Compliance with and through the Rules of Corporate Governance in China

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by
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Abstract

This thesis takes a forward-looking approach to review China's corporate governance comprehensively and critically from the perspective of compliance with and through corporate governance rules in China. After comparing the corporate governance compliance regimes in China and the UK, this thesis suggests that the way to improve corporate governance in China is to introduce some non-governance rules that requiring governance changes into corporate governance rules. And the non-governance rules can be supplemented by other corporate governance rules to make compliance more likely. At the heart of this thesis are five main contributions. First, it argues that traditional penalties are no longer an effective deterrent to prevent and reduce corporate crimes, and compliance as an ex ante regulatory tool shows the trend of the law shifting from ex post punitive deterrence to ex ante preventive initiatives. Second, it argues that the use of voluntary self-regulation in corporate governance has become an effective measure to improve corporate governance, as it allows companies to adapt their corporate governance structure to their own circumstances and thus achieve high compliance. Third, it finds that whilst China's current corporate governance compliance system has all the rules to solve agency problems between the various constituencies, does not effectively address these issues and compliance in practice is ineffective, and it makes several arguments to account for this deficiency. Fourth, it examines the UK corporate governance rules, arguing that achieving a truly effective compliance regime requires strengthening corporate governance autonomy and weakening government regulation. Fifth, it argues that strengthening autonomy and weakening coercion should be the direction for the reform of corporate governance compliance rules in China. It is believed that this thesis will have positive implications for both corporate governance and compliance in China.

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Company Law of the People's Republic of China (2018 Amendment)

Criminal Law of the People's Republic of China (2020 Amendment)

Foreign Investment Law of the People's Republic of China 2019

Securities Law of the People's Republic of China (2019 Revision)

Law of the People's Republic of China on the State-Owned Assets of Enterprises 2008

The United Kingdom

Bribery Act 2010

Companies Act 2006

Company Director Disqualification Act 1986

Crime and Courts Act 2013

The Civil Procedure Rules 1998

The United States

Foreign Corruption Practices Act 1979

Sarbanes-Oxley Act 2002

U.S. Sentencing Guidelines Manual 2021

List of Abbreviations

ALI	American Law Institute
BA 2010	Bribery Act 2010
CA 2006	Companies Act 2006
CBRC	China Banking Regulatory Commission
CCP	Communist Party of China
CDDA	Company Directors Disqualification Act
CIRC	China Insurance Regulatory Commission
CSRC	China Securities Regulatory Commission
DPAs	Deferred Prosecution Agreements
FCPA	Foreign Corrupt Practices Act
FIL	Foreign Investment Law
FRC	Financial Reporting Council
FSGO	Federal Sentencing Guidelines for Organisations
LLCs	Limited Liability Companies
LSE	London Stock Exchange
MSMEs	Micro, Small and Medium Enterprises
NPAs	Non-prosecution Agreements
NPC	National People's Congress
OECD	Organisation for Economic Cooperation and Development
SASAC	State-owned Assets Supervision and Administration Commission
SFO	Serious Fraud Office
SOA	Sarbanes-Oxley Act
SOEs	State-Owned Enterprises
SPP	Supreme People's Procuratorate
USSC	United States Sentencing Commission
WTO	World Trade Organisation

Declaration

I hereby declare that no material contained in the thesis has previously been submitted for a degree in this or any other institution, and the thesis is based on individual research.

Statement of Copyright

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Chapter 1 Introduction

1.1 Research background

Since the 1990s, China has been exploring the establishment of a modern enterprise system as part of its transition to a market-oriented economy.[1] One of the core tasks of modern enterprise system is to establish a corporate governance system in China. China has made great efforts to promote corporate governance, but the construction of China's corporate governance system is still at the stage of improvement. Most of China's modern enterprises were converted from Chinese state-owned enterprises ("SOEs"), so the construction of corporate governance in China is heavily government involved, which in turn has resulted in a highly concentrated ownership structure of Chinese companies and an underdeveloped corporate governance external market. The overall corporate governance rules in China are fundamentally characterised by a bias towards regulation and restriction of companies, and a highly concentrated share ownership structure that allows the majority or controlling shareholders to dominate the company, undermining the incentive and efficiency of other governance bodies to manage the company.

In addition to the corporate governance rules that are designed to address companies' governance, companies are still subject to a number of other regulations that apply to companies which are not themselves "corporate governance rules" (non-governance rules). These non-governance rules say what companies can and cannot do, but not how they should be "governed". On the one hand, compliance with corporate governance rules can improve corporate governance in China. On the other hand, to improve corporate governance, it is not enough for companies to comply with corporate governance rules, companies also need to comply with other non-governance rules. Compliance with corporate governance rules can ensure greater compliance with other non-governance rules by requiring companies to change

[1] Guanghua Yu, *Comparative Corporate Governance in China: Political Economy and Legal Infrastructure* (Routledge 2007) 26.

their governance, which the thesis refers to as compliance through corporate governance. Compliance with corporate governance rules can improve corporate governance in China, and compliance can be better achieved through corporate governance rules. The way to improve corporate governance in China is to introduce compliance regimes that aim to ensure greater compliance with non-governance rules into Chinese corporate governance rules. In recent years, China has also embarked on a quest to localise corporate compliance. The emphasis on corporate compliance in China is compelled by the compliance requirements imposed by extraterritorial jurisdictions on the development of companies. In order to gain a competitive advantage in the international market, many multinational companies in foreign jurisdictions are constantly raising their awareness of compliance and establishing sound corporate governance mechanisms. As more and more Chinese companies move into overseas markets, the risk of compliance and management for Chinese companies continues to increase.

Compliance requirements in most western countries are not only stringent, but already extraterritorial. However, most Chinese companies do not have the internal regimes in place to meet overseas compliance requirements to deal with corporate crises. This requires Chinese companies to not only comply with their own domestic laws and regulations, but also to be familiar with the compliance requirements imposed by extraterritorial laws and regulations. China's unfamiliarity with the compliance systems and requirements of western countries increases the likelihood that Chinese companies will be subject to extraterritorial legal penalties.

Compliance has attracted great interest in both academics and practitioners in China. The banking and financial sectors took the lead in initiating compliance risk management. The year 2018, also known as the "Year of Compliance" in China, saw the release of the *Guidelines for the Compliance Management of Enterprises' Overseas Operation*[2] and the *Guidelines on Compliance Management of Central Enterprises (for Trial Implementation)*[3], marking the official launch of China's administrative-led reform to improve the compliance management

[2] Jointly issued by the National Development and Reform Commission, the Ministry of Foreign Affairs and the Ministry of Commerce in 2018.
[3] Issued by the State-owned Assets Supervision and Administration Commission of the State Council in 2018.

capabilities of Chinese enterprises.[4] Then the pilot reform of corporate criminal compliance led by the Supreme People's Procuratorate ("SPP") has led to further attention and development of compliance in China, which could be regarded as the starting point for the localisation of corporate compliance in China. A growing number of scholars have also begun to call for restructuring the Chinese criminal policy on corporate crimes through criminal compliance regime.[5] As a result, corporate governance compliance in China is still in its infancy and there are many problems, including excessive control by the company's majority shareholders towards the company and its board of directors, managers and supervisory board and insufficient managerial freedom of the company's management, resulting in a low incentive for the company to comply. In addition, the rights and interests of stakeholders in Chinese companies, including minority shareholders, are not strongly protected. Establishing compliance regimes in companies is an important way to enhance and improve corporate governance in China.

Finally, current compliance research in China is in a fragmented state, with a one-sided focus on the area of criminal law and a bias towards the criminal significance of compliance. While recognising the importance of the introduction of compliance regimes into China, it fails to see the fact that compliance regimes as a criminal incentive ultimately rely on the establishment or improvement of corporate governance to achieve their purposes. Many of the current corporate crimes are not caused by the intentional actions of natural persons in the business, but to a large extent by the inadequacy of the company's internal management system or some deficiencies in the organisational structure of the business.

In order to implement the criminal policy of "combining leniency with rigidity"[6] and protecting the private economy, China is currently conducting a pilot reform to introduce criminal

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4 Ruihua Chen(陈瑞华), (企业合规的基本问题) 'The Basic Issues of Corporate Compliance' (2020) 1 China Law Review 178, 186.

5 See Guoxiang Sun(孙国祥), (刑事合规的理念、机能和中国的构建) 'The Concept, Function and Construction of Criminal Compliance in China' (2019) 2 Criminal Science 3; Bencan Li(李本灿), (企业犯罪预防中合规计划制度的借鉴) 'Learning from Compliance Program System in Corporate Crime Prevention' (2015) 4 China Legal Science 177 and Ruihua Chen(陈瑞华), (刑事诉讼的合规激励模式) 'Compliance Incentive Model for Criminal Proceedings' (2020) 6 China Legal Science 225.

6 Supreme People's Court, *Notice of the Supreme People's Court on Issuing the Some Advice on Implementing the*

compliance, which aims to provide incentives for companies to establish internal compliance programs to prevent and control potential corporate violations and reduce the damage of corporate crimes to the social interests. However, criminal compliance as a legal incentive is an effective way, but not the only way, to push companies to improve their corporate governance structures to detect and prevent corporate crimes. The pilot reform is still at the initial and exploratory stage and needs to be further justified at both theoretical and practical levels.

Few research has been done on the impact of compliance in China from the perspective of corporate governance and how to use corporate compliance to achieve the purpose of improving corporate governance. Research on compliance in China is scattered, and it is important to systematically address the corporate governance compliance rules in China. In addition, even though China is currently experiencing the emergence of corporate compliance practices as a result of the pilot reform of criminal compliance, the effectiveness of compliance in practice needs to be further examined and discussed. In the face of domestic and international compliance pressures, China needs to reform its corporate governance compliance rules in order to improve the governance of Chinese companies and gradually align them with world standards. This research contributes to filling this gap and will provide further insight into corporate governance in China.

The UK is renowned for its well-developed corporate governance system, and the new offence under the Bribery Act 2010 is one of the most stringent corporate compliance requirements in the world. The UK's mature corporate governance compliance regimes reflect the world's trend to improve corporate governance by adopting a combination of self-regulation and legislative rules. And the UK's corporate governance compliance model has important implications for China's reform of its corporate governance compliance rules. However, both borrowing and transplanting the regimes have to consider the adaptability. This research therefore also analyses the feasibility of transplanting the UK experience to China.

Criminal Policy of Combining Leniency with Rigidity (August 2010).

In conclusion, this study thus attempts to systematically discuss the corporate governance landscape in China from a corporate compliance perspective, to reveal the problems that have arisen from the construction of a corporate governance compliance system in China in corporate practice, and to highlight the positive significance of introducing compliance regimes into Chinese corporate governance rules to improve corporate governance in China. In addition, the UK's corporate governance rules on compliance are selected as a comparative study to provide overseas advanced experience that can be drawn upon for the establishment of a corporate governance compliance system in China.

1.2 Research questions

The thesis addresses the following research questions and aims to fill the gaps in the current research on corporate governance compliance in China by answering these questions.

1. What is compliance in the context of corporate law? In which ways are "compliance" and "corporate governance" connected?

2. What is the corporate governance landscape in China? What are the corporate governance rules that companies comply with in China?

3. What are the issues of compliance with corporate governance rules in China? And what are the reasons for these problems? How should compliance with corporate governance rules best be achieved?

4. What are the non-governance rules that companies need to follow? What is the distinction between corporate governance rules and non-governance rules that apply to companies? How compliance and corporate governance rules are connected?

5. What lessons does the UK's compliance with and through corporate governance regimes bring to China? Can a system that has worked well in the UK be transplanted to China with the same or similar results? And how feasible the UK's experience will be transplanted into China?

6. How should China reform corporate governance compliance?

1.3 Research scope

This thesis deals with two issues, namely, compliance with corporate governance rules and compliance through corporate governance rules. Corporate governance is defined as "the system by which companies are directed and controlled"[7]. The rules that say how companies are governed referred to in this thesis as "corporate governance rules", and rules that say what companies can and cannot do are called "non-governance rules". Thus, not only does the thesis discuss how compliance with corporate governance rules can improve corporate governance, compliance through corporate governance rules also falls within the research scope of the thesis, as companies are not only subject to corporate governance rules, but also to other non-governance rules. Compliance with these non-governance rules can be better achieved by complying with corporate governance rules that require companies to change their governance.

Specifically, chapter 2 focuses on both compliance with corporate governance rules and compliance through corporate governance rules, but much of it focuses on compliance through corporate governance rules. Then, chapter 3 focuses on compliance with corporate governance rules by discussing the corporate governance rules that Chinese companies need to comply with. Chapter 4 continues to focus on compliance with corporate governance rules by discussing whether compliance with Chinese corporate governance rules has had the effect of promoting corporate governance. In addition, section 4.6 is intended to emphasise the importance of

[7] *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing, 1992) (Cadbury Report), para 2.5.

corporate compliance in attracting foreign investors.

Chapter 5 focuses on both issue of compliance with corporate governance rules and compliance through corporate governance rules. The "comply or explain" regime and derivative claims regime are corporate governance rules, and section 5.2 and 5.3 discuss how compliance with these rules can be achieved in the UK, respectively. The disqualification regime and the corporate liability regime in section 5.4 and 5.5 are non-governance rules. The aim of compliance with these non-governance regulation can be better realised with the help of complying with the other corporate governance rules. And chapter 6 looks at reforming corporate governance compliance in China from both issues.

1.4 Research methods

This thesis adopts the doctrinal research method and comparative research method.

Firstly, the doctrinal research method. Different laws and regulations and academic literatures relate to this research topic have been selected and analysed. In addition to the laws and regulations, there is ample research findings on corporate governance and compliance in both China and the UK, which provide a solid research foundation for this thesis. However, there are few studies in China that systematically link corporate governance and compliance. This thesis therefore presents a critical analysis and discussion based on prior research on corporate governance compliance in both countries, exposing the problems with corporate governance compliance rules in China and offering its unique insights into reform.

Secondly, the comparative research method. The UK is worldwide known for its strict standards and high level of corporate governance. The design of the UK's distinctive compliance regimes has played a key role in driving corporate governance in the UK. This thesis selects the UK as a comparative study to compare the choices of the two different legal jurisdictions in terms of corporate governance compliance regime models, clearly reflecting the problems in Chinese corporate governance compliance rules and providing a big picture for reforming the Chinese compliance model. However, unlike the UK companies, Chinese companies have highly concentrated ownership structures, China could therefore transplant the UK experience to a limited extent and reform its own localised corporate governance rules.

1.5 Structure of the research

This research is presented in 7 chapters. And the structure of this research is as follows.

Chapter 1 (*Introduction*) offers a basic introduction of this whole research, including its background, research questions, research scope, research methods and structure of the research.

Chapter 2 (*Compliance in the Context of Corporate Governance*) sets out the theoretical framework for corporate governance compliance in this research. It begins by defining what compliance is and explaining the importance of compliance in the corporate context. In addition, the deterrence theory can also provide a theoretical basis for corporate compliance, but traditional ex post penalties are no longer an effective deterrent for companies. The concept of deterring corporate crimes should be shifted towards ex ante preventive measures such as corporate compliance. This chapter goes on to discuss the relationship between compliance and corporate governance, as well as the code and standard of compliance in corporate governance context, proving a theoretical basis for the research in China in the following chapters.

Chapter 3 (*The Corporate Governance Landscape in China*) provides an overall picture of the corporate governance landscape by introducing corporate governance rules in China. This includes the legal framework of corporate governance in China and its characteristics and the share ownership structure of Chinese companies. In addition, the relationship between shareholders and directors within the company and the role of takeovers in corporate governance in China are also presented.

Chapter 4 (*Compliance with Corporate Governance Rules in China*) puts the emphasis on compliance with corporate governance rules in the Chinese context. With the introduction of Chapter 3, it can be learned that the agency problem in Chinese companies is mainly the conflict between controlling shareholders and minority shareholders rather than the shareholders and directors, which is considered to be related to the ownership structure of Chinese companies. In order to reduce agency costs in companies, China has taken a number of measures to focus not only on the relationship between shareholders and directors of the company and the protection of the interests of minority shareholders, but also on protecting the rights and interests of other stakeholders. This chapter will discuss whether Chinese companies' compliance with these measures in corporate governance has had the desired effect in practice, and whether Chinese corporate governance compliance has served to protect foreign investors.

Chapter 5 and Chapter 6 are the main bodies of this research.

Chapter 5 (*Lessons from the UK on Compliance with and through Corporate Governance Rules*) compares the UK model of corporate governance by focusing on compliance with and through corporate governance rules in the UK. In terms of corporate governance practices, the "comply or explain" regime under the UK Corporate Governance Code provides a flexible compliance mechanism for companies, and under statute laws, derivative claims and director disqualification regime are both useful experiences in protecting the interests of company shareholders. In addition, the Bribery Act 2010 creates a new incentive for corporate compliance through criminal law means. The feasibility of transferring the UK compliance regimes to China will also be answered in this chapter.

Chapter 6 (*Reforming Corporate Governance Compliance in China*) makes recommendations for reforming compliance with and through corporate governance rules in China. This research argues that in contrast to the UK corporate governance compliance rules, the Chinese model focuses too much on restrictions and controls and ignores the role that can be played by mechanisms characterised by autonomy and incentives in corporate governance rules.

Reconstructing corporate governance compliance in China requires strengthening corporate autonomy and weakening government and regulatory interference. Each of the four main perspectives will be discussed in terms of introducing self-regulation regimes, strengthening internal corporate compliance mechanisms, strengthening the managerial freedom of corporate boards and establishing a criminal compliance regime, arguing that compliance with the non-governance rules is more likely to achieve when supplemented by other corporate governance rules.

Chapter 7 (*Conclusion*) concludes the whole thesis. It summarises the contributions of this research and presents recommendations for reforming China's corporate governance compliance rules.

Chapter 2 Compliance in the Context of Corporate Governance

2.1 Introduction

Corporate compliance has gained widespread attention in recent years, with a strong promotion of compliance at both national and international level. And companies continue to develop internal compliance mechanisms to meet the requirements of legal norms and improve their corporate governance.

Although both academic researchers and practitioners are increasingly concerned with compliance in the context of corporate law, the studies of corporate compliance are still in a fragmented state. There is a lack of systematic discussion on the definition, the position and role of compliance in the context of corporate law, its relationship with corporate governance and the standards required to achieve effective compliance.

This chapter establishes the theoretical framework of this thesis and focuses on the compliance in the context of corporate governance, including compliance with corporate governance rules and compliance through corporate governance rules. However, much of this chapter focuses on the latter issue. This chapter is structured as follows. Section 2 conceptualises compliance from both perspectives, including its definition, origin and development. The third section focuses on compliance through corporate governance rules and discusses the importance of compliance in the context of corporate law and tries to answer why compliance mechanisms should be introduced in corporate governance. Then, section 4 mainly focuses on compliance through corporate governance rules as well and places the deterrence theory in the corporate context and discusses its relationship with corporate compliance. Following that, section 5 first introduces the concept, origin and development of modern corporate governance and then discusses the relationship between compliance and corporate governance, showing that non-governance rules can be supplemented by corporate governance rules to make compliance with the other non-governance regulations more likely. The sixth section examines the current corporate governance compliance codes and standards at the national and international levels respectively, and identifies the alienation that has occurred since the codes were introduced into China. Section 7 concludes the whole chapter.

2.2 Conceptualising compliance

2.2.1 definition

It is also not a new concept that individuals and companies should act in compliance with the laws and regulations that apply to them. But as it has evolved over the last five decades, compliance has been given different definitions in different contexts. For example, it has been argued that compliance is a collection of regulations that one wants to comply with and the response to them.[8] From this perspective, compliance can be seen as an interaction between

[8] Vikramaditya S. Khanna, 'Compliance as Costs and Benefits' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 13.

rules and behaviour.

Contemporary research on compliance is characterised by a multidisciplinary and multi-perspective approach, such as in the field of criminal law, antitrust, data protection, etc. This thesis focuses only on compliance in the context of corporate context, or more precisely, compliance under corporate governance.

The meanings of compliance in the context of corporate law are basically threefold. Firstly, compliance with the rules means that the companies' operations are subject to the legal rules that apply to the companies. Secondly, a compliance regime is an internal mechanism developed within a company to prevent legal risks and avoid the creation of illegal activities. Thirdly, compliance is a form of corporate governance that aims to create a compliant culture for the company.

First and most traditionally, compliance means adherence to a wide range of regulations, both legal and non-legal. These regulations include not only formal statutory laws, but also cover regulatory rules, codes and guidelines, industry practices, international conventions and even commercial organisations' internal policies. From the government's perspective, compliance requires companies to adjust their behaviour to meet the boundaries of laws and regulations. While from the perspective of the company, in order to achieve compliance effect, it is required to establish a mechanism within the company to adjust and monitor the behaviour of the company's internal personnel to prevent violations of laws and regulations.

Secondly, compliance is also associated with risk management.[9] It is considered as a legal instrument of risk management in a global risk society.[10] The failure to prevent and manage the company's business risk will lead to the failure of achieving the company's business strategies and aims. To prevent such negative outcomes from occurring, an adequate procedure

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[9] Sharon Ward, *The Changing Face of Compliance: Managing Regulatory Risk* (1st edn, Routledge 2015).
[10] Marc Engelhart, 'The Nature and Basic Problems of Compliance Regimes' (2018) <https://pure.mpg.de/rest/items/item_2643714_7/component/file_3007899/content> accessed 16 April 2021.

or internal mechanism is needed within the company to achieve a monitoring and prevention effect. Compliance can be seen as a new form of self-management, which can effectively reduce the risks and crises faced by companies during the business activities.

Thirdly, compliance is considered as a form of corporate governance and also an important aspect of corporate governance. This view can be understood from both a macro and micro perspective. The macro perspective can be understood as relating to compliance risk prevention and control, as compliance mechanisms designed with the primary aim of effectively preventing the occurrence of risks, once effectively implemented and enforced, it will reduce corporate crimes and can therefore be understood as a form of corporate governance. And from a micro perspective, the corporate governance compliance is related to a range of internal control activities within a company, and compliance is used to ensure that these activities comply with various norms in the context of corporate law. The establishment of a compliance mechanism revolves around how the relationship between the shareholders, the board of directors and the management of a company. The setting up of a compliance mechanism involves a restructuring of the company's internal structure. For example, the design and implementation of compliance mechanisms cannot be achieved without the approval and support of the company's high-level personnel. After all, some people believe that compliance is a tool used by a company's managers to control their internal activities.[11] In addition to that, more and more companies are establishing compliance departments, employing compliance officers and professionals and providing compliance training to employees in order to meet their compliance obligations.

It should be mentioned here that compliance sometimes has a narrower meaning in the Chinese context because of the late attention it has received in China. In China, the definition of compliance is not set out in formal legislation, but is mostly found in administrative regulations and departmental rules. The term "compliance" first appeared in the *Interim Provisions on Auditing Work of the Ministry of Civil Affairs* issued by the Ministry of Civil Affairs of the People's Republic of China in 1989, but it did not define compliance. Thereafter corporate

[11] J.S.Nelson, 'Compliance as Management' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 104.

compliance did not attract widespread attention and discussion, but rather it was not until the early 21st century when the China Securities Regulatory Commission ("CSRC") began to apply compliance management regulations among securities companies that corporate compliance really came to the forefront of Chinese scholars and practitioners.

Although the requirements for compliance vary from sector to sector in China, Chinese companies are basically required to comply with the applicable laws and regulations of the state, regulatory provisions, industry codes and standards, international treaties and rules, the company's bylaws and relevant internal rules and regulations. Since March 2020, corporate compliance, in the Chinese context, refers in particular to the "pilot reform of enterprise compliance" led by the SPP of China, also known as the "reform of enterprise compliance non-prosecution".

In most cases, the terms of "compliance" and "compliance plan", "compliance procedure", "compliance program" are interchangeable. The definitions that do exist are in fact more like multi-dimensional interpretations of the compliance function. This can be seen more clearly from the official definition of some concepts relating to compliance, for example, according to the *Guidelines Manual* issued by the United States Sentencing Commission ("USSC") in 2021, a "compliance and ethics program" is a program designed to prevent and detect criminal conduct.[12] And compliance procedure in the UK context refers to a procedure established within a company to prevent illegal activities from occurring by persons associated with the company.[13]

In summary, the above definitions appear to provide a relatively clear definition of compliance in the context of corporate governance. Compliance can be given different definitions and different functions in different contexts. As for corporate governance compliance under this study, it contains two layers of meaning. One is compliance with the corporate governance rules in order to improve corporate governance, and the other is compliance through corporate

[12] U.S. Sentencing Guidelines Manual 2021, §8B2.1.
[13] Bribery Act 2010, s 7(2).

governance rules, namely, using corporate governance rules to achieve compliance with other non-governance rules that make up most of the regulation that applies to companies.

2.2.2 origin and developments

The corporate crises and failures that erupted in the financial sector in the 1970s and 1980s, as well as in 2007-2008, raised questions about the effectiveness of government regulation. Corporate governance has been a hot topic around the world ever since. Although it originated in the United States, it has developed substantially in the United Kingdom and has spread throughout the world. At almost the same time, compliance was also introduced to China, but due to lack of attention, the development of compliance in China was slower than that in the United States and the United Kingdom.

United States

It is generally accepted that compliance originated in the United States.[14] Compliance first emerged in the United States in 1963 from a judge's decision refusing to recognise the obligations of company directors to enforce compliance mechanisms in their companies.[15] And the United States antitrust criminal proceedings sparked by electrical cases in the 1960s catalysed the corporate compliance program as well.[16]

A growing number of corporate crime scandals contributed to the development of compliance as a criminal incentive. It was the Foreign Corrupt Practices Act ("FCPA") published in 1977, which was designed to combat the bribery of foreign officials, that really brought compliance into the public eye. By the 1990s, the United States officially spread the impact of compliance

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[14] See Sean J Griffith, 'Corporate Governance in an Era of Compliance' (2015) 57 William & Mary Law Review 2075 and Paulo De Sousa Mendes, 'Responsive Regulation, Enforced Self-regulation, and Corporate Liability' (2022) 33 Criminal Law Forum 285.
[15] Miriam Hechler Baer, 'Governing Corporate Governance' (2009) 50 Boston College Law Review 949.
[16] Harvey L. Pitt and Karl A. Groskaufmanis, 'Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct' (1989) 78 The Georgetown Law Journal 1559.

around the world when the USSC promulgated the *Organisation Sentencing Guidelines* ("Guidelines") in 1991, which was considered as the hallmark of the emergence of contemporary compliance in the United States.[17] Compliance program is included in the Guidelines as a mitigating factor, granting companies with an effective compliance and ethics program a treatment of receiving a substantial reduction of punishment.[18]

By 2002, the enactment of the Sarbanes-Oxley Act ("SOA") further enhanced the importance of compliance in the United States. It required every public company to establish and maintain an adequate internal control structure and procedures for the disclosure of financial information and to provide an assessment of their effectiveness.[19] Criminal law instruments provided a significant incentive for companies to set up internal mechanisms to monitor and prevent the occurrence of criminal acts, and also improved the efficiency of prosecution services through self-reporting by companies.

In addition, the United States followed the tradition of offenders being able to reach settlement agreements with prosecutors to reduce the prosecution investigation costs, it provided companies with a tool of deferred prosecution agreements ("DPAs") or non-prosecution agreements ("NPAs") to avoid being charged only if they promised to establish a compliance program within the company in return as a remedy.

These statutory laws all attached severe penalty requirements to corporate failures, leading to an increasing incentive for companies to establish internal control procedures within the company to prevent recurrence of violations.

United Kingdom

Although compliance was born in the United States, it has been substantially developed in the

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[17] Griffith (n 14).
[18] USSG 2021, §8C2.5(f).
[19] SOA 2002, article 404.

United Kingdom.

Globalisation has made compliance a phenomenon that cannot be unique to just one specific country. Compliance has developed rapidly worldwide in the last two decades. The United Kingdom is a representative country that attaches great importance to corporate compliance. Corporate compliance in the UK also began with a re-examination of the financial sector. Unlike the US, however, the UK does not use coercive means to enforce compliance, but rather encourages companies in the UK to adopt compliance voluntarily. The UK provides best practice in the form of corporate governance codes on how companies can improve corporate governance in terms of board composition, relations with shareholders, audit and supervision and accountability, to help companies address issues related to corporate governance.

In addition, corporate compliance in the UK has matured in the area of anti-corruption and anti-bribery. It has attached anti-bribery compliance requirements to commercial organisations through the Bribery Act 2010. Under the Bribery Act 2010, the only defence for organisations is to prove that they have already put an effective compliance procedure in place within the organisation to prevent the bribery activities.[20] The effect of the defence of the having "adequate procedures", is an important aspect of the Bribery Act 2010 and provides incentives to businesses to do something to prevent bribery.[21]

The UK codes and standards of effective compliance in corporate governance will be discussed in more detail in section 6.

China

Unlike the US and the UK, China's concern about corporate compliance does not stem from the financial scandals of domestic companies, but rather from the serious operational risks and

[20] BA 2010, s 7.
[21] Jonathan Mukwiri, 'British Law on Corporate Bribery' (2015) 22 Journal of Financial Crime 16.

severe penalties faced by Chinese multinational companies listed overseas,[22] which is a reactive type of concern and adoption. Chinese companies are at risk of serious criminal sanctions as a result of the extraterritorial reach of the United States enforcement. Extraterritorial compliance practices have forced Chinese companies to passively embrace the introduction of corporate compliance systems. As more and more domestic corporations rush to the overseas market, the risk of operation and management is increasing. Chinese companies have weak awareness of corporation self-management and crisis prevention, and lack of unified standards and incentives to regulate their behaviour. By contrast, many foreign multinational companies have more mature compliance cultures and practices in their home countries, and compliance requirements in most western countries are not only stringent but already extraterritorial.

Compared with the US and the UK, the development of compliance in China is relatively slow. Compliance in China first began in the banking, securities and financial institutions sectors. Since 2002, the Bank of China has been working on compliance risk management, for example, by establishing "Legal and Compliance Department" and Chief Compliance Officer, and since then other large Chinese banks have also started to manage internal compliance risks.[23] In 2006, the China Banking Regulatory Commission ("CBRC") issued the *Guidelines on Compliance Risk Management in Commercial Banks* ("Guidelines"), in which compliance was formally defined for the first time in China. The term "compliance" in the Guidelines is defined as the business activities of a commercial bank that meet and accord with the letter and the spirit of the laws, rules and standards.[24] Subsequently, CSRC promulgated the *Trial Implementation of the Compliance Management of Securities Companies* in 2008, and thus corporate compliance was officially introduced into China.

By the end of 2018, the State-owned Assets Supervision and Administration Commission of the State Council ("SASAC") promulgated the *Guidelines on Compliance Management of*

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[22] BBC, 'US Bans Sale of Huawei, ZTE tech Amid Security Fears' (BBC, 26 November 2022) <https://www.bbc.co.uk/news/world-us-canada-63764450> accessed 15 February 2023.
[23] Li (n 5) 190.
[24] Guidelines on Compliance Risk Management in Commercial Banks (2006), article 3.

Central Enterprises in order to promote compliance management of central enterprises. Six important ministries and departments,[25] including the Ministry of Foreign Affairs and the Ministry of Commerce, promulgated the *Guidelines for the Compliance Management of Enterprises' Overseas Operation* in order to help enterprises improve their international competitiveness.

In common with the practice of the US and UK, incentives in terms of criminal liability have contributed to the overall development of compliance in China. The SPP of China has officially started piloting corporate compliance reforms since 2020, exploring the path of using criminal law incentives to push companies to build compliance mechanisms.

Within the academia, Chinese scholars have fragmented the study of corporate compliance into different disciplinary studies, criminal compliance, administrative compliance and the emerging civil compliance. These studies singularly discuss the development and application of compliance in various fields, ignoring the original meaning and utility of compliance in the context of corporate law. This has led some scholars to argue that corporate compliance has become alienated in China.[26]

To summarise, compliance originates from high-risk industries, such as banks, securities and other financial sectors, and the compliance requirements in these areas are often more refined. Compliance has developed rapidly in the last 20 years and entered into 21st century with a greater diversity of topics and the emergence of new areas of research such as criminal compliance, data compliance, anti-money laundering compliance and intellectual property and anti-monopoly compliance. Some scholars believe that compliance has evolved from the initial diversion to be merged into the mainstream in recent years.[27] Up to now, more attention has

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[25] National Development & Reform Commission (former State Development Planning Commission), Ministry of Foreign Affairs, Ministry of Commerce, The People's Bank of China, State-owned Assets Supervision and Administration Commission of the State Council, State Administration of Foreign Exchange and All-China Federation of Industry and Commerce.

[26] Feng Deng(邓峰), (公司合规的源流及中国的制度局限)'The Origin and Convergence of Corporate Compliance and Its Chinese Institutional Limitations' (2020) 1 Journal of Comparative Law 34.

[27] Ibid.

been paid to the ethics and responsibilities of companies to create a system that encouraged good business practices. However, it has been pointed out that even today, compliance researches are still under-theorised.[28] From a legal perspective, compliance is scattered across different branches of law. Some academic studies focus on compliance in the corporate context, some on the area of criminal law, and others focus solely on compliance in the area of antitrust. Compliance studies should take a cross-sectoral approach, but the current research shows that the links between the sectors are not strong enough.

2.3 Importance of compliance in the corporate context

Compliance is becoming increasingly important to the companies and society as a whole. The importance of compliance has grown worldwide through legal and regulatory requirements and ongoing debate among academics over the past few decades. It is becoming apparent that compliance may be a costly investment at the beginning, but it does not take long to pay off.[29]

It is not difficult to find the growing importance of compliance in corporate governance. The ongoing financial scandals, corruption and bribery in companies in recent years have been the result of corporate non-compliance. The importance of compliance in the corporate context can be seen in three ways. Firstly, as a form of self-regulation, compliance can replace some of the state's enforcement functions and save regulatory resources. Secondly, Compliance can identify the different risks to a company's operations and can effectively prevent and deter the occurrence of internal violations. Finally, even if violations have already occurred, compliance can also be used as a defence when in charge of a company and as a mitigating factor at the sentencing stage.

[28] Griffith (n 14).
[29] Martin T. Biegelman and Daniel R. Biegelman, *Building a World-Class Compliance Program* (John Wiley & Sons 2008) 82.

2.3.1 reducing the need for regulatory involvement

Compliance, as a form of legal enforcement, can replace some of the state's enforcement functions.[30] Regulators are unlikely to have sufficient resources and energy to address all the issues that arise in a company, but compliance culture which internalised within a company, once it functions effectively, can largely obviate the need for state regulation and can therefore help solve the dilemma of limited resources.[31]

According to some countries, willingness to cooperate with the regulator is one of the factors in measuring compliance. A company's acceptance of the conditions for reconstituting the company in a compliant manner is an indication that the company is willing to self-report violations as a sign of cooperation with the regulator. According to the United States Environmental Protection Agency, they have initiated a total of approximately 2,500 civil investigations for non-compliance in each of the past ten years, with an average of over three fifths of companies voluntarily disclosing and reporting violations within their company each year.[32]

Initially, it was the government that managed the conflicts among the various stakeholders within the company. Governments can relieve themselves of the pressure to resolve these conflicts by handing over the obligation of compliance to companies. According to Fiona Haines, one of the purposes of compliance is that the government wants to use compliance to manage the conflicts caused by the public's request for companies to take more measures to reduce their negative impact on society and companies' requirements to reduce the legal obligations imposed on them.[33]

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[30] Geoffrey Parsons Miller, 'The compliance function: An overview' in Jeffrey N. Gordan and Wolf-George Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2018) 981.
[31] Ibid.
[32] Cary Coglianese and Jennifer Nash, 'Compliance Management Systems: Do they make a difference?' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 571.
[33] Fiona Haines, 'Compliance and Contestation' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 93.

And the development of a compliance culture in a company will significantly reduce the need and probability of government regulation. This is why more and more governments are encouraging companies to develop compliance programs.

The legal risks to corporate compliance are essentially the same risks that regulators need to address. From an efficiency point of view, given the lack of resources and the limited energy of the government, resorting to the private sector, more precisely to companies that are in the best position to manage and control themselves, would be more efficient in regulating non-compliance behaviour. For example, compliance mechanisms can also play a role in assisting the state to monitor violations by company employees. After all, with the development of the world economies, it is very difficult for the state to regulate the behaviour of companies' insiders, especially for large companies.

Further, compliance can reduce the cost of public intervention in corporate regulation. Compliance can play a positive role in mitigating and avoiding the reputational damages that regulations caused to a company. There is also the incentive for other companies to emulate the good social impacts achieved as a result of compliance, such as a good reputation, a premium for shares and more inward investment.

But compliance does not completely exclude governmental and regulatory involvement in the affairs of the company. The introduction of compliance can be recognised as a "sharing responsibility and power between regulators and regulated entities."[34] In this sense, corporate compliance is in fact a new way of encouraging regulators and companies to share the responsibility of regulating corporate behaviour and improving corporate governance. The concept of "new compliance" has been introduced to encourage regulators to get involved and work with compliance to move forward.[35] It is perhaps more important for the government to play the role of promoting compliance rather than enacting it.

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[34] Baer (n 15).
[35] David Jackman, *The Compliance Revolution: How Compliance Needs to Change to Survive* (John Wiley & Sons 2015).

In addition to the benefits it brings to governments, compliance is valued and pursued because of the benefits it can bring to companies themselves, as discussed in more detail in the next two sections.

2.3.2 managing corporate risks and preventing illegal activities

Corporate scandals do not only have an impact on the financial profitability of a company, but also, and more importantly, on its reputation. Managing the risks that can have a negative impact on a company's reputation is an important task that companies are facing today. In order to identify and manage risks, there needs to be measures within the company that can detect and deter the risks and ensure that the company is operating in a proper way. Sometimes, failure to identify risks will result in failure to achieve the company's business objectives.

There are different risks involved in running a company. According to the definition given by the American Law Institute ("ALI"), the "compliance risk" is about the risks that an organisation will experience financial, operational, or reputational losses, legal sanctions, or other negative consequences because of its unwillingness or failure to follow laws, regulations, rules, its code of ethics, its ethical standards, or legally applicable or otherwise binding industry codes of conduct, or to cooperate appropriately with regulator.[36] This definition reveals almost the full range of risks that compliance is designed to identify.

When the compliance program is embedded in the company's daily operating policies, it will identify the company's operational risks in a timely manner. In order to manage risks, a compliance program that a company established generally includes several elements: a clear and unambiguous internal compliance policy, appropriate internal procedures to ensure effective implementation of the policy, a positive attitude and commitment to compliance at the

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[36] ALI, Principles of the Law: Compliance and Enforcement for Organisations (Tentative Draft No.2, 2021),§ 4.01.(b) a.

top, knowledge of the company's internal staff, regular compliance training for employees, mechanisms for evaluating compliance procedures, regular internal monitoring and external review mechanisms, open channels for reporting and anonymity protection for whistleblowers, etc.

Some scholars separate the preventive and detective measures of the compliance program. Measures with a preventive function refer to the internal company procedures that are set up to identify risks to the company's operations, while measures of a detective nature are those with a monitoring and self-reporting nature, such as the whistleblowing hotlines.[37] But in fact, both preventive and detective measures aim to detect violations and deter non-compliance in a more timely manner with the help of internal compliance mechanisms.

On the other hand, a well-implemented compliance program can reduce a company's future risk by detecting and preventing misconduct. A compliance program not only helps companies comply with a wide range of regulations and prohibitions, but also allows companies to prevent and detect possible misconduct at every stage of their business. For companies, while a compliance program cannot fully guarantee that no non-compliant activity will ever occur, it can reduce the risk and cost of non-compliance by providing a regime of internal control. If the compliance program works well, violations can be detected and stopped in time to prevent further damages to the company and the whole market.

In addition, compliance can reduce the probability and severity of violations. When risks develop into illegal outcomes, the company's liability cannot be avoided. Based on the enterprise liability, companies, as employers, are liable for the actions of their own employees. It is therefore in the companies' interest to have appropriate procedures in place within the company to monitor and prevent violations based on the identified risks.

It is important for companies to prevent internal violations of laws and regulations from

[37] Eugene Soltes, 'The Professionalization of Compliance' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 27.

occurring. This is because whether it involves administrative, civil or criminal penalties, or compliance investigations, it can cause irreversible damages to a company's reputation. Internal company mechanisms that can effectively prevent this from happening will address this negative impact at the source by reducing the likelihood of being targeted by regulatory authorities. The potential advantages such as avoiding reputational damage to the company that brought by the risk identification function of compliance can preserve and add value to the company in a subtle way.

In addition to that, in the long run, a culture of compliance will develop within the company to help it achieve its business objectives in a compliant manner. In this way, compliance programs can also help companies maintain or increase their credibility in the marketplace eventually.

Therefore, carrying out a compliance program has become an important governance strategy for modern corporations. Because of this, compliance has also driven the growth of the corporate sector. Many companies have created separate compliance departments to meet the regulatory demands of compliance, requiring the hiring of compliance officers and compliance staffs. In addition to this, in order to provide effective oversight and review of the compliance program, companies will also engage external professional teams, typically law firms, to provide compliance training to the employees and to assist with risk prevention and control.

2.3.3 remedying harm from the non-compliant conduct

The rapid further development of the function of compliance originates to a large extent from the fact that individual countries treat it as a legal incentive.

Compliance can be regarded as a kind of remedial action. Compliance seeks to mitigate a company's liability even if the offence has inevitably occurred. An effective compliance program can be used as a mitigating factor for punishment imposed on the company. For example, the United States Federal Sentencing Guidelines for Organisations ("FSGO") allows for a reduction in a company's fines if the company had an effective compliance program in place at the time of the offence.[38] And the prosecutors will take into consideration that whether the company adopt the implementation of the compliance program or improvement of the existing one when convicted crimes or agreed on a plea agreement.[39]

Moreover, compliance can not only used as a mitigating factor at the sentencing stage, but also a defence when in charge of a company. The *Principles of Federal Prosecution of Business Organisations* in the Justice Manual sets out the factors that prosecutors need to take into account when deciding whether to prosecute a corporation, which includes "the adequacy and effectiveness of the corporation's compliance program at the time of the offense"[40], and the improvement of existing compliance program.[41] It is important to note that the existence of a compliance program does not in itself necessarily determine a non-indictment outcome for a company. To achieve non-indictment, prosecutors will also need to examine the actual effectiveness of the compliance program, including whether the program was adequately designed to maximise the prevention and detection of employee wrongdoing, and whether the company's management played a role in the misconduct engaged in by the employee.[42]

The importance of compliance is also reflected in the severe penalties that come with ignoring them. Put differently, non-compliance itself can serve as a criminal sanction. There is no better known example of this than the offence of "Failure of Commercial Organisations to Prevent Bribery" under Section 7 of the Bribery Act 2010 in the UK. According to the Act, the commercial organisation will be guilty of the offence if any person associated with the organisation bribes another person intending to obtain or retain business or an advantage in the conduct of the business for the organisation.[43] And the only defence for the organisation is to prove that it had in place an adequate procedure in the company designed to prevent persons

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38 USSG 2021, s 8C 2.5(f) (1).
39 McNulty Memorandum, 'Charging a corporation: Factors to Be Considered', <https://www.justice.gov/sites/default/files/dag/legacy/2007/07/05/mcnulty_memo.pdf> accessed December 14 2020.
40 Justice Manual, Title 9-28.300 A (5) < https://www.justice.gov/jm/jm-9-28000-principles-federal-prosecution-business-organizations > accessed December 14 2020.
41 Ibid 9-28.1000.
42 Ibid 9-28.800.
43 BA 2010, article 7(1).

associated with the organisation from undertaking such conduct.[44] In other words, the lack of compliance procedures within a commercial organisation that would prevent bribery by persons associated with it would result in the commercial organisation committing the offence.

2.4 Deterrence theory in the corporate context

Deterrence is expected to influence and even change people's behaviour. Traditionally, deterrence theory suggests that crimes can be deterred by the threat of punishment.[45] It also offers an insightful perspective for policymakers to design and enforce legal regimes that can be used to deter individuals from committing crimes through punishment, in other words, to encourage individuals to consciously comply with the law that has been designed.[46]

Corporate crime is more complex than individual crime because corporations do not have the same subjective intent as individuals. Based on the vicarious liability, companies are vicariously liable for the actions of their employees. The deterrence theory, when placed in the corporate context, means that legal policymakers prevent companies and their internal members from committing illegal and criminal activities through the design of a corporate law system. Traditionally, severe penalties have been used to deter companies, but has this been truly effective in preventing corporate crimes?

This section mainly focuses on compliance through corporate governance rules. The questions to be addressed in this section are whether the deterrent effect of severe criminal penalties is truly effective in reducing corporate crimes? How should the legal regimes be designed to achieve the aim of deterring corporate crimes from occurring? And to what extent does the deterrent effect need to be legally effective in order to deter violations of the company? The relationship between deterrence and compliance in the corporate context needs to be discussed

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[44] Ibid, article 7(2).
[45] Andy B. Anderson, Anthony R. Harris and JoAnn Miller, 'Models of Deterrence Theory' (1983) 12 Social Science Research 236.
[46] Alex Raskolnikow, 'Deterrence Theory: Key findings and challenges' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 179.

first before these questions are answered.

2.4.1 the relationship between deterrence and corporate compliance

Deterrence can be thought of as a response based on fear of the punishment of the contrary behaviour.[47] This response can be either negative or positive. A negative response means that someone refrains from acting in a certain way because he or she is afraid of the outcome of the punishment. While a positive response means that someone takes the initiative to act in a certain way to avoid the occurrence of the result because his or her fear of the result of the punishment. Putting this into the corporate context, if the legal policymakers can pre-determine the legal consequences of certain actions, then the company and its members will choose to avoid behaviour that can violate the legal norms out of fear. In other words, the legal mechanism then has a deterrent effect on the company.

The prior study found that there are different types of deterrence.[48] This section focuses on two of them. The first is specific deterrence, in which an individual refrains from committing a certain type of crime because he or she is deterred by the consequences of punishment. And the second is general deterrence, where a potential offender chooses not to commit a crime based on the fear of punishment someone has already suffered. Both specific and general deterrence suggest that people will reduce non-compliant behaviour based on their fear of punishment. This provides the basis for corporate compliance.

Because crimes can be reduced by the threat of punishment, policymakers can also use the threat of punishment to deter companies from breaking the law. But how? According to the opinion of some economists, a rational person, will weigh the criminal benefits that can be derived from their actions and the costs of crimes.[49] As it suggests, "on one side of the

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[47] Jack P. Gibbs, *Crime, Punishment and Deterrence* (Elsevier 1975) 2.
[48] Ibid, and Alec Samuels, 'Principles in Sentencing' (1969) 1 Dublin University Law Review 78.
[49] Thomas A Loughran, Greg Pogarsky, Alex R. Piquero and Raymond Paternoster, 'Re-examining the Functional Form of the Certainty Effect in Deterrence Theory' (2012) 29 Justice Quarterly 712.

deterrence equation is conformance collectively articulated norms, on the other is the pursuit of naked self-interest".[50] Then if the cost of breaking the law is high enough, people will not engage in illegal activities, even if there are calculated gains. In other words, the decision to comply with the law depends on whether the benefits of compliance outweigh the costs of breaking the law. People will choose to comply with the rules that are more favourable to them, and the penalties continue to exacerbate the costs of violations.

The law has therefore consistently been used by imposing severe penalties on companies to increase the cost of corporate crimes in order to deter corporate criminal behaviour. Moreover, since the primary purpose of corporations is to make profits, the deterrent effect will be more effective on a perceived more rational calculator such as corporations, which are believed to be more susceptible to the deterrence-based approach.[51] This approach is referred to in this section as the specific deterrence approach.

However, it raises some doubts as well. First, taking the high criminal fines as an example, will the company always be in a state of deterrence to such penalties? Second, if criminal penalties are no longer a strong enough deterrent for companies, especially large companies, and crimes continue to occur, is it possible to devise a deterrent approach targeted at crimes that have already been committed by other companies to reduce the likelihood of the company and other companies committing them again? This approach is referred to as the general deterrence approach in this section. And each of these two approaches is discussed below.

2.4.2 specific deterrence approach

To some extent, the laws deter companies by pursuing corporate criminal liabilities to reduce corporate crimes. Without the deterrence of criminal liability, the companies, as profit

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[50] Jodi L. Short, 'Competing Normative Frameworks and the Limits of Deterrence Theory: Comments on Baker and Griffith's Ensuring Corporate Misconduct' (2013) 38 Law & Social Inquiry 493, 500.

[51] Patrick Bishop, 'Criminal Law as a Preventative Tool of Environmental Regulation: Compliance versus Deterrence' (2009) 60 Northern Ireland Legal Quarterly 279.

maximisers, will not consciously give up those behaviours that have low crime costs and high profits.

Companies, unlike individuals, do not have criminal minds and therefore cannot commit crimes themselves. To address the issue of holding companies criminally liable, in the UK, for example, apart from specific corporate criminal offences created by the Parliament,[52] companies are primarily liable for criminal offences committed by their employees or agents within the company through the theory of vicarious liability and the identification doctrine.[53]

The vicarious liability suggests that companies should hold criminally liable for the illegal activities of their employees or agents who acting on behalf of them. The justification for the existence of vicarious liability is rooted in the belief that the company creates risks for those acting in its behalf in the pursuit of profits. Although the conduct is not intentionally caused by the company, the company has created a risky environment that could have resulted in criminal conduct, then the company is justified in being liable for the risks created and does not need to prove the subjective intent on the part of the offender, nor on the part of the company. In addition to this, the employees are also carrying out business on behalf of the employers. In short, it is reasonable to hold the companies vicariously liable for the illegal actions occurred within the company.

Vicarious liability is considered to be a strict liability in the field of criminal law because it does not require the proof of fault. This can have a deterrent effect on companies. It has been suggested, for example, that making companies vicariously liable can reduce corporate crimes, with more severe penalties leading to a smaller number of corporate crimes.[54]

However, as most criminal offences require the proof of subjective intent of the offender, the

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[52] For example, Corporate Manslaughter and Corporate Homicide Act 2007, BA 2010 and Criminal Finances Act 2017.
[53] Ali Shalchi,'Corporate Criminal Liability in England and Wales' (CBP 9027, June 2022).
[54] Jennifer Arlen, 'The Potentially Perverse Effects of Corporate Criminal Liability' (1994) 23 Journal of Legal Studies 833.

identification doctrine has been relied upon to establish corporate criminal liability in the UK. The identification doctrine requires a company to be held criminally liable for the acts of those within the company who are considered to be the "directing mind or will" of the company.[55] In practice, this is mostly the case for the actions of the company's board of directors or the senior managers. In any event, whether it is a specific corporate criminal offence created by the Parliament, or the corporate criminal liability under the vicarious liability or the identification doctrine, it is difficult to avoid the fact that companies should bear criminal responsibility for the actions of their agents.

Further, following the intensive academic researches, the certainty, severity and celerity of punishment have been identified as indispensable factors in reducing wrongdoings.[56] And there appears to be a positive correlation between increasing certainty, severity and swiftness of punishment and reducing crime. Scholars who support this relationship argue that these factors need to be increased to reduce crime rates.[57] People behave in certain ways out of an instinctive desire to pursue their own interests, and severe penalties can act as a deterrent to people's behaviour. The harsher and more explicit the punishment, the more likely people are to comply with the law.

However, with the mistrust of companies brought about by the corporate scandals that have emerged, a number of scholars have argued that legislative penalties can no longer act as an effective deterrent to corporate crimes.[58] And the use of substitute tool for punishing companies has considered to gradually evolve into a shell mechanism adopted by the regulatory authorities.[59]

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55 See *Lennard's Carrying Co* [1915] AC 705 at 713; *Tesco Supermarket Ltd v Nattrass* [1972] AC 153 at 173.
56 See Oludara Akanmidu, 'The Deterrence Theory: A Case for Enhanced Enforcement of Directors' Duties' (2017) 1 Corporate Governance and Organisation Behaviour Review 25, Benjamin Van Rooij, Adam Fine, Yanyan Zhang and Yunmei Wu, 'Comparative Compliance: Digital Privacy, Deterrence, Social Norms, and Duty in China and the United States'(2017) 39 Law & Policy 73 and Kirk R. Williams and Richard Hawkins, 'Perceptual Research on General Deterrence: A Critical Review' (1986) 20 Law & Society Review 545.
57 Akanmidu (n 56) 10.
58 Win Swenson, 'Growing the Carrot Encouraging Effective Corporate Compliance' (1996) 109 Harvard Law Review 1783.
59 Deng (n 26).

For companies, the most significant penalties are monetary penalties, fines, precisely.[60] However, the effectiveness of fines as a deterrent has been widely questioned. In many cases, fines imposed on companies often do not have a significant deterrent effect, as some companies seeing this as one of the necessary costs of running a company on a day-to-day basis.[61] Fines therefore have little impact on large companies. Imposing a fine on a company is not the same as punishing the behaviour of the insiders. Put it differently, when the fine is paid, the company's internal behaviour may be completely unaffected and will not change in any way and the same behaviour may continue to occur next time. In this case, how can fines reduce corporate crimes? Furthermore, civil fines issued by the enforcement agencies are sometimes even more substantial than criminal fines. Specific criminal fines do not provide the most effective deterrent effect to corporate crimes. Moreover, for companies today, the fear of reputational losses far outweighs the fear associated with criminal fines.[62]

2.4.3 general deterrence approach

If legislatively prescribed penalties are no longer an effective deterrent to crimes, then why not change the solution and adopt a preventive approach to deter individuals and companies from committing offences?

As we discussed before, because the criminal offences require the proof of subjective intent of the perpetrator, the identification doctrine, rather than vicarious liability, is the main basis for corporate criminal liability in the UK.

In the UK's traditional system of corporate criminal liability, the identification doctrine applies when the perpetrator represents the "directing mind and will" of the company, usually limited

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[60] Celia Wells, *Corporations and Criminal Responsibility* (Oxford University Press 2001).
[61] John C. Coffee Jr, 'Crime and the Corporation: Making the Punishment Fit the Corporation' (2021) 47 Journal of Corporation Law 963.
[62] Jonathan M. Karpoff and John R. Lott JR, 'The Reputational Penalty Firms Bear from Committing Criminal Fraud' (1993) 36 The Journal of Law and Economics 757.

to directors and senior managers of the company.[63] However, the British courts have been cautious in holding companies criminally liable for the illegal activities of those who acting on their behalf within the company, leading to the problem that in practice it is not an easy task to criminalise companies. This inevitably affects the deterrent effect of penalties on companies.

Feldman and Kaplan have challenged the effectiveness of using penalties to deter corporate behaviour from a behavioural ethics perspective.[64] It is argued that much of the analysis on deterrence theory assume that penalties will make the potential offender consider the resulting consequences in the decision-making process. But if penalties do have a sufficient deterrent effect on perpetrators, they may not choose to commit the offence in the first place. Coupled with the fact that fines against companies are no longer effective in deterring offences from occurring, how can the probability of a recurrence of the offence be reduced?

Criminal behaviour attributed to a company, if it has already occurred, indicates that there is a problem with the internal governance of the company, and improving the corporate governance structure may prevent the recurrence of violations from the source. An effective internal control mechanism set up within the company can detect violations and the company will then take measures to prevent them from occurring, which can achieve the expected effect of deterrence, changing wrongdoers' behaviour and reducing misconducts. Compliance regimes fulfill this requirement. And backed by punishments, compliance can be made more effective.

There are two ways in which compliance can be effective in reducing the likelihood of a company breaking the law: (1) by providing a sentencing incentive to companies willing to adopt compliance mechanisms that prevent the reoccurrence of crimes; (2) by making the company's lack of a compliance regime a legal deterrent, that is, making the companies criminally liable if they fail to effectively prevent insider crimes from occurring as a result of a

[63] See *Lennard's Carrying Co* [1915] AC 705 at 713; *Bolton Engineering Co Ltd v T J Graham & Sons Ltd* [1957] 1 QB 159 at 172; *John Henshall (Quarries) Ltd v Harvey* [1965] 1 All ER 725 at 729 and T*esco Supermarket Ltd v Nattrass* [1972] AC 153 at 173.

[64] Yuval Feldman and Yotam Kaplan, 'Behavioural Ethics as Compliance' in Van Rooij B and Sokol DD (eds), *The Cambridge Handbook of Compliance* (Cambridge University Press 2021) 50.

lack of compliance regime. Both perspectives involve the companies themselves setting up an internal system to supervise their employees to prevent the occurrence of illegal activities, and the companies are in the best position to monitor the behaviour of its members than any regulators.

In addition, the general deterrence approach is considered to be more effective than the specific deterrence approach from a policy-making point of view. This is because the punishment of a certain group of people can then serve as a warning and education for all remaining violators.[65] Therefore, in the context of corporate law, at least from the perspective of policy and efficiency, there should also be a preference for using the effectiveness of the general deterrence approach to regulate corporate behaviour. Especially today, companies are more fearful of the negative impact of reputational damages on their company than of fines. The loss of a company's reputation can lead to a fall in its image and share price in the short term, but in the long term it can seriously affect a company's inward investment, potential business opportunities and competitive position in the market. It can therefore act as a warning and deterrent to other companies to reduce and avoid non-compliance with the law.

To summarise, deterrence theory provides the theoretical underpinning for compliance. The purpose of deterrence can be divided into two main areas, preventing future non-compliance and encouraging future compliance.[66] The traditional model of deterring corporate crimes, whereby companies are punished after they have committed a crime by imposing severe penalties afterwards, has now proved difficult to achieve the desired deterrent effect on companies, especially the large ones. Compliance, however, as an ex ante regulatory tool, reflects a shift in the law from an ex post punitive deterrent to an ex ante preventive initiative.

2.5 Relationship between corporate governance and compliance

[65] Rooij and others (n 56).

[66] Christopher Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Compliance and Ethics* (Bloomsbury 2015).

The previous section discusses how, from a theoretical perspective, the traditional ex post punitive deterrent approach has been proved ineffective in preventing corporate criminal behaviour and that companies should be encouraged to adopt a new preventive approach to compliance. This section looks at issues arising in practice and finds that the successive corporate failures have led to the identification of problems with corporate governance and the failure of traditional state-imposed legislation to intervene in market regulation to effectively prevent corporate failures from occurring. Compliance returns to the forefront of corporate governance.

To understand the relationship between corporate governance and compliance, it is necessary to start with a brief introduction to the definition, origin and development process of corporate governance.

2.5.1 where it all began: governing failures and corporate governance

As already mentioned in the first section of this chapter, the global corporate crises in the financial sector in the last three decades of the last century have created distrust of companies and governments. In order to regain public confidence in companies in the financial sector and to restore their credibility, governments and regulators are beginning to explore whether there are any deficiencies in the existing regulatory system.

The focus of corporate governance did not come at a time when companies was thriving, but when they were in crisis. The term "governance" used to emphasise the function of governing in the public sector. "Corporate governance" was first used in the United States in the 1970s to regulate the authority of corporate management, which attributed to the conflicts that arise between the company managers and investors at that time.[67] Successive corporate scandals officially pushed corporate governance to the highest public spot. The US Congress then turned

[67] See Brian R. Cheffins, 'The History of Corporate Governance' in Mike Wright, et al. (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2013) 46 and Harwell Wells, 'The Birth of Corporate Governance' (2009) 33 Seattle University Law Review 1247.

to a way of leaving the obligation of complying with the law and the burden of the costs of breaking it to the company to decide.

Although the focus on corporate governance first emerged in the United States, the United Kingdom was the first country to focus on strengthening corporate governance practices at the international level and has led the world ever since.

Corporate governance did not come to the fore in the UK until the 1990s. Similarly, the British companies were also in crisis at that time due to successive problems with the company's management. The UK, like the US, began its discussion of corporate governance with the proper role that the board of directors should play in the affairs of the company. The corporate crises in the UK erupted first in the financial private sector and drew a continuing attention to the governance of financial reporting and accountability. In response to that, the Corporate Governance Committee was set up in 1991 by the accountancy profession, the London Stock Exchange ("LSE"), and Financial Reporting Council ("FRC"). And the committee chaired by Sir Adrian Cadbury published its famous and influential final report on the financial aspects of corporate governance, known as the Cadbury Report[68], in 1992, which defined corporate governance as "the system by which companies are directed and controlled."[69]. The release of the Cadbury Report marked the beginning of compliance with modern British corporate governance.

Apart from the UK, corporate governance began to spread rapidly around the world in the 1990s and early 2000s. In the wake of corporate failures, it was discovered that direct intervention in market regulation through legislation was not effective in preventing corporate failures. As can be seen from the past history of the US and the UK, it was the government that has pushed compliance to the forefront of corporate governance. Both the US and British government turned to a new pattern of governing companies, consider bringing private forces into public

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[68] *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee Publishing,1992) (Cadbury Report).

[69] (n 7).

sector to address the corporate crises. With the reform of integrating privatisation into public sector emerged in western countries, the meaning of self-organising was also incorporated into the new governance.[70] Compliance is back in the public eye again.

2.5.2 corporate governance and compliance approaches

Compliance and corporate governance are closely related. The recent focus on corporate governance stems from the scandals caused by non-compliance, and good corporate governance requires the proper performance of duties within the legal framework of the company. Then a good compliance mechanism within a company can effectively improve the level of corporate governance.

Corporate failures call for reform in the area of corporate governance. However, it has been proven that compliance with the traditional government regulations is not an effective way to manage companies. The conventional government solutions to corporate problems were through ex post penalties in an attempt to deter corporate behaviour, but corporate failures and scandals were arguably a result of decreasing level of compliance and a failure of the deterrent effect of ex post penalties. Companies therefore needed to reconsider their internal structures, regardless of the reasons for their failures. It is clear from the origin and developments of compliance that corporate failures give rise to compliance and force companies to start looking at problems in corporate governance. Compliance, in turn, can help companies improve their corporate governance.

A new legal instrument needs to be suggested to solve these problems. After a spate of corporate failures, governments have begun to favour a self-regulatory approach to improving corporate governance. There was also an international recognition of the need for public sector reform for economic development and the importance of relying on private forces for corporate

[70] Anne Mette Kjær, *Governance* (1st edn, Polity Press 2004).

regulation.

But the regulatory approaches used to promote the corporate governance compliance vary across jurisdictions. As it was discussed in the previous section, the United States provided different stringent legal mandates to give companies strong pressures to put compliance programs in place. Statutory laws play a major role in promoting the development and spread of compliance in the United States. In contrast, the UK relied on corporate governance codes of conduct to encourage companies to use the best practices in corporate governance set out in the codes on a "comply or explain" basis. Companies can choose to align themselves with the codes' recommendations, or they can choose not to comply but need to provide explanations for non-compliance. This effectively leaves the decision on how to apply compliance in corporate governance to the company itself. This section discusses the UK model of corporate governance compliance.

Compliance reflects the value of the new emerging corporate governance model. The function of compliance is consistent with the aims and needs of modern corporate governance. In other words, compliance serves the function of corporate governance. From a corporate perspective, corporate governance is the need to establish a system within the company to ensure that the company operates in the best interests of their investors.[71]

Since the 1990s, corporate governance reforms in the UK have focused on the relationship between shareholders and the management. The Cadbury Report suggested that the essence of any good corporate governance is the managerial freedom to move the company forward, but this freedom must be exercised within a framework of effective accountability.[72] Thus, the centre of the reform of UK corporate governance was to ensure that the board of directors manages the company in an open and transparent manner, and to make sure that the long-term interests and value of shareholders are maximised in the running of an organisation.[73] To

[71] Charles J. Fombrun, 'Building Corporate Reputation Through CSR Initiatives: Evolving Standards' (2005) 8 Corporate Reputation Review 7.
[72] Cadbury Report 1992, para 1.1.
[73] Ibid.

achieve this objective, the Cadbury Report provided the best practice of corporate governance, allowing companies to voluntarily choose to comply with the practice or not. However, the companies were still required to provide explanations for any deviations from the practice.

The reason for this arrangement is to bridge the gap between directors and shareholders, giving shareholders more access to the information they need to know about the company. Corporate governance originated from the separation of ownership and control.[74] Investors in British companies are decentralised and seldom participate in the decision-making process of the company.[75] Therefore, the conflicts between directors and shareholders are significant, and a mechanism is needed to minimise the conflict within the organisations to achieve good governance.

Considering the Cadbury Report as a starting point, the British government offered a series of reports for companies as the guidance of best practices in corporate governance. This "no-one-size-fits-all" approach not only provided the world with a new template for corporate governance, but also drove compliance a major step forward. This approach actually enhances shareholder oversight of the company through the company's disclosure of information.

While corporate governance has previously been focused on the authority of management and the protection of shareholders' interests, it is now seen as a broader set of organisational, managerial and operational systems designed to achieve long-term strategic objectives to meet the requirements of shareholders, directors, management, employees and other company insiders and external stakeholders, and to adopt legal and regulatory mandates as a tool to satisfy all stakeholders within the corporate entity. And from the government's perspective, corporate governance is about ensuring that companies are more competitive in the marketplace through increased accountability within a legal framework. The main function of policies and legislation is therefore to provide a comprehensive mechanism to safeguard the rights of the various stakeholders in the company.

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[74] Priyanka Kaushik Sharma, *Corporate Governance Practices in India* (Palgrave Macmillan Press 2015) 14.
[75] Ibid 20.

In addition, the requirements of modern corporate governance need to be enforced by effective compliance mechanisms of the companies. For example, according to the Organisation for Economic Cooperation and Development ("OECD"), corporate governance relates to the internal means by which corporations are operated and controlled.[76] Assuming that laws and regulations are optimally designed to address the various conflicts of interest in corporate governance, the degree of compliance with these laws and regulations determines the effectiveness of corporate governance. Regulations and rules are only valid when they are followed by individuals and organisations. The setting up and implementation of compliance mechanisms in corporate governance is also considered to contribute to the improvement of firms' value.[77]

In short, corporate failures have created a need to reform corporate governance, and a number of countries have shifted their focuses from government regulations to self-regulatory enforcement by private organisations, which is widely recognised as an effective way to improve corporate governance, and the effective implementation of these mechanisms can help companies develop a culture of compliance that increases the accountability of all parts of the company.

As the global economy continues to evolve, new standards of good corporate governance are being actively explored today, both nationally and internationally. For today's companies, how to build a compliance culture through the adoption of corporate governance regulation into their own internal structures is the real daunting challenge.

It should be noted, both the US and the UK embarked on corporate governance reforms in response to the corporate scandals in the financial sector, but they chose different approaches to address the issues of corporate governance. There are also different models regarding new

[76] OECD Principles of Corporate Governance (1999), preface 5.
[77] Aigbe Akhigbe and Anna D. Martin, 'Valuation Impact of Sarbanes-Oxley: Evidence from Disclosure and Governance within the Financial Services Industry' (2006) 30 Journal of Banking & Finance 989.

forms of corporate governance. For example, the US chooses corporate legislation, while the UK follows a soft law model with the codes. One used the mandatory corporate legislation and the other preferred a voluntary soft law code.

However, it is not only in the UK that more and more companies tend to adopt the best practices and standards provided in the corporate governance codes to govern their companies, even if the codes are purely voluntary in nature. The various codes and standards of corporate governance compliance will be discussed in detail in the next section.

2.6 Codes and standard of compliance in corporate governance

There are multiple laws and regulations, as well as codes of conduct and standard of compliance in corporate governance in the context of different jurisdictions. The relationship between compliance and corporate governance, and what legal approach is best suitable for establishing the standard of compliance in corporate governance is worthy to be discussed.

2.6.1 why codes?

While the rising importance of compliance has become self-evident worldwide, different forms of compliance requirements exist both in the national and international context. Different jurisdictions may have different approaches and attitudes to compliance. Some of them, like the United States, have elevated the adoption of compliance obligations to a specific legal requirement, while others are implementing it only as a recommendation. For example, the United States tends to use mandatory statutory requirements to advance corporate compliance. The influential example among them is the SOA in 2002 which required the management of a company to state in its annual report the establishment and maintenance of internal control structure and procedures for financial reporting, i.e. compliance mechanisms, and an assessment of such structures or procedures.[78]

However, compared with the United States, the current international preference is to promoting the application of compliance to companies in each country in the form of recommendations, with governments and regulators simply providing guidelines or guidance on what constitutes an effective compliance program, leaving room for companies to adapt and apply it in light of their own individual circumstances.

Code is the new form of corporate governance rules and a new way of solving corporate governance problems. With its soft law nature, it is often used as the opposite of laws and regulations with hard law nature. Generally, it consists of a set of corporate governance best practice recommendations as perceived by the body enacting it.

Globalisation has made solving corporate governance problems more than just a national issue. The international debate as to whether hard law or soft law measures should be used to address problems in corporate governance has never been stopped. However, in response to the wave of corporate collapses and crises around the world, more and more countries and international organisations choose to give recommendations in the corporate sector to improve standards of corporate behaviour. They all show a growing interest in adopting corporate governance codes to improve corporate governance.

Awareness of the uniqueness of each company and the complexity of corporate governance structure has led to a tendency to deal with corporate governance issues with a flexible standard. Unlike legislations, corporate governance codes, with soft law nature, refer to a set of non-binding standards and practices designated by regulators of different natures for the purpose of improving corporate governance.[79] The codes encourage companies to adapt flexible regimes towards corporate governance and compliance with the codes are usually voluntary. This means

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[78] SOA 2002, s 404(a).
[79] European Commission Internal Market Directors General, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States* (Weil, Gotshal & Manges 2002).

that there is no legal obligation to comply with the standards of compliance set out under the codes.

A clear standard of compliance with the company's business practices is also considered to be the threshold for the study of corporate governance issues.[80] For corporate governance, paper compliance and non-compliance can lead to the same negative results. Only effective compliance programs can truly improve corporate governance. It is therefore essential to clarify the forms and standards of compliance in the context of corporate governance. Even though some countries recognise the adoption of compliance as a legally mandatory requirement, the design and assessment of the effectiveness of compliance programs is flexible though.

Just as the requirements for adopting compliance are mandatory in the United States in some cases, the United States does not adopt a completely rigid approach and criteria for assessing the effectiveness of compliance programs. For example, recognising that each company may face different circumstances, the *Evaluation of Corporate Compliance Program* issued by the U.S. Department of Justice (Criminal Division) provides general elements of an effective compliance program in the form of answers to the three questions[81] that prosecutors are most interested in when charging a company.

The measures taken by companies to achieve compliance will be more effective if they remain consistent with the intrinsic spirit of the codes rather than the letter of them. Codes provide different standards of compliance, because not only the economic and political environment and judicial system of each country differs, but also the historical background, shareholding structure and size of each company is different. As the Cadbury Report suggested, companies may face greater risks in complying with the letter of the requirements than they do in complying with the spirit inherent in them.[82] Compliance measures should be designed to be

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[80] Charles J. Walsh and Alissa Pyrich, 'Corporate Compliance Programs As a Defense to Criminal Liability: Can a Corporation Save Its Soul?' (1994) 47 Rutgers Law Review 605.
[81] "Is the corporation's compliance program well designed?", "Is the program being applied earnestly and in good faith?" and "Does the corporation's compliance program work in practice?"
[82] Cadbury Report 1992, para 1.10.

implemented with a greater focus on the spirit inherent in the compliance requirements, including what the requirements are intended to achieve and how they are designed to achieve a truly effective compliance outcome.

The trend towards encouraging companies to adopt compliance through codes and the flexible guidance on compliance standards can be seen as efforts to reduce the likelihood of paper compliance. What works for one company does not necessarily work for another. There is no single standard of corporate governance compliance in the world. However, China could draw some characteristics and lessons for effective corporate governance compliance from certain national and international trends. The following sections focus on the international best practices and the position of British and Chinese corporate governance codes.

2.6.2 compliance with the UK codes and standard

Although the reform of corporate governance begun in the United States,[83] it is the United Kingdom that is said to be the representative country in the world for corporate governance codes with higher standards and more comprehensive provisions. And it was not until the first code was introduced in the UK that the world gradually adopted codes for corporate governance to improve corporate behaviour. The worldwide spread of the codes was generally inspired by the Code of Best Practice published in the UK in 1992.

It is well known that the United Kingdom has been at the forefront of corporate governance in the world. Corporate failures in the UK financial sector have led to the gradual realisation that direct government involvement in market regulation through legislation is probably not an effective deterrent to commercial failures. The UK believes that the accountability of company boards and the protection of shareholders' rights should be left to a more flexible approach. Instead, it encourages a voluntary adoption of best practices as a response to the corporate

[83] Cheffins (n 67) 57.

governance issues.

The UK corporate governance codes can be divided into the 1992 version and its successors, as the subsequent reports and codes have largely inherited the basis requirements of the 1992 version and been reviewed on that basis. The UK corporate governance codes include the Cadbury Report in 1992, the Greenbury Report in 1995,[84] the Hample Report in 1998,[85] the Combined Code in 1998 which supersedes the former three reports,[86] the Turnbull Report in 1999,[87] the Smith Report and Higgs Review in 2003,[88] the UK Corporate Governance Code in 2010[89] and its following revisions[90].

The first commonality between the codes is that they all follow a "comply or explain" route. According to Philip and Niamh, what lies in the core of the UK corporate governance codes is flexibility, applying on a comply or explain basis.[91] The Cadbury Report in 1992 was the first to introduce the "comply or explain" approach and set the basic requirements for subsequent successors in the UK corporate governance compliance for over thirty years. The "comply or explain" approach is the foundation of the flexibility which requires all listed companies registered in the UK to state whether they are complying with the code or to give reasons for any areas of non-compliance.[92] In other words, compliance with the codes is voluntary for companies. In addition, any deviations from the Code provided in the annual report and the explanations given in response to them are reviewed by the shareholders, not the government or any regulator. This arrangement on the one hand makes the affairs of the company more open and transparent through the information disclosed in the annual report, on the other hand, it

[84] Study Group on Directors' Remuneration, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (Gee Publishing, 1995).
[85] Committee on Corporate Governance: *Final Report* (Gee Publishing, 1998).
[86] Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice* (May 2000).
[87] *Internal Control: Guidance for Directors on the Combined Code* (The Institute of Chartered Accounts in England & Wales, 1999) ("Turnbull Report").
[88] Audit Committees, *Combined Code Guidance: A Report and Proposed Guidance by an FRC-appointed group chaired by Sir Robert Smith* (2003) and Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (2003).
[89] The Combined Code was revised and renamed the UK Corporate Governance Code.
[90] FRC, *UK Corporate Governance Code* (2016) and FRC, *UK Corporate Governance Code* (2018) (current edition).
[91] Philip J. Shrives and Niamh M. Brennan, 'A Typology for Exploring the Quality of Explanations for Non-compliance with UK Corporate Governance Regulations' (2015) 47 The British Accounting Review 85.
[92] Cadbury Report 1992, para 1.3.

enhances communication between shareholders and the board of directors and gives shareholders the opportunity to understand how the company normally operates.

The codes used in corporate governance in the UK from 1992 onwards all reflect the avoidance of the use of legislation to deal with corporate affairs and corporate failures. Compared with the statues, the codes with a soft law nature preferred the flexibility of companies to follow the spirit inherent in the codes rather than fully strict application of their provisions in the conduct of the companies' affairs.

Secondly, the recommendations of these codes are primarily directed at the responsibilities of the board of directors. They all give recommendations on improving the standard and quality of board governance and encourage the board of directors to be able to choose the ways that are best suited to the long-term success of the company in accordance with its own situations. Specifically, they present a comprehensive set of norms on the role and composition of the board of directors, its relationships with shareholders, auditing and information disclosure, monitoring and supervision, etc.

Finally, the "comply or explain" approach essentially requires companies to achieve corporate compliance by better meeting their disclosure obligations. Through the disclosure requirements, potential investors in the market will be able to compare the compliance status of different companies more easily. This flexible mechanism therefore allows companies to proactively internalise compliance as a best option for the company due to concerns about the company's position and competitive advantage in the market.

In addition, because codes are practice-based, each revised version of the code is enacted after improvements have been made to address the problems that have arisen in practice in the previous version, which will be more conducive to the development of corporate governance standards that are truly appropriate for companies.

2.6.3 international efforts on corporate compliance codes and standard

The international push for corporate compliance began in the late 20th and early 21st centuries. There is also an international preference for using international codes and guidelines to determine compliance obligations and standards. The rapid spread of the codes in the world cannot be achieved without the efforts of international organisations. They are dedicated to encouraging more and more countries to adopt best practice approaches to address the corporate governance issues. The reason for international organisations, represented by the OECD and the World Bank Group, to promote the codes is to advance new global standards of corporate governance to an international level.

The OECD is one of the influential international organisations in the world to set international standards for corporate governance and has laid the foundation for subsequent international developments. It recognised the importance of corporate governance to the global economy back in 1996.[93] In 1998, the Business Sector Advisory Group on Corporate Governance chaired by Ira M. Millstein submitted its report entitled *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* ("the Millstein Report") to the OECD at its request. The report realised that to improve the economic performance of companies through raising the awareness of significance of corporate governance, it was important to focus not only on the government, but also on the role of the private sector. The Advisory Group refused a "one-size-fits-all" approach and offered a market-based perspective, encouraging companies to incorporate more flexibility in their corporate governance practices.[94]

In 1999, OECD developed a framework for standards of good corporate governance, consisting of five basic principles.[95] The principles focus on the protections of shareholders' rights, the

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93 Serdar Celik and Mats Isaksson, 'Adapting Global Standards to a Changing World' <https://millstein.law.columbia.edu/sites/default/files/content/images/01181_Millstein%2010th%20Anniversary%20Essay%201.pdf>accessed 2 February 2023.

94 Business Sector Advisory Group on Corporate Governance, *Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets* (April 1998) ("the Millstein Report"), para 10. <https://read.oecd-ilibrary.org/industry-and-services/corporate-governance-improving-competitiveness-and-access-to-capital-in-global-markets_9789264162709-en#page16> accessed 2 February 2023.

95 The right of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and

equitable treatment of all shareholders, the rights of stakeholders, disclosure requirements and the accountabilities of the board. The following revisions[96] of these principles are maintaining the non-binding nature. These standards are not legally binding and primarily intended to guide the governments and other participants to build a good corporate governance framework. Compliance with these standards and principles is therefore wholly voluntary as well.

In 2004, the OECD issued the *Compliance Risk Management: Managing and improving Tax Compliance* in order to regulate the tax obligations of small businesses. It continued to avoid being a prescriptive scheme for OECD countries to follow blindly, and instead promote a principle-based approach to managing compliance risks.[97] Recognising the important role that a company's internal compliance framework plays in preventing and detecting bribery of foreign public officials in international business transactions, the *Good Practice Guidance on Internal Controls, Ethics and Compliance* issued by the OECD in 2010 continued to provide guidance, in a non-legally binding manner, for companies to establish effective internal controls and compliance programs.

Another investor-led organisation, the International Corporate Governance Network has followed the OECD in adopting voluntary compliance. It adopted and enriched the five OECD Principles and issued the *Statement on Global Corporate Governance Principles* in 1999, which is also considered to be one of the key corporate governance principles in the world.

The World Bank Group is also unwilling to set uniform standards for countries in terms of corporate governance, and has not even issued a unified code. Instead, it emphasises that countries should apply the international best practices to develop their own programs based on their actual conditions.[98] In addition to that, in the decade from 1991 to 2001, 35 corporate

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transparency and the responsibilities of the board. Meeting of the OECD Council, *OECD Principles of Corporate Governance* (2004).

[96] Ibid.

[97] Centre for Tax Policy and Administration, 'Compliance Management: Managing and Improving Tax Compliance' (October 2004) < https://www.oecd.org/tax/administration/33818656.pdf> accessed 13 February 2023.

[98] Magdi Iskander and Naderah Chamlou, *Corporate Governance: A Framework for Implementation* (The World Bank 2000).

governance codes were introduced in the European Union member states.[99]

Although different organisations have different considerations and emphases on corporate governance, they have gradually formed a unified international standard when they are combined. There is no precise document that clearly defines the standard of compliance. This is due to the characteristics of the company and its governance. There are no two companies with identical corporate governance situations. Companies differ in the type and magnitude of risks they face, depending on their sizes, the way they operate, the people within them and so on. This is perhaps why more and more countries are choosing to define compliance standards in the form of codes whose main feature is flexibility.

2.6.4 China: alienation from the codes

Compared to the UK and international developments in the field of corporate governance, Chinese corporate governance compliance starts late, but China also shows a trend towards flexibility in the conduct of corporate affairs and encouraging companies to comply with best practices. However, the international code of corporate governance, which is wholly voluntary in nature, has been alienated into three different forms after its introduction into China, namely codes, guidelines and measures. These different forms of documents, issued by different departments of the Chinese government, all set out standards on compliance, but all differ to varying degrees from the UK and mainstream international corporate governance codes.

Firstly, the Chinese Securities Regulatory Institutions and Market Supervision and Management issued the *Code of Corporate Governance of Listed Companies* in 2018. Compare with the principle-based approach chosen by the OECD and the UK, this Chinese corporate governance code is more like a short version of the Chinese Company Law, which restates and highlights the relatively important provisions of the Company Law relating to the regulation of

[99] (n 79).

listed companies. The overly detailed regulations result in limited scope for companies to choose to apply them according to their own circumstances.

Secondly, some of the guidelines issued in China are in line with the voluntary nature, such as the *Guidelines on the Overseas Anti-monopoly Compliance of Enterprises* issued by the State Administration for Market Regulation in 2021 and the *Guidelines for the Compliance Management of Enterprises' Overseas Operation* issued by the State Development & Reform Commission in 2018. These guidelines only provide general guidance for enterprises on overseas antitrust compliance, and enterprises are advised to consult the latest versions of antitrust legal regulations of the relevant local jurisdictions in China when applying them. However, they also reflect the shortcomings of the guidelines, as the compliance standards set out in these guidelines are mostly general descriptions, which are too simple compared to other international codes, and ultimately make it difficult for companies to apply them in practice.

Thirdly, the compliance management measures and guidelines issued by China's three major financial regulatory bodies all emphasise government regulatory involvement and are not entirely voluntary. The CSRC requires the securities and funds business institution to submit an annual compliance report to the CSRC when submitting the annual report.[100] Apart from that, the CSRC could authorise an external professional institution to evaluate the effectiveness of the compliance of the company, where the CSRC or any of its local offices finds any violations of laws or regulations or has any major hidden compliance risk, it may urge the securities and funds business institution to make rectification.[101]

In addition, the China Insurance Regulatory Commission ("CIRC") also requires insurance companies to submit annual compliance reports to it for regulatory purposes,[102] and the CIRC may also take different levels of supervisory measures against the company depending on the

[100] Measures for the Compliance Management of Securities Companies and Securities Investment Fund Management Companies (2020), article 30.
[101] Ibid, article 31.
[102] Issuing the Measures for the Compliance Management of Insurance Companies (2016), article 37.

circumstances.[103] Finally, the *Guidelines on Compliance Risk Management for Commercial Banks* issued by the CBRC in 2006, although named as guidelines, are essentially the same as the regulatory measures of the CSRC and the CIRC. Article 26 of this guidelines requires commercial banks to submit their compliance policies, procedures and guidelines to the CBRC, and to report to it their compliance risk management plans and compliance risk assessments.

Also of particular note is that both compliance documents issued by the SASAC in China for central enterprises reflect the strict supervisory requirements of the regulator for central enterprises. The *Guidelines for the Compliance Management of Central Enterprises* in 2022 requires the compliance departments to submit the annual reports regarding of compliance management to the SASAC.[104] While the *Measures for Compliance Management of Central Enterprises* ("Measures") in 2022 provides that the SASAC may order the central enterprises which violate the Measures to make rectification and hold them liable if any loss or adverse impact has been caused.[105]

As can be seen from the above discussion, the codes under the Chinese corporate context are superficially in line with the form of corporate governance codes advocated internationally, but still essentially emphasise the involvement of regulators to varying degrees, and do not conform to the non-legally binding nature of international codes.

2.7 Conclusion

Compliance is not a new concept. Until today, compliance is everywhere. There seems to be a common phenomenon all over the world today where everyone is talking about compliance, but no one seems to have a perfect definition of compliance. The definitions that do exist today are in fact more like multi-dimensional interpretations of the compliance function.

[103] Ibid, article 38.
[104] Guidelines for the Compliance Management of Central Enterprises (2022), article 28.
[105] Ibid, article 37.

Corporate compliance arises from corporate crises in different business sectors and is further developed under the regulation and promotion of the government. Corporate compliance has its roots in corporate crises in different business sectors and has been further developed by government regulation and facilitation. As a form of self-regulation, compliance can replace some of the state's enforcement functions and save regulatory resources. Compliance mechanisms developed within companies can also effectively prevent and deter the occurrence of internal violations by identifying different risks in the company's operations. In addition, an effective compliance program can even play a role in the conviction and sentencing stages of a company.

Traditional penalties are no longer an effective deterrent to prevent and reduce corporate crimes, and compliance as an ex ante regulatory tool shows the trend of the law shifting from ex post punitive deterrence to ex ante preventive initiatives. Compliance serves as a vital function in enhancing corporate governance by the prevention and detection of corporate misconduct. It represents the regulatory nature of companies controlling and governing their behaviour to legal and social norms. At both a national and global level, compliance plays a significant role in corporate governance.

While there is a worldwide trend to adopt voluntary corporate governance codes to provide best practices to promote corporate compliance and improve corporate governance, the current Chinese codes differ from the world trend and continue to emphasise government regulation of corporate affairs. In order to accelerate the development of compliance for domestic companies and to increase the competitive advantages of Chinese companies abroad, China should align itself with the worldwide standards.

Chapter 3 The Corporate Governance Landscape in China

3.1 Introduction

The study of corporate governance landscape in China is of great importance to the study of compliance with Chinese corporate governance rules. On the one hand, because the corporate governance environment of a country determines how the internal governance institutions and mechanisms of a company should be designed, and on the other hand, the achievement of corporate compliance in modern society no longer only requires regulation by company law alone, but also involves the concerted efforts of securities law, criminal law and rules of other regulatory authorities, it is therefore important to understand the situation of corporate governance in China before conducting a comprehensive review of compliance with corporate governance rules in China.

Since 1993, China has been exploring the establishment of a modern enterprise system for three decades. China's first Company Law was introduced at the same year as a response to this demand, officially starting the construction of China's corporate governance system. The core of China's modern enterprise system is to improve corporate governance. Improving corporate governance is important for Chinese companies to achieve successful long-term growth and to enhance their international competitiveness.

Although the start and development of corporate governance in China is relatively late compared to some developed countries, Chinese corporate governance has developed its own characteristics over time. China's corporate governance has moved towards market-oriented reforms, but the results have not been as effective as expected. The purpose of this chapter is to provide a systematic overview of the corporate governance landscape in China and to summarise the characteristics of the Chinese corporate governance system.

This chapter focuses on compliance with corporate governance rules which try to change the companies' governance in China and is structured as follows. Section 2 begins by providing an overview of the legal framework for corporate governance in China. After comparing the self-regulation of corporate governance in the UK, section 3 points out that China's legal rules on corporate governance do not include self-regulation of the same nature as in the UK, as the regulatory status of the rule-makers leaves the implementation of the rules still under tight governance control, revealing the strictly regulatory nature of corporate governance in China. Then section 4 discusses the role of corporate takeovers in Chinese corporate governance. It is found that the primary role of takeovers in Chinese corporate governance system is to protect the legitimate interests of investors and shareholders, and Chinese corporate governance rules overlook the compliance incentive role that takeovers can play in urging directors to perform their duties. The fifth section goes on to describe the characteristics of the ownership structure of Chinese companies and analyses how a concentrated ownership structure affects the corporate governance of Chinese companies. Further, section 6 examines the relationship between shareholders and directors in Chinese companies under the influence of Chinese concentrated share ownership structure. The final section concludes the whole chapter.

3.2 Legal framework of corporate governance in China

From the founding of the People's Republic of China in 1949 until the late 1970s, China's corporate reforms were not market-oriented.[106] With the establishment of the opening-up policy in 1978, China began its transition to a market economy. The number of private companies began to increase from then onwards. The concept of private economy was added to the 1988 Constitution, but the reforms were still based on Chinese SOEs.

In response to the requirement to establish a modern enterprise system as proposed by the Third Plenary Session of the 14th Central Committee of the Communist Party of China ("CCP") in 1993, China began to construct a modern corporate governance mechanism with Chinese characteristics. In other words, the construction of a modern corporate governance mechanism in China has only been in place for thirty years now. Further, with the globalisation of the

[106] Andrew Keay and Jingchen Zhao, 'Transforming Corporate Governance in Chinese Corporations: A Journey, Not a Destination' (2018) 38 Northwestern Journal of International Law & Business 187.

economy and the accession to the World Trade Organisation ("WTO") in 2001, both SOEs and other types of Chinese companies continued to reform accordingly to meet the basic requirements under international standards.

Over the past few decades, a basic legal framework for corporate governance including company law, securities law, criminal law and other regulatory regulations has been established in China. But even so, the predominantly public and state-controlled nature of the economy remains unchanged. These political contexts are also subtly influencing the legal framework of corporate governance in China. While the government plays an important and influential role in China's corporate governance landscape, this is not the case for companies themselves.

A complete and effective legal framework for companies is important for corporate governance. The current Chinese corporate governance legal system has formed a corporate governance structure with clear rights and responsibilities and effective checks and balances among the board of shareholders, the board of directors, the supervisory board and the management. Before taking a closer look at the problems in corporate governance in China, a brief overview of its legal framework is quite necessary.

3.2.1 basic laws

Company Law

The Company Law of the People's Republic of China ("Company Law") sets out the basic legal framework for corporate governance in China. Improving the corporate governance structure with Chinese characteristics has always been the focus of Chinese Company Law.

The first Company Law in China was enacted in 1993 to speed up the transition from a planned economy to a market economy in preparation for China's accession to the WTO. The 1993 Company Law was enacted to provide a legal basis for the corporatisation of SOEs. At that time, although the SOEs have been corporatised and restructured, they still followed the traditional corporate model and have not developed a modern corporate governance structure.

The further development of modern corporate governance in China was represented by the 2005 Company Law. It was a response to the pressure of global competition following China's accession to the WTO. The 2005 Company Law shifted the focus of regulation from SOEs to all market players. It relaxed the government control and regulation of companies and gave company more autonomy to enhance the competitiveness of companies by expanding the shareholders' right to information, introducing a duty of fidelity and diligence of directors to the company to strengthen the powers and responsibilities of directors, supervisors and senior officers, clarifying the derivative action regime and giving greater autonomy to the articles of association, etc.

Subsequent amendments[107] to the Company Law have also reflected the tendency of China to be in line with the world standards of corporate governance. Although the Company Law has undergone a number of amendments in the three decades since it was first promulgated, its basic framework design has not fundamentally changed. The Chinese Company Law divides Chinese companies into two categories, limited liability companies ("LLCs") and joint stock limited companies, and regulates these two different types of companies with different provisions respectively. For the purpose of regulating the corporate activities and protecting the legitimate rights and interests of companies, shareholders and creditors, the Chinese Company Law sets out the organisational structure that a company should have and its statutory powers. The corporate governance structure sets up with a separation of powers and checks and balances among the four governing subjects, the board of shareholders, the board of directors and the supervisory board and managers.

According to the Company Law in China, the board of shareholders is the highest authoritative

[107] Since 2005, the Company Law has undergone two amendments, in 2013 and 2018, and the applicable version is now the Company Law (2018 Amendment). The following provisions of the Company Law in China in this study are from the 2018 Amendment, unless explicitly marked otherwise.

body of the company[108] and determines the company's operational guidelines and investment plans, and is responsible for the selection and replacement of directors and supervisors.[109] The company is required to regularly disclose to the shareholders the information relating to remuneration received by directors, supervisors and senior officers[110] from the company.[111] Also, in order to adapt to the continuous development of modern science and technology and innovate corporate governance methods, the listed companies are required to provide shareholders with the channel of online voting so as to make it convenient for the shareholders to attending the general meeting.[112]

The board of directors, as the decision-making body of the company, is required to be responsible to the board of shareholders and execute the resolutions of the board of shareholders.[113] The Company Law requires the directors and senior officers to comply with laws, administrative regulations, and the articles of association, and shall owe the duties of fidelity and diligence to the company.[114] In addition, the directors are required to assume liability for the resolutions of the board of directors. While the company suffers serious losses due to the violation of laws and regulations or the articles of association and the resolutions of the general meeting of shareholders, the directors participating in the adoption of the resolutions shall be liable for compensation to the company.[115]

In addition, Chinese companies choose a two-tier board system of corporate governance.[116] There is both a board of directors and a supervisory board within the company. The supervisory board is the supervisory body of the Chinese companies. Since the supervisory board is

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108 Company Law 2018, article 36, 98.
109 Ibid, article 37(1) and (2).
110 According to art 216 (1) of the Company Law 2018, a "senior officer" refers to any manager, deputy manager, financial principal, secretary to the board of directors of a listed company, or any other person specified in the arts of association.
111 Company Law 2018, article116.
112 Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (2020), article 4.3.5; Stock Listing Rules of the Shenzhen Stock Exchange (2020), article 8.2 and Stock Listing Rules of the Beijing Stock Exchange (2021), article 4.1.10.
113 Company Law 2018, article 46.
114 Ibid, article 147.
115 Code of Corporate Governance of Listed Companies (2018), article 23.
116 Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-Owned Enterprises' (2014) 47 Cornell International Law Journal 631.

responsible for supervising the legality and compliance of the performance of duties of directors and senior officers within the company, directors and senior officers shall not concurrently serve as supervisors.[117]

The managers are the executive body of the company, who are required to be hired or dismissed upon the decision of the board of directors and be subject to the supervision of the board of directors.[118] They are also required to strictly implement the decisions of the board of shareholders and the board of directors.

From the above system design of the internal structure of Chinese companies in the Company Law, it is clear that the Chinese Company Law is intended to follow the internal governance concept of separation of powers and checks and balances: the company manager is accountable to the board of directors, the board of directors is accountable to the company's board of shareholders and the supervisory board, as the supervisory body, is responsible for overseeing decisions on company affairs. The Chinese Company Law adheres to the principle of shareholder primacy and the internal governance structure of the company follows a path designed to make the manager accountable to the board of directors and the board of directors accountable to the board of shareholders.

Securities Law

Apart from the Company Law, the Securities Law of the People's Republic of China ("Securities Law") is the primary and most important law in China's legal framework for corporate governance.

The regulation of listed companies has been the main focus of China's Securities Law. Due to the significance and publicity of listed companies, the regulation of listed companies occupies an important position in the whole Chinese corporate governance system and is also the pioneer

[117] Company Law 2018, article 51.
[118] Ibid, article 49, 113.

of Chinese corporate governance reform. In order to regulate the behaviour of listed companies, apart from the Company Law which sets up a special section to make provisions,[119] the Securities Law also has a special chapter of Chapter IV to govern the takeover activities of listed companies.

The information disclosure regime is another major focus of China's Securities law. An issuer and other persons with information disclosure obligations as prescribed by laws, administrative regulations, and the rules of the securities regulatory agency of the State Council are required to perform their information disclosure obligations in a timely manner in accordance with the Securities law.[120] The fulfilment of information disclosure obligations helps investors to fully understand the company's situation and facilitate their investment judgement and choices.

The main mission of Securities law in China is to promote corporate governance of listed companies from a regulatory perspective, aiming to protect the interests of investors and form a healthy market environment of investment.

Criminal Law

Criminal law is often used to cover conduct in companies that involves the commission of a crime. The Criminal Law of the People's Republic of China ("Criminal Law") regulates, on the one hand, the acts disrupting the order of company administration, and on the other hand, the illegal acts of relevant personnel in the company's governance system.

The Criminal Law in China is made up of two parts, the general provisions and the specific provisions. The general provisions of the Criminal Law clearly stipulate that a company which commits an act endangered society that is considered a crime under the law shall bear criminal responsibility.[121] In the specific provisions of the Criminal Law, there are special sections to

[119] Ibid, ch 4 s 5.
[120] Securities Law 2019, article 78.
[121] Criminal Law 2020, article 30.

regulate the acts that hinder the administrative order of companies.[122] For example, the crime of false capital contribution and withdrawal of capital,[123] crime of fraudulently issuing securities,[124] crime of illegal disclosure or non-disclosure of important information,[125] crime of obstructing liquidation,[126] crime of accepting bribes by non-state functionaries,[127] crime of offering bribes to non-state functionaries, crime of offering bribes to foreign public officials and officials of public international organisations,[128] crime of illegally operating similar businesses,[129] crime of illegally making profits for relatives and friends,[130] crime of being cheated for irresponsibility in signing or fulfilling contracts,[131] crimes of dereliction of duty by personnel of state-owned companies, enterprises and institutions, and crimes of abuse of power by personnel of state-owned companies, enterprises and institutions[132]. The above crimes not only apply to the company itself, but also the directly responsible supervisors, other directly responsible personnel, controlling shareholders, and actual controllers who meet the circumstances set forth in the relevant provisions need to bear criminal liability as well.

In addition, preventing and combating transnational commercial bribery has increasingly become an important part of the governance of corruption offences in various countries, contributing to the development of corporate criminal compliance. Chinese academics are also currently actively exploring the introduction of a criminal compliance regime to help companies prevent and detect the occurrence of violations, which will be discussed in Chapter 6.

3.2.2 departmental rules and regulations

The CSRC is in a leading position to promote and enforce corporate governance in China. In

122 Ibid Chapter 3 Section 3.
123 Ibid article 159, for the company promoters and shareholders.
124 Ibid article 160.
125 Ibid article 161.
126 Ibid article 162, including article 162(1) crime of concealing or deliberately destroying financial vouchers, financial account books and financial statements and article 162(2) crime of false bankruptcy.
127 Ibid article 163.
128 Ibid article 164.
129 Ibid article 165, for directors and managers of state-owned companies.
130 Ibid article 166, for work personnel in state-owned companies.
131 Ibid article 167, for people in charge of state-owned companies.
132 Ibid article 168.

general, it is responsible for playing a complementary role to those areas not covered by the Chinese Company Law and the Securities Law. The CSRC mainly exercises centralised and unified supervision of the securities and futures markets, regulates the securities market conduct of listed companies and their shareholders who are required to fulfil their obligations under the laws and regulations and has the power to investigate and impose penalties for securities and futures violations.

The CSRC issued the *Code of Corporate Governance of Listed Companies* (the "Code") which established the basic framework of the corporate governance structure of Chinese listed companies in 2001 in order to improve the corporate governance practices in China. In 2018, the CSRC has revised the Code again to focus not only on local Chinese corporate issues such as the constraints on controlling shareholders, but also to enhance the protection of investors' rights in order to achieve convergence with international standards.

In order to protect the legitimate rights and interests of investors and the independence of the company, clear rules of procedure of the board of shareholders and the board of directors have also been formulated by the CSRC. If any director, supervisor or secretary of the board of directors violates any law, administrative regulations or articles of associations and fails to effectively perform his or her duties, the CSRC and its local office have the power to order him or her to take corrective action, as well as a public censure issued by the stock exchange, and if the circumstances are serious enough or the violator fails to take actions, the CSRC may ban him or her from access to the securities market.[133] In addition to systematically restricting the boundaries of the duties of directors, supervisors and senior managers, further provisions have been made by the CSRC on the behaviour, legal liability of controlling shareholders, actual controllers and their related parties. The controlling shareholders, actual controllers and their affiliated parties of a listed company shall not directly appoint or dismiss senior executives by bypassing the board of shareholders or the board of directors.[134] In addition, listed companies are also required to establish an internal control system, and the board of directors is responsible

[133] Rules for the Shareholders' Meetings of Listed Companies (2022), article 49.
[134] Code of Corporate Governance of Listed Companies (2018), article 51.

for the effective implementation of the internal control system.[135] A listed company shall ensure the reliability of financial reports and guarantee the company's standard operation.[136]

The CSRC has always regarded the relationship between companies and investors as an important part to improve the corporate governance structure. In order to strengthen the relationship between companies and investors, China has established an information disclosure system in its corporate governance legal system. The directors, supervisors, senior managers, controlling shareholders and actual controllers of a listed company shall, in accordance with the law, perform their information disclosure obligations in a timely manner and ensure that the information disclosed is true, accurate, complete, concise and fair, and shall not contain any false records, misleading statements or material omissions.[137] The CSRC may require the above-mentioned person with information disclosure obligations[138] to make an explanation, or provide relevant materials or professional opinions of the securities company or securities service institution in time, and cooperate with the CSRC in its inspection and investigation.[139]

The directors, supervisors, senior managers, the secretary of the board and financial person-in-charge of a listed company shall be liable for the genuineness, accuracy, completeness, timeliness and fairness of the information disclosure and financial reports of the company.[140] If the person with information disclosure duties violates any provisions of these measures, it shall be regulated by the CSRC or punished in accordance with the articles of the Securities Law, and may even be transferred to the judicial authorities for enforcement of criminal responsibility.[141] Each listed company shall conscientiously disclose information, treat all of

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[135] The Stock Listing Rules of Beijing Stock Exchange (2021), article 4.1.24.
[136] Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (2020), article 4.3.2.
[137] See Securities Law 2019, article 78; Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (2020), article 4.1.1 and 4.1.5 and c 5; Stock Listing Rules of the Shenzhen Stock Exchange (2020), ch 2 and Measures for the Administration of Information Disclosure by Listed Companies (2021), article 4.
[138] According to article 62(2) of the Measures for the Administration of Information Disclosure by Listed Companies (2021), the term "person with information disclosure obligations" means a listed company, or any of its directors, supervisors, officers, shareholders, and actual controller; an acquirer; each party, or any other natural person or entity, related to material asset restructuring, a seasoned offering, or a material transaction, or any person related thereto; a trustee in bankruptcy, or any of its members; or any other person undertaking information disclosure obligations as required by laws, administrative regulations, and the CSRC.
[139] Ibid, article 50.
[140] Ibid, article 51.
[141] Ibid, ch 5.

its shareholders fairly and avoid selective disclosure.[142] Moreover, the CSRC has formulated the *Guidelines for the Relationship Between Listed companies and Investors* in 2005 to protect the legitimate rights and interests of investors, especially public investors, by intensifying the information communication, enhancing the transparency of information disclosure to protect the participation, lawful rights and interests of shareholders.

In addition, independent directors are introduced as external forces in Chinese legal framework of corporate governance to supervise and improve the corporate governance structure. The CSRC issued the *Guiding Opinions on Establishing the Institution of Independent Directors in Listed Companies* in 2001, and officially introduced the independent director system into Chinese corporate governance system. Independent directors are required to perform their duties independently as external directors of the company.[143] Listed companies are required to have independent directors.[144] Independent directors have the obligation of good faith and due diligence to the company and all shareholders, that is, they should earnestly perform their duties in accordance with the requirements of relevant laws and regulations, guidelines and the articles of association, especially to protect the legitimate rights and interests of minority shareholders from damage,[145] which may include related-party transactions, external guarantee, mergers and acquisitions and distribution of profits and other matters closely related to the interests of minority shareholders.[146]

The current provisions on independent directors are designed to ensure that they are not affected by major shareholders, actual controllers or units and individuals with interests with the above-mentioned persons. Therefore, independent directors are required to serve in up to five listed companies in principle for ensuring sufficient time and energy to effectively perform their duties,[147] and shall not hold any positions of any listed companies other than members of the

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142 The Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders (2004), article 3.3.
143 See Guiding Opinions on Establishing the Institution of Independent Directors in Listed Companies (2001).
144 Company Law 2018, article 122.
145 (n143), article 1(2).
146 Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (2020), article 4.2.6.
147 Rules for the Independent Directors of Listed Companies (2022), article 6.

special committee of the board of directors.[148] In addition, no independent directors shall have a relationship with the listed company that employs him or her and its main shareholders that may hinder his or her independent and objective judgment.[149]

Moreover, listed companies are encouraged to set up special committees such as those for audit, strategy, nomination, remuneration and appraisal. The members of these committees shall all be directors and they shall be responsible to the board of directors.[150] And it is required that the members of special committees should include a certain number of independent directors.[151] It thus can be regarded as an extension of the Chinese independent director system.

3.2.3 rules on Chinese SOEs

As the development of SOEs is crucial to the development of corporate governance in China and indeed the Chinese economy, an examination of SOEs is indispensable to the study of corporate governance in China. In fact, China has also never stopped trying to improve the efficiency of SOEs in terms of institutional design. This section therefore introduces the legal framework of corporate governance for SOEs in China. Improving corporate governance structures has also been an important task in the reform of Chinese SOEs over the years.

The history of SOEs reform is a reform of China's transition from a state-controlled economy to a market-based economy. Corporate governance in China began with the reform of SOEs and focused on how to establish a modern corporate governance structure for SOEs through the pressure of market forces to improve the dynamism and operational efficiency of SOEs.[152]

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148 Code of Corporate Governance of Listed Companies (2018), article 34.
149 Ibid, article 35.
150 Measures of the Beijing Stock Exchange for the Continuous Regulation of Listed Companies (for Trial Implementation) (2021), article 6.
151 See (n 143), article 5(4); Code of Corporate Governance of Listed Companies 2018, article 38 and Rules Governing the Listing of Stocks on the Science and Technology Innovation Board of Shanghai Stock Exchange (2020), article 4.3.11.
152 Kaixiang Liu and Jing Liu（刘凯湘, 刘晶）,（我国股东会中心主义的历史成因-以国有企业改制为线索）'The Historical Causes of Shareholder Centralism in China: Taking the Reform of State-Owned Enterprises as a Clue' (2021) 36 Legal Forum 51.

With the introduction of the Chinese opening-up policy in 1978, SOEs were also given greater autonomy.[153] The 1993 Company Law provided the legal basis for the conversion of SOEs into companies, requiring them to convert their operating mechanisms and establish a standardised internal management structure in accordance with the law.[154] The corporatisation of SOEs resulted in the state becoming the controlling shareholder of the company.

Ownership of state-owned property rights in a company belongs to the State.[155] The state-owned assets supervision and administrative body delegated by the State Council and the local people's government perform the contributor's functions for SOEs and enjoy the contributor's rights and interests on behalf of the state.[156] However, the State Council and local people's governments shall separate the public administration function from the capital contribution function and shall not interfere with the independent operation of the enterprises.[157]

Accordingly, in terms of the establishment of functional bodies, the body performing the contributor's function exercises the rights and fulfils the obligations of shareholders. And the body performing the contributor's function is responsible for the appointment or removal of the board of directors, supervisory board and senior managers.[158] The standing Committee of the people's congress at every level legally exercise the powers of supervision through hearing and deliberating the work reports on the performance of the body performing the contributor's function.[159] And the management is the executive body of the SOEs, appointed and dismissed by the board of directors in accordance with the law and subject to the supervision of the board of directors and the supervisory board. The general manager is accountable to the board of directors.[160]

[153] Keay and Zhao (n 106).
[154] Company Law 1993, article 7.
[155] Ibid, article 4.
[156] Law of the People's Republic of China on the State-Owned Assets of Enterprises 2008, article 4, 11.
[157] Ibid, article 6.
[158] Ibid, article 22.
[159] Ibid, article 63.
[160] Guidance from The General Office of the State Council on Further Improving the Corporate Governance Structure of State-Owned Enterprises 2017, article 3(1).

Significant matters of SOEs also need to be decided by the body performing contribution functions, such as mergers, splitting, increase or reduction of registered capital, distribution of profits and petition for bankruptcy.[161] As for significant matters concerning important SOEs, the body performing the contribution function shall report to the corresponding people's government for approval before making a decision. The so-called "important SOEs" are determined by reference to the provisions of the State Council.[162]

The distinctive feature of the rules on Chinese SOEs is the legal status of the Party Group of CCP in the corporate governance structure of SOEs. The Party Group is involved in all aspects of decision-making, implementation and supervision of the SOEs,[163] with the Party appointing national officials to the board of directors, the supervisory board and the management and attending the corresponding meetings.[164] The Party organisation and its departments and the Party Committee of the state-owned assets supervisory body should set the criteria and procedures for the selection and appointment of managers by the board of directors.[165]

The above key rules governing Chinese SOEs show that the Chinese government has a tight control of SOEs. The government is not only the controlling shareholder of the SOEs, but also the regulator.[166] Further, the political objectives of SOEs themselves have also resulted in the legal framework provided by China not doing much to improve the operating performance of SOEs. As the construction of China's corporate governance system began with the corporatisation of Chinese SOEs and the state is therefore deeply involved. As SOEs focus on the protection of state assets and emphasise the position of the state as the major shareholder, the construction of modern corporate governance system in China inevitably reflects a reverence for the position of the board of shareholders.[167]

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[161] State-Owned Assets of Enterprises 2008, article 31.
[162] Ibid, article 34.
[163] (n 160), article 2 (5)(1).
[164] Ibid, article 2 (5)(2).
[165] ibid, article 2 (5)(3).
[166] Qiao Liu, *Corporate Governance 2.0: The Great Shakeup* (Palgrave Macmillan 2016).
[167] Liu and Liu (n 152).

To provide companies with a good rule of law environment for corporate governance, different laws and rules need to dovetail with each other and fill each other's gaps. In summary, the above basic laws and departmental rules and regulations together form the basic legal framework for corporate governance in China. The legal rules of corporate governance in China are characterised by mainly mandatory legislation to regulate companies, and the departmental regulations are also mostly regulatory in nature. In addition, the development of Chinese SOEs has always been under the government's control.

3.3 Corporate governance self-regulation in China

In addition to regulating corporate governance by using statutory rules to prohibit certain corporate conduct, corporate governance can also take the form of allowing companies to self-regulate according to their own characteristics to deal with issues in corporate governance.

In recent years there has been a boom in self-regulation in the field of corporate governance both at national and international level. Before exploring whether self-regulation is applicable in the context of corporate governance in China, a definition of self-regulation should be discussed at first.

3.3.1 what is corporate governance self-regulation?

Literally, self-regulation is a form of regulation. In a simplistic sense, it refers to members of the private sector managing their own affairs.[168] In fact, however, self-regulation is a broad term covering "a variety of self-regulatory practices with little or no state intervention and formality whereby a multitude of non-state actors may also be involved as direct and indirect regulators".[169] According to OECD, self-regulation "involves a group of economic agents

[168] Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford University Press 1997) and Peter Drahos (ed), *Regulatory Theory: Foundations And Applications* (ANU Press 2017) 140.
[169] Nicholas J Lord, 'Regulating Transnational Corporate Bribery: Anti-bribery And Corruption in the UK and

voluntarily developing rules or codes of conduct that regulate or guide the behaviour, actions and standards of its members"[170]. In addition, it can also be applied to many different sectors with different forms, including but not limited to environment, labor, health and anti-bribery.[171] The most distinctive and generally accepted feature of self-regulation is its flexibility on regulation in comparison with other legislative mechanisms.[172] Therefore, it is often considered as an alternative to direct government involvement as a regulatory strategy.[173] Then the self-regulation in the corporate governance context can be thought of as the companies or industries[174] regulating their own internal actions and affairs.

There are various arrangements of self-regulation.[175] Self-regulation can be categorised into pure self-regulation and enforced self-regulation in terms of enforcement.[176] Pure self-regulation is for companies or industries to voluntarily self-monitor their non-compliance behaviour,[177] usually in the form of voluntary codes of conduct to regulate or change companies' behavior. Its biggest weakness is not enforceable. The motivation behind pure self-regulation is often market-driven. In other words, companies choose to voluntarily self-regulate out of the fear of the reputational risk of non-compliance, and pressure form stakeholders such as employees, consumers and investors.[178] However, not all companies are deeply affected by the negative feedback from the market, and they may choose not to enforce the rules of self-

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Germany' (2013) 60 Crime, Law and Social Change 127, 139.

170 OECD Report, Alternatives to Traditional Regulation 6 < https://www.oecd.org/gov/regulatory-policy/42245468.pdf> assessed 27 July 2023.

171 Julia Black, 'Decentring Regulation: Understanding the Role of Regulation And Self-Regulation in A 'Post-Regulatory' World' (2001) 54 Current Legal Problems 103 and Monique Boekaerts, Paul R. Pintrich and Moshe Zeidner (eds), *Handbook of Self-Regulation* (Academic Press 2010).

172 Daniel Fitzpatrick, *The Politics of Regulation in the UK: Between Tradition, Contingency and Crisis* (Palgrave Macmillan 2016) 64.

173 John Braithwaite, 'Enforced Self-regulation: A New Strategy for Corporate Crime Control' (1982) 80 Michigan Law Review 1466.

174 In this sense, some scholars also refer to it as industry self-regulation, meaning self-regulation by member firms to improve the reputation of the industry as a whole. See Michael Lenox, 'Do Voluntary Standards Work Among Corporations? The Experience of the Chemicals Industry' in Dana Brown and Ngaire Woods (eds), *Making Global Self-Regulation Effective in Developing Countries* (Oxford University Press 2007) 62.

175 See OECD Report (n 170)34; Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Clarendon Press 1994) 109 and Lord (n 169).

176 Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1st edn, Oxford University Press 1992).

177 Jodi L. Short and Michael W. Toffel, 'Coerced Confessions: Self-Policing in the Shadow of the Regulator' (2008) 24 The Journal of Law, Economics & Organization 45.

178 David Graham and Ngaire Woods, 'Making Corporate Self-Regulation Effective in Developing Countries' in Dana Brown and Ngaire Woods (eds), *Making Global Self-Regulation Effective in Developing Countries* (Oxford University Press 2007).

monitoring. Thus, pure self-regulation driven by the market forces has a limited impact on promoting corporate compliance.

It has been argued that the success of pure self-regulation requires more desirable regulatory forces to help to enforce them,[179] such as coercive ongoing regulations by regulators.[180] Government regulatory activities continue to play an active role in urging companies to comply.[181] Then, enforced self-regulation is advocated. Enforced self-regulation is considered as a "middle path between (pure) self-regulation and command and control government regulation"[182] where companies are required to devise their own rules and are responsible for monitoring them. However, in contrast to pure self-regulation, the standards to be achieved under enforced self-regulation are set and enforced by the regulators, not by the companies or industries.[183]

Pure self-regulation and enforced self-regulation, which are both forms of regulatory strategies, are not exclusive, but should be combined to promote corporate compliance. Regulatory measures characterised by coercion are unnecessary when companies' behaviour can simply be adjusted by market forces.[184] Enforced self-regulation, on the other hand, can avoid the weaknesses of pure self-regulation in terms of lack of enforcement, while at the same time combining its advantages of flexibility to stimulate the potential for corporate self-regulation. In other words, enforced self-regulation can rely on both market and state power to ensure better enforcement of (pure) self-regulation.[185]

The reason why regulators should choose to delegate authority to companies to self-regulate when they are perfectly capable of enacting legislative rules is worth discussing. Self-regulation is known as an alternative to government regulation for its flexibility, adaptability and lower

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[179] Drahos (n 168).
[180] Short and Toffel (n 177).
[181] Ibid.
[182] Robyn Fairman and Charlotte Yapp, 'Enforced Self-regulation, Prescription, and Conceptions of Compliance Within Small Businesses: The Impact of Enforcement' (2005) 27 Law & Policy 491.
[183] Ibid, 493.
[184] Ayres and Braithwaite (n 176) 3.
[185] Fairman and Yapp (n 182) 517.

costs. Organisations generally choose to apply self-regulation for three main purposes of safeguarding the organisations' own interests and the public interest, as well as to avoid direct state intervention towards the organisation.[186]

Firstly, self-regulation demonstrates the autonomy of the company to manage its own affairs. This is based on the belief that the company is in an optimal position to understand and assess its own situation. In this regard, it is more in the company's own interest to leave it to itself to deal with the problems and crises it encounters in its operations than to other regulators, such as the government, who do not know the actual situation of the company.

Secondly, self-regulation by companies means that there is no need for the government to invest significant effort and resources in the regulation of corporate affairs. It can be seen as an alternative to the statutory regulation. On the other hand, it also saves companies the time and resources they would otherwise have to spend on the regulatory activities.[187]

Another major reason for the advocacy of self-regulation is that it is believed the practical rules can be more easily led to compliance.[188] Self-regulation is, to some extent, a summary of best practice in different industries based on the experience of companies in their operations and is more applicable as it is more relevant to the actual situation of the company, making self-regulatory measures easier to achieve compliance by companies than general legislative rules.

3.3.2 corporate governance self-regulation in the UK

Corporate governance compliance in the UK is enabled and known by effective self-regulation.[189] Thus, to be able to discuss and evaluate the corporate governance self-regulation

[186] Rob Baggott, 'Regulatory Reform in Britain: The Changing Face of Self-regulation' (1989) 67 Public Administration 435.
[187] Fairman and Yapp (n 182).
[188] Ian Bartle and Peter Vass, 'Self-regulation and the Regulatory State: A Survey of Policy and Practice' (University of Bath 2005).
[189] Alan Dignam, 'Capturing Corporate Governance: The End of the UK Self-Regulating System' (2007) 4 International Journal of Disclosure and Governance 24.

in China, it is better to first analyse the self-regulatory regimes involved in the UK.

Self-regulation is not new in the UK. According to Baggott, there is a long tradition of self-regulation in the UK.[190] The UK is considered to have a preference for self-regulation compared with other countries which can be traced back to the 19th century or even earlier.[191] Most European countries, because of the civil law system, do not apply self-regulation and prefer a strong statutory regulation. In recent decades, self-regulation is gaining renewed attention in the UK corporate sector because the corporate scandals and crises of recent years has led to a loss of confidence in the effectiveness of government regulation and a call for a more flexible approach to regulate.

Self-regulation is a distinctive feature of the regulatory and enforcement system for corporate governance in the UK. The reason why the UK chose to use self-regulation in the first place was out of economic considerations, in order to save expenditures on public finances.[192] The most controversial shortcoming of self-regulation is the effectiveness of its implementation in practice. But this mechanism has been proven to have a positive effect on corporate governance in the UK. An important reason for this is that self-regulation is designed with the core of the company being subject to stakeholder scrutiny and increased transparency of information.

Self-regulation in the field of corporate governance in the UK takes many forms, such as industry associations using their internal rules to constrain and regulate the behavior of their members to a certain extent.[193] For example, takeover activities have been regulated by the Panel on Takeovers and Mergers since 1968 and have been subject to the City Code on Takeovers and Mergers. Until 2006, their enforcement had been entirely self-regulatory, without any statutory backing.[194] Pure self-regulation with no government or regulator involvement at all is rare.[195] The most representative of corporate self-regulation in the UK is

190 Baggott (n 186).
191 Bartle and Vass (n 188).
192 Hodges (n 6).
193 Alan C. Page, 'Self-Regulation: The Constitutional Dimension' (1986) 49 The Modern Law Review 141.
194 See Jonathan Mukwiri, *Takeovers and the European Legal Framework: A British Perspective* (Routledge 2009).
195 David Kershaw, 'Corporate Law and Self-Regulation' in Jeffrey N. Gordon and Wolf-Georg Ringe (eds), *The*

the Corporate Governance Code ("the Code"),[196] which is the main focus of this thesis. The enforcement of compliance with the Code is left to the market, rather than any regulator. Other than providing explanations, companies do not face any regulatory penalties or scrutiny for their non-compliance.

In order to develop a free, transparent and efficient market economy, the UK allows shareholders and investors a high degree of freedom to buy shares and sell. However, it results in a lack of supervision and excessive power of the company's management because the shareholders and investors often choose to sell their shares and exit the company directly when the company is in crisis. Thus, the UK has sought a self-regulatory approach for regulation in response of the above problems.

The core of the Cadbury Report in 1992 was therefore the need to regulate the issue of board over management so as to protect shareholders' investments. Measures include focusing on the responsibilities of the board of directors and regulating non-executive directors, separating the roles of the board of directors, and not merging managers and directors to avoid creating the problem of excessive concentration of power among one person, and the board of directors should set up special committees. However, after that, there was the problem of excessive management salaries. Many companies still have high management salaries even when they are not profitable, so the Green Committee focused on solving the problem of directors' compensation, and the measures taken include requiring the company to make a greater degree of information disclosure in its annual statements. The Hample Committee continued to review the recommendations of the above two reports and issued the Combined Code, and the Higgs Report in 2003 mainly focused on the function of non-executive directors. The most notable feature of the above reports is that they are not legally enforceable. In other words, the above reports are advisory in nature and companies can voluntarily choose to apply them or not.

Oxford Handbook of Corporate Law and Governance (1st edn, Oxford University Press 2018).
[196] Jean J. du Plessis and Chee Keong Low (eds), *Corporate Governance Codes for the 21st Century: International Perspectives and Critical Analyses* (Springer 2017).

Further, in order to avoid a mandatory one-size-fits-all approach, the strategy of the UK Corporate Governance Code 2018 is to promote a good corporate governance model by offering several basic principles. With these detailed principles and guidelines, companies are better able to apply them in practice. These rules follow the main ideas of the previous reports and focus on how the board of directors can better achieve the company's long-term interests and goals. The five basic principles involve the composition, functions, duties of the board of directors, communication with shareholders and stakeholders, and audit, risk and internal controls of the company, with provisions below each principle specifying the committee's responsibilities and how the value of the committee's work is reflected in the annual report. Still, the Code remains non-mandatory nature and its recommendations on what can contribute to good corporate governance are principle-oriented rather than detailed article guidelines.

Prerequisites for companies to compliance with voluntary self-regulation are information, transparency and disclosure.[197] However, because of the unevenness of market responses to the above prerequisites, enhanced measures should also be used to urge companies to comply with their own self-regulatory codes of conduct.[198] The UK Corporate Governance Code, in order to achieve good corporate governance, on the one hand emphasises the voluntary nature of the application by companies and on the other hand places the compliance obligation on the board of directors. In addition to the focus of the different reports mentioned earlier, which all revolve around how the board can achieve the long-term development of the company, the Code also includes the *Guidance on Board Effectiveness*, which guides the company directors to use it to support their actions and corporate activities. In addition, the FRC has also issued the *Guidance on Audit Committee and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*.

Rather than opting for rigid statutory rules, the Code has opted for a flexible approach known as "comply or explain". The "comply or explain" approach requires companies to comply with the best practice guidance and good corporate governance principles provided by the Code, and

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[197] Graham and Woods (n 178).
[198] Ibid.

conversely companies can provide reasonable explanations for their non-compliance to the company's shareholders for them to assess whether the reasons are justified and credible. This approach can be found to allow companies to choose whether to apply the Code according to their own needs, and a greater degree of compliance can naturally be achieved. In addition, the Listing Rules asks the company to make a statement about how it has applied these principles and how the company applies these principles to achieve its objectives and what results it has achieved in the form of reports, which can help investors have a clearer understanding of the company's situation. And this will be discussed further in Chapter 5.

Public regulations in the UK also come into play again when the decentralisation of public power to private institutions fails. The regulation of corporate bribery in the UK also involves self-regulation, but it is not pure self-regulation, as it incorporates a high degree of state intervention aimed at incentivising companies to manage their internal bribery.[199] A company will be criminally liable if its organisational structure is ineffective in preventing persons within the company from committing acts of bribery. With such incentives, companies will be more motivated to self-monitor and enforce corporate governance rules. This will also be further explored in chapter 5.

3.3.3 corporate governance self-regulation in China

Different countries and regions may have different manifestations of self-regulation, but the main characteristic of self-regulation is the absence of governmental intervention.[200] According to Cheffins, "the regimes governing company affairs, equity markets, and financial services which have self-regulatory characteristics are not examples of self-regulation in its purest form."[201] While there may be varying degrees of government involvement in the regulatory mechanisms governing corporate affairs, mechanisms with direct government regulation certainly cannot be called self-regulation.[202] Self-regulation in the UK does not even

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[199] Lord (n 169).
[200] Nina Cankar, 'Transition Economics and Corporate Governance Codes: Can Self-regulation of Corporate Governance Really Work?' (2005) 5 Journal of Corporate Law Studies 285.
[201] Cheffins (n 168) 365.
[202] Baggott (n 186).

have any regulator and relies entirely on the market to adjust itself.

The fundamental characteristic of self-regulation regime is not backed by laws. In contrast, China does not have such self-regulation with the same soft nature in corporate governance as in the UK. Chinese corporate governance rules are too restrictive for Chinese companies, with mostly mandatory rules regulating corporate activities and a lack of arbitrary norms that respect corporate autonomy.

The self-regulation that is currently promoted in China to guide companies to improve their corporate governance is in fact subject to the Chinese regulators. Among the regulators of corporate governance in China, the CSRC is in the completely dominant position. The CSRC has administrative attributes by virtue of being under the jurisdiction of the State Council in China. And it is responsible for the unified supervision and management of China's securities and futures markets in accordance with the laws and regulations and the authority of the State Council. Its supervision is therefore belonging to direct regulation which is not self-regulation.

Besides, the bodies that are empowered to establish regulations of self-regulatory nature in China, such as the two major stock exchanges, which lack independence due to the government control, are also considered as the de facto state organ.[203] China's stock exchanges are required to take orders from the CSRC and have no incentive to self-regulate as well. Even though the CSRC has issued many best practices for companies to guide their corporate governance, in reality, few companies consciously comply with these practices and design and change their corporate governance structures accordingly.[204]

The *Code of Corporate Governance of Listed Companies (2018 Revision)* ("Chinese Code") issued by the CRSC, contains not only some principles but also more comprehensive and detailed provisions, including but not limited to the rights and obligations of shareholders, the

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[203] Jiangyu Wang, *Company Law in China- Regulation of Business Organisations in a Socialist Market Economy*, (Edward Elgar 2014) 17.
[204] Chen Shi, *The Political Determinants of Corporate Governance in China* (Routledge 2012).

composition, responsibilities and the rules of procedure of the board of directors and the supervisory board and senior managers, the duties of independent directors and special committees, as well as the focus of different stakeholders of the company and the company's social responsibility, etc. Formally, it looks like a guiding standard formulated by the regulatory authority which encourages the company to implement the spirit set forth in the code according to their own circumstances, but in essence, it is more like a simpler version of the Chinese Company Law. The Chinese Code issued by the CSRC is basically a standard set out in accordance with the Company Law, the Securities Law and relevant laws and administrative regulations in China, and draws on the practical experience of corporate governance at home and abroad. Although its intentional purpose is also to encourage the company to implement the spirit set forth in the standards according to their own characteristics, however, the way these rules lead to corporate compliance is more rigid, rather than a method of purely guiding soft law nature.

It has also been argued that although the Chinese Code shows the intention of applying soft law for regulation, due to the identity of the CSRC as an official regulatory entity, there is a kind of regulatory regulation that is alienated into "soft in the surface and hard inside",[205] which is different from the spirit embodied in the British self-regulation. In fact, Chinese legislation has taken into account the balance between corporate governance and corporate autonomy in Company Law. All places not mandatory in the Company Law should fall within the scope of corporate autonomy. Therefore, unless otherwise provided in the law, the internal affairs of the company shall be specified by a company's articles of association.[206] Unfortunately, however, in practice, shareholders of Chinese companies rarely use the autonomous space of the articles of association to establish rules of deliberation and voting that are in their own interests.[207]

The self-regulation of corporate governance in the UK shows that, in practical terms, the market

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205 Lan Wang(王兰), (公司软法定位及其与公司法的衔接)'The Soft Law Positioning of Companies and Its Interface with Company Law' (2021) 5 China Legal Science 266, 276.
206 Company Law 2018, article 43, 48.
207 Beijing Chaoyang District People's Court, *White Paper on the Protection of Minority Shareholders' Rights in Limited Liability Companies* (2021) 18.

will drive corporate compliance through its own forces, without the need for the government to devote significant regulatory resources. As a result of non-compliance, companies are likely to be subject to civil, administrative or even criminal penalties, resulting in reputational damages in the market. The loss of reputation in the market will have a further negative impact on the company's stock prices. Reputational damages in the marketplace have been identified by the Office of Fair Trading ("OFT") in the UK as one of the most significant drivers of corporate compliance.[208] However, the current legal framework in China ignores this as well.

3.4 The role of takeovers of corporate governance in China

Corporate governance can be divided into internal governance and external governance. Takeover, as a method of external governance, is considered to be an effective means of reconfigure the corporate structure. As takeover can be used as an incentive tool to effectively discipline and urge a company's management to properly perform their duties to improve corporate performance and thus prevent them from losing their jobs in a corporate takeover to achieve corporate compliance, their role in China's corporate governance system therefore needs to be discussed.

Takeover, in China, refers to the acquisition of a listed company by purchasing its shares through tender offer or negotiated private agreements.[209] And the key difference between a takeover and other types of acquisitions is that the takeover must result in the acquirer taking effective control of the target company.[210] As such, takeover inevitably leads to conflicts between multiple stakeholders within the company, particularly affecting the interests of minority shareholders and directors of the target company. On the one hand, if the company's management do not comply with their obligations in their day-to-day operations, this increases the risk of the company being acquired. On the other hand, once a corporate takeover has taken

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[208] Office of Fair Trading, *Drivers of Compliance and Non-compliance with Competition Law: An OFT Report* (OFT 1227, 2010).
[209] Securities Law 2019, article 62.
[210] Wang (n 203).

place, the acquirer can remove underperforming management from the target company and the directors of the target company may do things that are detrimental to the interests of the company for fear of losing their current jobs or positions in the company, resulting in the target company being controlled by the management and infringing on the rights of shareholders, especially minority shareholders. Therefore, the compliance performance of the management occupies an important position in corporate takeovers and is important in protecting the rights and interests of investors in the target company, achieving corporate compliance and improving corporate governance.

However, while Chinese corporate governance rules also recognise the value and role of takeovers in improving corporate governance, the focus on corporate takeovers has mostly been on the protection of the interests of shareholders of the target company, ignoring the positive role that takeovers can play in helping to achieve corporate governance compliance. This section therefore focuses on the role of takeovers in corporate governance in terms of protecting the interests of minority shareholders of the target company and the compliance obligations of directors.

3.4.1 rules governing corporate takeovers in China

Corporate takeovers in China are mainly regulated by the Chapter 4 of the Securities Law, "Takeovers of Listed Companies", the *Measures for the Administration of Takeovers of Listed Companies (2020 Revision)* ("Measures") and *Measures for the Administration of Information Disclosure by Listed Companies (2021 Revision)* issued by the CSRC. In general, the legal rules governing takeovers of companies in China can be described as supportive and encouraging.

3.4.2 protection of the interests of the target company's minority shareholders in corporate takeovers

Corporate takeover is a specific act by which a company takes direct ownership of the assets of a target company or indirectly enjoys operational control of that company. The protection of shareholders of the target company, especially minority shareholders, has been the focus of the legal regimes of corporate takeovers in various countries. China's corporate governance focuses on the protection of the interests of minority shareholders of the target company in the process of corporate takeover mainly due to the following considerations.

Firstly, as major shareholders often hold a large proportion of the share capital, a corporate takeover will significantly affect their control over the company. In such cases, the majority shareholders tend to use their own interests as a yardstick to judge whether to accept a takeover bid. If the target company is already at a disadvantage and the takeover is in the interests of the majority shareholders, it is highly likely that the majority shareholders of the target company will make the choice at the expense of the minority shareholders, resulting in conflict between the majority and minority shareholders. Especially in China, where the ownership structure of companies is generally concentrated, it is common for majority shareholders to protect their own interests by infringing on the interests of minority shareholders because of their superior shareholding.

Secondly, due to their fragmented shareholding and information asymmetry, minority shareholders are not only in a vulnerable position in the day-to-day management of the company, but are also highly vulnerable in the takeover activities of the company. It is highly likely that a corporate takeover will result in a complete change in the business strategy and development direction of the target company, and the investment and development of minority shareholders may be negatively affected to a large extent. There is also a high risk that the interests of minority shareholders of the target company will be further harmed by fraud and insider trading if the majority shareholders agree to the corporate takeover. Therefore, there is a strong need for laws and regulations to protect the interests of minority shareholders.

The Chinese corporate legal system protects the interests of minority shareholders of target companies in takeovers mainly by implementing the principle of equality of shareholders and the obligation to disclose information.

Implementation of the principle of equality of shareholders

Firstly, the Securities Law in China stipulates that the takeover conditions proposed by the offer shall be applicable to all shareholders of the target company,[211] which naturally includes minority shareholders.

Secondly, the right of minority shareholders to freely trade is protected. The Measures provides that when the issued shares of a listed company held by a purchaser reaches 30% of the company through securities trading at the stock exchange, and the purchaser continues to increase the shareholding, it shall send out a general or partial tender offer.[212] This seemingly mandatory bid requirement for major shareholders is in fact to protect the right of minority shareholders to sell their shares. This is because at this point the company already effectively has operational control over another company and the mandatory requirement of the law effectively gives the minority shareholders of the target company the opportunity to opt out.

Moreover, considering the embarrassing situation that the remaining shareholders of the target company who have not accepted the takeover offer will be in after a successful takeover, the law therefore provides that when the takeover offer period expires and the shares held by the offeror reach ninety percent of the total number of shares of the company, the remaining shareholders have the right to compulsorily sell their shares to the offeror under the same conditions.[213]

Implementation of the disclosure obligation

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[211] Securities Law 2019, article 69.
[212] Ibid, article 24.
[213] Interim Provisions on the Management of the Issuing and Trading of Stocks (1993), article 51.

A takeover is a process whereby the acquirer assumes control of another company and therefore creates a situation where the acquirer becomes the majority shareholder. If no disclosure obligation is imposed on the acquirer, it is easy for the majority shareholders to manipulate the decision-making process of the takeover and the minority shareholders do not even have the opportunity to participate in the corporate takeover. Chinese laws and regulations therefore protect the interests of minority shareholders through an information disclosure regime, requiring that offerors should fulfil their information disclosure obligations during the takeover process to ensure that the corporate takeovers are conducted in an open and fair manner.

Firstly, when a shareholder's shareholding reaches a certain percentage, it is required to report and disclose the intention to hold a large number of shares. This is because a large shareholding is often a precursor to a takeover. It is only when the offeror's information is disclosed that other shareholders can better understand their position in the takeover.

Specifically, according to the Chinese Securities Law, where the ratio of the outstanding voting shares of a listed company held by an investor alone or jointly with others through agreements and other arrangements reaches 5% by securities trading on a stock exchange, the investor shall, within three days after the fact occurs, file a written report with the securities regulatory agency of the State Council and the stock exchange, notify the listed company, and announce it, and shall no longer purchase or sell the stock of the listed company during the aforesaid period. And whenever the investor increases or decreases its holding of the outstanding voting shares of the listed company by 5%, it shall report and announce the increase or decrease and from the day when the fact occurs to the third day after its announcement, shall no longer purchase or sell the stock of the listed company.[214] However, unfortunately, the Securities Law also does not further require the disclosure of the purpose of the substantial shareholding by the majority shareholder or the obligation of the acquirer to disclose information to the shareholders of the target company. If these two requirements could be included in the future disclosure provisions of the Securities Law could provide better protection for the interests of minority shareholders

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[214] Securities Law 2019, article 63.

of the target company.

Not only that, the acquirer is further required to truthfully disclose the subsequent plans after the completion of the takeover, including whether it intends to change the main business or make major adjustments of the listed company in the next 12 months, whether it intends to change the composition of the current board of directors or senior managers of the listed company, and whether there is any contract or tacit understanding with other shareholders on the appointment and removal of directors and senior managers,[215] and whether there are compensation or other similar arrangements for the directors and senior managers of the listed company to be replaced.[216] Where the shareholders of the target company transfer their shares to the offeror by agreement, they shall investigate the subject qualification, integrity and takeover intention of offeror, and disclose the relevant investigation in the report on the change of rights.[217] Any offeror or its actual controller causes any loss to the target company by taking advantage of takeover of a listed company shall be liable in damages in accordance with the Securities Law.[218]

Finally, when, through the securities trading of the stock exchange, the shares in which the investors have the rights and interests reach 5% of the issued shares of a listed company, they shall prepare a report on the change of rights and interests within 3 days from the date of the occurrence of the takeover fact, and submit it to the CSRC and the stock exchange to notify the listed company and make an announcement.[219] While the major shareholder successfully controls the operation of the target company after the takeover, there is the possibility may further damage the rights and interests of minority shareholders, which makes it necessary to offer remedies to minority shareholders. In addition, the offeror may assign new management to control the target company, in the case of takeover of a listed company by agreement, the period from the conclusion of takeover agreement to the transfer of relevant shares shall be the

[215] Standards for the Contents and Forms of Information Disclosure by Companies Offering Securities to the Public No. 17-Tender Offer Report (2020), article 27.
[216] Ibid, article 29(3).
[217] Measures for the Administration of the Takeover of Listed Companies (2021), article 53.
[218] Securities Law 2019, article 196.
[219] (n 217), article 13.

transitional period for takeover of the listed company. During the transition period, the purchaser shall not re-elect the board of directors of the listed company through the resolution of the controlling shareholder, and if there are sufficient reasons to re-elect, the directors on the board of directors from the purchaser shall not exceed one-third of the board members.[220]

3.4.3 compliance incentives of directors in corporate takeovers

It is argued that the motivations of corporate takeovers can be divided into three categories, namely the interests of management and shareholders, pure shareholder interests, and pure management interests.[221] If the takeover is based on the first type of motivation, the common interests of management and shareholders, then it will have the most ideal result that the probability of a successful takeover is very high. Otherwise, it will be the most difficult model if the takeover is out of the pure shareholder interests, because the management lacks the motivation to support the takeover activity, and the decentralised share ownership structure makes it more difficult to reach decisions. Finally, the takeover made purely out of the interests of the management seems to be the most justified model for the management standing in the best position to provide suggestions on whether the company should continue to operate, but it also makes it the most likely to infringe on the interests of shareholders and the company for being a purely self-interested behaviour of the management.

However, researches on corporate takeovers in China have mainly focused on the legal protection of shareholders, arguing for legislation to strengthen the obligations of company directors and prevent them from abusing their power, while ignoring the role of corporate takeovers in providing compliance incentive for the management. In many cases, corporate takeovers occur because of the board's incompetence in the management of the company.

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220 Ibid, article 52.

221 Jincheng Ning(宁金成), (论公司接管中的股东权保护)'The Protection of Shareholder's Rights in the Process of Taking over the Listing Company' (2001) 34 Journal of Zhengzhou University 12.

Corporate takeovers intensify the natural conflict between the directors of the target company and the acquirer. Once a corporate takeover has taken place, the management of the target company is inevitably affected beyond its own will. In the case of Chinese companies, the management of the company consists mainly of the board of directors and the managers, who are subordinate to the board of directors and are responsible for implementing the board's resolutions, so the compliance drive of the management referred to in this section mainly refers to the compliance incentive of the directors. The threat of a corporate takeover will act as a compliance incentive for the directors of the target company to work diligently. And the results and risks associated with takeovers, including the loss of jobs and prestige, can make managers more motivated to improve the quality of the company's practices.[222]

Firstly, takeover necessarily results in a transfer of corporate control.[223] When the acquirer takes control of the target company, it is very likely that the previous management may be reorganised or replaced. Once the takeover is successful, the board will be controlled by the new directors. Therefore, in order to preserve the directors' position in the company, it is best to opt for compliance in the first place to prevent a takeover from happening. In particular, directors of Chinese companies generally do not hold shares in the company, or hold fewer shares than necessary to maintain their position in the company, and are therefore more likely to lose their directorship in the company as a result of a takeover.

Secondly, the board of directors of a Chinese company will be in a passive position once the takeover of the company has commenced. Under Chinese takeover rules, it is difficult for directors to use takeover defences.[224] The directors of the target company may, of course, have the option to defend themselves against a takeover by the company with anti-takeover measures. However, China takes a restrictive approach to anti-takeover measures by directors.

China has borrowed from the UK model in the regulation of anti-takeover measures by giving

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[222] Michael C. Jense, 'The Efficiency of Takeovers' (1985) The Corporate Board 16.
[223] Paul L. Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn, Thomson Reuters 2016) 917.
[224] Juan Chen, *Regulating the Takeover of Chinese Listed Companies: Divergence from the West* (Springer 2014).

the power to decide on anti-takeover to the board of shareholders. The decision on anti-takeover by the company belongs to the board of shareholders and the board of directors is not allowed to take anti-takeover measures without the resolution of the board of shareholders. This approach is based on two main considerations. Firstly, if anti-takeover measures are not strictly limited, an external acquirer will not be able to successfully complete the takeover process, thus defeating the purpose of the takeover as an external regulatory measure to monitor the company. Secondly, resistance to takeovers by directors of target companies is not always entirely in good faith and may come at the expense of the company and its shareholders, and appropriate restrictions on anti-takeover measures will serve to protect the interests of the company and the company's shareholders.

In addition, corporate takeover can not only affect a director's current position in the target company, but can also have a negative impact on the company's reputation and potential career positions in the future. The ability to act as a director is closely related to his or her previous employment. Directors' competence in their jobs and their income are said to require labour market projections from information on their current and past performance.[225]

The directors of the target company therefore have a legitimate reason and personal motivation not to expect the takeover to take place. And for directors, an effective way to stop a company takeover from happening at source is to perform their duties in a compliant manner. Fear of losing their jobs and the negative effect on their future career path can make directors choose to operate in compliance in order to strengthen their position in the company. The risk of a potential takeover makes directors strive to comply with laws and regulations and improve the performance of the company. Furthermore, if directors ensure that their duties in the company are carried out in a compliant manner, compliance can lead to alignment of directors' interests with those of the company and shareholders, then the interests of the company will be maximised and the level of corporate governance will be successively improved.

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

In conclusion, as stated in the Measure, the role played by takeovers in Chinese corporate governance is primarily to protect the legitimate rights and interests of investors and shareholders. It is for this reason that lawmakers and academics have overlooked the compliance incentive role that takeovers can play in urging directors to perform their duties.

3.5 Share ownership structure of Chinese companies

The share ownership structure of a company is the basis of the corporate governance structure, and optimising the ownership structure is one of the effective paths to improve corporate governance. For historical reasons, the ownership structure of Chinese companies differs from the dispersed ownership of UK companies and has distinct highly concentrated Chinese characteristics.

This section explores the characteristics of the share ownership structure of Chinese companies and identifies the impact it has on Chinese corporate governance. While a concentrated share ownership structure can have a positive impact on corporate governance to some extent, the dual characteristics of China's overly concentrated share ownership structure and the dominance of state-owned shares have resulted in controlling shareholders in Chinese companies taking advantage of their shareholding to control the management of the company and encroach on the rights of minority shareholders,[226] which in turn has led to a failure of corporate governance.

3.5.1 highly concentrated share ownership structure and its historical background

Any discussion of corporate governance in China should not avoid the study of the state involvement in corporate ownership.[227] This is because the share ownership structure of

[226] Wei Shen, Qiong Zhou and Chung-Ming Lau, 'Empirical Research on Corporate Governance in China: A Review and New Directions for the Future' (2016) 12 Management and Organization Review 41.
[227] Donald C. Clarke, 'Corporate Governance in China: An Overview' (2003) 14 China Economic Review 494.

Chinese companies is heavily influenced by state and government involvement. The state-owned economy dominates China's economic development, but its level of corporate governance has not been promising, which is inseparable from the characteristics of China's concentrated share ownership structure.

Due to historical factors, state-owned ownership has been a distinctive feature of Chinese companies. Most of the listed companies in China are converted from SOEs and the share ownership structure reflects the institutional characteristics of state-owned equity dominance.[228] This is attributed to the fact that the reform of Chinese modern enterprise system began with the SOEs.[229] Before the 1980s, state-owned ownership was the only legal form for Chinese enterprises.[230] The state enjoyed absolute property ownership and managerial rights over the SOEs. Later, during the contracting period,[231] China incentivised the management to work for the SOEs and improve their financial performance by making them self-managed and being responsible for their own profits and losses.

In 1993, the 14th Central Committee of the Communist Party of China adopted the decision that China should establish a modern enterprise system in order to achieve the market-based economy transition, in which the corporatisation of SOEs was the main focus. However, the government still occupied a dominant position in this reform. The shareholding structure of Chinese companies was divided into three types of shares: state-owned shares, legal person shares and public shares. While the state-owned shares and legal persons shares, which were in the absolute majority, were non-tradeable shares and cannot be freely circulated in the securities market. And because of the illiquidity of the shares, the majority shareholders of the company were overly concerned with the assets of the company, resulting in a situation where the majority or controlling shareholders abused their power against the minority shareholders. In

[228] Dan He, *The Legal Protection of Investors and Ownership Structure: Theory and Empirical Evidence* (1st edn, SUFE 2014) 56.
[229] Peizhong Gan and You Zhou(甘培忠, 周游), (我国公司法建构中的国家角色)'The Role of the State in the Construction of Chinese Company Law' (2014) 2 Contemporary Law Review 56.
[230] Cindy A. Schipani and Junhai Liu, 'Corporate Governance in China: Then and Now' (2002) Columbia Business Law Review 1.
[231] This refers to the mid to late 1980s - early 1990s.

Chinese companies, it is difficult for minority shareholders to compete with the majority or controlling shareholders due to their absolute dominance in terms of equity.

On the one hand, it was difficult for minority shareholders to compete with the majority shareholders in Chinese companies due to the absolute dominance of majority shareholders in terms of equity. Moreover, majority shareholders were not concerned that the company would suffer a fall in share price as a result of poor management and thus lack the incentive for corporate governance.[232] On the other hand, the illiquidity of shares also led to a failure of external market mechanisms, in other words, it made corporate takeovers impossible in such cases.

As a result, two characteristics of share ownership structure in China are formed, namely the dominance of state-owned shares and the high concentration of share ownership structure. In order to achieve the transition to a market economy, China carried out a reform of split shares, abolishing the division between tradeable and non-tradeable shares in companies. However, even with the reform, the high concentration of equity has not been fundamentally altered.

In SOEs, the state has always played the role of controlling shareholder, and safeguarding national interests has become a priority of legislative reform in the early stage.[233] The implementation of the share ownership structure of the centralisation of the board of shareholders is the best way for the state to exercise power, which is reflected in the supremacy of shareholders' interests in the company. It was pointed out that the purpose of SOEs reform in China is not to realise the separation of ownership and control, but to further optimise it so as to finally realise the control of enterprises.[234] The role of the state as the controlling shareholder tends to result in an administrative approach to managing the company, leading to inefficient corporate governance. In addition, the management of SOEs is often appointed by

[232] Qiong Fu and Li Cao(傅穹,曹理), (公司治理模式：全球一体化与中国本土化的相互渗透)'Corporate Governance Models: The Interpenetration of Global Integration and Chinese Localisation (2012) 20 Journal of National Prosecutors College 135.
[233] Liu and Liu (n 152) and Wang (n 116).
[234] Liu and Liu (n 152) 56.

the government rather than recruited by the market, and management is more likely to carry out the will of the controlling shareholder, the state or government, as shareholder representatives and board members often vote in accordance with the government's instructions. The management of Chinese SOEs therefore plays little substantive role in the governance of the company.

Not only that, the dominance of state-owned shares in administrative governance has continued to affect listed companies in China.[235] With the reform of split share and the reform of state-owned asset management system, the proportion of state-owned shares in listed companies began to decline. However, against the backdrop of the continued absolute dominance of state-owned shares, it has been difficult for weak institutional investors to make a difference. It is also for this reason that the development of institutional investors in China has been slow, resulting in high costs for minority shareholders to participate in corporate governance.[236] Major shareholders hold a large number of shares, so they have more voting rights and an advantage in deciding on major matters such as the composition of the board of directors and the internal affairs of the company.

Compared with some developed countries such as the UK, the share ownership structure of Chinese companies is highly concentrated. It means that the majority of a company's shareholding is controlled by one or few large shareholders. In Chinese companies, the first largest shareholder holds the largest proportion of shares and is in the absolute dominant position of the company, with a large gap between the shareholding of other shareholders and even the second largest shareholder.[237] According to statistics, the average shareholding of the largest shareholder in listed companies in China is 45.3%.[238]

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235 Weian Li and Yuanzhen Li(李维安，李元祯), (中国公司治理改革迈向新阶段)'China's Corporate Governance Reform Moves to a New Stage' (2010) 10 Directors & Boards 23.
236 Haifeng Wang(王海峰), (数字经济时代股东积极主义的制度创新)'Institutional Innovation of Shareholder Activism in the Era of Digital Economy' (2021) 4 Law Science Magazine 74,75.
237 Bao Jiang and Jian Li, 'Research on the Impact of Ownership Structure to Operation Performance of the Chinese Listed Port Companies' (2015) 2 International Journal of e-Navigation and Maritime Economy 63.
238 Chong-En Bai, Qiao Liu, Joe Liu, Frank M. Song and Junxi Zhang, 'Corporate Governance and Market Valuation in China' (2003) William Davidson Working Paper 564.

3.5.2 the impact of highly concentrated share ownership structure on Chinese corporate governance

The focus of the corporate governance mechanisms corresponding to different shareholding structures should be different. From the perspective of Chinese Company Law, the design of the board of directors for decision-making, the supervisory board for supervision and the managers for implementation makes each of the company's organs responsible and independent of each other. However, the shareholding structure of Chinese companies plays a subtle role in this.

Share ownership structure can have an influence on the efficiency of corporate governance. In fact, a concentrated shareholding is not necessarily detrimental to corporate governance. On the contrary, it has been suggested that a relative concentration of shareholdings can provide large shareholders with sufficient incentives and capacities to monitor the management, and therefore the concentration of state-owned shares in China can play a positive role in enhancing the efficiency of Chinese SOEs to some extent.[239] A higher degree of equity concentration implies a higher level of awareness and participation in corporate governance by the majority shareholders, who will have a greater incentive to monitor the management, which in turn will reduce the agency costs and improve corporate value. However, this is mostly the case in companies with a more dispersed share ownership structure. The agency costs of Chinese companies are not caused by conflicts between shareholders and management, but rather by the intense conflicts between majority or controlling shareholders and minority shareholders in Chinese companies due to the centralised share ownership structure, resulting in the major agency problems of Chinese companies arising between controlling and minority shareholders, as will be discussed in more detail in Chapter 4.

However, the over-concentration of shareholding in Chinese companies, rather than an

[239] Jianxiang Jiang(蒋建湘), (我国国有公司股权结构及其法律改革-以公司治理效率为主要视角)'Share Ownership Structures in Chinese State-owned Enterprises and Legal Reform: Taking the Corporate Governance Efficiency as the Main Perspective' (2012) 6 Science of Law 131,133.

appropriate concentration, can be detrimental to the corporate performance. The concentrated shareholding structure makes the major shareholders fully capable and able to control the company to realise their own interests. And some empirical studies have found that this adverse effect will increase as the proportion of state-owned shares rises.[240]

The highly concentrated share ownership structure of Chinese companies has brought a number of disadvantages to the development of corporate governance in China, mainly in terms of the effective control of the company by the controlling shareholders. The highly concentrated share ownership structure has led to the main conflicts in the internal governance of Chinese companies being conflicts between shareholders, especially between majority or controlling shareholders and minority shareholders, which are more often manifested in the use of dominant positions by majority or controlling shareholders to oppress minority shareholders.

Firstly, a highly concentrated share ownership structure means that the absolute dominance of a single shareholder is evident and can easily lead to the problems of abuse of power by the majority or controlling shareholders. And the formation of a dominant position of the majority or controlling shareholders diminishes the opportunities for other shareholders to participate in corporate governance, resulting in the will of the majority or controlling shareholder being carried through to corporate decision-making process. On the contrary, if more shareholders are involved in corporate governance, it is more conducive to the formation of scientific decision-making. In addition, conflicts between the state, as the controlling shareholder, and other shareholders of Chinese SOEs should not be ignored as well.

Secondly, even though a concentrated share ownership structure would give controlling shareholders more incentive to monitor the company, the problem of major shareholders infringing on the interests of minority shareholders through connected transactions is of greater concern. The high concentration of shareholding in a company makes it highly likely that controlling shareholders will abuse their control to transfer company property, infringe on the

[240] Dian Yang, 'Corporate Governance and Firm Performance: A Sociological Analysis Based on Chinese Experience' (2014) 35 Social Sciences in China 44.

company's interests for personal gain and cause losses to other stakeholders such as the company's creditors.

Thirdly, the controlling shareholders effectively control the board of directors and the supervisory board of the company and have a negative impact on the proper and independent performance of their duties. Moreover, the company's management lacks the motivation and ability to manage the company and to make autonomous decisions because of the controlling shareholder's control over the company.

In addition, the role of the supervisory authority is hardly exercised in the company. The supervisory board of a Chinese company is also elected by the board of shareholders. The control of the company by the majority or controlling shareholder results in the supervisory board effectively representing the interests of the majority or controlling shareholder as well. Although China introduced a system of independent directors to represent the interests of minority shareholders in 2001 in order to address the plight of the board of directors and supervisory board in the context of a high concentration of shareholdings, the design of the system, whereby candidates for independent directors are nominated by the board of directors or the supervisory board of listed companies, or by shareholders that individually or jointly holds 1% or more of the issued shares of a listed company and are elected by the board of shareholders,[241] has resulted in the practice that most of the independent directors are nominated by the controlling shareholders and actual controllers of the company. As a result, the majority of independent directors still represent the positions and interests of the controlling shareholders.

To sum up, due to the concentrated ownership structure of Chinese companies and the current corporate procedures, companies are in a position of being controlled by controlling shareholders and there is insufficient incentive for internal organs of companies to participate in improving corporate governance, which has largely hindered the development of corporate

[241] Rules for the Independent Directors of Listed Companies (2022), article 12.

governance in China.

3.6 Relationship between directors and shareholders in Chinese companies

The relationship between shareholders and directors in a company is one of the most important topics of research in the field of corporate governance. An examination of the corporate governance landscape in China therefore cannot be separated from a study of the relationship between directors and shareholders of a company.

In the common law system, the relationship between directors and shareholders is generally defined as an agency relationship, with directors deriving their authority from the delegation of shareholders. China has taken the design of the common law system into account and requires the board of directors to be accountable to the board of shareholders in the Company Law. However, this design has created alienation in Chinese corporate practice, making the relationship between shareholders and directors tend to be subordinate, and even in many companies the directors are completely subject to the majority or controlling shareholders, which is completely different from the concept of separation of powers and checks and balances in the setting of the corporate structure in Chinese Company Law. This section argues that the root cause of this alienation can be attributed to the highly concentrated share ownership structure of Chinese companies.

As far as the corporate sector is concerned, the relationship between directors and shareholders is crucial and the checks and balances between them largely affect the effectiveness of corporate governance. Directors in Chinese companies are heavily influenced and controlled by shareholders, resulting in a lack of independence of directors in the company and a lack of motivation to move the company forward, which weakens the efficiency of corporate governance development in China.

3.6.1 directors are subject to shareholders

In terms of institutional design alone, the board of shareholders and the board of directors in the Chinese Company Law appear to have a clear division of powers and responsibilities, which are independent of each other and subject to checks and balances. The Company Law in China gives more actual power to shareholders than to directors. However, in terms of Chinese corporate practice, the board of directors of Chinese companies is the executive organ of the board of shareholders, and directors are subject to the shareholders on a day-to-day basis and have little independence in the company.

Firstly, under the Chinese Company Law, the board of shareholders is the authority organ of the Chinese companies.[242] However, it has chosen to be silent on the positioning of the board of directors in the company. The result is that the shareholders of a company enjoy the legal basis to decide on all affairs of the company and the authority of the directors is limited.

Secondly, the board of directors is accountable to the board of shareholders,[243] and, naturally, the directors are also accountable to the shareholders. The directors of the company are elected and dismissed by the board of shareholders, and the board of shareholders exercise the functions and powers to determine matters relating to the remunerations of directors.[244] And the board of directors is responsible for convening the meeting of the board of shareholders and reporting to it on its work, and executing the resolutions of the board of shareholders.[245] The Chinese Company Law does not explicitly mention the position of the board of directors in a company and therefore Chinese academics are divided on this issue. Recently, the Civil Code of the People's Republic of China ("Civil Code"), however, explicitly states that the board of directors is the executive organ of the company and "exercises the powers of convening meetings of the authority, deciding on the business plans and investment proposals of the legal person, deciding on the establishment of the internal management bodies of the legal person, and other powers

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[242] Company Law 2018, article 36.
[243] Ibid, article 46.
[244] Ibid, article 37(2).
[245] Ibid, article 46(1)(2).

and functions as stipulated in the articles of association of the legal person."[246] Although the provisions of the Civil Code cannot replace the Company Law, the position of the board of directors in the Civil Code provides some indication of the Chinese legislator's understanding and attitude towards the status of the company's board of directors.

Thirdly, the Chinese Company Law enumerates the powers and functions of the board of shareholders and the board of directors respectively, but it is not clear. A comparison of the provisions of the Company Law on the responsibilities of the board of shareholders and the board of directors reveals that the former determine the company's operational guidelines and investment plans,[247] and the latter determine the company's operational plans and investment schemes;[248] the former deliberates on and approves the annual budget and final accounts of the company,[249]and the latter formulates the company's annual budget and final accounts;[250] the former deliberates on and approves the company's profit distribution plans and loss recovery plans,[251] and the latter formulates the company's profit distribution plans and loss recovery plans;[252] the former make resolutions on any increase or decrease of the company's registered capital[253]and the issuance of corporate bonds,[254] and the latter formulates the company's plans on the increase or decrease of the company's registered capital and the issuance of corporate bonds;[255] the former makes resolutions on the merger, division, dissolution, liquidation or transformation of the company;[256] the latter formulates the company's plans on the merger, division, dissolution or transformation of the company.[257]

The above provisions of the Company Law have been widely criticised in Chinese literature because of the ambiguity of the language.[258] However, it can still be seen that the Company

246 Civil Code 2020, article 81(1)(2).
247 Company Law 2018, article 37(1).
248 Ibid, article 46(3).
249 Ibid, article 37(5).
250 Ibid, article 46(4).
251 Ibid, article 37(6).
252 Ibid, article 46(5).
253 Ibid, article 37(7).
254 Ibid, article 37(8).
255 Ibid, article 46(6).
256 Ibid, article 37(9).
257 Ibid, article 46(7).
258 For example, Feng Deng believes that "the division and definition of power among the board of shareholders,

Law follows the idea that the decision-making power on major affairs is given to the board of shareholders and the decision-making of general affairs belongs to the board of directors, which further leads to the problem of unclear boundaries. What are the major affairs of a company? What are the general affairs of the company? And where exactly should the line be drawn? This lack of clarity in the regulations exacerbates the possibility in practice of shareholders controlling all the affairs of the company. In addition, the Company Law also allows companies to set out the powers and functions of the board of shareholders and the board of directors in the articles of association,[259] but as the Company Law does not provide legislative clarity on the relationship between these two bodies, this leads to further confusion in practice as to the attribution of powers between shareholders and directors. On the contrary, it would be a wiser institutional design if the Company Law formally established the position of the board of directors in the company and made it the decision-making centre of the company, separately stipulating the matters in the company that can only be decided by the board of shareholders.

It is argued that this above institutional arrangement in the Chinese Company Law draws on the concept of political governance regime of the National People's Congress of the People's Republic of China ("NPC") as the supreme organ of power in the Chinese Constitution.[260] Other scholars further analogise the relationship between the board of shareholders and the board of directors in Chinese companies to that between the NPC and its Standing Committee, whereby the latter is a permanent organ of the former and is responsible for implementing the resolutions of the former.[261] And it has also been pointed out that this notion of power distribution is a continuation of the concept of "subordinates are responsible for superiors" in Chinese administrative system.[262]

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the board of directors and managers in many corporate affairs is inoperable." See Feng Deng(邓峰), (中国法上董事会的角色、职能及思想渊源：实证法的考察)'The Role, Function and Ideological Origin of The Board of Directors in Chinese Law: An Investigation of Empirical Law' (2013) China Legal Science 98, 103.

[259] Company law 2018, article 37 (11), 46(11).

[260] Schipani and Liu (n 230).

[261] Deng (n 258) 107.

[262] Peizhong Gan and Liyan Ma(甘培忠, 马丽艳), (董事会中心主义治理模式在我国公司法中的重塑)'Reshaping the Board Centered Governance Model in China's Company Law' (2021) 5 Law and Economy 92, 101.

In addition, independent directors are also members of the board. As mentioned earlier, China has introduced independent directors into its corporate governance system in order to balance the relationship between shareholders and directors, but in practice, China's independent directors are also deeply influenced by controlling shareholders and lack independence.

3.6.2 shareholders and directors in Chinese SOEs

The situation is even more serious in Chinese SOEs. The state is the controlling shareholder in Chinese SOEs and is also the regulator. In SOEs, the state or the government, as the controlling shareholder, influences the affairs of the enterprises through the board of directors.[263] Some SOEs do not have effective corporate governance structures, and even when boards of directors are set up in enterprises, they fail to achieve the expected results in practice.

Firstly, the owner of the state assets is the Chinese people, but the Chinese people as a whole cannot manage the company themselves, so the law authorises legal institutions to exercise the power and rights on behalf of the people. As mentioned earlier, the shareholders of SOEs are state asset management agencies or bodies authorised by the government to perform contribution functions in accordance with the law, which dictates that they are less likely to actively pursue their own maximum interests in the company as individual shareholders do. In addition, in SOEs, the government, as the controlling shareholder, can control the company by controlling the election and appointments of the board of directors. This is because the primary purpose of the government in being the controlling shareholder in a company may not be to maximise profits, but simply for political reasons.[264]

Secondly, in China, the state-owned assets supervision and administration institution exercises the functions and powers of the board of directors in wholly state-owned companies. The state-

[263] Jenny Fu, 'State Capitalism and Corporate Law: The Governance of State-owned Enterprises in China' in Roman Tomasic (ed), *Routledge Handbook of Corporate Law* (Routledge 2017) 145-162, 148.
[264] Zhaofeng Wang, 'Corporate Governance under State Control: The Chinese Experience' (2012) 13 Theoretical Inquiries in Law 487.

owned assets supervision and administration institution can authorise the company's board of directors to exercise some of the functions and powers of the board of shareholders and decide important matters of the company, other than those relating to the merger, division or dissolution of the company, the increase or reduction of its registered capital or the issuance of corporate bonds, which must be decided by the state-owned assets supervision and administration institution. Specifically, the merger, division, dissolution or petition for bankruptcy of an important wholly state-owned company shall be examined by the state-owned assets supervision and administration institution and shall be then submitted to the people's government at the same level for approval.[265] The members of the board of directors in wholly state-owned companies are appointed by the state-owned assets supervision and administration institution, and the chairman and deputy chairman are also designated from the members of the board of directors.[266] This results in a lack of incentive for company directors to act in the best interests of the company and all investors. The lack of incentive for shareholders and directors of SOEs to participate in the affairs of the company is a major cause of corporate governance deficiencies in SOEs.

As can be seen, the reason why Chinese Company Law is designed in this way is to ensure that the board of directors can implement the decisions of the board of shareholders to the maximum extent and maximise the interests of shareholders. The subjection of directors to shareholders demonstrates the primacy of the board of shareholders and the pursuit of maximising shareholders' rights in the Chinese companies. These rules have undermined the independence of companies' directors and their incentives to manage the company, in contrast to the international trend, including the UK, to value the role played by the board of directors in promoting corporate governance. The main reason for the subjection of directors to shareholders, especially minority shareholders, is attributed to the highly concentrated share ownership structure of Chinese companies, which further hinders the development of corporate governance in China and it will be discussed next.

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265 Company Law 2018, article 66.
266 Ibid, article 67.

3.6.3 the reason behind: highly concentrated share ownership structure

Different share ownership structures lead to different corporate governance structures.[267] The proportion of different shares in the total share capital of the company and the relationship between them allow the shareholders to exercise their power in different ways, which in turn affects the corporate governance model of the company.[268] For example, the insider ownership structure, represented by Germany and Japan, where managers are given priority over external investors, results in excessive management power, a lack of incentive for shareholders to monitor directors, insufficient protection for minority shareholders and difficulties in attracting foreign investment. Outside ownership structure, represented by the UK and the US, generally has a very developed financial market to support it, and the shares of the company is relatively dispersed. As a result, shareholders tend to vote with their feet when the company is in trouble, choosing to sell their shares and exit the company outright rather than monitoring management to improve corporate governance.[269]

In contrast, the highly concentrated share ownership structure of Chinese companies has created a phenomenon where the majority or controlling shareholders in the company control the company's directors.[270] The presence of controlling shareholders means that they will enjoy an absolute advantage in the composition of the board of directors and in the formation of corporate decisions, resulting in a situation where the company is controlled by an individual or partial shareholder and the independence of directors is again reduced. The majority or controlling shareholders often directly control the directors by virtue of their shareholding, making the directors the spokespersons of their own interests. Directors lack the incentive to actively participate in the affairs of the company due to the influence of the majority and controlling shareholders. By virtue of the majority rule, the majority or controlling shareholders

[267] See Michael J. Rubach and Terrence C. Sebora, 'Comparative Corporate Governance: Competitive Implications of an Emerging Convergence' (1998) 33 Journal of World Business 167.
[268] Gang Wei, Mingzhai Geng, 'Corporate Governance in China: Some Current Issues' (2008) 34 Managerial Finance 934.
[269] Ibid.
[270] Bin Liu(刘斌), (重塑董事范畴:从形式主义迈向实质主义)'Clarifying the Concept of Corporate Directors: Confirming Substance over Form' (2021) Journal of Comparative Law 82.

of a company have the incentive and ability to take full control of the board of directors to serve their own interests. As a result, the board of directors of a Chinese company under this shareholding structure does not have much discretionary power.

In addition, a situation where a company's directors are heavily influenced by shareholders not only undermines their independence and freedom to manage the company, but because shareholders are in control of the selection and dismissal of directors, the directors are effectively representing the interests of controlling shareholder rather than the interests of the company while being subject to the shareholders. The convergence of shareholders' and director' interests is highly likely to infringe on the interests of minority shareholders in companies with highly concentrated ownership structure.

In conclusion, in practice, the relationship between shareholders and directors in Chinese companies is one of decision-execution at the subordinate level, rather than the separation of powers and checks and balances designed by the Chinese Company Law, which is reflected in the fact that directors are heavily influenced and controlled by shareholders, with insufficient independence and limited discretionary power. Directors are supposed to be at the heart of corporate governance because of their day-to-day involvement and management of the company's affairs and their familiarity with the company's development strategy and direction. However, Chinese directors are heavily influenced by shareholders, especially controlling shareholders, and lack natural incentives and motivation to manage the company, which together lead to inefficient corporate governance. Enhancing the independence of Chinese company directors is therefore an important aspect of improving corporate governance in China.

3.7 Conclusion

The corporate governance landscape in China can be characterised by the following points.

China has established a basic legal framework for corporate governance of Chinese companies with a number of basic laws, administrative regulations and departmental rules, which effectively regulate the relationship between the various stakeholders within the company. However, on the whole, Chinese corporate governance rules reflect a fundamental bias towards regulation and restriction rather than encouraging corporate autonomy.

The soft law nature of self-regulation found in the UK Corporate Governance Code is not present in China's corporate governance rules. China's corporate governance code remains heavily regulatory in nature. However, the use of voluntary self-regulation in corporate governance has become an effective measure to improve corporate governance, as it allows companies to adapt their corporate governance structures to their own circumstances and thus achieve high compliance.

The capital markets in China became active after the Chinese split share reform, creating the conditions for the emergence of corporate takeovers. China's corporate governance rules also recognise the value and role of takeovers in improving corporate governance, but the focus on corporate takeovers has mostly been on protecting the interests of the target company's shareholders, ignoring the positive role that takeovers can play in helping to achieve corporate governance compliance. Indeed, the threat of a corporate takeover will act as a compliance incentive for the directors of the target company to work diligently.

Deficiencies in the share ownership structure can be detrimental to the efficiency of corporate governance. Compared to some western countries such as the UK, Chinese companies have a highly concentrated share ownership structure, with the majority or controlling shareholders dominating the company. The direct control of directors by the majority and controlling shareholders of the company has resulted in a lack of incentive for directors to manage the company, leading to inefficient corporate governance. And this is even more serious in Chinese SOEs.

In order to meet and keep in line with global standards of corporate governance, China has made great efforts to improve the corporate governance landscape and build a corporate governance system, especially by continuously improving corporate governance of domestic companies and encouraging local companies to go out and attract foreign investors. However, there are still some shortcomings in the development to date. As of now, the task of corporate governance system in China has shifted from establishing a basic legal framework to how to improve it after three decades of exploration. Compliance will be the new direction for improving and refining corporate governance in China, which will be the focus of the next chapter.

Chapter 4 Compliance with Corporate Governance Rules in China

4.1 Introduction

Agency conflicts are one of the main causes of inadequate corporate governance. Corporate governance is seen as a response to agency problems.[271] One of the objectives of corporate governance is to reduce the agency costs of a company. Corporate governance compliance can be achieved by reducing corporate agency costs and resolving corporate agency problems, while at the same time, compliance can mitigate agency costs in a company. China's corporate governance compliance system contains a range of measures aimed at resolving corporate agency conflicts. Having discussed the legal framework of corporate governance in China in the previous chapter, it is necessary to further examine how Chinese companies comply with the established corporate governance system under a concentrated share ownership structure and whether compliance has had the effect of improving corporate governance in China. This chapter therefore continues to discuss compliance with corporate governance rules in China and examines whether compliance with these rules which are designed to reduce agency costs has achieved the practical effect of promoting corporate governance in China.

[271] Jiangyu Wang, 'Corporate Governance in China: The Law and Its Political Logic' in Roman Tomasic (ed), *Routledge Handbook of Corporate Law* (Routledge 2017) 183.

The following sections of this chapter are organised as follows. Section 2 begins with a description of the agency problems that exist in Chinese companies. Unlike the agency problems between shareholders and management in UK companies, the agency problems in Chinese companies with a highly concentrated share ownership structure tend to be more of a conflict between controlling shareholders and minority shareholders. The subsequent sections therefore focus on how Chinese corporate governance rules have reduced agency costs and what corporate compliance effects have been achieved.

Section 3 shows that in order to achieve corporate governance compliance, China pays attention not only to the interests of shareholders but also to the protection of the rights and interests of the company's stakeholders. Corporate compliance will be better achieved when company management incorporates consideration of stakeholders' various interests in the corporate decision-making process. However, the stakeholder-related provisions of the Chinese Company Law alone are not sufficient to protect the rights of stakeholders and need to be combined with other relevant laws.

Since the management of a company is at the heart of corporate governance, in order to achieve better corporate governance outcomes, management should be given sufficient incentives to comply in order to motivate them to run the company, and this can be achieved by increasing the managerial freedom. Section 4 then focuses on the relationship between managerial discretion and shareholder power in Chinese companies. It is found that due to the high concentration of ownership in Chinese companies, ownership and management are not fully separated and management is de facto subject to the majority or controlling shareholders, leaving the board of directors and senior managers of Chinese companies without much discretion and independence.

Corporate governance compliance could also be achieved by effectively protecting the interests of minority shareholders. Due to the agency conflicts in Chinese companies, the protection of minority shareholders of companies in China should focus on the regulation of the power of controlling shareholders. Section 5 argues that China's corporate governance legal system is relatively weak in protecting minority shareholders, cannot act as an effective check on controlling shareholders and plays a very limited role in achieving and promoting corporate governance compliance. However, there is room for improvement in the legal protection provided by China's corporate governance rules for minority shareholders' rights and interests.

Compliance with the above-mentioned legal rules on corporate governance issues will have an impact on foreign investors' investments as well. Section 6 therefore discusses the relationship between China's corporate governance compliance system and the protection of foreign investors. Finally, section 7 concludes the chapter.

4.2 The extent of agency problem and agency costs

Compliance can mitigate agency problems and agency costs. Unlike the UK, the main agency problem in Chinese companies is the conflict between controlling shareholders and minority shareholders. This is mainly due to the highly concentrated ownership structure of Chinese companies. A well-designed and effective compliance mechanism can be used to address the agency problems of Chinese companies. The reminders of this chapter then go on to discuss whether compliance with these rules has had the practical effect by analysing legislative attempts to mitigate agency problems in China.

4.2.1 ownership structures and the agency problem in Chinese companies

Agency theory describes the conflict of interests between principals and agents. The loss caused by agency problems to both parties of the transaction is the agency cost. Beginning with the studies of Berle and Means[272] and Jensen and Meckling[273], much of the literatures on agency problems arising in the companies have focused on the conflicts between shareholders and managers resulting from the separation of ownership and control. However, this is not the case in China. The agency problem in Chinese companies is mainly the conflict of interests between majority shareholders and minority shareholders, also known as the "principal-principal agency problem".[274] This is mainly due to the highly concentrated ownership structure of Chinese companies, which in turn exacerbates the agency problems and agency costs of Chinese companies.

Different ownership structures can expose different companies to different agency problems, with the ownership structure reflecting the degree of control over the company among shareholders. In companies with a decentralised ownership structure, shareholders are forced to delegate the right to manage the company to hired professionals due to the reduced shareholding of each shareholder and information asymmetries, which can lead to problems of inconsistency between the actions of managers and the interests of shareholders, generating agency costs. And it is argued that the separation of ownership and control creates and accelerates the agency conflicts between shareholders and managers.[275]

After observing and analysing the ownership structure of companies in 27 different countries, it was found that in most countries there is a tendency for ownership to be concentrated, with controlling shareholders being prevalent in most large companies, rather than what Berle and Means claimed.[276] China is no exception. The majority shareholders of Chinese companies, including listed companies, are either in a dominate position or in a position of relative control.[277] Empirical data suggests that, as of 2018 more than four-fifths of Chinese listed

[272] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation & Private Property* (11st edn, Transaction Publishers 2010).
[273] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305.
[274] Jian Sun, Rongli Yuan, Feng Cao and Baiqiang Wang, 'Principal-Principal Agency Problems and Stock Price Crash Risk: Evidence from the Split-share Structure Reform in China' (2017) 25 Corporate Governance: An International Review 186.
[275] Berle and Means (n 272).
[276] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 54 The Journal of Finance 471.
[277] Xudong Zhao(赵旭东), (公司治理中的控股股东及其法律规制)'Controlling Shareholders in Corporate

companies have majority shareholders holding more than 20% of the equity.[278]

In addition, agency problems are more acute in Chinese SOEs due to the predominance of state-owned shares in listed companies in China.[279] In China's listed companies, which are mainly converted from SOEs, the government and other legal persons usually hold the highest proportion of shares and are the largest shareholders, with the second largest shareholder holding much less than the first largest shareholder.[280] Agency problems in SOEs are also exacerbated by the non-profit maximisation objectives and inadequate management incentives.[281] A study of agency problems between controlling and minority shareholders in Chinese listed companies found that controlling shareholder ownership has a significant negative impact on the value of Chinese companies. The market value of a company with a controlling shareholder is significantly lower than that of a company without a controlling shareholder. Moreover, the agency cost is greater in companies where the government is the controlling shareholder.[282]

While the presence of majority or controlling shareholders makes agency conflicts between shareholders and managers less common, it can give rise to other agency problems. In countries and regions with concentrated ownership structures where ownership and control are not well separated, there do not appear to be serious agency problems between shareholders and managers. Majority shareholders tend to impose their will on directors and management. The more concentrated a shareholder's shareholding is, the more voting power that shareholder has, and the more opportunities he or she has to put the people they want on the board. However, because of the concentration of ownership, the majority shareholder has sufficient power to

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Governance and Their Legal Regulation' (2020) 42 Chinese Journal of Law 92.

278 Fuxiu Jiang and Kenneth A. Kim, 'Corporate Governance in China: A Survey' (2020) 24 Review of Finance 733.

279 Lixin Colin Xu, Tian Zhu and Yi-min Lin, 'Politician Control, Agency Problems and Ownership Reform: Evidence From China' (2005) 13 Economics of Transition 1.

280 Ibid.

281 Fengqin Chen, Nancy Huyghebaert, Sen Lin and Lihong Wang, 'Do Multiple Large Shareholders Reduce Agency Problems in State-controlled Listed Firms? Evidence from China' (2019) 57 Pacific-Basin Finance Journal 1.

282 Minggui Yu, Xinping Xia and Hongbo Pan(余明桂, 夏新平, 潘红波), (控股股东与小股东之间的代理问题：来自中国上市公司的经验证据)'Agency Problems between Controlling Shareholders and Minority Shareholders: Empirical Evidence from Chinese Listed Companies' (2007) 19 Management Review 3.

control the company and to make personal gains for himself or herself by influencing various decisions of the company.

Agency conflicts in China are mainly manifested in the abuse of power by the majority shareholders to infringe on the interests of minority shareholders. According to Shleifer and Vishny, once equity is concentrated in the hands of individual shareholders, there is a tendency for them to expropriate the interests of minority shareholders.[283] As a result, when the interests of the majority shareholder conflict with those of the minority shareholder, the majority shareholder is likely to choose to act in its own interest, often at the expense of the minority shareholder. Whether it is a connected transaction, transfer of company assets or appropriation of investment opportunities, these actions are detrimental to the interests of the company and minority shareholders, as the majority shareholder uses its control over the company to choose for its own personal benefit when a conflict of interest arises.

As a result of the concentration of ownership, the majority shareholders have enough power to control the company and to make personal gains for themselves by influencing various decisions of the company. In addition, minority shareholders with small shareholdings are likely to be prevented from participating in the management of the company by the control of the majority or controlling shareholders, and the power to manage and supervise the company is to some extent transferred to the majority or controlling shareholders.

4.2.2 compliance and agency cost

It has been argued that the agency cost in corporate governance cannot be completely eliminated, but can be reduced and controlled within reasonable limits through certain mechanisms.[284] In China, when the controlling shareholder controls the company, it becomes

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[283] Andrei Shleifer and Robert W. Vishny, ‘A Survey of Corporate Governance’ (1997) 52 The Journal of Finance 737.
[284] Dan Wang(王丹), (派生诉讼在控制公司代理成本机制中的角色和功能定位)‘The Role and Function of Derivative Litigation in the Mechanism of Controlling Corporate Agency Cost’ (2021) 5 Journal of CUPL 167.

difficult for other institutions within the company to perform their functions. In other words, it is also difficult for the internal governance mechanisms of the company to function. A well-designed and effective legal mechanism can be used to address agency problems in companies.

The reason for agency problems and agency costs in companies is that conflicts of interest arise between different organs in the company. In the Chinese context, it is the controlling position of the controlling shareholder that creates a conflict of interest by creating a disadvantage for management, minority shareholders and other stakeholders in terms of access to information and participation in the affairs of the company. Compliance can be achieved by balancing the conflicting interests of these different subjects.

Firstly, compliance would be achieved through managerial discretion, where management are not only given discretion but also empowered to exercise that direction in the interest of the company as a whole, including constraining the behaviour of the majority. Internal checks and balances fail because of the inadequate separation of powers in companies with a concentrated ownership structure and the inability of the board of directors to completely free itself from the influence of the controlling shareholders. Compliance can free the managerial discretion of directors from majority shareholders' control by requiring them to act in the interests of the company as a whole.

Secondly, compliance will be achieved by restraining the behaviour of the majority shareholders in encroaching on the interests of the minority shareholders. Restraint and restrictions on the behaviour of majority shareholders will help monitor their self-interested behaviour and mitigate conflicts of interest between them and minority shareholders, thus effectively achieving corporate compliance.

Thirdly, the inclusion of stakeholders' interests in the management's decisions will facilitate effective compliance. In addition, the involvement of stakeholders such as creditors, employees and consumers can help monitor the behaviour of majority shareholders. Stakeholders can contribute to compliance by disciplining the behaviour of the majority shareholder and the management.

The next sections of this chapter examine how compliance can be achieved in China to reduce agency costs from a number of different perspectives, including managerial discretion, stakeholder and minority shareholder protection. It concludes by answering the question of whether corporate governance compliance in China has served to protect foreign investors in Chinese companies.

4.3 The various interests of stakeholders in Chinese companies

The active participation of stakeholders is considered to be one of the conditions for achieving corporate governance.[285] Considering the protection of various stakeholder rights in a company's decision-making process accelerates the process of achieving corporate compliance. Before discussing whether Chinese corporate governance rules provide effective protection for stakeholders, it is important to look at who the stakeholders of Chinese companies are and why corporate governance in China needs to focus on stakeholder interests.

4.3.1 the importance of stakeholders for corporate governance in China

The traditional model of corporate governance generally adopts the principle of shareholder primacy.[286] It emphasises that the actions of the company and the management are supposed to prioritise the interests of shareholders. However, with the continuous development of the global economy, corporate behaviour affects not only the interests of shareholders but also those of different stakeholders, such as the company's employees, creditors, customers, etc.

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[285] Silvia Ayuso, Miguel A. Rodriguez, Robert Garcia-Castro and Miguel A. Arino, 'Maximizing Stakeholders' Interests: An Empirical Analysis of the Stakeholder Approach to Corporate Governance' (2014) 53 Business & Society 414.
[286] Adolf A. Berle, 'Corporate Powers as Powers in Trust' (1931) 44 Harvard Law Review 1049.

Stakeholders themselves therefore refer to groups whose interests are closely linked to those of the company.

Stakeholder theory only came to the attention of Chinese scholars in the late 1990s. People began to realise that there are many problems in the daily operation of a company, which was no longer just a matter between shareholders and managers. In order to achieve long-term corporate growth, it is also necessary to take into account other subjects that will have an impact on the interests of the company besides the shareholders. It was then suggested that shared governance between stakeholders and the company management could be achieved to improve the efficiency of corporate governance, for example by allowing creditors of the company to sit on the company's board.[287]

However, a stakeholder model of corporate governance needs to be achieved by adjusting the fiduciary duties of the board of directors to stakeholders. This will inevitably increase the cost of running and managing a company, so why should the company be concerned about the various rights of stakeholders? There are three main reasons can be summarised.

Firstly, the various interests of stakeholders are closely connected to the company. Various stakeholders invest in the company through different forms. For example, the company's employees invest their labour and intellect, and customers and creditors provide financial support. When a company fails, shareholders will suffer direct losses. But shareholders are not the only ones whose investments will be affected. Stakeholders, such as creditors and employees, do not have the same access to sell their shares and exit the company as shareholders, but on the other hand, the failure of the company inevitably has a negative impact on them.[288] Stakeholders' demands should therefore also be internalised by the company as part of its governance.

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[287] See Weian Li(李维安), (制定适合国情的中国公司治理原则)'Call for Corporate Governance Principles of China Fit for Situation of Our Country' (2001)1 Nankai Business Review 4.
[288] Margaret M. Blair and Lynn A. Stout, 'A Team Production Theory of Corporate Law' (1999) 24 The Journal of Corporation Law 751.

Secondly, stakeholders' rights can also be affected by non-compliance by the company and its members. The extent to which a company's stakeholders' rights are protected in the company reflects the level of compliance. The self-interested behaviour of controlling shareholders not only infringes on the interests of the company's minority shareholders, but also has an impact on the various rights and interests of stakeholders. And one of the main reasons for paying attention to the role of stakeholders in corporate governance is that the internal imbalance caused by the excessive power of controlling shareholders in the company can be better balanced by paying attention to the rights and interests of stakeholders. Failure to focus on stakeholder protection can result in a situation where a company incurs costs in the course of its business that affect stakeholders but does not have to pay for them.[289] Conversely, stakeholders can contribute to the formation of company decisions. Balancing stakeholder interests in the decision-making process is a form of monitoring and discipline for the company's management and helps the company to achieve compliance.

And finally, protecting the interests of stakeholders will contribute to the long-term development of the company and improve corporate governance, as it relies on the combined efforts of all those who have an interest in the company. Not only do they provide various forms of investment to the company, stakeholders also bear the risks of the company's operations to varying degrees. The relationships between various stakeholders and the company can also affect the efficiency of corporate governance. The long-term development of a company cannot be achieved without the support of its stakeholders. The cost to the company in the short term as a way of protecting stakeholders will pay off in the long run in terms of the company's reputation. Stakeholder claims cannot therefore be ignored if the company aims to achieve long-term and compliant growth.

Since the 1990s, there has also been a growing body of Chinese theoretical literatures that argues that corporate development should not focus solely on the interests of shareholders.

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[289] Feng Yu(余峰), (企业社会责任对企业财务绩效的影响及其传导机制)'The Impact of Corporate Social Responsibility upon Corporate Financial Performance and Its Transmission Mechanism' (2016) 33 Journal of Shenzhen University (Humanities & Social Sciences) 82.

Some argued that a corporate governance model that introduces stakeholder protection is more in line with China's legal choices.[290] And corporate governance in China needs to propose new optimisation paths under stakeholder theory, and to review and examine the traditional corporate governance paradigm.[291] Others point out that the operation of a company should transition from simply maximising the interests of shareholders to taking into account the interests of stakeholders, and that maximising the interests of shareholders has priority rather than exclusivity.[292] And in recent years, there have also been a number of Chinese studies linking the protection of the rights and interests of various stakeholders to corporate social responsibility.[293]

The stakeholder theory may not completely replace the traditional shareholder primacy, but it should be used as a supplementary method to remind companies to pay more attention to the demands of stakeholders other than shareholders.[294] As discussed in the previous chapter, the legal system of Chinese companies is designed around the primacy of shareholders' interests. However, the extent to which the law protects other stakeholders in the company, in addition to shareholders, will also have an impact on the effectiveness of corporate governance. Corporate compliance will be better achieved when company management incorporates consideration of stakeholder interests into the decision-making process. However, the current Chinese legal

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290 Liming Liu and Songmei Zhang(刘黎明, 张颂梅), (“利益相关者”公司治理模式探析)'Exploring the 'Stakeholder' Model of Corporate Governance' (2005)7 Journal of SWUPL 96.

291 Yan Zhang and Yulan Wang(张艳, 汪玉兰), (上市公司治理的优化路径-基于利益相关者理论的分析)'Optimization Path of Listed Company Governance: An Analysis Based on Stakeholder Theory' (2014) 26 Journal of Changchun University of Technology (Social Science Edition) 25; Yong Wang and Xiaodong Zhou(王涌, 周晓冬), (论公司法修订中公司治理的目标迁移及范式重塑)'On the Migration of Objectives and the Reshaping of Paradigm in Corporate Governance in the Revision of Company Law' (2023) 44 The Theory and Practice of Finance and Economics 146.

292 Ye Lin(叶林), (公司利益相关者的法学分析)'The Lawful Analysis of Correlation Persons of the Company's Benefits' (2006) 26 Hebei Academic Journal 165.

293 See Tiantao Shi(施天涛), (《公司法》第 5 条的理想与现实：公司社会责任何以实施？)'The Ideals and Realities of Article 5 of the Companies Law: How can Corporate Social Responsibility be Implemented?' (2019)13 Tsinghua University Law Journal 57; Yu (n 238); Zhenhua Fan and Fang Zhang(樊振华, 张舫), (公司社会责任的制度悖论及其克服)'The Institutional Paradox of Corporate Social Responsibility and its Overcoming' (2014) Social Science in Hunan 156; Youzhi Xue and Tinyu Xibei(薛有志, 西贝天雨), (公司治理视角下企业社会责任行为的制度化探索)'An Institutional Exploration of Corporate Social Responsibility Behaviour from the Perspective of Corporate Governance' (2022) 2 Nankai Journal (Social Science Edition)183 and Qunfeng Chen(陈群峰), (论公司社会责任司法化对利益相关者的保护)'On the Protection of Stakeholders by the Judicialization of Corporate Social Responsibility' (2013)10 Journal of Law Application 82.

294 Qingjie Zhou and Zhenhua Sun(周清杰, 孙振华), (论利益相关者理论的五大疑点)'Five Major Doubts about Stakeholders' (2003) 5 Journal of Beijing Technology and Business University (Social Science) 18.

provisions play a limited role in protecting the various interests of Chinese companies' stakeholders.

4.3.2 legal regulations towards the protection of stakeholders in Chinese companies

4.3.2.1 stakeholders in Chinese companies

Stakeholder protection provided by the Chinese legal system began with the Chinese listed companies. The *Code of Corporate Governance for Listed Companies* ("the Code") issued by the CSRC in 2002 provided for the first time a chapter dedicated to the rights of stakeholders of listed companies. According to the Code, a listed company shall respect the lawful rights of banks and creditors, employees, clients, suppliers, communities and other stakeholders to promote the sustainable and sound development of the company.[295] The Code further requires companies to protect the interests of employees by establishing diversified communication channels with them.[296] In addition, it also requires listed companies to integrate ecological and environmental protection into their corporate governance,[297] and to fulfil their social responsibility in community welfare, disaster relief and other public welfares.[298]

The provisions of the Company Law in China set the basic legal standard for other laws and regulations in terms of stakeholder protection. The Company Law enacted in 2005 required companies to bear social responsibilities when conducting their business operations in Article 5. But it did not further specify the relationship between the fulfillment of social responsibility and stakeholders, nor did it explain how the company should fulfill this obligation. The Code provides more detailed provisions compared with the Company Law. And the SASAC requires central enterprises to pursue economic benefits while being responsible to stakeholders and the

295 Code of Governance for Listed Companies (2002), article 83.
296 Ibid, article 85.
297 Ibid, article 86.
298 Ibid, article 87.

environment and fulfilling their social responsibilities.[299]

Researchers from Nankai University defined stakeholders in Chinese companies in their proposed draft principles of corporate governance in China as shareholders, operators, employees, creditors, suppliers, customers and communities, and they suggested that corporate governance mechanisms should ensure that each of these stakeholders enjoys equal treatment as equal rights holders in companies.[300] Whether they are shareholders, employees or creditors, they all bear different degrees of risks to the company and the standard to judge whether they are stakeholders should be whether they can provide input for the company to create wealth by either providing material capital or human costs.

4.3.2.2 stakeholder protection under Chinese Law

After reviewing the above Chinese legal regulations, this section identifies the main stakeholders in Chinese companies are the company's employees, creditors, consumers and the environment. The extent to which they are protected by the provisions of Chinese law is examined separately below.

Employees. Of all the stakeholders in Chinese companies, employees occupy the most important position in Chinese legal system, which reflects in the fact that Chinese Company Law has always emphasised the importance of employee participation in corporate governance. With regard to the protection of employees' interests, the Company Law requires companies to sign employment contracts with their employees, to buy social insurances and to solicit the opinions of the employees on major issues relating to the company's operations through the company's labour union or the assembly of the representatives of the employees.

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299 Guidance on the Fulfillment of Social Responsibility by Central Enterprises (2008).
300 Research Group on Chinese Corporate Governance Principles of Nankai University, 'Chinese Corporate Governance Principles and Explanations (Draft)' (2001) 1 Nankai Business Review 9, 11.

Since the supervisors of a company can attend the meetings of the board of directors and raise questions or make suggestions on the matters resolved at the meetings,[301] and have the right to demand any director or senior manager to make rectifications when he or she act against the interests of the company,[302] the Company Law requires that the supervisory board include representatives of shareholders and an appropriate proportion of representatives of the company's employees, of whom not less than one third should be employees,[303] increasing the opportunity for employees to participate in corporate matters that may affect their own interests.[304] In addition, the Company Law also recommends that the board of directors of a company limited by shares may include representatives of the company's employees.[305]

Creditors. When China first promulgated its Company Law in 1993, article 1 listed protecting the legitimate rights and interests of companies, shareholders and creditors as one of the reasons for the enactment of China's Company Law, and it has remained unchanged in the subsequent amendments. In addition, the Company Law also makes specific provisions for the protection of creditors, mainly providing procedural protection in terms of merger, split-up, increase and deduction of registered capital and dissolution and liquidation of the company. Specifically, the company shall notify the creditors within ten days after making the decision of merger, split-up and reducing registered capital and make a public announcement on the newspaper within thirty days, otherwise the company may be fined by the company registration authority not less than 10,000 yuan but not more than 100,000 yuan.[306] Moreover, the liquidation group should also notify the creditors within ten days after its formation and announce in the newspaper within sixty days.[307] Any of the members of the liquidation group shall be liable and make compensations for any losses caused to creditors due to intentional or gross negligence.[308] In addition, article 20 of the Chinese Company Law is also a protection clause for the interests of creditors. It requires a shareholder who abuses the independence of the company's legal

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[301] Company Law 2018, article 54.
[302] Ibid, article 53(3).
[303] Ibid, article 51.
[304] Ibid, article 17, 18.
[305] Ibid, article 108(2).
[306] Ibid, article 173,175,177 and 204.
[307] Ibid, article 185.
[308] Ibid, article 189.

personality and the limited liability of its shareholders by evading debts and seriously damaging the interests of the company's creditors to be jointly and severally liable for the company's creditors.

Consumers. In order to protect the legitimate rights and interests of consumers, China enacted the Law of the People's Republic of China on the Protection of Consumer Rights and Interests in 1993. In addition to this, the relevant provisions of the Contract and Tort Liability sections in the Civil Code may also be applied.

Environment. The Civil Code for the first time incorporates environmental protection into the basic provisions of its General Provisions, demonstrating the importance attached to environmental protection and sustainable development in national legislation. It requires that the parties to civil legal regulations should engage in civil activities contributing to the conservation of resources and protection of environment.[309] Chapter 7 of the Civil Code provides for liability for environmental pollution and ecological damage. In addition, the Civil Code mentions the requirements for environmental protection mainly in the Contract section. For example, the parties shall avoid wasting resources, polluting the environment and compromising ecology in the course of performing a contract.[310] And in the sales contracts, the seller shall adopt a packaging method that is conducive to the protection of the ecological environment, in addition to the packaging method agreed by the parties and common method regarding the delivery of the subject matter.[311]

The Chinese Institute of Corporate Governance of Nankai University incorporated the governance evaluation of stakeholders into the governance evaluation system of listed companies in China to ensure that all stakeholders enjoy equal treatment and equal rights, and include stakeholder governance in the construction of China's corporate governance evaluation and governance system. From the data it provides, the degree of stakeholder participation in

[309] Civil Code 2020, article 9.
[310] Ibid, article 509.
[311] Ibid, article 619.

China has increased year by year, primarily due to the fact that listed companies have improved the mechanisms of online voting and proxy voting and enabled stakeholders to better understand the company through information disclosure.[312]

4.3.3 evaluation of stakeholder legal protection for Chinese companies

Although China has also been raising the profile of stakeholders in corporate governance, there are still some shortcomings in the legal system of various stakeholder protection. The main problem with the legal provisions on the protection of stakeholders' interests in China is that they are a recipe for non-compliance.

Firstly, the legal provisions for the protection of various interests of stakeholders by Chinese companies are too broad and general for management to comply with. Although corporate social responsibility has been explicitly written into Chinese Company Law in 2005, there is a lack of further provisions on the specific definition of the concept of social responsibility, how companies can comply with their social responsibility and the consequences they will face for non-compliance. Specifically, what is social responsibility? How should companies achieve social responsibility? What is the relationship between the realisation of corporate social responsibility and the protection of stakeholders in China?

The overly abstract provisions of the Company Law not only lead to non-compliance by companies, but also the courts are unable to directly invoke this provision in judicial practice to rule on corporate responsibility. Also, the Company Law does not address the issue of penalties, i.e. what is the liability of a company if it does not comply with the social responsibility provisions? The silence of the Companies Law on these issues has led to a significant reduction in the incentive for company management to comply with the provisions relating to the protection of stakeholders' interests. On the contrary, article 20 of the Company

312 Weian Li(李维安), (中国上市公司治理评价研究报告)*China Corporate Governance Evaluation Report* (1st edn, The Commercial Press 2016) 127.

Law provides that shareholders of a company who abuse their independent status as legal persons and limited liability of shareholders to evade debts and seriously damage the interests of the company's creditors shall be jointly and severally liable for the company's debts. Such clear provisions can be used as a direct basis for trial in judicial practice, and at the same time, the company management is more motivated to comply with the provisions because it knows in advance the clear consequences of its actions.

Secondly, as already mentioned, in addition to the general provisions of article 5, the Company Law also makes relevant provisions for the protection of the interests of employees and creditors of the company. For example, the right of employees to participate in the affairs of the company is ensured by stipulating the proportion of employee representatives on the board of directors and the supervisory board,[313] and the interests of creditors are protected from infringement through procedural matters such as the merger, split-up and bankruptcy of the company.[314] The Chinese Company Law adopts both general provisions to first recognise the general obligation of Chinese companies to operate their business in a socially responsible manner, and specific provisions for specific stakeholders in the sub-articles corresponding to the general provisions. However, the Company Law does not further clarify the subject of compliance obligations, making it difficult to comply with the social responsibility provisions in practice.

Although the Code provides more detailed provisions than Company Law, it still does not detail the ways in which stakeholders can pursue remedies. For example, it provides in a rather general term that listed companies should provide stakeholders with the opportunities and channels to seek relief if their rights and interests are infringed.[315] This means that in China, specific protection and remedies for stakeholders' rights and interests still need to be found in specific provisions of other specialised laws. It is doubtful that such an approach, which is regulated by general provisions only, will actually serve to protect stakeholders' interests in practice.

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313 See Company Law 2018, article 51 and 108(2).
314 Ibid, article 173,175,177, 185, 189 and 204.
315 Code of Corporate Governance for Listed Companies (2002), article 84.

By contrast, in the UK, the duty of the board of directors to be accountable to the company's stakeholders is clearly reflected in its Companies Act 2006 ("CA 2006"). Company directors have a duty to promote the success of the company under section 172 of the CA 2006. According to this, company directors must act in a manner that they consider is most likely to promote the success of the company for the benefit of all its members, including taking into account the interests of the company's employees, the company's business relationships with suppliers and customers, and the impact that the company's day-to-day operations will have on the community and the environment. The duty to balance the interests of different stakeholders closely related to the company is placed on directors and enshrined in legislation, reflecting the importance given to the interests of stakeholders in the UK corporate governance rules.

The UK model is worth learning form in China. Given that the board of directors is primarily responsible for the operational management of the company, it should be the boards who are responsible for the protection of stakeholders' rights and interests in Chinese companies. Stakeholders' demands could motivate the company' board of directors to establish a more complete corporate structure within the company and therefore promote corporate compliance.

On the other hand, in addition to the impact on the internal application of the company, the general provisions of the Company Law may also lead to difficulties in judicial practice. The courts will have a wide margin of discretion in interpreting these provisions, further increasing uncertainty and confusion in the application of the law in protecting the interests of stakeholders.

In conclusion, the wide range of stakeholders with varying degrees of potential impact on the operation of a company cannot be fully protected by the provisions of the Company Law alone. While the Company Law also lists protective measures for different stakeholders in its sub-clauses, violators cannot be held liable solely on the basis of these provisions and need to be combined with other relevant laws. The Company Law should only provide protection for certain specific subjects in general provisions and in certain specific matters, and the rest should be left to special laws. For example, the protection of the interests of creditors is mainly reflected in Contract law, which in the case of China is regulated by the Civil Code. The protection of the interests of the company's employees could be left to the Chinese Labour law.[316] A combination of compliance with the general provisions of Company Law and the relevant provisions of special laws can provide more effective protection of the rights and interests of different stakeholders and thus achieve corporate compliance in China.

4.4 Managerial discretion in corporate governance

As noted earlier, management as agents are required to be authorised to act on behalf of the principals, i.e. shareholders, to represent their interests and expectations in their companies. Shareholders will delegate certain decision-making powers to the company's management for the sake of the company's growth. In turn, the extent to which management is free to make decisions in the company is referred to as managerial discretion, reflecting management's influence on outcomes at the organisational-level.[317]

The extent of managerial discretion affects the authority of a company's management to make decisions about the company's affairs. While a company's shareholders expect management to achieve a greater return on investment for the company, an excessive scope of decision-making power will result in management having too much managerial freedom, which may put shareholders' capital at risk and management's actions may move in a direction that deviates from the company's interests, while too little scope for managerial discretion may also result in management being too constrained to use its expertise to create values for the company and lack the motivation to drive the company forward. Delineating an appropriate range of managerial discretion is therefore crucial to the development of the company and facilitate the maximum contribution of company management to drive the company forward in a compliant

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[316] Ye (n 245).
[317] See Hambrick D.C and Finkelstein S., 'Managerial Discretion: A Bridge Between Polar Views of Organizational Outcomes' (1987) 9 Research in Organizational Behavior 369 and David B. Wangrow, Donald J. Schepker and Vincent L. Barker III, 'Managerial Discretion: An Empirical Review and Focus on Future Research Directions' (2015) 41 Journal of Management 99.

manner. The scope of management discretion is therefore crucial to the development of the company and only the right scope can lead the company to achieve long-term growth in a compliant manner. Do corporate governance rules in China set the right boundaries for company management to help them achieve corporate compliance?

The managerial discretion to run a company rests with those who are actually responsible for the management of the company. In Chinese companies, the subjects who exercise managerial discretion are generally the board of directors and the managers. As the Chinese Company Law defines the board of directors as the executive organ of the board of shareholders and the manager is in turn responsible for implementing the board's resolutions, the management of a Chinese company does not enjoy the same strong managerial discretion as the board of directors in other extraterritorial jurisdictions, which results in a lack of incentive for the management of a Chinese company to comply and has a negative impact on the efficiency of corporate governance in China. Therefore, delineating the appropriate scope of managerial discretion is beneficial for company management to maximise their contribution to improving corporate governance in a compliant manner. The purpose of this chapter is to discuss how managerial discretion in Chinese companies can achieve corporate compliance in order to promote corporate governance.

4.4.1 the reality of managerial discretion in Chinese companies

Chinese corporate legal norms take a passive approach to the discretionary powers granted to company management, resulting in a lack of compliance incentives for company management to improve corporate governance.

The Chinese Company Law adopts a closed and specific enumeration of the powers and functions of the board of directors and managers ("the management"). The management can only exercise the specific powers set out in the legal provisions. According to Chinese Company Law, the board of directors of Chinese companies is responsible for implementing the resolutions made by the board of shareholders and has the power to decide on the company's business policies and investment plans, the establishment of the company's internal management and the formulation of the company's program and basic management system.[318] The manager, elected by the board of directors, is responsible to the board and performs the functions and powers delegated by the board of directors. The manager of the company is responsible for implementing the resolutions of the board of directors and for drafting and organising the implementation of the plans and programs of the company.[319]

In Chinese companies, the board of directors is not a decision-making organ but an executive organ, and the board is generally responsible for the implementation of the resolutions of the board of shareholders. The recently enacted Civil Code formally establishes the status of the board of directors as an executive organ in Chinese companies.[320] In practice, the authority of the board of directors is limited to the resolutions and the authorisation of the board of shareholders. The power to make decisions on major business-related matters in a company belongs to the board of shareholders, the power to make decisions on general matters and to execute major matters belongs to the board of directors, while the company manager is more of an auxiliary organ to the board of directors, helping the board of directors to deal with the details of the company. This hierarchical design of delegated legislation effectively creates a hierarchy of management within the company, with the managers accountable to the board of directors and the board of directors accountable to the board of shareholders, in line with the basic logic of subordinates being accountable to superiors.[321] Relying on the board of shareholders to delegate all of the company's operational management and decision-making powers leaves management with very limited discretion to comply. This situation does not allow the company's management to play much influence on whether the company's decisions are formed in a compliant manner.

Due to state control, management of Chinese SOEs has even more limited managerial discretion

[318] For detailed powers and functions of the board of directors, see Company Law 2018, article 46.
[319] For detailed powers and functions of the managers, see ibid, article 49.
[320] Civil Code 2020, article 81.
[321] Deng (258).

and even less incentive to comply. The control rights of SOEs in China belong to the state or its agencies. The managers of SOEs place the interests of the state above the interests of other shareholders.[322] In SOEs, the members of the board of directors are appointed by the state-owned assets supervision and administration institution, and the chairman and vice-chairman are designated by the state-owned assets supervision and administration institution from among the members of the board of directors.[323] The managers of a wholly state-owned enterprise are appointed or dismissed by the board of directors, and with the consent of the state-owned assets supervision and administration institution, a member of the board of directors may also serve as manager.[324] This has resulted in a lack of incentive for the management of SOEs to manage the business and maximise the company's profits. The operation and development of Chinese SOEs is sometimes motivated by political purposes than by profits, and management lacks the incentive to run the company properly to maximise profits, instead they are more concerned with the realisation of their own interests. The state, as the majority shareholder in SOEs, is far away from the daily business affairs of the enterprises, providing the opportunity and possibility for the management to pursue their own interests rather than those of the company.[325] As a result, the managerial discretion granted by Chinese law to the management of SOEs is not sufficient to drive management's incentive to comply.

4.4.2 managerial discretion controlled by shareholders

In Chinese corporate practice, managerial discretion is controlled by the board of shareholders. According to data, by the end of 2004, of the 1,324 listed companies in China, about two-thirds of them were held by the largest shareholder with a shareholding of 20% or more. Among them, about 36.7% were held by the largest shareholder with more than 50% shareholding.[326] This gives the controlling shareholders the absolute ability to control the board of directors.

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322 Jiang and Kim (n 278).
323 Company Law 2018, article 67.
324 Ibid, article 68.
325 Yu Liu, Mihail K. Miletkov, Zuobao Wei and Tina Yang, 'Board Independence and Firm Performance in China' (2015) 30 Journal of Corporate Finance 223.
326 Ciyun Zhu(朱慈蕴), (资本多数决原则与控股股东的诚信义务)'The Majority Rule Principle and the Controlling Shareholder's Duty of Good Faith' (2004) 4 Chinese Journal of Law 104.

The power of shareholders is used to monitor and limit the discretion of management. In terms of the provisions of the Company Law, the provisions relating to the powers of the board of directors can be interpreted as residual powers of the board of shareholders, with the substantive powers of corporate control remaining within the powers of the board of shareholders. The authorisation of the board of directors is granted by the board of shareholders[327] and the statutory functions and powers of shareholders cannot be transferred. According to that, it is the responsibility of shareholders to determine the extent to which management can make decisions for the company in their place, including major matters such as investment strategy and business plans. The reason why shareholders expect management to comply with existing rules is to avoid opportunistic behaviour by management that infringes on their own interests. In this case, management's compliance behaviour actually serves to protect the interests of shareholders rather than the interests of the company.

This legislative design is thought to have been influenced by the administrative model of Chinese SOEs.[328] In Chinese academic studies, the relationship between the board of shareholders and the board of directors of Chinese companies has been considered by many scholars to be a subordinate relationship with administrative attributes.[329] The controlling shareholders play a decisive role in the nomination and removal of board members. Moreover, they have the power to make decisions on major corporate matters and have the right to remove directors and other managers. In addition, most listed companies in China have been converted through SOEs,[330] where state-owned and legal person shares are common,[331] and the fact that board members often serve as managers at the same time has led to the ability of major shareholders to control the entire management and a weakened compliance incentive for management.

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327 Company Law 2018, article 37.
328 Peixin Luo(罗培新), (股东会与董事会权力构造论:以合同为进路的分析)'Theory of the Construction of the Powers of the Board of Shareholders and the Board of Directors: An Analysis Using the Contract as a Way Forward' (2016) 2 Political Science and Law 122.
329 See Gan and Ma (n 262) and Deng (n 258).
330 Keay and Zhao (n 106) 196.
331 Wei and Geng (n 268).

In addition, while the board of directors enjoys a degree of decision-making power over the company's decisions, whether these proposals are ultimately adopted depends largely on the preferences of the shareholders or controlling shareholders.

Not only that, Chinese legal provisions impose too many mandatory norms on the company's management, which to a certain extent affects its discretion to manage the company according to the actual situation.

4.4.3 compliance and managerial discretion

It is known from agency theory that non-compliance by a company's management can have a negative impact on corporate governance.[332] There is therefore a need to motivate management's compliance drive. Both the constraints and incentives imposed on management by the institutional environment can have an impact on their behaviour in the company. In order to achieve better corporate governance outcomes, management must be given sufficient compliance incentives to motivate them to run the company, and this can be achieved by increasing management's discretionary freedom.

Increasing the managerial freedom of Chinese companies requires a two-fold approach. One is to reduce shareholder control and influence over management, and the other is to mobilise management incentives to run the business through market discipline.

Firstly, compliance incentives for the management need to be achieved through the devolution of power by the board of shareholders. The board of shareholders should respect the discretion of management and not abuse their power to interfere with matters within the authority of the board of directors.

[332] Andrew Keay and Joan Loughrey, 'The Framework for Board Accountability in Corporate Governance' (2015) 35 Legal Studies 252.

As can be seen from the previous discussion, the design of China's legal rules has resulted in low discretionary powers for managers of Chinese companies. Due to the high concentration of ownership structure in Chinese companies, ownership and management are not fully separated and management is de facto subject to the majority or controlling shareholder, leaving the board of directors of Chinese companies without much discretion and independence.

It has been argued that managerial discretion under the corporate governance mechanisms involved in the company needs to be aligned with the company's objectives.[333] Providing in the Company Law that managerial discretion should serve the overall interests of the company could address the issue of shareholder control over management. It needs to be made clear that the board of directors should be the executive body of the company rather than the executive body of the board of shareholders, and that both the board and managers should serve the interests of the company as a whole and not those of the shareholders.

In addition, the constructing a system of fiduciary duties for directors and managers of Chinese companies in the Chinese legal system, consisting of the directors' duty of loyalty and duty of diligence, is another attempt to explore the boundaries of managerial discretion.[334] The Chinese Company Law delineates the scope of a director's duty of loyalty through prohibitions.[335] However, it should further clarify the direction of the directors' duty of loyalty by requiring them to act in the interests of the company as a whole.

In short, it is necessary to design a mechanism that limit the degree of managerial discretion to a reasonable scope and set it to a reasonable range to prevent the management from abusing their discretion to benefit themselves and shareholders. Management's compliance with this mechanism will ensure that management's actions serve the overall interests of the company, while also mitigating the problem of shareholders using their influence over the management

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333 Jon Aarum Anderson, 'The Concept of Managerial Discretion in Corporate Governance- Better Off Without it?' (2017) 17 Corporate Governance (Bradford) 574.

334 Gan and Ma (n 262).

335 For more detailed prohibitions, see Company Law 2018, article 148.

to serve their own interests.

Secondly, China should use market forces to mobilise managerial discretion compliance incentives. Reputation is crucial for companies' directors, and losing reputation in the market is a better incentive for directors to perform their duties in a compliant manner in the company than to use other monetary measures. For directors of SOEs, losing their directorship may even have a negative impact on their future of political career.[336] In China, such a market mechanism is not well developed,[337] and directors who fail in this company can easily continue to serve in other companies. The fear of losing jobs and future directorships can also be used as an incentive for directors to comply. Therefore, Chinese Company Law needs to consider introducing a director disqualification regime that can deter directors who engage in non-compliance, so as to limit their future qualifications as directors or positions in other companies, so as to urge them to perform their duties in a compliance way and promote the company's compliance development.

To summarise, this section argues that in order to achieve improved corporate performance and better corporate governance outcomes, management must be given sufficient incentives. How legal mechanisms can be put in place to give management sufficient freedom to manage the company and create checks and balances with controlling shareholders in Chinese companies will be further discussed in chapter 6.

4.5 Minority shareholder protection

Given that the main agency problem of Chinese companies is the conflict of interest between controlling shareholders and minority shareholders, providing effective protection for minority shareholders' rights and interests against the actions of controlling shareholders is one of the core issues in building a compliance system for corporate governance in China. As can be seen

[336] Fuxiu Jiang and Kenneth A. Kim, 'Corporate Governance in China: A Modern Perspective' (2015) 32 Journal of Corporate Finance 190.
[337] Ibid.

from the discussion in sections 2 and 3 of this chapter, controlling shareholders are in a dominant position in Chinese companies and minority shareholders are in a position where their legal rights and interests are highly vulnerable to be infringed. Therefore, in order to achieve corporate compliance, Chinese corporate governance rules must focus on and enhance the protection of minority shareholders' interests.

China's corporate governance rules provide relatively complete legal protection for minority shareholders of companies, but there is room for further improvement as some of the norms are too broad and lack operability in practice. In addition, the degree of protection of minority shareholders' rights in a country or region may be related to the extent to which controlling shareholders deprive minority shareholders of their interests.[338] The weak protection of minority shareholders in China is reflected, on the one hand, in the weakness of China's legal rules in protecting the rights and interests of minority shareholders, and, on the other hand, the imperfect regulation of the rights and obligations of controlling shareholders in China's legal rules, resulting in the rights and interests of minority shareholders in Chinese companies being vulnerable to infringement. Due to the extreme lack of provisions for controlling shareholders in Chinese corporate legal rules, the absence of legal provisions has led to a serious mismatch between the actual position of controlling shareholders in corporate governance practice and their responsibilities under the law, making the conflict between controlling shareholders and minority shareholders increasingly the most significant conflict in Chinese corporate governance and the most important factor affecting the construction of a compliance system for corporate governance in China.

Therefore, this section further examines whether the current level of protection for minority shareholders in China contributes to the achievement of corporate governance compliance by discussing how the current Chinese legal system responds to the conflict of interests between controlling shareholders and minority shareholders in Chinese companies.

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338 Rafael and Shleifer (n 276) and Zohar Goshen and Assaf Hamdani, 'Majority Control and Minority Protection' in Jeffrey N. Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (2015) 449-469 <https://doi.org/10.1093/oxfordhb/9780198743682.001.0001> accessed 27 January 2023.

4.5.1 the extent of conflict between controlling shareholders and minority shareholders in Chinese companies

Minority shareholders are the main investors in Chinese companies. Unlike the controlling shareholders, they are often in a weak position in the company due to their small capital contribution, which makes it difficult for them to follow up the day-to-day operation of the company at all times and exacerbates the difficulty for minority shareholders to participate in the affairs of the company. Particularly in Chinese companies, the controlling shareholders, as the de facto main deciding body of corporate governance, are seen as the ultimate controllers of the company and inevitably choose to protect their own interests at the expense of minority shareholders when conflicts arise.[339] There are several ways in which controlling shareholders can infringe on the interests of minority shareholders in Chinese companies.

First, connected transactions. Connected transactions are not necessarily detrimental to the company and they can improve the efficiency of the company by reducing the companies' transaction costs. However, it is also easy for controlling shareholders to use connected transactions with improper purposes to engage in a transfer of benefits to violate the rights of minority shareholders.[340]

Second, insider trading. Controlling shareholders take advantage of the information asymmetry between themselves and minority shareholders to benefit themselves at the expense of minority shareholders by means of corporate transactions.[341]

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339 Zhao (n 277).

340 JinQian Qiu, 'Corporate Governance in China: From the Protection of Minority Shareholders Perspective' (2006) 2 The Corporate Governance Law Review 311; Jun Zhao and Chenglong Lv(赵骏, 吕成龙), (上市公司控股股东自利性并购的隧道阻遏研究)'Prevention of Self-interest Acquisition of Holding Shareholder of Listed Companies' (2012) 34 Modern Law Review 83.

341 Ruikun Zheng and Chao Sun(郑瑞琨, 孙超), (上市公司中小股东权益保护现状分析与对策建议)'The Analysis of Current Situation of the Protection of Minority Stockholders' Rights and Interests in Public Companies and the Countermeasures' (2021) 37 Journal of University of Science and Technology Beijing (Social Science Edition) 553 and Zhu (n 326).

Third, abuse of controlling position to reduce or cut off the access for minority shareholders to participate in the affairs of the company.[342] Controlling shareholders can use the majority rule to elect directors and supervisors to the company to represent their own interests, ultimately mixing their own interests with those of the company, making it extremely difficult for minority shareholders to participate in the affairs of the company and express their views.

In addition, by virtue of their control over the board of shareholders, controlling shareholders can exclude the minorities from participating in corporate governance. As minority shareholders have a relatively low shareholding, it is difficult for them to play an influential role in major decisions on their own, while controlling shareholders can achieve complete exclusion of minority shareholders from resolutions on major corporate matters by using the majority rule. The controlling shareholders have the ability to use their voting power to substantially control and exercise the powers and functions of the company's board of shareholders. In turn, the controlling shareholder can control the selection of the company's directors and supervisors and thus fully implement their own will on major matters closely related to the development of the company, without taking into account the views of minority shareholders.

The controlling shareholders can restrict the interest of minority shareholders in exercising their voting rights by establishing procedures and conditions that increase the cost of minority shareholders' participation in the meetings of the board of shareholders.[343] In most cases, the minorities' interests cannot be protected by exercising their voting rights and opposing rights, because the meeting of the board of the shareholders is actually a meeting of controlling shareholders. Even in the event of explicit opposition from minority shareholders, the controlling shareholders can still pass the company's resolutions by virtue of their majority shareholding ratios and enjoy an absolute advantage in voting rights, thereby successfully elevating their personal will to the company's will, and also with a corresponding binding effect

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[342] Shuliang Wang, 'Issues in the Protection of Minority Shareholders' Rights and Interests under China's Company Law' in Masao Nakamura (ed), *Changing Corporate Governance Practices in China and Japan: Adaptations of Anglo-American Practices* (Palgrave Macmillan 2008).
[343] Zhu (n 326).

on minority shareholders. However, the ultimate negative consequences resulting from these decisions are shared by all shareholders, including minority shareholders, and the company.

Although China has attempted to curb the behaviour of controlling shareholders through strict regulations in legislation and regulatory rules, cases of infringement of minority shareholders' interests by controlling shareholders continue to emerge. Currently, infringement of the rights of minority shareholders is becoming more and more subtle, making legal regulations more difficult. If controlling shareholders of companies with concentrated ownership structure are not subject to laws and regulations, they can easily take advantage of their dominant position in the company to pursue their own personal interests at the expense of minority shareholders. Therefore, effective regulation of controlling shareholders is key to protecting the interests of minority shareholders in Chinese companies and is an important part of compliance governance in China.

4.5.2 Chinese legal protection on minority shareholders

The following are the basic rules of the Chinese corporate governance rules for minority shareholder protection and the effect of compliance in practice.

4.5.2.1 basic rules for the minority shareholder protection

The protection of minority shareholders is often linked to the regulation of controlling shareholders. A concentrated share ownership structure is the main reason why controlling shareholders in Chinese companies are highly vulnerable to infringement of the rights and interests of minority shareholders.[344] The ownership structure of Chinese companies is highly concentrated, with absolutely or relative control by the state or private individuals or institutions. The rights between shareholders and managers do not achieve the absolute separation like

[344] Zhao (n 277).

foreign companies. And the directors and supervisors elected by shareholders still reflect the interests of controlling shareholders and they can easily impose their will on others. This centralised share ownership structure in China concentrates the rights of control in the hands of controlling shareholders, giving them the opportunity to abuse their power against the interests of the minorities.

A negative correlation exists between the concentration of ownership and the quality of legal protection of investors in companies. La Porta et al. have found that companies with weak investor protection tend to have concentrated ownership structures.[345] With shares concentrated in the hands of a single or small number of controlling shareholders, the likelihood of minority shareholders being victimised in the event of inconsistent interests is greatly increased. Although concentration of ownership is not only a phenomenon unique to China, even in countries like the UK and the US, which are known for their highly decentralised ownership structures and strong protection for minority shareholders, companies with concentrated ownership make up a large proportion of listed companies,[346] the Chinese legal system does not protect the rights of minority shareholders in companies as strongly as the UK and the US.

The legal protection afforded to minority shareholders in China takes two main forms. One is to give minority shareholders the right to prevent infringements from occurring, and the other is to ensure that minority shareholders can seek redress if their rights are infringed. The main measures include minority shareholders' right to information, cumulative voting rights, exclusion of voting rights and the right to bring direct or derivative actions against corporate wrongdoings.

First, shareholders' right to information. The shareholders' right to information refers to the right of shareholders to know and be informed about the management of the company and is an

[345] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Law and Finance' (1998) Journal of Political Economy 1113.
[346] Goshen and Hamdani (n 338).

effective tool for shareholders to participate in corporate governance. The shareholders' right to information about the company is a prerequisite and basis for shareholders to exercise their other rights, which is particularly important for minority shareholders who are in a disadvantaged position in terms of information. Firstly, Chinese Company Law gives shareholders the right to review and duplicate the company's articles of association, resolutions of board of shareholders' meetings, board of directors' meetings and supervisory board' meetings, as well as financial reports. And, it also provides a remedy for shareholders to plead the people's court to demand the company to offer if the company refuses the request of shareholders.[347] Secondly, the Companies Law compels companies to disclose to shareholders on a regular basis the remuneration received by directors, supervisors and senior managers from the company,[348] and this provision naturally applies to minority shareholders as well.

Second, cumulative voting rights. The cumulative voting system means that in the election of directors or supervisors at a general meeting of the board of shareholders, each share has the same number of votes as the number of directors or supervisors already preferred, and the voting rights owned by shareholders can be used centrally.[349] The Company Law in China allows for the implementation of the cumulative voting system for the election of directors and supervisors at general meeting of the board of shareholders.[350] In practice, minority shareholders rarely have the opportunity to participate directly in the day-to-day management of the company's affairs because of their small shareholding, but the cumulative voting rights help minority shareholders to avoid the monopoly of controlling shareholders by pooling their voting rights and thus having the opportunity to elect representatives to protect their interests,[351] such as independent directors and to a certain extent mitigating the conflicts of interest between controlling shareholders and minority shareholders.

Third, exclusion of voting rights. This means that when a shareholder or director has an interest

[347] Company Law 2018, article 33.
[348] Ibid, article 116.
[349] Ibid, article 105(2).
[350] Ibid, article 105(1).
[351] Wang (n 342).

in a matter or resolution to be discussed at the meeting of the board of shareholders or the board of directors, the shareholder or the director may not vote on that matter or resolution.[352] According to the article 16 of the Chinese Company Law, if a company intends to provide guaranty to a shareholder or actual controller[353]of the company, a resolution must be passed through the board of shareholders. The shareholders or the shareholder dominated by the actual controller as mentioned in the preceding paragraph cannot participate in voting on the preceding matters. Article 124 also provides that directors of a listed company who have a relationship with the companies involved in the matter to be decided at the meeting of the board of directors shall not exercise the right to vote on that resolution nor vote on behalf of any other person. The system of exclusion of shareholders' voting rights aims to dispatch shareholders who have an interest in the resolution of the board of shareholders to abuse their voting rights and infringe upon the interests of minority shareholders. However, it is also clear from the above provisions that the Chinese Company Law currently only excludes shareholders' voting rights on corporate guarantees and connected transactions.

In addition, shareholders are also required to separately count and disclose the votes of minority shareholders when deliberating on major matters affecting the minorities.[354] Further, China has also broadened the ways in which minority shareholders can exercise their voting rights. Listed companies are required to use network technology to reduce the cost of minority shareholders to participate in the meeting of the board of directors by providing online voting methods when holding the meeting.[355]

Fourth, direct shareholder litigations. Under the Chinese Company Law, shareholders may bring a lawsuit in the People's Court if the directors and senior management violate any laws, administrative regulations or the articles of association to the detriment of shareholders' interests.[356] This provision naturally applies to the minority shareholders of company as well.

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352 Zhu (n 326).
353 According to the definition given by the article 216 (3) of the Company Law 2018, an "actual controller" refers to anyone who is not a shareholder but is able to hold actual control of the acts of the company by means of investment relations, agreements or any other arrangements.
354 Rules for the Shareholder's Meeting of Listed Companies (2016), article 31.
355 Stock Listing Rules of the Beijing Stock Exchange (2021), article 4.1.10.
356 Company Law 2018, article 152.

Fifth, derivative actions of shareholders. Article 151 of the Chinese Company Law provides for derivative actions for shareholders in Chinese companies. The derivative action is one of the most controversial measures among the legal efforts aimed at safeguarding the interests of minority shareholders in the company in China. Where any wrongdoers infringe on the interests of the company and cause any loss, the board of directors or supervisory board of the company refuses or delays to initiate a legal action or in any urgent situation, the law gives the shareholders, especially minority shareholders, a way to protect the interests of the company and themselves, and allows shareholders to initiate a derivative action in their names. As a powerful weapon to protect minority shareholders, derivative litigation directly gives the minorities the right to sue those who infringe on the interests of the company and can also play a certain deterrent effect on other directors and senior officers, which has a certain positive significance in reducing the company's agency costs and urging the management to operate in compliance.

4.5.2.2 compliance with the basic rules on minority shareholder protection

Firstly, it is clear from the previous discussion that the protection of minority shareholders in China is mainly reflected in the restrictions on the power of controlling shareholders. The use of legal rules to create checks and balances on the exercise of power by controlling shareholders can serve to effectively protect the interests of minority shareholders, and corporate compliance outcomes are thereby achieved and promoted to a certain extent. China's legal rules aimed at protecting the interests of minority shareholders can promote corporate compliance in the following ways.

The shareholders' right to information is a prerequisite for shareholders to exercise other rights and participate in corporate governance. The varying degrees of information disclosure requirements in China's corporate governance rules have, to a certain extent, ensured the right of minority shareholders to be informed of material corporate matters and increased the opportunities for minority shareholders to participate in corporate governance on an equal footing with major shareholders.

On the one hand, it ensures that minority shareholders have the opportunity and effective participation in company meetings. Both the cumulative voting rights and the shareholder exclusion of voting rights designed for this purpose effectively limit the opportunities for controlling shareholders to obstruct the exercise of minority shareholders' voting rights and for controlling shareholders or directors to use connected transactions to infringe on the interests of minority shareholders. On the other hand, minority shareholder's right to information is also enhanced through the shareholder's right to consult and copy the articles of association, records of company's meetings and financial and accounting reports granted by the Company Law.

Secondly, the direct litigation under article 151 and the derivative actions under article 152 by shareholders of the Chinese Company Law also together ensure that minority shareholders have access to the courts to seek remedies.

All of the above measures are conducive to protecting the rights of minority shareholders of the company. Complete protection mechanisms for minority shareholders' rights will create checks and balances with the exercise of controlling shareholders' power and, in the context of controlling shareholder-centric corporate governance practices in China, help controlling shareholders make corporate decisions in a compliant manner. At the same time, corporate compliance also means that the rights of minority shareholders will not be so easily infringed. However, in practice, these measures have had limited effect in protecting the rights of minority shareholders, many of which do not address the essential issues of corporate governance in China and have had limited effect in achieving corporate compliance.

First, although the current rules have created some checks on controlling shareholders, the issue of controlling shareholders' dominant position in the company has not been fundamentally addressed. The Chinese Company Law provides many opportunities to enhance minority shareholders' understanding of and participation in the affairs of the company, but controlling shareholders can still use the company's concentrated ownership structure and their own shareholding to manipulate the board of shareholders and management, while ignoring minority shareholders' requests. For example, a minority shareholder's request for access to the company's documents and information is effectively approved at the discretion of the controlling shareholder, while the decision on whether the company will adopt a cumulative voting system is left to the board of shareholders, and in fact the controlling shareholder is perfectly capable of removing cumulative voting rights by amending the articles of association.[357] This institutional arrangement effectively returns to the controlling shareholder the rights and interests that should have been granted to minority shareholders.

Second, article 20(2) of the Chinese Company Law and article 83(1) of the Civil Code both provide for liability in the event that a shareholder abuses his or her rights and causes damages to other shareholders. However, the problem of overly broad and vague provisions has resulted in the inability to directly invoke this provision to hold shareholders liable in practice.

Thirdly, there are still many problems with the institutional design of the regime of derivative actions in practice, leaving minority shareholders in a deadlock where they cannot effectively protect their rights. Some judges and scholars have started from the judicial cases of shareholder's derivative actions in recent years and found that many lawsuits filed by the minority shareholders have been concluded by rejecting their litigation claims.[358] The following reasons are briefly explained here, and the Chinese derivative actions will be discussed in more detail in chapter 6.

In the first place, Chinese Company Law is too restrictive on the standing of plaintiffs to bring derivative actions. According to the Company Law, only shareholders of a limited liability company or joint stock limited company separately or aggregately holding 1% or more of the

[357] See Company Law 2018, article 105.
[358] Hong Chen and Jiaodong Zhang(陈洪, 张娇东), (股东代表诉讼制度可诉性补强研究)'Research on the Enhancement of the Enforceability of the Shareholder Representative Litigation System' (2016) 6 Journal of Law Application 62.

total shares of the company for 180 consecutive days or more may request to initiate a lawsuit in the people's court.[359] Shareholders need to satisfy both the percentage of shareholding and time requirement in order to have the opportunity to voice their interests, which brings great difficulties for minority shareholders to initiate a lawsuit individually. Clearly, this prerequisite prevents minority shareholders who individually hold a small number of shares and who cannot easily consolidate to meet the percentage shareholding requirement from filing a lawsuit to protect their rights and interests under this article. The original intent of this provision was to prevent shareholders from abusing their right to sue and affecting the normal operation of the company. However, if a situation arises where a company's minority shareholders cannot effectively join together to reach the requirement, it will result in the minority shareholders being unable to seek legal remedies in a timely manner.

Moreover, the aforementioned problem of minority shareholders being at a disadvantage in obtaining information about the company due to the controlling shareholders' control of the company's management also affects the filing of derivative actions. As minority shareholders are not involved in the business operations and management of the company, their access to and collection of information about the company is inherently limited. At the same time, there is no guarantee of the truthfulness and accuracy of information and evidence provided by shareholders and management with whom minority shareholders have a conflict of interest.[360]

Further, the design of preliminary procedure poses difficulties for minority shareholders to provide evidence. In order to prevent minority shareholders from abusing the right to interfere with the company's autonomy and daily operation and management, the Company Law has set up a preliminary procedure for shareholder derivative litigation, that is, minority shareholders need to exhaust all internal remedies before they can bring a derivative action to the court, which is of great significance in preventing minority shareholders from abusing their litigation rights. However, due to the shortcomings in the application of this provision, it poses an obstacle to the protection of the rights of minority shareholders. Under this provision, a

[359] Company Law 2018, article 151(1).
[360] Wang (n 284).

shareholder may initiate a legal action in the court as long as the board of directors or the supervisory board turn down the shareholders' requests or fail to initiate a legal action within 30 days or in any urgent situation that may cause irreparable damage to the company. In practice, however, the board of directors and the supervisory board may not reject a shareholder's request outright but by way of deliberately delay. How should minority shareholders prove that the board of directors or the supervisory board has rejected their requests in such case? In addition, the Company Law in China does not further define "urgent situation", which prevents minority shareholders from successfully bringing a derivative action.

4.5.3 independent director system in China

The independent director system is an important measure of legal transplantation to protect the interest of minority shareholder in Chinese companies. Curbing the abuse of power by controlling shareholders and protecting the interests of minority shareholders are the main reason for the introduction of the independent director system in Chinese corporate governance.[361] However, it has been widely criticised since its introduction into the Chinese corporate governance system.[362] This section argues that China's independent director system has not had the effect of effectively protecting the legitimate interests of minority shareholders that policy makers intended to achieve in the practice of Chinese corporate governance, and has played an extremely limited role in driving companies towards compliance.

The independent director system itself is a monitoring mechanism, with independent directors acting as external monitors to establish checks and balances of power with internal members of

[361] See Junhai Liu(刘俊海), (我国《公司法》移植独立董事制度的思考)'Thoughts about Chinese Company Law's Transplanting the System of Independent Directors'(2003) 21 Tribune of Political Science and Law 41and Qing Han(韩晴), (独立董事治理与声誉回报-基于累计投票选举的分析)'Independent Directors Corporate Governance and Reputation Reward- Evidence from Cumulative Voting of Independent Directors' (2016) 38 Jinan Journal (Philosophy and Social Sciences) 95.

[362] See Liufang Fang (方流芳), (独立董事在中国:假设和现实) 'Independent Directors in China: Hypothesis and Reality' (2008) 26 Tribune of Political Science and Law 110; Donald C. Clarke, 'The Independent Director in Chinese Corporate Governance' (2006) 31 Delaware Journal of Corporate Law 125; Guo Feng (冯果), (整体主义视角下公司法的理念调适与体系重塑)'Conceptual Adaptation and Systemic Remodeling of Corporate Law from a Holistic Perspective' (2021) China Legal Science 61.

the company. It can also be argued that the independent directorship can be seen as an external monitoring tool introduced in China to alleviate the internal agency problems of Chinese companies.

The independent director system in China was piloted in listed companies. In 1997, the establishment of an independent director system within listed companies was not mandatory, but rather recommended in nature, allowing listed companies to set up independent directors within the company according to their actual needs.[363] In 1997, the CSRC issued the *Guidelines on the Articles of Association of Listed Companie*s to encourage listed companies to establish independent directors in accordance with their actual needs.[364] And in 1999, the CSRC and the State Economic and Trade Commission jointly issued the *Opinions on Further Promoting the Standardisation and Deepening the Reform of Overseas Listed Companies*, which clearly required that external directors make up more than half of the board of directors in overseas listed companies.[365] It was not until 2001 that China fully implemented the independent director system in listed companies, requiring listed companies to have independent directors.[366]

The role of independent directors in China is mainly to speak out on behalf of minority interests.[367] In order to achieve the institutional objective of protecting the interests of minority shareholders, the legislator's institutional design for independent directors focused on two aspects.

Firstly, the independence of independent directors is maintained. The term "independent director" is focused on "independence". Simply put, independent directors must be independent to ensure that they remain impartial and objective in the matters and resolutions of the

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[363] Guidelines on the Articles of Association of Listed Companies (1997).
[364] Ibid, article 112.
[365] Opinions on Further Promoting the Standardisation and Deepening the Reform of Overseas Listed Companies 1999, article 6.
[366] Guidance on the Establishment of Independent Director System in Listed Companies 2001 ("Guidance"), and in order to give full play to the role of independent directors in corporate governance, the CSRC promulgated the Rules for Independent Directors of Listed Companies in 2022, replacing the 2001 Guidance.
[367] See Rules for the Independent Directors of Listed Companies 2022, article 5.

companies they oversee. Under the Chinese Company Law, an independent director cannot hold a position in a listed company other than that of a director and does not have any relationship with the listed company and its majority shareholders with which he or she is employed that might prevent him or her from exercising independent and objective judgment.[368] In addition, an independent director may, in principle, serve as an independent director of up to five listed companies at the same time, while also ensuring that he or she has sufficient time and energy to perform his or her duties.[369]

Secondly, independent directors are required to have a duty of good faith and diligence to listed companies and all shareholders, including minority shareholders.[370] Companies are required to obtain pre-approval from independent directors for material connected transactions[371] in order to curb the misappropriation of funds from controlling shareholders to the company.[372]

The introduction of independent directors to monitor the company's resolutions on behalf of minority shareholders' interests has had the effect of promoting corporate compliance through external regulation to a certain extent. However, whether independent directors can truly play a role in protecting the interests of minority shareholders and promoting corporate governance compliance in China has been a controversial topic.[373] A number of empirical studies suggest that independent directorships are not very effective in controlling agency costs in Chinese companies.[374]

First, there is the question of the "independence" of "independent director". Although the CSRC requires that independent directors should not hold any positions in a company other than that

368 Rules for the Independent Directors of Listed Companies (2022), article 2.
369 Ibid, article 6(3).
370 Ibid, article 5.
371 According to the article 22(1) of the Rules for the Independent Directors of Listed Companies (2022), "major connected transactions" refer to related-party transactions to be made between the listed company an affiliated involving a total amount of more than three million yuan or more than 5% of the value of the latest audited net assets of the listed company.
372 Ibid.
373 Clarke (n 362).
374 Zuoping Xiao and Desheng Chen(肖作平,陈德胜), (公司治理结构对代理成本的影响-来自中国上市公司的经验证据)'The Impact of Corporate Governance Structure on Agency Costs - Empirical Evidence from Chinese Listed Companies' (2006) 12 Finance & Trade Economic 29.

of directors or have an affiliation with the company that employs them or its major shareholders, and that independent directors are entitled to express independent views on important corporate matters,[375] the fact that controlling shareholders have a controlling position in the company makes it difficult for independent directors to maintain their independence.

In China, independent directors are nominated by the board of directors or the supervisory board or shareholders that individually or jointly holds 1% or more of the issued shares of the company, and then elected by the board of shareholders.[376] Ultimately, however, the controlling shareholders effectively control the nomination and election of independent directors.[377] The lower proportion of independent directors in companies with a more concentrated shareholding structure reflects the potential tendency for shareholders with a controlling position to indeed have significant influence in the nomination and election of independent directors.[378] It is entirely possible that controlling shareholders may even employ independent directors who are not independent and have weaker supervisory powers, only to superficially meet the CSRC's compliance requirements, which in practice cannot be achieved.

Second, although independent directors are given the right by the CSRC to express independent views on matters in listed companies that may prejudice the rights and interests of minority shareholders, the original intention of the Chinese rule makers was to use the participation of independent directors in the affairs of the company as a form of external oversight to monitor the board of shareholders of the company to form resolutions in a compliant manner and to speak up for the interests of minority shareholders. However, China's corporate governance rules ignore the issue of the pathway of information for independent directors. Independent directors' monitoring of corporate compliance relies on the information obtained about the

375 Guidance on the Establishment of an Independent Director System in Listed Companies 2001, article 6(1)(5).
376 Rules for the Independent Directors of Listed Companies 2022, article 12.
377 Wei Cai, 'The Dilemmas of Independent Directors in China: An Empirical and Comparative Study' (2017) 18 European Business Organization Law Review 123 and Peng Jiang(姜朋), (独立董事相对论) 'Independent Director Relativity' (2015) 27 Peking University Law Journal 1529.
378 See Michael Bradley and Dong Chen, 'Does Board Independence Reduce the Cost of Debt?' (2015) 44 Financial Management 15 and Ling Lei Lisic, Terry L. Neal, Ivy Xiying Zhang and Yan Zhang, 'CEO Power, Internal Control Quality, and Audit Committee Effectiveness in Substance Versus in Form' (2016) 33 Contemporary Accounting Research 1199.

company, which is usually provided by the company's management.[379] However, due to the controlling shareholders' control over the company's management, it is highly likely that the company information provided by management also serves the interests of the controlling shareholder rather than the interests of the company as a whole. How can independent directors achieve protection of minority shareholders' rights and interests when they are unable to judge the actual situation of the company?

Finally, most of the independent directors in China are from the elites who are already employed in various industries.[380] Although they have professional knowledge and skills, their unfamiliarity with the internal situations of the company and their limited time and energy to participate in the affairs of the company allow them to make a very limited contribution to the interests of minority shareholders.

Great expectations are placed on the independent director system by Chinese policymakers in terms of regulating the infringement of controlling shareholders on the interests of minority shareholders, but there are still many problems in terms of its effectiveness in practice, and it is even more difficult to achieve its role in monitoring corporate compliance. The failure of the introduction of independent director system has also been seen as a result of China transplanting foreign models without considering its own adaptability.[381] This, in turn, may serve as a warning that China's corporate governance compliance rules need to be localised when drawing on foreign experience. The question of how to improve the current legal system so that independent directors have sufficient capacity and incentives to discipline controlling shareholders and protect the rights of the minorities to pursue corporate compliance governance will be further discussed in Chapter 6.

To summarise, a more serious problem than the abuse of management discretion in Chinese

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379 Fang (n 362).
380 Xiaofeng Guan, 'On Legal Issues of Independent Directors' (2007) 2 Frontiers of Law in China 616,620.
381 Lay-Hong Tan and Jiangyu Wang, 'Modelling an Effective Corporate Governance System for China's Listed State-owned Enterprises: Issues and Challenges in a Transitional Economy' (2007) 7 Journal of Corporate Law Studies 143.

companies is the conflict between shareholders, particularly between controlling and minority shareholders. The ownership structure of Chinese companies gives the majority shareholders the opportunity to manipulate the company and infringe on the rights of minority shareholders. In many cases, the rights of minority shareholders to participate in corporate governance and to follow the business operations of the company are not protected. Although Chinese legal provisions attempt to provide shareholder derivative actions and other protections for the legal rights of minority shareholders, the protection of minority shareholders is relatively weak throughout China's corporate governance rules, which do not serve as an effective check on controlling shareholders and play a very limited role in achieving and promoting corporate compliance.

There is room for improvement in the legal protection provided by China's corporate governance rules for minority shareholders' rights and interests. However, in reconstructing the system of protection of minority shareholders' interests in Chinese companies, what is important is not how to introduce new systems such as independent directors to solve the problem, but rather that more attention should be paid to a more fundamental solution to the corporate governance problem, namely the regulation of controlling shareholders. It is the imbalance in China's corporate governance structure that has led to a lack of effective restraint on controlling shareholders that has made it easy to infringe on the interests of minority shareholders. The fact that a company's controlling shareholders are constantly given the opportunity to abuse their rights to the detriment of the interests of other entities in the company is itself a symptom of the imbalance in China's corporate governance structure.

Only by improving corporate governance arrangements can a controlling shareholder be restrained to a certain extent, while reducing the obstacles for minority shareholders to seek legal remedies and thus achieve corporate compliance. In other words, a well-designed and implemented mechanism is needed in China to limit the self-interested behaviour of controlling shareholders and protect minority shareholders. A mechanism that facilitates minority shareholder participation in corporate governance is essential and will also be of great benefit to companies in attracting foreign investment.

4.6 Protection of foreign investors in Chinese companies

The rapid growth of the global economy has made it inevitable for investors to start investing overseas and operating across borders. Yet recurring corporate scandals in recent years have not only caused company bankruptcies and stock market instability, but have also undermined investor confidence. Foreign investors need to assess the situation of Chinese companies before making an investment. Not only is the political, economic and cultural environment in China critical for foreign investors, but the ability of Chinese legislation and regulations to provide adequate protection and support their long-term investment and development is a key factor influencing their investment.

Following China's accession to the WTO, an increasing number of foreign investors are showing interest in investing in China. The willingness of foreign investors to invest is most likely based on a positive outcome after assessing the overall investment environment and the level of corporate governance in the country. Therefore, corporate compliance is particularly important for attracting foreign investors. The degree to which corporate compliance is achieved influences the level of corporate governance, and the internal aspects of corporate governance have a direct impact on the protection of foreign investors. Corporate compliance means that companies are more protective of foreign investors and, in turn, more attractive to foreign investment. In order to attract foreign investment, China must establish a legal framework that effectively protects foreign investors and gives them sufficient confidence and security to invest in China.

Not only that, China has also committed to continuously expanding the areas and channels for foreign investment since its accession to the WTO. Moreover, China adheres to its fundamental national policy of opening up and encourages foreign investors to invest within China in accordance with the law. The legal framework consisting of the Company Law, Foreign

Investment Law of the People's Republic of China ("FIL") which were promulgated in 2019 and came into force in 2020 and the *Regulation for Implementing the Foreign Investment Law of the People's Republic of China* ("FIL Regulation") issued by the State Council in the same year and the *Interpretation of the Supreme People's Court on Several Issues concerning the Application of the Foreign Investment Law of the People's Republic of China* is a complete set of legal rules consisting of basic laws, administrative regulations and judicial interpretations enacted by China to actively attract foreign investment and protect the legitimate rights and interests of foreign investors. Their successive enactments put an end to the confusing situation where foreign investment was regulated by the outdated "Chinese three laws on foreign investment"[382]and the overlapping and conflicting rules of the Company Law, the Labour Law and the Contract Law.

Since the Company Law clearly states that "the LLCs and joint stock limited companies invested by foreign investors shall be governed by this Law. Where there are otherwise different provisions in any law regarding foreign investment, such provisions shall apply",[383] the FIL and other relevant rules and regulations and the Chinese Company Law have a relationship between special law and general law. This means that in matters concerning foreign investment and foreign investors, the foreign investment legal regulations should be applied as a matter of priority, with the Company Law playing a complementary role.[384]

First, to reflect China's sincerity in attracting foreign investment, the FIL grants foreign investors and their investment preferential treatment no less favourable than that of domestic investors and their investments during the investment entry stage,[385] changing the previous situation where foreign investors could only enjoy national treatment after entry.

Second, another highlight of the FIL's protection of foreign investors is the policy commitment

[382] Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures 1979, Law of the People's Republic of China on Foreign-Capital Enterprises 1986 and Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures 1988.
[383] Company Law 2018, article 217.
[384] Wang (n 203) 9.
[385] Foreign Investment Law 2019, article 4.

aimed at limiting the government' abuse of its administrative power. Article 25 stipulates that local Chinese people's governments at all levels and their relevant departments shall honor the policy commitments made to foreign investors and foreign-invested enterprises as well as the various contracts entered into in accordance with the law. Article 27 of the FIL Regulation further explains that the written policy commitments provided by the government specifically include complementary policies, preferential treatment and facilitation conditions applicable to investment in the respective regions.

However, in practice, foreign investors are more concerned about the protection and development of their investment once it enters than the threshold policy preferences granted from the national level. In more detail, the attraction of foreign investment depends on the stability of a country's legal environment, the protection of investors by its laws and regulations and the compliance of the internal governance of the investing company. On the one hand, the degree of protection afforded to foreign investors by Chinese laws and regulations has a direct impact on foreign investment. If the rights of a company's shareholders can be easily expropriated, foreign investors will be reluctant to invest. On the other hand, the extent to which Chinese laws and regulations provide adequate legal protection to the various subjects of the company will also have an impact on the willingness of foreign investors to invest in China. The degree of protection for the internal subjects of a company determines the degree of compliance, and a sound corporate governance structure is necessary to achieve a thorough protection of the internal subjects of a company, and corporate compliance cannot be achieved without a sound internal governance structure.

Therefore, from a micro perspective, another important way to protect foreign investors in Chinese companies is to improve the corporate governance compliance system. The key measures described earlier in this chapter to improve corporate governance by reducing corporate agency costs and achieving corporate compliance, including a company's ability to manage its internal affairs in a balanced manner, the extent to which it pays attention to and protects the claims of its stakeholders, and whether it provides effective protection for minority shareholders, are among the most critical factors affecting foreign investment and the protection of foreign investors. The extent to which these factors are realised depends in turn on the framework of the Chinese legal system and the compliance level of the company. Furthermore, compliance has a direct impact on the reputation of the company in a competitive market, and companies need a good reputation to attract foreign investors. A good reputation needs to be backed up by a good corporate governance compliance system, and a company with a high level of compliance also helps to protect the legal rights of foreign investors in the company.

In short, the level of corporate governance compliance has become a key factor for foreign investors in determining whether a company is suitable for investment. Although China's corporate governance rules are constantly working to improve corporate governance compliance, there is still room for improvement. In order to attract more foreign investment to China and help Chinese companies achieve international growth, the corporate governance compliance system needs to be restructured to provide foreign investors with more comprehensive legal protection and a compliant investment environment.

4.7 Conclusion

Compliance can reduce agency costs and solve agency problems of the company, and this chapter then focuses on corporate governance compliance in China, particularly in light of the unique characteristics of China.

It is found that corporate governance compliance in China is mainly achieved through the following focused paths.

Firstly, the board of directors is not only required to serve the interests of the company's shareholders, but also to focus on the various interests of stakeholders in the decision-making process. Secondly, the company's management is given discretionary powers to be allowed to manage the company within the limits of compliance in order to maximise the company's interests. Furthermore, in order to solve the agency problems between controlling shareholders and minority shareholders in the company, the Chinese corporate governance system is also concerned with the protection of minority shareholders' interests, while at the same time focusing on restricting and regulating the abuse of power by controlling shareholders, and only by striking a balance between the two can corporate governance compliance be better promoted.

However, China's current corporate governance compliance system, although all of the above measures are included, does not effectively address these issues and compliance in practice is ineffective.

Firstly, China's corporate governance system has drawn on overseas corporate governance experience, but corporate governance mechanisms in some jurisdictions are designed based on the separation of ownership and control of a company and are primarily designed to address agency problems between shareholders and company management, which is not the case for China. The highly concentrated share ownership structure of Chinese companies has led to the fact that the main agency problem of Chinese companies is the agency conflict between controlling shareholders and minority shareholders, rather than between shareholders and management. Chinese corporate governance rules should therefore focus on the regulation and restriction of controlling shareholders and the protection of minority shareholders' interests. However, China's current legal system plays a limited role in these two areas. And the situation becomes even worse in Chinese SOEs.

Secondly, the absolute dominance of controlling shareholders in Chinese companies, in addition to tending to infringe on the rights of minority shareholders, also undermines management's incentive to run the company freely, negatively affects the protection of the rights of various stakeholders in the company, including minority shareholders, employees, creditors and other stakeholders, leading to poor corporate governance compliance and discouraging the attraction of foreign investment.

Both the restrictions on the powers of shareholders, directors and senior management and the protection of various corporate stakeholders, including minority shareholders, reflect the legislative significance of the Chinese corporate governance rules regarding the separation of powers, balance and mutual checks between different corporate organs. However, the high concentration of ownership makes it difficult for the separation of powers and checks and balances between the internal organs of the company to work, for example, the board of directors and the supervisory board have difficulty in escaping the constraints and control of the controlling shareholders in Chinese companies. As can be seen from the discussion in this chapter, under China's current corporate governance rules, both the board of directors, the supervisory board and company managers are highly susceptible to being used by controlling shareholders as a tool to control the company, resulting in less discretionary freedom and independence for management, reflecting the deficiencies in China's corporate governance structure and hindering the achievement of corporate compliance.

Achieving corporate governance compliance in Chinese companies aims to reduce agency costs and address agency problems. Therefore, given that the main conflict in Chinese corporate governance is the conflict of interest between controlling and minority shareholders, it is important to first curb the abuse of dominance by controlling shareholders and to establish other corresponding mechanisms on this basis. However, China's legal provisions are not sufficient to regulate controlling shareholders.

Thirdly, China's corporate governance compliance rules is largely scattered across the Chinese Company Law, high-level policies, government regulations and the CSRC's rules, and has yet to form a complete compliance system. Many of the provisions were well-intentioned legislatively, but have led to many ambiguous applications in judicial practice. Overly broad legal provisions are difficult to achieve in practice for the purpose of achieving corporate governance compliance. China's corporate governance system should move from abstract to concrete provisions.

Nevertheless, China has largely constructed its own corporate governance compliance framework and the focus has now shifted from establishing a corporate governance compliance system to improving the corporate governance compliance system. However, the effectiveness of any set of systems and mechanisms depends on the effectiveness of implementation in practice. For China's corporate governance legal rules, it is important to explicitly incorporate corporate compliance obligations into the existing legal framework, so that abstract legal rules are translated into concrete practical guidelines. The significance of emphasising corporate governance compliance is to ensure that the relevant mechanisms of corporate governance can be implemented to the greatest extent possible, thereby achieving improved corporate compliance and enhanced corporate governance. On the one hand, it can help legislators and academics to solve problems arising in the practical application of companies as soon as possible and promote the localisation of corporate governance in China. On the other hand, good compliance can help companies to attract foreign investment and promote the internationalisation of Chinese companies.

The effectiveness of the design of a corporate governance system depends on the unique characteristics of each jurisdiction and how these characteristics influence the development of legal rules to achieve the goal of corporate governance compliance. In the next chapter, therefore, the study turns its attention to the UK's corporate governance compliance rules to explore whether they can provide insights to help China improve its corporate governance compliance system.

Chapter 5 Lessons from the UK on Compliance with and through Corporate Governance Rules

5.1 Introduction

The common law system, represented by the UK, provides strong and complete protection for investors, which has to be attributed to a well-developed system of corporate governance system. In China, on the other hand, the protection of investors in companies, especially minority shareholders, is relatively weak, and the study of the UK corporate governance compliance regime is therefore of great importance to China.

The high standard of the UK corporate governance compliance rules has been admired around the world and it deserves to be a model for other jurisdictions. After the discussion and analysis in the previous chapters of this study, it is found that the Chinese corporate governance compliance system still has a number of deficiencies that need further reform. It should be necessary to discuss the UK model before jumping to any suggestions on reforming the current corporate governance structure in China. The purpose of this chapter is, after summarising the features and progress of the UK corporate governance compliance system, to compare the current situation in China and to examine what lessons can be learned from the UK experience or what aspects can be transferred to China.

The UK's corporate governance system contains not only corporate governance rules, but also a large number of non-governance rules. This chapter focuses on these two issues by selecting the four most representative regimes of the UK corporate governance system, and argues that achieving a truly effective compliance regime requires strengthening corporate governance autonomy and weakening government regulation.

Specifically, the UK corporate governance rules involve a framework of statutes, codes and practices, aiming to achieve the long-term success of the company by motivating businesses to self-compliance under the changing situations. First, the UK Corporate Governance Code allows companies to fail to comply with its provisions through a "comply or explain" regime as long as they can provide an explanation for the non-compliance. Second, the derivative claims regime under the CA 2006 is also part of the corporate governance rules and aims to protect the interests of shareholders by restraining director misconduct, in essence it is more concerned with protecting the managerial freedom than the interests of minority shareholders.

This is mainly reflected in the respect given by the legislation and the courts to the autonomy of companies to conduct their internal affairs. In addition, while the director disqualification regime under the Company Director Disqualification Act 1986 further extends the scope of corporate regulation, it belongs to non-governance rules, given that it is designed to disqualify directors who engage in misconduct from holding office in other companies, cut off the opportunity to violate the rights of other potential corporate stakeholders and the public interest, and to promote future compliance by directors, rather than to guide companies on how to manage their internal affairs. Finally, the rules of corporate liability regime under Bribery Act 2010 are non-governance rules as well. By creating a new form of offence, it has helped UK companies to shift the focus of their fight against bribery offences from ex post punishment to a proactive corporate compliance culture, mobilising the incentive for corporate compliance. The purpose of complying with these non-governance rules can be better achieved with the help of compliance with other corporate governance rules.

The reminders of this chapter are structured as follows. Sections 2 to 5 discuss the four main regimes of corporate governance compliance rules in the UK. Section 2 begins by describing the "comply or explain" regime in the UK Corporate Governance Code, which illustrates how self-regulation of a voluntary nature can incentivise companies to consciously comply with the principles of good corporate governance. Section 3 then looks at the derivative claims regime under the CA 2006. The role played by the derivative claims in corporate governance in the UK is reviewed, first through analysing the deficiencies of the old rules in common law and then though the establishment of a statutory regime under the CA 2006. Following this, section 4 goes on to the Company Directors Disqualification Act 1986 which also put restrictions on directors by disqualifying them from participating into the management of future companies for a certain period of time, in contrast to the negative qualification of directors in China. And section 5 considers the new offence under the Bribery Act 2010 as an expansion of corporate liability so that companies have sufficient incentives to prevent bribery and comply internally, it also discusses the role of deferred prosecution agreements played in handling corporate bribery cases. After the overview of the four main regimes, section 6 summarises the main characteristics of the UK approach and make a comparison with the Chinese position. The implications of the UK corporate governance compliance regime for China and the feasibility of transplanting are discussed. Section 7 concludes the chapter.

5.2 The "comply or explain" regime under the UK Corporate Governance Code

The first edition of the UK Corporate Governance Code ("UK Code"), which has been published for over thirty years, devised a new "comply or explain" approach for governing companies. The main feature of this mechanism is that it is not legally enforceable. The first purpose of this section is therefore to answer the question of why companies in the UK would voluntarily comply with a code that is legally unenforceable.

Furthermore, by introducing and examining the spirit inherent in the "comply or explain" regime in the UK Code, this section finds that the explanations provided by the companies are the key to ensuring that the principle is effectively implemented. The section then further explores why corporate compliance with a "comply or explain" regime that is voluntary in nature would drive corporate governance forward in the UK.

5.2.1 three features of "comply or explain" regime

As early as 1992, the Cadbury Report, the first version of the UK Code, claimed that the essence of any system of good corporate governance should be allowing the boards of their companies to exercise their power freely within the framework of effective accountability.[386] The Cadbury Committee believed that "there would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements"[387].

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[386] (n 72).
[387] Ibid, para 1.10.

Achieving this objective depends on the application of the UK Code. To help UK companies achieve good corporate governance, starting with the Cadbury Report, the UK Code has innovatively chosen not to set out strict rules, instead, it provides an up-to-date set of principles and detailed provisions of a voluntary nature that provide companies with guidance on good corporate governance practice. At the heart of the Code is a new "comply or explain" regime which is considered as the "trademark of corporate governance in the UK"[388].

Under this regime, all listed companies registered in the UK should state whether they have complied with the provisions of the Code or give reasons and justify for any non-compliance in their annual reports or accounts. Compared to legislative measures, this "comply or explain" regime has three basic features and should not be overlooked.

First, its voluntary nature. Full and strict compliance with the Code is not mandatory and favoured, as this form of compliance is likely to be formalistic that companies do not apply the principle in practice at all. Therefore, under the UK Code's "comply or explain" regime, there is no regulatory body to monitor compliance by companies and the explanations in the statements issued by companies are addressed to the company's shareholders. It is important to clarify that while a company may voluntarily choose whether or not to comply with the Code, as non-compliance with the Code allows for an explanation to be provided accordingly. However, in the case of non-compliance with the Code, the requirement for the company to provide an explanation is mandatory.

Second, the flexibility. There are no mandatory requirements in the Code as to how companies should explain the deviations from the Code in their annual reports, in terms of both content and form, as long as they are clear enough for shareholders to evaluate them effectively. If shareholders are not convinced, they should be able to ask the board to explain their position.

Third, the board plays a major role in corporate governance. As can be seen from the statement

388 The UK Corporate Governance Code (2010) 4.

in the Cadbury Report, the rules of the UK Code consider that the board of directors in a company is appropriately tasked with achieving good corporate governance. Explanations for non-compliance are provided by the board of directors because the board of directors of a company is more aware of the company's operations and can be trusted to provide a reasonable and accurate explanation for the company's deviations from the Code. Also, the reason for leaving explanations to shareholders to assess is to enhance better communication between directors and shareholders.

5.2.2 key to "comply or explain" regime: explanation

The key to the "comply or explain" regime should be the explanations. The quality of principles and practices provided in the UK Code are quite important as there is a significant possibility that companies may choose not to provide any explanations and simply opt for full compliance, as well as paper compliance. The effectiveness of this regime in corporate governance is greatly reduced if the company does not provide an explanation or if the quality of the explanation is not sufficient to enable shareholders to understand and assess the company's situation. According to the UK Code, any explanations derived from the departure from the Code are not recommended to be treated as breaches.[389] A good quality explanation is in fact a way of complying with the spirit of the Code. However, according to the *Improving the quality of 'comply or explain' reporting* published by the FRC in 2021, companies in practice are more inclined to boilerplate explanations with poor quality.

Consistent with the voluntary and flexible nature of the "comply or explain" regime under the UK Code, the explanations provided by different companies should be diverse and individualised. The diversity and individuality of the explanations reflects the true value that the "comply or explain" approach can bring to corporate governance. Any explanation of the alternative arrangements that is in the spirit of the Code should provide sufficient clarity so that

[389] Combined Code 2003, preamble, para 7.

shareholders can evaluate to the fullest extent.

However, a quality explanation should include factors that are of genuine concerns to the companies' shareholders. Specifically, the explanation provided by the company should answer the following questions: (1) which provisions of the Code does the company choose to depart from? (2) why did the company choose this specific kind of arrangements rather than complying with the provisions of the Code? (3) what is the likely impact of this departure on the company's performance? (4) how does this approach fit the company's own needs and benefit corporate governance? (5) is the company's deviating practice phased or permanent? Besides, the explanations in the annual report are for shareholders to evaluate. In addition, if shareholders are not convinced by the explanations provided, the board can be called upon to explain their position. For improving the level of corporate governance, compliance may not be as strict as effective, but explanations should be as comprehensive as possible.

5.2.3 reasons for voluntary compliance for the UK companies

Since the Cadbury Report in 1992, the "comply or explain" approach has been believed to foster corporate compliance. The "comply or explain" regime now has a history with high reputation locally and globally for three decades. The UK believed that the regime would improve the long-term success of the companies. There are certain reasons that this voluntary approach is widely welcomed by the company boards. The "comply or explain" regime under the UK Code drives compliance for companies based on the flexibility of the regime and the government's trust in market forces.

5.2.3.1 flexibility

One of the main reasons why the UK companies comply with the UK Code is the flexibility provided by the "comply or explain" regime.

Firstly, the rules under the "comply or explain" regime leave the boards enough room to use their managerial freedom that offered by the Code to move the company forward and freely decide what can achieve good corporate governance. Companies are given the opportunity to explain and justify any deviations from the Code on their own merits, as long as any non-compliance is given the opportunity to be fully disclosed. As discussed in the previous sections, the dispersed ownership structure of the UK companies makes agency costs exist between the board of directors and shareholders. It is argued that the target of the Code is regarding how directors choose to exercise their agency.[390] Any decisions by the board may have an impact on shareholder's investment as a result. In this context, disclosure is particularly important. This regime is precisely designed to increase the opportunities for dialogue between shareholders and directors through the requirement of disclosure imposed on the board of directors, so that shareholders can understand the company's compliance and give feedback in a timely manner.

Secondly, the flexibility of the "comply or explain" regime is also reflected in the no-one-size-fits-all approach to corporate governance. This no-one-size-fits-all approach reflects the careful consideration given to smaller companies in the UK corporate governance rules. The environment in which companies operate is so varied that sometimes it may be more effective to do things out of order. Given by the different sizes, complexities and other reasons, smaller companies may face different risks and less need for regulation during their management than large corporations. Therefore, "comply or explain" regime is beneficial for small companies to consider what is the best for them according to their own circumstances. But in spite of this, the need for good governance should be the same as that of other large companies, both to achieve the successful development of the company. The UK Code therefore does not introduce a separate set of rules for small companies, but chooses the same standard, which is where the benefits of flexible regime come into play.

In contrast, the statutory approach is more inflexible and rigid. The "hard" requirements

[390] John Roberts, Paul Sanderson, David Seidl, and Antonije Krivokapic, 'The UK Corporate Governance Code Principle of 'Comply or Explain': Understanding Code Compliance as 'Subjection'' (2020) 56 Abacus 602.

imposed by the statutory measures are supposed to be the minimum threshold for the company. Companies often attempt to comply fully with the letter of the statutory provisions in order to avoid penalties, and rarely take the time to explore the original spirit of the legislation, which is more regarded as the task of academics and practitioners. The “hard” measures with statutory regulations can be useful in most circumstances, but there is still a need to make room for exceptions. The principles of the Code are deliberately descriptive so that to give companies enough discretion to adjust their strategies. A precise interpretation of deviations from the Code may be beneficial to good corporate governance practices, as it is also in line with the spirit of “comply or explain”. Moreover, it can help the authorities to identify additional examples of best practices based on the individual deviations from the company. Another advantage of the “comply or explain” nature is that when the principles and provisions provided by the UK Code do not actually improve corporate governance, the individualised mechanism under the flexibility can fill this gap.

Flexible and detailed practice guidelines are more helpful to companies in understanding the spirit behind the rules than statutory regulations. For instance, where the CA 2006 in the UK only provides for the number of non-executive directors on the board, flexible principles and provisions can help companies understand the rationale for placing non-executive directors on the board and how to make appropriate arrangements to achieve the best practice. The guidance provided in the Code is an ex ante regulation of potential problems in corporate governance or the behaviour of the company’s board of directors, so that the companies and their boards know from the outset what constitutes compliant behaviour.[391]

This flexible mechanism not only facilitates the board’s reference to compliance in practice, but also allows the board to more effectively internalise the rules of the Code into corporate governance, reducing the likelihood that companies will simply choose non-compliance and paper compliance because of completely rigid regulations.

[391] Iain MacNeil and Xiao Li, ‘ ‘Comply or Explain’: Market Discipline and Non-compliance with the Combined Code’ (2006) 14 Corporate Governance 486.

5.2.3.2 the role of market discipline

However, the concerns about the "comply or explain" regime are also obvious. It is worrying that, given the profit-seeking nature of companies, they may not follow the seemingly complex scheme provided by the Code, which requires a clear list of non-compliance before providing a quality explanation, but simply choose not to comply or ignore it. The major concern of this "soft" regime is the absence of enforcement.[392] How to ensure that the voluntary approach accompanied by disclosure requirements to be more effective than a statutory approach with severe sanctions? And how to ensure that the companies have enough motivation to urge themselves to comply? What if the companies refuse to offer any explanations for non-compliance? And why does the UK insist on this approach when it may have predicted that the negative outcomes would inevitably occur?

The answer is that the UK government believes in the power of the market. Another important reason why UK companies are compliant with the UK Code is that the "comply or explain" regime uses the power of the market, rather than the power of government intervention, to bring companies into voluntary compliance and to speed up the movement of companies in the market.

Firstly, there is little reason for governments or regulators to be fear that companies will choose not to comply with the provisions of the Code. This is because sooner or later the market will provide feedback to companies on their non-compliance. The committees of the UK Code have been all reluctant to impose statutory obligations and sanctions on non-compliant companies throughout. The essence of "comply or explain" is an evaluation of disclosure and communication between shareholders and directors. And the image and reputation of the companies would be affected by this regime with the help of the market. A qualified, shareholder-acceptable explanation towards the deviation from the Code is de facto beneficial to the company's development and can be justified. Conversely, the compliance situation within the company would be worrying if the company does not comply with the Code and gives no

[392] Ian and Braithwaite (n 176) 106.

or poor explanations of non-compliance. Then the stock price will fall and the eventually causing the company to be eliminated from the market. Potential investors can also assess the performance of the company based on the information and explanations disclosed and decide on the next course of action. The "comply or explain" regime therefore emphasises the self-regulatory power of the market, rather than the deterrent power of the regulator, and incentivises directors to comply from the inside out through the power of the market.

Secondly, with this mechanism in place, the government or regulators also do not have to worry about companies or companies' management not providing explanations for non-compliance. The reasons why companies do not provide explanations can be divided into two categories. First, because the breach is deliberate and therefore the company is unable to provide a reasonable explanation for it. Second, the company does not take the importance of the explanation seriously. The first situation may not only lead to negative results in the market, but may even result in penalties for breaking other laws. The second can be resolved by shareholders changing the management of the company.

Furthermore, as the changing market environment will continue to influence the corporate landscape, the implementation of the UK Code will continue to be reviewed and assessed by the selected successor body and the subsequent review demonstrates a strong confidence in market forces. And the reason for different selected body is based on the consideration that without the continuous supervision of the selected committees, the task of monitoring the application of the Code is likely to fall into the control of the government, which will lose the original intention and internal spirit of the regime set up by the Code.

In summary, the most important implication that the "comply or explain" regime under the UK Code for corporate governance in China is the UK's willingness to govern companies in an industry-autonomous manner, achieving a high level of corporate compliance in a cost-effective way without the need for significant government regulatory resources. However, achieving corporate governance compliance with the help of this one regime alone also has shortcomings and may not be sufficient to enforce compliance in corporate governance. The UK authorities have therefore proposed additional schemes, which will be discussed in later sections of this chapter.

5.3 The derivative claims regime under the Companies Act 2006

As mentioned in the previous section, it has long been recognised in the UK that directors of a company play an important role in achieving good corporate governance. If company directors fail to ensure compliance in the performance of their duties, they will be at risk of committing self-interested acts that are detrimental to the interests of the company and, in turn, to the interests of its shareholders. The performance by directors of their duties has a direct impact on the corporate governance of a company. After giving shareholders more access to understand the position of the board of directors, how could shareholders seek remedies against wrongdoings by directors?

Generally speaking, when the interests of a company are infringed by the misconduct of a member of the company, the appropriate plaintiff entitled to bring an action should be the company. However, if an internal member of the company, such as the controlling shareholder or the board of directors that controls the company, refuses to bring an action on behalf of the company, the interests of other stakeholders may be unfairly affected. Especially in Chinese companies with concentrated ownership structures, it is not uncommon for controlling shareholders to control the company, and if the company is unable to bring a lawsuit because of insider control, the interests of minority shareholders can be difficult to protect. Is it possible for shareholders, particularly minority shareholders, to seek redress when the wrongful acts of a company's directors infringe on the company's interests? The derivative claims regime is designed to address this issue, with its ability to defend the interests of the company by bringing an action against directors for misconduct and, on the other hand, serving as an incentive for directors to perform their duties in a compliant manner within the company.

The derivative claims regime is another major institutional tool driving corporate governance in the UK, reflecting the choice of legal rules between managerial freedom and investor protection. So which value is the derivative claim regime in the UK designed to protect? This section describes the development of the derivative claims regime through a comparison of the rules under common law and the CA 2006, and explores whether the UK approach has a preference between managerial freedom and the interests of minority shareholders.

5.3.1 the old rules under the common law

The introduction of the deficiencies of the common law in relation to derivative claims will enable us to better understand the implications of the new statutory rules. The old rules were severely limited in relation to the bringing of derivative claims by shareholders. Prior to the commencement of the reform of the derivative claims regime in the UK, the general rules on derivative claims could only be found in the case law.

The known *Foss v Harbottle* rules[393] ("*Foss* rules") have established the two basic principles for members to bring proceedings on behalf of their companies. The first is the "proper plaintiff" principle. The proper plaintiff for a derivative claim is the company. Only the company itself can bring an action against the directors for breach of their duties to the company under the doctrine of independent corporate personality. Second, the "majority rule". That is, the decisions of the company should reflect the will of the majority of the company. After all, it is unlikely that the directors would have acted against themselves.

It is not difficult to see how the two basic principles of the *Foss* rules would create a contradiction: given that the proper plaintiff in a derivative claim should be the company itself, it would be logical for the company to bring a derivative claim against the misconduct of directors based on the majority will. However, if the majority will of the company is already

[393] (1843) 2 Hare 461; 67 ER 189.

controlled by the misbehaving directors, a derivative claim cannot be brought.

The *Foss* rules thus identified two exceptional situations to the application of "proper plaintiff" principle and the "majority rule": (1) where the wrongs done by the directors constitute fraud on the minorities; and (2) where the wrongdoers are in control of the company.[394] As noted earlier, these two exceptions are permitted because in these circumstances the company may never have the opportunity to bring an action.

However, there were also some problems during the application of these exceptions, as the courts would require the shareholders to prove that the wrongdoers are in control of the company or that there has been fraud on a minority. This also raises a number of issues in practice. First, the rules of defining "fraud" and "control" were complex and depended on the court's explanations on individual cases, and many of them were old-fashioned. The courts needed to constantly review previous rules when applying them, which is time-consuming and costly. Second, it could be very difficult for individual shareholders who hold different amounts of shares of different sizes of companies to find out who was in actual control of the companies, especially in large companies. Further, it is sometimes difficult and imprecise to determine whether an individual actually controls a company based solely on the percentage of voting shares he or she owns in a large company.

To summarise, the old rules under the common law restricted the ability of shareholders to bring derivative claims against directors for misconduct. It was difficult for shareholders to initiate a derivative claim under the old rules, especially when the rules can only be found in case law which were hard to get access to for individuals. Moreover, the application of this rule and the exceptions could not keep up with the development of new situations.[395] On this basis, the Law Commission gave its recommendations that the *Foss* rules should be replaced by a new, more accessible and modern derivative claims regime.[396]

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394 See Law Commission, *Shareholder Remedies: A Consultation Paper* (Law Com No 142, 1996).
395 Arad Reisberg, 'Derivative Claims, the UK Companies Act 2—6 and Corporate Governance: A Roadmap to Nowhere?' (2008) 9 International Financial Review 337.
396 Law Commission (n 394), para 15.3.

5.3.2 the new statutory regime under the CA 2006

With the development of the global economy and increased investor demand for good corporate governance, compliance with the *Foss* rules under common law can no longer meet the need to protect shareholders' interests and improve corporate governance in the UK. The reform of derivative claims started with a review relating to the director's duties carried out by the Department of Trade and Industry in the UK in 1992. In 1995, the Law Commission continued a review and worked on projects about the rights and remedies of the shareholders. These rules were then incorporated into the CA 2006 and finally established in Part 11 of the Act as a statutory footing.

There are several improvements to the derivative claims regime under the CA 2006 as compared to the *Foss* rules.

Firstly, the scope of claims that can be brought by shareholders has been expanded. According to the section 260 of the Act, there are three elements to a derivative claim: (1) the proceeding is brought by a member of the company; (2) the cause of action is vested in the company; and (3) and relief is sought on the company's behalf. Section 260 (3) sets out the circumstances in which a director breaches his or her duties and causes the bringing of derivative claim, which is "only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company", and the cause of action can be brought against not only directors but also another person.

This suggests that a company shareholder may also have a derivative claim against a director for negligence. Moreover, in the event of negligence, a derivative claim can be brought even if the shareholder cannot prove that the director has benefited from the negligence. In addition, the shareholder does not need to prove that the director who committed the wrongful act had control over the company.[397] Thus, the new rules not only change the fact that under the *Foss* rule it was difficult for shareholders to prove that the wrongdoing director controlled the company, it also makes the career risks for directors much higher and effectively urges directors to perform their duties in a compliant manner.

Secondly, more modern procedural rules have been put in place. Under the new statutory regime, shareholders no longer need to prove the wrongs done constitute fraud on the minorities or the wrongdoers are in control of the company to bring a derivative claim, they only need to satisfy the procedural rules set out in the Act. Permissions to bring or continue a derivative claim must then be decided by the court.[398] The CA 2006 introduces a clear and strict set of rules for procedural requirements of derivative claims, namely a two-stage procedure. At the first stage, the court requires the member who bring a derivative claim must disclose a *prima facie* case for court's decision on whether to continue the claim without requiring evidence from the defendant. Otherwise, the court must dismiss the application and it may make any consequential order that it considers appropriate.[399] The company is not required to provide any evidence at this stage. If it successfully passes the first stage, the court may require the defendant to provide evidence, at the second stage.

The court's discretion is also limited to some extent by the Act. In deciding whether to grant a permission, the court must consider the following factors, including whether the member acted in good faith in seeking to pursue the claim; whether the member was acting in the performance of a duty to promote the success of the company; whether the act or omission was likely to have been authorised or ratified by the company and whether the company could or decide not to pursue an alternative claim.[400] For example, if the alleged wrongdoer was acting in accordance with the general duty under section 172 of the Act, or if the alleged act was authorised or approved by the company, permission must be refused. It is already clear that the legislation places great importance on respect for the company's autonomous decisions.

[397] Explanatory Notes to the Companies Act (2006), para 491.
[398] CA 2006, s 261(1).
[399] Ibid, s 261(2).
[400] Ibid, s 261(3).

The new derivative claims regime under the CA 2006 overcomes the difficulties of limiting the remedies sought by shareholders under the common law by expanding the range of derivative claims that can be brought, which has led to concerns that the number of shareholder actions in the UK will proliferate, but this is not a problem due to the strict judicial control procedures.

5.3.3 an assessment of the UK's position

Compliance with derivative claims regime is important for corporate governance because it not only disciplines the behaviour of directors, but also helps to reduce agency conflicts of the companies by protecting the rights of minority shareholders at the same time. However, if the rules for derivative claims are not well designed, they may also have a negative effect on corporate governance and development. In addition, if it is too easy for shareholders to bring derivative claims, it can make directors wary of making decisions on corporate matters. Directors may also tend to be conservative in their day-to-day operations in order to avoid exposing themselves into litigation. This is highly detrimental to the effectiveness and efficiency of corporate governance.

As mentioned earlier, the implementation of the UK Code is based on market forces. The involvement of derivative claims means that shareholders can intervene directly in the actions of directors under the provisions of the CA 2006 without having to wait for feedback from the market, changing the situation of passively waiting for company management to provide an explanation for non-compliance. While the new statutory regime under the CA 2006 does not completely overturn the *Foss* rules, it builds on them with procedural reforms to overcome the difficulties in bringing derivative claims under the old rules.[401] The statutory derivative claims regime has played an important role in promoting compliance by directors and others with their duties and protecting the interests of minority shareholders, but by comparing the old and new

[401] (n 397).

rules, this section argues that the UK derivative claims regime places more emphasis on corporate autonomy and focuses more on preserving the freedom of management of the company than on protecting the interests of minority shareholders. The reasons for this are as follows.

Firstly, the derivative claims regime focuses on protecting the interests of the company rather than the interests of individual shareholders.

The statutory derivative claims in Part 11 of the CA 2006 are closely linked to the general provisions on directors' duties in Part 10 of the Act. Section 170 of the Act clearly stipulates that directors own the general duties to the company, not to individual shareholders. This is why a shareholder can only bring a derivative claim on behalf of the company to seek relief. In addition, section 260, which allows shareholders to bring actions against former directors and shadow directors, is also considered to be another manifestation of the greater focus of derivative claims on the protection of the interests of the company.[402]

Moreover, if the derivative claim is successful, the outcome accrues to the company. The UK rules on bearing the litigation costs actually discourage the companies from bringing derivative claims. The "loser pays" rule means that if a derivative claim fails, the shareholders bear the costs. The arrangement that the company is not liable for the failure of the litigation and that the outcome of a successful litigation is attributable to the company has to be seen as a way of protecting the interests of the company as well.

Secondly, the UK derivative claims regime is more concerned with protecting the managerial freedom than the interests of minority shareholders. This is mainly reflected in the respect shown by the legislation and the courts to the autonomy of companies in the conduct of their affairs.

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[402] See James Kirkbride, Steve Letza, Clive Smallman and James Kirkbride, '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, 211.

The statutory derivative claims regime continues the spirit inherent in the common law rule that derivative claims brought by shareholders should be exceptional. This philosophy has influenced the conservative approach to the derivative claims regime in the UK. The statutory setting up of a two-stage procedure leaves open the possibility that a large number of derivative claims may not be successfully brought. The two-stage process is designed to minimise the involvement of companies in litigation. In addition, the practice of not requiring companies to provide evidence at the beginning of the first stage of the two-stage process is also intended to avoid companies being involved in the unmeritorious litigation. The company will only become involved if the court agrees at the first stage that the derivative claim should proceed, in other words, if the derivative claim is dismissed by the court at the first stage, the company will not be involved in the process at all. Furthermore, both the company's prior approval and ratification are grounds on which the court must dismiss the derivative claim, meaning that the court will not uphold an application for a shareholder's derivative claim as long as the company has reached a resolution, even if the resolution is potentially contrary to the interests of the minority shareholders, reflecting the court's reluctance to reassess an issue that could be resolved internally by the company.

Further, in the UK, whether a derivative claim can be brought and continued depends on the discretion of the courts. The courts dominate the entire process, even with the guidance provided by the CA 2006 in some respects. It has been argued that the courts in practice have adopted an overly restrictive approach on deciding whether to allow the proceeding to be initiated and doubted whether it would result in the extension of availability as it was respected.[403] In fact, during the initial discussions on whether derivative claims should be reformed, some people have already expressed their concerns about whether the new regime could overly expand the scope of litigation and lead to negative consequences.[404] However, the Law Commission made it clear at that time that the availability of the new regimes would not

[403] Arad Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action' (2009) 6 European Company and Financial Law Review 219.
[404] Law Commission, *Shareholder Remedies* (Law Com No 246, 1997), para 6.10.

be made too much changes and the new procedures would be "subject to tight judicial control at all stages"[405]. Coupled with the traditional reluctance of the British courts to get involved in disputes over the internal management of companies, the number of derivative claims in the UK has not been significant in practice.[406]

The reason that the legislation was designed from the outset to subject the bringing of derivative claims to strict judicial control remains consistent with the belief that the bringing of derivative claims should be exceptional, reflecting the focus on protecting the manifestation of board freedom in the UK Code and reaffirming the importance that it is the board that drives corporate governance compliance.

Finally, it should be mentioned that derivative claims are often compared with the unfair prejudice petition under section 994 of the CA 2006, arguing that "the unfair prejudice petition might generally appear to be more attractive than a derivative action due to the fact that there is not the same permission process that applied to the latter, and the claimant is able to get a remedy that relates to his or her own personal interests".[407] However, this section believes that this is because of the different focus of the two regimes. Petitions under section 994 is to protect the interests of minority shareholders, whereas a derivative claim is designed to redress the corporate wrongs and aims at corporate entities. In practice, because of the procedural limitations of derivative claims, minority shareholders are less likely to bring actions than under unfair prejudice, reflecting the reluctance of the courts to intervene in the internal governance of corporate disputes.

Any rules on derivative claims are said to contain two main features, minimum involvement of the management of the company and the protection of investors.[408] The design of the legal rules to favour these two determines how derivative claims regimes differ from country to country.

405 Ibid, para 6.13, 6.112.
406 Andrew Keay, 'Assessing and Rethinking the Statutory Scheme for Derivative Actions under the Companies Act 2006' (2016) 16 Journal of Corporate Law Studies 39.
407 Ibid, 61.
408 Reisberg (n 395).

The study found that the UK derivative claims regime tends to protect the autonomy of company management rather than the interests of minority shareholders.

5.3.4 a brief overview of the Chinese position

Almost simultaneously with the UK's inclusion of derivative claims in the CA 2006, China introduced a derivative action regime in its 2005 Company Law, which came into effect in 2006. However, the same regime appears to have had different effects in the two countries.

First, the requirements for standing as a plaintiff in derivative actions in China are even more stringent than in the UK. In China, a shareholder of a limited company must satisfy both the number of shares held and the duration of the shareholding to bring a derivative action. The 1% shareholding and 180-day shareholding requirements under Chinese Company Law are too stringent, resulting in many shareholders being unable to meet the requirements, which inevitably defeats the purpose of a derivative action under Chinese Company Law.

Second, the Company Law in China also imposes restrictions on the procedures for bringing derivative actions in order to avoid abuse of rights by shareholders. Under the Chinese Company Law, the shareholders are required to request in writing the supervisory board to initiate a lawsuit in the people's court before they bringing a derivative claim. If the supervisors have committed misconduct, the shareholder may request in writing the board of directors. If the aforementioned supervisory board or board of directors refuse to lodge litigation after receiving the written request or fail to initiate litigation within 30 days after receiving the written request, or if the situation is so urgent that failure to initiate litigation immediately would cause unrecoverable damages to the interests of the company, the shareholder shall have the right to initiate a lawsuit directly in the people's court in his or her own name in the interests of the company.[409] As can be seen from the above provisions, Chinese Company Law also

[409] Company Law 2018, article 151.

requires shareholders to exhaust internal company remedies before bringing a derivative claim, but this has obvious flaws compared to the two-stage procedure in the UK.

On the one hand, under this provision, a shareholder is entitled to bring a derivative action directly to court even if the company does not consent to the shareholder bringing the action. This provision does not prevent a shareholder from bypassing the company to bring a derivative action in court. On the other hand, as Chinese companies are heavily internally controlled and there is a high probability that the board of directors or the supervisory board will reject a shareholder's request for a derivative action, so if the court accepts the case under the "urgent situation" provision, it may give rise to suspicion of interfering with the internal management of the company.

The protection of minority shareholders by Chinese companies is relatively weaker than in the UK, and the regulatory environment in China's external markets is imperfect as well. In such circumstances, derivative actions in China should more appropriately serve to urge management to act in compliance to protect the interests of minority shareholders. However, given the different share ownership structures and external environment, the legal design of the derivative action regime in China should probably be different from that in the UK. Whether the Chinese derivative action regime strikes a good balance between the protection of shareholders' interests and management's freedom, and whether it can be improved to achieve better corporate governance compliance based on the lessons learned from the UK regime, will be discussed in more detail in section 6 of this chapter.

5.4 The disqualification regime under the Company Director Disqualification Act 1986

Directors occupy such an important position in driving compliance with UK corporate governance rules that regulating their conduct is an important and inescapable issue in corporate governance. In practice, many directors will not perform their duties in full compliance with, for example, the general obligations under section 172 of the CA 2006. In the UK, the Company

Directors Disqualification Act 1986 ("CDDA") provides for a director disqualification regime which disqualifies directors who have abused the advantages of the limited liability of the company against the public interest from serving as directors of other companies in the future and participating in the affairs of the company for a certain period of time. This makes directors aware that their non-compliance will not only accountable to the company, but may also have an impact on their future ability to act as directors in new companies.

The CDDA established a mechanism to restrain directors from engaging in misconduct. Under this regime, the court may disqualify a director of a company who has engaged in misconduct from acting as a director in the future on the basis of an application made by the Secretary of State or the official receiver.

Since the regime is not about how to govern a company, it is not essentially a corporate governance rule, but rather a non-governance rule. This section therefore focuses on compliance through corporate governance rules. It first briefly introduces the provisions of the CDDA regarding the director disqualification regime, then analyses the role played by this regime in the UK corporate governance compliance system by describing its nature and rationale, and finally considers whether it has any implications for improving the legal regulations of corporate governance in China.

5.4.1 a brief overview of the disqualification regime

The CDDA covers a wide range of directors, including shadow directors and anyone who carries out the functions of directors within the company regardless of the title attached to them.[410] The title of the position is not important, but rather the nature of the duties performed by that person. This brings company directors within the ambit of the Act as far as possible. If a company director falls within the provisions of the CDDA that trigger disqualification as a

[410] CDDA 1986, s 6(3C), 9E (5) and 22(4).

director, the court will disqualify the person from continuing as a director in accordance with the relevant provisions of the Act.

Under the CDDA, there are three statutory grounds on which a director may be disqualified: disqualification orders issued by the court, disqualification undertakings offered by the directors and automatic disqualifications. The period of disqualification ranges from 2 to 15 years, depending on the seriousness of the director's misconduct. There are several types of directors' misconduct can be targeted as the grounds for disqualification under the CDDA. Details are set out below.

5.4.1.1 disqualification orders

An application for disqualification of a director may be made to the court by the Secretary of State or the official receiver in a company if the director's conduct is considered to be harmful to the public interest.[411] In practice, it is the Insolvency Service, acting on behalf of the Secretary of State to seek a disqualification order.

The court may issue disqualification orders against directors on various grounds: conviction of indictable offence,[412] persistently breaches of companies legislation,[413] fraud etc., in winding up of a company,[414] summary conviction,[415] unfitness,[416] competition infringement,[417] participation in wrongful trading,[418] undischarged bankrupts[419] and failure to pay under county court administration order[420]. The maximum period of disqualification for a director in any of the above circumstances, other than a breach of the relevant provisions of the companies

411 Ibid, s 7(1).
412 Ibid, s 2.
413 Ibid, s 3,5
414 Ibid, s 4.
415 Ibid, s 5. It mainly relates to convictions for failures to comply with companies legislation relating to returns, accounts and similar matters to be sent to the Registrar of Companies.
416 Ibid, s 6,7.
417 Ibid, s 9A.
418 Ibid, s 10.
419 Ibid s 11.
420 Ibid, s 12.

legislation, is 15 years, indicating that the number of years of disqualification is positively related to the seriousness of the director's conduct.

One important criterion for determining whether a director of a company is unfit to continue to manage the company and for the court to determine whether a director should be disqualified is "unfitness".

In all of the above situations, unfitness under section 6 is at the heart of the CDDA's regulation of director's misconduct. The majority of cases that have ended with a disqualification order have been made under section 6 of the Act.[421] And the order issued is mandatory when the director's conduct satisfies the requirements under section 6. Even if the director does not benefit from the misconduct, the court will disqualify him or her for unfitness.[422] Simply put, the court has no discretion at all in such cases. The court shall make a disqualification order where it is satisfied that a person's conduct as a director of a company which has become insolvent makes him unfit to be concerned in the management of a company. The minimum period of this disqualification is 2 years, and the maximum is 15 years.[423] This is to legally ensure that those directors who act improperly are deprived of qualifications for at least two years. In addition, matters to be taken into account when determining unfitness requires reference to the Schedule 1 of the CDDA.

The legislative obligation on the courts to enforce disqualification of directors reflects on the one hand the UK government's determination to regulate directors who have engaged in non-compliance, and on the other hand demonstrates side-by-side through the provisions of the Act and the Schedule the high standards of conduct expected of directors in the UK corporate governance rules.[424]

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[421] The Insolvency Service, 'Guidance: Company Directors Disqualification Act 1986 and Failed Companies' (2022) <https://www.gov.uk/government/publications/company-directors-disqualification-act-1986-and-failed-companies/company-directors-disqualification-act-1986-and-failed-companies>accessed 1 November 2022.
[422] Meyrick Williams, 'Directors' Disqualification' (2005) 2 International Journal of Disclosure and Governance 281, 285.
[423] CDDA 1986, s 6.
[424] Sally Wheeler, 'Directors' Disqualification: Insolvency Practitioners and the Decision-Making Process' (1995) 15 Legal Studies 283.

5.4.1.2 disqualification undertakings

At any stage of the proceedings, directors can offer an undertaking that has the same legal effect as a disqualification order. It is intended to save the time and cost of the proceedings and to improve the efficiency of the disqualification process without the need for proceedings. If the court accepts the undertaking, the disqualification proceedings will be concluded.

The proposed disqualification undertakings acceptable to the State of Secretary mainly occur in the following situations:

(1) a director's conduct of the solvent company makes him unfit to be concerned in the management of the company;[425]

(2) a person as a director is committing or has committed of competition law,[426] the maximum period of disqualification undertaking under this is 15 years.[427]

Because of the time and cost savings of litigation, disqualification undertakings now appear to be the main way of disqualifying directors in the UK, rather than the disqualification orders. To encourage directors to offer disqualification undertakings, shorter periods of disqualification will be imposed on those who make them voluntarily.[428]

5.4.1.3 automatic disqualification

There is also a special situation that the person would be imposed on an automatic

[425] CDDA 1986, s 7(2A).
[426] Ibid, s 9(B).
[427] Ibid, s 9B(5).
[428] Samet Caliskan and Pereowei Subai, 'A Comparative Study on Disqualification of Company Directors in the UK and Nigeria: Lessons for Turkey' (2023) 30 Journal of Financial Crime 549.

disqualification without the need of the court when the person is an undischarged bankrupt, subjecting to a bankruptcy restrictions order or undertaking or a debt relief restrictions order or undertaking or under a moratorium period under a debt relief order.[429]

5.4.1.4 consequences of breach the disqualification

When the disqualification orders are made or the disqualification undertakings are accepted by the court, the individual may face many prohibitions and restrictions.

A person who is disqualified from being a director will not be able to serve as a director of any company registered in the UK or of any overseas company connected with the UK without the court's permission, but only be able to carry on business as a sole trader, or in partnership with others, with unlimited liability.[430] This institutional arrangement is also consistent with the original purpose for which the director disqualification regime was established, to control the misconduct of directors who abuse the advantages of corporate limited liability. It is worth noting that in certain circumstances, a director may apply for permission to continue to operate under an order or undertaking.[431] And this is in consideration of the fact that a director can be given a second chance if disqualification would have a detrimental effect on the management of the company. The procedures and requirements for applying for leave are also stipulated in this section of the CDDA.

However, he or she cannot be an insolvency practitioner under any circumstances. Even if the person can obtain a position in a company, he or she cannot serve as a receiver or manager of a company's property or being involved in the promotion, formation and management of a company without having a permission of the court. Moreover, violating the terms of disqualification order or undertaking will constitute a criminal offence, fined and/or

[429] CDDA 1986, s 11.
[430] Caroline Bradley, 'Enterprise and Entrepreneurship: The Impact of Director Disqualification' (2001) 1 Journal of Corporate Law Studies 53.
[431] CDDA 1986, s 17.

imprisonment for up to two years,[432] and may be subjected to a longer disqualification period. In addition to that, anyone who violates the disqualification order or undertaking may be personally liable for the company's debts.[433] In addition, the information of the person who was given the disqualification order or offered the undertakings will be made public and can be found in Companies House.[434]

For others, if someone participates in the management of the company under the instructions of the disqualified director, he or she will be liable for all the relevant debts of a company.[435] And if it is the body corporate who acts in contravention of a disqualification order or undertaking, the body corporate is guilty of an offence[436]and the company's senior officers or managers may also bear personal responsibility.

However, the worst result of disqualification on directors should be the reputational impact of being disqualified. Reputational penalties are far more of a deterrent to directors today than monetary sanctions. For the individual director, the negative reputational impact will result in his or her inability to serve as a director in other companies and a decline in personal income. Therefore, the deterrent effect of the negative reputational impact of the director disqualification regime under the CDDA on directors will effectively drive directors to act in compliance in corporate governance.

5.4.2 the nature and rationale of the regime

The main debate about the director disqualification regime is whether the primary purpose of the regime is to protect the public interest from director's misconduct or to punish non-compliant wrongdoers. When it comes to the debate on this issue, much of the literature cites

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432 Ibid, s 13.
433 CDDA 1986, s 15.
434 'Search for Disqualified Company Directors'<https://www.gov.uk/search-the-register-of-disqualified-company-directors>accessed 1 November 2022.
435 CDDA 1986, s 15(1).
436 Ibid, s 14(1).

the view of the judge in a particular case, quoted as:

"The primary purpose of the section (6) is not to punish the individual but to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to creditors and others. Therefore the power is not fundamentally penal. But if the power to disqualify is exercised, disqualification does involve a substantial interference with the freedom of the individual. It follows that the rights of the individual must be fully protected……"[437]

The essential purpose of the director disqualification regime is not to punish the directors who commit non-compliance, but to protect the public interest from the interference by disqualified directors. The reasons for this are as follows.

Firstly, the election of directors to a company is an area of corporate autonomy, but national legislation imposes qualifications on them precisely on the basis of the public interest. The appointment of an unqualified person as a director, primarily responsible for the management of the company, can create unpredictable risks to the decision making and future direction of the company. The primary purpose of director disqualification regime under the CDDA was initially designed to regulate and control the abuse of limited liability by company directors and to make new arrangements towards that.[438] Based on the doctrine of limited liability, directors only bear limited liability for the company's debts to the extent of their capital contributions. Some would set up a new company immediately after its collapse, ignoring the other harmful consequences for the company and society. Apparently, the main disadvantage of this approach is that it is not conducive to protecting the interests of the company's stakeholders, such as creditors. The CDDA was therefore created to protect the interests of creditors in the LLCs and it later expanded to all companies, not just limited to LLCs.[439]

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[437] See Stephen Griffin, 'The Disqualification of Unfit Directors and the Protection of the Public Interest' (2020) 53 Northern Ireland Legal Quarterly 207, 212.
[438] National Audit Office, *The Insolvency Service Executive Agency: Company Director Disqualification* (1993).
[439] Companies covered by the CDDA 1986 include listed companies, public companies, private companies, companies limited by shares, guarantee or unlimited companies and unregistered companies.

Secondly, the protection of the public interest by the regime is clearly expressed in section 7 of the CDDA. The disqualification regime is a restriction on the future conduct of directors. Disqualification of a director does not merely disqualify a person from being a director of his or her company, but further regulates the duties of a director by limiting his or her opportunity and eligibility to act as a director or to participate in the management of other future companies for a certain period of time. In addition, detailed information about the person who has been disqualified by court order or accepted by undertaking will be made public and can be found in the Companies House.[440]

One of the effective ways to increase deterrence is publicity. The disqualification regime prevents the disqualified directors from triggering the failure of other companies through the deterrent of losing jobs and loss of reputation. The sanctioning effect of this regime is thought to be effective in preventing a disqualified director from being given another opportunity to manage third party funds and interests through the company.[441] This is because a person who is not yet able to meet the basic operational requirements in his or her current company can hardly be expected to perform competently in a new company for a short period of time.

Thirdly, the legislation of a disqualification regime significantly limits the discretion of the courts. Prior to the introduction of the CDDA, the courts had complete and unlimited discretionary power as to whether to disqualify unfit directors. It was not until in 1982 that Sir Kenneth Cork recommended that the court should be required and not merely empowered to prohibit a person from doing so if a person's conduct makes him or her unfit to be concerned in the management of a company.[442] The introduction of the CDDA strengthened the court's power to grant disqualification orders, greatly reduced the opportunities for directors to use the court's discretion to take advantage of the law to avoid punishment, and was more conducive to protecting the interests of creditors and others. On the one hand, the realistic deterrent effect

[440] (n 434).
[441] Caliskan (n 428).
[442] Sir Kenneth Cork, GBE, Insolvency Law and Practice, *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) para 1813-1817.

urges those currently serving as directors in a company to exercise prudence and diligence in discharging their duties and responsibilities, and on the other hand, it deters future breaches by directors through a predictable deterrent effect. In addition, disqualification of disqualified directors ensures economic order in the market and prevents disqualified directors from harming the legitimate interests of other companies and stakeholders.

Finally, in addition to the CDDA, section 1184 of the CA 2006 provides the Secretary of State with the power to disqualify a person subject to foreign restrictions from being a director of a UK company and from participating in its management. This indicates that there is a trend towards stricter restrictions on the conduct of directors in corporate governance in the UK and that the disqualification regime may be extended further.[443]

In summary, despite there are some controversial and critical views among the academics on the effectiveness of the CDDA,[444] the director disqualification regime under the CDDA, as an effective regulatory mechanism in the UK corporate governance compliance system, is another classic practice that is highly conducive to improving corporate governance. On the one hand, it protects the interests of the company and its stakeholders more comprehensively. Whereas the derivative claims regime discussed earlier gives members within the company the right to bring proceedings against directors who have engaged in misconduct within the company, the disqualification regime further extends the scope of regulation by disqualifying directors who engage in misconduct from serving in other companies, infringing on the rights of other potential companies and stakeholders, which is arguably a form of future protection against future director non-compliance. And finally, the combined effect of the above will raise the standard of conduct of company directors to achieve and promote compliance with corporate governance in the UK. The establishment of the director disqualification regime in the UK is in fact a reflection of the role that company directors are expected to play in the governance of UK companies.[445]

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443 See Williams (n 422).

444 See Richard Williams, 'Disqualifying Directors: A Remedy Worse than the Disease' (2007) 7 The Journal of Corporate Law Studies 213, and Bradley (n 354).

445 Richard Williams, 'Enlighted Shareholder Value in UK Company Law' (2012) 35 University of New South

5.4.3 the position of China

There is no director disqualification regime in China, only provisions on the negative qualifications of company directors. Negative qualification of directors is not the same as director disqualification regime. Negative qualification of a director means that a person is not qualified to be a director and the law restricts his or her qualifications to be a director, rather than disqualifying him or her from continuing to be a director due to a breach of the law during his or her tenure as a director. The director disqualification may be one of the circumstances in which the law provides for negative qualification of being a director, but negative qualification of a director is broader in scope.

At present, the circumstances in which a person cannot act as a director as set out in the Chinese Company Law include: incapacity or limited capacity for civil conduct; being sentenced to imprisonment for corruption, bribery, encroachment of property or misappropriation of property, or disrupting the order of the socialist market economy, the execution period of which has not exceeded five years; being a director or factory director or manager of a company in bankruptcy and liquidation, and being personally responsible for the bankruptcy of the company, not more than three years have elapsed since the date of completion of the bankruptcy and liquidation of the company; being legal representative of a company whose business license has been revoked or ordered to be closed for violation of the law, for which he or she is personally liable, not more than three years have elapsed since the date of revocation of the business license of the company; a debt of a large amount is due and unsettled.[446]

Apart from that, according to article 15 of the Enterprise Bankruptcy Law of the People's Republic of China, during the period from the date when the people's court decides to accept an application for bankruptcy to the day when the procedures for bankruptcy are concluded, the

Wales Law Journal 360.

[446] Company Law 2018, article 146.

legal representative or the financial manager and other operators of the debtor shall not assume any post of director in any other enterprises. There are also departmental rules and regulations for the negative qualification of specific directors in various industries.[447] The CSRC also imposes restrictions on the conditions for the appointment of independent directors.[448] As can be seen from the Company Law in China, the negative qualifications for directors in China are limited to three or five years. In contrast, departmental regulations issued by the CSRC and the China Banking Regulatory Commission, impose mostly lifetime restrictions on those who are not sufficiently qualified to serve as directors.

Compared to the director disqualification regime under the CDDA in the UK, the Chinese regulations on negative qualification for directors also limit to some extent the opportunity for some unqualified individuals to become directors of a company and provide for different periods of time of disqualifications. However, in terms of its practical effect, the following deficiencies remain.

Firstly, the negative provisions on director disqualification in the Chinese Company Law have the same result as the disqualification regime in the CDDA, i.e. they restrict a director from acting as a director of a company for a certain period of time, but the difference lies in the consequences of a breach of the provisions. In China, the legal consequences of the provisions relating to the negative qualifications of directors are not as severe as those provided for in the

[447] See China Banking and Insurance Regulatory Commission, Provisions on the Administration of the Office Qualifications for the Directors, Supervisors and Senior Executives of Insurance Companies (2021); CSRC, Bylaws of Listed Companies (2022), article 95; Measures for the Office-Holding Administration of the Directors, Supervisors and Senior Executives of Futures Companies (2022 Amendment), article 19; CBRC, Implementation Measures of the China Banking Regulatory Commission for the Administrative Licensing Items concerning Chinese-Funded Commercial Banks (2022 revision), article 81.

[448] According to article 7 of the Rules for the Independence Directors of Listed Companies 2022, the following persons may not serve as an independent director: (1) persons holding a position in the listed company or its affiliated enterprise and their lineal relatives and major social relations ("lineal relatives" refer to spouse, parents, and children, among others; and "major social relations" refer to siblings, parents-in-law, children-in-law, siblings' spouses, and spouse's siblings, among others); (2) individual shareholders who directly or indirectly hold 1% or more of the issued shares of a listed company or rank among the top ten shareholders, and their lineal relatives; (3) persons who hold positions in the shareholding entities that directly or indirectly hold 5% or more of the issued shares of the listed company or that rank the top five shareholding entities of the listed company, and their lineal relatives; (4) persons who fell under any of the circumstances set out in the preceding three subparagraphs in the most recent year; (5) persons that provide financial, legal, consulting, or other services to that listed company or its affiliated enterprises; (6) other persons as set out by any law, administrative regulation, departmental rule, or any other provision; (7) other persons prescribed in the articles of association of the company and (8) other persons determined by the CSRC.

CDDA.

Section 1 (1) of the CDDA sets out the requirements for directors during a disqualification order:

(1) he shall not be a director of a company, act as receiver of a company's property or in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company unless (in each case) he was the leave of the court, and

(2) he shall not act as an insolvency practitioner.

While according to the Company Law in China, any elections or appointments which violate the requirements shall be invalid. And where any director is under any of the circumstances as mentioned above during his or her term of office, the company shall remove him or her from his or her position.[449] As can be seen, the law only removes his or her directorship in the company and does not completely prevent the director from participating in the management of the company in other ways or serving as a director in other companies.

Secondly, Chinese regulations and even Company Law leaves too much discretion to the company. Both qualifications and disqualifications of directors are of paramount importance to companies, and the presence of unqualified persons as directors of a company will have an impact on other stakeholders of the company and on the public interest. The disqualification of directors is a regime designed to protect the public interest, and therefore needs to be regulated by mandatory legislation, rather than being left to the discretion of individual companies. In fact, the restrictions and limitations on directors' duties imposed by Chinese regulations on the negative qualifications of directors are not sufficient to prohibit them from entering the commercial market and participating in the management of other companies as directors.

Thirdly, while China provides for circumstances in which directors may not serve as directors

[449] Company Law 2018, article 146.

in a company and the company's obligation to remove such directors, there is no supporting mechanism to urge the company to fulfil this obligation. Should a company be held liable if it fails to comply with its obligation to remove an unqualified director? Chinese law is not responsive to this either, which greatly reduces the effectiveness of the oversight of companies. The director disqualification regime under the CDDA solves this problem by directly and forcibly cutting off the opportunity for directors to re-enter a new company and participate in the management of the business from the legislative level.

Finally, because of the above deficiencies in China's negative director disqualification provisions, they are also much less effective in safeguarding other stakeholders in the company and the public interest.

In conclusion, in light of the UK experience, China should construct its own director disqualification regime. Simply stipulating the duties of directors cannot effectively prohibit the unlawful acts of directors. It is necessary to build a system of regulating directors' duties and depriving the qualifications of unfit directors to ensure that directors perform their duties in a compliant and diligent manner. What is most attractive for China to learn from the UK's director disqualification regime is that it not only limits director misconduct and promotes the proper performance of directors' duties, but also unwittingly incorporates the protection of the various stakeholders of the company into the directors' obligations. While disqualification of directors appears to be essentially a rule of a punitive nature, its primary purpose is not to punish the disqualified director, but to protect the public interest. China can therefore learn from the positive role that this regime has played in protecting corporate stakeholders and public interest as well.

Although China does not yet have a complete director disqualification system in place, given that China already has relatively well-defined provisions on the negative qualifications of directors in laws and departmental regulations, it has the basis for establishing a director disqualification regime, which can be transplanted to the Chinese corporate governance system by drawing on the UK experience. Moreover, Chinese academics have already seen the reference significance of the disqualification regime under the CDDA to Chinese Company Law.[450] And some scholars proposed to introduce the process of disqualification under the CDDA into China and standardise it through precedents.[451] This will be further discussed in section 6 of this chapter.

5.5 The corporate liability regime under the Bribery Act 2010

The measures and regimes for achieving corporate governance compliance in the UK referred to in the previous sections of this chapter are through civil enforcement regimes, not criminal enforcement regimes. This section turns the focus of this study to another way in which corporate governance is promoted in the UK by incentivising corporate compliance through criminal means.

The Bribery Act 2010 ("BA 2010"), which eventually came into effect on April 2010, combats the bribery offences from a company law perspective. Its introduction has sparked and renewed the worldwide focus on corporate compliance. The BA 2010 increases the potential liability of UK companies through improvements to certain bribery offences and the creation of new offences that related to bribery, maximising compliance as a criminal incentive for companies to establish compliance procedures to improve corporate governance.

5.5.1 background to the BA 2010

How to hold companies criminally liable has always been a challenge for national legislation, and the UK is no exception. This is because companies, unlike individuals, do not have a

450 See Qinglin Chang(常青林), (取消公司董事资格法律制度研究–以英国法为中心)'A Study of the Company Director Disqualification Regime: With a Focus on the UK' (DPhil thesis, China University of Political Science and Law 2008) 46；Chenglin Pan(潘成林), (董事任免制度研究)'Study on Appointment and Removal System of Directors' (DPhil thesis, Jilin University 2013) 4 and Min Ye(叶敏), (公司董事法定任职资格问题研究)'Study on the Statutory Qualifications of Company Directors' (2006) 3 Law Science 110, 115.
451 Ibid (Chang).

criminal mind. In order to overcome the dilemma that companies do not have an independent mind and therefore cannot be held criminally liable, the UK applies the doctrine of identification to combat corporate crime. Under the identification doctrine, the conduct of the person who represents the "directing mind and will" of the company, generally the senior officers of the company, will be attributed to the company. The question arises, however, what if the offence is not committed by a senior officer of the company, but only by an employee with no "directing mind and will" of the company? Should the company still be held criminally liable for his or her actions?

The harm of bribery to the world economy is obvious. The combination of domestic and international pressures has led the UK government to take a fresh look at the regulation of bribery offence. On a domestic level, the UK's previous regulations on corruption and bribery were scattered across different Acts[452] and the distinction between the regulation of bribery offences in the public and private sectors has been blurred. In addition, successive international conventions[453] have raised the international standards for combating economic crimes. In response to criticism from the OECD Bribery Working Group that the British legal system was not meeting its international obligations,[454] since 1998, the UK began to realise that the existing criminal liability regime for corporate economic crimes did not fit the purpose of addressing bribery offences both at the domestic and international level, and the old English law was fragmented and antiquated, which made it difficult for the courts to apply. The UK government therefore decided that the UK's corporate liability regime should be re-stated in a modern way.[455]

The reform of corporate liability regime in the UK stems from the issues of corporate criminalisation. As already noted, a company is capable of committing criminal offences based

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452 Public Bodies Corrupt Practices Act 1889, the Prevention of Corruption Act 1906 and the Prevention of Corruption Act 1916.
453 OECD Anti-bribery Convention; Second Protocol of the Convention on the Protection of the European Community's Financial Interests; Council of Europe's Criminal Law Convention on Corruption; European Council's Framework Decision 2003/568/JHA.
454 OECD United Kingdom: Phase 2 Report on the Application of the Convention on Combating Bribery of foreign public officials in international business transactions and the 1997 Recommendation on Combating Bribery in International Business Transactions (March 2005), para 194.
455 Law Commission, *Legislating the Criminal Code: Corruption* (Law Com No 248, 1998).

on its separate legal personality, but the problem of the corporate criminal liability is that it attributes the fault element to the companies that do not have minds as natural persons. In the traditional criminal liability system in the UK, apart from the specific legislation creating specific criminal offences for corporates, companies can generally be prosecuted for criminal offences committed by its members through identification doctrine or vicarious liability.[456] As one of the main features of British corporate law, the identification doctrine is applied when someone committed the crime represents the "directing mind and will" of the company. In other words, when a member within the company acts as the "directing mind or will" of the company or acts under the discretion of the "directing mind or will", the company should be liable for the member's behaviour based on the identification doctrine. Although there is no further clear definition of "directing mind and will" in the law, in practice it is usually limited to the directors and senior managers of the company.

Alternatively, the vicarious liability is more applicable in civil law and only arises from the strict liability in criminal area because it does not require the proof of fault. A company may be held vicariously liable for the criminal acts or omissions committed by its members, in other words, the employers may be responsible for the criminal offences of their employees in the course of employment. However, the offences are relatively rare. Therefore, the general rule for attributing the corporate liability in the UK is the identification doctrine. In practical terms, however, the UK courts have adopted a more cautious attitude in applying the identification doctrine to hold companies criminally liable, which made it more difficult to prosecute companies, especially as the "directing mind and will" of large multi-national companies may not be directly involved in the company's business operations in the same way as smaller companies, making it difficult to prove that the internal members of the offence were the "directing mind or will" of the company or under the "directing mind or will" of the company to commit the offence.

Since the *Second Protocol of the Convention on the Protection of the European Communities'*

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[456] Ali Shalchi, 'Corporate Criminal Liability in England and Wales' (HC Library Briefing CBP 9027, 2022) < https://researchbriefings.files.parliament.uk/documents/CBP-9027/CBP-9027.pdf > accessed 31 July 2022.

Financial Interests, international conventions have begun to require companies to take criminal responsibilities for failing to monitor or prevent crimes committed by their internal members. In order to fulfill the obligations under the convention, the UK Parliament has relied on the BA 2010 to address the issues associated with the application of identification doctrine. It replaces the previously fragmented and antiquated legal system and offers a world-leading and far-reaching standard on combating bribery crimes in a modern way.

The BA 2010 has a very broad territorial scope, which include proceedings for the offences committed in or in connection with the UK anywhere.[457] It creates a legal framework of two general bribery offences, namely bribing another person and offences related to being bribed (section 1 and 2), the offence of bribery of foreign public officials (section 6) and a new corporate offence of failure of commercial organisations to prevent bribery (section 7). Section 1, 2 and 6 are in fact modern expressions of the old law and do not change the spirit inherent in the application of the identification doctrine, whereby a company may only constitute the three offences under the identification doctrine if the person committing the offence has the criminal intention to do so. Section 7, however, creates a wholly new form of corporate liability that represents a significant expansion of the scope of the UK's position on fighting against bribery, and, in doing so, gives a strong impetus to corporate compliance. The following discussion will therefore focus on the newly created offence.

5.5.2 the corporate liability of failure to prevent bribery

While the BA 2010 is criminal in nature, the new offence under section 7, "failure of commercial organisations to prevent bribery", reflects the shift in the UK from the use of ex post criminal instruments to ex ante flexible and preventative corporate governance mechanisms within companies in combating bribery offences.[458]

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[457] BA 2010, article 12.
[458] Peter Alldridge, 'The Bribery Act 2010- Guidance to Corporations' (2012) 6 Law and Financial Markets Review 140.

Under section 7 of the BA 2010, a commercial organisation is guilty of an offence if it fails to prevent bribery by a person associated with it within the company. The new offence of section 7 redefines the principle of identification doctrine. The identification doctrine is hard to apply when a commercial organisation is held criminally liable under sections 1, 2 and 6 to prove the "directing mind or will" of the company. In contrast, the new form of strict liability created by section 7 of the BA 2010 does not require proof of the commercial organisation's intent and knowledge, that is, a commercial organisation may be held liable for failing to prevent a person acting on their behalf from engaging in bribery even if it did not know about the bribery. The BA 2010 makes a "failure to prevent model" for corporate liability that provides for an offence of failing to prevent a substantive offence rather than the substantive offence itself.[459] In addition, it changes the difficulty of holding companies criminally liable under the identification doctrine, as any bribe committed by a person associated with the company can be a cause of criminal liability for the company under the Act. The creation of this new offence is therefore undoubtedly one important way of overcoming the difficulty of attributing liability to companies.

The only defence of corporate liability is the "adequate procedure" under section 7(2) of the BA 2010. A commercial organisation needs to prove that it has an "adequate procedure" in place within the company to prevent persons associated with the company from undertaking the bribery. The BA 2010 itself does not further explain the "adequate procedure" and in order to assist individual companies in establishing adequate procedure for the statutory defence of bribery prevention, section 9 of the Act empowers the Secretary of State to provide guidance in this regard. The Ministry of Justice, acting as the Secretary of the State, published a guidance about adequate procedures to prevent persons associated with them from bribing, the Bribery Act 2010 Guidance ("the Guidance").[460] The Guidance does not provide fully descriptive provisions, but rather gives six general principles.[461] Each principle is explained in detail and

[459] Ministry of Justice, *Corporate Liability for Economic Crime, Call for Evidence: Government Response* (2020), para 9 (iii).
[460] The UK Parliament required that the guidelines shall be issued three months before the Act coming into force so that commercial organisations can familiarize themselves with adequate procedures to prevent bribery offences.
[461] Proportionate procedures, top-level commitment, risk assessment, due diligence, communication and monitoring and review.

subsequent case studies further explain the application of several principles in different contexts and are intended to help companies understand how to comply with them in practice.

The six principles are primarily characterised by flexibility, allowing commercial organisations to determine the most appropriate procedures to develop based on their own characteristics. It is clear from the six principles that the government's aim in enacting the BA 2010 is not to sanction corporate bribery offences with severe criminal sanctions, but rather to develop a corporate culture within companies that resists bribery. Rather than opting for a "one-size-fits-all" approach, the government claimed that they were more inclined to offer an outline rather than a descriptive one and they deliberately refused to provide more precise examples on the section 7 defence,[462] because it is unnecessary to require commercial organisations of different sizes to establish the same adequate procedures under the same terms, taking into account that the businesses carried out by organisations of different sizes vary. For example, small companies may face less bribery risks than large multinational companies.

The offence of "failure of commercial organisations to prevent bribery" coupled with the Guidance are significant in promoting corporate governance compliance in the UK.

The "failure to prevent model" provides companies with an incentive to comply and to pay greater attention to the quality of their organisational structure. Bribery is often very subtle and difficult to detect. The "failure to prevent model" provides an incentive for companies to detect misconduct themselves and to actively self-report and cooperate with the authorities. The new offence makes commercial organisations aware that they can help protect themselves from liability simply by having a compliance program and anti-bribery procedures in place within the company, providing a strong incentive for companies to adopt compliance measures to avoid business risks and create a compliant company culture with anti-bribery as an entry point. As such, it is seen as a focus on the quality of a company's internal systems to effectively prevent insiders from committing bribery, as opposed to offences committed against specific

[462] Ministry of Justice, *Government Response to the House of Lords Select Committee on the Bribery Act* (2019), para 50.

individuals within the company under the old rules.[463]

In addition, the BA 2010 allows companies to structure their compliance regimes to prevent bribery offences in a flexible manner that is tailored to their own circumstances. There are no uniform rules on "adequate procedure" under the Act and the six principles offered by the Guidance are only a general practical guide to help companies structure their own procedures to meet the compliance obligations, rather than mandatory requirements. The "no-one-size-fits-all" approach allows companies to build compliance procedures within the company to avoid corporate liability according to their own characteristics, and provides a significant incentive for different types of companies to achieve corporate governance compliance.

While criminal sanctions are regarded as "in any event inadequate to deal with many of the problems that arise within companies",[464] the UK's new offence of "failure of commercial organisations to prevent bribery" reflects the fact that combating corporate bribery and corruption offences does not have to be a serious criminal exercise, and that it is entirely reasonable to design a more modest corporate governance regime and internalise it as a conscious crime prevention drive for companies.

5.5.3 deferred prosecution agreements

Deferred Prosecution Agreements ("DPAs") are set out in the Crime and Courts Act 2013 as a means of delaying the prosecution of companies, which can be regarded as a positive development in relation to the offences under the BA 2010. Although the DPAs are not derived from the BA 2010 and they are applicable to many economic crimes other than bribery offences, according to the data provided by the Serious Fraud Office ("SFO"), most of the DPAs with significant influence are related to corporate bribery.[465] Thus, it is worthy to be discussed here

463 Mukwiri (n 21).
464 Law commission, *Shareholder Remedies* (Law Com CP 142,1996), para 1.13.
465 See SFO, 'Deferred Prosecution Agreements'< https://www.sfo.gov.uk/publications/guidance-policy-and-protocols/guidance-for-corporates/deferred-prosecution-agreements/> accessed 17 July 2022.

as it plays a significant role in affecting the conduct of the company to prevent bribery and implementing corporate compliance program.

As noted earlier, the purpose of "failure of commercial organisations to prevent bribery" is to encourage commercial organisations to self-identify the misconduct and implement preventive procedures in a timely manner to detect criminal behaviour from occurring. The DPAs serve the same purpose as they provide an effective incentive for companies to self-report and establish compliance procedures and cooperation with regulators. The main design of the UK's DPAs is as follows.

Firstly, DPAs do not apply to individuals. And unlike the US, the DPAs in the UK must be approved by the courts. The courts must give reasons for its decision on granting a DPA and the entire process will be subject to public scrutiny. It is up to the judge to decide whether the proposed DPA is in the interest of justice and whether its proposed terms are fair, reasonable and proportionate. According to the Crimes and Courts Act 2013, the first stage of the preliminary hearing must be held in private, and the final hearing should be given in the open court.[466]

The court needs to consider the following factors when deciding whether to grant a DPA. First, the seriousness of the conduct. The more serious the offence, the less likely it is that a DPA will be entered into; second, the promptness of the companies' self-reporting and the degree of cooperation between the companies and the relevant regulatory authorities; third, whether there is any history of similar conduct against the organisations; and finally, whether the organisation in its current form is actually a different subject from the organisation that committed a crime.[467]

The company which the prosecutors consider to prosecute has to comply with the conditions and requirements imposed by the agreement between it and the prosecutors. Paragraph (6)(1)

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466 Crime and Courts Act 2013, Sch 17, para 8 (7).
467 See SFO V Standard Bank-Courts and Tribunals Judiciary, < https://www.judiciary.uk/wp-content/uploads/2015/11/sfo-v-standard-bank_Preliminary_1.pdf> accessed 2 June 2023.

of Schedule 17 of the Crimes and Courts 2013 requires the Director of Public Prosecutions and the Director of SFO to jointly issue a Code of Practice and give corresponding guidance ("DPA Code of Practice"). According to section 2.3 of the DPA Code of Practice, a valid DPA must refer to other codes of practice and guidance.[468] Also, the prosecutors must fully consider the DPA Code of Practice when they are deciding whether granting a DPA is appropriate. While the rules are not mandatory, failure to comply with the rules will make it harder for companies to demonstrate a reasonable defence is in place when reaching a DPA agreement to avoid prosecution.[469] This will in turn push companies to establish compliance programs as an effective defence. Prosecutors have the discretionary power to decide whether to issue an offer to sign a DPA with a company after ensuring that the evidential stage is met and the public interest would likely to be met. In this regard, whether a company has an effective compliance program or the ability to demonstrate significant improvements to its compliance program is an important factor for prosecutors to consider when applying the public interest test.[470]

The DPAs essentially delay or avoid criminal prosecutions of a company for a fixed period of time by establishing a compliance program to prove that the companies' violations are negligent. The government's objective is to incentivise companies to contribute to the fight against corruption through bribery cases. The BA 2010 has had a major impact on the UK's anti-corruption culture, effectively incentivising companies to develop anti-bribery policies and establish anti-bribery procedures. While the introduction of DPAs has encouraged companies to self-discover and proactively report non-compliance, at the same time, it has also helped to avoid the negative influence on the legitimate rights and interests of company stakeholders, further assisting companies ensure future compliance.

In conclusion, the new corporate responsibility regime under the BA 2010 facilitates companies putting compliance procedures in place and the DPAs further assist companies in achieving future compliance. The UK has successfully used the opportunity to internalise corporate

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468 Including The Code for Crown Prosecutors, The Joint Prosecution Guidance on Corporate Prosecutions and the Bribery Act 2010: Joint Prosecution Guidance and The DPA Code.

469 (n 467).

470 DPA Code of Practice (2013), para 2.8.1(iii).

liability to prevent bribery offences as a means of promoting corporate governance compliance, which is worth learning from China.

5.5.4 implications of the BA 2010 for China

Chinese legislation has always been less tolerant of bribery offences in the public sector and more tolerant of them in the private sector. However, as the global economy continues to develop, the need for China to regulate economic crimes in the private sector is increasing. Since 2002, China's procuratorial authorities have been pushing for compliance reforms for companies involved in different criminal offences, which are still in the pilot phase and can draw on the successful experience of the BA 2010.

As can be seen from the experience of the UK BA 2010, firstly, the UK shows a tendency to intensify the fight against commercial bribery, completely removing the boundary between the public and private sectors and treating commercial bribery and bribery of public officials as equivalent. Secondly, preventative measures that focus on improving the internal structure of companies provide better incentives for companies to comply than ex post punitive measures, and furthermore, the use of preventative measures to combat corporate crime reflects the UK's confidence in the effectiveness of corporate self-regulation.

Indeed, the provisions of the BA 2010 have already inevitably had an impact on Chinese companies as it applies not only to UK companies but also to foreign companies doing business in the UK. In particular, the offence of failure of commercial organisations to prevent bribery applies to any organisation that "carries on a business, or part of a business, in any part of the United Kingdom, regardless of where it is incorporated or formed"[471], and an offence exists if a person with "a close connection to the United Kingdom" and it includes "any body incorporated under the law of any part of the UK". This means that as long as a Chinese

[471] Ministry of Justice, *Consultation on Guidance About Commercial Organisations Preventing Bribery (Section 9 of the Bribery Act 2010)* (CP 11/10 2010).

company has a business relationship with the UK, it falls within the jurisdiction of the BA 2010 even if it does not open any physical company in the UK. At a time when Chinese companies are so keen to break down the boundaries between countries and pursue opportunities for economy development, the impact of not being subject to the extraterritorial reach of the UK BA is very minimal. China should take measures to prevent and mitigate the risks that the Chinese companies may face under BA 2010.

In summary, the BA 2010 redefines a new type of criminal corporate liability. It successfully shifts the original attribution of criminal conduct and criminal liability to insiders to focus on improvements in the internal governance structure of the company. The use of a new offence has mobilised companies to take the initiative in compliance, while flexibly guiding companies to establish compliance procedures that respect the different needs of different types of companies, significantly reducing the risk of paper compliance and effectively improve corporate governance. Of course, while BA 2010 provides strong and effective legal support for the UK's fight against bribery offences, the Act is more significant in that it helps UK companies shift the focus of their fight against bribery offences from ex post punishment to a proactive corporate compliance culture simply by creating a new form of offence that is worthy of emulation in China.

5.6 Implications of transplanting the UK compliance regimes to China

By introducing the four main previous UK corporate governance regimes, this section first summarises the experience of the UK corporate governance compliance model and finally discusses the feasibility of its transplantation to the Chinese corporate governance system.

Compared to the UK corporate governance compliance regimes, the Chinese regulations are more restrictive on companies and do not give full play to the power of corporate autonomy. The construction of the UK's corporate governance compliance regimes offers three major lessons for China, including relying on self-regulation and trusting in the power of market discipline, enhancing the board's managerial freedom to drive corporate governance compliance and creating a corporate compliance culture through preventive measures.

5.6.1 reliance on corporate self-regulation

One of the distinctive features of the UK's corporate governance compliance regime, compared to China, is its reliance on corporate self-regulation.

The implementation of corporate governance compliance in the UK is becoming increasingly personalised and the existence of allowing compliance to be personalised has accelerated the process of achieving compliance in UK companies. The UK sets out principles for good corporate governance through the UK Code, supported by detailed provisions to further help the boards and companies better understand how the relevant provisions of the principles apply in practice. At the same time, the flexible regime of "comply or explain" gives the company enough space for autonomy, and to a certain extent, it avoids the possibility of the company responding the requirements with a tick box approach. It can be seen that the UK considers flexible voluntary regulation to be more efficient in the area of corporate governance than a one-size-fits-all approach.

In contrast, China does not have the self-regulation with the same nature as the UK Code in the area of corporate governance. China does show a tendency in some places to regulate corporate governance issues through rules of a soft law nature, for example, the *Code of Corporate Governance for Listed Companies* ("Chinese Code") revised by the CSRC in 2018. However, due to the identity of the CSRC as an official regulatory body in China, the Chinese Code is considered to be "soft on the outside but hard in the inside".[472] And the regulator can be influenced by political forces therefore leading to weak enforcement.[473] In addition, the provisions of Chinese corporate legislation are too general, creating many practical problems

472 Wang (n 205).
473 Graldine Szott Moohr, 'The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement' (2009) 46 American Criminal Law Review 1459.

in application, and the lack of detailed guidelines makes it difficult to achieve a high rate of corporate compliance as well.

Corporate governance in the UK achieves the goal of corporate self-compliance by means of self-regulation. Firstly, the UK Code is perfectly designed to respect the companies' internal governance rights, giving companies the autonomy to adjust corporate decisions to their own conditions. The key to the "comply or explain" regime is the explanations provided by the company for non-compliance. Allowing companies to provide explanations means that compliance with the Code's provisions is not entirely mandatory. It is permitted for the company directors to not strictly follow the guidance as long as high-quality explanations are provided. It can be seen that the UK rule makers believed that this non-interference with internal governance was a more effective way of protecting the interests of companies and achieving long-term success. Legislative measures with corresponding mechanisms are better placed to intervene when companies are unable to resolve conflicts on their own, ultimately creating a culture of compliance within the company by raising the standards of corporate governance.

In addition, another advantage of self-regulation in achieving corporate compliance is its flexibility. The Guidance of BA 2010 makes it clear that "it is designed to complement, not replace or supersede, other bribery prevention guidelines published by industry or sector bodies or by non-governmental organisations."[474] The Government has also deliberately chosen a flexible approach with principle-based provisions as guidelines to help companies adapt the application of the BA 2010 to their own circumstances. Appropriate procedures established within companies to prevent bribery are also based on the principles provided by the government and companies are encouraged to establish procedures within their companies that are genuinely tailored to their own conditions.

The governments and regulators cannot decide what procedures are best for companies, and there is no better way to understand a company's needs than the company itself. The self-

474 (n 471) 4.

regulation set-up allows for different companies to ultimately apply compliance with different outcomes, which in turn provides more meaningful corporate practice in corporate governance in the UK and facilitates the government to effectively update guidance based on market feedback. What is "appropriate" and "best" for a company, after all, varies from company to company.

However, self-regulation has its own disadvantages. Namely, the question of the effectiveness of enforcement. Self-regulation cannot be achieved without the assistance of market forces. A properly and efficiently functioning market can save the government regulatory resources and costs. China's market is not as mature as the UK one, so it should learn from the advantages of UK self-regulation in corporate governance on a limited basis, as China does not have a highly mature market mechanism to back it up.

5.6.2 focus on the role of the board of directors in achieving corporate compliance

The UK experience suggests that the board of directors should be at the heart of corporate governance. The regulation of directors in corporate governance needs to be considered in two ways. First, to reasonably limit the power of the board of directors to ensure that the board acts in the interests of the company; and second, to ensure that the board has independent managerial freedom, independent of the control of the board of shareholders or controlling shareholders. Achieving a balance between the two to the greatest extent is one of the most important tasks of the corporate governance. The board of directors plays an important role in the day-to-day running of the company, as can be seen from the UK model of corporate governance rules, which places the obligation of corporate compliance primarily on the board of directors and places great emphasis on motivating directors to comply.

Firstly, as mentioned earlier, the UK's corporate governance compliance rules are centred on the company's board of directors. And as far back as the Cadbury Report in 1992, it was known that boards of directors in UK companies need discretionary powers in order to help the company achieve its long-term goal of successful growth. It was claimed that “the effectiveness with which their boards discharge their responsibility determines Britain’s competitive position.”[475] The Cadbury Report, which set the tone for corporate governance compliance rules in the UK, argued that the company boards “must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability.”[476] Additionally, the CA 2006 makes it clear that the board owns a general obligation to the company, rather than to any individual. Under section 172, directors own the duty to promote the success of the company. The corporate governance compliance system in the UK serves to reserve the managerial freedom of directors to the greatest extent, and aims to promote the development of the company by giving full play to the autonomy of directors and increase the confidence of shareholders and potential investors.

In addition, the flexibility of the “comply or explain” regime increases directors’ discretion by allowing directors to choose alternative arrangements that they believe are the best way to achieve corporate governance, as long as they provide a high quality explanation to shareholders rather than other regulators. If shareholders are not convinced, they may ask the boards to explain their position. In other words, while the “comply or explain” regime in the UK Code does provide shareholders with greater access to information about the company’s affairs through disclosure and deepens communication between shareholders and directors, however, directors are still free to run their companies.

Apart from the UK Code, which requires boards to provide explanations for non-compliance, UK statutes restrict the misconduct of company directors primarily through derivative claims regime and director disqualification regimes. While the derivative claims regime allows shareholders to bring actions on behalf of the company against non-compliant directors for conduct that is detrimental to the company’s interests, the procedural requirements of CA 2006 in relation to the derivative claims regime suggest that the regime remains focused on protecting the discretion of directors more than protecting the interests of certain minority shareholders.

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[475] (n 72).
[476] Ibid.

When the Law Commission were reviewing the law of shareholder remedies, it was pointed out that a proper balance must be struck between "enhance shareholder confidence" and "not to impose significant new burdens on management".[477] Even if shareholders are legally allowed to sue directors on behalf of their company, they still tend to use litigation as a remedy, and the main purpose is to urge directors to act in compliance. Although the legitimacy of derivative claims is determined by legislation, the details of procedural requirements are set out in rules of court to achieve the maximum of flexibility.[478] And the statutory procedural settings reflect the court's reluctance to intervene in the companies' internal affairs. Indeed, it is still the first priority to protect the discretionary power of directors and companies. The continuation of derivative claims is only allowed when the court confirms that the director has committed wrongdoing and the company has not brought a proceeding. The court only intervenes when the company is unable to resolve the disputes internally. This approach not only takes into account the fact that lack of pre-procedures will cause the company to be entangled in meaningless lawsuits and fall into unnecessary costs, but more importantly, it reflects the court's desire of not to intervene in the companies' internal governance. In other words, the UK tends to intervene in the affairs of a company only when there is a very legitimate basis to do so.[479]

Moreover, even if a shareholder relies on the derivative claims regime to sue a non-compliant director in a company, the director is still free to run the company. The existence of derivative claim would have a negative influence on the company's reputation in the market, and a loss of confidence in the directors may affect the investment and price of the company's shares. As a result, companies and their directors may choose to comply proactively for fear of such market pressure and reputational impact.

While the director disqualification regime reflects the enhanced obligations of company directors in the UK, it also provides an incentive for company directors to comply effectively.

[477] Law Commission (n 464).
[478] Law Commission (n 404), para 6.111.
[479] Keay (n 406).

This is because corporate misconduct can already affect not only the director's position in the company, but even the right to enter other companies as a director or to participate in the management of the business, which is prohibited by law. At the same time, the disqualification of a director not only results in the loss of the director's job, but the reputational damage further reduces his or her future income. The CDDA promotes compliance with the future conduct of company directors through the director disqualification regime. Both derivative claims regime and director disqualification regime seem to be tough legislations on regulating the misconduct of directors of the company, the disqualification regime goes a step further. The main purpose of disqualification of directors is not to punish directors, but to prevent unqualified directors from continuing to participate in the internal management of the company, so as to protect the future interests of the company and the public interest, and provide a free and fair market environment to the company.

However, China's corporate governance system focuses too much on the restrictive function of regulation and neglects the incentive effect on directors. In order to protect the interests of shareholders, especially the interests of the minorities, China also has regulations on the obligations of directors. In contrast, however, China has not done enough to protect the discretionary powers of directors. For instance, China also has a statutory footing on derivative action, but there is still room for further reform because it is believed that the rigid provisions of this regime restrict the discretionary power of directors in companies.[480] Moreover, China does not have the same director disqualification regime as under the CDDA, but Chinese laws and departmental regulations set out negative qualification conditions for directors. This is a far from a sufficient incentive for directors to comply. Companies and individuals who violate the regulations will not face the same serious consequences under the CDDA. The provisions of the regulations in China on the negative qualifications of directors are not mandatory enough and leave too much discretion for companies. The directorship is only removed from the current company and the director is not completely prevented from participating in the management of the company in other ways or serving as a director in other companies.

[480] Shaowei Lin, 'Derivative Actions in China: One Step Forward, Two Steps Back?' (2012) 23 International Company and Commercial Law Review 197.

To sum up, no matter what jurisdiction it is, a good corporate governance system must deal with the conflicts between various interests within the company. China's corporate governance system should draw on the UK's focus on management discretion. However, reconstructing and improving China's corporate governance rules will, after all, need to take into account China's national context. In the UK, the main agency problem in corporate governance is the conflict of interest between shareholders and directors. In contrast, in Chinese companies, due to their highly concentrated share ownership structure, the main agency problem is the conflict between controlling shareholders and minority shareholders. Not only that, majority or controlling shareholders in Chinese companies are generally involved in the operation and management of the company and enjoy absolute control over the appointment of directors, even by themselves as directors. Therefore, in order to give the board of directors more managerial freedom, China should not only learn from the UK regimes but also discipline the behaviour of controlling shareholders.

5.6.3 achieving a corporate compliance culture through preventive measures

The BA 2010 demonstrates that the UK is beginning to shift from ex post disciplinary measures to ex ante preventive mechanisms in the fight against corporate crimes, reflecting the government's focus on the quality of internal organisational structures, raising the compliance awareness of corporate organisations through the strict liability of the new crime model, and maximising the incentives for proactive compliance through heavy fines.

The model of "failure to prevent bribery" under the BA 2010 has a sufficient deterrent effect on crime prevention. Bribery is so insidious that it cannot be eradicated by purely reactive measures. The legislative design of the BA 2010 highlights the importance of crime prevention by deterring companies through strict criminal liability on the one hand, and by reshaping organisational culture through the sole defence to mobilise business organisations to proactively establish compliance procedures and mechanisms to prevent crime in their companies on the other. As already suggested, the aim of BA 2010 is not to increase conviction rates, but to change corporate culture in order to reduce the incidence of bribery.[481] If commercial organisations are compliant with the BA 2010, bribery will be prevented in the first place because the adequate procedures have been already in place, and there will be no need to worry about punitive measures afterwards.

The new crime model of the BA 2010 not only raises awareness among commercial organisations, but establish compliance mechanisms to prevent crime through the incentive of heavy penalties. The "failure of commercial organisations to prevent bribery" also reflects the UK government's belief that companies can identify and prevent their own criminal behaviour and ensure that they trade transparently in the marketplace. Rather than having obligations imposed directly by legislation, UK business organisations are encouraged to self-discover risks within their companies and to comply with legal guidelines as appropriate to their own circumstances, thereby truly internalising anti-bribery as part of company policy and corporate culture.

The effectiveness of different regimes set out in the UK laws may be questioned because the regimes have not resulted in a significant increase in litigation. However, this should not be the only measure of the effectiveness of the legislation, but should instead be understood in the context of the regulatory purpose of different regimes. The primary purposes of both the director disqualification regime under the CDDA and the expansion of the corporate liability under the BA 2010 are not to increase conviction rates, but rather to reshape the corporate compliance culture by increasing the deterrent effect on directors or companies through the design of the legislation. This is more effective in providing incentives for companies to comply through preventive measures rather than ex post facto penalties. These above non-governance rules are well supplemented by the corporate governance rules that change the companies' governance to make compliance more likely.

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[481] House of Lord, House of Commons, Joint Committee, *Draft Bribery Bill* (2008-09, HL 115-1, HC 430-1), para 232.

In conclusion, even when public powers are used to regulate directors' conduct in the UK, they are premised on protecting directors' discretion as far as possible. The legislative measures represented by derivative claims regime, director disqualification regime and the corporate liability under the BA 2010 are essentially designed to raise the standard of management behaviour. Different from the three regimes, BA 2010 focuses more on the confidence of shareholders rather than managerial discretion. The expansion of the scope of corporate liability has promoted the companies to strengthen their internal governance structures through criminal incentives. And the strict requirements of "failing of commercial organisations to prevent bribery" help the companies create a culture of compliance that is transparent and fair.

5.6.4 feasibility of transplantation in China

This chapter has demonstrated that the UK has promoted corporate compliance in the area of corporate governance by respecting the corporate autonomy as far as possible on the one hand, rather than opting for different rigid regulations imposed on the company. On the other hand, corporate governance in the UK has shifted from the traditional regulatory approach, which relies on ex post penalties, to an ex ante preventive model of compliance governance. Is the approach chosen by the UK directly transferable to the Chinese corporate governance compliance system?

Although the UK's compliance regimes represent a high international standard of corporate governance and has proven to work well in practice, it is also necessary to see the differences between the UK and Chinese corporate governance landscape. The UK's corporate governance compliance model is designed for companies with decentralised ownership structure and focuses on adjusting the main conflicts between shareholders and management of the company, while Chinese companies have a concentrated ownership structure and conflicts between shareholders and management are not common, but are mostly reflected in the infringement of minority shareholders and the control of management by major or controlling shareholders. Based on the above-mentioned differences between China and the UK, China should not blindly transplant the UK experience in order to avoid maladjustment in practice. There is a need for localised thinking and analysis in relation to the local governance issues of Chinese companies. The transplantation of the UK experience in reforming the Chinese corporate governance rules should be based on a comprehensive understanding and analysis of the UK corporate governance regimes, followed by an exploration of the possibility of transplanting them into Chinese legal framework with taking into account the Chinese unique characteristics.

The independent director system is the result of China's failed attempt to transplant foreign experience. The mission of the independent directors in China is essentially to monitor the behaviour of the board of directors and controlling shareholders. However, as mentioned earlier, in Chinese companies with concentrated ownership structures where the controlling shareholders control the directors and management of the company, it is unlikely that the controlling shareholders and directors will elect independent directors to be responsible for monitoring themselves. Thus, the independent director system may be a successful experience in companies with dispersed ownership structures, if it is blindly transplanted without regard to the characteristics of Chinese companies, it may eventually lead to alienation and failure.

This chapter argues, firstly, that it is feasible for China to learn from the UK experience of adopting soft self-regulation in corporate governance, as it is more flexible than hard rules and companies can make arrangements accordingly to suit their own circumstances. Allowing individualised compliance regimes to be constructed can provide more effective incentives for companies to comply with corporate governance rules. However, as mentioned earlier, the effectiveness of self-regulation needs to be complemented by a well-developed market that ensures timely feedback on corporate non-compliance. Pure self-regulation by individual companies or industries is not strong enough, there should be more desirable regulatory forces to help to enforce them.[482] And it has been found that government regulatory activities still play an important and positive role in urging companies to comply.[483] China does not have the

[482] (n 168).
[483] Short and Toffel (n 177).

same developed market environment as the UK, so it would be best for China to start by introducing relevant guidelines with the support of government, and gradually guide companies in different sectors to comply with the good corporate practices set out in the relevant guidelines. It is definitely not a one-night thing to achieve corporate governance compliance in China, after all, the UK Code has been in operation for over 30 years.

Secondly, in terms of common practice between China and the UK, China can also learn from the UK's advanced experience. In terms of the derivative claims and the negative qualification conditions for directors, as discussed before, there is still room for further reform of the relevant provisions in China. Beyond this, there are several local issues that need to be addressed in light of the actual situation in China. For example, the impact of the highly concentrated share ownership structure of Chinese companies on corporate governance compliance models, and the regulation of the behaviour of controlling shareholders in Chinese companies.

Furthermore, in light of the extraterritorial jurisdiction of the BA 2010 and the pressure on Chinese companies to meet high compliance standards, China has also embarked on pilot reforms to promote corporate compliance through criminal enforcement regimes. However, China's criminal compliance regime is still at the pilot and start-up stage and requires further exploration and research. The UK model of taking compliance as a criminal incentive to improve corporate governance at source in the BA 2010 could be used as a reference for China.

Finally, this section points out the problems in China by summarsing the characteristics of the four main compliance regimes in UK corporate governance in contrast to the current situation in China. Compared to the UK corporate governance compliance regimes, China ignores the power of corporate autonomy and market forces and relies excessively on legislative and government regulatory measures. In addition, China should look to the UK's current corporate governance compliance model and establish preventive compliance mechanisms by requiring governance changes within companies to detect and prevent violations at the source, achieving corporate compliance and improve corporate governance. In other words, compliance with the corporate governance rules explored in this chapter can ensure greater compliance with those non-governance rules.

This chapter argues that the UK's corporate governance compliance regimes have, to varying degrees, beneficial elements that China can transplant and learn from, but legal transplantation is not a matter of copying the legal rules of another country. Although the UK's corporate governance compliance system is of great significance to China, China still needs to take into account its own characteristics and carefully consider the adaptability of these regimes in China when borrowing and transplanting from the UK.

5.7 Conclusion

No single jurisdiction in the world can have a perfect model of corporate governance that works for all companies. However, those advanced experiences that have been proven to achieve improved corporate governance are worthy of learning from in other jurisdictions. Especially when placed in the context of a global economy so closely interconnected, keeping pace with international corporate governance standards and rules is crucial to the development of Chinese companies. The UK's well-established corporate governance compliance system, even combined with criminal means to build a governance system of a preventive nature, represents a high standard and advanced policy direction for corporate governance in the world, and is an important reference value for Chinese companies to improve their corporate governance mechanisms and align with international standards.

This chapter argues that the four compliance regimes of UK corporate governance all have varying degrees of relevance to corporate governance reform in China and are feasible for transplantation.

Firstly, China should introduce the corporate self-regulation into its corporate governance system, using flexible instruments to promote the establishment of individualised compliance regimes for companies based on their own characteristics. However, relevant official corporate governance guidelines need to be introduced with the support of the government, as China does not have a market environment as developed as that of the UK.

Secondly, China could learn from the UK's advanced experience and improve the derivative action system in Chinese Company Law and construct a Chinese director disqualification regime. Unlike Chinese legislation which treats the board of shareholders as an absolute authority, the UK's corporate governance rules are based on the concept of enhancing the managerial freedom to drive the company forward in a compliant manner. China's corporate governance regime should place greater emphasis on the role of the board of directors in promoting compliance with corporate governance, and respect the discretion of directors to manage the company while ensuring that they perform their duties properly within an accountability framework. In addition, the UK practice of protecting the public interest and the rights of corporate stakeholders through a director disqualification regime could also be learned from China. Finally, the construction of a criminal compliance regime in China could draw on the compliance incentive model in the BA 2010.

In short, the UK has opted for a flexible and autonomous approach to regulation, relying on market forces to maximise the impact on companies. The UK corporate governance rules follow the internal logic of achieving better corporate governance by maximising the discretion of directors, minimising interference in internal conflicts within the company and focusing on achieving the interests of shareholders while taking into account the interests of other stakeholders. It reflects a balanced protection of the interests of different stakeholders of the company, including shareholders, and achieves a good balance between the different corporate subjects involved in corporate governance issues, which is a valuable experience for China's corporate governance rules that need to check the power of controlling shareholders, give the board of directors greater managerial discretion and enhance the protection of minority shareholders and other stakeholders' rights.

Transplantation is not the same as blindly copying. China's corporate governance reform needs to build a compliance mechanism that is applicable to China and can solve Chinese companies' problems in the Chinese context. It will be discussed in detail in the next chapter how China should draw on the UK experience to reform its own corporate governance system.

Chapter 6: Reforming Corporate Governance Compliance in China

6.1 Introduction

The opportunities and pressures brought by globalisation have created a pressing need for China to address corporate governance issues. In recent years, overseas companies have poured into China to seek new opportunities as foreign investors in Chinese companies. And a good corporate governance compliance landscape is an important indicator for foreign investors to measure whether to invest or not. At the same time, Chinese companies are also breaking the boundaries between countries and going public overseas. To achieve long-term success of the companies, they must align themselves with the international compliance standards.

The UK is one of the countries with the highest and the most complete standards of corporate governance in the world. It is well known that the UK is renowned for its strong investment protection. The summary of the key features and strengths of the UK's corporate governance compliance regimes in the previous chapter shows that the UK values the managerial freedom in promoting the achievement of corporate governance compliance, and that the government is reluctant to intervene coercively in matters within the autonomy of the company, even the criminal enforcement regime serves to incentivise companies to establish compliance regimes in their companies, calling for companies to focus on the quality of their internal corporate structures and then prevent non-compliance by companies.

Compared to the UK, compliance with China's more regulatory-oriented corporate governance laws and regulations has resulted in weaker protection for investors, especially minority shareholders. Strengthening autonomy and weakening coercion should be the direction for the reform of corporate governance compliance rules in China.

A review of the UK's corporate governance compliance system shows that the UK's corporate governance rules focus on the latter, between protecting the interests of investors, especially minority shareholders, and the managerial discretion of the company, following the perception that good corporate governance can be achieved to the greatest extent if the board of directors are free to manage the company.

The effectiveness of any mechanisms cannot be tested without implementation. The construction of China's corporate governance system, because of its late start, is characterised to varying degrees by legal transplants of legal regulations, including the Company Law. However, the difficulty of fully taking into account the unique characteristics of the Chinese judicial environment before transplanting the foreign laws has led to a number of problems for Chinese companies in practice. Some of the extraterritorial experience that have been transplanted in the past has not been successful in China, indicating the need for reform to take into account its own characteristics. China lacks an open and mature market environment compared to the UK, so the design of corporate governance compliance rules should be more focused on the improvement of internal corporate governance structures and the protection of the interests of the minority shareholders.

The Chinese legal system of corporate governance has been designed from the outset to draw on the useful and beneficial experience of UK legislation, and Chinese scholars have been committed to comparative studies of corporate legislation, which demonstrates the trend and hope of aligning China with the high compliance standards of the world. Although there are many differences between the UK and China in terms of historical development, economic environment, judicial system and company share ownership structure, after an in-depth analysis of the UK's corporate governance system, it is believed that China has the basis to adopt the advanced experience that the UK has made for decades to improve corporate governance, which has important references significance for China to re-examine and reform the corporate governance compliance system. As discussed in the previous chapter, the UK's corporate governance system includes not only corporate governance rules, but a number of non-governance rules that require governance changes. This chapter therefore focuses on compliance with and through corporate governance rules and aims to critically analyse the different problems in China's corporate governance compliance rules and to suggest the next steps for reform on this basis.

This chapter proceeds as follows. Section 2 discusses the strong regulation and weak autonomy that characterises China's corporate governance rules and suggests that self-regulation and market-oriented mechanisms should be introduced to guide companies to develop flexible internal compliance regimes that can meet their own needs and bridge the gap between Chinese legislation and corporate practice. And section 3 emphasises that improvements in corporate governance also depend on the internal design of compliance regimes and their effective implementation, and points out that reform of internal compliance regimes in China should focus on the regulation of controlling shareholders. Section 4 points out the insufficient managerial freedom and compliance incentives in Chinese companies and argues that in the Chinese context, motivating directors to comply by limiting shareholder control over directors and increasing directors' managerial discretion is an important way to improve corporate governance in China. Section 5 goes on to discuss the role of civil and criminal enforcement regimes in the corporate governance compliance system, arguing that criminal enforcement regimes provide a greater incentive for corporate compliance than civil enforcement regimes because of their severe deterrents. Section 6 then introduces the pilot reform of Chinese criminal compliance regime and makes relevant recommendations for its future improvement. Finally, section 7 concludes the chapter.

6.2 The case for self-regulation and market-oriented compliance regimes

The key feature of a compliance regime is effectiveness, not just full compliance with the letter of the law. The result of full compliance with the provisions of legislation is likely to be paper compliance, which hardly serves to improve corporate governance in practice.

The UK's corporate governance experience suggests that enacting and relying on a specific set of mandatory legislation to achieve corporate governance is not the only option, but the flexible self-regulation and timely feedback from the market can also achieve the goal of promoting corporate compliance. The role that statutes can play in corporate governance has been questioned as well.[484] Others attribute the success of corporate governance in the UK to the de-involvement of governmental regulation.[485] The UK system of corporate governance compliance is a more market-oriented model. The self-regulatory nature of the UK Code has proven to raise the standards and awareness of corporate governance.[486]

By contrast, China's corporate governance system has evolved along with the reform of SOEs and the rise of private enterprises in the market, in which the government has played a leading role. Although Chinese market-oriented reform has been started from the 1980s and has made great achievements, and a complete corporate governance system has been established under the guidance of the government in China. However, the existing corporate governance system is not perfect, and the government's control of enterprises and the centralised share ownership structure have contributed to a situation of poor performance in corporate governance. The main reason for this is that the current corporate governance system in China gives companies insufficient incentive to comply. In this context, improving market-based mechanisms, weakening government coercion and strengthening market autonomy is one of the important measures to reform China's corporate governance compliance rules.

This section argues that, in order to improve corporate governance, China could learn from the

[484] Christine Parker, *The Open Corporation: Effective Self-regulation and Democracy* (Cambridge University Press 2002).
[485] John C. Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001) 111 The Yale Law Journal 1.
[486] Committee on Corporate Governance: Final Report (Gee Publishing, 1998).

UK's self-regulation in corporate governance, giving companies more managerial autonomy and guiding them to develop internal compliance mechanisms that are flexible and can meet their own needs.

This section focuses on the following issues. Firstly, it should be clear that there is no self-regulation in China of the same nature as in the UK and the regulations that currently exist in the field of corporate governance in China are not real self-regulation. Secondly, this section identifies the shortcomings of current legislative measures in China leading to the need to introduce self-regulation and market-oriented regime. And thirdly, as China's market is not yet sufficiently developed as the UK, China is currently unable to apply self-regulation and a market-oriented regime to corporate governance all at once, relying entirely on market discipline. Instead, China could introduce corporate governance guidelines with the support of the government and the judiciary to gradually guide companies in applying best practices regarding corporate governance. However, the government and judiciary should only play a role in drafting the guidelines and not act as the actual regulator of self-regulation in order to avoid changing the nature of self-regulation in achieving UK's corporate governance compliance.

6.2.1 no self-regulation in current Chinese corporate governance compliance rules

Self-regulation does not exist in current Chinese corporate governance compliance rules. Self-regulation refers to the establishment of a professional mechanism by a group of individuals or organisations to self-regulate their behavioural activities in order to raise the standard of conduct, and voluntarily accept the rules and corresponding obligations.[487] The main characteristics of self-regulation is the absence of any intervention of government.[488] It is claimed that the essence is industry regulating itself.[489] Therefore, certain codes such as those introduced in China cannot be self-regulation in essence, but can only be said to contain

[487] Page (n 193).
[488] Cankar (n 200).
[489] Dignam (n 189).

elements that encourage self-regulation.

Taking the latest versions of the Corporate Governance Code for both countries as a comparison, that is, *Code of Corporate Governance of Listed Companies (2018 Revision)* ("Chinese Code") and *The UK Corporate Governance Code (2018)* ("UK Code"), the differences between the two are obvious. Firstly, in terms of content, the UK Code is made up of five parts, namely, Board leadership and company purpose, Division of responsibilities, Composition, Succession and evaluation, Audit, risk and internal Control and Remuneration. And the Chinese Code issued by the CSRC consists of nine chapters, namely, General Provisions, Shareholders and general meeting of shareholders, Directors and board of directors, Senior executives and corporate incentive and restraint mechanisms, Controlling shareholders and their affiliated parties and listed companies, Institutional shareholders and other relevant institutions, Stakeholders, environment protection and social responsibilities, Information disclosure and transparency and supplementary Provisions. Compared with the UK principle-based guidelines, the Chinese version is more of a restatement and refinement of the provisions of Chinese Company Law and does not leave enough room for companies to adapt themselves to the needs of the company, and the increasingly detailed provisions risk leading to increasingly rigid application by companies in practice. And alternatively, companies may simply choose not to apply the rules because they are too detailed for their own application, ultimately resulting in total non-compliance.

The more elabourate the legislative rules on compliance, the more likely it is that the effect in practice will be contrary to the original spirit of the legislation. Therefore, the development of rules on corporate governance is not to be better to be more detailed and mandatory. Effective compliance requires flexible guidelines that are motivating and encouraging rather than mandatory rules that are completely rigid and make application difficult. In addition, although the Chinese newly revised *Guidelines on the Bylaws of Listed Companies (2022 Revision)* by the CSRC is called "Guidelines", its name does not match the real nature. The essence of self-regulation should not be legally enforceable, and companies should have the power to apply it on their own. The regulations currently issued by China in this field are all legally binding.

Furthermore, as mentioned earlier, the subject of the promulgation and regulation of the Chinese code, the CSRC, is heavily administrative in nature. Non-compliance with the Chinese code by companies can actually lead to serious administrative penalties, which both makes it difficult in practice for companies to choose to apply the provisions of the code in a flexible manner according to their own circumstances, and also alienated self-regulation from corporate practice in China.

6.2.2 legislation versus self-regulation and market-oriented regime

Chinese companies are regulated by uniform legal rules. Chinese corporate governance rules are centred on the Company Law, which uniformly designs a corporate governance structure appliable to both limited LLCs and joint stock companies, ignoring the different needs of companies of different sizes. This can also be interpreted as the Chinese corporate governance model being an artificially created governance model imposed on companies by law rather than a voluntary choice for companies. While there are many problems with these unified rigid regulations, as the UK experience demonstrates from the side the importance of individualised compliance.

Firstly, legislation always has a time lag, and timely feedback from the market cannot be reflected in legislation in real time. The rigid corporate governance rules do not keep up with the needs of the market and cannot lead to good corporate performance. In contrast, the principle of efficiency better served by the operation of market-oriented regimes. Self-regulation helps corporate governance rules to be updated in a timely manner and guides the market participants to comply with the rules more efficiently. A country's judicial and enforcement resources are limited, and the market can help to optimise corporate governance structures.

Secondly, legislation inevitably overlooks the different situations of certain companies, as there is a need for more general application. Rigid rules fail to bring good performance to the companies because they cannot meet the needs of a changing market. A flexible mechanism can compensate for this shortcoming of legislation, as self-regulation can reveal the company's internal governance problems in real time, and the company's internal decisions in this regard can be more responsive to the company's real needs than those of external regulators.

China has a large number of micro, small and medium enterprises ("MSMEs"), and the needs of MSMEs are different from those of large companies. Sometimes, it would be costly for companies of different sizes to follow rigid, uniform rules. And small companies may face higher costs in terms of compliance, as small companies may not need to have very sophisticated compliance mechanisms in place because they have so few internal staff, but the need to meet the mandatory requirements of legislation may lead to additional costs for small companies. In other words, in order to achieve an effective corporate governance compliance regime in China, the needs of companies of all sizes, including MSMEs, need to be catered for. This is why corporate governance system in China requires a mechanism that is flexible and can be adapted to its own circumstances.

Thirdly, more rigid rules are more likely to lead to "paper compliance". For example, there should be no best answer to the question such as how many non-executive directors should be on the board, as each company's board is different in size with different needs. In this case, it is better to offer flexibility set by guidelines than rigid rules. If a company is only interested in fulfilling the compliance requirements on paper, there will be situations where the company has a perfect compliance record but still commits offences. And this would defeat the original purpose and the inherent spirit of making a company compliant. To achieve the goal of a company voluntarily engaging in compliance, it has to demonstrate that acting in compliance can create value for it. And a one-size-fits-all approach is hardly likely to achieve this goal. Directive and prescriptive rules that can lead to adequate consultation of members within the company on corporate matters may work better in practice. In addition to this, transforming the external supervision by the administrative departments into the self-regulation of companies will significantly reduce the costs of governmental regulation. By adopting guidelines, the needs of MSMEs can be kept in mind and, where possible, clearer language can be used to make the application of the rules easier for MSMEs to understand.

It is very important that legislation reflects a response to the changing business environment. At the same time, it is also very difficult due to the lag of the legislation. However, the original intention of the legislation will be realised to a greater extent if market factors can be incorporated into the legislation and at the same time, leaving enough room for judicial discretion to the courts. Moreover, the formal and obscure language of the legislation is difficult for the average person who is not a judicial practitioner or academic scholar to understand, and guiding rules would be beneficial in facilitating implementation. In conclusion, China should develop a more flexible and applicable regime in terms of corporate governance compliance rules that draws on market forces than the current uniform and rigid legislative system.

6.2.3 to sell compliance as a profit not a burden

It is claimed that rules set by the industry internally are more likely to be respected by companies in the sector than regulatory measures set by the government.[490]

Strengthening autonomy and weakening coercion should be the direction for the reform of corporate governance compliance rules in China. As mentioned earlier, compared with self-regulation, the legal provisions of Chinese corporate governance compliance rules focus on regulation and restriction, ignoring guidance and encouragement, showing excessive rigidity and compulsion, and lack of flexibility. Reconstructing a more effective corporate governance compliance system should release more space for corporate governance, give more flexibility to legal norms and regulations and maximise the motivation and creativity of corporate self-

[490] Ben Pettet, *Pettet's Company Law: Company and Capital Markets Law* (3rd edition, 2009) 194.

regulation so as to achieve the best results of corporate governance.

On the other hand, the role played by the government needs to be repositioned. The Chinese government's preference for strict regulation has limited the market's positive role in self-regulation of corporate activities. Then the Chinese government should therefore learn to be less intrusive in corporate activities and shift its role in corporate governance from that of a rule maker and regulator to a facilitator of rule enforcement, which will be more conducive to the full play of market-oriented regimes. Given the increasingly individualised needs of companies for compliance regimes, it will be more beneficial for companies to achieve compliance if the government is to take responsibility for facilitating compliance enforcement rather than setting uniform mandatory rules on compliance.

However, the UK has adopted self-regulation because it has a highly developed market environment. And a flexible regime allows the industries to regulate themselves to their fullest extent and to mobilise the self-motivation of companies. As it was pointed out, the decentralisation of shareholdings, an honest external market and sophisticated market incentives are the necessary conditions for the common law model of corporate governance.[491] China, on the other hand, differs from the UK model in all these respects. The successful implementation of the UK Code has been aided by a mature market. By contrast, China does not have such a mature market which has not yet developed to effectively advance corporate governance in China,[492] and this is the main reason why the UK model cannot be directly applied in China. And for an imperfectly developed market, it is essential to apply mandatory legislative rules to regulate the activities of companies.[493]

The stock market in China is dominated by state-owned listed companies and is subject to strict constraints.[494] In addition, SOEs and MSMEs, which make up the majority of Chinese

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491 Philip A. Wellner, 'Effective Compliance Programs and Corporate Criminal Prosecutions' (2005) 27 Cardozo Law Review 497.
492 Tan and Wang (n 381).
493 Ngozi Vivian Okoye, *Behavioural Risks in Corporate Governance: Regulatory Intervention As a Risk Management Mechanism* (Routledge, 2015) 208.
494 Ding Chen, *Corporate Governance, Enforcement and Financial development: The Chinese Experience* (Edward Elgar, 2013).

companies, do not have the theoretical and empirical basis for the separation of ownership and management. The complete adoption of self-regulation of soft nature would probably result in companies not implementing it at all, while a uniform policy for all industries would ignore the different needs of different companies in reality, perhaps resulting in rigidity in application and adding unnecessary costs to companies as well. Therefore, China could learn from the UK practice in this regard and try to introduce a corporate governance code centred on a "comply or explain" regime as a supplementary tool for companies to establish compliance regimes and use market forces to drive companies to comply on their own.

Therefore, the reform of corporate governance compliance system in China should be localised. And the design of this system should focus on how to provide incentives for companies to promote voluntary compliance. Although China has not yet achieved the exact same mature market environment as the UK, judging from the laws and regulations promulgated by China, the judicial environment and prerequisites for the introduction of a soft law regime are already in place in China. In this regard, China should abandon the fully unified one-size-fits-all model and try to introduce self-regulation and market-oriented regimes to corporate governance rules, shifting the focus from the complete legislative regulation and government supervision to corporate self-regulation in conjunction with market deployment, with the government or authorities issuing corporate governance guidelines with "comply or explain" regime as the central feature to help companies establish a compliance regime to improve corporate governance, while reducing legislative and judicial intervention in corporate governance compliance. This will, on the one hand, ensure that China's goal of achieving corporate governance compliance will not be defeated by the inability to ensure timely feedback from the market, and on the other hand, companies will be free to choose the best approach for their development and allow them to make appropriate and flexible adjustments to legislative provisions in practice according to their own circumstances, which will facilitate the realisation of the value of efficiency first.

As in the UK, the voluntary codes of best practice are regarded as tools to encourage corporate self-regulation to improve corporate behaviour. In terms of the UK Code, the enforcement of self-regulation would be left to a specialised committee in the market. In this regard, the optimal choice of China should be the CSRC, which is responsible for making rules and recommendations on the conduct and activities of internal members in the securities market. With regard to the corporate governance code issued by the CSRC, specific measures should include the following points.

Firstly, the subject of the compliance obligation is not clear in the Chinese corporate governance rules. It is recommended that the compliance obligations of companies should be explicitly stipulated in the Chinese Company Law and given to the board of directors who will be responsible for reporting on the company's compliance and non-compliance at the annual general meeting and in the company's annual report. And then the task of introducing specific corporate governance guidelines should be handed over to the CSRC. However, the CSRC should develop a truly self-regulatory corporate governance code for listed companies, and learn from the "comply or explain" regime of the UK experience, that is, if a company does not comply with the relevant provisions of the code, it is only required to provide explanations and reasons for doing so. In addition, as directors and management in China are in most cases entirely subject to the company's majority or controlling shareholder, in order to prevent them from influencing the statement of compliance, companies could also be required to submit the explanation provided to the CSRC as well.

Secondly, the specific content of the code may consist of three parts. The first part covers the ways in which the legislature and the judiciary have concluded in practice that they consider conducive to the achievement of good corporate governance by adopting a principle-based approach. The second part should provide a detailed explanation under each principle, focusing on the spirit inherent in that principle. And the third part provides relevant guiding cases in the form of appendices, the most appropriate being those issued by the Supreme Court. The board of directors is required to comply with the guidelines in the day-to-day running of the company or to state the reasons for any non-compliance in the company's general meeting or annual report, and be open to be questioned by shareholders.

Thirdly, self-regulation and market-oriented mechanisms could be considered for application first in a few sectors that are already well developed. For example, the securities sector and the banking sector. It is advisable to gradually promote the piloting of corporate governance code in China according to the characteristics of each sector. The regulator could start with compliance regulation for the financial sector and listed companies, promote the establishment of compliance systems for SOEs and listed companies, and guide these large companies to comply first by issuing compliance guidelines. In addition to this, China should also explore the compliance paths for MSMEs, allowing them to streamline their compliance procedures under the *Measures for the Compliance Construction, Evaluation and Examination of Enterprises Involved in Criminal Cases*.[495]

Finally, in terms of the UK's institutional design, the keys of the market-based regime are the statement of compliance and the explanations for non-compliance. An explanation with good quality is also a way of complying with the Code. However, judging from the data already published in the UK, it appears that tick-box compliance that is fully consistent with the requirements of the Code will be the mainstream.[496] According to the *Improving the quality of 'comply or explain' reporting* published by the FRC in 2021, companies in practice are more inclined to boilerplate explanations with poor quality. How to ensure the good quality of the explanations is therefore the key to ensuring that the market-oriented regimes work effectively.

China could learn from the UK approach to issue official guidelines in this regard to avoid boilerplate explanations provided by the companies. Any explanation of the alternative arrangements that is in line with the spirit of the code should provide sufficient clarity so that shareholders can evaluate to the fullest extent. Specifically, the explanation provided by the company should cover: (1) the specific provision of the code from which the company has

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[495] Measures for the Compliance Construction, Evaluation and Examination of Enterprises Involved in Criminal Cases (2022), article 17.

[496] See FRC, *Review of Corporate Governance Reporting* (November 2020).

chosen to depart from; (2) the reasons why the company has chosen such an arrangement to manage the company and for not complying with the provisions of the code; (3) the positive or negative impact of such a departure on the company's operations, and (4) whether the company's non-compliance is a temporary arrangement. Besides, the explanations in the annual report are for shareholders to evaluate. If shareholders are not convinced, they should be allowed to ask the board to explain to them the reasons for the deviation. For corporate governance, full compliance with the code may not necessarily lead to the best corporate governance, but the more comprehensive the explanations, the better corporate governance will be.

Once the design of the system has been completed, the following issue that needs to be addressed is the implementation of the regimes. Any mechanism for non-compliance that lacks penalties runs the risk of being ineffective. In addition to the legislation and governmental regulation, the enforcement of the code should be left to the market. Shareholders will easily be able to distinguish the companies with poor compliance and companies with good compliance and decide the next investments accordingly. On the one hand, the market will reward companies for their autonomous governance behaviour and companies with good compliance will receive more inward investment from the market. On the other hand, improved corporate governance will, in turn, increase the market value of the company. Only such mechanisms, which are both consistent with the company's own values and beneficial to its value enhancement, will give the company sufficient incentive to comply.

To summarise, such self-regulation and market-oriented regimes can help China sell compliance as a profit not a burden, whereas compliance with rigid rules means that companies are forced to choose to be compliant rather than actively trying to be compliant. As has been argued, compliance with rules should not in itself be a criterion for assessing a company's compliance, as it implies that the company acts passively as a recipient of rules for certain behaviour, rather than subjectively as an active and responsible citizen.[497] However, the self-

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[497] Parker (n 484).

regulation and market-oriented compliance regime also have their own drawbacks in corporate governance. The main criticism has focused on the effectiveness of enforcement. This section argues that self-regulation and market-oriented compliance regime alone are not sufficient enough for the Chinese corporate governance compliance system, and that the gap in corporate governance rules related to self-regulatory rules with soft law nature needs to be filled by some hard instruments.

6.3 The role of internal compliance mechanism in corporations

Corporate compliance requires not only compliance with external regulations, but also the establishment of detailed internal mechanisms to enforce those regulations. While the role of the market can incentivise companies to take the initiative to comply based on market pressures, the improvements of corporate governance ultimately rely on companies to design internal compliance mechanism and ensure its effective implementation. A combination of internal mechanisms and external regulation can make compliance more effective.

In China, the legal design of the internal mechanism of corporate governance within companies adopts the concept of separation of powers and checks and balances. In terms of the provisions of the Chinese Company Law, there are four different statutory bodies within the company, namely the board of shareholders, the board of directors, the supervisory board and managers, exercising different statutory powers and responsibilities, cooperating with each other and exercising mutual checks and balances. Chinese companies, however, do not achieve good corporate governance compliance results. The main internal cause of the failure of corporate governance in China is the lack of compliance motivation of all four major bodies, which can be attributed to the effective control of Chinese companies by controlling shareholders.

This section first points out that the reason why the current internal compliance mechanisms of Chinese companies are not effective is that the internal bodies of the companies are all under the influence of the controlling shareholders, thus resulting in low motivation for compliance.

It then proposes recommendations for reforming the internal governance compliance mechanisms of Chinese companies from the perspective of how different entities can free from the influence of controlling shareholders.

6.3.1 the influence of controlling shareholders on the internal compliance mechanism of Chinese companies

In the context of highly concentrated share ownership structure in Chinese companies, the conflict between controlling shareholders and minority shareholders serves as the most important agency conflict in the company, and most of the problems in the internal mechanism of corporate governance in China also originate from the controlling shareholders of the company. It has been pointed out that most of the corporate scandals and violations of law in listed companies are related to excessive control and abuse of power by controlling shareholders.[498] The manipulation of companies by controlling shareholders to the detriment of the legitimate rights and interests of minority shareholders and investors is widespread in the Chinese securities market. Hence, the powers and obligations of controlling shareholders should least be ignored by the Chinese corporate legislation. However, the Chinese Company Law is almost completely silent on the provisions of controlling shareholders.

Firstly, the management of Chinese companies lack the incentive to comply because they are controlled by the controlling shareholders. Although the highest powerful authority of the Chinese company should by law be the board of shareholders, in corporate practice it has been replaced by the controlling shareholders. And the actions of the board of directors and management of Chinese companies, in effect the actions of directors and managers, are largely subject to the controlling shareholders. The controlling shareholders with majority shareholding and majority voting rights control the appointment and removal of the directors and management and the decision-making power on major issues of the company by virtue of the majority rule. The directors and managers of the company are thus effectively representatives

[498] Zhao (n 277).

of the controlling shareholders and do not have de facto independence. Naturally, the board of directors and management lack the conditions and motivation to perform their duties in order to promote corporate compliance.

Secondly, the supervisory board of Chinese companies also plays a very limited role in corporate governance due to the influence of the controlling shareholders. The supervisory board, as the supervisory body of the company, monitors the conduct of directors and mangers in the execution of their duties on behalf of the shareholders and can also propose the dismissal of directors and managers who have committed irregularities. However, the supervisory board has not achieved the desired effect in Chinese corporate governance practice. Its decorative role within the company has been widely criticised by Chinese academics, and some have even emerged to advocate the abolition of the supervisory board regime.[499] The main reason for the difficulty in making the supervisory board effective in corporate governance is that it is in fact also subordinate to the board of shareholders in Chinese companies. The supervisory board is influenced by the controlling shareholders and loses its independence as a supervisory body. Under the Chinese Company Law, the supervisory board is elected and replaced by the board of shareholders, while the board of directors decides on its remuneration. As a result of this set-up, the supervisory board essentially represents the views of the shareholders and cannot and will not perform its duties independently to monitor the actions of the management, thus making it more difficult to protect the interests of minority shareholders and the company.

In addition, although the supervisory board is responsible for monitoring the conduct of directors and managers in the performance of their duties in the company, this is essentially an ex post facto passive monitoring mechanism. In practice, the supervisory board in Chinese companies are rarely involved in the day-to-day management of the company and are unable to influence the decision-making process of the company, which weakens the effectiveness of their

[499] See Shaoxia Shi(石少侠), (我国新《公司法》中的公司治理结构)'Corporate Governance in the New Corporation Law of China' (2007) 21 Contemporary Law Review 3; Peizhong Gan(甘培忠), (论完善我国上市公司治理结构中的监事制度)'Improving the Supervisory System in the Corporate Governance Structure of Chinese Listed Companies' (2001) 5 China Legal Science 74 and Wei Cai(蔡伟), (公司内部监督责任体系的困境:基于对监事的再考察)'The Dilemma of Corporate Internal Supervisory System: Based on the Re-examination of Supervisors' (2018) 30 Peking University Law Journal 1656.

oversight of the company's affairs. The ex post supervision also means that it is difficult for the supervisory board to provide guidance or incentives to the company's directors and management to perform their duties in a compliant manner and to prevent irregularities from occurring.

Thirdly, independent directors are also not immune from the influence of controlling shareholders. It was the inefficiency of the supervisory board in performing its duties that led to the introduction of independent directors in China in 2001. The purpose of introducing independent directors was to allow them to perform their supervisory function and safeguard the interests of the company as a whole, and especially those of minority shareholders. Instead of essentially changing the dilemma of internal corporate governance in China, the introduction of independent directors has created a number of new problems. The main reason is still that independent directors have failed to break away from the control of controlling shareholders. Independent directors of Chinese companies often have very close personal relationships with controlling shareholders, which undermines their independence as external supervisors.

Further, the division of responsibilities between the supervisory board and independent directors of Chinese companies is unclear, and independent directors, as "part-timers" of the company, have more limited opportunities and ability to participate in corporate governance than the company's supervisors. The introduction of independent directors also highlights the fact that China's approach to reform is to improve the efficiency of corporate governance by increasing the number of governance bodies, rather than optimising and improving the internal governance mechanisms of the company itself. By contrast, the UK experience shows that companies can function effectively even without a supervisory board. Why? The independence of the supervisory body should be the basis for the effective functioning of the supervisory mechanism. For example, the number of supervisory bodies is not the key to solving the problem, it is the ability of the supervisory body to maintain its independence that is the key to the effective functioning of the company's internal supervisory mechanism. The inability to maintain independence from the influence of controlling shareholders is the essential reason affecting the inability of the supervisory board and independent directors to effectively monitor management's compliance in managing the company.

Finally, controlling shareholders can easily use their dominant position to infringe on the interests of minority shareholders of Chinese companies. The inability of the company's board of directors, supervisory board and managers to form checks and balances with the controlling shareholder exacerbates the potential for the interests of the company's minority shareholders to be compromised.

It is clear from the above discussion that the effectiveness and standards of internal corporate governance in China depend to a large extent on the responsibility of the controlling shareholders rather than on the governance rules and structures pre-designed by the Company Law. In other words, compliance in fact depends fundamentally on the will of the controlling shareholders and how well he or she complies with the established legal rules.

Therefore, in order to reform the internal compliance mechanism within Chinese companies, the main issue that should be focused on is the regulations on controlling shareholders. On the one hand, the abuse of power by controlling shareholders should be restrained and controlled, while on the other hand, the improvement of the functions and powers of other corporate governance bodies should be designed in such a way as to create checks and balances on the controlling shareholders.

6.3.2 reforming the role of controlling shareholders

The core of reforming the internal compliance regimes of Chinese companies is to revisit the role of controlling shareholders in the internal governance of the company. The internal mechanisms of the company can constrain and regulate the behaviour of controlling shareholders and impose fiduciary obligations on them as a compliance incentive to reduce the influence of controlling shareholders on other governance entities.

6.3.2.1 controlling shareholders as the centre of regulation

Reforming the internal compliance mechanisms of Chinese companies requires releasing the incentive for the board of directors and the supervisory board to perform their functions in a compliant manner, while protecting the interests of the company's minority shareholders. This begins with regulating the behaviour of the controlling shareholders.

The role played by controlling shareholders in corporate governance can be either positive or negative. On the one hand, by establishing the principle of voting rights and majority rule, China has legislatively facilitated the exercise of rights by controlling shareholders. Based on their dominant position in the company, controlling shareholders can help the company to formulate and implement the business policies that are beneficial to the company's development, but on the other hand, controlling shareholders can also infringe on the interests of other participants in the company by virtue of their large percentage of voting rights. A controlling shareholder can serve the interests of the company and all other shareholders with its own advantages based on legitimate purposes, or it can seek undue benefits for itself at the expense of the company and others based on improper purposes.

The controlling shareholders effectively hold control of the operation of the Chinese companies, and the management and supervision of the internal affairs of the company are largely controlled by the controlling shareholders. Since most corporate governance problems in Chinese companies are caused by controlling shareholders, reform of the company's internal compliance regimes should also be based on the regulation of controlling shareholders. A study of UK corporate governance rules also reveals that China should not only learn from the UK experience but also consider the actual situation of Chinese corporate governance when reconstructing its corporate governance compliance regimes. Unlike the UK where agency problems are conflicts between shareholders and management and there are few special rules for controlling shareholders, the Chinese corporate governance compliance regime should be designed with the controlling shareholder as the centre of regulation.

6.3.2.2 fiduciary duties of controlling shareholders

Currently, there are only two provisions in the Chinese Company Law regarding controlling shareholders, one being article 21 and the other being an explanation of the concept of controlling shareholders located in a supplementary provision.[500] Article 21 of the Company Law not only prohibits, in a cursory manner, controlling shareholders and actual controllers of a company from using their affiliation to the detriment of the company's interests, but also does not further stipulate the legal consequences of a violation of this article by controlling shareholders.

The Chinese Company Law should require controlling shareholders to own fiduciary duties to the company and other shareholders.

Traditional company law holds that fiduciary duties bind directors in their actions and that there should be no special obligations between shareholders other than the obligation to contribute capital. When a shareholder exercises his or her voting rights as a shareholder, it is entirely permissible to consider only his or her own interests to the exclusion of the interests of other shareholders.[501] However, although the traditional company law theory does not involve the setting of the fiduciary duties to shareholders, with the expansion of the power of controlling shareholders, the violation of the rights and interests of the minority shareholders continue to occur. Coupled with the fact that it is the controlling shareholders who truly holds the power of management in Chinese companies, many scholars have argued that it is reasonable to impose

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[500] Company Law 2018, article 216 (2). A "controlling shareholder" refers to a shareholder whose capital contribution occupies 50% or more in the total capital of a limited liability company or a shareholder whose stocks occupies more than 50% of the total equity stocks of a joint stock limited company or a shareholder whose capital contribution or proportion of stock is less than 50% but who enjoys a voting rights according to its capital contribution or the stocks it holds is large enough to impose a big impact upon the resolution of the shareholders' meeting or the shareholders' assembly.

[501] Zipora Cohen, 'Fiduciary Duties of Controlling Shareholders: A Comparative View' (1991) 12 University of Pennsylvania Journal of International Business Law 379.

a fiduciary duty on the controlling shareholder to balance its relationship with minority shareholders.[502] And it is also noted that where controlling shareholders effectively control the management of the business and act as directors, the relationship between the controlling shareholders and the minority shareholders can be analogous to the relationship between the directors and the minority shareholders, and therefore the fiduciary duty needs to be extended to the relationship between controlling shareholder and the company.[503]

English law does not impose fiduciary duties on controlling shareholders, but seeks relief primarily through ex post equitable judicial review, like unfair prejudice remedy.[504] However, the UK imposes restrictions on the exercise of voting rights by majority shareholders in two circumstances: (1) when the resolution of the company involves a change in the memorandum and articles of association of the company. The power of the majority shareholder is subject not only to the limitations imposed by statute law but also to the rules of equity established by case law. English case law asserts that a majority shareholder may only change the memorandum of association if it is acting in good faith in the interests of the company as a whole; (2) the majority shareholder must not act in a way that constitutes a fraud on minority shareholders, including the exploitation of minority shareholders' rights.[505]

Unlike the UK, US law imposes fiduciary duties on controlling shareholders to ensure that they control the company on a fair, just and equitable basis.[506] Controlling shareholders are subject to an entire fairness review to prove that they have not breached their fiduciary duties.

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502 See Lawrence E. Mitchell, 'The Death of Fiduciary Duty in Close Corporations' (1990) 138 University of Pennsylvania Law Review 1675; Iman Anabtawi and Lynn Stout, 'Fiduciary Duties for Activist Shareholders' (2008)60 Stanford Law Review 1255; Zhao (n 228); Xuewen Zhang(张学文), (封闭式公司中的股东信义义务:原理与规则)'Shareholder Fiduciary Duties in Closed Companies: Principles and Rules' (2010) 22 Peking University Law Journal 262; Jianing Zheng and Lingjie Wang(郑佳宁, 王凌杰), (有限公司控股股东信义义务的适用)'Application of Fiduciary Duty of the Controlling Shareholders of Limited Company' (2022) 4 Business and Economic Law Review 39 and Jianwen Wang(王建文), (论我国构建控制股东信义义务的依据与路径)'On the Basis and Path of Introducing Fiduciary Duty of Controlling Shareholders in China' (2020) 1 Journal of Comparative Law 93.

503 A. Patricia Houlihan, 'Corporate Law' (1981) 30 Drake Law Review 679.

504 Leon Anidjar, 'A Macro-level Investigation of Transatlantic Controlling Shareholder's Fiduciary Duties' (2022) 42 Legal Studies 185.

505 Cohen (n 501).

506 See Anidjar (n 504) and Ernest Lim, 'Controlling shareholders and Fiduciary Duties in Asia' (2018) 18 Journal of Corporate Law Studies 113.

In China, as in the UK, fiduciary duties are imposed on the directors of the company, rather than the controlling shareholders. The general bearers of fiduciary duties in Chinese companies are directors, managers and other senior management. This may be related to the fact that many Chinese corporate regulations have been borrowed from the UK corporate system, even though there are many differences in the characteristics of companies in the two countries. However, given the dominant position of controlling shareholders in Chinese companies, failure to impose statutory obligations on them would result in an inability to hold them accountable. This also highlights the need to incorporate the unique features of the legal system of one jurisdiction when transplanting from another.

The inevitable conflict of interest between controlling shareholders and the company and other corporate participants is considered to be the root cause of the fiduciary duties on controlling shareholders.[507] Imposing fiduciary duties on controlling shareholders can effectively restrain their self-interested behaviour. The imposition of fiduciary duties on controlling shareholders is also considered to be an ex ante mechanism used by companies with concentrated share ownership structure to prevent personal gains at the expense of minority shareholders.[508] In order to better protect the rights and interests of minority shareholders in Chinese companies and to prevent controlling shareholders from taking advantage of their dominant position to abuse their power, the fiduciary duties of controlling shareholders in Chinese companies should not only be owed to the company, but also to other shareholders, especially minority shareholders.

There are currently a number of provisions in China's departmental regulations that impose restrictions on the conduct of controlling shareholders. For example, article 7 of *Measures for the Administration of the Takeover of Listed Companies* (2020) prohibits the controlling shareholders in effective control of the company from abusing the rights of shareholders.[509]

[507] Wang (n 502).
[508] Anidjar (n 504).
[509] "No controlling shareholder or actual controller of a target company may misuse the stockholder's rights thereof to damage the lawful rights and interests of the target company or any other shareholder".

And article 40(2) of the *Guidelines on the Articles of Association of Listed Companies* (2022)[510] and article 63 of the *Code on Governance of Listed Companies* (2018)[511] has also clearly stipulated that the controlling shareholders of a listed company have fiduciary duties to the company. However, the current provisions are of a lower legal rank, broadly described and do not provide strong protection to the company's minority shareholders. Therefore, the fiduciary duties of controlling shareholders should be formally introduced into the Chinese Company Law in order to address the lack of regulation of those subjects in Chinese companies that truly enjoy control over the company.

In addition, the fiduciary duties of controlling shareholders mean that the controlling shareholders need to consider the interests of other shareholders and the company as a whole when exercising their powers.[512] The fiduciary duties of the controlling shareholders should be distinguished from the fiduciary duties of the directors. The former focuses on the fact that the controlling shareholders, as investors and owners of the company, should be obliged to the interests of the other shareholders in the company, especially the minority shareholders, while the latter mainly refers to the directors, as fiduciaries of the company, should be obliged to the interests of the company. Specifically, fiduciary duties include the duty of care and the duty of loyalty.[513] The former refers to the controlling shareholder's prudent attitude in the conduct of the company's affairs, while the latter requires the controlling shareholder to act in the interests of the company and other shareholders as a whole and not to act in a manner that is prejudicial to the legitimate interests of the company and its other shareholders for personal gain.[514]

Finally, the liability of the controlling shareholders in the event of a breach of fiduciary duty should be clearly defined. Article 20 of the Company Law of China only provides for the

[510] "The controlling shareholder or actual controller of the Company shall have a duty of good faith to the Company and the holders of the publicly traded shares of the Company".
[511] "A controlling shareholder or actual controller shall assume fiduciary duty for the listed company and other shareholders".
[512] Ciyun Zhu, 'A Critical Analysis of the Majority Rule Principle and Controlling Shareholders' Fiduciary Duties: A Chinese Perspective' (2004) 16 Australian Journal of Corporate Law 248.
[513] Tiantao Shi(施天涛), (公司治理中的宪制主义)'Constitutionalism in Corporate Governance' (2018) 4 China Law Review 89, 104.
[514] Anabtawi and Stout (n 502) 1262, 1265.

liability of shareholders of the company in principle, and there are no specific provisions for controlling shareholders. It is proposed that the Company Law should establish a mechanism for holding controlling shareholders liable and clarifies the liability for damages in the event of abuse of voting rights and other powers by controlling shareholders.

The ability of controlling shareholders to function in an internal mechanism conducive to corporate governance depends on the design and implementation of the company's internal compliance mechanism. It is also because the majority or controlling shareholder is in a favourable position in corporate governance through the majority rule that the law should not only establish a reasonable system of internal checks and balances to restrain the behaviour of controlling shareholders, but also enhance the company's incentive to comply by giving the company's board more managerial freedom and independence of supervisory bodies, while also enhancing the protection of minority shareholders.

The reminders of this section therefore focus on reform proposals regarding the reform of the supervisory board and independent directors, as well as the protection of minority shareholders, with a closer discussion of the board's compliance incentives and restraints in section 4 of this chapter.

6.3.3 reform of the supervisory board and independent director system

Corporate compliance cannot be achieved without the efforts of supervisory bodies. The design of the supervisory mechanism is an important part of building the company's internal compliance mechanism. Supervisors need to judge whether decisions made by the board of directors and management within the company comply with laws and regulations and whether they have been properly and appropriately implemented. As the supervisory body of the company established by the Company Law, the supervisory board of a Chinese company is obliged to supervise the board of directors and management to ensure that they perform their duties in a compliant manner. Although the Chinese Company Law does not yet provide for the performance of the supervisory board's compliance supervision duties, the CSRC has required the supervisory board of securities and funds business institution to supervise the performance of compliance management duties by directors and senior managers,[515] and has the power to propose the dismissal of directors and senior managers who are primarily responsible for or have leadership responsibility for the occurrence of significant compliance risks.[516]

As mentioned earlier, there have been many voices in China calling for the abolition of the supervisory board system. After all, not all corporate governance systems have to include a supervisory board. In the UK companies, for example, the directors take on the responsibility of supervising the management. In addition to the dual functions of decision implementation and supervision by the board of directors within the company, the UK also has a highly developed securities market as external supervision and there is no need for a separate supervisory board apart from the board of shareholders and the board of directors. However, it is clear from the provisions of the Draft of Company Law of the People's Republic of China ("Company Law Draft") and the Civil Code that the legislator is determined to retain the supervisory board.[517] Based on this premise, the fundamental issue that needs to be addressed in order to maximise the role that the supervisory board should play in corporate governance is to free it from the control of the controlling shareholders and to achieve independence of the its position in order to make it more motivated and impartial in monitoring the directors and management. Therefore, specific reform proposals are as follows.

Firstly, addressing the issue of controlling shareholders' control over the election of supervisors is a prerequisite for dealing with other issues relating to the independence of the supervisory board. The supervisory board, in line with the board of directors, is elected by the board of shareholders, so it is usually also under the control of the majority or controlling shareholders.

Secondly, the power of the supervisory board to know the internal information of the company

[515] Compliance Management Measures for Securities Firms and Securities Investment Fund Management Companies (2020), article 8(1).
[516] Ibid, article 8(2).
[517] See the Company Law Draft 2021, article 76, 130 and Civil Code 2020, article 82.

should be strengthened. The basis for the supervisory powers of the supervisory board is its access to information about the company's management. Although it is the obligation of the board of directors and senior managers to provide the supervisory board with information about the company,[518] and the supervisory board can also conduct an investigation when it finds abnormalities in the company's business conditions.[519] However, in Chinese companies where the majority or controlling shareholders control the board and management, it is difficult for the supervisory board to effectively supervise the board of directors and the information provided by the board of directors is likely to be information that has been agreed by the shareholders.

An effective way to solve this problem is to bypass the control of the board of directors and controlling shareholders and allow the information to go directly to the supervisory board. The CSRC requires the securities and fund operators to set up a compliance officer in place, who will report to the board of directors and the principal person in charge of management on the compliance status of the operation and management.[520] The compliance management system construction plan drawn up by the managers of the central enterprises is also required to be approved by the board of directors before it can be organised and implemented.[521] In this regard, it is proposed that the Company Law in China should also require that the subject of a company with an obligation to report on the company's operations also has an obligation to report to the supervisory board in addition to the board of directors. If the supervisory board disagrees with the report, it should be allowed to question the board of directors and be given the power to dismiss the company's compliance officer.

6.3.4 enhancing the protection of minority shareholders

The internal compliance regimes of Chinese companies should also focus on protecting the

[518] Company Law 2018, article 150 (2).
[519] Ibid, article 54.
[520] Compliance Management Measures for Securities Firms and Securities Investment Fund Management Companies (2020), article 15(1).
[521] Measures for the Compliance Management of Central Enterprises (2022), article 9(1).

interests of minority shareholders. The protection of the interests of minority shareholders requires not only rules on the conduct of controlling shareholders, but also providing opportunities for minority shareholders whose interests have been damaged to seek remedies. And the existing company legal norms in China provide insufficient protection for them.

At present, the remedies provided by Chinese Company Law to minority shareholders are mainly as follows.

First, to broaden and increase the channels and opportunities for minority shareholders to participate in corporate resolutions. At present, Chinese Company Law only grants minority shareholders the right to make suggestions or raise questions about the business operation of the company.[522] It is proposed to increase the right of minority shareholders to make formal proposals on the operation of the company. Secondly, the right of shareholders to request the company to purchase their stock rights. However, only three situations are covered: (1) when the company does not distribute profits to shareholders for five consecutive years and the company has made profits continuously for those five years and meets the conditions for distributing profits; (2) when the company merges, separates or transfers its main property; (3) when the business term stipulated in the articles of association expires or other reasons for dissolution stipulated in the articles of association arise and the board of shareholders amends the articles of association by resolution to make the company exist continuously.[523]

However, the above rights applicable to minority shareholders are in fact not set out for minority shareholders alone, but are included in the rights of other shareholders in general. Moreover, in practice, it is difficult for minority shareholders to participate in the management of the company because of the majority rule and the control of the controlling shareholders.

Accordingly, articles 151 and 152[524] of the Companies Law therefore provide for derivative

[522] Company Law 2018, article 97.
[523] Ibid, article 74.
[524] "If any director or senior manager damages the shareholders' interests by violating any law, administrative regulation, or the bylaw, the shareholders may lodge a lawsuit in the people's court".

rights and direct action rights for shareholders respectively. The following focuses on the reform of derivative actions in China.

When a company is fully controlled by insiders such as controlling shareholders, it will be almost impossible for the company to be held liable for the infringement, let alone the rights and interests of other investors. In response to the situation where a company insider infringes the interests of the company but the company fails to pursue its liability, article 151 of the Company Law stipulates the relevant content of derivative actions with restrictions on the percentage of shareholding, the duration of the shareholding and the performance of internal remedies.

There are a number of differences between the Chinese legislation and provisions in other jurisdictions.

Firstly, high standing requirement. A distinction is made between LLCs and joint stock companies in respect of plaintiffs. Shareholders of the limited liability company are entitled to bring derivative actions, regardless of their shareholding. While a shareholder of a joint stock company must hold at least one percent of the company's shares, individually or in the aggregate, for at least 180 consecutive days as the subject of the action. Although the provision is intended to prevent frivolous litigation, the strict standing requirement is highly detrimental to the protection of the interests of minority shareholders, because it is very difficult for them to meet the requirement of holding 1% of the company's equity. Excessive restrictions on the eligibility of plaintiffs will not be conducive to the protection of the interests of the minority shareholders. Therefore, after analysing the derivative actions brought by shareholders in Chinese practice, some scholars found that the vast majority of derivative actions in China are applied to LLCs.[525]

[525] Donald C. Clarke and Nicholas C. Howson, 'Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China' in Dan W. Puchniak, Harald Baum and Michael Ewing-Chow(eds) *The Derivative Action in Asia: A Comparison and Functional Approach* (Cambridge University Press, 2012).

Secondly, in addition to the possibility for shareholders to bring derivative actions against directors and senior management for non-compliance, the Company Law in China also allows shareholders to bring actions against "others who infringe upon the legitimate rights and interests of the company and cause damage to the company" ("others")[526]. As the Company Law does not further define "others", there is potential for causing confusion in practice. The "others" here should be further defined in the legislation to include the controlling shareholders, who may bring a lawsuit in the people's court for the benefit of the company against the controlling shareholders for infringing the legitimate rights and interests of the company and causing damage to the company. This would give minority shareholders the opportunity to free from the controlling shareholders' control of the company, as the company is likely to refuse to file a lawsuit outright due to the controlling shareholders' manipulation.

Thirdly, in order to prevent shareholders from abusing the derivative actions, the procedure for exhausting internal remedies for derivative actions is premised on the same principles as in other countries. As noted before, the difference is that Chinese Company Law requires shareholders to request in writing the supervisory board or the supervisor of the limited liability company with no supervisory board to initiate a lawsuit in the people's court for infringement by directors, and to request in writing the board of directors or the executive director of the limited liability company with no board of directors to lodge an action in the people's court for infringement by supervisors. The reason for this is to respect the company's right to autonomy. If the company is willing to exercise the right of action by itself, then the shareholders should respect the company's decision. However, if the controlling shareholder has full control over the board of directors and the supervisory board, the company may simply reject the shareholder's request.

There are three circumstances in which a shareholder may bring a derivative action directly: (1) the supervisory board, or supervisor of a limited liability company with no supervisory board, or board of directors or executive directors refuses to lodge a lawsuit after receiving a written

[526] Company Law 2018, article 151 (3).

request; (2) they fail to initiate a lawsuit within 30 days after receiving the request; (3) in an emergency, the failure to lodge an action immediately will cause unrecoverable damages to the interests of the company. These circumstances were designed to protect the minorities from filing derivative actions in a timely manner, but the lack of uniform criteria and standard for reasons of the company's refusal has resulted in a situation where a shareholder can file a derivative action directly, bypassing the company, as long as the company refuses or fails to respond, not to mention in urgent situations. In addition, the litigation incentives under this mechanism are insufficient. Since the proceeds of a derivative lawsuit belong directly to the company, the shareholders filing the lawsuit can only benefit indirectly through their shareholding in the company, so many minority shareholders prefer to sell their shares rather than bringing a derivative action. Especially in a joint stock company with a dispersed shareholding, the benefits of filing a lawsuit may be out of balance with the cost in time and money.

The following suggestions for improvement are made in response to the above noted issues.

Firstly, the threshold requirements for shareholders of a joint stock company to bring derivative claims should be lowered. It is suggested that China should draw on the provisions of the CA 2006 in the UK regarding derivative actions, whereby the court is responsible for examining the eligibility of shareholders as plaintiffs. That is, the plaintiff is required to disclose a prima facie case for applying the court's permission.[527] If the court is satisfied that the plaintiff is qualified to bring a derivative action, it should grant permission and continue the claim; otherwise, the action should be refused and dismissed.

Secondly, there is a need to clarify the standards for the board of directors or supervisory board to refuse to file a lawsuit and the "urgent situations" in order to improve the binding force of company decisions on shareholders. Specifically, the circumstances in which the board of directors or the supervisory board deliberately delay or obstruct shareholders from filing a

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[527] CA 2006, pt 11, article 261.

lawsuit, as well as "urgent situations", should be clearly enumerated and the responsibilities of directors and supervisors should be defined as well.

Thirdly, it should be clarified that shareholders can file derivative lawsuits against insiders such as large shareholders or controlling shareholders who take advantage of their controlling positions to damage the interests of the company and the minority shareholders, and attach importance to the regulation of misconduct of controlling shareholders from the legislative level. In an analysis of derivative action in China from 2006-2019, it is found that the main defendants in Chinese derivative actions are controlling shareholders, not directors and managers.[528]

Finally, in terms of litigation incentives, the UK experience could be drawn upon to allow plaintiffs to apply to the court for compensation from the company. This is particularly relevant where the wrongdoer is a controlling shareholder. Allowing the plaintiff shareholder who brings the claim to be compensated directly would avoid a situation where the proceeds of the action appear to go to the company but actually go to the controlling shareholder. Alternatively, it is proposed to learn from the UK that the plaintiff could apply to the court for an indemnity order for the costs of the claimant incurred in the claim, which is decided by the court according to its discretion.[529]

6.4 The balance between managerial restraint and incentives for compliance

There is discretionary power of managers between the restrictions imposed on them and the complete freedom to manage the company. Managerial discretion can be defined as the extent to which decision makers are free to manage the organisation in a given situation.[530]

According to the Chinese Company Law, the board of shareholders decides on the company's

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[528] Jingchen Zhao and Chuyi Wei, 'Shareholder Remedies in China-Developments Towards a More Effective, More Accessible and Fairer Derivative Action Mechanism' (2021) 16 Capital Markets Law Journal 445.
[529] The Civil Procedure Rules 1998, article 19.9.
[530] Wangrow, Schepker and Barker (n 317).

operational guidelines and investment plans,[531] and the board of directors are responsible for determining the company's business and investment plans[532]and basic management system.[533] In addition, a manager of the company is responsible for managing the production and business operations of the company.[534] It follows that "managerial discretion" in the Chinese context should refer to the functions held by the board of directors and managers in the company. The low discretionary power of the board of directors and managers in Chinese companies due to the dominant position of the controlling shareholders and their effective control over Chinese companies has resulted in a lack of incentive to comply and is another major impediment to the development of corporate governance compliance in China.

The question to be answered in this section is how, in order to ultimately achieve good corporate governance outcomes, the behaviour of the management can be limited to a legal compliance framework that prevents them from exploiting opportunism for their own benefit, while maximising incentives for them to perform their duties in a compliant manner and to make decisions for the benefit of the company. With reference to the compliance experience of UK corporate governance, in order to achieve this goal, in the Chinese context, firstly, the management must be given real power and full responsibility for the management of the business, avoiding being completely subject to the instructions of the board of shareholders or controlling shareholders, and the independence of the management must be protected. Secondly, relevant restraints and monitoring mechanisms must be put in place for the exercise of managerial discretion to ensure that it is carried out within a framework of compliance.

Before answering the question of how to achieve a balance between managerial restraint and compliance incentives, it is necessary to clarify what the factors limiting managerial discretion are in Chinese companies. This section first summarises the issues faced by Chinese company boards in comparing the different contexts of China and the UK, and then suggests that to promote corporate governance compliance in China requires reliance on the board's freedom

[531] Company Law 2018, article 37(1).
[532] Ibid, article 46(3).
[533] Ibid, article 46(10).
[534] Ibid, article 49(1).

to drive the company forward, and that corporate governance rules should give the board more discretionary powers.

6.4.1 low managerial discretionary power in Chinese companies

With the prevalence of ownership and management theories, there is even a suspicion that the managerial power exceeds decision-making power. The rapid development of the economy has led to a continuous dilution of the ownership structure and an expansion of managerial power. Directors and managers are constantly seeking their own interests at the expense of the company's interests in the course of the company's business operations, which can easily result in the interests of shareholders and the company being compromised. In the UK, the management is regulated in such a way that the interests of directors are aligning with those of shareholders, maximising the interests of shareholders and the company by ensuring that directors have independent managerial freedom.

However, this is not the case in China. Firstly, as stated in the previous section, decision-making power in Chinese companies is generally concentrated in the majority shareholders or controlling shareholders. Although the Chinese Company Law provides that the board of shareholders is the centre of the decision-making power in the company, in practice it has evolved into a de facto domination of the company's operations by the majority or controlling shareholders, with the management becoming their spokesperson. The fact that the board of directors is elected by the board of shareholders, coupled with the centralised share ownership structure of the company, makes it easy for the board of shareholders to control the board of directors. In addition, the alignment of shareholders' interests with those of the management can further undermine the interests of minority shareholders. The board of shareholders in Chinese companies therefore enjoys extensive and overwhelming power in the company.

Secondly, the unclear distribution of power between the board of shareholders and the board of directors under the Chinese Companies Law has resulted in the management discretion of

Chinese companies being effectively shared between the board of shareholders and the board of directors, the boundaries of which are not clear. Combined with the control of the controlling shareholder over the company's operations under a centralised ownership structure, board of directors in Chinese companies does not have much managerial autonomy.

It has been a challenge in corporate governance to strike a balance between managerial incentives and restraints to legitimately manage the company. The lack of managerial incentives in Chinese companies, especially in SOEs where the state is in control, has weakened the incentives of the management.[535] Excessive high standards of compliance will limit the enthusiasm and motivation of the company's management to make decisions for the company, while too low a standard will not be conducive to promoting corporate governance. This issue is not addressed in the Chinese Company Law and there is a lack of relevant practical experience, and the gaps in the legal rules need to be filled.

The Chinese Company Law places too much emphasis on the regulation and restriction of the company management, resulting in a low incentive for them to manage the company and comply. The reasons are as follows.

Firstly, the Chinese Company Law does not impose an obligation on directors to serve the interests of the company as a whole. A s a result, the corporate regulations on management within Chinese companies also do not take in to account the overall interests of the company. The purpose of the UK's corporate governance rules for regulating management is to urge directors to serve and promote the long-term success of the company. However, while the Chinese Company Law is structured to design a company's internal governance framework in accordance with the legislative concept of checks and balances of power, unfortunately, due to the unreasonable allocation of functions to each governance body, the participants in the company are in effect pursuing their own best interests without taking into account the overall interests of the company. In contrast, the provisions of the UK CA 2006 regarding the general

[535] Dongwei Su and Chen Lin, 'Does State Control Affect Managerial Incentives? Evidence from China's Publicly Listed Firms' (2009) 10 Journal of Business Economics and Management 291.

duty of directors to "promote the success of the company" directly impose an obligation on UK directors to safeguard the interests of the company, rather than a particular individual.

Secondly, unlike the UK and even the international trend, strong interference by the board of shareholders in the management of companies is a distinctive feature of corporate governance in China.[536] The far-reaching power granted by the Company Law to the board of shareholders to intervene in the management of the company is in turn given to the controlling shareholders in practice. The legal norms of the Chinese Company Law do not clearly define the organs responsible for management decisions in a company, and the decision-making and enforcement powers regarding corporate affairs cross back and forth between the board of shareholders and the board of directors. This does not serve the purpose of a reasonable distribution and compliant performance of powers between the board of shareholders and the board of directors to jointly promote corporate governance, but rather makes it easier for controlling shareholders to infringe on the managerial discretion of directors.

Moreover, as mentioned in the previous section, the controlling shareholder of a company actually holds the real decision-making power, but the lack of provisions for controlling shareholders in the Company Law makes it difficult to hold them accountable in practice. In addition to that, the legal regulations do not explicitly state that the board of directors is the centre of authority for business and operational decisions, but instead directly assign the responsibility for company's violations to the directors and managers, which inevitably discourages them from running the company. In SOEs, the directors are appointed directly by the state to run the company and are usually government officials. Management is therefore even less motivated to run the company and they are not concerned with how the company is actually doing.

Another reason for the lack of managerial discretion is that legislation places too much emphasis on the supervision of management. In order to regulate the behaviour of the

[536] Wang (n 203).

management, China has followed the German model and introduced a supervisory board system. According to the design of the Company Law, in Chinese companies, the board of shareholders and the supervisory board are not subordinate to each other, but have a parallel relationship in order to achieve the objective of allowing the supervisory board to monitor the behaviour of the board of directors. In practice, however, this developed into the supervisory board taking away some of the powers of the board of directors. Later on, the Chinese corporate governance system introduced the system of independent directors. As an institutional product of companies with highly decentralised ownership structures, the independent director system was also introduced for the purpose of monitoring the conduct of company directors. However, it has not only failed to achieve the desired effect, but it has also caused confusion in corporate practice due to the overlapping functions with the supervisory board since its introduction into the Chinese corporate governance system.

Finally, Chinese legislation contains too many restrictive provisions that limit the exercise of discretionary power by company management and make it difficult to motivate them to manage for the maximum benefit of the company.

6.4.2 compliance incentive for directors

The board of directors should be the primary body responsible for driving corporate compliance and improving corporate governance. Achieving good corporate compliance requires a balance of incentives and constraints for the directors. While restrictions on directors' behaviour can help prevent them from abusing their power to protect the interests of shareholders and the company, strong restrictions on the board of directors are less necessary in China, given the dominant position of board of shareholders, particularly controlling shareholders, in Chinese companies.

Conversely, without strengthening the discretionary powers of the board of directors, the influence of Chinese companies by controlling shareholders will not be significantly weakened, nor will it be possible to weaken or even change the situation where controlling shareholders control the company. Therefore, in the Chinese context, reducing some of the existing powers of the board shareholders to control the board of directors and mobilising the board of directors' incentives to comply by increasing the board's managerial discretion is an important way to improve Chinese corporate governance.

Firstly, drawing on the UK experience, the obligations of the board of directors should be allocated to the objective of advancing the overall interests of the company and written into the Chinese Company Law as a prerequisite for binding the board of directors to perform their duties with respect to corporate compliance.

In addition, the Chinese Company Law should highlight the board of directors as the centre of authority for operational decisions in the company. In order to effectively address the issue of controlling shareholders controlling the decision-making power of a company's board of directors, the Company Law should make it clear that the board of directors has decision-making power over all business matters of the company, unless otherwise provided for in laws, regulations and the company's articles of association. It is recommended that a prior approval by the board of shareholders and a "comply or explain" regime can be adopted. With the exception of major matters such as connected transactions, which must be reported to and approved by the board of shareholders in advance, all other matters fall within the autonomy of the board of directors to make decisions. Also, as an example of the UK Code, the board should be responsible for issuing annual compliance statement reports, disclosing the company's internal affairs and compliance situation and providing explanations for any non-compliance.

As for the separation of powers between the board of directors and managers, the directors' delegation of some authorities to the managers can improve the efficiency of dealing with the company's affairs, but it should be made clear that the manager's authority to make and execute decisions on certain matters of the company is derived from the authority of the board of directors, emphasising the board's position as the centre of company's business decisions.

Secondly, the Chinese Company Law should clarify that the duty of compliance within the company belongs to the board of directors. In fact, China already has relevant provisions in this regard. For example, the Beijing Stock Exchange requires that directors should fully consider the legal compliance of the matters under consideration, the impact on the company and the risks involved, perform their duties prudently and express a clear personal opinion on the matters under consideration.[537] *The Guidelines on Compliance Management for Central Enterprises (for Trial Implementation)(2018)* stipulates that the main body responsible for promoting the improvement of the compliance management system and studying and deciding on major matters related to compliance management is the board of directors.[538] However, due to the low legal hierarchical effect of the above provisions, they played a limited role in urging companies to comply in practice. Thus, if the compliance obligations of the board of directors can be formally written into the Chinese Company Law, it can greatly promote the effect of corporate compliance. In addition, imposing compliance obligations on company directors is also a form of self-monitoring by the directors of their own business conduct.[539]

While all participants in corporate governance should have the obligation to exercise their powers in a compliant manner, the achievement of corporate compliance still requires an independent and complete corporate governance body responsible for the uniform formulation and implementation of regulatory rules. The assignment of this task to the board of directors, which is specifically responsible for the management of the company, is based on the efficiency considerations of safeguarding the long-term interests of the company and promoting effective corporate governance. Furthermore, only by formally incorporating this practice into the Chinese Company Law that breaches of this obligation can be explicitly made as a basis for holding decision-makers accountable, thereby incentivising directors to perform their duties in compliance with the interests of the company.

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537 The Stock Listing Rules of the Beijing Stock Exchange (for Trail Implementation) (2021), article 4.2.11.
538 The Guidelines on Compliance Management for Central Enterprises (for Trial Implementation) (2018), article 5.
539 Jingshan Chen(陈景善), (董事合规义务体系-以董事会监督机制为路径依赖)'Directors' Compliance Obligation System: Taking the Supervision Regime of the Board of Directors as a Path Dependence' (2022) 3 China Law Review 53,59.

Finally, the incentives for the management can also be implicit, for example, through the deterrent effect of giving them an incentive to operate conscientiously for fear of losing their jobs.[540] And it has been found through research that implicit incentives are more effective for the management than explicit measures in China.[541] While the Chinese Company Law provides for negative qualifications to act as a director, it does not stipulate any legal liability on the directors or companies who violate the requirements. China could learn from the UK's experience in this area and establish a director disqualification regime. People who are unsuitable for the role of director in their current companies will not be able to perform the tasks associated with being a director in another company for a short period of time. If an unqualified director is selected for another company, the other company will be vulnerable to a corporate crisis or even failure caused by the mismanagement of the unfit director, and the company will then face the dilemma of replacing the management or takeover. In this sense, the director disqualification regime would not only improve corporate governance, but also save companies unnecessary costs and risks. In other words, directors need to do their utmost to create a professional image of themselves as competent directors by performing their duties in a compliance manner. With the deterrent of disqualification as a director, the board will be motivated to better manage the company to prevent itself from being removed from the company or even from serving as a director. A good corporate governance mechanism should not only focus on the accountability of violators, but also on whether it can deter possible violations in the future.

Of course, the expansion of directors' managerial freedom in order to incentivise them should not be without limits and boundaries. The Company Law also needs to clarify the consequences of a breach of a director's compliance duty, as a deterrent to incentivise company directors to comply. Directors who breach their compliance obligations and cause losses to the shareholders and company should be subject to civil, administrative or even criminal liabilities. In addition, in order to provide an incentive for company directors to comply, considerations could be given

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540 Jean Tirole, 'Corporate Governance' (2001) 69 Econometrica 1.
541 Su and Lin (n 535).

to setting up an exemption mechanism for director's liability. Specifically, the circumstances in which directors has fulfilled their compliance obligations may be used as a legal ground for mitigating or exempting them from liabilities, and the possibility of future compliance by the non-compliant directors may also be taken into account when holds them liable for breaching the compliance obligations, such as whether the director can actively cooperate with the regulators and whether the director can take measures to make up the losses and help to achieve and improve corporate compliance.[542]

In conclusion, achieving good corporate compliance results requires a balance of managerial incentives and constraints. In the Chinese context, given the dominant influence of shareholders, especially controlling shareholders, over company directors, China should incentivise company directors to comply by giving them more managerial freedom. However, the expansion of powers should not be without boundaries and the directors' actions need to be reasonably limited by laws and regulations.

6.5 The choice between civil and criminal enforcement regime

The effectiveness of civil enforcement of corporate governance relies heavily on the systemic design of corporate legal system. It is clear from previous systematic introduction and analyses that there are a number of deficiencies in China's corporate governance legal system, resulting in the civil enforcement mechanism failing to adequately motivate various corporate entities to promote corporate compliance. The institutional arranges for corporate governance, as represented by the Chinese Company Law, are not even as effective as the administrative measures of Chinese regulators in deterring corporate misconduct. While the compliance guidelines that have been issued in recent years in China are mostly administrative in nature, and the Chinese government has attempted to impose an administratively-led approach to the

[542] Qingsong Wang and Lang Song(汪青松, 宋朗), (合规义务进入董事义务体系的公司法路径)'The Company Law Path of Compliance Obligations Incorporated into the Directors' Obligation System' (2021) 4 Northern Legal Science 77, 88.

development of a corporate compliance regime, however, administrative enforcement has been limited to specific areas and has been ineffective in promoting corporate compliance.

Inadequate incentives for compliance with corporate governance rules also adversely affect the implementation of corporate governance rules. In recent years, the international pursuit of corporate liability has begun to shift from a focus on civil liability for senior corporate officers to criminal liability for companies. The corporate compliance regime has also expanded from the purely corporate law arena to the criminal area. The failure of civil regulatory enforcement to encourage companies to behave in a law-abiding manner makes criminal law the only option to change this phenomenon.[543]

Criminal enforcement mechanisms for compliance refer to those measures that provide incentives for companies to prevent and control potential offences in the management of their business activities through preferential convictions and penalties, reinforce corporate compliance awareness and encourage companies to improve their internal governance structures to promote corporate governance. The promotion of corporate compliance through criminal enforcement regimes has attracted worldwide attention since the US FCPA created a significant deterrent to companies committing overseas corruption through increased enforcement. The subsequent SOA of 2002 has greatly facilitated corporate compliance through extremely strict criminal liability.

The development of criminal enforcement in the UK, not just in the US, has been important in stimulating corporate compliance. The BA 2010 and the DPAs in the UK have also been shown to play a significant role in both deterring corporate crime and promoting corporate compliance. Criminal enforcement allows companies to be encouraged to avoid harsh criminal penalties by having an effective compliance program or compliance procedure in place within the company, and internal governance regimes that do not meet compliance requirements will result in companies being at risk of serious criminal liability.

[543] Graldine Szott Moohr, 'The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement' (2009) 46 American Criminal Law Review 1459.

Criminal enforcement is becoming increasingly important as legislators are beginning to realise that civil penalties do not necessarily promote corporate compliance, as measures such as fines have a limited deterrent effect on companies today, and that the crime prevention function of criminal measures is consistent with the aims of corporate compliance regime. Criminal enforcement represents a shift in the approach to corporate governance from an ex post regime to an ex ante one.[544]

Therefore, China needs to introduce criminal instruments to provide stronger incentives for companies to comply. In this regard, the BA 2010 and the DPA regime provide a useful model for establishing a criminal enforcement mechanism for corporate compliance in China. However, while enforcement by means of criminal instruments can be effective in promoting corporate compliance, the power of civil law instruments should not be ignored. After all, criminal law instruments should play a complementary rather than a primary role in regulating corporate governance issues.

Reflections on the choice of whether China's corporate governance compliance regime is enforced by civil or criminal enforcement are as follows.

Firstly, corporate non-compliance is no longer just a matter of civil liability, but also involves criminal liability. The introduction of a criminal enforcement mechanism into the corporate governance compliance system can therefore have a positive effect on facilitating the achievement of corporate compliance.

Secondly, criminal enforcement regime is a better incentive for corporate compliance because of the more effective deterrent than civil enforcement regime.

Civil enforcement mechanisms to promote compliance mainly refer to the use of civil measures

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544 Hodges (n 66).

and market deterrence to improve corporate governance and promote corporate compliance by balancing the conflicting interests of various corporate governance players through measures such as self-regulation, bringing derivative actions and director disqualification. In addition, civil enforcement of compliance can help to mitigate conflicts between companies and public authorities, and China therefore should not ignore its use of civil enforcement regimes. However, China's corporate governance system is not well developed and the use of the above-mentioned civil remedies has a limited deterrent effect on bad corporate governance, in other words, the deterrent effect of civil remedies is not sufficient to effectively motivate companies to establish internal compliance mechanisms to prevent crime. China's underdeveloped and ineffective corporate legal system makes it very difficult to combat corporate non-compliance and improve corporate governance.[545]

Today, a negative reputational crisis for a company as a result of a criminal conviction can be an extremely effective compliance driver for companies. In such cases, companies would be greatly motivated to do so if they were informed that an effective process could be established internally to prevent criminal liability from being incurred.

Thus, China needs to introduce criminal instruments to provide companies with a stronger incentive to comply, but should not overemphasise the role of criminal enforcement regimes in corporate compliance. Criminal instruments are unnecessary when private civil actions can deter companies from breaking the law.

Thirdly, civil and criminal enforcement regimes are not mutually exclusive, but need to be combined to jointly promote corporate compliance and achieve an effective interface between the two. The UK experience shows that the UK's corporate compliance governance rules are characterised by a combination of these regimes. The combination of civil and criminal enforcement regimes can contribute more effectively to corporate governance compliance.

[545] Xinting Jia and Roman Tomasic, *Corporate Governance and Resources Security in China: The Transformation of China's Global Resources Companies* (Routledge 2010).

In conclusion, in order to more effectively enhance compliance incentives, civil enforcement regimes, represented by the Chinese Company Law, can be combined with criminal enforcement regimes to achieve corporate compliance. The effectiveness of civil and criminal law mechanisms in corporate practice is different. In the area of corporate governance compliance, civil mechanisms provide less incentive for companies to comply than criminal mechanisms. Moreover, in order to achieve corporate compliance to improve corporate governance outcomes, civil and criminal mechanisms need to be combined rather than substituted for each other.

6.6 Introduction of a criminal compliance regime

Traditionally, China has relied heavily on an ex post facto punitive approach to the governance of corporate criminal liability. In some cases, the consequences of criminal penalties for companies may affect a large number of innocent stakeholders such as company' employees, creditors and customers, and may even have a negative impact on society as a whole. Out of the consideration of social and public interests, China also needs to transform the way in which corporate crime is governed. The introduction of a criminal compliance regime is a useful attempt to combat corporate crime by means of ex ante preventive measures.

From the experience of extraterritorial exploration, it can be seen that corporate compliance plays a positive role in preventing illegal and criminal acts by internal member of the company. Even if a company commits a criminal offence, the compliance regime can be used as a criminal law incentive to reduce or eliminate the company's criminal liability. As a result, corporate compliance is gradually being criminalised. A growing number of countries have introduced criminal incentives to encourage companies to build compliance mechanisms, as a factor affecting the company's conviction or sentencing. In essence, the discussion of introducing a criminal compliance regime is also about finding ways to incentivise the establishment of compliance mechanisms within companies and to promote self-regulation. In the UK, this has been achieved primarily through the creation of new corporate offence and the introduction of

DPAs in legislation, while China is currently conducting a pilot reform of “corporate compliance non-prosecution”.

This section first briefly introduces the ongoing pilot reform of corporate criminal compliance in China, and then reveals the problems in China’s introduction of criminal compliance regime based on a comparison with the UK experience, and makes recommendations for reform.

6.6.1 a brief overview of Chinese criminal compliance

Corporate compliance in China begins with the passive acceptance of extraterritorial compliance requirements by large companies in the context of globalisation. Because of the presence of long-arm jurisdiction in other countries, the business risks faced by many multinational companies have risen to the level of serious criminal penalties.[546] Meanwhile, the mitigation and exemption from criminal liability that comes with compliance has generated a great deal of academic interests. Although compliance is an important topic in corporate governance, it is interesting to note that the need for corporate compliance was not examined until companies became involved in criminal cases and faced severe criminal penalties.

The criminal compliance regime in China is developed by a top-down approach which is led by the SPP. The SPP launched an innovative pilot reform of compliance for enterprises involved in cases in March 2020, gradually extending from criminal compliance to administrative compliance and corporate governance compliance. To date, 10 provincial-level procuratorates have selected a total of 27 municipal-level and 165 grassroots-level procuratorates to carry out the reform work. In order to prevent the ambiguity that Chinese compliance refers only to compliance with criminal law norms, the SPP has been using the term “compliance of the enterprises involved in the case” rather than “criminal compliance” in official documents, but it is still essentially a pre-pilot for the introduction of criminal compliance regime in China.

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[546] Xiaofan Meng, ‘Implications of Foreign Corporate Criminal Compliance Non-Prosecution Systems for the Establishment of an Effective Corporate Compliance Conditional Non-Prosecution System in China’ (2022) 656 Advances in Economics, Business and Management Research 708.

Criminal compliance in China is, in essence, a pilot reform on “compliance non-prosecution”. The term “compliance non-prosecution” refers to a system being explored by the Chinese procuratorial authorities to guide enterprises that have committed minor offences and are committed to compliance to establish a compliance mechanism, with prosecutors or third-party organisations monitoring and inspecting compliance on an ongoing basis and deciding whether to prosecute the enterprise based on the results of the final rectification. It should be noted here that as the term “compliance of the enterprises involved in the case” has been used in official documents in China’s criminal compliance pilot reform, rather than “compliance of corporations” or “compliance of companies”, this section is unified with the term “enterprises” to be consistent with the official Chinese terminology.

During the past three years, two models have been developed from the pilot exploration of China’s compliance non-prosecution. One is for the procuratorial authorities to issue a decision of non-prosecution in cases of unit crimes[547] with minor circumstances, while ordering the enterprises involved to take remedial measures and making a procuratorial recommendation requiring them to establish a compliance regime within a certain period of time (the “prosecutorial suggestion” model or the “relative non-prosecution” model). The other is that after the decision to suspend prosecution, the procuratorial authorities will set a time limit for compliance supervision and inspection, and the company’s compliance will be rectified and accepted before the expiry of the period, and a decision not to prosecute will be made if the conditions are met (the “conditional non-prosecution” model).[548] The conditional non-prosecution model, where the decision to prosecute is based on the effectiveness of a company’s compliance regime, gives companies more incentive to comply than the first prosecutorial suggestion model.

[547] Unit crime differs from corporate crime in that the former is generally broader in scope and includes corporations, enterprises. non-business institution, government agencies and non-governmental organisations, see Jing Lin, ‘Corporate Crime Control in China: An Observation from Culture Perspective’ (2019) 22 Journal of Money Laundering Control 472.

[548] This system was originally only applicable to juvenile criminal cases in China, but in practice, the DPA system, which was borrowed from the West, has given the nature of conditional non-prosecution to compliance.

China's compliance non-prosecution reform has undergone two rounds of trials so far. The first round was mainly conducted in grassroots procuratorates, while the second round was deployed by provincial procuratorates in a unified manner.

6.6.2 comparison of criminal compliance regime between China and the UK

Although both China and the UK have introduced criminal law instruments to incentivise corporate compliance drives in order to improve corporate governance, there are still some differences between the two.

Firstly, most of the pilot cases in China's compliance non-prosecution are minor cases committed by micro and small enterprises, and very few cases of crimes committed by large enterprises are involved. In contrast, DPAs are only used in the UK for major corporate crime cases. Moreover, to date, there have been 11 cases in the UK where DPAs have been applied,[549] whereas from March 2021 to the end of June 2022, procuratorial authorities across China have handled a total of 2,382 cases involving corporate compliance, including 1,584 cases where third-party supervision and assessment mechanisms have been applied, with decisions not to prosecute 660 companies and 1,159 people in accordance with the law.[550]

Secondly, the scope of application is different. The UK's DPAs only apply to economic crimes.[551] However, judging from the pilot cases published so far, it appears that China's compliance non-prosecution involves a wide range of offences and there are no special restrictions on the scope of the crimes involved.

Thirdly, the lead authorities are different. In the UK, SFO is responsible for reaching a DPA with the company involved in the case, and has a more uniform standard of review for cases.

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549 (n 465).
550 Official Website of the Supreme People's Procuratorate of China, 'Deepening the Guidelines for Typical Cases, Promoting Compliance Reform for Companies Involved in Cases' (August 2022) <https://www.spp.gov.cn/xwfbh/wsfbt/202208/t20220810_570413.shtml#3> accessed 25 Jan 2023
551 Crime and Courts Act 2013, sch 17 pt 2.

In China, however, it is the lowest level of the procuratorate that is responsible for reaching the agreement with the company involved in the case. Due to the limited professional knowledge of the grassroots procuratorates, the review standard of each individual cases varies. This may also explain the low number of DPAs reached so far in the UK and the increasing number of companies in China that have been granted “no prosecution” treatment.

Fourthly, the results of applying compliance are different. In other words, the main purpose of the UK’s compliance regime in dealing with corporate crimes is to give companies an incentive to establish compliance mechanisms and thereby improve the corporate governance environment. In contrast, the current Chinese pilot situation shows that China’s compliance non-prosecution does not only exclude criminal liability for eligible companies, but also excludes liability for those responsible for the company. This makes both the company involved in the crime and the members of the company an incentive target for compliance, and the result of leniency towards the enterprise involved in the crime is retroactive to the relevant persons in charge of the enterprise involved in the crime, with the result in some cases that no one has been held criminally liable for the corporate crimes.[552]

6.6.3 problems with the current introduction of criminal compliance in China

Firstly, the premise of China’s compliance non-prosecution needs to be further considered. The advantage of applying DPAs mainly to large companies in the UK is that these companies often already have compliance programs in place or have the prerequisites to establish compliance regimes because they have relatively complete corporate governance structures, so compliance incentives are likely to be effective in practice. China’s compliance non-prosecution is currently

[552] Official Website of the Supreme People’s Procuratorate of China, ‘The Supreme People’s Procuratorate Releases Typical Cases of Corporate Compliance Reform Pilot’ (June 2021) < https://www.spp.gov.cn/spp/xwfbh/wsfbh/202106/t20210603_520232.shtml) > assessed 24 Jan 2023;‘Typical Cases of Corporate Compliance (Second Batch)’ (December 2021) < https://www.spp.gov.cn/spp/xwfbh/wsfbt/202112/t20211215_538815.shtml#2 > accessed 24 Jan 2023; ‘Typical Cases of Compliance by Companies Involved in the Case (Third Batch)’(August 2022) < https://www.spp.gov.cn/xwfbh/dxal/202208/t20220810_570419.shtml> accessed 24 Jan 2023 and ‘The Supreme People’s Procuratorate Releases Typical Cases of Compliance by Companies Involved in the Case (Fourth Batch)’ < https://www.spp.gov.cn//xwfbh/wsfbt/202301/t20230116_598548.shtml#1> accessed 29 April 2023.

targeted at MSMEs. It is clear that Chinese MSMEs do not have such prerequisites that large UK companies have, and it may be difficult to achieve the desired effect by forcing the establishment of a compliance regime.

Furthermore, a comparative study of cases in the UK where the DPAs have been applied shows that the UK's DPAs are mainly applicable to cases of crimes committed by large multinational companies and do not apply to cases of individual crimes.[553] As can be seen from both the normative documents issued by the SPP and the typical cases published, China, on the other hand, allows procuratorates to sign DPAs with enterprises in individual crime cases. Whether this practice has deviated from the purpose of introducing criminal compliance to prevent corporate crimes through improved corporate governance needs further examination.

Secondly, China's compliance non-prosecution reform has encountered obstacles to the attribution of corporate criminal liability, which affects the interface between criminal compliance and corporate governance compliance systems. The traditional Chinese doctrine of unit crime holds that the responsibility of the unit needs to be presumed through the pursuit of the responsibility of natural persons. Therefore, the accountability of insiders in the unit is subject to the premise that the unit constitutes a crime. However, the introduction of the compliance system requires that the enterprise not be held criminally liable in criminal cases, but only the perpetrator be held liable. But how can the perpetrator be held separately criminally liable when the prerequisites for criminal liability have been eliminated in the case of compliance non-prosecution?

Both the traditional UK principles of vicarious liability and the identification doctrine have encountered difficulties in attributing criminal liability on companies. The BA 2010, however, cleverly solves this problem. It shifts the central focus of liability from the "controlling mind and will" to whether the company has internal mechanisms in place to prevent bribery, which means that a commercial organisation is presumed to be guilty whenever it fails to effectively

553 (n 465).

prevent bribery from occurring, unless it can prove that it has adequate compliance procedure in place to prevent it.

This is because the existence of a compliance mechanism demonstrates that the company did not have an intention of committing the offence and that reasonable regulatory obligations were met, thereby realising the separation of corporate liability and personal liability. The UK's "failure of commercial organisations to prevent bribery" approach gets away from the dilemma of how to separate personal and corporate responsibility by not focusing on which member of the company committed the offence, but rather on the corporate level, as long as the company does not have a compliance mechanism in place that can effectively prevent the commission of the bribery, then the company commits an offence. This already provides sufficient incentive for companies to establish compliance mechanisms.

Thirdly, the actual effectiveness of criminal compliance regime in China is open to question. The introduction of criminal compliance in China originates from a drive of policy, lacks unified legislative guidance and does not establish specific standards for compliance rectification. Compared with the text of the UK's DPAs, the four batches of typical cases issued by the SPP are relatively general and brief, and the elabouration on the facts of the case, the process of reaching compliance non-prosecution, the subsequent rectification and effects are not fully explained. The lack of a unified standard of application that can be referred to has led to problems of different approaches in practice. In addition, the companies involved in the cases are usually given six months, or even two to three months, to establish and assess their compliance regimes after they are granted non-prosecution for compliance. This not only raises doubts about the effectiveness of the mechanism, but also shows that the procuratorial authorities lack of substantive review of the companies' compliance situation after rectification. Such uniform process-oriented compliance may lead to eventual paper compliance.

Fourthly, the criminal compliance incentives provided by the procuratorial authorities for the companies involved in the case are seriously insufficient. As China has not yet formally established a compliance non-prosecution system, under the current legal framework, the construction of a compliance regime in enterprises is not applicable to the enterprises involved in the case as a statutory sentencing circumstance.

6.6.4 how to reform?

In response to the problems reflected above, this section offers the following insights into the next direction of reform of criminal compliance in China.

First, considering the actual situation in China, the application of criminal compliance non-prosecution should not only apply to large companies, but can also cover MSMEs, but different compliance standards need to be established for them. The use of criminal compliance as an incentive to encourage large companies to establish compliance procedures within the company is important for preventing corporate crime and improving corporate governance structures, as criminal offences committed by large companies are likely to involve the employment of a large number of internal employees, the legitimate rights and interests of creditors and customers, and even affect society as a whole. However, most large companies have complete corporate governance structures and foundations for establishing a compliance regime. In this respect, the application of compliance incentives in large companies better reflects the inherent value of criminal compliance.

In MSMEs, the will of the company and the will of the executives can almost completely coincide and there is no basis for separating corporate and personal responsibility. Therefore, compliance standards should be appropriately lowered for MSMEs. At present, China is implementing “simplified compliance” for MSMEs. For example, the People’s Procuratorate of Jinshan District in Shanghai allows for simplified compliance procedures for companies based on the scale of their operations, management loopholes and other specific circumstances, and offers lenient treatment based on the company’s rectification. Such pilots should be popularised.

Second, compliance should be individualised and the requirement to establish compliance regimes should not be given directly to all companies in a uniform manner. In practice, not all companies can apply the compliance non-prosecution reform. Faced with the issue of the period of rectification of compliance, it is not appropriate to introduce overly detailed and rigid rules towards that. The procuratorial authorities and third-party organisations should specify the period in the light of the type of crime involved in the company, the size of the company and other practical circumstances. The current period of compliance supervision and inspection set by the procuratorial authorities is generally too short. For practical reasons, it is recommended that the compliance inspection period could be limited to one to three years, and that the period can be set at six months to three years for simplified compliance applicable to the MSMEs.

Third, the results of the application of criminal compliance by enterprises need to be continuously monitored and evaluated. China is piloting the selection of a third-party supervision and assessment organisation for the enterprises involved in the case, which will be responsible for investigating, assessing and supervising the compliance commitments of the enterprises involved in the case, and will use the results of the inspection as an important reference for the people's procuratorates in handling cases.[554] More importantly, however, the standards for prosecuting compliance non-prosecution should be unified to avoid paper compliance in practice.

Fourth, legislation should be introduced to strengthen the incentives for criminal compliance. First of all, China's criminal compliance can learn from the UK model, where the establishment of compliance procedures within a company is formally used as a defence against criminal liability. In addition, the establishment of a compliance mechanism or the setting up of compliance procedures by a company should be considered as a mitigating circumstance in terms of penalties. It is recommended that the courts should issue specific sentencing guidelines on compliance and that the procuratorial authorities should make corresponding sentencing

[554] See Guiding Opinions on Establishing a Third-Party Supervision and Evaluation Mechanism for the Compliance of Corporates Involved in Cases (for Trail Implementation) (2021).

recommendations to the courts.

Finally, a system of DPAs for corporate offences should be established, with the establishment of a compliance mechanism as a prerequisite for enterprises to reach a DPA with the prosecuting authority.

Drawing on the UK experience, it is important to firstly, legislate that the existence of an effective compliance program or the ability to demonstrate a significant improvement in the compliance program is a prerequisite for a company to enter into a DPA with the prosecutor. Secondly, the implementation of the compliance mechanism must be monitored by the prosecuting authority on an ongoing basis during the inspection period following the conclusion of the DPA. In this regard, the UK does not adopt a prosecutor-led model, opting instead for a substantive review of the DPA by the court after the prosecutor and the company involved in the case have entered into a DPA, with a decision to approve or disapprove based on a review of whether the agreement is in the interests of justice and whether the relevant terms are fair, reasonable and proportionate. DPAs in the UK must be approved by the court and the court must give reasons for granting the DPA and the whole process will be subject to public scrutiny. It is therefore suggested that China could follow the UK's approach and that the deferred prosecution process should be led by the procuratorate, but that the content of the agreement should be subject to court review.

In conclusion, modern compliance as a legal incentive is rapidly developing worldwide. The introduction of criminal compliance in corporate governance reflects the implementation of the concept of combining punitive and preventive measures. Only by combining penalties and incentives can corporate governance be improved more effectively. The UK's experience of using criminal compliance to incentivise corporate compliance is worth learning from in China, but it is also important to recognise that the UK has gone through a long process of justification to achieve this effect. China is currently in the pilot phase of introducing criminal compliance, the main purpose of which is to prevent corporate crimes by providing penal incentives for companies to self-regulate. However, China's current criminal compliance pilot has revealed a number of problems and there is still a long way to go before the aim of preventing corporate crimes can be achieved.

6.7 Conclusion

Strengthening autonomy and weakening coercion should be the direction for the reform of corporate governance compliance rules in China. The recommendations for reform in this chapter are as follows.

Firstly, in order to improve corporate governance, China should learn from the UK experience in introducing self-regulation and market-oriented regimes in corporate governance, giving companies more managerial autonomy and guiding them to develop flexible internal compliance mechanisms that can meet their own needs.

Secondly, corporate compliance requires not only compliance with external regulations, but also the establishment of detailed internal compliance regimes within the company to enforce these regulations. Currently, the internal compliance regimes of Chinese companies do not function effectively. The reason for this is that the internal governance bodies of companies are under the influence of the controlling shareholders, resulting in a low incentive to comply. Reforming the internal compliance regimes of Chinese companies requires restraining and controlling the abuse of power by controlling shareholders, releasing the incentive of the board of directors and supervisory board to perform their functions in a compliant manner, and protecting the interests of the company's minority shareholders.

Thirdly, corporate governance compliance requires the managerial freedom by the board of directors. China's corporate legislation should assign the corporate compliance obligation to the board of directors, while giving the management more decision-making power and managerial freedom to enhance their incentive to comply and avoid being subject to the company’s board of shareholders or controlling shareholders. In addition, China’s corporate governance rules should also impose restrictions on the exercise of managerial discretion to ensure that the management fulfils its obligations within a compliance framework.

Finally, criminal enforcement regimes provide a greater incentive for companies to comply than civil enforcement regimes. China needs to introduce a criminal compliance regime to provide stronger incentives for companies to prevent corporate crimse by establishing compliance procedures. However, China’s compliance non-prosecution reform is still at a pilot stage and there are still many problems, which need to be continuously studied and improved in light of the problems revealed in the course of future reforms.

In conclusion, reforming China’s corporate governance compliance system is not something that can be accomplished overnight. Because the most fundamental reason why China’s corporate governance rules are not well enforced is the heavily concentrated ownership structures of Chinese companies, and this is not going to change or improve radically any time soon. Therefore, China still has a long way to go in improving corporate governance.

Chapter 7 Conclusion

Compliance research in China presents a fragmented picture, especially in the area of corporate governance, which lacks systematic research. This research fills this gap by providing a systematic and novel perspective on the achievement of corporate governance in China through the promotion of corporate compliance. Through a systematic and critical review of compliance with and through corporate governance rules in China, this thesis shows that the Chinese corporate governance rules have been ineffective in promoting corporate governance in China and that there is room for further reform. The main contributions of this research are as follows.

Firstly, this research not only defines compliance in the context of corporate law, but also comprehensively sorts out the relationship between corporate compliance and corporate governance. The essence of compliance is to legally incentivise companies to regulate themselves, ultimately achieving the aim of preventing corporate misconduct and crimes. The application of compliance cannot be separated from the companies' corporate governance structures, and the effectiveness of compliance in practice should be tested by corporate governance. Regardless of the corporate governance model, improving corporate governance depends to a large extent on how well the different compliance regimes under each model are implemented in practice.

Secondly, although China has made a number of legislative attempts to improve corporate governance, the effectiveness of corporate compliance has not been very effective. This research reveals that the underlying reason for this is that Chinese corporate governance rules place too much emphasis on restrictions and regulations of companies and not enough on incentives and rewards for companies, resulting in a general lack of incentive for Chinese companies to comply.

Thirdly, this study compares and examines the UK's corporate governance compliance regimes and finds that there are many differences in the theoretical foundations of corporate governance between the UK and China. These differences prevent China from simply copying the UK's experience. There is a specific context in which any system is formed and developed, and the most important thing in transplanting and implementing foreign systems and experiences is whether they are compatible with the political, judicial and social environment of the jurisdiction. In light of China's national context, this study argues that China's corporate governance compliance rules need to be localised and reformed on the basis of advanced practices of the UK compliance regimes, and accordingly proposes the following reforms.

China should introduce self-regulation and market-oriented regimes in corporate governance rules and build a flexible framework of corporate governance structures based on the principle of corporate autonomy. Improving corporate governance compliance in China should focus on the ability of companies to self-regulate and resolve internal corporate conflicts. The legal system should be designed in such a way as to leave enough room for companies to be free to manage their companies according to their own situations. And it is more important for the government to play the role of promoting compliance rather than enacting it.

Chinese companies should establish internal compliance regimes that focus on regulating the behaviour of controlling shareholders in order to promote corporate compliance. This includes requiring controlling shareholders to fulfill their fiduciary duties to the company, increasing the incentive for the board of directors and the supervisory board to comply by giving more managerial freedom to the board and increasing the independence of the supervisory board to carry out their functions, while protecting the interests of minority shareholders of the company.

Criminal enforcement regimes provide a greater incentive for companies to comply than civil enforcement regimes. China needs to introduce a criminal compliance regime to provide a stronger incentive for companies to establish compliance procedures within the company.

There is no single, universal corporate governance approach that can solve all corporate governance problems, nor is there a perfect corporate governance model that can be applied to all different jurisdictions, and corporate crises and failures will continue to occur. The establishment of compliance-oriented corporate governance rules is important for the long-term development of Chinese companies in the future.

The reason why this research encourages the introduction of compliance regimes into the Chinese corporate governance rules to improve corporate governance is that it is the intrinsic compliance motivation of companies that effectively drive the achievement of corporate compliance. The essence of corporate compliance should be corporate autonomy, and legal regulation and government supervision should perform a supplementary remedial function. A company managed by compulsory legal means will not only increase compliance costs for the company, but the compliance effect will also be greatly weakened, and there is even a risk of paper compliance.

China’s modern corporate governance was born out of the planned economy and the reform of SOEs, resulting in a tendency to rely excessively on regulatory measures and mandatory norms to deal with corporate affairs. Reform of Chinese corporate governance rules therefore needs be further developed in the direction of respecting corporate autonomy, while government regulation should be relaxed to incentivise companies to move forward in a compliant manner to achieve long-term success, rather than adding to the costs and pressures of compliance by externally imposing legal requirements that do not apply to the actual situation of the companies.

Although China’s current corporate governance compliance rules have many shortcomings that lead to unsatisfactory compliance results, however, it should be noted that a basic legal framework of corporate governance compliance has been established in China. The problems of corporate governance in China could not be solved overnight. The UK model of corporate governance compliance demonstrates that there is still a long way to go to reform localised Chinese corporate governance compliance rules, but it can be seen as a good time to bring China’s corporate governance in line with the world standards.

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