and voting in person or by proxy at the meeting as the measure, the scheme of arrangement involved in the PCCW privatisation case would acquire approval from 83 per cent of shares in value, but would fail to satisfy the negative requirement because 17 per cent of shares in value held by the independent shareholders present and voting either in

person or by proxy voted against the scheme, more than the statutory threshold of 10 per cent.

- (ii) By using all the independent shareholders whether or not present and voting as the measure, the scheme would be blocked because it had been approved by only 38 per cent of shares in value.

Therefore, to some extent, it is the imperfect statutory voting mechanism that led to the controversy in the PCCW case.

As a partial conclusion relating to the head count test in Hong Kong, it is undeniable that shareholding by nominees and inconsistent yardsticks in regulations would have a negative effect. However, the solution is not to abolish the head count test, but to improve the veracity of voting. In addition, the yardstick should be amended to be coherent.

There have been similar arguments in relation to abolishing the head count test in the United Kingdom. However, the decision in 2006 to resist such an amendment attested to the belief that such design achieves ‘the right balance’.⁷⁵¹

In the context of mainland China, there is no similar voting mechanism in the Company Law 2005, which states that, unless otherwise provided for by this Law, the discussion of issues and voting procedures of the shareholders' meeting in a limited liability company shall be provided for in the bylaw.⁷⁵² Further, Art.44 provides: ‘A resolution made at a shareholders' meeting on revising the bylaw, increasing or reducing the

⁷⁵¹ *House of Lords Hansard*, 28 March 2006, GC 326.

⁷⁵² Company Law of the People's Republic of China (Revised in 2005), Article 44.

registered capital, merger, split-up, dissolution or change of the company form shall be adopted by the shareholders representing 2/3 or more of the voting rights.⁷⁵³

As to a joint stock limited company, similar to a limited liability company, any resolution shall be adopted by shareholders representing more than half of the voting rights of the shareholders present, and should have 2/3 or more of the voting rights held by shareholders present in favour of the specific issues listed above.⁷⁵⁴

However, the head count test can be found in the Enterprise Bankruptcy Law of the People's Republic of China. Art.84 stipulates that 'where 1/2 or more of the creditors in the same voting group at the creditors' meeting agree to a draft of rectification plan, representing 2/3 or more of the total amount of the creditors' right, it shall be deemed as an adoption of the draft of rectification plan'.⁷⁵⁵ However, it is difficult to determine whether such scheme of arrangement in the Bankruptcy Law of China could be used as a method of privatisation, and there is no evidence to show that such a head count test could be applicable to members of the company.

As a partial conclusion in respect of legal protection of minority shareholders, it should be accepted that a dual threshold, combining a share value test and a head count test, could be an important mechanism to reinforce the veto power of minority shareholders to protect their shareholding in the company from a compulsory buy-out by the majority. Therefore, it could be introduced into Chinese Company Law in the next legal reform.

⁷⁵³ Ibid.

⁷⁵⁴ Ibid, Article 104.

⁷⁵⁵ Enterprise Bankruptcy Law of the People's Republic of China, Article 84.

(2) Role and Power of the SFC

The SFC is an independent non-governmental statutory body outside the civil service, responsible for regulating the securities and futures markets in Hong Kong.⁷⁵⁶ The statutory objectives as set out in the Securities and Futures Ordinance (SFO), which came into operation on 1 April 2003, are:⁷⁵⁷

- (a) To maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- (b) To promote understanding by the public of the operation and functioning of the securities and futures industry;
- (c) To provide protection for members of the public investing in or holding financial products;
- (d) To minimise crime and misconduct in the securities and futures industry;
- (e) To reduce systemic risks in the securities and futures industry; and
- (f) To assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

As a part of its mission, the SFC did its best in the PCCW privatisation case to protect the interests of individual public investors. Without the intervention of the SFC, the ultimate outcome of PCCW's scheme of arrangement would have been different. Therefore, the result of that appeal was not only a victory for minority shareholders, but also a good

⁷⁵⁶ SFC, 'Introducing the SFC' (*SFC Website* <<http://www.sfc.hk/sfc/html/EN/aboutsfc/intro/intro.html>> accessed 07-03-2012).

⁷⁵⁷ SFC, 'Regulatory Objectives' (*SFC Website* <<http://www.sfc.hk/sfc/html/EN/aboutsfc/objectives/objectives.html>> accessed 07-03-2012).

example of how the SFC can fulfil its responsibility to provide legal protection to minority shareholders. One reason for its success, in the view of this thesis, is that the SFC is independent from government, so it will not be influenced by any political power, which in the context of mainland China may have interests contrary to those of the minority shareholders.

The equivalent organisation in mainland China, the China Securities Regulatory Commission, is a ministry-level unit directly under the State Council.⁷⁵⁸ As an administrator of the market, the CSRC is under the leadership of the State Council, as well as the State Assets Administration Committee, a key player in the market. The question then arises of how fairness can be guaranteed in respect of the operation of the CSRC. Furthermore, it is uncertain to what extent the CSRC would intervene in a conflict between a listed company controlled by the state and a certain number of individual minority counterparts. The issues relating to the CSRC will be discussed in detail, in comparison with the SEC in the United States.

(3) Independent Judgment of the Court

The reason for considering this issue here, although without the availability of an appropriate proof, is the supposition that there would have been a different legal outcome had the PCCW privatisation case been presented to a Court in mainland China.

As mentioned in the Scheme document, one of the Joint Offerors was China Netcom Corporation (BVI) Limited, held by China Network Communications Group Corporation, a listed company dominated by the state. Hence, the state had an interest in the case, against the interest of

⁷⁵⁸ CSRC, 'The China Securities Regulatory Commission: Dedicated to Protecting Investors' Rights and Interests' <http://www.csrc.gov.cn/pub/csrc_en/about/> accessed 07-03-2012.

minority shareholders. Given the close relationship between the court and the government in mainland China, it is reasonable to doubt whether fairness could have been achieved by the court, with full consideration of minority shareholders, as happened in the Hong Kong Court of Appeal. Therefore, this thesis insists that the independence of the court is also crucial for minority protection in China.

6.2 Comparative Study of the SEC and the CSRC

6.2.1 A General Review of the Operation of the SEC

The SEC was established during the Great Crash, in 1929, in order to help reform the federal regulation of securities markets and to restore investor confidence in the capital market. Under the Securities Act 1933 and the Securities Exchange Act 1934, it is required that: (a) companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing; and (b) people who sell and trade securities - brokers, dealers, and exchanges - must treat investors fairly and honestly, putting investors' interests first.⁷⁵⁹

Therefore, the SEC considers transparency of information as the most important safeguard for investors.⁷⁶⁰ It believes that all investors, including both institutional shareholders and individual minority shareholders, should have the same access to vital corporate data, based on which they can make a judgment to buy, hold, or sell. Based on this consideration, the SEC holds that the institution of independent audit is one of the most important mechanisms to guarantee information disclosure and to realise

⁷⁵⁹ SEC (n 671) 3.

⁷⁶⁰ Ibid 1.

investors' protection.⁷⁶¹

The mission of the SEC comprises three targets: (1) to protect investors; (2) to maintain fair, orderly, and efficient markets; and (3) to facilitate capital formation. Investor protection is the core of its mission. Mary L. Schapiro, the chairman of the SEC, has stated explicitly: 'Protecting investors is our core mission. And, everything we do is with that goal in mind. When we shut down an insider trading scheme, we are protecting investors. When we detect fraud during an examination, we are protecting investors. When we adopt rules or provide guidance to ensure fair markets or to provide investors with the information that they need, we are protecting investors.'⁷⁶²

To realise its mission, the SEC has set out four strategic goals for Fiscal Years 2010-2015.⁷⁶³ Of these goals, one emphasises self-improvement, while the other three are aimed at providing investors with a more successful securities market. The two main ways to achieve this are promoting market regulations and developing investor education.

- *Promoting Market Regulations*

As noted by Cathleen L. Casey, Commissioner of the SEC, the market needs 'a strong, vigorous, independent and fair regulator. The SEC must craft clear and understandable regulations, actively promote a culture of compliance by all market participants, and enforce aggressively and impartially the laws and regulations on the books. In the end, the vitality of

⁷⁶¹ Research by Campbell and Parker concludes that the SEC believes the independent audit is a critical aspect in protecting the interest of the investing public and a vital component of the capital markets disclosure mechanism. See David R Campbell and Larry M Parker, 'SEC Communications to the Independent Auditors: An Analysis of Enforcement Actions' (1992) 11 Journal of Accounting and Public Policy 297, 298.

⁷⁶² SEC, 'Strategic Plan for Fiscal Year 2010-2015' US Securities and Exchange Commission <<http://www.sec.gov/about/secstratplan1015f.pdf>> accessed 01-11-2012, Message from the Chairman.

⁷⁶³ Ibid.

our securities markets depends on the success of these efforts.’⁷⁶⁴

Therefore, the SEC should first help to set up a sound regulatory environment. Apart from the federal securities laws, more rules and policies are needed, in order to improve disclosure of corporate affairs, achieve better corporate governance, promote high quality accounting standards, and enhance the accountability of financial intermediaries and other market participants. More importantly, these regulations should be clear and easily understood by the public.

Secondly, the SEC should foster and enforce compliance with these regulations, including by investigation of illegal activities. Emphasis will be placed on, but not limited to, corporate disclosure, securities offerings, insider trading and market manipulation.⁷⁶⁵ Once illegal activity has been confirmed, it will be disclosed to the public, so that investors can make changes or keep their holding based on their own judgment.

- *Developing Investor Education*

The SEC believes that many investors in the United States are naïve individuals. They and their families bet their futures on a healthy securities market. Hence, providing fair access to crucial information and imparting knowledge of how to use that information are important tasks for the SEC.

In order to get a better understanding of various investor needs, the SEC has highlighted a set of initiatives, including: (a) informing rulemaking with research on investor behaviour; (b) reshaping how agency information is made available to investors; (c) addressing Investor Advisory Committee input; (d) modernising technology and service offerings targeted at

⁷⁶⁴ Ibid 8.

⁷⁶⁵ Ibid.

assisting the investing public; and (e) expanding collaborative partnerships.⁷⁶⁶

Along with the persistent effort on improving corporate disclosure, investor education could help individual investors in particular to understand rules and policies, and to know more about their investment; for example, where they can get the corporate information they need, and how to understand the information being disclosed.

When reviewing its effectiveness, it should be noted that the SEC has made some mistakes in the past. For example, in 1935 the SEC promulgated a set of rules relating to proxy voting. This was intended to ensure that accurate information was explained fairly to the investors, and that voting was not manipulated by any party in the company.⁷⁶⁷ However, while the provision of accurate information before voting should have benefited shareholders, in practice these rules increased communication costs, so that shareholders became isolated and joint activities became more difficult.⁷⁶⁸

Under pressure from opponents, the SEC eased the proxy voting rules, in the following respects: (a) As long as there is no direct interest involved, market participants were free to communicate with each other in relation to voting issues; (b) With regard to the proxy contest, the power of the SEC to secure changes would be mitigated by outside public monitoring; and (c) Public companies were required to offer their shareholders' lists, which would make it easy for shareholders to communicate.⁷⁶⁹ In short, in order to resolve the collective choice problem, it was necessary to diminish the

⁷⁶⁶ Ibid 36.

⁷⁶⁷ John Pound, 'Proxy Voting and the SEC --- Investor Protection Versus Market Efficiency' (1991) 29 *Journal of Financial Economics* 241, 241.

⁷⁶⁸ Ibid 242.

⁷⁶⁹ Ibid 281.

obstacles to shareholders' communication.

With reference to the current operation of the SEC, legal economists use the cost versus benefits approach to evaluate the effectiveness of its regulatory activities. The implementation of a certain regulation may bring benefits for investors, but will also involve some cost. Scholars have concluded that the regulations issued by the SEC are generally inefficient, since, although they have helped to increase corporate transparency, they generate more costs than benefits.⁷⁷⁰

Moreover, it is not necessarily the case that if regulations are not implemented, corporate scandals will occur. The case of Enron was a rare exception. On the other hand, even with such rules and policies, it is not possible to say that all kinds of corporate scandals would be completely eradicated. A surprise \$2 billion loss of JPMorgan on credit derivatives trading, reported in the middle of 2012,⁷⁷¹ testifies to this. The costs of new regulations are inevitable and massive, especially the cost of disclosure of information on corporate affairs. Sometimes, such costs could even exceed the loss investors might incur.

More interestingly, Langevoort reviewed the Enron case in detail and held that the SEC should take partial responsibility for the financial loss caused to investors. Because the SEC painted a too perfect picture, in which market regulations were strong enough to prevent almost all corporate scandals, it created a gap between investors' expectation and the real corporate governance status.⁷⁷² Therefore, Langevoort suggests, in

⁷⁷⁰ Stephen J Choi and A C Pritchard, 'Behavioral Economics and the SEC' (2003) 56 Stanford Law Review 1, 30

⁷⁷¹ Tom Braithwaite, 'JPMorgan Loses \$2bn in "Egregious" Error' *Financial Times* (New York 11-05-2012) <<http://www.ftchinese.com/story/001044515/en#>> accessed 30-11-2012.

⁷⁷² Donald C Langevoort, 'Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda' (2003) 48 Villanova Law Review 1139, 1140.

addition to continued effort to increase corporate transparency, the SEC should improve investor education, in particular to reduce the gap between investors' expectations and the real situation. In that way, investors will not be misled into believing that there is no risk, but will be able to make an objective assessment of the actual risk. Similarly, Pound argues that many new investors are relatively naïve, so that teaching capital providers how to invest is equally as important as improving the market itself.⁷⁷³

Langevoort also claims that the SEC has intervened in market development too much. He argues that tighter control systems may lead to worse outcomes.⁷⁷⁴

Of course, the SEC also has its supporters. The Public Oversight Board has noted the important role played by the SEC as a link between self-regulation and government regulation.⁷⁷⁵ Moreover, Langevoort points out that the workings of the SEC are far more complicated than its critics can imagine, since 'the SEC operates in a complex political ecology, making law in response to a multitude of shifting incentives, both external and internal'.⁷⁷⁶

Generally speaking, the regulatory work of the SEC, which is not all composed of economists, could be judged fairly well in accordance with its distinctive identity as the 'investor's champion',⁷⁷⁷ at the expense of a certain amount of productivity. The global financial crisis in 2008 taught the SEC several lessons through which it can improve its performance in the

⁷⁷³ Pound (n 767) 247.

⁷⁷⁴ Donald C Langevoort, 'The SEC As A Lawmaker: Choices About Investor Protection in The Face of Uncertainty' (2006) 84 Washington University Law Review 1591, 1624.

⁷⁷⁵ POB, *A Special Report. What is QCIC? What is Peer Review? What is the POB? What is Self-Regulation?* (Public Oversight Board 1991), 10.

⁷⁷⁶ Langevoort, 'The SEC As A Lawmaker: Choices About Investor Protection in The Face of Uncertainty' (n 774) 1623.

⁷⁷⁷ Ibid 1624.

future. For example, the SEC is enhancing risk-based examinations of financial firms, improving fraud detection techniques, and safeguarding investors through proposed rules related to custody of assets held by investment advisers.⁷⁷⁸

However, the SEC has realised that its effectiveness is inevitably restrained by certain factors. Therefore, instead of drawing a perfect picture to the public, it has highlighted certain of these factors in its strategic plan, including (a) resources, in terms of number of staff, expertise, and information systems; (b) the delayed recovery of the global financial system; (c) the understanding of systemic risk and effective use of risk-management tools; (d) regulatory changes that may affect the outcomes of current activities, even those outcomes that would benefit the market and investors at this stage; (e) the risks of over-regulation or under-regulation; and (f) the lack of care and diligence in the decision making by investors.⁷⁷⁹

6.2.2 The Development of the CSRC

Established in 1992, the Chinese CSRC is a ministry-level government agency led directly by the State Council. It carries out regulation and supervision of the securities and futures markets nationwide pursuant to the Securities Law, the Securities Investment Fund Law, the Regulations for the Supervision and Administration of Securities Firms, the Regulations for the Administration of Futures Trading and other applicable laws and regulations for the purpose of maintaining fair, efficient and transparent operation of the securities and futures markets.⁷⁸⁰

⁷⁷⁸ For more improvements, see SEC, 'Strategic Plan for Fiscal Year 2010-2015' (n 762) 4.

⁷⁷⁹ Ibid 5.

⁷⁸⁰ CSRC, 'China Securities Regulatory Commission Annual Report 2011' <http://www.csrc.gov.cn/pub/csrc_en/about/annual/> accessed 07-11-2013, 3.

The CSRC comprises 22 functional departments; 4 affiliated institutions; 4 special committees; 36 regional offices located in various provinces, autonomous regions, direct-controlled municipalities and independent-budget cities; and 2 securities supervision offices stationed at the Shanghai Stock Exchange and the Shenzhen Stock Exchange.⁷⁸¹

The statutory duties of the CSRC are stated in Article 179 of the Securities Law:⁷⁸²

- (a) Formulating, according to the law, rules and regulations related to the supervision and regulation of the securities market and lawfully exercising its authority of approval;
- (b) Supervising and regulating, according to the law, the offering, listing, trading, registration, securities depository and clearing services;
- (c) Supervising and regulating, according to the law, the securities-related business activities of issuers, listed companies, securities firms, securities investment fund management firms, securities service providers, stock exchanges, and securities depository and clearing agencies;
- (d) Formulating, according to the law, qualification criteria and code of conduct for practitioners in the securities industry, and supervising the implementation thereof;
- (e) Supervising and inspecting, according to the law, information disclosures in connection with securities offering, listing and trading;

⁷⁸¹ Ibid.

⁷⁸² Securities Law of the People's Republic of China (Revised in 2005), Article 179. Similar provisions can be found in Article 76 of the Securities Investment Fund Law and Article 50 of the Regulations for the Administration of Futures Trading.

- (f) Providing guidance to and supervising activities of the securities industry associations according to the law;
- (g) Investigating into and imposing sanctions on violations of laws and administrative regulations on the supervision and administration of the securities market; and
- (h) Other duties provided by laws and administrative regulations.

In order to discharge its statutory duties, the CSRC is provided with certain rights:⁷⁸³

- (a) Conducting on-site inspections on securities issuers, listed companies, securities firms, securities investment fund management firms, securities service providers, stock exchanges and securities depository and clearing agencies;
- (b) Entering the premises where a violation is suspected to have been committed in order to conduct investigation and take evidence;
- (c) Inquiring into the parties concerned and any entity and individual involved in the matter under investigation, and requiring them to provide statements in respect of such matter;
- (d) Examining and making copies of the property rights registrations and communication records and any other materials in connection with the subject matter under investigation;
- (e) Examining and making copies of the securities trading records, records of securities registrations and transfers, financial and accounting information and any other relevant

⁷⁸³ Ibid, Article 180. Similar provisions can be found in Article 77 of the Securities Investment Fund Law and Article 51 of the Regulations for the Administration of Futures Trading.

documents and materials of the parties concerned and any entity and individual involved in the subject matter under investigation, and sealing the documents and materials which are likely to be transferred, concealed or destroyed;

- (f) Examining the cash accounts, securities accounts and bank accounts of the parties concerned and any entity and individual involved in the subject matter under investigation; freezing or seizing such accounts upon due approval by a CSRC senior executive, where there is evidence to substantiate signs of transfer or concealment of illegal funds, securities or any other properties, or where key evidence has been or may be concealed, forged or destroyed; and
- (g) Restricting, upon due approval by a CSRC senior executive, securities trading of the parties concerned for the purpose of investigating major violations of securities-related laws or regulations, such as market manipulation and insider trading, for a period of up to 15 trading days, which may be extended for another 15 trading days as required in complex cases.

In order to adapt to the changing market, the CSRC has continued since 2000 to issue rules and regulatory documents, opinions and guidelines on specific issues. Some noteworthy regulatory activities are reviewed below.

(1) Developing Awareness of Minority Protection

With reference to the special concern of minority protection, the CSRC promulgated three new regulations in the early 2000s,⁷⁸⁴ including the Code of Corporate Governance for Listed Companies in China (2002). These new rules have brought the following changes to benefit minority

⁷⁸⁴ Henk Berkman, Rebel A Cole and Lawrence J Fu, 'Political Connections and Minority Shareholder Protection: Evidence From Securities - Market Regulation in China' (2010) 45 Journal of Financial and Quantitative Analysis 1391, 1392.

shareholders: (a) The power of minority shareholders at the annual shareholders' meeting has been increased; (b) Shareholders involved in related-party trading are prohibited from voting on such issues at the shareholders' meeting; (c) Companies are no longer in principle permitted to guarantee loans of their controlling shareholders; (d) The institution of independent directors has been introduced into Chinese corporate governance; and (e) Corporate transparency has been increased, especially in terms of related-party trading.

However, scholars have challenged the effectiveness of such regulatory reform. A study by Berkman et al. suggests that the new rules could be effective only if the companies did not have close ties to the government.⁷⁸⁵ Given that most of the listed companies in the Chinese market have been transformed from SOEs and are still controlled by the state, this could indicate the uselessness of the regulatory reforms initiated by the CSRC.

(2) IPO Section

To achieve better management of IPOs, in 2001 a merit-based review system was introduced for the issuing of securities, replacing the quota system. Under the quota system, local governments had the decisive say on who would get the quota; whereas according to the new system, the decision-making power over the qualification to issue shares publicly is granted to the CSRC.⁷⁸⁶ In the view of this thesis, this is good news for investors, the public minority shareholders in particular, because the CSRC cares much more about the quality of the listed companies than do local governments, which may have other concerns such as taxation

⁷⁸⁵ Ibid 1414.

⁷⁸⁶ Yihong Zhang, 'The Party's Long Shadow: the Party's Control and Influence Over the Corporate Governance of Chinese Listed Companies' (2012) 23 *International Company and Commercial Law Review* 323, 341.

targets or political strategies. It is also possible for the local government to help companies become listed even where they are not qualified, for example, by using fraudulent listing documents.

A good example to illustrate this is the case of Shengjing Shanhe.⁷⁸⁷ The Hunan based company was one of the 'Key Reserve Enterprises' selected by the local government and enjoyed financial and political supports. The CSRC halted its IPO at the last minute due to fraudulent listing documents, which had been ignored by the local government and exposed by the financial media. As a result, fortunately, the interests of public investors were protected by the CSRC.

(3) Insider Trading

In the last decade, the CSRC has been deemed the main force of anti-insider-trading. Based on years of experience, the CSRC has clarified the definition of insiders, and the category of 'other insiders', according to relevant provisions. For example, in the case of Li Qihong,⁷⁸⁸ the CSRC explicitly pointed out that the government official could be accountable as 'other insider', as long as he took advantage of his position and acquired material information that had not been disclosed to the public.

Similarly, when defining the scope of inside information, the CSRC has fulfilled its statutory duty by using statutory interpretation techniques to resolve the uncertainties of the Securities Law. According to Article 75 of the Securities Law, the term 'insider information' refers to information that concerns the business or finance of a company or may have a major effect on the market price of the securities thereof and that has not been

⁷⁸⁷ Junqiang Wu, 'Shengjing Shanhe Bei Fou: Ouran Dayu Biran [The Rejection of Shengjing Shanhe: Avoidable Rather Than Inevitable]' Huaxia Daily <<http://stock.hexun.com/2011-04-08/128588021.html>> accessed 09-11-2012.

⁷⁸⁸ Bo Kong and Yizhu Mao, 'Li Qihong Neimu Jiaoyi Shenyuan [The Abyss of Li Qihong's Insider Trading Case]' Outlook Weekly <<http://news.sina.com.cn/c/2011-05-14/170822464899.shtml>> accessed 09-11-2012.

publicised in securities trading.⁷⁸⁹ In order to provide a clearer definition to guide market practice, the CSRC states that insider information is ‘any material, non-public information, regardless of whether it is corporate information or market information; and whether it is related to securities specifically or generally’.⁷⁹⁰ Moreover, the CSRC, generalising from practice, clearly defines certain kinds of information that fall into the category of ‘other important information’ under Article 75 of the Securities Law.⁷⁹¹

Moreover, in order to overcome the difficulty of evidence acquisition during the inspection of insider trading, the CSRC promotes an insider registration system⁷⁹² whereby the details of persons who have knowledge of relevant inside information are recorded.⁷⁹³

(4) Commercial Bribery

Commercial bribery is not unique to China, but is an important obstacle to further development of the Chinese market. Theoretically, the CSRC is the statutory inspector charged with eradicating it. However, research for this thesis has found that the regulatory methods used by the CSRC are questionable. The CSRC requires listed companies and their subsidiaries to complete a self-evaluation form to report their self-examination and self-correction of commercial bribery. Only if the score is below 60 points⁷⁹⁴ will the CSRC start an investigation of corporate operation.

⁷⁸⁹ Followed this general description, eight categories are listed, including ‘any other important information’: see Securities Law of the People's Republic of China (Revised in 2005), Article 75.

⁷⁹⁰ Hui Huang, ‘Insider Trading and the Regulation on China's Securities Market: Where Are We Now and Where Do We Go From Here?’ (2012) 5 Journal of Business Law 379, 386.

⁷⁹¹ For instance, in the Pan Haishen Case, the non-public earning forecast was identified as ‘other important information’. CSRC, ‘Administrative Penalty Decision by the CSRC (2008) No.12 [Zhongguo Zhengjianhui Xingzheng Chufa Shu (Pan Hai Sheng) (2008) No.12]’ <http://www.csrc.gov.cn/pub/zjhpublic/G00306212/200804/t20080430_23109.htm> accessed 09-11-2012.

⁷⁹² Huang (n 790) 388.

⁷⁹³ It includes who these persons are, when and where they come to know the information, and what the information is about.

⁷⁹⁴ The evaluation is scored out of 100. Scores of 80 points or above are excellent, those under 60 are failed and the rest are passed.

Zhang has noted that the scoring sections of the self-evaluation form cannot provide any evidence, and therefore the mechanism cannot work appropriately in terms of market inspection and investor protection.⁷⁹⁵ Therefore, suggested by this thesis, the CSRC should introduce more practicable and powerful methods to fight against commercial bribery in the further development.⁷⁹⁶

(5) Split Share Structure Reform

As noted in the Introductory chapter, in 2005 the CSRC promulgated a milestone reform, the so-called 'split share structure reform' aimed at the further improvement of the Chinese securities market. The CSRC issued the Guiding Opinions on Split Share Structure Reform of Listed Companies and the Measures for Administration of Split Share Structure Reform of Listed Companies.⁷⁹⁷ Under the reform, non-tradable shares of the listed companies would be able to trade freely in the market, while shareholders who held tradable A shares would be compensated. The compensation could take various forms, subject to approval by shareholders' meeting. In 2008, the CSRC claimed that the reform had been implemented successfully in the Chinese market,⁷⁹⁸ albeit that this thesis has argued that the state, as the controlling shareholder, may enjoy more benefits from the liquidation than minority investors.

⁷⁹⁵ Zhang (n 786) 339.

⁷⁹⁶ Owing to the length and key emphasis of this thesis, more effective method for the CSRC to control the commercial bribery could be found in other researches. See, Kenneth J DeWoskin and Ian J Stones, 'Facing the China Corruption Challenge' (2006) 169 *Far Eastern Economic Review* 37, 38; and Haiping Wang, Guodong Chen and Hua Chen, 'Jinrong Xiaofeizhe Quanyi Baohu: Shichang Shiling Yu Zhengfu Jieru [Legal Protection of Participants of Capital Market: Defects of the Market and Intervention of the Government]' (2013) 125 *Journal of Shandong University of Finance* 50, 53.

⁷⁹⁷ The former was issued on August 23, 2005, jointly by the CSRC, State-Owned Assets Supervision and Administration Commission, Ministry of Finance, People's Bank of China and the Ministry of Commerce. The latter was issued on September 4, 2005, by the CSRC. See, Wai Ho Yeung, 'Non-tradable Share Reform in China: A Review of Progress' (2009) 30 *Company Lawyer* 340, 340.

⁷⁹⁸ Rong Wang, 'Chinese Capital Market on a New Historical Starting Point' *China Securities Daily* (13-11-2008).

(6) Information Disclosure

Having learnt from the experience of other jurisdictions in mature markets, the CSRC realised the importance of the disclosure of corporate information. Therefore, in 2007, the CSRC issued the Administrative Measures on Information Disclosure by Listed Companies,⁷⁹⁹ to set a minimum standard of information disclosure.

According to this regulatory document, corporate information should be disclosed truly, accurately, completely and in a timely manner. Falsehood, misleading statements and major omissions are forbidden.⁸⁰⁰ Corporate documents, including the prospectus, listing memorandum, listing announcement, periodic reports and interim reports, are required to be disclosed to the public accordingly.⁸⁰¹ Yet, such regulation has not significantly improved the defect of corporate transparency in practice in China.⁸⁰²

6.2.3 The Problems of CSRC Operations

Since 2008, the Chinese securities market has been regarded as a nightmare for individual Chinese investors. The Shanghai Composite Index reached a record high of 6,093 points in late 2007, but dropped dramatically to 1800 points one year later, and remains at approximately 2000 points today.⁸⁰³ No doubt, the depressed market has been influenced by the worldwide financial crisis, but the poor protection level of investors is undeniably another key factor.

⁷⁹⁹ Administrative Measures on Information Disclosure by Listed Companies, issued on 03-01-2007, <<http://finance.sina.com.cn/stock/y/20070201/22423304956.shtml>> accessed 18-12-2013.

⁸⁰⁰ Ibid, Article 2.

⁸⁰¹ Ibid, Article 5.

⁸⁰² Zongxin Zhang and Weiye Zhu, 'Woguo Shangshi Gongsi Xinxi Pilu Zhiliang de Shizheng Yanjiu [Empirical Research on the Quality of Corporate Information Disclosure of Chinese Listed Companies]' (2007) 12 Nankai Economic Studies 48,50.

⁸⁰³ For the historical figures of the indexes, see, 'Shanghai Stock Exchange Composite Index' (n 1).

Evidence shows that the CSRC has made great efforts in regulating listed companies, especially in terms of disclosure of corporate information, including the prospectus, periodical reports and ad hoc reports. Meanwhile, certain institutions have been introduced into the Chinese corporate legal system, such as independent directors, internal control, equity incentive schemes, proxy voting and cumulative voting.⁸⁰⁴ To some extent, the CSRC has helped to improve the legal protection of minority shareholders in China. Yet, is that enough?

Taking the issue of anti-insider-trading as an example, despite the empirical evidence that the number of disclosures of insider trading cases has increased recently, scholars still hold that those cases may be just 'the tip of the iceberg'.⁸⁰⁵ With the development of the Chinese securities market, especially since the establishment of a Growth Enterprise Market and the blooming of index futures, short sale and margin lending, it is foreseeable that the difficulty of anti-insider-trading will be increased. The CSRC itself has affirmed this and stated in a joint circular that:

At present, the situation we face in preventing and fighting insider trading in the capital markets is very dire. The identities of insiders are very complicated, the trading methods are very elusive, the operating forms are very secretive, and the detection works are very difficult. With the introduction of index futures, insider trading has become more complicated and more secretive.⁸⁰⁶

⁸⁰⁴ CSRC, 'China Securities Regulatory Commission Annual Report 2011' (n 780) 79.

⁸⁰⁵ Huang (n 790) 382 and 388.

⁸⁰⁶ CSRC, 'Opinion on Preventing and Combating Insider Trading' <http://www.gov.cn/zwjk/2010-11/18/content_1748349.htm> accessed 18-12-2013.

Moreover, it should be noted that, although the CSRC has disclosed and penalised certain illegal activities in the market, there have been few cases in which minority shareholders have been compensated for their financial loss.⁸⁰⁷ Therefore, it may be too early to conclude whether the CSRC has done enough in relation to anti-insider-trading so as to provide better protection of investors.

According to the findings of this research, there are four main factors obstructing the CSRC in discharging its statutory duties: (1) shortage of professional staff; (2) immaturity of regulatory activities; (3) absence of powerful rights; and (4) its compromised position as a market regulator

(1) Shortage of Professional Staff

As a ministry-level unit, the staff of the CSRC totals only about 400 around the country.⁸⁰⁸ Apart from personnel in the headquarters in Beijing, each local branch has around 10 commission members. However, investigation by CSRC staff is one of the most important ways to detect wrongdoing in the market.⁸⁰⁹ Hence, it is not surprising that the CSRC would struggle to carry out its important mission.

Moreover, among these committee staff, very few have a financial industry background, while most come from courts, prosecution or law firms and know little about securities.⁸¹⁰ Absence of professional knowledge and experience in practice has hampered commission members from detecting questionable behaviours. Consequently, it is doubtful whether the CSRC can be an appropriate safeguard of the market.

⁸⁰⁷ Guanghua Yu and Shao Li, 'Against Legal Origin: Of Ownership Concentration and Disclosure' (2007) 7 *Journal of Corporate Law Studies* 287, 304.

⁸⁰⁸ CSRC, 'China Securities Regulatory Commission Annual Report 2011' (n 780) 7.

⁸⁰⁹ Another two are complaints to the Civil Complaint Office of the State Council and complaints to the CSRC.

⁸¹⁰ CSRC, *Internal Annual Report* (Chinese Securities Regulatory Commission, 2002).

(2) Immaturity of Regulatory Activities

Although the CSRC has issued several administrative documents to achieve a better market environment and to improve the quality of corporate governance of Chinese listed companies, critics have noted that such regulations cannot be entirely implemented in practice, mainly because of poor legislative skills and lack of market regulatory experience.⁸¹¹

First of all, the regulations promulgated by the CSRC are mainly on an issue-by-issue basis, which has led to the co-existence of more than 200 laws, regulations and standards relating to securities activities.⁸¹² Redundant regulations make it more difficult for market participants, particularly individual minority investors, to understand the real situation. Furthermore, issuing regulations too frequently would negatively influence the stability of the securities market, which is crucial for its further development.

Second, there remain many ambiguities and uncertainties in these regulatory documents. Taking as an example the 2006 CSRC Guidelines for Articles of Association of Listed Companies, which is a compulsory regulation for companies listed in the two stock exchanges in mainland China, Art.178 (5) provides that:

[in the case that] the operation and management of the company experience a great difficulty, continuation will lead to significant losses suffered by the shareholders, and the

⁸¹¹ Xiang Ke, 'Zhongguo Zhengquan Jianguan Jigou Lifaquan Wenti Yanxi [Research on the Legislative Power of the CSRC]' (2011) 1 *Caijing Lilun yu Shijian* [Economics Theory and Practice] 123, 126.

⁸¹² Yuwa Wei, 'Securities Regulation and Corporate Governance in China' (Corporate Accountability Conference, Melbourne, Australia, 08-02-2006), <<http://hdl.handle.net/10072/13270>> accessed 18-12-2013, 69.

crisis cannot be solved by other means, shareholders with more than 10 per cent of the voting rights can request the People's Court to wind up the company.⁸¹³

In literal terms, the provision provides an option for shareholders who are not powerful enough to influence business decisions, to block risky corporate operations. However, here the question arises as to the situations in which such a provision might be applicable. What is a great difficulty and how big a loss would be deemed as significant loss under the Guidelines? Such uncertainties in the regulations issued by the CSRC obstruct their implementation in practice and prevent their wide use by minority participants.⁸¹⁴

(3) Absence of Powerful Rights

As mentioned above, the CSRC has been granted several rights to help it to fulfil its mission, yet it continues to demand more powerful rights. It has been claimed that the statutory rights granted by the Securities Law are too general, while market practice is too complicated for the CSRC to regulate and supervise. Therefore, only if equipped with more powerful rights, for example the enforceable investigation right or the veto right against any intervention by other government organs, could the CSRC achieve its regulatory role.

In research focusing on insider trading, Cheng found that many insider trading cases in China involve ranking government and party cadres. Yet, under the current legal system, the CSRC lacks the power to investigate or penalise such individuals.⁸¹⁵ Cheng reports an interview with the

⁸¹³ CSRC Guidelines for Articles of Association of Chinese Listed Companies, Article 178(5).

⁸¹⁴ K L Alex Lau, 'The 2006 CSRC Guidelines for Articles of Association of Listed Companies: A Hong Kong Viewpoint' (2009) 30 Company Lawyer 92, 93.

⁸¹⁵ Hongming Cheng, 'Insider Trading in China: the Case for the Chinese Securities Regulatory Commission'

director in the Shanghai branch of the CSRC, who complained:

We don't have sufficient power and resources to investigate. For example, we cannot enter a company to search for evidence. We cannot obtain through subpoena any evidence relevant to determining whether a violation of the securities laws has occurred. When we apply for a search warrant courts are normally reluctant to issue the warrant for us. This has increased difficulties for investigators to obtain evidence for insider trading offences. During the investigation of Chinese Science Group's insider trading, for example, some major offenders had fled long before a search warrant was issued.⁸¹⁶

Another senior official explained that:

Actually, we did discover a large number of cases through our detection efforts. But the Party Disciplinary Committees wanted to deal with them through the Party and governments' internal disciplinary measures, because they didn't want those cases to dilute the reputation of China, the stability of Chinese capital markets...⁸¹⁷

(4) Compromised Position As a Market Regulator

In theory, the CSRC should stand in a neutral position as the regulator and supervisor of the securities market, so as to achieve fairness, order and effectiveness. However, the unique history of state-owned enterprises has resulted in close links between the CSRC, government organs, and many

(2008) 15 Journal of Financial Crime 165, 165.

⁸¹⁶ Ibid 169.

⁸¹⁷ Ibid.

listed companies transferred from traditional SOEs. In such cases, the government, especially the central government, is both player and referee in the same match. Inevitably, this causes problems.

In fact, there have been few cases in which the CSRC has punished listed companies on the ground of their irregular activities. Even where a penalty has been incurred, it has been insufficient to act as a deterrent.⁸¹⁸ Therefore, the low cost of violation could easily bring about new corporate scandals at the expense of the interests of minority shareholders. More importantly, as long as the penalty has not been handed to the shareholders directly as compensation for their financial loss, it is eventually returned to the wrongdoer, the listed company with the state as its ultimate capital provider, via the financial allocation by the central government. As such, the function of discipline and caution of law cannot be realised in practice.

6.2.4 What Lessons Can China Learn from the SEC?

One of the most important purposes of comparative research is to find out what we can learn from the comparative object, in this case the SEC in the US. In fact, over the past two decades the CSRC has borrowed certain insights of market regulation from the US. A typical example is the Code of Corporate Governance for Listed Companies, issued by the CSRC. This could be evidence of convergence of international corporate governance practice, since almost all the articles have parallel provisions in the regulations in Anglo-American countries.⁸¹⁹ Guo Shuqing, the chairman of the CSRC, stated in 2011 that they were trying a set of reforms to

⁸¹⁸ In most cases, the penalties imposed by the CSRC were much lower than the illegal gains acquired by the questionable companies.

⁸¹⁹ Zhao and Wen (n 335) 374.

transform the market into a genuine one rather than a casino.⁸²⁰

However, before drawing conclusions, it is necessary to address the question of why a jurisdiction that has more in common with the German model should transplant institutions designed for a common law model.⁸²¹ This research highlights two points to support learning from the common law model. The first is the tremendous change that has taken place, whereby the planned economy has been abolished and a market-oriented economy has been adopted in its place. On the surface, China now has a modern system of corporate governance. The second point is that the American market developed rapidly and now leads the world. Therefore, it is reasonable for China to learn from the United States.

Of course, what to learn is another question. Legal transplantation should be selective. The unique local situations, including traditions and culture, should also be taken into account. For instance, freedom of the market is highly praised by American scholars. From their viewpoint, when a securities market has reached a stage of development, the market should be run freely under the market rules, which would boost an efficient allocation of capital. In other words, intervention by the government should be reduced or prohibited. Similarly, Cai argues that to create a strong securities market in order to facilitate the development of listed companies as well as the national economy as a whole, the state should set the market free.⁸²² However, the situation in China tells a different story.

⁸²⁰ The respected Chinese economist, Jinglian Wu, defined the securities market in China as a casino. He claimed: 'More hazardedly, prevalent fraud and illegal trading have kept investors from harvesting returns. Today's stock market has turned into a paradise for profiteers. As announced by some foreigners, China's stock market exists as a casino that has yet to be regulated. Even a casino has its rules. For example, you are not allowed to steal a glimpse of another person's card. In our stock market, however, there are so many underhanded dealings, such as stealing a glimpse at others' cards, cheating and swindling.' David Li and Li Hong Xing, 'China Launches SMEs Private Placement Bond' (2012) 33 *Company Lawyer* 284, 286.

⁸²¹ Zhao and Wen (n 335) 377.

⁸²² Wei Cai, 'State Control and the Weak Stock Market in China' (2010) 17 *Journal of Financial Crime* 179, 179.

Scholars have pointed out that the Chinese securities market is developing in a special pattern, in which government control has been maintained.⁸²³ This distinctive characteristic may push the CSRC to find a unique regulatory method to balance the interests involved.

This research identifies three aspects where the CSRC could borrow experience from advanced jurisdictions, including the US, the UK and Hong Kong.

(1) Improving Independence

It is necessary to note the practice in the UK. Despite the accountability owed by the FSA to the Treasury Minister, and through the Minister to Parliament, the FSA was an independent non-governmental body, funded entirely by the firms it regulates.⁸²⁴ Financial independence could be an important basis of independent operation. Alternatively, the CSRC could emulate the operation of the SEC. As an agency of the federal government, the SEC keeps its role as a regulator and referee, promulgating rules and policies fairly and inspecting and punishing illegal market activities strictly. With special concern of Chinese commercial and political environment, this thesis would prefer the US model which the CSRC could learn from to improve its independence. It is because entirely self-funded by the CSRC would not be achieved so easily at this moment. Being the agency of the Chinese government, rather than one of the departments of the government, the CSRC would be able to act independently as the regulator and referee, minimizing the undue influence by other government departments.

⁸²³ Jingyun Ma, Fengming Song and Zhishu Yang, 'The Dual Role of the Government: Securities Market Regulation in China 1980-2007' (2010) 18 *Journal of Financial Regulation and Compliance* 158, 167; also see Parry and Zhang (n 13) 115.

⁸²⁴ FSA, 'Who Are We?' (*The Financial Services Authority* 2012) <<http://www.fsa.gov.uk/about/who>> accessed 09-19-2012. Currently, the FSA has now become two separate regulatory authorities, the Financial Conduct Authority and the Prudential Regulation Authority. More details, see <<http://www.fsa.gov.uk/>> accessed 23-04-2014.

(2) Increasing Corporate Transparency

In 2007, the regulations on the disclosure of information by listed companies were implemented. This was the first time the CSRC had acted on its realisation of the importance of corporate transparency to achieve a fair capital market.⁸²⁵ For further development, this research suggests that the CSRC should re-evaluate the current institutions in the corporate governance regime, and amend the defects. For example, the influence of independent directors and supervisory board should be improved, a higher accounting standard should be adopted and the regulations relating to information disclosure should be more specific.

(3) Developing Investor Education

Investor education has been ignored by the CSRC in the past. However, the importance of such education is no longer in doubt. The SEC has set out several initiatives in its strategic plan, which should be introduced into Chinese corporate governance practice. From the point of view of this research, investor education in China should emphasise three issues: (a) investment decision making; (b) personal assets management; and (c) market participation. Equipped with such knowledge and skills, a minority shareholder's rights would not easily be infringed. In other words, his interest would be protected.

In addition to the above three areas where it could learn from the experience of the SEC, the CSRC should pay more attention to the issue of dividend distribution. In practice, the controlling shareholder cares little about dividend distribution, due to the relatively concentrated shareholding structure. Controlling shareholders can acquire much more benefit from

⁸²⁵ Ma, Song and Yang (n 823) 166.

control than from dividends, for example, through related-party transactions or tunnelling. Undoubtedly, some of these benefits are acquired illegally. However, it is currently difficult to inhibit all illegal market activities, owing to deficient corporate regulations. As such, the controlling shareholder would prefer to enjoy the benefit of corporate control individually rather than to share the dividends with minority shareholders. Therefore, the capital returns of the minority shareholders are quite poor. By the middle of 2008, although the capitalisation of the two stock exchanges in mainland China had been reported as reaching RMB 2,339.70 billion, the dividends in total were a mere 35 per cent or so of the total money raised, approximately RMB 826.60 billion since the market was established.⁸²⁶ If dividend distribution could be improved by the CSRC, minority shareholders would receive more regular benefits.

Notwithstanding the above, as a government organ, the CSRC has political limitations that will not be changed in the short term. It will continue to be difficult for the CSRC to stand up for individual minorities against the majority shareholder, which is usually the state. What this research would expect is that the CSRC attempt to promote a fair and effective market, to increase the quality of corporate governance in Chinese listed companies and to improve investor protection as a whole.

This thesis maintains that, if the general level of investor protection could be increased, minority shareholders would receive more benefits. An empirical study focusing on the Chinese stock market concluded that, in a jurisdiction with a concentrated shareholding structure, the higher the protection level of investors, the more effectively the 'hollowing out'

⁸²⁶ Yangtse News, 'Shangshi Gongsi Tie Gongji Chulu: Bai Yu Jia Gongsi Shinian Mei Fenhong [Hundreds of Listed Companies Have No Dividends For Ten Years]' *Yangtse News* (10-09-2008) <http://finance.ifeng.com/zq/zqyw/200809/0910_923_777017.shtml> accessed 15-11-2012.

behaviour of controlling shareholders could be limited.⁸²⁷ Based on this finding, if the CSRC could improve the legal protection of investors in general, the majority shareholder would have less opportunity to infringe the rights of the minority.

Coincidentally, some of the suggestions by this research are mentioned in the CSRC's Annual Report 2011, released in 2012. The CSRC are making efforts mainly in the following respects: (a) continuing the reform and development of the stock market; (b) promoting the interconnection of bond markets; (c) facilitating the reform and innovation of the futures market; (d) improving the quality of listed companies; (e) enhancing the compliance and development of intermediaries; (f) strengthening investor protection; (g) opening up the capital market to the outside world; and (h) engaging in international financial regulatory reform and cooperation.⁸²⁸

6.3 Conclusion

Sound corporate governance cannot rely solely on internal structures, but also requires the help of external institutions. In terms of minority protection in China, the CSRC, as the market administrator, should guarantee a healthy and fair market for minority investors, preventing the interests of minorities from being infringed by the controller, just as the SFC did in Hong Kong in the case of PCCW.

As reviewed by this thesis, the CSRC has attempted to promote better corporate governance in Chinese listed companies, by issuing the corporate governance code, introducing independent directors and

⁸²⁷ Xiangyang Yang and Suning Huang, 'Study on the Relationship of the Protection for Investors, Related Transactions and Company Efficiency: Taking Pan-Yangtze River Delta as Example' (International Conference on Artificial Intelligence, Management Science and Electronic Commerce; 8-10 Aug 2011).

⁸²⁸ CSRC, 'China Securities Regulatory Commission Annual Report 2011' (n 780) 1-4.

reinforcing the information disclosure standard. However, its effectiveness in achieving its mission and improving minority protection is still under question.

The main reasons for such doubts are that the CSRC suffers from a shortage of staff, and from a lack of capability, market regulatory experience, legislative skills and powerful rights to investigate and penalise the faults that undermine the fairness of the market and infringe the rights of minorities.

Therefore, in the belief that the CSRC could become an important external helping hand for minority protection, this thesis suggests that, first of all, the independence of the CSRC should be improved. Otherwise a fair market with a higher level of investors' protection will never be achieved.

Moreover, increasing corporate transparency is essential. As stated in an earlier chapter of this thesis, minority shareholders could make relatively better investment decisions based on accurate and timely corporate information.

Finally, investor education is another important way for the CSRC to help in terms of minority protection. With the benefit of such education, minorities in the Chinese market would have a better understanding of their investments and, consequently, the ability to protect themselves when necessary.

Chapter Seven: Proposals for Reform

Executive Summary

To improve the legal protection of minority shareholders in Chinese listed companies, this thesis argues that it is not necessary to cut all connections between the government and the company. Indeed, this would be impossible and irrational. Rather, this thesis suggests a large-scale adjustment of ownership structure, in order to eliminate the conflict of interest between the majority shareholder, the state, and the minority investors. Accordingly, infringement of minority rights by the majority shareholder would be decreased.

As argued by this thesis, listed companies should be strictly divided into two area categories: competitive and non-competitive. Companies in the competitive area should prioritise shareholders' interests, pursuing higher investment returns; while companies in the non-competitive area should achieve both commercial targets and public governance functions. Furthermore, this thesis emphasises that state-controlled listed companies in the former category should compete fairly with other business entities, and eventually quit the competitive area.

In addition, this thesis establishes an ideal model to improve corporate governance quality and minority protection in China. According to this 'board-centralised model with a three-level structure', one or more state-owned assets management companies would be established, as the insulation layer between government and the listed companies, in order to eliminate undue government intervention over the company operation.

To guarantee the independence of the board of directors, both in the state-owned assets management companies and in the listed companies, this thesis suggests a new design of board composition. In the state-owned assets management companies, the board of directors should be composed of governmental directors, independent directors and executive directors. The difference between such companies in the competitive and non-competitive areas is merely the proportion of the three kinds of board members. However, the board composition of listed companies is more complicated. Listed companies in the competitive area should have a majority of independent directors, whereas listed companies in the non-competitive area should have shareholder representatives, independent directors and executive directors on the board, so as to ensure that both the commercial target and the public governance functions are achieved.

7.0 Introduction

In this thesis, legal protection of minority shareholders in China has been investigated in detail. It is undoubtedly true that Chinese policy makers have realised the importance of minority protection in the further development of corporate governance in China. Therefore, various institutions that may potentially increase the protection level have been introduced or reinforced by legislation in the gradual reform.

However, the minority protection level overall in Chinese listed companies is still not sufficient to safeguard the interests of minority investors. As argued by this thesis, the key issue of corporate governance in China is state control. This reduces the independence of corporate operations and results in a complicated corporate structure, compared with Anglo-American counterparts. Moreover, undue intervention by the state also

prevents the reforms introduced so far from being effective.

The research for this thesis included comparative investigation of practical experience of minority protection in other advanced jurisdictions, such as the UK and the US. The findings lead to the conclusion that many institutions, such as shareholder activism, independent directors and an external market regulator, may be more effective in minority protection without control by the state.

Therefore, this chapter re-thinks the issue of state control and puts forward an ideal model to improve the protection of minorities, taking into account the lessons learnt from other jurisdictions and the unique domestic environment. With regard to the minority protection mechanisms already incorporated in corporate law, suggestions will be given in the Concluding Chapter.

7.1 Re-think of the Reform of Listed Companies Controlled by the State

State-controlled companies comprise a brief name used by this thesis. The term refers to those listed companies controlled by the state. Such companies are an important component of the Chinese national economy. Under the Chinese Constitution, state assets belong to all citizens, who have no individual right to occupy, operate, acquire profits or dispose of the assets. The central government is the representative of assets owners and the State Assets Supervisory and Administration Committee (SASAC), a ministerial government department, acts as the authorised capital provider. Since the 1980s, the gradual reform of state-controlled companies has been an important concern of national economic

development. Improving the quality of corporate governance of state-controlled companies is one of the key aims of the reform.

7.1.1 Rejuvenation of State-controlled Companies

The two-track economic system, with both state-owned and private sectors, results in unbalanced distribution of productive resources.⁸²⁹ The state sector, whose efficiency is obviously lower than its private counterpart, claims disproportionate social resources, owing to improper intervention by the government. In other words, the two-track economic system cannot satisfy the needs of the real market. Undue government involvement, corruption and rent-seeking prevail in the market, resulting in the infringement of shareholders rights in state-controlled companies, especially those of minority investors. Ultimately, this impedes the development of the Chinese economy.⁸³⁰

When considering corporate reform, to improve the governance quality of state-controlled companies, the question is raised as to which operational target such companies ought to pursue: maximising shareholders' interests or some other goal? Alternatively, what role should the state-controlled companies play in the market?

From the political point of view, party documents clarify that the state sector should remain the dominant part of the national economy and should be developed together with the private sector.⁸³¹ However, what is

⁸²⁹ The productive resources refer to materials, labor or money which is used to create goods or services. More specific researches on distribution of such resources could be found, see Benjamin Croft, 'The Contest for Community Paradigm: Wealth Maximisation or Resource Equalisation?' (1999) 6 UCL Jurisprudence Review 60-82; and Ravi Chauhan, 'Equality is not Equal. Dworkin's Equality of Resources' (1999) 6 UCL Jurisprudence Review 38-59.

⁸³⁰ Wenkui Zhang, 'Weixian de Ziwo Taozui [Dangerous Narcissism]' *Zhongguo Gaige* [Chinese Reform] <<http://magazine.caixin.com/2012-06-04/100397013.html>> accessed 26-09-2013.

⁸³¹ Enterprise Institution of the Institution of Development of State Council, *Zhongguo Qiye Fazhan Baogao 2012* [*China Enterprise Development Report 2012*] (Zhongguo Fazhan Chubanshe [Development Press of

the exact meaning of 'dominant part'? And how can the two sectors develop together?

According to a government announcement, the two sectors should be encouraged to develop in different areas. The state sector should dominate those areas essential for political governance, while it should compete fairly in other areas. Nonetheless, the distinction between different areas remains uncertain. Ramanadham agrees that in theory two kinds of powers could co-exist, one being non-economic, concerned specifically with politics and ideology, and the other economic, based on pragmatism. However, in the real world, the boundary between the two remains invisible.⁸³²

Certainly, the state sector has already expanded outside the areas that should be controlled by the state. The operational targets of state-controlled companies are multiple, driven by public concerns, economic needs and other interests. Even worse, in many competitive areas the state sector competes with its private counterpart unfairly, having advantages in resources, political support and information, among others.

At the 15th National Congress of the Communist Party of China, in 1997, national economic adjustment was espoused.⁸³³ The Congress explicitly noted that the areas in which the state sector should get involved are those important industries and key fields rooted in the governing of the country by the CCP, specifically: national security, natural monopolies, public welfare, the pillar industries and industries of high and new

China] 2012), 93.

⁸³² Venkata Vemuri Ramanadham, *The Economics of Public Enterprise* (Routledge 1991), 35.

⁸³³ Gu Yue, 'The 15th National Congress of Communist Party of China' (<http://news.xinhuanet.com/ziliao/2003-01/20/content_697173.htm> accessed 16-07-2013).

technology.⁸³⁴

However, the reform plan was implemented only until 2004. In 2006, SASAC nominated seven industries that should be fully controlled by state-controlled companies, namely: the military, grid power, petrochemical, telecommunications, coal, civil aviation and shipping industries. Moreover, in some other important industries, state-controlled companies are required to achieve partial control. Hence, monopoly by state-controlled companies took shape.

Facing the global financial crisis in 2008, the Chinese central government launched an anti-crisis investment scheme, involving 4 trillion RMB in total. With this massive investment, the government planned to stimulate domestic demand. Capital was poured into affordable housing projects, transportation infrastructure, rural infrastructure, financial credit support and industrial restructuring.⁸³⁵ More specifically, power grid, telecommunications, transportation, equipment, construction, metallurgy, and construction materials were the key industries selected by the government.⁸³⁶ Referring to the above list of industries controlled by the state sector, it is clear that state-controlled companies were the main force in the 4-trillion RMB investment scheme, thus acquiring enormous financial support from the state. In the words of Zhao and Shi, the scheme resulted in a 're-boom of state-controlled companies'.⁸³⁷

Currently, Chinese state-controlled companies and their assets are mainly distributed in the manufacturing, non-financial services and financial

⁸³⁴ Ibid.

⁸³⁵ Changyong Wang and Huanyu Zhang, '4 Wanyi, Da Zhengjiu [4 Trillion: Great Rescue]' (2008) 24 *Caijing Zazhi* [Caijing Magazine] 84, 85.

⁸³⁶ Ibid.

⁸³⁷ Xiao Zhao and Guicun Shi, 'Da Kuozhang Hou Guoqi Hechu Qu [Where is the Exit for State-owned Enterprises after Expansion]' (2012) 4 *Zhongguo Gaige* [Chinese Reform] 24, 26.

industries. The manufacturing industry alone includes 20,510 state-controlled companies nationwide.⁸³⁸ In 2010, the total assets, net assets, and net profit of all state-controlled companies were 130 trillion RMB, 25 trillion RMB and 2 trillion RMB, respectively.⁸³⁹

Accordingly, it is clear that state-controlled companies in China operate mainly in competitive areas, contrary to the case in many western countries. In addition, some state-controlled companies in non-competitive areas also operate some competitive businesses, such as real estate construction. The state-controlled companies enjoy 80-90 per cent market shares in the telecommunications and civil aviation industries. In the financial services industry, most market participants are controlled by the state.⁸⁴⁰

Although the weight of the state sector in the national economy has decreased since the 2000s, especially in the manufacturing industry,⁸⁴¹ its influence in the industry chain is still significant. This is because the state sector dominates the energy resource, raw materials and equipment industries that decide the structure and price of lower industries in the chain.

Furthermore, most state-controlled companies in China are large enterprises. Among those firms ranked in the top 500 in China in 2011, 316 were state-controlled companies, equal to 63 per cent of the total. The income, profit and assets of state-controlled companies amounted to

⁸³⁸ National Bureau of Statistics of China, *China Statistical Year Book 2011* (China Statistics Press 2011), 532.

⁸³⁹ *Ibid.*

⁸⁴⁰ *Ibid.*

⁸⁴¹ In the manufacturing industry, the business volume of state-controlled companies in 32 out of 34 sub-categories has clearly decreased. See, Xiaohong Chen, 'Guoyou Jingji Buju: Bianhua, Yingxiang Yinsu he Zhanwang [Distribution of State-owned Economy: Changes, Effective Factors and Prospect]' (2009) 1 *China Development Review* (Chinese Version) 47, 48.

approximately 83%, 82% and 90% of the total, respectively.⁸⁴² Therefore, even if some state-controlled companies do not occupy a large proportion of market share, they are still capable of affecting the industry due to their leading position. In some other industries, state-controlled companies dominate the market, for example PetroChina in the petrochemical industry, China Mobile Communication Corporation in telecommunications, and the Industrial and Commercial Bank of China in banking.

Compared with other OECD countries, the impact of state-controlled companies on the Chinese national economy is much greater.⁸⁴³ Using the ratio of state assets to GDP to weight the state sector in the national economy, Chen finds that in China in 2007 the ratio was roughly 3:1, while the average ratio of the other 16 countries was only 0.25:1.⁸⁴⁴ The result indicates how greatly Chinese state-controlled companies can affect the national economy.

This thesis does not claim that the Anglo-American governance model is perfect. On the contrary, a series of corporate governance scandals have revealed defects of corporate governance in the US private sector. However, even though the Chinese national economy escaped severe disturbance during the global financial crisis due to the rejuvenation scheme for state-controlled companies, scholars have noted certain costs behind the scheme's success. Specifically, (1) The Chinese economy has suffered high inflation. Not until the end of 2011 did the CPI index drop to 5 per cent. High inflation results in serious shrinkage of private wealth, making it impossible to boost domestic consumption; (2) Because the 4-trillion RMB scheme involved fixed investment plans, the state sector took

⁸⁴² Angang Hu, 'Guoyou Qiye Shi Zhongguo Jueqi de Lingtouyang [State-owned Enterprise is the Leader of the Economic Rise of China]' <<http://www.sasac.gov.cn/n1180/n1271/n20515/n2697206/14877127.html>> accessed 16-07-2013.

⁸⁴³ Chen (n 841) 53.

⁸⁴⁴ Ibid.

up a huge amount of loans, although its efficiency is relatively lower than the private sector. As a result, the development of the private sector has been restrained; and (3) The multiplier effect of massive investment by central government led to a widespread investment wave by local governments, which in turn caused a local debt crisis two years later.⁸⁴⁵

7.1.2 New Problems during the Reform of State-controlled Companies

In order to achieve further development of the Chinese economy, a set of reforms has been introduced by the government, seeking better governance quality. However, Chinese economic reform is a huge and gradual project, hampered by poor foundations and insufficient experience of a market-oriented economy. Therefore, it is difficult to guarantee that all parts of the reform are being implemented in an absolutely correct way.

This section highlights four issues that have arisen during the reform: (1) the gap between corporate profits of state-controlled companies and benefits to citizens; (2) the consistent deficiencies in state-controlled companies; (3) the demolition of the market environment by monopoly; and (4) the irrational requirement to increase the value of state assets.

(1) The Gap between Corporate Profits of State-controlled Companies and Benefits to Citizens

According to Chen, the lower the proportion of the state sector in the national economy, the higher the sensitivity of domestic consumption to GDP.⁸⁴⁶ This means that citizens living in those countries with a low proportion of state-sector companies would be able to enjoy more benefits

⁸⁴⁵ Zhao and Shi (n 837) 28.

⁸⁴⁶ Zhiwu Chen, 'Shouru Zengzhang yu Jingji Zengzhang Weihe Bu Tongbu [Why Did the Increase of Income Not Keep Pace with the Increase of Economy]' *Jingji Guancha Bao* [*The Economic Observer*] (13-12-2010).

when the GDP grows. Conversely, people would receive less benefit in those countries with a high proportion of state-sector companies, such as China.

It seems ironic that, with the growth of GDP, people living in a communist country receive less benefit than people in a capitalist country. In theory, Chinese state assets belong to all citizens living in mainland China. Why then, can people not share the benefit of the growth of GDP?

The paradox is caused by a systemic defect of state ownership. In theory, each citizen in the country should be one of the owners of state assets, having a fair share of property rights. However, in practice the property right of state assets should be enjoyed collectively, which means that no single citizen could occupy, use or dispose of the assets individually. Therefore, peoples' residual rights cannot actually be realised.

A further reason to explain the paradox, as explained by Chen, is the existence of a huge agency cost in such an ownership system.⁸⁴⁷ Evidence for this hypothesis might be found in the low profit delivered to the government. In 2010, the total profits created by state-controlled companies amounted to approximately 2 trillion RMB, while the part delivered to the government was only 0.044 trillion RMB, equivalent to 2.2 per cent of the total amount.⁸⁴⁸

(2) The Consistent Deficiencies in State-controlled Companies

In spite of the enormous amount of profit, it cannot be denied that the efficiency of state-controlled companies is still inadequate in general. This view is supported by Mengfu Huang, Chairman of the National Federation

⁸⁴⁷ Ibid.

⁸⁴⁸ Zhao and Shi (n 837) 26.

of Industry and Commerce, who claims that the operation of such massive state assets is inefficient. Dozens of trillions RMB of state assets deliver only several billion profits.⁸⁴⁹

As reviewed by this thesis, the low efficiency of state-controlled companies is by nature a structural problem. Corporate executives are quasi-civil servants, managing the company but being evaluated by a similar standard as for civil servants. The majority shareholder, the state, enjoys the benefits of corporate control, such as related-party transactions or even tunnelling. Hence business performance becomes less important. To deal with this problem, a thorough re-structure is necessary, linking the benefit of each interest group directly to corporate performance.

The low efficiency of corporate operations leads to low dividends, which negatively affects the investment return of shareholders, especially those minorities who are not capable of enjoying any benefit of corporate control. Moreover, it is almost impossible for minorities to achieve better management through their own activities under the current corporate structure. Hence, most minority shareholders seek a better premium of share price on the stock market, rather than a reliable dividend stream(s). This is not the optimal choice either for minority shareholders or for the Chinese capital market.

(3) Demolition of Market Environment by Monopoly

In many industries in China, natural resources, raw materials, price-setting and key information are monopolised by state-controlled companies. The government or administrative departments abuse their powers to provide additional support biased toward state-controlled companies. Such

⁸⁴⁹ Ibid.

monopoly by the state sector cannot help to resolve corporate deficiencies, but will ultimately destroy the fairness of the market.

(4) The Irrational Requirement to Increase the Value of State Assets

To date, the key principle in the operation of state assets is to maintain or increase their value. This is rooted in the nature of state assets, which belong to the whole people within the country, according to the Constitution⁸⁵⁰ and the newly-promulgated Law of the People's Republic of China on the State-Owned Assets of Enterprises.⁸⁵¹ Since they involve the interests of all citizens, such state assets ought to be managed cautiously, based on an understanding of their nature.

However, here arises a legal question, namely: When state assets are invested in a company, who should enjoy property rights? In accordance with the Chinese Company Law, as well as commercial practice in other countries, the investment relationship is based on the legal fact that shareholders transfer the property right of the assets to the company in exchange for corporate shares.⁸⁵² Accordingly, with independent legal personality, the company shall acquire the entire property right of all the assets invested in it. In other words, when the government transfers state assets to a company, no matter how many corporate shares it holds, the state assets should belong to the company rather than the whole people. Yet this deduction is not reflected in the current laws.

In addition, even if state assets held by the company have been explicitly defined as belonging to all citizens in China, the requirement to increase their value can still be challenged. Certainly, state assets should be operated with special caution, but pursuing an increase in value should

⁸⁵⁰ Constitution of the People's Republic of China, Article 6.

⁸⁵¹ Law of the People's Republic of China on the State-Owned Assets of Enterprises, Article 3.

⁸⁵² Company Law of the People's Republic of China (Revised in 2005), Article 27 and 28.

come with the necessary precondition that this should not damage the interests of the private sector.

By taking advantage of political support and lower costs of capital, state-controlled companies gain considerable profit, increasing the value of state assets. However, this is at the expense of fairness in the market. As a result, the private sector has to overcome more difficulties in order to develop. In the macro aspect, the citizens' right to undifferentiated development is infringed. Since both state and private sectors involve people's interests, how can we tell which is more important? Moreover, if state assets are to be operated with the requirement to increase their value, how can the state sector eventually exit the competitive area?

For state-controlled companies in the non-competitive area, which will be discussed later in more detail, it is impossible to increase the value of state assets. Such companies are established to meet the needs of some public governance functions. The products or services they provide, such as the national grid for electricity, or public transportation, are part of social welfare. Therefore, the target of corporate operation should be to maximize the public interest, rather than profit.

This thesis agrees that the requirement to maintain the value of state assets is rational, so as to guarantee cautious management. However, the requirement to increase the value is irrational, in both the competitive and the non-competitive areas. In order to achieve better resource allocation and to improve corporate governance quality in China, state assets should flow toward the non-competitive area, to increase social welfare.

7.1.3 Direction for Further Reform of State-controlled Companies

State-controlled companies exist under both planned and market-oriented economies. For example, in the western countries, such as the United Kingdom, state-controlled companies have an important position, helping the government to remedy market defects. In other words, the market does not repel state-controlled companies.

On the other hand, a sound corporate governance arrangement would, in theory, be able to improve the efficiency of state-controlled companies. State control is not by nature an inefficient mechanism. In Singapore, state-controlled companies such as Temasek have even higher efficiency than their private counterparts.⁸⁵³ Similar cases exist in France, for example, Renault.⁸⁵⁴ Accordingly, the conclusion can be drawn that good efficiency is derived from good governance. In corporate operations the government should act as a wise representative of assets owners, rather than take on the roles of both market participant and market regulator. Administrative intervention should be prohibited.

Certainly, such a reform target cannot be achieved in the short time. The combination of governmental functions and enterprise management has a long history in China, so that it will be very difficult to change. As noted by scholars, the commercial sector in China has long been under the control of the state government.⁸⁵⁵ Even today, the political nature of the assets is the key consideration in company law.⁸⁵⁶ For example, if the assets belong to the state, transferring such assets would need special approval by the SASAC.

⁸⁵³ Gu (n 660) 130.

⁸⁵⁴ Ibid.

⁸⁵⁵ Yue Wu (ed), *Gongsì Zhìlì: Guóqì Suoyóuquán yú Zhìlì Mùbiào* [Corporate Governance: Property Right of State-owned Company and Governance Targets] (Law Press China 2006), 33.

⁸⁵⁶ Shengbei Zhang, *Zhōngguó Shàngshì Gongsì Kòngzhìquán Fǎlǚ Wéntí Yánjiū: Quèxiān yú Gǎiliáng* [Legal Research on the Right for Corporate Control of Chinese Listed Companies: Defects and Improvement] (Law Press China 2007), 16.

Of course, the existence of difficulties must not become an excuse to stop moving forward. As emphasised by Wu, one of China's preeminent economists, the difficulties China is facing now may be much more than the beginning of reform. Rather, they are due to the fact that the breaking down of the original system was accompanied by the emergence of new interest groups, which represent resistance to further reform.⁸⁵⁷ Indeed, since the rejuvenation of the state sector, some licenses that used to be issued to private companies have become invalid. Meanwhile, many medium or small size private companies have been merged with state-controlled companies to consolidate their monopoly position. However, Wu insists that only by moving on can China achieve sustainable economic growth.⁸⁵⁸

As insisted upon throughout this thesis, in order to achieve further development, it is necessary to have a better corporate governance regime, especially in terms of minority protection. Giving more confidence to minority investors would attract diversified investments to support the Chinese national economy. For this purpose, structural reform on the macro level will be the precondition for the improvement of corporate governance on the micro level. Without clarification of rights, obligations and operation methods in relation to state assets, companies may continue to fail to maximise the interests of shareholders as a whole.

Therefore, this thesis suggests that the state sector should launch structural reform by means of: (a) Explicitly distinguishing between competitive areas and non-competitive areas. Moreover, the competitive area could be further divided into two categories: industries with strong

⁸⁵⁷ Jinglian Wu, 'Guo Jin Min Tui: Zhongguo Gaige de Fengxian ["Guo Jin Min Tui": the Risk of Chinese Reform]' (2012) Z3 China Private Economy of Science & Technology 74, 75.

⁸⁵⁸ Ibid.

foundations and industries with weak foundations;⁸⁵⁹ (b) Setting up operational targets in accordance with the different classifications to which the state-controlled companies belong; and (c) Keeping the separation of governmental functions from enterprise management.

Generally speaking, state-controlled companies in the non-competitive area should prioritise the public interest, helping the government to fulfil public governance functions. For example, such a company may be established to make up for gaps in the market. Conversely, the target for state-controlled companies in the competitive area should be the same as for normal private companies, pursuing better performance and maximising the interests of shareholders as a whole, while competing with their private counterparts in a fair market. For the long term, this thesis insists that the state should exit the competitive area by selling its corporate shares.

(1) Non-competitive Area

According to western economic theory, state-controlled companies should be limited to some key areas where the private sector is either not able or not willing to invest.⁸⁶⁰ In modern societies, national economic governance cannot rely on policy making, but should be supported by state-controlled companies.

State-controlled companies in non-competitive areas are normally established to remedy market defects and relieve the conflicts that arise during market development. They either supplement the private sector, creating a desirable environment for its development, or fulfil the public needs for infrastructure, by providing public products or services. In the

⁸⁵⁹ For more details about the classification, see Hu (n 656) 15.

⁸⁶⁰ Gu (n 660) 135.

macro aspect, with the help of state-controlled companies the economic structure could be optimised, while national safety and social stability could be guaranteed. As Liu argues, state-controlled companies have three main functions: providing fundamental services, adjusting the economic structure to make it more efficient, and promoting political stability.⁸⁶¹

Considering the intention of establishing such companies, their operational targets are accordingly not profit-driven. Instead, satisfying the public interest should be the first priority of corporate management. Given this corporate target, in practice it is impossible to separate entirely governmental functions from corporate management.

(2) Competitive Area

As mentioned above, according to western theory, state-controlled companies do not usually participate in market competition. The situation in China is different, a result of the unique domestic environment.

State-owned enterprises were initially formed at a time when social productivity was extremely poor. The state called for industrialisation and a modern economy. To achieve such improvement, developing the state sector was the best policy choice. Moreover, during the transformation from planned economy to market-oriented economy, macro-economic policies, such as fiscal, tax, and monetary policies, were not sufficient to meet the complicated situation. State control could act as the coordinator of interest conflicts during the gradual reform.

As a consequence, to push state-controlled companies to quit the

⁸⁶¹ Huaping Liu, *Reset the Relationship between Chinese Government and State-owned Enterprises* (Southwest University of Finance and Economics Publishing Houses 2005), 6.

competitive area entirely would be too extreme in the short term. On the one hand, those companies still dominate the market, in terms of capital, technology, human resource, equipment and products. On the other hand, the private sector is not sufficiently mature to fill the gap in the market left by the quitting of the state sector. Such a move may lead to uncontrollable economic turbulence.

However, this thesis insists that, with the development of the Chinese market-oriented economy, state-controlled companies should eventually quit the competitive area. At present, the reform should be implemented step by step, as shown in Figure 1.

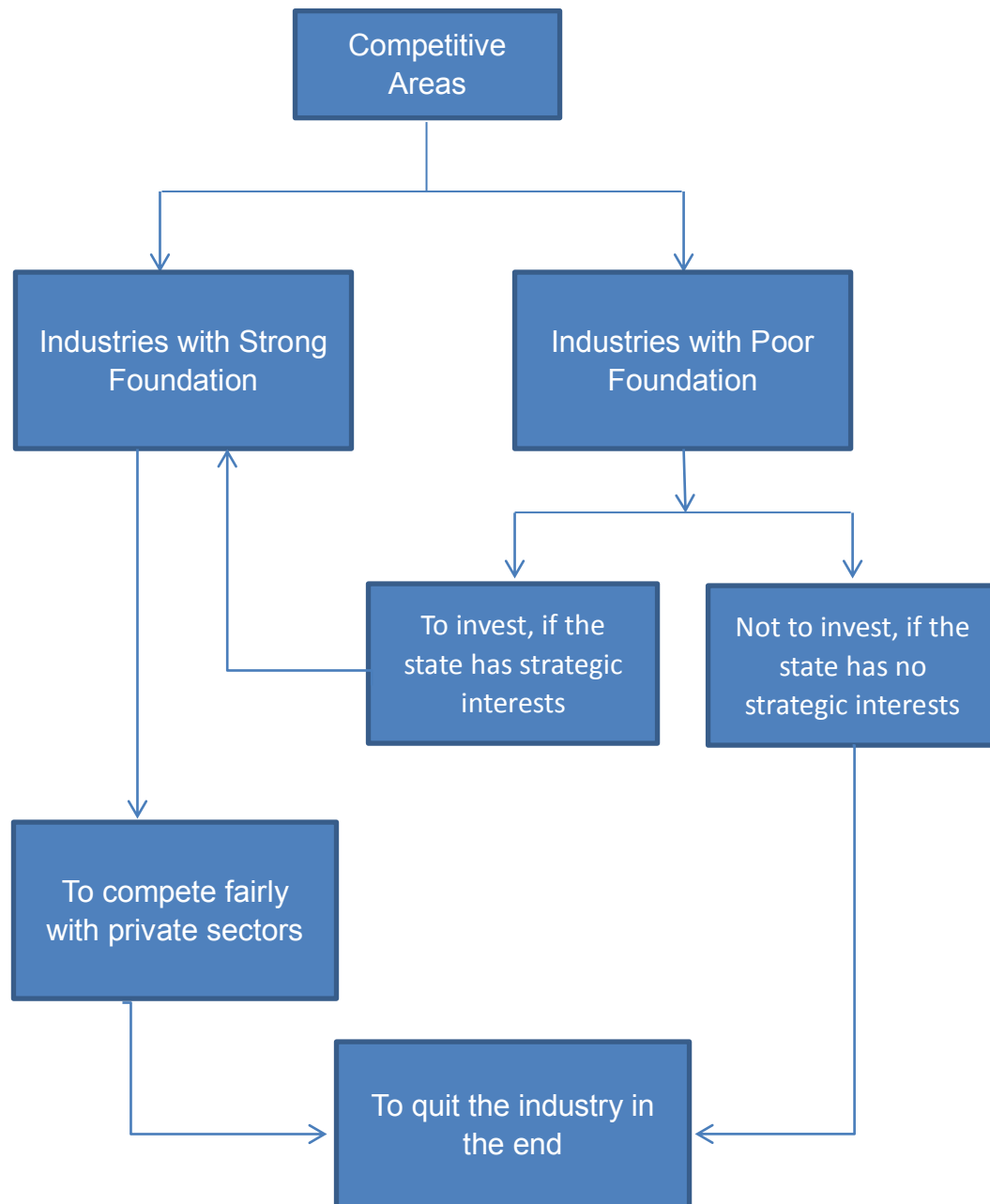


Figure 1: The Operation Direction of State-controlled Listed Companies in the Competitive Area

Liu suggests that state-controlled companies in the competitive area should adopt profit-driven strategies. That is to say, such companies should take advantage of their capital and information to invest in the most profitable business, regardless of geographical and industrial

restrictions.⁸⁶²

Indeed, in current practice, many state-controlled companies do operate in this way, increasing the value of state assets. However, this thesis holds a dissenting viewpoint. First, the rationale of increasing the value of state assets has already been questioned.⁸⁶³ Secondly, the pursuit of profit-driven strategy by state-controlled companies has been regarded as a cancer on the Chinese national economy. Profit created by the state sector depends not on sound management and high efficiency, but on easy access to capital with the help of the government. This thesis argues that with better corporate governance practice, and a market that is open and fair, the private sector may produce more benefits.

7.2 An Ideal Board-Centralised Model with Three-level Structure

While this thesis is seeking changes to improve the legal protection of minority shareholders in Chinese listed companies, it argues that a substantial change in the macro economy is the necessary basis for such a proposal. This is because most listed companies in the Chinese capital market are at the lower level of a pyramid shareholding structure, and have an indivisible relationship to state assets and the government.

Therefore, this thesis believes a better corporate governance structure of Chinese listed companies should be designed to balance fairly the various interests held by different groups, including but not limited to the state, the local governments, the Communist Party, minority investors and other stakeholders. This is also the fundamental way to minimise the conflict of interests between the controlling shareholder and minorities.

⁸⁶² Ibid 254.

⁸⁶³ For a detailed illustration, see 7.1.2(4) of this chapter, page 332.

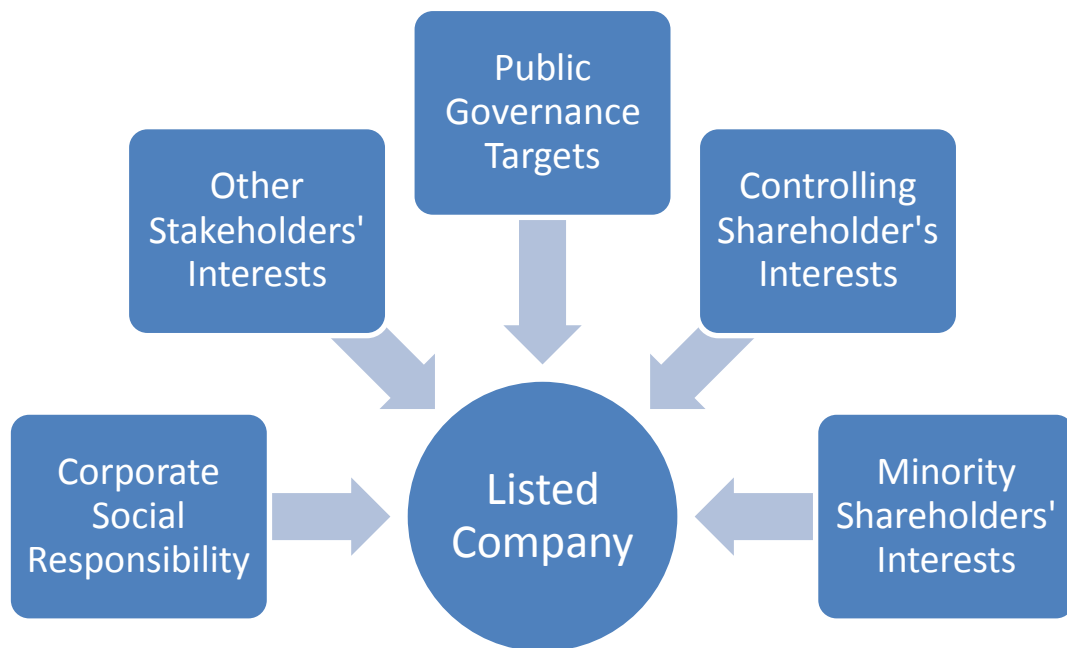


Figure 2: Interests of Different Parties Involved in Chinese Listed Companies

As demonstrated by Figure 2, listed companies in the Chinese market are affected by the demands of various interests. In most cases, the controlling shareholders are different levels of government; alternatively companies may be owned or controlled by government. Hence, among all the interest concerns, the willingness to maintain and increase the value of state assets, and certain public governance targets, become in practice the first two priorities in corporate operation.

According to a survey by the Chinese Entrepreneurs Institution in 2007, focusing on top corporate executives, including the legal representative of the company, targets such as 'Creating a sustainable and outstanding enterprise', 'Paying more attention to employees' welfare' and 'Achieving personal value' have been considered more important than 'Increasing profit to realise the investment of shareholders'.⁸⁶⁴

⁸⁶⁴ Lan Li, *Zhongguo Qiyejia Chengzhang 15 Nian: 1993-2008*, *Zhongguo Qiyejia Chengzhang Yu Fazhan*

Here a question arises as to how the interest of the controlling shareholder can be realised, if corporate executives give profitability low priority in day-to-day management, even though it is commonly believed that the interests of the controlling shareholder would be guaranteed. To answer this question, this thesis argues that in most cases the controlling shareholder acquires investment return not through dividends, but from the benefits of corporate control. For example, the corporate controller could receive greater benefits by tunnelling or related-party transactions. Moreover, unlike dividends, the benefits of corporate control enjoyed by the majority shareholder are exclusive, which cannot be shared with minorities. Therefore, it can be concluded that the interests of minority shareholders do not carry enough weight in Chinese listed companies. This thesis believes that taking the interests of minority shareholders into account properly in corporate decision making, rather than sacrificing them, is already a step forward compared with the current situation of minority protection.

In order to achieve such a balance of interests, this thesis suggests that a board-centralised corporate structure should be established,⁸⁶⁵ based on the practical experience in Anglo-American companies, to get rid of unnecessary political intervention. A professional and independent board of directors would balance the various interests of different groups according to the criterion of achieving the success of the company. In this way, the interests of minorities, an important concern in corporate governance, could be taken properly into consideration in the board room, and be better protected by the board of directors against the controlling shareholder.

Baogao [15 Years Growth of Chinese Entrepreneurs: 1993-2008, Reports on the Growth and Development of Chinese Entrepreneurs] (China Machine Press 2009), 14.

⁸⁶⁵ In this thesis, 'the board' in the board-centralised structure refers to the board of directors.

Accordingly, this thesis provides a new ideal model with different structures for different market participants. The provisionally named 'Three-level Structure Model' is based on the principle that the decision-making power over corporate operations should be truly exercised by the board of directors. The rationales of such an arrangement are discussed later in this chapter.

7.2.1 Description of the Ideal Model

As has been mentioned, the Chinese government plays a dual role in the capital market. It is both the administrator of the social economy, taking charge of public governance, and the representative investor of state assets, exercising the legal rights of a capital provider. Due to this complex characteristic, the government as controlling shareholder has a composite target to pursue, concerned with both social stability and corporate profitability. Accordingly, pursuit of this target impacts upon the company's operations, through administrative activities and controlling power over corporate affairs. The pursuit of financial returns and the achievement of public management have similar weight in corporate decision making, which inevitably results in low efficiency in those state-owned or state-controlled listed companies. Therefore, separating government functions from corporate management is the vital guiding concept of the proposed new system.

To date, most state-controlled listed companies operate in a two-level structure, in which the State-owned Assets Supervision and Administration Commission (SASAC), a ministerial-level department of central government, exercises the shareholder's right on behalf of the owners of

state-owned assets, officially defined as all citizens in the China mainland. There is no intermediate institution between the government and the listed companies. Under this structure, the government can easily and directly intervene in the daily operation of listed companies controlled by the state, which may make it impossible to separate the governmental functions from corporate management. In order to overcome such systematic problems, this thesis proposes that a three-level structure, 'Representative of Owners of State-owned Assets - State Assets Management Companies - Listed Companies', be introduced into Chinese corporate governance.

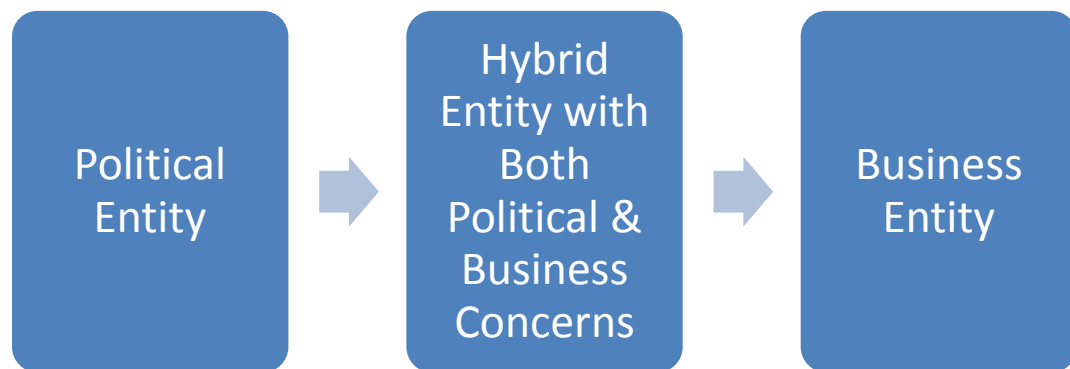


Figure 3: Conversion Function of Three-level Structure

Political Entity: Governments at Different Levels

Hybrid Entity: State Assets Management Companies

Business Entity: Listed Companies in Different Industries

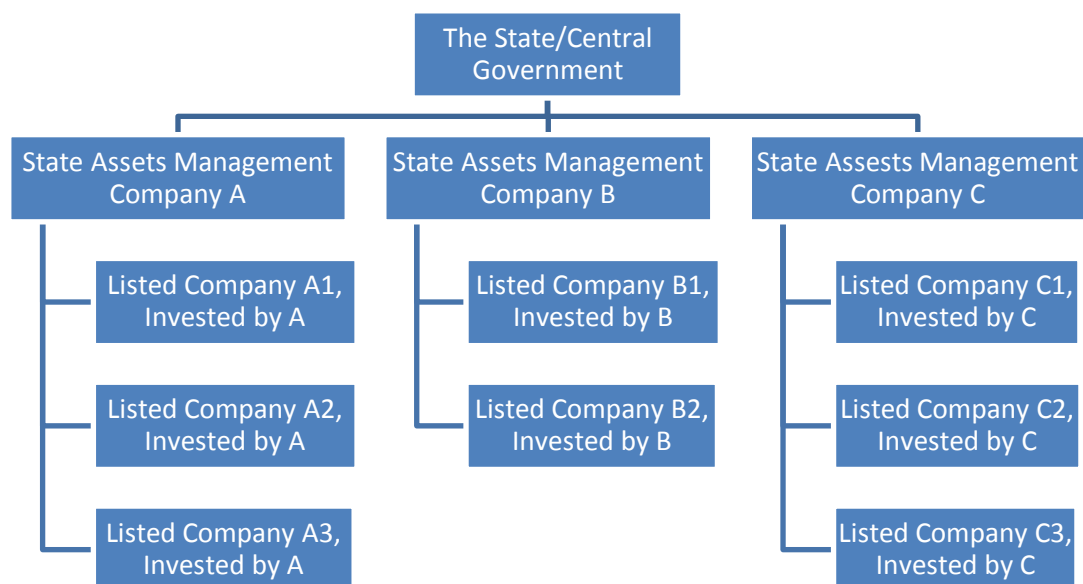


Figure 4: Hierarchical Arrangement of ‘Three-level Structure Model’

As shown in Figure 3 and Figure 4, state assets management companies are intermediate institutions between the state and the market. Authorised by the government, state assets management companies acquire the rights of use and disposition over the state assets, and then invest this capital into listed companies on the market. In accordance with commercial regulations, state assets management companies exchange the property right of state assets of listed companies on the market for corporate shares. The relationship between the state and the state assets management company is one of administrative trust, while the relationship between the state assets management company and the listed company invested in is a typical commercial relation between shareholder and company.

As such, the three-level structure can be simply understood as ‘Government - Investment Holding Company - Listed Companies Invested by the Former and Other Minority Shareholders’. As the intermediary between the government and other market participants, the state assets

management company is the most important factor for the success of the proposed new structure.

The 'Three-level Structure Model' is inspired by the example in practice of Temasek, an investment company based in Singapore. Temasek is a Singapore exempt private company incorporated on 25 June 1974 and wholly owned by the Ministry of Finance. It owns a portfolio worth \$198 billion as at 31 March 2012, mainly in Singapore, Asia and growth markets.⁸⁶⁶ However, under Singapore's Constitution and laws, neither the President of Singapore nor the government is involved in its investment, divestment or other business decisions, except in relation to the protection of Temasek's past reserves. It owns and manages its assets with full commercial discretion and flexibility under the guidance of its board of directors, including investment, divestment and business decisions.⁸⁶⁷ Controlling a tremendous amount of state assets while maintaining extremely high independence has been regarded as the key reason for Temasek's success. As a state-owned enterprise, Temasek has been assigned an overall corporate credit rating of 'Aaa' by Moody's and 'AAA' by Standard & Poor's, with a healthy 17% shareholder return annually, much higher than most private sectors.⁸⁶⁸

The experience of Temasek is a perfect model for China. Luo holds a similar viewpoint, although given the huge amount of state assets in total in mainland China, China needs not one Temasek, but perhaps more than ten.⁸⁶⁹ Similar to the attitude outlined earlier, whereby state assets should take different functions in the competitive and non-competitive realms, this

⁸⁶⁶ Temasek, 'Corporate Profile' <<http://www.temasek.com.sg/abouttemasek/corporateprofile>> accessed 28-05-2013.

⁸⁶⁷ Temasek, 'Temasek Review 2012'

<http://www.temasekreview.com.sg/governance/governance_framework.aspx> accessed 28-05-2013.

⁸⁶⁸ Temasek, 'Corporate Profile' (n 866).

⁸⁶⁹ Jiangang Luo, *Weituo Daili: Guoyou Zichan Guanli Tizhi Chuangxin [Trust and Agent: Innovation of State-owned Assets Management System]* (China Financial & Economic Publishing House 2004), 230.

thesis suggests the state assets management companies should be designed differently in accordance with the realm to which they belong, because the two kinds of company would have different corporate targets. The detailed structure will be introduced later in this thesis.

7.2.2 The Rationales for this Design

(1) The Importance of Board of Directors in Corporate Operations

As mentioned above, if the minority shareholders are to fight for their interests against the controller of the company, they should be able to count on the help of a professional and independent board of directors. In the view of this thesis, in a mature legal environment, the board of directors would take minorities' interests fairly into account to achieve the long-term success of the company. In other words, the interests of minority shareholders would be reflected in the decisions made by the board.

Of course, there is still a gap to be bridged between the ideal status and current practice. Boards of directors in Chinese listed companies remain incapable of protecting minorities, in terms both of legal rights and the independence of the boards. As a consequence, this thesis argues that companies in different levels of the 'Three-level Structure Model' should adopt different corporate governance systems with special regard to composition and decision-making power.

Before illustrating these systems in detail, two relevant issues should be reviewed in advance: the legal ground of board-centralisation and the relationship between the government and the board.

(a) The Legal Ground of Board-centralisation

Since the commencement of the new Company Law in 2005, the powers granted to boards of directors over corporate affairs in the non-wholly-state-owned listed companies, or alternatively the listed companies invested in by the state assets management company and various minority investors in the lowest level of the 'Three-level Structure Model', have been clearly stated. Nevertheless, as noted earlier in this thesis, the powers held by boards of directors in Chinese listed companies are relatively weak. This situation is adverse to the aims of improving the independence of the corporate board and balancing the conflicting interests of different groups in order to increase minority protection. This thesis will explain later the extent to which the powers of the Chinese board should be reinforced.

There is regulatory uncertainty about the grant of powers to the board of directors in a wholly state-owned company, which is the usual legal form of the state assets management company in the middle level of the 'Three-level Structure Model'. Without clear legislation, it would be very difficult for the state assets management company to establish a board-centralised governance structure. As a result, it would be impossible to protect corporate operations from unnecessary administrative interventions.

Article 67 of Chinese Company Law 2005 provides that:

A solely state-owned company shall not set up the shareholders' meeting, and the functions of the shareholders' meeting shall be exercised by the state-owned assets supervision and administration institution. The state-owned assets supervision and administration institution may authorize the board of directors of the company to exercise

some of the functions of the shareholders' meeting and decide on important matters of the company, excluding those that must be decided by the state-owned assets supervision and administration such as merger, split-up, dissolution of the company, increase or decrease of registered capital as well as the issuance of corporate bonds. The merger, split-up, dissolution or application for bankruptcy of an important solely state-owned company shall be subject to the examination of the state-owned assets supervision and administration institution, and then be reported to the people's government at the same level for approval.⁸⁷⁰

As shown, the policy makers used 'may' when providing for the grant of some shareholder rights to corporate directors by the state-owned assets supervision and administration institution, rather than 'shall', as in the former Company Law 1993. On the face of it, the provision expressed in the new law mirrors the original idea that, as the representative owner of state assets, the state-owned assets supervision and administration institution should, in general, exercise its right alone, cutting short the agency chain so as to decrease agency costs.⁸⁷¹ However, in fact, the provision quoted above embodies created uncertainty as to the circumstances in which and as to the extent to which the corporate board would be authorized rights to make decisions on important corporate affairs. The state-owned assets supervision and administration institution has large discretion, which, in the view of this thesis, represents an obstacle to the separation of governmental functions from corporate management.

⁸⁷⁰ Company Law of the People's Republic of China (Revised in 2005), Article 67.

⁸⁷¹ Haijun Liu, *Xiandai Gongsi Fa [Modern Company Law]* (Law Press China 2008), 722.

After 15 years' debate, the Law of the People's Republic of China on the State-Owned Assets of Enterprises was finally promulgated in 2008, and for the first time the decision power of boards of directors in wholly state-owned companies was clarified. With the exception of merger, split, increase or reduction of registered capital, issuance of bonds, distribution of profits, dissolution and petition for bankruptcy of a wholly state-owned enterprise or a wholly state-owned company, which should be decided by a representative institution of the capital providers, other corporate decisions fall to the board of directors.⁸⁷²

As understood by this thesis, the new regulation implies a legislative trend towards board-centralisation in Chinese corporate governance, which this thesis holds to be a positive development. In other words, except for those specific requirements in law, administrative regulations or company constitution, it is possible that the board of directors will be granted more powerful rights over corporate operations in the near future.

Nevertheless, the problem of uncertainty regarding directors' power has not been resolved entirely. This is because, first of all, the Law of the People's Republic of China on the State-Owned Assets of Enterprises, and the Company Law 2005, are formally equal in status. Hence the enforcement of the former would not influence the validity of the latter. A new revision of the Company Law is needed to clarify the decision-making powers of the board in wholly state-owned companies.

The second reason is that, to date, the articles of association of wholly state-owned companies and any amendments to them are formulated by the SASAC; or formulated by the board of directors and approved by the

⁸⁷² Law of the People's Republic of China on the State-Owned Assets of Enterprises, Article 31 and 32.

SASAC. Hence, the government still holds the final say on the substance of corporate constitutions. Such decisive power enables the government to retain corporate control over and above the board of directors by formulating or amending the company's constitution, explicitly declaring the limited scale of corporate affairs which may be decided in the boardroom.

Yet, it seems irrational to deprive the autonomy of corporate owners on such issues by setting up or amending a company's constitution. If this were done, the legislation would be inflexible and would impede the maximisation of shareholders' interests. Consequently, this thesis suggests that the government launch some pilot schemes, as it has done with many other reforms in China,⁸⁷³ leaving a wider scale of corporate affairs for the board to decide. Such an approach would provide the opportunity for corporate boards to gain experience of balancing political concerns with business targets, and allow the government to test to what extent it could separate administrative functions from daily corporate management.

(b) Independence of the Board of Directors

Lack of board independence is not unique to China, but is a tough issue of corporate governance around the world. However, it is undeniable that the problem is more troublesome where state-owned assets are involved. The effectiveness and the responsibility of the board of directors would be influenced frequently by both government and management. On the one side, the board of directors would be forced to take into account political issues as required by the government, for example, assisting the government to carry out certain tasks of public management. On the other

⁸⁷³ The experience of the successful split share structure reform can be learnt from here.

side, the board may face difficulty in controlling and monitoring executives. Having a close relationship with policy makers, the executives in state-owned or state-controlled companies tend to report directly to the relevant administrator or to the government, rather than seek instruction by the board.

Therefore, in order to guarantee the independence of the board, it is vitally important to reset properly the relationships between government and corporate boards in different levels of the new arrangement, the 'Three-level Structure Model'. This thesis argues that owing to the direct link between the government and the state assets management company, the board in this kind of company should be relatively independent from the government, but at the same time, it should be supervised by the government. The involvement of government in this kind of company, as the representative of the owners of state assets, is inevitable and necessary.⁸⁷⁴

However, the listed companies on the lowest level of the 'Three-level Structure Model', those invested in by the state assets management company and by very many minority investors, present a different case. This thesis believes that the less the government intervenes in listed companies, the better the performance of those companies will be. Keeping this kind of company as an independent market participant would help to promote a healthy and fair market environment. Hence, government supervision of the board of directors should be limited to companies in the middle level of the new model, while the boards of listed companies on the lowest level should be monitored only by shareholders, even though the dominant part of corporate shares are finally held by the

⁸⁷⁴ The participation of the government is similar to the involvement of shareholders in corporate operations in normal business companies, monitoring the activities of the directors to reduce agency costs.

companies in the middle level, which partly represents the will of the government.

With regard specifically to administrative interventions, currently most come from SASAC. Some are rooted in authorisation by law or administrative regulations, while others stem from self-authorisation by SASAC itself. Since the establishment of this ministerial-level department, SASAC has been required to act as the representative of owners of state-owned assets, as well as the administrator of companies with state-owned assets.⁸⁷⁵ This dual role has the potential to cause serious problems, and challenges the fairness of the market. Accordingly, this thesis urges the government to separate the two roles played by SASAC in the next reform.

It has been argued that SASAC itself is an incompetent representative of such a tremendous amount of state-owned assets. As mentioned in a policy analysis report by the World Bank Group in 2002, SASAC staff should possess abundant business experience and have the ability to evaluate comprehensive corporate affairs, such as marketing, manufacture, corporate finance and other business strategies.⁸⁷⁶ However, under the current system of bureaucracy, most staffs in SASAC are the officials of administrative departments or Communist Party cadres, lacking the necessary capabilities to operate state-owned assets. As stated by a senior leader of SASAC, the personnel 'are more likely to have no idea how to perform as a representative of the owners of state-owned assets'.⁸⁷⁷

⁸⁷⁵ Shuguang Li, 'GuoZi Fa Dingwei Benzhi Shi Zhengfu Dingwei [Determination of the Nature of the Law of the People's Republic of China on the State-Owned Assets of Enterprises is to Determine the Function of Government]' *21st Century Business Herald* (27-06-2008).

⁸⁷⁶ The WBG, 'The Policy Analysis Report: International Experience for China's Reform of SOEs' <<http://wenku.baidu.com/view/fa6fe690daef5ef7ba0d3c9a.html>> accessed 23-12-2002.

⁸⁷⁷ Shengke Wang, 'Guoziwei Zai Dingwei [Re-positioning of the State-owned Assets Supervision and Administration Committee]' *21st Century Business Herald* (06-01-2005).

As a result, considering the complexity and difficulty of being a competent representative, an earlier chapter of this thesis has suggested that such responsibilities should be fulfilled by several governmental departments collectively. Any single entity, whether SASAC or the Ministry of Finance, would feel helpless when faced with the mission to govern the corporate operation and personnel of approximately 150 central government-controlled enterprises with more than RMB 30 trillion gross assets. Therefore, it could be more rational for the central government, rather than any one department of it, to exercise the duties of a representative of owners of the state-owned assets. Under the direction of the central government as a whole, relevant departments could fulfil certain functions according to their administrative powers. For example, the budget could be decided by the National People's Congress; capital allocation could be left to the Ministry of Finance; and SASAC could act simply as a monitor of state-owned assets. In this way, checks and balance could be realised.

It has been argued by Gu that the supervision of state-owned assets may be achieved better if SASAC could be defined solely as a monitor, rather than as both monitor and regulator.⁸⁷⁸ The supervisory work should include but not be limited to: (i) Investigating and evaluating the implementation of relevant laws, administrative regulations and departmental rules relating to the board of directors of state assets management companies; (ii) Monitoring the operation of the board and establishing the assessment system to evaluate the board as a whole as well as the directors individually; (iii) Monitoring the investment plans or arrangements provided by the state assets management company. In the competitive area, SASAC should not involve itself in the decision making

⁸⁷⁸ Gongyun Gu, 'Guoyou Zichan Lifa Zongzhi Ji Jiben Zhidu Xuanze [The Principles and Basic System of Legislations in Relating to State-owned Assets]' (2008) 6 Legal Science Monthly 67, 72.

on investment plans. Rather, to realise the government's right to know, the state assets management company should send its annual investment plan to SASAC for record. However, in the non-competitive area, because the capital would usually have a fixed investment target, SASAC could reject the investment plan if that fixed investment target had been changed; and (iv) Investigating self-dealing by the state assets management company, so protecting the state assets from abuse or illegal manipulation.

(2) The Importance of the Insulation Layer in the 'Three-level Structure Model'

As has been noted, in addition to improving legislation, in order to achieve a better quality of corporate governance in China it is also necessary to reduce the control and intervention of the government. According to Li, emphasis should be placed not only on the shareholding structure, but also on the government's administrative management of listed companies, because this is too common in the Chinese market.⁸⁷⁹ In China, administrative management refers to administrative involvement in the corporate business plan, appointment and dismissal of senior executives and resource allocation in corporate operations,⁸⁸⁰ while economic management is defined as a profit-based governance model that removes other unnecessary public governance targets.⁸⁸¹ In accordance with economic management, personnel affairs should be removed from administrative management by adopting a competitive mechanism, and resource allocation should be subject to market discipline.

⁸⁷⁹ Wei-an Li and Guoping Zhang, 'Jingli Ceng Zhili Pingjia Zhishu Yu Xiangguan Jixiao de Shiji Yanjiu: Jiyu Zhongguo Shangshi Gongsi Zhili Pingjia de Yanjiu [Research on the Top Management Governance Evaluation Index and Empirical Study on Relationship between the Index and Governance Performance: Based on Corporate Governance Evaluation of Public Listed Companies in China]' (2005) 11 *Economic Research Journal* 87, 87.

⁸⁸⁰ Wei-an Li, 'Yanjing Zhong de Zhongguo Gongsi Zhili: Cong Xingzheng Zhili Dao Jingji Zhili [Chinese Corporate Governance in Gradual Progress: from Administrative Management to Economic Management]' (2009) 12 *Nankai Business Review* 1, 1.

⁸⁸¹ *Ibid.*

Currently, government control over the listed companies in China is normally carried out through the following ways: (i) Soft budget constraint.⁸⁸² An excess of government intervention is one of the most important reasons for soft budget constraints in corporate operations, which negatively affects the governance quality of Chinese listed companies; (ii) Personnel affairs. Exercising the decision-making power of appointment and dismissal of key personnel is one of the most common ways for the state to control listed companies, even though such control has been criticized as one of the main reasons for low efficiency in corporate operations. Sometimes, such influence could be indirect; (iii) Executive remuneration; and (iv) Support in capital raising, whereby the policy maker provides political arrangements and rules in favour of state-owned or state-controlled companies with regard to raising capital in the market. In research focusing on the different decisions made by state-owned banks in response to applications by different types of listed companies for long-term loans, Li and Jiang find that the state-owned and state-controlled listed companies could acquire long-term loans much more easily than could private firms.⁸⁸³ To overcome those disadvantages, more and more private listed companies are seeking political connections to the government. In the view of this thesis, such a trend would amplify the current defects, rather than achieve a fair and sustainable market.

As mentioned, with the aim of separating government functions from corporate management, the state assets management company is the core of the ideal model presented here. Established by the government,⁸⁸⁴

⁸⁸² The term 'soft budget constraint', originally formulated by Kornai to illuminate economic behaviour in socialist economies marked by shortages, is now regularly invoked in the literature on economic transition from socialism to capitalism. For more detail, see, J Kornai, *Economics of Shortage* (North-Holland 1979).

⁸⁸³ Bin Li and Wei Jiang, 'Zhidu Huanjing, Guoyou Chanquan Yu Yinhang Chabie Daikuan [Institutional Environment, State Ownership and Bank Lending Discrimination]' (2006) 12 *Journal of Financial Research* 30, 30.

⁸⁸⁴ Here 'government' includes both central government and all provincial-level governments.

the state assets management company is a wholly state-owned legal entity, authorised with the right to operate state assets. The investment strategies it makes should aim to maintain the value of state assets. It acts as an insulation layer, cutting off direct connection between the policy sector and the business sector. Without significant administrative intervention, the listed company could concentrate entirely on capital management and thus operate the business more efficiently. In line with the suggestion by Cheng, such state assets management companies could still satisfy the unique ownership by all the people in this country.⁸⁸⁵ In the matter of law, the government is the representative of the capital providers of the state assets management company, all the citizens in mainland China, exercising rights as a shareholder. Such rights mainly refer to the decision-making powers over the appointment and/or dismissal of directors, mergers and acquisitions, company dissolution and other important corporate affairs.⁸⁸⁶

From the point of view of legal personality, the state assets management company should be a participant in a fair market in the same way as other ordinary companies, since its business activities are no different from the capital investment operated by other counterparts. As to the governance structure, it is suggested that the state assets management company should make reference to other ordinary market participants. Most mechanisms of modern corporate governance, for example, performance-based remuneration packages and balanced internal monitoring systems, should be introduced into the new model, excepting only those relating to some specific issues on which the government should have a say, such as personnel affairs and decision-making powers regarding important events.

⁸⁸⁵ In Chen's research, she argued that, to resolve the problems of state-owned or state-controlled companies listed on the Chinese market, clear definition of ownership by the people as a whole is of great importance. See, Hehong Chen, Zhihui Liu and Hongliang Wang, *Guoyou Guquan Yanjiu [Research on State-owned Shares]* (China University of Political Science and Law Press 2000), 265.

⁸⁸⁶ Company Law of the People's Republic of China (Revised in 2005), Article 38.

However, the number of representatives of the government in such a company should be strictly limited by law. In that way, the state assets management company in the new model would be able to avoid unnecessary administrative interventions.

As an independent legal entity with a modern corporate governance structure, the state assets management company has to make its own decisions, assume sole responsibility for its profits or losses and take on relevant legal obligations. This thesis would like to highlight that business risks are inevitable for all companies in the market, including state assets management companies. Accordingly, the previous principle of managing state assets to maintain and increase the value of state-owned assets should be abandoned. In other words, to maintain or increase the value of state assets could become a corporate target, rather than a political instruction which leaves a door for the government to enter to intervene. Otherwise, the separation of governmental function from enterprise management will never be achieved.

In short, the state assets management company in the ideal model possesses two main characteristics: (i) it inevitably has direct connection to the government; and (ii) it is independent from the government. In order to achieve successful economic reform, the government must relinquish undue control and assist the state assets management companies to achieve independence.

Under the three-level structure, the listed companies in the various industries in the lowest level of the new model have functions different from those of the state assets management company, although they are all, to some extent, ultimately controlled by the state. The corporate

governance regime for those listed companies will be more similar to that of private sector companies. The relationship between the state assets management company and those listed companies is based on capital investment, rather than political instruction. In other words, it should be regulated not by political documents, but by the Company Law. The shares of listed companies, held by the state assets management company, should be managed under market rules. Administrative approval by the SASAC will not be necessary for such operations, except for some special companies.⁸⁸⁷

To achieve the full separation of governmental function from enterprise management, this thesis suggests that the state assets management company should be encouraged to disperse its capital to various listed companies, as a majority shareholder, or even a minority one. The ability of the state assets management company to set up another wholly state-owned company should be limited by law. This is because, as a shareholder, the state assets management company can only legally exert its influence over listed companies through the board of directors, which is normally nominated by the controlling shareholder, who also has the decisive vote. Consequently, direct interventions in corporate affairs may be avoided to the maximum extent.

7.2.3 The Ideal Design of Board of Directors of State Assets Management Company

As illustrated by this thesis, the board of directors will be the core institution of the ideal model to improve the quality of Chinese corporate governance, especially those listed companies owned or controlled by the

⁸⁸⁷ Xiangsong Ye, *Property Rights and the Managerial Structure of State-owned Enterprises* (Economy & Management Publishing House 2000), 139.

state. Therefore, this section focuses on the structure of the board of directors. The specific institutions designed for minority protection reviewed in the earlier chapters of this thesis should, undoubtedly, be incorporated into this ideal model. More detailed suggestions for those institutions will be put forward in the concluding chapter. In order to facilitate the better performance of the board, its structure should be reformed by law, moving from an administration-based structure to one that is market-oriented.

With regard to the structural re-design, this thesis insists that companies in different levels and different areas of the ideal model should be considered differently. Generally speaking, companies in the competitive area should be encouraged to participate in market competition in the same way as normal private business sectors, so that the structural reform of the board of directors should focus on the de-politicisation; while state control and market-oriented operations should co-exist in the companies in the non-competitive area. This is because public management functions make up the main performance targets in those companies in the non-competitive area. Therefore, the thorough separation of governmental function from enterprise management is unnecessary and irrational.

The proposed governance mechanisms of state assets management companies, in both the competitive and non-competitive areas, as well as the listed companies in the lowest level of the three-level model, again in both the competitive and non-competitive areas, are now discussed detail.

(1) Non-competitive Area

- *The Structure of Boards of Directors of State Assets Management Companies in the Non-competitive Area*

Capital management in the non-competitive area has multiple goals, concerned both with maximising social benefit and with the maintenance or increase in the value of state assets. As a consequence, the design for boards of directors of such companies cannot be wholly according to the usual market-oriented practice. Moreover, relying merely on commercial laws, such as Company Law or Securities Law, is not sufficient to run such companies well, since the legislation focuses on the ‘microeconomic’ field, regulating the individual rights and obligations. However, the state assets management companies in the non-competitive area could be regarded as instruments for the state to get involved in social economic activities. Authorisation to exercise some part of public governance makes it inevitable that administrative interests must be taken into account. Hence, the new board structure should be designed to balance public interests and commercial needs, as shown in Figure 5.

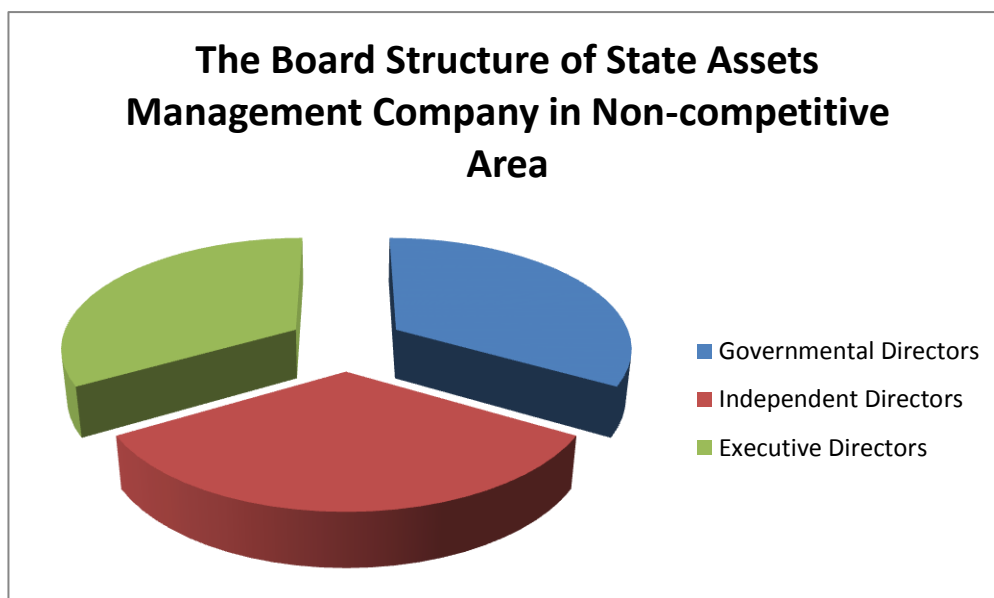


Figure 5: The proposed new board structure in state assets management company in non-competitive area

Due to the special legal personality of the state assets management

company as a wholly state-owned company, all the members of the board are selected by the government. However, this does not mean the government can wield absolute control over the board. Independence is still the first priority. Only an independent and professional board can improve the governance quality of Chinese listed companies.

To illustrate, this thesis suggests the board of such companies in the middle level of the three-level model should be composed of the following three kinds of members.

First, governmental directors are necessary, but should make up no more than one third of all members. The governmental directors are representatives of the capital provider, the government. Therefore, those directors are essentially civil servants, but are appointed to sit on the board of state assets management companies. In order to guarantee the independence of such directors from the executives, governmental directors will be paid not by the company, but directly by the government, as would any normal civil servant.

The rationale to have such governmental representatives on the board is to ensure that the public interest is reflected in the board's decision making. It provides a proper method for the government to participate in corporate management. However, it should be kept in mind that appropriate participation is not equal to a mixture of governmental function and enterprise management. Governmental directors may expound the government's political concerns in the board room. However, in common with the other directors, they have only one vote per person in meetings. Therefore, since they account for no more than 1/3rd of the total board members, the governmental directors would not be able to control voting

outcomes. In other words, having these governmental representatives on the board is setting up a new path for the government to convey its political concerns to the board room, rather than direct administrative intervention. The limitation of no more than 1/3rd of all board members keeps the balance of the board and helps to achieve the board's independence from the government.

Secondly, independent directors are the professional consultants on the board, and key monitors of corporate insiders. Similar to normal corporate practice, independent directors are those board members who have no direct or indirect connection with the company that would negatively affect their independent judgment on corporate affairs. More importantly, according to the All-right Model proposed by this thesis,⁸⁸⁸ independent directors are probably one of the best guarantees of minority protection. This is because only independent directors, selected from the market for professional managers on the basis of their former performance and business experience, could objectively balance all the relevant interests in decision making, including the interests of minority shareholders. However, given the problems such as lack of working time and insufficient access to company information, this thesis suggests that the number of independent directors should total not more than 1/3rd of the board.

Thirdly, executive directors remain important in Chinese listed companies. As mentioned before, the key issue of corporate governance in China is different from that in the Anglo-American world, where the power of executives results in serious agency problems, infringing all shareholders' interests. Executives in Chinese listed companies are not that powerful in general. On the contrary, this thesis argues that executives, in most cases

⁸⁸⁸ For more detail, see Part 3.4.1 of this thesis, page 156.

the top-level managers of the company, can help the board to fulfil its functions much better. This is partly because, equipped with professional knowledge and skills, full-time working hours and explicit legal powers and duties, the executives have unrivalled detailed knowledge of the business, and possess more important corporate information than anyone else on the board. They can help the governmental directors and independent directors to make better decisions.⁸⁸⁹ Furthermore, including executives on the board could improve the quality of decision implementation. By participating in the decision-making process, executives could reach a better understanding of corporate strategies and, accordingly, exercise their functions in the most appropriate way, in line with decisions made in the boardroom.

Nevertheless, it should be kept in mind that one of the functions of the board is to monitor and evaluate corporate management. In order to maintain the necessary independence from management, it is important to limit the number of executives on the board. Therefore, while strongly backing the rationale to include executives, this thesis suggests that the number of executive directors should be limited by law. No more than 1/3rd may be a proper choice.

As to the employee directors provided for in the current Company Law,⁸⁹⁰ this thesis questions their necessity. The reasons for including employee directors on the board may be based on several concerns. First of all, the intention might be to reflect the Constitution of the PRC, which states: 'The basis of the socialist economic system of the People's Republic of China is

⁸⁸⁹ As discussed in former chapters, corporate leaders in Chinese listed companies, especially the directors, are still far from being well experienced in general. Many are academics or governmental officials, and lack experience in corporate affairs. More details see Part 3.3.5 of this thesis, page 143. Cooperating with management is therefore a good way to fulfil their duties. Only when those governmental directors or independent directors were capable of making corporate decisions professionally and independently, would system permit a reduced number of executives on the board.

⁸⁹⁰ The Companies Act 2006, Section 45.

socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people.⁸⁹¹ Alternatively, the aim might be to achieve special protection of employees.⁸⁹²

However, this thesis questions whether these employee directors, who normally come from the front line or junior management, could be fully qualified as directors to determine corporate strategies. Partially pursuing the interests of employees may impede the company's success in the long run. This thesis would further argue that a professional and independent board of directors would be able to take employees' interests fairly into account, because it is the board's responsibility to protect the interests of all stakeholders, including employees.

In short, this thesis proposes a three-pronged structure for board reform in state assets management companies in the non-competitive area. The fundamental principle of such a system is to balance different interests in the boardroom. Governmental directors stand up for the purpose of public management, independent directors contribute their professional knowledge and experience to the board to reach more efficient decisions, while executive directors resolve the problem of information asymmetry. The interests of all groups could be bargained, and eventually balanced, at the board meetings. As such, corporate decisions could be made that ensured the success of the company.

● *The Powers of Boards of Directors in State Assets Management*

⁸⁹¹ Constitution of the People's Republic of China, Article 6.

⁸⁹² More literatures relating to the employee director, see Jeremy Lewis and Andrew Edge, 'Fiduciary Duties of Employee Directors' (2004) 10 Tolley's Employment Law-Line 32; Martin Edwards, 'Company Directors as Employees' (1986) 7 Company Lawyer 204-206; Dirk Otto, 'German Co-determination Culture under Attack' (2005) 45 European Lawyer 15; and Christine Windbichler, 'Cheers and Boos for Employee Involvement: Co-determination as Corporate Governance Conundrum' (2005) 6 European Business Organization Law Review 507-537.

Companies in the Non-competitive Area

Generally speaking, the powers authorised to the board in state assets management companies in the new model are almost the same in both the non-competitive and competitive areas. The starting point for such a design is to reinforce the independence of state assets management companies by constraining the decision powers held by government over corporate affairs.

The only difference in the system is that the government would be granted certain controlling powers in relation to the operation of state assets management companies in the non-competitive area. As argued by Hu et al., the products provided by state-owned companies in the non-competitive area could be distinguished from those provided by private counterparts by their public character. Sometimes the government defines the products or services offered by such state-owned companies as an extended part of public management. With the purposes of safeguarding the social interest and coordinating various resources, the government should be allowed more involvement in determining corporate structure and important personnel affairs in those companies, compared with other listed companies.⁸⁹³

This thesis cannot agree with Hu et al.'s suggestion that the government be allowed rights in personnel decisions. However, it does argue that, in addition to alterations to the corporate constitution, changes in registered capital, corporate separations, mergers and dissolutions, as well as liquidations, the government should be granted a final say on the following issues: (i) Alteration to the company's main business. Owing to the particular purpose of establishing such a company, to provide products

⁸⁹³ Haitao Hu, *Guoyou Zichan Guanli Falv Shixian Jizhi Ruogan Lilun Wenti Yanjiu [Theoretical Research on Legal System of Management of State-owned Assets]* (Zhongguo Jiancha Chubanshe [Chinese Procuratorate Press] 2006), 275.

and services in the best interests of social welfare, the main business of such a company should not be easily changed by the company itself; (ii) Limitation of investment strategies, plans and directions. As mentioned, such a company shares some public functions with the government. Therefore, the corporate strategies and business plans should keep pace with public policies. To ensure this, government should be granted certain power over corporate strategies and planning; (iii) Pricing and rate setting.⁸⁹⁴ Products and services provided by companies in the non-competitive area could be regarded as a part of social welfare, where the core target is the maximisation of the public interest. Hence, the government should have a decisive influence on price setting; and (iv) Issues of corporate transformation and assets transfer.

Apart from the specific circumstances listed above, this thesis opposes any other intervention by the government over corporate affairs. All other decision-making powers should be granted to the board of directors so as to improve corporate independence and governance quality. Of course, the government could monitor and evaluate the performance of the board as a shareholder.

(2) Competitive Area

● *The Structure of Boards of Directors of State Assets Management Companies in the Competitive Area*

As is the case with private sector companies, state-owned capital in the competitive area should be operated with the purpose of maximising returns. Accordingly, the board of directors in such companies ought to comprise more professional managers who have adequate knowledge, skills and experience. Only when operated by such a board could a state

⁸⁹⁴ Ibid 276.

assets management company in the competitive area achieve high efficiency and make timely and proper in a rapidly changing market.

In the three-level model provided by this thesis, the structural design of the state assets management company is extremely important, since it directly connects to the government on the one hand, and should remain independent from the government on the other. When re-structuring the board in such a company in the competitive area, this thesis recommends that the rights held by the government as shareholder should be narrowed by law, in order to avoid excessive administrative involvement. Instead, more business affairs should be decided by the board of directors, according to their independent business judgments.

As to the composition of the board, this thesis suggests a similar three-pronged structure as that introduced above for the companies in the non-competitive area, including governmental directors, independent directors and executive directors, but with different proportions of each, as shown in Figure 6.

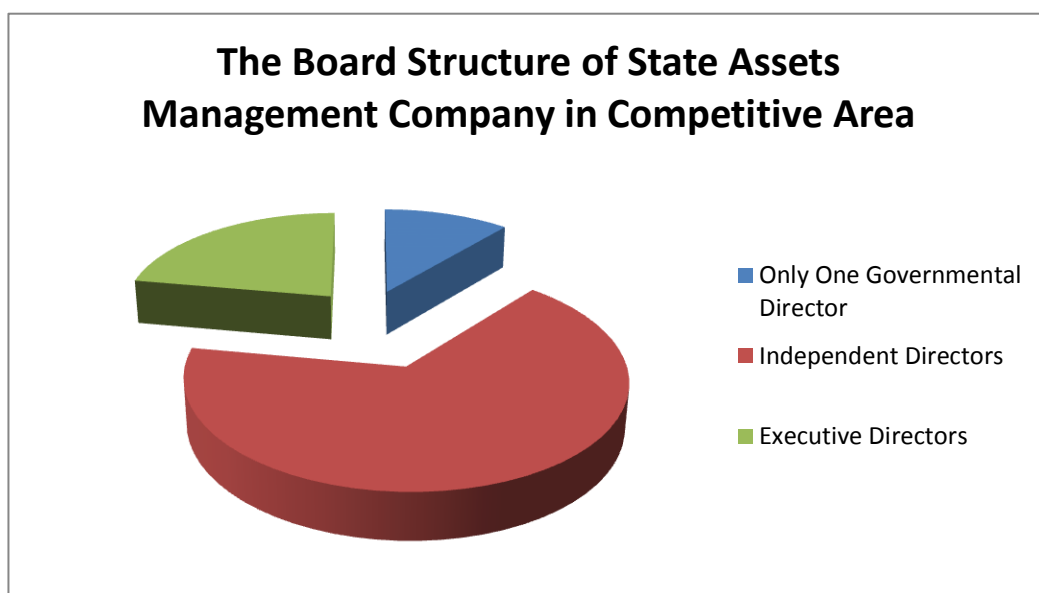


Figure 6: The new board structure in state assets management company in competitive area

First, it is rational to have governmental directors sitting on the board in state assets management companies in the competitive area. Governmental directors, as the guarantors of state interests, could report information from the boardroom to the government. It is true that SASAC has already implemented an external supervisor mechanism to oversee the board performance, and the National Audit Office has made board efficiency of state-owned enterprises a concern of the national economic audit. However, those mechanisms can only provide ex post monitoring and external supervision. By contrast, having governmental directors on the board could help the government to discover wrongdoing in the decision-making process and to take action before damage occurs.

Of course, corporate independence is the key principle of this restructuring. Therefore, the number of governmental directors should be strictly limited. This thesis suggests that one governmental director will be enough to keep the government updated with corporate information. In a 'one head one vote' voting system, the existence of one governmental director could hardly have a substantial impact against the independent decisions of the board.

Secondly, the board should include independent directors. As noted, it is extremely important for such companies in the competitive area to keep board independence and ensure the capabilities of board members. As a result, decisions made by the board will be professional, and guaranteed to be in the company's best interests. Furthermore, only without the control of government or the executives could the board fully achieve its role as

internal monitor over corporate management. Therefore, in accordance with the All-right Model suggested by this thesis, the independent directors should occupy the majority of seats in the boardroom.

Thirdly, with a special concern about information asymmetry, it is still rational to have executive directors, to help a professional and independent board to make timely and proper decisions with the best current information. However, to avoid the interlocking of board members and executives, the number of executives on the board should be restricted by law. China can learn from the business practice of other countries, where the number of executive directors on the board is relatively few. In Temasek, only the CEO plays a dual role of board member and executive.⁸⁹⁵ Accordingly, this thesis suggests that only one or two executives sit on the board.

In short, independent directors should dominate the board in state assets management companies in the competitive area.

- *The Powers of the Board in State Assets Management Companies in the Competitive Area*

To what extent the board should be granted power over corporate affairs is another key issue of board-centralisation. In theory, such decision power should not be improperly challenged by shareholders. In other words, despite the fact that it is prohibited by laws or corporate constitution from exercising certain rights, the board could freely decide operative activities in accordance with its independent judgment, in order to maximise corporate interests.

⁸⁹⁵ Temasek, 'Temasek Review 2007' <<http://www.temasekholdings.com.sg>> accessed 15-07-2013.

The restrictive separation of governmental functions from enterprise management is the basis of sound operation by state-owned companies in the competitive area. Temasek is a good example from which China could learn. Here this thesis wishes to highlight not the source of capital invested in the company, but the operation under a market-oriented rule which has led to the success of this wholly state-owned company in Singapore. More specifically, the board of directors has been granted a wide set of decision-making powers over various corporate affairs to satisfy the needs of a rapidly changing market.

Therefore, in the context of Chinese legislative reform, this thesis concludes that three aspects could be improved in order to reinforce board powers while also avoiding insider control. First, the rights of the representative of capital providers, exercised by the government, should be tightly limited by law. That is, new legislation should explicitly formulate the definition and range of important affairs in which the government should be involved. Such important affairs refer to certain fundamental issues, including but not limited to: (i) formulation and amendment of the articles of association of the company; (ii) increase or decrease of the registered capital; (iii) separation or merger of the company; and (iv) dissolution and insolvency. Other corporate affairs, including strategy making and business plans, should be discussed and decided in the boardroom, with decision powers explicitly authorized to the board of directors. Secondly, the new legislation should strictly prohibit any enlarging of government power over corporate operation by amending the corporate constitution. Otherwise, the board independence would still be threatened by the state. Thirdly, the government, as the market regulator, should be forbidden to intervene, veto or correct the decisions made by the board via legal procedure, unless such decisions violate the laws,

administrative regulations or the articles of association of the company.

In order to monitor the board so as to prevent the agency cost problem, this thesis proposes action in the following three areas: (i) The evaluation method of board performance should be improved; (ii) Access to information should be guaranteed; and (iii) Statutory duties of directors and remedies should be well designed and strictly interpreted.⁸⁹⁶ As a consequence, the government would be able to ensure that board members were performing at their best to operate the company; otherwise, it could simply dismiss the board member or search for legal remedies.

7.2.4 The Ideal Design of Board of Directors of Listed Companies Invested in by the State Assets Management Company

(1) Competitive Area

First of all, it should be kept in mind that the existence of state-controlled or state-invested listed companies in the competitive area is a by-product of the gradual reform of the Chinese market. The final objective should be that the state quit the market in competitive areas. As such, listed companies invested in by state assets management companies should have no difference from other listed companies, being operated by a professional and independent board with a majority of independent directors. In accordance with the All-right Model, governmental directors should not sit on the boards of such companies, as shown in Figure 7.

⁸⁹⁶ This is the viewpoint concluded by this thesis in Chapter Three, page 184.

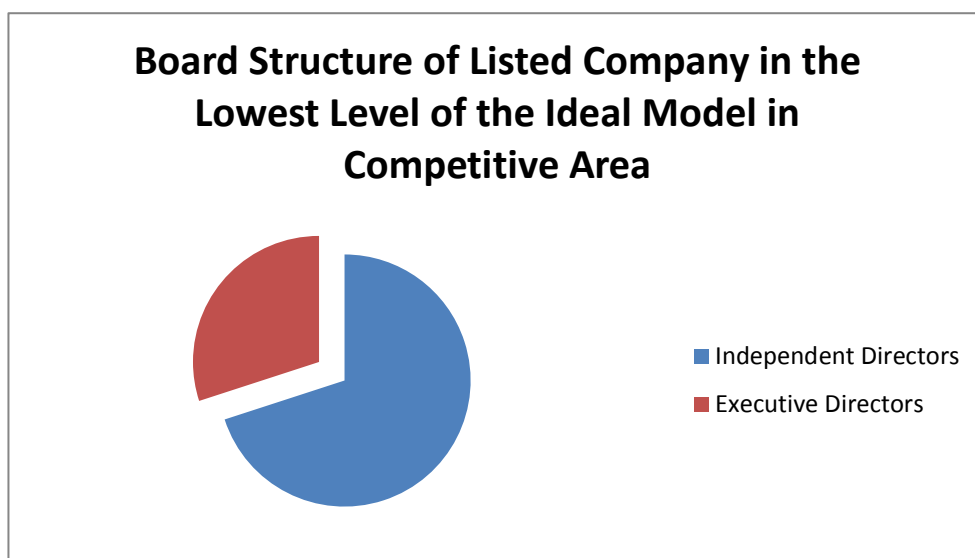


Figure 7: Board Structure of Listed Company Invested in by State Assets Management Company in the Competitive Area

The goal of corporate operations is to achieve the success of the company, maximizing the interests of shareholders as a whole. In particular, independent directors should place special emphasis on the issue of minority protection. Only with a sound level of minority protection could the confidence of public investors be revived. If this were achieved, listed companies with state assets could attract more private capital, diluting the shareholding of the state and helping the state to achieve its ultimate aim.

In common with other private listed companies, the board of a listed company invested in by a state assets management company is authorized under company law to exercise corporate operations. However, according to current company law, the board of directors have little substantial influence over corporate affairs other than in designing the internal management structure, appointing managers, determining remuneration of managers and implementing the decisions made by the shareholders' meeting. More fundamental decision powers remain with

shareholders; for example, in strategy making and disposal of corporate assets. Indeed, this situation did conform to the political need during the gradual reform of the Chinese market. Nevertheless, there remains a large gap compared to the legislative model under the board-centralisation concept that has been argued for above.

According to Hamilton, to ensure the dominance of corporate affairs by the board of directors, powers exercised by shareholders should be narrowed to four aspects:⁸⁹⁷ (1) appointing and dismissing board members; (2) ratifying corporate transactions when necessary; (3) formulating and amending the corporate constitution; and (4) determining important events which are outside the range of daily operations, such as corporate mergers, compulsory share exchanges or disposal of all corporate assets. In terms of how to balance the interests of all stakeholders, including the majority shareholder, minority shareholders, creditors and employees, this thesis believes it could be better to leave this issue to a professional and independent board.

In accordance with the board-centralisation concept, Xu lists the following powers that should normally be granted to the board of directors in an ideal model:⁸⁹⁸ (1) monitoring business operations and evaluating management performance; (2) investigating and approving when necessary financial goals, important business plans and activities; (3) investigating and approving when necessary important changes of audit or accounting methods in corporate financial reporting; (4) implementing other duties conferred by law or by the corporate constitution; (5) making corporate strategies; (6) providing consultation to top-level management; and (7) providing advice to shareholders.

⁸⁹⁷ Robert W Hamilton (ed), *The Law of Corporations* (West Publishing Company 1986), 155-161.

⁸⁹⁸ Chuanxi Xu (ed), *Gongsi Zhili Yuanze: Fenxi yu Jianyi* [*Principles of Corporate Governance: Analysis and Recommendations*](Restatements of the Law, Law Press China 2006), 101.

(2) Non-competitive Area

Due to the special characteristics of listed companies in the non-competitive area, the state assets management company, as the shareholder, would usually possess a dominant proportion of corporate shares to guarantee the political interests behind the business. Therefore, another three-pronged board structure would be introduced, this time with no governmental director.

It should be reiterated that the listed company in the lowest level of the three-level model has no direct power relationship or investment relationship with the government. Instead, it is wholly or partly invested in by the state assets management company, which is in the middle level of this new model. Hence, the representatives of shareholders should replace governmental directors on the board. Such representatives could be elected by shareholders at the shareholders' meeting. Accordingly, this thesis suggests the introduction of a three-pronged board, with equal proportions of shareholder representatives, independent directors and executive directors, as shown in Figure 8.

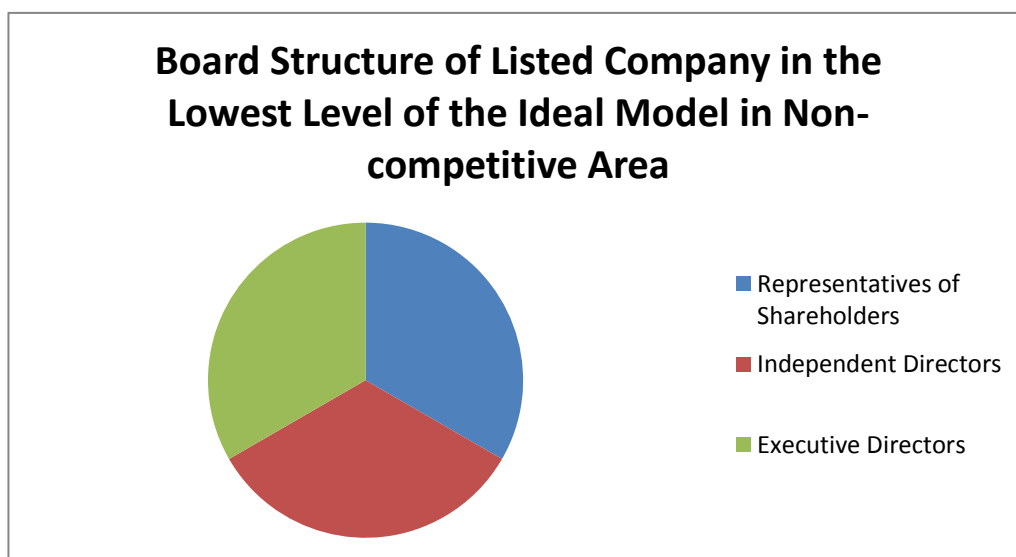


Figure 8: Board Structure of Listed Company Invested in by State Assets

Management Company in Non-competitive Area

Although listed companies in the non-competitive area should also be encouraged to operate independently under market rules, they could not enjoy the same freedom as their counterparts in the competitive area, because the products or services they provide impact upon social welfare. Therefore, in order to prevent short-term actions by the board, some business decisions should be left to shareholders to consider, rather than be voted on in the boardroom. These should be explicitly listed by new legislation, but could include, for example: (1) changes of investment strategy or investment plans; and (2) changes of business operations, such as price setting, branch establishment, types of operation, and service hours.

Conclusions

Over the past two decades, the Chinese national economy has developed dramatically. Due to globalisation, the business environment in China is becoming more and more like that in the western developed countries, for example, the UK and the US. However, based on different political concerns and cultural background, Chinese corporate governance has its own key issue, the fact that most of the listed companies in the Chinese market, with a relatively concentrated shareholding structure, are controlled by the state, directly or indirectly. This is the main obstacle to improving minority investor protection.

The aim of this thesis is to uncover the deficiencies of current legislation and provide suggestions for further legal reform that would enhance minority investor protection. To that end, using a comparative methodology, this thesis has investigated comprehensively the specific governance mechanisms that are or would be beneficial for minority protection.

In addition to the ideal model illustrated in the previous chapter, what follows comprises a set of suggestions concluded from each chapter, to support that ideal model.

(1) Invoke Institutional Shareholder Activism

Corporate scandals in Anglo-American countries have driven a rise in shareholder activism, whereby shareholders seek to get more involved in corporate management, in order to safeguard their own interests. In terms of motivation and capability, this thesis has argued that institutional

investors would be the proper catalysts of such activism, rather than individual minority shareholders.

Among all kinds of institutional shareholders, the thesis found that the mutual funds, which have little conflict of interest with the portfolio companies, are the most highly motivated to participate in corporate operations, in order to achieve the better performance of the company and a higher return on its investment.

However, to date institutional investors in Chinese listed companies have contributed very little to minority shareholder protection. The main reasons for this are the concentrated shareholding structure, especially the control by the state, and the lack of helpful legal mechanisms, such as a more appropriate voting mechanism, to fight against the controller.

In the view of this thesis, as long as the ideal model illustrated in Chapter Seven could be implemented, institutional shareholders in Chinese listed companies, with more motivation and professional knowledge and skills, would be able to increase the level of protection of minorities' interests. In addition, this thesis suggests that more practical mechanisms should be instituted by law to promote active participation by minority shareholders. For example, the law should formulate the content in a notice of shareholders' meeting to ensure that minority shareholders understand their rights relevant to the meeting.

(2) Lower the Actionability Requirements of the Derivative Claim

The derivative claim is a type of litigation initiated by shareholders in the name of the company, based on wrongs done to the company, against the

wrongdoers. The compensation from the lawsuit belongs to the company directly, rather than to the claimant shareholder. Such a litigation technique has been widely accepted throughout the world. Given a similar conservative attitude towards the derivative claim, this thesis made a comparative investigation of the technique as used in the UK and in China. Although there remain some uncertainties and areas to be clarified, the 'two-stage' litigation proceeding in the UK provides a good example for China.

The Chinese Company Law 2005 incorporates the derivative claim. However, to date there have been few successful cases. In fact, this thesis has noted, the requirements to initiate a derivative claim are so strict that it is extremely unlikely that minority shareholders could do so.

In terms of the *locus standi* requirements to initiate a derivative claim, minority shareholders in Chinese listed companies should satisfy two conditions: a minimum shareholding percentage of no less than one per cent of the total shares, and a minimum shareholding period of at least 180 days. As argued by this thesis, such *locus standi* requirements are too difficult for Chinese minorities to fulfil. As to the litigation procedure, unlike the 'two-stage' proceeding in the UK, the Chinese Company Law implements a pre-procedure requirement, named the Demand Rule, whereby shareholders should exhaust the possibility of internal remedies before bringing the lawsuit.

Indeed, the legal design of the derivative claim should achieve a good balance, to provide a remedy for shareholders to protect the company's interests on the one hand, and to protect the normal business management from unmeritorious or speculative claims on the other.

However, according to the argument in this thesis, the problem in China is not an excess of unmeritorious and speculative claims, but rather a lack of participation by minority shareholders in corporate operations. Therefore, lowering the *locus standi* requirement and abolishing the Demand Rule would result in the wide use of derivative claims in China, which would in turn be helpful to protect the interests of minorities.

(3) Improve the Design of Cumulative Voting

Unlike the traditional 'One Share One Vote' voting system, cumulative voting provides shareholders with extra votes based on the number of nominees to the board. Shareholders can allocate all their votes to any of the candidates. Such a system increases the possibility for minority shareholders to elect directors who stand for their interests.

Nevertheless, the cumulative voting system is not suitable for all situations. It will only help the minority shareholders to have a say in the election if collectively they hold a certain amount of corporate shares. This is not currently the case in Chinese listed companies. Because the controlling shareholder, the state, possesses a huge advantage in terms of shareholding, in practice cumulative voting results in no fundamental change.

The ideal model suggested by this thesis could represent the solution to the problems created by the concentrated shareholding structure. In addition, the 'Threshold Voting' system mentioned in Chapter Two is suggested as a better voting mechanism to improve the current cumulative voting system. According to this system, a 'minimum supporting rate' would be required in the first round of voting, so that a candidate should obtain a certain number of votes before being elected as a board member.

Moreover, with the belief that cumulative voting would increase the bargaining position of minorities against the controller, this thesis proposes that such a voting system could be used more widely, and not just in the election of board members.

(4) Perfect the Supervisory Board

As explained in Chapter Four, the supervisory board was the first internal monitoring body in Chinese corporate governance, introduced by the Company Law 1993. The institutional design originated in Germany, where the supervisory board (*Aufsichtsrat*) is the link between shareholders and the management board (*Vorstand*). To fulfil its responsibility as the representative of the company, monitoring the management, the supervisory board has been granted the rights to appoint and dismiss members of the management board and to determine the remuneration of those directors.

However, the legal design of the supervisory board in China is different from that in Germany. Instead of being a middle layer between the shareholders and the management board, the supervisory board in a Chinese listed company is merely an internal monitoring body reporting to shareholders, and has little practical power to keep the board of directors accountable. Given the lack of determination right on appointment and dismissal, the supervisory board does not pose a threat to directors, so that the effectiveness of its internal monitoring is open to question. Furthermore, inadequate independence, motivation and relevant knowledge also inhibit the effectiveness of the supervisory board.

The unsatisfactory position of the supervisory board was made worse when Chinese policy makers added the institution of independent directors into the existing corporate structure, but failed to specify a clear division of their responsibilities. Therefore, neither of the two internal monitoring bodies has performed as well as expected.

As a solution, this thesis strongly suggests that legislators revise the Company Law to clarify the responsibilities of the supervisory board and the independent directors. Only with clear job division can the co-existence of the two internal monitoring institutions safeguard the interests of shareholders, especially those minorities who have little participation in corporate affairs. In addition, it is necessary to reinforce the powers held by the supervisory board, to keep the executives accountable. As argued by this thesis, the right to dismiss board members without approval by shareholders, and the right to veto board decisions relating to important events, could be granted by law to the supervisory.

(5) Limit the Influence by the Party Committee of the CCP

As the special participant in Chinese corporate governance, the party committee of the CCP has an important influence on corporate management. As concluded through the research for this thesis, intervention from the party committee of the CCP does not provide any help to improve minority protection in practice; on the contrary, such intervention can infringe the rights of minorities.

Currently, the party committee in a Chinese listed company has decisive impact on personnel issues and important decision making. Moreover, it is required by party documents to act as another internal supervisor of

corporate management.

As reviewed by this thesis, such party committee intervention disrupts corporate management and ultimately infringes the interests of minorities who simply desire the company to perform well. First, the party committee's preference in personnel issues is not based mainly on a candidate's ability to manage the business, but takes more account of political concerns. Consequently, the corporate performance under the leadership of such an appointee would be open to question. Secondly, in decision making, the involvement of the party committee would integrate into corporate decisions many public management concerns, which ought to be fulfilled by the government rather than the listed company. Hence, rather than being in the interests of all shareholders as a whole, the corporate decision may reflect only the will of the controlling shareholder, the state. As such, minority shareholders' interests would be sacrificed. Thirdly, if the party committee participates in decision making, how can it discharge the monitoring duty fairly? Last but most importantly, Chinese legislation only grants rights to the party committee in a listed company; there are no legally imposed responsibilities to keep this participant accountable.

Although, in the view of this thesis, the best solution to overcome these problems would be to remove the party committee from the corporate structure, in practice this will not be possible in the short term. Therefore, this thesis suggests that the mismatch of rights and responsibilities should be corrected by revising the law, to keep the party committee accountable to the company and all shareholders, including the minority. Furthermore, the amendment should limit influence by the party committee to political affairs. All interventions in corporate personnel issues and business

decision making should be banned, to ensure the independence of corporate management and, accordingly, achieve a better performance to realise the investments of shareholders.

(6) Reinforce the External Monitoring Institution

A well-designed corporate governance system needs not only a sound internal monitoring institution, but also a powerful external monitoring institution. Through the case study and comparative research, this thesis found that a market regulator, such as the SFC in Hong Kong and the SEC in the US, can act as an effective external monitoring institution to safeguard the interests of minority shareholders.

Established in 1992, the CSRC is the market regulator in China. With a requirement to put specific emphasis on minority protection, the CSRC has set forth certain regulations to improve such protection. It has put efforts into limiting insider trading, fighting against commercial bribery, increasing corporate transparency and providing more investor education.

However, in spite of these positive activities, there remain significant shortcomings, which prevent the CSRC being as effective as expected in terms of minority protection. These include a professional staff that is too few in number and lacks necessary regulatory knowledge and skills; a lack of powerful rights, and doubts over independence, which should be guaranteed. In addition to addressing these shortcomings, as part of its future development the CSRC should adopt two further targets: (1) increasing corporate transparency; and (2) developing the education of minority shareholders in particular.

If all these suggestions, along with the ideal model introduced in Chapter Seven, could be realised in practice in the further development of Chinese corporate governance, then the legal protection of minority shareholders could be improved significantly.

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