WORLDWIDE CORPORATE GOVERNANCE CONVERGENCE WITHIN A PLURALISTIC BUSINESS LEGAL ORDER---COMPANY LAW AND INDEPENDENT DIRECTOR SYSTEM IN CONTEMPORARY CHINA

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Worldwide Corporate Governance Convergence within

A Pluralistic Business Legal Order

--Company Law and Independent Director System in Contemporary China

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Part I  Worldwide Corporate Convergence of Global Non-State Actors

Chapter 1  Corporate Legal Regimes of Global Non-State Actors

A blurring of traditional national boundaries puts a premium on creativity and constant vigilance. The corporate ecosystem of the 21st century will be characterized by a blurring of once distinct boundaries: between public and private, foreign and domestic, insider and outsider, friend and foe. Corporations are freer to pursue opportunities to make profits wherever they find in the world and to exploit them according to the requirements of circumstance, not the blind dictates of tradition. The growing fluidity of vital business relationships will require constant vigilance and improvisation by all who are concerned.3

The transnational relationships that demolish borders and sovereignties thus unite power at the national and international levels and gradually lead to the development of one unifying capitalist global system. The global order of this world

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2 Metaphor that all corporations in the world are just like all the plants and living creatures in a particular area and should be considered together with their physical environment. Within this ecosystem, corporations link with each other and affect one another.

3 Anthony Bianco, The Ecosystem, BUSINESS WEEK, Aug. 28, 2000
consists of various territorial and functional legal orders that coexist with competition or cooperation to regulate social and economic life. This phenomenon derives from the fact that they pursue different goals and defend different interests. Deterritorialized legal orders, pursuing their own interests beyond state borders by providing themselves with production factors (labor, capital) and by selecting positive normative environments (lenient environmental regulations and so on) when it is in their best interest to do so, are challenging the equilibrium historically found within states.\(^4\) They thus challenge the capacity of the state to serve as a conciliator of divergent interests.

In the context of multi-state integration, the unifying and constitutional role of enterprises was emphasized.\(^5\) A consistent, cooperating “New Business Order” has been built globally in order to deal with the growing fluidity of the new, developing business world. Taxes and tariffs will largely disappear, worldwide accounting standards will increasingly develop, business and government will form partnerships to create minimum privacy standards for commercial transactions and governments will sign multilateral agreements delineating acceptable business practices. To


comply with the new business order, a “New Pluralistic Business Legal Order” developed; it consists of a set of internationalized laws and regulations and a certain kind of corporate governance structure presently agreed by most of the countries in the world to be the most efficient and profitable systems. However, as some countries conform to the newly formulated business legal order, predictable and unpredictable conflicts arise within this “New Pluralistic Business Legal Order.”

Corporate governance within this “New Pluralistic Business Legal Order” provides a critical mechanism for containing risk, for raising capital externally as well as for regulating an organization’s economic activities internally. The policy-makers are increasingly aware of the essential role good corporate governance plays in improving the financial market’s stability and in increasing investment incentives and economic growth amid this “New Pluralistic Business Legal Order.”

This dissertation will, in Part I, introduce the dominant corporate model and corporate ownership structure as well as the most efficient corporate governance system under the influence of this “New Pluralistic Business Legal Order” which was promoted by the proponents of the theory of global convergence of corporate governance.

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6 A new legal order was built up to be complied with the new world order, it appears to be a set of internationalized laws or regulations that were agreed by most of the countries in the world presently. However, in some developing countries like China, they are on their way to fit in the new formulated legal order, the predictable/unpredictable conflicts create a “new pluralistic business legal order.”
governance; in Part II, argue how this phenomenon impacts China’s corporate governance system during its ongoing economic legal reforms, what are the path dependencies and other problems they have been encountering, and the author’s suggestive measures; in Part III, conclude by exploring why the path dependencies are harder to overcome in China, a “rule of man” country than other “rule of law” countries.

Chapter 2 Worldwide Corporate Governance Convergence

According to the Organization for Economic Co-operation and Development (OECD)’s findings in its “Principles of Corporate Principles,” “an effective corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.” These Principles have provided extensive guidance for legislative and regulatory initiatives for countries either with shareholder-oriented or stakeholder-oriented corporate governance.

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7 The Convention of the OECD was signed in Paris on December 14, 1960, and came into force on September 30, 1961. The member countries include without limitation France, Germany, Japan, Korea and the United States.

8 The OECD Principle of Corporate Governance were endorsed by OECD Ministries in 1999 and have since become an international milestone for parties involving in corporate governance.

9 In common law system like the UK and US, the corporate governance forms focus on shareholders’ interests rather than stakeholders’ interests. The corporate governance forms in common law system
forms; or with the concentrated or the dispersed ownership model.

I. Dominant Corporate Forms

Shareholder-Oriented Form v. Stakeholder-Oriented Form

Institutional differences in the essence of corporate governance, capital markets, and law exist around the globe. Since the driven purpose of corporate governance for civil law system and common law system are different,\(^{11}\) shareholder-oriented form and stakeholder-oriented form have been developed accordingly.\(^ {12}\)

At the end of the nineteenth century, the core functional features of the corporate form which are widely accepted by large-scale worldwide companies are essentially identified across various jurisdictions as possessing the following characters: “(1) full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm, as distinct from the

\(^{10}\) In civil like China, Germany, Japan, and Taiwan, the corporate governance forms focus on stakeholders’ interests rather than shareholders’ interests. The corporate governance forms in civil law system is regarded as “stakeholder-oriented.”

\(^{11}\) Richard Smerdon: A practical Guide to Corporate Governance, 3-7, Sweet & Maxwell, 1998

firm’s owners;\textsuperscript{13} (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.”\textsuperscript{14}

The above mentioned characteristics, “both individually and in combination, offer important efficiencies in organizing the large firms with multiple owners that have come to dominate developed market economies.”\textsuperscript{15} Protecting shareholder interests rather than the interests of stakeholders like creditors, laborers, and consumers become the major duty of these above-mentioned five characteristics of the corporate form. “Shareholder-oriented” form prevailed “stakeholders-oriented” form in this finding.

After years of experimenting, the idea of the “standard shareholder-oriented model” introduced by scholars, businessmen and government authorities has been gradually formalized. The primary elements of this consensus are: (1) the shareholder class should hold the ultimate control of the corporations; (2) shareholder interests are the first priority to be concerned with while managers of the corporation are making decision; (3) non-controlling shareholders’ rights are well protected

\textsuperscript{14} See Henry Hansmann & Reinier Kraakman “The End of History for Corporate Law” at 439,440.
\textsuperscript{15} Id at 440.
against exploitation by the controlling shareholders; (4) the interests of creditors, employees, and consumers should be protected by contractual or regulatory means; (5) shareholders’ interests are primarily based on the market value of the shares of public corporations. The share values will increase if a firm place its shareholders’ interests rather than labor’s interests, political agendas, management, or the private benefits of controlling shareholders.”

II. Dominant Corporate Ownership Models

Concentrated Ownership Model v. Dispersed Ownership Model

While the boundaries of territories become vague, competition is created among companies by various corporate governance regimes. The basic corporate ownership structures decide whatever economic/legal environments corporate governance regimes provide for their domestic companies. The two major formats of corporate ownership models are “dispersed-ownership” and “concentrated ownership.” They are often the major competitors in the market of corporate

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16 *Id* at 441

17 See Christopher John Gulinello, *The Revision of Taiwan's Company Law: The Struggle Toward a Shareholder-Oriented Model in One Corner of East Asia*, at 6

governance regimes.19

The dispersed-ownership model is characterized by a diffuse body of corporate ownership whereas the concentrated-ownership model is characterized by a centralized body of corporate ownership. This dispersed-ownership model always comes with a stronger securities market compared with the concentrated ownership model. The securities markets in this model are equipped with more adequate shareholder protection measures than what are provided in the concentrated-ownership model. Scholars have found that dispersed ownership mostly exist in common-law systems since they are able to provide adequate protections to minority shareholders. A more centralized body of corporate ownership is found in concentrated-ownership model. This model does come with weaker securities markets compared with the dispersed ownership model, but their strong bank systems and other professional institutions play a crucial supporting role to

19Id; See Rafael La Porta et al, Corporate Ownership Around the World, 54 J. Fin. 471, 471-72 (1999) (surveying concentrated ownership and dispersed-ownership countries); see also Lucian Arye Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127, 129 (1999), (suggesting that some countries have diffuse body of ownership and some have concentrated ownership); Amir N. Licht, The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems, 26 Del. J. Corp. L. 147, 149 (2001) (questioning why companies in some countries have dispersed ownership and in other countries concentrated ownership).
maintain the healthy operation of the market.\textsuperscript{20} The companies in concentrated-ownership models greatly depend on the banks to provide them necessary capital.\textsuperscript{21}

A worldwide inventory indicated that the depth and liquidity of equity markets around the world associate closely with common-law systems consistently outperforming civil-law system.\textsuperscript{22} If the finding is correct, it is not hard to imagine that countries with civil-law system are tempted to adopt rules of common-law legal systems to disperse their ownership structure to develop deeper and more liquid securities markets.\textsuperscript{23}

\textbf{Chapter 3 Worldwide Convergence Toward Shareholder-Oriented/Dispersed Ownership}

I. Shareholder-Oriented/Dispersed Ownership

A deeper tendency across developed market jurisdictions has been a convergence toward a single, standard corporate structure. The essential legal features of a shareholder-oriented ideology are well established among those developed market

\begin{itemize}
  \item \textsuperscript{20} See Coffee, supra note 21, at 642-43.
  \item \textsuperscript{21} See Coffee, supra note 21, at 643
  \item \textsuperscript{22} Id., at 4
  \item \textsuperscript{23} Id., at 5
\end{itemize}
jurisdictions and noticeably dominate the development of worldwide corporate forms. Striving to increase long-term shareholder value has become the most competitive corporate governance theory among developed economies. As the shareholders’ values are attracting the spotlights, established legal measures to protect shareholders’ rights have become an important indicator of a healthy and appealing corporate governance system. A series of examinations of worldwide corporate governance and ownership have concluded that there is a correlation among adequate legal protection of shareholders, dispersion of ownership, and strong securities markets. Several empirical experiences suggest that a shareholder-oriented corporate body with adequate legal protection for minority shareholders will disperse its ownership structure and this dispersed ownership structure will be able to develop a more valuable equity market.

II. Overarching the Opinions

24 Henry Hansmann and Reinier Kraakman, The End of History of Corporate Law p439
25 See La Porta et al., Corporate Ownership Around the World, 54 J. Fin. 511-513; Rafael La Porta et al., Legal Determinants of External Finance, 52 J. Fin. 1131, 1149 (1997); Rafael La Porta et al., Law and Finance, 106 J. Pol. Econ. 1113, 1152 (1998)
26 “Shareholder-oriented “ model refers to a model whose primary goal is to maximize the shareholders’ interests to protect shareholders’ rights.
27 “A shareholder who owns less than half the total shares outstanding and thus cannot control the corporation’s management or single-handedly elect directors.” Black Law Dictionary, p1381
28 La Porta et. al., supra note 26, at 512 (stating that designing an adequate legal system to protect minority shareholders’ interests will enhance the effect of dispersion of ownership.)
Opponents of theory of global convergence of corporate governance argue that worldwide corporate governance regimes are converging toward dispersed-ownership and shareholder-oriented model and they also doubt whether the globalization convergence process reflects U.S.-centric chauvinism. Some do hold suspicions about the superiority of the efficiency of the shareholder-oriented/dispersed ownership model as well. One of the weaknesses of the shareholder-oriented/dispersed ownership model usually discussed is their overemphasis on shareholders’ interests. This bias encourages management to focus on grabbing short-term gains for shareholders rather than on a long-term plan for the company. This management prejudice is especially easy to be observed as management levels consider merger and acquisition offers. In addition, since the ownership structure is relatively decentralized, enterprises following the shareholder-oriented/dispersed ownership model may have an inferior ability to audit the performance of managers than the one with concentrated ownership.

Although there are debates on the global convergence toward the shareholder

31 Jeremy Edwards & Hlaus Fischer, Banks, Ffinance, and Investment in Germany (1994); Coffee, supra note 24
oriented/dispersed ownership model, there is a worldwide tendency that countries have devoted themselves to design corporate governance systems that can better protect minority shareholders in order to create strong securities markets. No matter how significant the reluctance from the controlling shareholders is, minority shareholder constituencies will ultimately grow to “create” relatively stronger “lobby forces” for formal legal protections,\textsuperscript{32} and a jurisdiction which adopts optimal legal protections for minority shareholders will help their domestic companies become more competitive in the global capital market. Equity markets develop more broadly and the value of such markets increase in countries with adequate minority shareholder protection.\textsuperscript{33} Or some are arguing the sequence maybe reversed based on the examination of the early development of the New York Stock Exchange and the London Stock Exchange. They asserted that back in the late 19\textsuperscript{th} Century, dispersed ownership arose largely in the absence of strong minority shareholder protection. They affirmed that the sequence shall be: the consistency (here, minority, dispersed public shareholders) first arise before they can become an effective

\textsuperscript{32} La Portal et. al, supra note 26, at 7 (stating how legal changes are implemented due to the lobby from the minority shareholders.)

\textsuperscript{33} La Porta et. al., supra note 26 at 511
lobbying force, and legal reforms are demanded by the consistency.\textsuperscript{34} Although arguments have not ended in “the direction of causation”, a dispersed ownership structure and a shareholder-oriented corporate law model is widely agreed to be the best combination for corporate governance.

However, Scholars have argued the incapability of providing adequate legal protection to minority shareholders in civil-law system stumble them to develop dispersed ownership structure.\textsuperscript{35} Most companies would prefer to rely on more efficient access to venture capital markets provided by strong securities markets in a dispersed ownership model rather than borrow their capital from stable resources such as banks in concentrated ownership system. A competitive corporate legal system must be able to connect to the global securities markets to develop limitless possibilities for the companies to attain the capital they need.\textsuperscript{36} That most large-scale international companies list on more mature securities markets proves the dispersed ownership model emerges victorious over the concentrated ownership

\begin{itemize}
\item \textsuperscript{34} John Coffee, \textit{Convergence and Its Critics: What are the Preconditions to the Separation of Ownership and Control}, Columbia Center for Law and Economies Working Papers No. 179, Sep. 12, 2000
\item \textsuperscript{35} John C. Coffee, Jr., The rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, YALE L. J.
\item \textsuperscript{36} Coffee, \textit{supra} note 34, at 641(introducing assumption by Berle & Mean that large scale industries need to raise capital from an accomplished securities markets in a dispersed ownership market.); id. at 649 (stating that stronger legal protection kind of guaranteeing the higher stock prices)
\end{itemize}
Chapter 4: Obstacles to Worldwide Corporate Governance -- Path Dependencies

Scholars constantly argue that the power of “path dependency” creates an obstacle as jurisdictions prepare themselves to converge toward the shareholder-oriented/dispersed ownership model.\(^{37}\) Even if we assume that market forces urge the predominance of the shareholder-oriented/dispersed ownership model in the world, certain path-dependent forces might involve and serve as strong obstacles in spite of market pressure.\(^{38}\) There is a great deal of scholarship categorizing path dependencies into different types based on different concerns and perspectives. The author will categorize path dependencies into two types based on which party is benefited: for the firm’s overall benefit, that is path dependency driven by efficiency; on the other hand, for certain interest groups’ benefits, that’s path dependency driven by “rent-protection” or “rent-seeking.”\(^{39}\)

I. Efficiency-Driven Path Dependency

This finding and the history of corporate transformation suggest that the existing legal and extra-legal institutions in a jurisdiction, on both a national level and a firm

\(^{37}\) The two major representing scholars are Lucian Arye Bebchuk and Mark Roe.

\(^{38}\) Bebchuk & Roe, *supra* note 23, at 131-132 (suggesting that path dependencies could not be removed by market forces.)

\(^{39}\) *Id.* at 147
level, would affect the adoption of the subsequent corporate legal structure.\footnote{Id. at 137-42 (addressing that efficiencies and corporate structures gained by development around these structures); id. At 153-157 (discussing corporate rules and efficiencies gained by development around these rules) }\footnote{Id. at 137, 139} And, the efficiency is the first reason to be concerned. The development of ownership structures rely on the pattern of whatever the jurisdiction used to have at earlier points in time.\footnote{Id. at 137, 139} In order to make the maximum profits of a firm without wasting any time or resources, or to avoid the risks leading to any possible losses, firms might possibly stick to their original structures in consideration of efficiency under the following circumstances: (1) “sunk adaptive costs,” i.e., once costs are sunk in the existing legal structure without no other better alternatives maintaining and continuing them often is efficient;\footnote{Id. at 139} (2) “complementarities,” in which costs are sunk in the professional institutions which are developed to facilitate the operations of the corporate structure and to maintain and continue them often is efficient;\footnote{Id. at 140} (3) “network externalities,” in which major ownership structures of other companies in the same jurisdiction will influence a firm’s decision on choosing its own ownership model;\footnote{Id at 141; See also Marcel Kahan & Michael Klausner, \textit{Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases}, 74 Wash. U. L.Q. 347, 350-53 (1996) ("discussing learning and network externalities in corporate contracts), and Mark A. Lemley & David} (4) “endowment

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\textit{Id.} at 137-42 (addressing that efficiencies and corporate structures gained by development around these structures); id. At 153-157 (discussing corporate rules and efficiencies gained by development around these rules) ;FN26

\textit{Id. at 137, 139}

\textit{Id. at 139}

\textit{Id. at 140}

effects;” in which players who have control over an existing structure may affect the total value that alternative structures would produce due to their valuation of having such control;45 or (5) “multiple optima.”46 Either of the above circumstances could cause a company’s hesitation in changing its current ownership structure. Firms prefer to maintain the status quo since any change of the ownership structure might cause unexpected, additional transaction costs. They would rather maintain their original way which provides the identity of efficient ownership structure. The consideration of path dependency is for the firm’s overall benefits.

II. Rent-Protection47 Driven Path Dependency

In addition to the efficiency considerations as above, the other major consideration related to a firm sticking to an existing path is rent-protection or rent-seeking. The efficiency consideration is taken from the perspective of the firm’s overall benefits, whereas, the rent-protection consideration focuses on the interests of a certain group of people in a firm. These groups of people control the

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45 Id. at 141
46 Id. at 142
47 Quoted from Professor David Skeel’s explanation, “In economies, a “rent” is a supracompetitive profit—more profit than in a competitive market. In the corporate context, scholars use the term to refer to the fact that controlling shareholders may be able to use their control to secure private benefits for themselves from the corporation (such as a high salary, or a lucrative contract with the corporation)
decision-making power of the firm and extract some private benefits from their positions. They not only are reluctant to change the status quo but also try to create certain corporate rules favoring their best interests in the firm. The corporate rules which set up the legal structure of a company influence all aspects of a company’s operation. Once the corporate rules are activated, it demands great transactional costs for firms to make changes in their corporate ownership models. This will then increase the difficulty in making changes and encourage the firm to stay in its current path.

III. Solutions

The efficiency consideration in the firm-wide benefits as well as the rent-protection consideration in certain groups' benefits, do serve as strong obstacles for jurisdictions intending to migrate to another corporate form or corporate structure. Relevant literatures suggest that the transformation of legal systems on a functional level rather than a formal level would make it more possible to avoid the struggle with path dependency and create a better climate for corporate governance convergence to

48 Id. at 137 (stating that the corporate rule could be able to decide which ownership structure to adopt, with or without controlling shareholders)
49 Id. at 142
They suggested that self-regulation is frequently the primary functional substitute to mandatory legal regulation, since self-regulation can encourage and support business activities that formal legal system cannot adopt.\textsuperscript{51}

In addition to the above findings, there are two other suggestions to persuade rent-protected controlling shareholders to move towards legal measures to protect minority shareholders: (1) to assure them that these changes increasing the protective measures for minority shareholders will increase their own wealth and this increase will be more valuable than their private benefit of control,\textsuperscript{52} i.e., the earnings from the reduced capital costs induced by the new rules will exceed their private benefits of control; and (2) those legal measures would protect their rights once they become minority shareholders.\textsuperscript{53}

\textsuperscript{50} Gilson, supra note 22, at 338 (suggesting that convergence on functional level will be an effective alternative while convergence on formal level is too costly.)

\textsuperscript{51} Coffee, supra note 31

\textsuperscript{52} Bebchuk & Roe, supra note 23, at 130, 142, 143-147 (explaining why some countries have dispersed ownership, but others don’t; describing also the reason for controlling shareholders to insist to have the shares dispersed is that they are afraid the possibility to lost their rents and not able to take advantage of the gain created by the efficiency) ; Coffee, supra note 22, at 654; Hansmann & Kraakman, supra note 17 (suggesting that the shareholder-oriented model not only benefits controlling shareholders, but also benefit minority shareholders); La Porta et al., supra note 23, at 471, 471-72, 512-513 (1999)

\textsuperscript{53} John C. Coffee, Jr., The Rise of Dispersed Ownership: The Role of Law and the State in Separation of Ownership and Control, Columbia Law and Economics Working Paper No. 182 (suggesting that most scholars that adequate protection of minority shareholders is the base of an efficient securities
Chapter 5  The Chinese Puzzle

Recent debate has argued that strong securities markets and dispersed ownership are unlikely to develop in civil law countries (such as China) for the following three major reasons: (1) the lack of adequate minority legal protection, (2) the incapability of public shareholders to hold control, and (3) the political susceptibility of diffuse ownership in “social democracies”. The opponents of the above principle have found that dispersed ownership arise in Europe.\footnote{Coffee, supra note 30} Some scholars argue that even the whole world is converging toward the same direction, China may be an exception since its economic achievements do not result from the certainty brought by a clear and definite legal system to support a shareholder-oriented/dispersed ownership model, but from the planned commands brought by their autonomous government.\footnote{Randall Peerenboom, China’s Long March Toward Rule of Law} However, in order to attract more foreign capital, is China, a country which declares itself as a "socialist market economy" \footnote{Article 1 of Chinese Company Law.}, converging toward the shareholder-oriented/dispersed ownership model?

Part II  China's Convergence with Worldwide Corporate Governance

\footnote{markets); at 33 (“stating how discussing how mergers of large corporations raised capitalization beyond the means of corporate raiders and, thus created more stable dispersed ownership.”)}
Preface

There is surely more than one route for China’s economic development. The essential key to economic development is to form an institutional structure derived from an individual country’s cultural institutions that would supply appropriate incentives, rather than adopt a complete set of Western institutions. Although individual countries face new and different problems as their economies develop, the fundamental elements of developed economies are identical. The secret to develop a healthy economy is to adapt efficient institutions from established economies. As what we have concluded in Part I, most of the established economies adopt the shareholder-oriented/dispersed ownership model. But how does this apply to China? How has China responded to the pressures of globalization? China is a country having not yet installed clearly defined property rights and is still under the control of a communist dictatorship. However, those apparent deficiencies that have appeared in the Chinese investment environment can hardly stop its rapid economic growth in the past two decades. Some scholars do not believe that there could be a

57 Institutions here refer to how human interaction—political, social and economic are structured as well as the prevailing and encouraging framework of a society. The institutions may be made up of formal rules (enactment of laws), informal constraints (norms, conventions and codes of conduct), and their enforcement characteristics.
58 Id.
meaningful encounter between the Chinese tradition and Western systems of law.\textsuperscript{60} It seems that none of the currently existing standard forms of economic and political theory can well explain China.\textsuperscript{61} Two features stand out while discussing the Chinese experience: “(1) While the institutions China employed are different from developed nations, the incentive implications were similar; and (2) China has been confronting new problems and pragmatically attempting new solutions.”\textsuperscript{62} Is China converging toward the shareholder-oriented/dispersed ownership model? What legal institutions have China employed? What historical and infrastructural factors have shaped and influenced the institutions in China? What solutions has China introduced to transform itself? And what are those suggestive measures the author provided to solve problems in China’s reforming corporate governance structure?

Part II elaborates on this discussion.

\textbf{Chapter 1 Corporate Legal Regime of China--- Company Law in China}

\textbf{I. General Information}

\textbf{A. Evolutionary History}

Some permutation of a company law has been on the books in China since

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\textsuperscript{61} North, supra note 61

\textsuperscript{62} Id.
Several enactments came up in 1914 (Republican), 1929 (Nationalist), 1946 (Nationalist) and 1994 (Communist). The 1994 Company Law (hereinafter referred to as the “CCL”) represented the crossing of a threshold for a corporate China. The most significant mission for the CCL was to restructure the organization and management of State-Owned Enterprises (“SOE”).

This CCL superseded provisional corporate regulations of the central government and the regulations of two municipalities. There were 11 Chapters and 230 Articles in the 1994 CCL. On October 27, 2005, the 18th Plenum of the 10th Chinese National People’s Congress passed an amendment of the CCL which took effect on January 1, 2006. This revised version contains 13 Chapters and 219 Articles. On the same date, in the same meeting, the Chinese National People’s Congress also passed an amendment of PRC’s Securities Law. There are 12 Chapters and 240 Articles in this newly revised version.

B. Incorporation of Companies

The government’s operative attitude toward the incorporation of companies is highly preserving and controlling. Companies need to fulfill conditions set forth in

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63 Qing Dynasty
either Article 23 (limited liability companies)\textsuperscript{64} or Article 77 (companies limited by shares)\textsuperscript{65} to incorporate in China. For the establishment of a limited liability company, the entity has to submit a company registration application, along with the articles of incorporation and the capital verification certificate to the company registration authority to apply for incorporation registration;\textsuperscript{66} for the establishment of a company limited by shares, the entity must submit a registration application, along with the promoters’ meeting minutes, the articles of incorporation, the capital verification certificate, the office documents and identification evidence of legal representatives, directors and supervisors, the proof of legal person qualification or natural person identification of promoters and proof of company's residence to the

\textsuperscript{64} The conditions of Article 23 of CCL is known as, “(1) the numbers of shareholders must reach the minimal statutory requirements; (2) the company capital contribution of shareholders must reach the minimal amount requirement of statutory capital; (3) the company’s articles of incorporation must be adopted jointly by the shareholders; (4) the company has a company name and is to establish a organizational institution in compliance with the requirement of a limited liability company; (5) the company has residence.”

\textsuperscript{65} The content of Article 77 is very similar with Article 23, it just carry some more shareholding characteristics. Article 73 of CCL is read as, “(1) the numbers of promoters must reach the minimal statutory requirements; (2) the total amount of company capital added up from subscription of promoters must reach the minimal amount requirement of statutory capital; (3) the issuance of shares and preparations for incorporation must be in conformity with relevant provisions of the law; (4) the company’s article association must be formulated by the promoters, and adopted at the promoters’ meetings if established by subscription; (5) the company has a company name and is to establish a organizational institution in compliance with the requirement of a company limited by shares; (6) the company has residence

\textsuperscript{66} See Article 30 of CCL.
company registration authority within thirty days after the promoters’ meeting.\textsuperscript{67}

Although the Chinese regulators have simplified the incorporation process in the newest amendment,\textsuperscript{68} this relatively strict incorporation procedure is similar to those extraordinary requirements held in England and the U.S. until the early 1800’s.\textsuperscript{69}

C. Forms of Companies

There are two forms of companies in the CCL: the “limited liability company” and the “company limited by shares” (also known as a joint stock company). This distinction corresponds roughly to the British models of the private company and the

\textsuperscript{67} See Article 93 of CCL.

\textsuperscript{68} According to Article 19 and Article 73 of the 1994 CCL, the incorporation applications need to be approved by the State Council or certain provincial government as the first approval before submitting the application for the company registration.

\textsuperscript{69} Norman Lattin, \textit{Evolution and Formation of Corporations: Legal Effects When Defectively Formed (Art. 54 Evolution of Anglo-American Corporations; Origin of the “Concession” Theory )}, The Law of Corporations, at 174-176, (explaining that days before the early 1800’s, corporate organization limited liability were deemed as special privileges those were merely granted to business entities with distinct connection with industries related to public welfare, such as railroads, banks, or traders with foreign lands. Those requirements were viewed to unfairly benefit the rich and powerful as the Jacksonian populists sprang up. The “general corporation acts” which allowed the incorporation process become inexpensive and only keep several basic filing requirements approachable to ordinary people was released accordingly. Really comprehensive “general corporation acts” came between the last quarter of the 19\textsuperscript{th} century and the first quarter of the 20\textsuperscript{th}. The Pennsylvania’s act was enacted in 1874, the New Jersey act or revision in 1896, the Delaware statute was completely overhauled in 1967 with amendmentss in 1968 and 1969. The Model Corporation Act of 1928 was the one drawn most suggestions.)
public company\textsuperscript{70} or the American model of the closely-held corporation and the publicly-held corporation.\textsuperscript{71} Limited liability companies are normally built as smaller corporations. The number of their shareholders is required to be less than fifty.\textsuperscript{72} According to Article 20 of the 1994 CCL, “a limited liability company is allowed to have only one shareholder if the shareholder is the state.” In the newest version of CCL, the above stipulation was wiped out. The definition of a wholly state-owned enterprise is found only in Article 65 of the 2006 CCL.\textsuperscript{73}

Different from the limited liability company, the company limited by shares shall have more than two but less than two hundred promoters.\textsuperscript{74} Companies limited by shares are allowed to issue their shares in public securities markets according to Article 121 of CCL, and Article 12 and 13 of Securities Law.

The concept of “limited liability” is a fundamental concept to Western company


\textsuperscript{72} According to Article 24 of CCL, a limited liability company shall be jointly incorporated by no more than fifty shareholders.

\textsuperscript{73} According to Article 65 of CCL, “ Wholly State-Owned Enterprise is a limited liability company invested by the State wholly, managed by state-owned capital supervision management organization according to the authorization by the State Council or local People’s government.

\textsuperscript{74} Refer to Article 79 of CCL.
law but is a relatively new idea to corporate China. The Chinese CCL regulators adopted principles of limited liability for corporate parallelism to Western systems—in particular the United States. The CCL stipulates that both of their legitimate company forms enjoy limited liability whereby the liability of shareholders is limited to the amount to which each shareholder has subscribed.\(^75\) One could not find the idea of “piercing the corporate veil”\(^76\) or restrictions on shareholders’ limited liability immunity as seen in the 1994 CCL.\(^77\) However, the 2006 CCL amendment transplants the “piercing the corporate veil” concept in Article 20. According to Article 20 of 2006 CCL, “Company shareholders who damage company or other shareholders’ rights by abusing his or her own shareholder’s rights shall be liable for the loss in accordance with the laws.”

**II. Major Players in Chinese Corporate Governance**

Except for those wholly state-owned companies, which may operate


\(^{76}\) A judicial act which impose personal liability on otherwise immune corporate officers, directors, and shareholders for the corporation’s certain unlawful behaviors.  See Sea-Land Services, Inc. v. Pepper Source, 993 F.2d 1309 (7th Cir. 1993) {p196 of Corporations cases and materials Williams Cary}

\(^{77}\) Gu, *supra* note 81, at 11
differently from normal companies, the “shareholders”, the “board of directors” and the “board of supervisors” are the three key actors on the stage of Chinese corporate governance. People may argue that the Chinese corporate governance structure is identical to the Germany’s two-tier system since both of them are equipped with both a board of director and a board of supervisors. As a matter of fact, the practical positions of a supervisory board in China and Germany are very different. In Germany, the supervisory boards are on the top of a hierarchical system, where it oversees the board of directors, and has the power to appoint and dismiss incapable directors. Nevertheless, in China, although the newest amendments grant supervisory board stronger power to supervise board of directors, it is not situated in a

78 Pursuant to Article 66 of CCL, “A wholly State-owned company shall not have a shareholders’ meeting. The State-authorized investment institution or the department authorized by the State shall authorize the board of directors of the company to exercise part of the functions and powers of the shareholders meeting and to make decisions on important matters of the company. However, the merger, division, dissolution, increase and reduction of capital, and issuance of company bonds must be decided by the State-authorized investment institution or by the department authorized by the State.”


80 Id, Aktiengesetz; Bulter, at 602, Andre, Jr. at 1823-1824; See also Michael Bradley et al., The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads, 62 Law & Contemp. Probs. 9, 52-53 (1999); Timothy L. Fort & Cindy A. Schipani, Corporate Governance in a Global Environment: The Search for the Best of All Worlds, 33 Vand. J. Transnat’l L. 852 (2000)
higher position than the board of directors. Both of the board of directors and the supervisory board are appointed and may be dismissed by shareholders.  

A. Shareholders

1. Powers

China, as a civil-law country, defines “corporate governance” as a system to efficiently regulate relationships among all interested parties such as creditors, consumers, business partners and so on, in a business organization. However, by the influence of the Anglo-American corporate governance concepts, “shareholders” have been singled out as a particularly important group. The general meetings of shareholders are considered the organ of supreme sovereign power of the corporation. The shareholders hold the following comprehensive decision-making powers according to Article 38 of the 2006 CCL: (1) to determine the company’s business policy and investment plan; (2) to elect and change directors and supervisors who are not employee representatives and to decide related matters regarding their remunerations; (3) to review and approve the reports from board of directors; (4) to review and approve the reports from the board of directors or supervisors; (5) to review and approve the company’s annual financial budget plan and financial account

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81 According to Article 38 and Article 103 of CCL.

82 Article 37, 99 of CCL.
plan; (6) to review and approve plans regarding profit distribution and loss recovery proposals; (7) to resolve whether to increase or reduce the company’s registered capital; (8) to resolve on whether to issue company bonds; (9) to make decisions on whether to merge, split, or transform company forms, to dissolve or liquidate, etc.; (10) to amend the company’s articles of incorporation; and (11) to pursue other powers which are stipulated in the articles of association. Although some of the above powers resemble those shareholders’ right in the United States, others such as those “to approve plans on corporate profit distribution and loss recovery proposals,” “to determine the directors' remuneration” and “to make resolutions on plans of bonds issuance” are reserved to the board of directors in the United States. It seems that the general meeting of shareholders has the power to exercise many managerial decisions. This institutional arrangement may work well in relatively small-scale limited liability companies with fewer shareholders. However, it may not be an inefficient corporate structure mechanism for publicly held corporations which have

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83 Article 38 of CCL.

84 See e.g., Article 7.01 (annual meeting), 7.02 (special meeting), 7.21 (voting entitlement of shares), 7.28 (voting for directors), 8.08 (removal of directors by shareholders), 8.11 (compensation of directors), 10.03 (amendments by board of directors and shareholders), 11.03 (action on plan), 14.02 (dissolution by board of directors and shareholders), 16.02 (inspection of records by shareholders) of Revised Model Bus. Corp. Act (1994).

85 Id., Article 8.01 (b) (general corporate power under the discretion of board of directors), 6.21 (issuance of shares), 6.40 (distribution to shareholders)
to respond to a competitive and changeable market.

2. Rights

In addition to the managerial powers, the 2006 CCL amendment has granted shareholders the right to bring lawsuits under different circumstances. Shareholders can initiate lawsuits with the resolutions of a shareholders' general meeting or when the board of directors violate the law or administrative rules and regulations, or infringe upon the shareholders’ rights.\(^86\) In addition to the above right to sue, which was taken from the 1994 CCL, the 2006 CCL enlarged the range of shareholder rights to sue. Shareholders are allowed to bring lawsuits when (1) shareholders and the company cannot reach an agreement to buy back those shares held by the shareholders under certain circumstances;\(^87\) and (2) directors or high-level managers violate the laws, administrative regulations or articles of incorporation which infringe shareholders’ rights.\(^88\) The shareholders are also allowed to bring shareholders’ derivative suits, analogous to the shareholders’ derivative rights under the U.S. corporate governance system. According to Article 152 of the 2006 CCL amendment, “directors, supervisors, high-level managers or other people that infringe

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86 Refer to Article 22 of 2006 CCL amendments. The same content can be found in Article 111 of the 1994 CCL.

87 Refer to Article 75 of 2006 CCL amendments.

88 Refer to Article 153 of 2006 CCL amendments
on the company’s benefits and other directors or supervisors that remain quiet during such infringement, the shareholders are eligible to initiate a lawsuit in his or her own name for the benefit of the company.”

This legislation also grants shareholders direct right to sue when their legal interests are invaded by directors or high-level managers.89

B. Directors

1. Qualifications:

Like the 1994 CCL, the 2006 CCL amendments restrict who can be directors either in limited liability companies or in companies limited by shares. Those limitations are found in Article 147, which prevent, for example, the following people from becoming directors: (1) a person without legal capacity or with restricted capacity for civil acts; (2) a person sentenced to certain criminal punishments or deprived of his or her political rights for committing crimes of bribery, invading others’ properties, or destroying the communist market economic order when no more than five years have elapsed since the enforcement dates; (3) a person who is the director, factory president, or manager for a bankrupt company due to his or her failure in management and was personally liable for the company’s bankruptcy, when

89 Refer to Article 153 of 2006 CCL amendments and Article 47 of PRC’s Securities Law.
not more than three years have elapsed since the date of the bankruptcy; (4) a person who is a legal representative of a company or enterprise whose business license was revoked due to a violation of the law and was personally liable for such revocation, when not more than three years have elapsed since the date of the revocation of the business license; and (5) a person with a relatively large amount debt due but not yet paid off.

Article 58 of the 1994 CCL stipulates that government officials cannot be directors, supervisors or managers of companies. However, there is no similar condition quoted in the 2006 CCL amendment. 90

In the 1994 CCL, there was no requirement for independent directors in publicly held corporations. Article 123 of the 2006 CCL amendments does clearly stipulate the need for listed companies to install independent directors but leaves further definition and decisions to the State Council.

2. Powers

Pursuant to Article 45 of the 2006 CCL amendment, the board of directors of a regular limited liability company shall be composed of three to thirteen members,

90 Huang Xuehai and Wang Shaochun, Qiye Fa Gongsi Fa Anli Jingxuan Jingxi[Selected Cases and Analysis in Enterprise Law and Company Law], Beijing: Falu chubanshe, 1998 (finding the four directors of a wholly state-owned limited liability company consists of four were all government officials.)
which may contain several employee representatives; and, pursuant to Article 109 of the 2006 CCL amendment, the board of directors of a company limited by shares shall be composed of 5 to 19 members, which may contain several employee representatives. Should a limited liability company be invested or established by two or more SOEs or two or more other state-owned investment entities, it shall include employee representatives on their board.\textsuperscript{91}

The board of directors shall be responsible for the shareholders’ meeting and shall be able to exercise the following powers: (1) to convene shareholders’ meetings and to report its work to the shareholders’ meetings; (2) to implement the shareholders’ meetings’ resolutions; (3) to determine the company’s business plan and investment proposals; (4) to formulate the company’s annual financial budget plan and financial proposals; (5) to formulate the company’s profit distribution plan and loss recovery proposals; (6) to formulate the company’s plan to increase or reduce the registered capital and issue company bonds (7) to propose the company’s merger, splitting, transformation and dissolution plans; (8) to determine how to install the company’s internal management mechanism; (9) to hire or fire the company’s manager, and hire or fire the company’s deputy manager or the responsible person for

\textsuperscript{91} Refer to Article 45 of CCL.
the company’s financial matters upon the recommendation of the manager, and to determine their compensation; (10) to formulate the company’s basic management system; (11) and other powers formulated in articles of incorporation.92

As one can find from the above, the board of directors does not seem to grant independent discretionary power, they mostly are to “implement” shareholders’ meetings’ resolutions, “formulate” and “propose” plans for shareholders’ meetings’ approval and “report” to the shareholders. This legislation is much different from the U.S. Modern Business Corporation Act, which requires that “all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.”93

In addition to the above-mentioned overall difference between Chinese boards of directors and the U.S. directors’ system, there exist some trivial distinctions between them. For example, the CCL does set the minimum and maximum number of board directors, sets a maximum term of three years for directors,94 and allows

92 Refer to Article 47 (limited liability company) and Article 109 (company limited by shares) of CCL.
93 Supra note 130, 8.01 (b) (1999)
94 Article 46, 109 of CCL.
absent director to vote by proxy. Nonetheless, the U.S. Model Business Corporation Act sets no concrete standards on the number of directors, sets a maximum term of one year for directors, and does not allow absent directors to vote by proxy.

3. Duties

According to Article 63 of the 1994 CCL, directors, supervisors, or managers shall be liable for compensation if they violate laws, administrative rules or provisions in the articles of incorporation while performing their duties and thereby cause harm to the company. It is far from clear that the 1994 CCL has imposed any duty of care on directors. However, the 1994 legislation does speak of a duty of loyalty for their directors and introduces several related principles. Supporting provisions can be found in article 59 of the 1994 CCL: “directors and managers shall faithfully exercise their duties and shall not take advantage of their status and powers to look for their own interests;” as well in as article 61 of the 1994 CCL: ”directors and managers shall

95 Art. 107 of CCL.
96 Art. 8.03 of Revised Model Business Corporation Act (1991)
97 Id., Art. 8.05
98 Id., Art. 8.20
99 Jian-Lin, Ni, The Profit Balancing between Shareholder Meetings and Board of Directors, Corporate Governance: Law and Practice, December, 2001, at 70
100 Id., at 82
not run businesses in the same category as the company, for themselves or for others, or pursue activities which will damage their company’s interests. The income derived from the above activities shall belong to the company. Directors and managers shall not enter into contracts or dealings either on behalf of themselves or on behalf of the company except as (otherwise) provided for in the articles of association.” Both “duty of care” and “duty of loyalty” have much more concrete and strict presentations in the CSRC’s “Required Conditions in Articles of Incorporation of Companies Listed Overseas” before the enactment of the 2006 CCL amendment.101

The 2006 CCL amendment has the same provision as the old Article 63. However, in addition to it, a “duty of care” and a “duty of loyalty” are imposed on directors, supervisors and high-level managers in Article 148 of 2006 CCL.102 The 2006 CCL amendment does not have provide a definition of the “duty of care,” but does keep the similar content of Article 59 and Article 61 of the 1994 CCL to illustrate the “duty of loyalty.”103 A significant difference is that in the new Article 149(5), directors or high-level managers “are allowed” to run businesses in the same

101 See Art 115 (duty of care), and Art. 116 to 121 (duty of loyalty) of Dao Jing Wai Shang Shi Gong Si Zhang Cheng Bi Bei Tiao Kuan [Required Conditions in Articles of Incorporation of Companies Listed Overseas].

102 Guang-Yuan, Ma, Explanation and Analysis of New Company Law, Chinalawinfo.com, Dec. 2005

103 Refer to Article 52 and 118 of CCL.
category as the company, for themselves or others if “they have the agreement from the shareholders’ meeting,” whereas the same situation in the old Article 61 could “never be allowed” to happen.

According to Article 69 of PRC’s Securities Law, issuers, directors and supervisors and high-level managers of listed companies are liable for the fake records, misleading description or major omission in public disclosed documents such as financial audit reports, listed reports, annual reports and so on. Article 73 and 74 of the Securities Law also prohibit insider trading between directors and supervisors and outsiders.

C. Supervisors

The supervisory board is one of the distinctive characteristics deriving from the German two-tier corporate governance structure. According to Article 52 and Article 118 of the 2006 CCL amendment, a limited liability company and a company limited by shares shall install a supervisory board composed of no less than three members, where a relatively smaller limited liability company may have one or two supervisors without setting up a supervisory board.

1. Qualifications:

The supervisory board shall be composed of representatives of shareholders and the proper proportion of the company’s employees.\textsuperscript{105} Company directors and high-level managers cannot also serve as supervisors.\textsuperscript{106} In addition, those supervisors shall avoid all the negative implications indicated in Article 147.

2. Powers:

According to Article 54 of CCL, a supervisory board shall exercise the following powers: (1) inspect the financial status of the company; (2) supervise directors’ or high-level managers’ acts and submit recall proposals if they violate laws, administrative rules, articles of incorporation or shareholders’ meetings’ resolutions; (3) request directors and high-level managers to correct their acts if they damage the company’s interests; (4) propose to convene interim shareholders’ meetings under the circumstance that the board of directors do not convene and preside over the shareholders’ meeting in accordance with this Law; (5) submit proposals to the shareholders’ meeting; (6) initiate lawsuits against directors and high-level managers according to Article 152 of this Law; and (7) such other responsibilities as listed in the articles of incorporation of individual companies.

\textsuperscript{105} See Art. 52 and Art. 118 of CCL.

\textsuperscript{106} Id.
The term of office of the supervisors shall be three years, and a supervisor may serve consecutive terms if he/she is re-elected upon expiration.\textsuperscript{107}

3. Duties

Unlike directors and high-level managers, supervisors only owe a certain level of fiduciary duties to the corporation and are subject to liabilities for breach.\textsuperscript{108} As the above-mentioned, supervisors are also liable for the fake records, misleading description or major omission in public disclosed documents in PRC’s Securities Law.\textsuperscript{109} They are prohibited to undertake insider trading activities as directors.\textsuperscript{110}

At the establishment of independent directors, a struggling relationship on powers and duties between supervisors and independent directors has emerged and heated up. This will be further addressed in the later chapters covering independent director.

III. Conclusion

Tracking from China’s civil law background, its prevailing corporate form is very likely to cling to the stakeholder-oriented model. Evidence can be found in Article 1 of the CCL: “This Law is formulated to protect the legal rights and interests of companies, shareholders and creditors, to safeguard the social and economic order

\begin{enumerate}
\item \textsuperscript{107} See Art. 53 and Art. 118 of CCL.
\item \textsuperscript{108} See Art. 148 and Art. 150 of CCL.
\item \textsuperscript{109} See Art. 69 of PRC’s Securities Law.
\item \textsuperscript{110} See Art. 73, 74 of PRC’s Securities Law.
\end{enumerate}
and to promote the development of the socialist market economy.”  This article
discloses that the CCL anticipates promoting the interests of all kinds of involved
parties that are also known as “stakeholders”.111

Nonetheless, the importing of a Westernizing shareholding system to China has
helped to straighten out Chinese enterprises’ corporate governance and their balance
sheets ahead of a public listing. Numerous transformations and restructures of SOEs
took place to adopt shareholding ownership system in Corporate China recently.112
Although several basic statutes in the CCL make it look stakeholder-oriented, the
introduction of some other protection mechanism for shareholders confirms their
determination to establish a healthy shareholding system with a fairer allocation
system in both SOEs and in POEs. The worldwide corporate governance

111 Neil King Jr. and Jason Dean, Untranslatable Word in U.S. Aide’s Speech Leaves Beijing Baffled,
112 Dow Jones Newswires, Bank of China Is Restructured, WALL ST. J., Aug. 25, 2004 (addressing
that the state-owned Bank of China has become a shareholding company 100%-owned by state-owned
Central Huijin Investment Co. The Bank of China shareholding Co. which was known as Bank of
China, among one of the four state-owned banks in China was launched with registered capital 186.39
billion yuan (approximately $22.52 billion) and an equal number of shares on August 23, 2004. This
bank was aiming for a domestic listing in 2005. Another formation of shareholding company ahead of
Bank of China is China Construction Bank. Policy makers proposed to extend the pilot program to
Industrial & Commercial Bank of China and Agricultural Bank of China which are both heavily
bad-debt-burdened; See also Sale of 25% stake is planned to Foreign investors before IPO, Wall Street
Journal, January 11, 05, A17, introducing that municipal government-owned Bank of Beijing also
announced an expectant deal of 25 stake transfer between them and a ING Group NV.)
convergence has silently influenced Chinese corporate governance system. More evidences can be found in several other rules the Chinese government has set up to further strengthen minority shareholders’ interests. What are the most important rules or mechanism? Are there path dependencies existing along the transforming process? What are the suggestive solutions? The author will make further explanation in Chapter 2.

Chapter 2 Worldwide Corporate Convergence in China ----Independent Director in Contemporary China

I. Protective Measures of Minority Shareholders in China

A study conducted by the Shanghai Securities Exchange identifies the following problems for Chinese corporate governance: (1) irrational shareholding structure; (2) lack of independence of the board of directors; (3) inability of board of supervisors to play its role; (4) relative weakness of oversight role of creditors; (5) unlimited powers of key management personnel; (6) low level of transparency and professionalism in investment decisions; (7) lack of a market for corporate control; (8) lack of a market for management services; (9) skewed system of incentives; (10) lack of protection of interests of small shareholders; (11) lack of a system for accountability; and (12) lack of a shareholder culture and corporate governance culture. The above items (1),

113 See China Economic Times (2000)
(2), (3), (5), (6), (10) are all closely related to exploitation of minority shareholders’ rights.

The significance of protecting minority shareholders’ rights as what the Shanghai Securities Exchange has concluded resulted mainly from the unique corporate shareholding structure with strong Chinese characteristics.

The feature of typical Chinese listed companies has been a few dominant controlling shareholders who often hold unlisted state or legal person shares as well as a group of scattered minority shareholders who hold a small portion of listed shares. Apparently, this concentrated ownership regime hardly experiences the “agency problem” that is comprehensively discussed by major American corporate governance literature. 114 Nevertheless, they are experiencing a severe problem of exploitation of minority shareholders’ rights. Under concentrated ownership structures, the board of directors under the control of certain dominant controlling shareholders will easily appropriate their powers to extract minority shareholders’ interests through means such as insider dealings, price manipulations, and so on. In China, the problems are even worse, since the controlling shareholders normally are the “state” which holds the sovereign power of all administrative agencies in this Communist country. The

114 See Berle and Means (1993), *The Modern Corporation and Private Property*
state controlling shareholders might look for reaching its own goals such as fulfilling the country-wide full-employment policy or benefiting the state’s financial situation rather than profit maximization which is the goal for regular shareholders’ investment.\textsuperscript{115} Such exploitation of minority shareholders’ interest will certainly discourage foreign investment in the Chinese securities markets. This phenomenon explains why firms without dominant state ownership have appeared to outperform firms with dominant state ownership in China.

In order to improve the current performance of the Chinese securities markets, the Chinese government adopted a series of legal measures to protect minority shareholders against the controlling shareholders, which primarily refer to the state in China, to help disperse ownership to attract foreign investment. On December 9, 2004, the Chinese government announced sweeping reforming regulations on protecting minority shareholders’ rights,\textsuperscript{116} giving minority shareholders strong power to have their voices heard.\textsuperscript{117} The China Securities Regulatory Commission

\textsuperscript{115} Mar & Young (2001:297), who report that two publicly listed companies, China Southern Airlines and China Eastern airlines, both of whose shares are dominated by state. The state has the power to force these Airlines companies to buy unnecessary air crafts from the state. Jiang (2001) proposes that controlling state shareholder s voluntarily refrain from policies that might hurt minority shareholders’ right

\textsuperscript{116} See Sweeping Rules Regarding Strengthening Protection of Society Public Shareholders

\textsuperscript{117} Dow Jones Newswires, \textit{China Gives Minority Shareholders bigger Role}, Wall Street Journal, Dec. 9,
(hereinafter referred as “CSRC”) further explained that those significant corporate decisions on whether to proceed with major investment or fund-raising efforts will be decided by the majority voting of public shareholders who attend shareholders’ meeting annually. The rules are expected to water down the dominant voting power held by the state, representing nearly $500 billion of listed company equity in China.\textsuperscript{118}

The 2006 CCL amendment established the flagship protective measures ever for minority shareholders’ rights.\textsuperscript{119} One can examine the protective measures from the following aspects:

1. Shareholders’ Rights to Review:

   The 2006 amendment expands the shareholders’ rights to include reviewing the meeting minutes of shareholders’ meetings, resolutions of board of directors and supervisory boards and the company’s accounting book.\textsuperscript{120}

2. Shareholders’ Rights to Request Acquisition of Shares and Initiate Lawsuit

   According to Article 75, shareholders are allowed to request the company acquire

\textsuperscript{118} Id.
\textsuperscript{120} Refer to Article 34 of CCL.
their shares if the company has not distribute profits for five consecutive profitable years; if the company merges, separates or transfers primary properties; or if the company could be dissolved according the articles of association. If the shareholders and the company cannot reach an agreement, the shareholders are allowed to bring a lawsuit.

3. Shareholders’ Rights to Request Dissolution

According to Article 183, shareholders with shareholding more than 10% are allowed to apply for dissolution of the company with People’s Court if the shareholders’ interests are suffering great loss.

4. Cumulative Voting Mechanism

According to Article 106, directors and supervisors could be elected by cumulative voting if so permitted by the company’s articles of association or shareholders’ resolutions.

5. Shareholders’ Derivative Suits and Direct Suits

In addition to the managerial powers, the 2006 CCL amendment has granted shareholders the right to bring lawsuits under different circumstances. Shareholders can initiate lawsuits when the resolution content or procedures of a shareholders’ general meeting or the board of directors violate the law or administrative rules or
articles of incorporation.\textsuperscript{121} The 2006 CCL amendment enlarges the range of shareholder rights to sue. Shareholders are allowed to bring lawsuits when (1) shareholders and the company cannot reach an agreement to buy back those shares held by the shareholders under certain circumstances;\textsuperscript{122} and (2) directors or high-level managers violate the laws, administrative regulations or articles of incorporation which infringe shareholders’ rights.\textsuperscript{123}

The shareholders are also allowed to bring shareholders’ derivative suits, analogous to the shareholders’ derivative rights under the U.S. corporate governance system. According to Article 152 of the 2006 CCL amendment, ”directors, supervisors, high-level managers or other people that infringe on the company’s benefits and other directors or supervisors that remain quiet during such infringement, the shareholders are eligible to initiate a lawsuit in his or her own name for the benefit of the company.”

6. Independent Directors Requirement

Article 123 of the 2006 CCL amendment requires listed companies to install an independent director system, but no stipulation regarding independent directors is

\textsuperscript{121} Refer to Article 22 of 2006 CCL amendments. Similar content can be found in Article 111 of the 1994 CCL.

\textsuperscript{122} Refer to Article 75 of 2006 CCL amendments.

\textsuperscript{123} Refer to Article 153 of 2006 CCL amendments and Article 47 of PRC’s Securities Law.
addressed in PRC’s Securities Law.

The 2006 CCL amendment has made significant improvements on the protection of minority shareholders’ rights. Among all the protective measures, the independent director system is the only mechanism needing other supportive enforcement rules than CCL to complete its functional role, and it is the most important and arguable design for a securities market developing toward shareholder-oriented/dispersed ownership model. The author believes that the evolution of a Chinese independent directors system represents an epitome in the development of the Chinese corporate governance structure. The following sections will extend more discussions and arguments on the developments of independent director system in China.

II. Independent Director System in China

China, a civil law country which supposes to focus on the benefits of stakeholders rather than shareholders in the corporate governance structure; a planned market economy which may focus more on the benefits of general public rather than minority shareholders’ rights, does not seem to be rich soil for the independent director system to grow. More path dependency problems might come up during the process of transplanting this independent directors mechanism. How can China fully
play out this independent director system designed for a civil law country? A capitalist system is tough, challenging, but exciting for Chinese regulators and all market participators.

Since the independent director system has been widely introduced and practiced in all aspects of U.S. corporate governance, it will be of great help to review U.S. experience before observing the Chinese practice.

A. U.S. Experience

1. Role of the U.S. Independent Directors

The concept of independent directors in the U.S. could be tracked back to the early 1970s—the bankruptcy incident of Penn Central Railroad Company.

Protector of Shareholder Interests

There were two perspectives emerging for independent directors during the evolution of the Anglo-American corporate legal system: protector of shareholder interests against management; and protector of broader social interests against the corporations as a whole. The former eventually prevails the latter in the U.S. corporate law practice. Since, unlike consumers, employees, creditors or suppliers of the company who are capable of protecting themselves through contracting,
shareholders are the only constituency whose investment is deeply sunk into the company and could hardly withdraw while something unfortunate happens.\(^{124}\)

**Substitute for External Regulation**

As a watchdog, independent directors could be viewed either as a substitute for external regulation or as an implementer of it. In America, the independent director mechanism primarily plays the role as a substitute rather than an implementer of external regulation for corporations.\(^{125}\) Courts and legislatures normally do not involve themselves too deep with the business decisions of corporate management. They leave considerable leeway for the board of directors with independent directors. In Delaware, even “fair scrutiny” (a fundamental, unobjectionable idea that promotes that business transactions between a corporation and a director should be on terms that are fair to the corporation) is not imposed on corporations as a substantive rule of law (or the Revised Model Business Corporation ACT (the “MBCA”)) if this transaction has obtained approvals from majority independent directors after full

\(^{124}\) See, e.g., Hansmann & Kraakman (2001:442) and Hansmann (1996:56)

\(^{125}\) Donald C. Clarke, *The Independent Director in Chinese Corporate Governance and “Guidance Opinion on an Establishment of Chinese Independent Director System in Listed Companies”*, 2 [2, Commentary Review of China University of Political Science & Law], 103 (2003) (explaining that the independent directors could play the role as either a substitute of external regulation or a implementer of it.)
2. Corresponding Laws and Rules

Most of the independent directors are allocated to be the exclusive members of the audit committee, nominating committee and compensation committee in large publicly held corporations in American corporate governance. The nominating committee and compensation committee are not presently required by law. However, the American Law Institute’s (“ALI”) Principles of Corporate Governance, the New York Exchange, the NASDAQ Stock Market, the Business Roundtable Statement, the Business Roundtable’s Corporate Governance and American Competitiveness, the Corporate Director’s Guidebook, and the Report on Overview Committees do require or recommend every corporation have a nominating committee and a compensation committee which constitute majority or disclosure.¹²⁶

¹²⁶ Id.
¹²⁷ Article 3.05, Article 3A.04 and Article 3A.05 of American Law Institute’s Principles of Corporate Governance, May 13, 1992.
¹²⁸ Id.
¹²⁹ Article 303A.04 of Listed Company Manual (last modified Nov. 03, 2004)
¹³⁰ Sec. 4.13 (f) and (h) of By-Laws of the Nasdaq Stock Market, Inc.
¹³¹ Page 2108-10
¹³² p.249
¹³³ p.1625-1627
¹³⁴ p.7-8
exclusively of independent directors.\textsuperscript{135}

Among the three types of special committees, audit committees have gradually played a more and more important role over these past couple decades.\textsuperscript{136} The audit committee is not required as a matter of state law, except in Connecticut.\textsuperscript{137} However, the Sarbanes-Oxley Corporate Reform Act\textsuperscript{138}, the ALI’s Principles of Corporate Governance, the Securities Exchanges Commission,\textsuperscript{139} the New York Stock Exchange,\textsuperscript{140} the NASDAQ Stock Market,\textsuperscript{141} the Business Roundtable Statement,\textsuperscript{142} the Business Roundtable’s Corporate Governance and American Competitiveness,\textsuperscript{143} the Corporate Director’s Guidebook,\textsuperscript{144} the Report on Overview Committees,\textsuperscript{145} the Report of the National Commission on Fraudulent Financial

\textsuperscript{135} Comments on Article 3A.04 and Article 3A.05 of American Law Institutie’s Principles of Corporate Governance.
\textsuperscript{136} Sec v. Falstaff, 629 F. 2d 62, 75 (D.C. Cir. 1980) (suggesting that the existence of [an audit] committee infers a widespread sense of “great care and precision through detailed review and oversight.”)
\textsuperscript{137} See Art. 33-318 (b) of Conn. Gen. Stat.
\textsuperscript{139} Sec. 202 of H.R. 3763-29
\textsuperscript{140} Article 303A.06 and 303A. 07 of NYSE Listed Company Manual.
\textsuperscript{141} Rule 4350(d) of Nasdaq Marketplace Rules
\textsuperscript{142} pp.218-219
\textsuperscript{143} p. 249
\textsuperscript{144} p. 1627
\textsuperscript{145} pp. 1351-60
Reporting (Treadway Commission)\textsuperscript{146} do have definite requirements or recommendations for largely-held corporations to implement and support the oversight function of the board.\textsuperscript{147} Since NYSE and NASDAQ are self-regulatory bodies, they even have to the right to prohibit companies from listing on their exchanges if they do not comply with the requirements.

Hereunder is a general introduction of major U.S. corporate rules regarding the independent director system based on requirements of disinterestedness (independence or significant relationship), audit committee as well as personal qualifications:

\subsection*{a. Delaware General Corporation Law and Modern Business Corporation Act}

**Disinterestedness Requirements**

A transaction-by-transaction approach on “conflicts of interest” was taken by the Delaware General Corporation Law (hereinafter referred as “DGCL”) and the Modern Business Corporation Act (hereinafter referred as “MBCA”). The state corporate statutes focus on defining certain business transactions involving ”conflicts of interest,”---such as transactions between a corporation and its directors or officers, or

\textsuperscript{146} pp. 40-41

\textsuperscript{147} Comments on Article 3.05 of ALI’s Principles of Corporate Governance.
between a corporation and another business entity, in which one of its directors or officers has related interests or the business opportunities taken by the corporate officers might belong to the corporation---and provide certain scrutiny to judge whether those who made the decisions had conflicts of interest. One recent shareholders’ derivative action was initiated by the shareholders of the Oracle Corporation alleging insider trading by the corporation’s chief executive officer (hereinafter referred as “CEO”), chief financial officer (hereinafter referred as “CFO”), and two directors. The Court of Chancery of Delaware held that ties with the Special Litigation Committee (hereinafter referred as “SLC”) were so substantial such as to cause reasonable doubt about the members’ independence. The Court further explained that “assessing the independence of the corporation’s SLC required an examination of whether the SLC could independently make the difficult decision entrusted to it: whether the CEO, CFO and two directors should face suit for insider trading-based allegations of breach of fiduciary duty.”

The state statutes were actually designed to displace the common law rules on

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148 Clarke, supra note 231, at 16
149 Oracle Corp. Derivative Litigation, 824 A.2d. 917, 917, Court of Chancery of Delaware 2003 (one of the numerous shareholder derivative suits which favors shareholders to hold that ties among special litigation committee members were so substantial that cause reasonable doubt about the members’ independence)
150 Ties among SLC, university they were tenured professors, and directors who was major benefactor.
conflict-of-interest transactions. The common law ruling on conflict-of-interest in many states in the late 19th century was absolute: many dealings involving conflict-of-interest could be easily rejected by the insistence of any stockholder.\textsuperscript{151}

The common law rules made the transactions involving conflict-of-interests defenseless. The person involved in conflict-of-interest dealings was supposed to be liable for returning the corporation to the \textit{status quo ante} according to common law rules. The state statutes allow the existence of conflict-of-interest dealings if they fulfill certain conditions such as the disclosure of the conflict-of-interest dealings or approval of these dealings by disinterested decision-makers, whether directors or shareholders. However, not having met the conditions does not necessarily indicate that the dealing is unlawful. It merely means that the common law rules might be applied by a court if any shareholder brings a suit. Examples could be found in both the DGCL and the MBCA.

Article 144 of the DGCL claims that a transaction is not void solely by a conflict of interest involved in a director’s or officer’s standing on both sides if one of the following conditions are fulfilled: (1) the relevant facts of the dealing have been

\textsuperscript{151} See, e.g., Wardell v. Railroad Co., 103 U.S. 651, 658 (1880) (“The law always condemned a person who enter into a transaction on his own behalf and on other parties’ behalf—play the role of other parties’ agent. Those transactions will relieve against him/her whenever the enforcement is seasonably resisted.)
disclosed to the board and a majority of disinterested directors ratify in good faith; (2) the relevant facts of the dealing have been disclosed to the shareholders entitled to vote, and the shareholders ratify this dealing in good faith;\textsuperscript{152} or (3) the terms set forth in the transactions, as of the time the directors or the shareholders authorize it, appear to be fair to the corporation. It is important to note that the last provision of Article 144 presents that the interested directors may be counted in reaching the presence of a quorum at a board meeting or a committee which would authorize the transaction.

The MBCA particularly claimed it only intends to deal with the challenges regarding conflicts of interest by directors, and left all other issues to the states’ existing common law jurisprudence. The MBCA suggests that shareholders could not claim for damages, injunction, or any other remedy on the grounds of existence of conflicts of interest met the following requirement: (1) sufficient disclosure was given and approval from a majority of disinterested directors followed; or (2) sufficient disclosure was given and approval from a majority of disinterested shareholders.

\textsuperscript{152} The Delaware Statute here does not require the ratification should come from disinterested shareholders, however, this requirement has been spelled out in the statute by case law. See, e.g., Marciano v. Nakash, 335 A. 2d 400, 405 n.3 (Del. 1987) ("Approval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)2, permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.")
followed; or (3) the terms set forth in the transactions as the time it is entered appear to be fair to the corporation.

The significant difference would be the distinct requirement of “disinterested directors” and “disinterested shareholders” are the only groups who are empowered to ratify the issues of self-dealing in MBCA, whereas, the Delaware State government is more open regarding this requirement. However, both of them do not provide an absolute and general definition of “independence” or require rigid institution of “independent director system”. They instead make a transaction-by-transaction scrutiny on “full disclosure” or “disinterest” in particular conflict-of-interest dealings.

b. American Law Institute’s Principles of Corporate Governance (1994)

Significant Relationship Requirements

In Art. 1.34 of ALI’s Principles of Corporate Governance, a clear explanation of “significant relationship” is given as follows: (1) the director is under the corporation’s employment within the two preceding years; (2) the director is an immediate family member\textsuperscript{153} of an officer or a senior executive with the two

\textsuperscript{153} \textit{Id.} at Article 1.26
preceding years; (3) the director has involved certain monetary activities\textsuperscript{154} which exceeded $200,000 during the two preceding years; and (4) The director is affiliated in a professional capacity with a law firm or an investment banking firm to the corporation or acted as a managing underwriter in an issue of the corporation’s securities, within the two preceding years.\textsuperscript{155}

The ALI Principles specifically note that the definition of “significant relationship” in Article 1.34 is not synonymous with the definition of “interested” in Article 1.23.

**Independent Directors on the Board**

The American Law Institute (hereinafter referred as “ALI”) suggests every large publicly held corporation\textsuperscript{156} should have a majority of directors who are free of any “significant relationship” with the senior executives on the board. The ALI also suggests that every publicly held corporation should have at least three directors who are free of any “significant relationship” with their senior executives on the board.

\textsuperscript{154} Id. (3) and (4) of Article 1.34

\textsuperscript{155} Id. (5) of the Article 1.34

\textsuperscript{156} ALI’s Principles of Corporate Governance, Article 1.24 “Large Publicly Held Corporation” means a corporation that as of the record date for its most recent annual shareholders’ meeting had both 2,000 or more record holders of its equity securities and $ 100 million or more of total assets;….”
Independent Directors on Audit Committee

The same Article also suggests that “The audit committee should consist of at least three members, and should be composed exclusively of directors who are neither employed by the corporation nor were so employed within the two preceding years, including at least a majority of members who have no “significant relationship”157 with the corporation’s senior executives.”158

Powers and Responsibilities of Audit Committee

According to Art. 3.05 of ALI’s Principles of Corporate Governance, “Every large publicly held corporation should have an audit committee to implement and support the oversight function of the board.”

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157 See Article 1.34 for more information of definition of “significant relationship”.
158 The roles of independent directors in major corporate governance principles, rules and legislation are introduced closely with the composition of audit committees. In addition to NYSE, both the American Stock Exchange (Article 121 of American Stock Exchange Listed Company Guide) and NASDAQ (Schedule D to the NASDAQ By-Laws) recommend or require their listed companies to equip with audit committees. The Business Roundtable Statement does give emphasis on the significance of three critical board committees which include the audit committee, and the audit committee was required to be composed entirely of non-management directors. (p.218-219 of the Business Roundtable Statement). To the same effect are the Business Roundtable’s Corporate Governance and American Competitiveness (p249 of the Business Roundtable’s Corporate Governance and American Competitiveness), the Corporate Director’s Guidebook (p1627 of the corporate Director’s Guidebook), the Report on Overview Committees (pp. 1351-60 of the Report on Overview Committees), as well as the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission) (pp.40-41 of the Report of the National Commission on Fraudulent Financial Reporting.)
The functions and powers of audit committees should include: (1) recommending the outside auditing firm, reviewing its compensation, and its proposed engagement terms as well as its independence; (2) reviewing the assignment of the senior internal auditing executive, if any; (3) communicating between the external auditing firm, the board, and the senior internal auditing executive; (4) reviewing the corporation’s annual financial statements and documents prepared by the outside auditing firm in connection with the audit as well as reports of the internal auditing department; (5) considering the adequacy of the corporation’s internal controls in consultation with the outside auditing firm and the senior internal auditing executive; and (6) considering major changes and questions regarding appropriate accounting principles and practices to be used in the corporation’s financial statements.

c. **Rules by New York Stock Exchange (“NYSE”)**

The NYSE, established in 1792, is one of the world's leading and most technologically advanced equities markets and is under the oversight of Securities Exchange Commission. A broad spectrum of market participants, including listed companies, individual institutional investors and member firms participate in the business activities in this fair, open and orderly market to access the best possible price through the interplay of supply and demand. As of December 31, 2006, the
NYSE and NYSE Arca were home to approximately 2,764 world-class issuers.\textsuperscript{159}

**Independence Requirements**

Members of audit committee cannot serve on the audit committee under the following circumstances: (1) Employment: A member director is/was an employee of the captioned company or any of its affiliates or its parent or predecessor within the preceding three years; (2) Business Relationship: A member director is a partner, controlling shareholder, or executive officer of an entity which engages in business activities with the captioned company, or serves as a consultant for the company, unless the company’s Board of Directors made a business judgment that this business relationship will not impair this member director’s independence; (3) Cross Compensation Committee: A member director serves as an executive of another entity where any of this company’s executives serve on such other entity’s compensation committee; (4) Immediate Family: A member director’s immediate family member is an executive officer of the company or its affiliates within the three preceding years.\textsuperscript{160}

**Independent Directors on Audit Committees**

\textsuperscript{159} See http://www.nyse.com/about/1088808971270.html
\textsuperscript{160} Id. at Art. 303.01 (B) (3)(a), (b), (c), (d)
The NYSE requires that each of its listed companies set up and maintain an audit committee which “shall consist of at least three directors, all of who have no relationship to the company that may interfere with the exercise of their independence from management and the company.”\(^{161}\)

**Conflict of Interest**

According to Article IV, Section 15 of the Constitution of NYSE, no director shall participate in the deliberation or adjudication of any matter in which he or she is personally interested.

**Professional Qualification**

At least one of the audit committee members should be an expert in accounting or financial management.\(^{162}\)

**d. Rules by NASDAQ**

NASDAQ is the largest electronic stock market in the United States. With approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. securities markets. Its listed companies are leaders across all areas of business including technology, retail, communications,

\(^{161}\) See Art. 303.01(A) and (B)(2)(a) of *New York Stock Exchange, Listed Company Manual*

\(^{162}\) *Id.* at Art. 303.01 (B)(2)(c)
financial services, transportation, media and biotechnology. As with the NYSE, it is also under the supervision of SEC.

**Independence Requirements on the Board**

According to the Article 4200(a)(15) of the NASDAQ marketplace rules, the independent director was defined as “a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of directors.” Following are a detailed description of a person who shall not be considered independent director: (1) a person was employed by the company or by any parent or subsidiary of the company at any time during the past three years; (2) a person or his or her family member\(^\text{163}\) who accepted any payments from the company or its parent or subsidiary in excess of U.S. $60,000 during any period of twelve consecutive months within the three years preceding the judgment regarding independence, other than the following reasons: (a) compensation for board of directors or board committee service; (b) payments from investments in the company’s securities; (c) compensation paid to a

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\(^{163}\) See 4200 (14) of the Nasdaq Marketplace Rules (explaining that “family member means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home”)
family member who is a non-executive employee of the company or its parent or subsidiary; (d) profits under a tax-qualified retirement plan, or non-discretionary compensation; (e) loans or payments from a financial institution, only if condition such as these loans or payments: (i) were made in the ordinary course of business or (ii) were made on substantially the same terms as those prevailing at the time for comparable transactions with the general public, or (iii) did not involve more than a normal degree of risk or other unfavorable factors, or (iv) were not otherwise subject to the specific disclosure requirements of SEC Regulation S-K, Item 404; or (v) not otherwise subject to the disclosure requirements of SEC Regulation S-K, Item 404; or (vi) permitted under Section 13(k) of the Act.

Independent Directors on Audit Committees

According to Article 4200 (1) (14) of NASDAQ Marketplace rules, national markets must institute audit committee with no less than three directors, and all of them should be independent. For certain small companies, they may have an audit committee composed of a majority of members who are independent directors.

Independence Requirements on Audit Committees

In addition to the above listed requirements for ordinary independent directors, independent directors serving on the audit committee are subject to additional, more
stringent requirements under Rule 4350(d) and cannot serve if: (1) a director’s family member is or was a executive officer of the company or its parent or subsidiary individual at any time during the past three years; (2) a director’s family member is a partner or a controlling shareholder or an executive officer of any entity to which the company made or from which the company received payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than the following: (a) payments from investments in the company's securities; or (b) payments under charitable contribution matching programs; (3) a director of the listed company who is, or whose family member is, employed as an executive officer of another organization where at any time during the past three years, any of the executive officers of the listed company serve on the compensation committee of such other entity; or (4) a director who is, or whose family member is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditing firm who worked on the company's audit at any time during any of the past three years. (5) in the case of an investment company, instead of the above conditions, an “interested” director of the company is defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the
board of directors or any board committee.

e. Sarbanes-Oxley Corporate Reform Act (2002)

The role of the independent director mechanism has a complete and aggressive description in the Sarbanes-Oxley Act (hereinafter referred as “SOX”), which was signed into law on July 30, 2002, along with rules proposed by two stock exchanges\(^\text{164}\) in the United States. However, the significance of SOX is not established because of its invention of the role of independent director, but because of its creation of a variety of mandatory corporate functions and being able to vastly increase their legal complexity, and ultimately enhance the requirement of corporate judgment that can endure challenge.\(^\text{165}\) SOX, known as the corporate-oversight law, requires greater independence by corporate directors in order to solve the scandals at Enron, Tyco, WorldCom and elsewhere. The independent director mechanism was promoted by Sarbanes and by Arthur Levitt\(^\text{166}\) in 2002. This Act tried to prompt greater vigilance by the audit committees.

*Independence Directors on Audit Committees*

\(^\text{164}\) New York Stock Exchanges and Naqsda


\(^\text{166}\) Arthur Levitt is the Chairman of Clinton Securities and Exchange Commission. He was made a media hero for his suggestion for the “corporate reforms” he [touted] that allegedly would have hindered the outbreak of Enron catastrophe for minority shareholders.
SOX picked up the trendy reform advice by requiring that an audit committee be responsible for looking on a company’s accounting practices and made up solely of independent directors.\textsuperscript{167}

\textbf{Independence (Disinterestedness) Requirements on Audit Committees}

In order to be considered as independent directors to serve on the audit committees, a member of the audit committee may not receive “any consulting, advisory, or other compensatory fee” from the company, or affiliate to the company or any of its subsidiaries thereof.\textsuperscript{168} It is important to note that, SOX give the SEC the authority to make exemptions for certain individual{s} on a case-by-case basis. In addition to general independence requirement, it’s more like a “disinterestedness requirement”.

\textbf{Powers and Responsibilities of Audit Committees}

The audit committee was established to audit the financial and accounting processes.\textsuperscript{169} This audit committee “shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer (including resolution of disagreements between management

\begin{footnotesize}
\textsuperscript{168} Id. Art 301 (B).
\textsuperscript{169} Id. Section 205 (confirming amendments of Section 3 (a) of the Securities Exchange Act of 1983)
\end{footnotesize}
and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related word, and each such registered public accounting firm shall report directly to the audit committee.”

The audit committee will need to “establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matter.”

The audit committee ought to supervise and ensure that the audit engagement team does not stay in its position longer than is permitted. The audit committee has the authority to hire independent counsel and other advisers at company’s expense. All those new responsibilities set forth in SOX may require the audit committees to stay in contact with outside auditors on a regular, continuous basis, and committee members may expect to meet in continuous sessions sometimes.

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170 Id. Section 301 (confirming amendments of Section 10 A of the Securities Exchange Act of 1934)
171 Id., Art. 301 (4).
173 Hazard & Rock, supra note 272
Professional Qualification

In addition, the company must disclose whether at least one of those committee members is a “financial expert,” and if not, explain the reason.175

3. Implementation of Independent Director System in the United States

The independent director system first obtained its clear definition in corporate America after it was signed into law as SOX. SOX has been considered the most comprehensive and powerful corporate reform act up to date. However, many criticisms thereafter have targeted the intention and efficiency of SOX.176 SOX was criticized as a USA Patriot Act which was driven by the political need of U.S. Congress to appear to be diligent in their incumbencies in response to the terrorist attacks of 2001.177 SOX was designed to regulate in areas that have traditionally been left to state corporate law.178 The enactment of this Act might signal the birth of “the creeping federalization of corporate law”179 since it dictates one-size-fits-all

175 Id, Art. 407 (codified at 15 U.S.C. Art.7265)
176 John Berlau, Sarbans-Oxley is Business Disaster, Insight Magazine, Jan 22, 2004, at 1, 2
177 Id, at 1.
178 Notes from Professor David Skeel of the University of Pennsylvania Law School, March 18, 2005.
179 Stephen Bainbridge,, Regulation Magazine
processes for testing internal controls for approximately all public listed companies. This Act not just passively “prohibits” conduct, but aggressively “mandates” prescriptively the structure and operation of audit committees. The SEC has come under fire from business society for its regulatory approach and has said that it will host a roundtable discussion to “evaluate the implementation” of SOX. It has been signaled in the SEC’s recent response that they would ponder to adjust the relevant provisions of SOX, if necessary.

One of the trendy reforms SOX promotes is independent director in audit committees. These independent directors are independent, receiving no salary or fees from the company other than for service as directors. It then says chief executive officers (CEOs), who are forced in another part of the law to possibly be liable for criminal penalties for earnings misstatements, have no say in hiring the outside auditor. The audit committee is the agency responsible for hiring, overseeing and compensating the auditors, and the auditor must report directly to the committee, not company management. Serving on a board has lost much of its appeal as a wave of corporate scandals has made this old-time prestigious position increasingly risky,

\[180 \text{ Id, at 1.}\]
\[181 \text{ Deborah Solomon, } SEC to Host Talks on Contentious Rules, Wall Street Journal, February 8, 2005, at A3\]
particularly acknowledging 10 former directors of WorldCom Inc. and Enron Corp. agreed in recent tentative court settlements to shell out a total $18 million and $13 million from their own pockets, respectively, to settle shareholder lawsuits.\textsuperscript{182}

Although the NYSE and NASDAQ have both proposed the facility of independent directors with relevant rules and regulations on board, no concrete evidence has shown that companies with strong independent director boards will look out more for shareholders interests. A large-sample study even found that “firms with more independent boards are not more profitable; indeed, there were hints in the data that they perform worse than other firms”\textsuperscript{183} An ironic example is “Enron,” whose board was comprised of 86\% independent directors, which would have been able to comply nearly perfectly with SOX. It is doubtful that the stricter the legal rules are, the more people will be well behaved.\textsuperscript{184} Even those strict rules are presumed to be effective


\textsuperscript{183} See a study done by professors from Standard Law School and the University of Colorado, and was reported in the Journal of the management consulting firm Booz Allen Hamilton. (find more concrete info.); See Bhagat & Black (2000) (“[T]here is no evidence that greater board independence leads to improved firm performance; if anything, there are hints in the other direction. The conventional wisdom that supports a very high degree of board independence … appears to rest on a shaky empirical foundation.”) and Klien (1998) (finding little evidence that monitoring committees usually dominated by independent directors—the audit, compensation, and nominating committees—-affect performance, regardless of how staffed).

\textsuperscript{184} “Strapped for time, the board must trust and rely on management. The board can ask the auditors to
and helpful on supervising the corporate governance, companies have their own discretion to choose not to be burdened by them. The number of companies that delisted their common shares from stock exchanges in order to avoid increased outside scrutiny has soared triple in 2003.\textsuperscript{185}

The “independence” issue is a debatable topic in the U.S. boardroom lately. The NYSE and the NASDAQ have been imposing rules to boost the number of directors without interests in supervising the companies they serve since 2004.\textsuperscript{186}

The NYSE rules require a majority of all directors shall be “independent,” as shall all directors on audit, nominating, compensation and corporate-governance committees. The definition of independent directors here refer to directors who are executives at entities that have significant business with the listed company they serve totaling more than $1 million, or 2\% of the entity’s revenue, whichever is greater.\textsuperscript{187}

Nonetheless, a review of 150 corporate filings initiated by the Wall Street Journal check things, but even the auditors can’t spend enough time to prevent problems. What prevents problems very simply is management choosing to run a clean ship, period.” said T. J. Rodgers, the outspoken libertarian CEO of Cypress Semiconductor Corp. when he was interviewed by Insight Magazine, see supra note 23.

\textsuperscript{185} Peter Loftus, \textit{Delisting Soared in 2003, Study Shows}, WSJ, Dec. 15, 2004 at B3F (referring to a study co-authored by professors from the Wharton School of the University of Pennsylvania and the University of Maryland’s Robert H. Smith School of Business.)


\textsuperscript{187} \textit{Id.}
highlights how exceptions and qualified independent directors under the rules limited their corporate governance effectiveness.\textsuperscript{188} Companies, have made their own calls on defining “independence”, regularly checking with exchanges to discuss particular directors.\textsuperscript{189} When it comes to particular case, it is a matter of “disinterestedness”.

The DGCL, MBCL and SOX does give judgment on individual case basis.

**B. The Chinese Practice**

1. **Role of Chinese Independent Directors**

   **Protector of Shareholders’ Interests**

   Deriving from the civil law system, different from common law system, China supposes to pay more attention on the interests of stakeholders than shareholders in the corporate governance structure. However, since China borrows the independent director system from Anglo American corporate law system, the notion of the independent director as representing stakeholders is lost in the newly-established Chinese independent director system. The independent directors in China are expected to protect shareholders rights against management, and fight for minority shareholders as their rights are exploited by controlling shareholders\textsuperscript{190} instead of

\textsuperscript{188} *Id.*

\textsuperscript{189} *Id.*

\textsuperscript{190} supra note 21
broader social interests against the corporations as a whole.

The Chinese literature and statutes find generalities about the functions of independent directors, such as preventing corruption, daring to ask sharp questions, questioning the board’s decisions and management operation to ensure the fair corporate governance practice. For most of discussions in China, the independent director system is regarded as a special prescription of medicine which is able to cure every disease that a company might have.

**Substitute of External Regulation**

Similar to American independent directors, Chinese independent directors tend to play the role as substitute of external regulation in relevant rules and guidelines, too. They are not only expected to help implement those standards at issue, but also perceived as a substitute for the external regulation. Those regulators tried to leave independent directors space for their independent fair judgments.

**2. Corresponding Rules and Guidelines**

 Scholars who advocate the absolute effect of rule of law and neoclassical economists alike have argued about whether rule of law is an indispensable element of sustainable economic development.  

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191 Randall Peerenboom, *China’s Long March Toward Rule of Law* (citing generally, Pistor , Katharina,
showed the world prominent economic growth without either duly perfecting their market mechanism and their domestic rule of law, something leaving many political scientists, economists and legal experts puzzled.\textsuperscript{192} It seems that China has been able to achieve phenomenal growth in the late 1990s thanks to its distinct economic and political evolutionary history.\textsuperscript{193} Nowadays, the Chinese are not satisfied with its established accomplishments but want to look for more outside investments.

According to a 1997 World Bank report, “countries with stable governments, predictable methods of changing laws, secure property rights, and a strong judiciary saw higher investment and growth than countries lacking these institutions.”\textsuperscript{194} In order to attract higher investment, Chinese regulators are trying to make its investment environment more transparent and predictable.

Although it seems that China has transplanted the whole independent director system borrowing from the Western studies, the developmental process of China's
system is different from that of the West. The Western market-oriented economic model was developed toward the Darwinian rules: the existing structures and institutions are presumed to be the relatively efficient ones \(^{195}\) unless path dependency considerations were involved. The independent director system resulted from a series of rule-competitions in a market-oriented economic model. However, in China, a market planned economic model, took many active steps through various Chinese governments or other authorities to encourage or require the installation of the independent director system before the involving players clearly feel the need. Requirements of independent directors are “administratively” imposed \(^{196}\). Rules, guidelines and regulations which require the establishment of the independent director system are promoted in quasi-corporate China \(^{197}\).

**Stock Exchange Rules**

There are two stock exchanges in China: Shanghai and Shenzhen. The Shanghai Stock Exchange was founded on November 26, 1990 and in operation on December 19 of the same year \(^{198}\) whereas, the Shenzhen Stock Exchange was

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\(^{195}\) See e.g., Williamson (1981:573-574) and Williamson & Ouchi (1981:389)

\(^{196}\) Clarke, *Supra note* 238

\(^{197}\) By “quasi-corporate China”, a special transitional period for China which seems to drift inexorably toward a market economy model, but, can’t avoid the struggle with the old planned economy model.

\(^{198}\) See the introductory page of the website of Shanghai Stock Exchange at
established on December 1, 1990.\textsuperscript{199} Compared to the Shanghai Stock Exchange, the Shenzhen Stock Exchange is considered a relatively smaller securities market bearing higher risks.\textsuperscript{200} Both of these two stock exchanges are non-profit-making membership institutions that are directly governed by the China Securities Regulatory Commission ("CSRC"). Their obligations are to legislate, supervise, self-regulate and standardize all of their listed companies under the PRC’s Securities Law.\textsuperscript{201} The most effective power reserved for them is to “delist” their listed companies if they break the rules of these two securities exchanges or the CSRC.\textsuperscript{202}

a. Shanghai Stock Exchange

The Shanghai Stock Exchange issued a set of draft “Listed Company Governance Guidelines” in November 2000. These Shanghai Guidelines were believed to provide a more refined version of independent director system\textsuperscript{203} than the CSRC’s “Guidelines for the Articles of Association of Listed Companies” of 1997.

\textsuperscript{199} See the introductory page of the website of Shenzhen Stock Exchange at
\textsuperscript{200} Rui-S Huang, \textit{The Development Concerning How Foreign Investment Merges Chinese Listed Companies}, Economic Daily
\textsuperscript{201} See Article 178, 179 and 180.
\textsuperscript{202} Clarke, \textit{Supra note} 238
Independent Directors on the Board

These Shanghai Guidelines require their listed companies to facilitate at least two independent directors. The independent directors should constitute at least 20% of the board of directors and at least 30% when the chairman of the board of directors and the general manager is the same person.

Independent Directors on Audit Committee

These Shanghai Guidelines also stipulate that all subcommittees of the board of directors have to be composed (principally) of and (chaired) by, independent directors.\(^\text{204}\)

While many significant expectations were imposed on the role of “independent directors” in these Shanghai Guidelines, it was surprisingly found that there was no description of the independence or disinterestedness requirement of independent directors.

b. Shenzhen Stock Exchange


Although both the Shanghai and Shenzhen Stock Exchanges have their own

\(^{204}\) Article 16 of Shanghai List Company Governance Guidelines Draft
stipulations about independent directors, their most recent rules regarding the institution and review of independent directors require them to follow the standards in the CSRC’s “Guideline Opinions on the Establishment of an Independent Directors System in Listed Companies”.205

Regional Government Rules

There are several regional governments that require their domestic SOEs or private companies to institute independent director systems.

c. Shenzhen Municipal Government

An “Opinion on Implementing the Further Acceleration of the Reform and Development of Shenzhen State-Owned Enterprises” was issued by the Shenzhen Municipal Government in January 2001. This Shenzhen Opinion requested an appropriate proportion of independent directors to be added to the boards of state asset management companies.206

d. Hebei Provincial Government

The “Provisional Measures for Standardizing the Governance of Company Legal Persons” was issued by the Hebei Provincial Government in late 2001. These Hebei


206 Clarke, supra note 231
Measures require their domestic companies to install independent directors, but leave the proportion of independent directors to be decided by individual company’s articles of association.²⁰⁷

These measures are claimed to be mandatory and require the companies to have independent directors from professional fields such as economics, finance, law and securities.

e. Guangzhou City

The “State Owned Capital Authorized Operation Institution Provisional Rules Governing Independent Directors” was issued by Guangzhou City on December 30, 2001. These Rules do have definite requirements for the professional background or independence.²⁰⁸ Independent Directors in these Rules do have powers to deeply involve themselves with the company's operation. Nevertheless, they are liable for losses of the company if those losses are caused by their misconduct.²⁰⁹

d. Guidelines for the Articles of Association of Listed Companies

The development of securities markets in China led to the establishment of a

²⁰⁷ Art 19 of the “Provisional Measures for Standardizing the governance of Company Legal Persons”
²⁰⁸ Article 4 and 5 of the “State Owned Capital Authorized Operation Institution Provisional Rules Governing Independent Directors”
²⁰⁹ Article 6 of the “State Owned Capital Authorized Operation Institution Provisional Rules Governing Independent Directors”
centralized market regulatory body in 1978. The establishment of the State Council Securities Commission (the "SCSC") and the China Securities Regulatory Commission (the "CSRC") in October 1992 marked an official formation of this centralized market regulatory body. The SCSC is a state authority responsible for exercising regulations governing the centralized market. The CSRC is the executive agency of SCSC, responsible for conducting supervision and regulation of the securities markets in accordance with the relevant rules.

In March 1995, the State Council formally approved the CSRC Organizational Plan thereby confirming CSRC to be a deputy-ministry rank unit directly under the State Council and the executive branch of the SCSC. In August 1997, the State Council decided to establish the securities exchanges markets in both Shanghai and Shenzhen under the supervision of the CSRC. Offices of the CSRC commissioners were set up in these two municipalities. In the National Finance Conference held by the Central People's Government in November 1998, they decided to reform the national securities regulatory body to directly supervise the local securities regulatory departments, and to place the securities organizations formerly supervised by the People's Bank of China under the centralized supervision of the CSRC. In April 1998, according to the State Council Reform Plan, the SCSC and the CSRC were
merged to form one ministry-rank agency directly under the State Council. The power and the functions of the CSRC have been strengthened since the reform. A centralized securities supervisory system was thus established. The CSRC not only has the power to regulate and supervise, but also has the power to investigate or levy penalties for illegal activities related to securities and futures.\footnote{See “Introduction of CSRC”, http://www.csrc.gov.cn/en/homepage/about_en.jsp} The CSRC has issued several regulations regarding corporate governance for listed companies to follow and the independent director system has constantly been emphasized in those regulations. The “Guidelines for the Articles of Association of Listed Companies” issued on December 16, 1997, was the first corporate governance regulation from the CSRC. In the Guidelines, the CSRC gives listed companies relatively clear guidance with respect to their Articles of Association. The listed companies whose Articles of Association include unacceptable divergence would need to be further informed by the CSRC of whether their applications would get approval.

**Independence Requirements**

The independent director requirement was only slightly mentioned in the Guidelines. Article 112 is the only Article mentioning the institution of independent directors. It was cited as “the company may elect independent directors according to
its actual needs,” as well as “the following people may not act as independent
directors: (1) shareholders or those employed by shareholding entities; (2) internal
personnel of the company (such as the manager of an employee); (3) persons with
self-interested relationship with affiliates or management levels of the company.\textsuperscript{211}

No definite terms are used to require the institution of special committees or that
confirm the proportion, qualifications and powers and duties of independent directors
in these Guidelines.

e. \textbf{CSRC/SETC Opinion on Further Promoting the Standard Operation and
Deeper Reform of Companies Listed Overseas}

The “Opinions on Further Promoting the Standard Operation and Deeper
Reform of Companies Listed Overseas” were jointly issued by the CSRC and the
State Economic and Trade Commission on March 29, 1999.\textsuperscript{212}

Since 1990, the average amount invested in overseas merger & acquisition
activities has reached 200 million dollars and, in 2002, the amount even climbed to
600 million dollars.\textsuperscript{213} This phenomenon triggered a need for the government to
better regulate companies listed abroad. These Opinions were established to require

\textsuperscript{211} See Art 112 of 1997 Guidelines.
\textsuperscript{212} ID in Chinese CG, find other resources
\textsuperscript{213} Ri Can, Huang, \textit{Developments on the M&A Activities Chinese Enterprises Involved Overseas},
Economic Daily
the ownership of companies listed abroad to be separated from the controlling body in its very first section.\textsuperscript{214} It is interesting to find that “outside director” and “independent director” simultaneously are in the same section. It requests that overseas listed companies should have outside directors fill at least half of the board, and that there should be at least two independent directors.

**Independence Requirements**

The independent director is required to be someone who is independent of the shareholders and not holding any position in the company. Nevertheless, there is no definition for outside directors.\textsuperscript{215}

**Powers of Independent Directors**

These Opinions further request that any transactions between a company and its affiliates have to be approved by the independent directors before this transaction becomes effective.\textsuperscript{216} These Opinions grant independent directors the power to report relevant situations directly to the company’s shareholders’ meetings and the

\textsuperscript{214} According to Section 1 of “Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas”.

\textsuperscript{215} According to Section 6 of “Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas”

\textsuperscript{216} Id.
CRSC.\textsuperscript{217}

f. **Draft Rules for Companies Seeking Listing on a Secondary Board**

A draft set of rules for companies looking for listing on a secondary board (operating and defined as “NASDAQ”) were reported on August 23, 2000 in the People’s Daily.\textsuperscript{218} The objective of these rules is to regulate companies seeking to be listed on a secondary board.

**Independence Requirements**

These draft Rules provide a relatively clear description of the qualifications of independent directors: people who were not (1) shareholders\textsuperscript{219}; or (2) directly related, or collaterally related within three kinship generations to company directors, supervisors, or officers, (3) directors, supervisors, or officers of affiliated enterprises; or (4) any person who was manipulated by the company.\textsuperscript{220} This draft did not disclose any obligation or powers of independent directors other than to attend board meetings.

\textsuperscript{217} Id.

\textsuperscript{219} This prohibition was originated from the special needs of controlling shareholders in family-controlled close corporations. Stroud v. Grace, 16 Del. J. Corp. L. 1588 (1991) (unreported case)( the Delaware Chancery Court found a corporate charter prohibiting their independent directors holding their stocks to be unusual, but not illegal.)

g. **Code of Corporate Governance for Listed Companies in China**

In accordance with the basic requirements of the Company Law, the Securities Law and relevant laws and regulations as well as other commonly accepted standards in internal corporate governance, the CSRC and the State Economic and Trade Commission jointly issued the “Code of Corporate Governance for Listed Companies in China” on January 7, 2001. This Code is a supplemental explanation to the existing laws. It is formulated to bring forward a healthy development of the securities market in China.\(^{221}\)

**Independence Requirements**

This Code mentions the independent director system significantly. It indicates that the independent directors should be independent from the said listed company as well as their major shareholders and they may not hold any other position in the same company.\(^{222}\)

**Independent Directors on Audit Committee**

The Code required that the audit committee, the nomination committee and the remuneration and appraisal committee be chaired by independent directors, and that the majority of the members of those committees be independent directors. It also

\(^{221}\) *Id.*, preface of the Code.

\(^{222}\) Refer to Article 49 of the Code of Corporate Governance for Listed Companies in China
added here that one independent director of the audit committee shall be an accounting professional.223

It’s worthy to note that this Code imposes duties of good faith and due diligence on independent directors. It specifically requests independent directors to concern themselves with the interests of minority shareholders.224

h. Draft Measures on the Administration of Securities Companies, Draft for Comments

The CSRC issued its proposed “Measures on the Administration of Securities Companies”, a draft for comments on June 20, 2001. These Draft Measures do make a big improvement on introducing a concrete independent director system.

Independence Requirements

This Draft Measures require the independent directors: (1) meet the conditions stipulated in the Company Law225; (2) not be employees of an entity which holds the company’s shares; (3) not be currently or in the last three years one of the company’s employees; (4) not have any relationship of interest with any of the company directors, supervisors or senior managers or anyone who is liable for financial audits in the

223 Id., at 52.
224 Id., at 50
225 According to Articles 57 and 58 of the 1994 Company Law
company; (5) not be employees of any entity which has significant relationship of interest with the company; (6) have at least five years of professional experience in either finance, law or accounting, and would be able to devote sufficient time and energy to perform the directors’ duties; and (7) meet other conditions required by CSRC.

**Independent Directors on the Board**

For the minimum proportion requirement, these Draft Measures require that independent directors have to constitute no less than one third of the board under any of the following circumstances: (1) the chairman of the board and the CEO (“chief executive officers”) of the company are the same person; (2) internal directors constitute at least one fifth of the board; (3) the company has been sanctioned for unlawful activity or certain extraordinary situations have occurred; (4) the reputation of the company is seriously deficient so that the interests of clients and shareholders may be affected; or (5) the department in charge of the company, its shareholders’ general meeting or the CSRC deems it necessary.

**Powers and Responsibilities of Independent Directors**

These Draft Measures require the approval of a majority of the independent directors for the following matters: (1) matters relating to audits; (2) transactions with
affiliates, loan guarantees, and admissions of security interests when borrowing; (3) hiring and firing senior officers; (4) salaries and other types of compensations for directors or senior officers; (5) the engagement or replacement of the company’s accounting firm; (6) other matters contained in the company’s articles of association; and (7) other matters required by CSRC.

i. **Guideline Opinions on the Establishment of an Independent Director System in Listed Companies**

After learning from the experimental practices in the above regulatory enforcement of the independent director system, the CSRC issued “Guideline Opinions on the Establishment of an Independent Directors System in Listed Companies” on August 16, 2001. These Guideline Opinions compose the most comprehensive regulatory measures regarding independent directors suggested by any Chinese governmental agency.

**Independence Requirements**

These Guideline Opinions declared that an independent director shall not be: (1) a person who holds a position in the listed company or its subordinate affiliates, or his or her direct relatives or major special relatives (direct relatives refer to spouse, parents, or children; major special relatives refer to siblings, parent-in-law,
daughter-in-law, son-in-law, and so on) ; (2) a person directly or indirectly holding at least 1% of the outstanding shares of the listed company or being among one of the top ten shareholders of the said listed company, or this person’s direct relatives; (3) a person who works under the employment of a legal person shareholder who holds at least 5% of the outstanding shares of the listed company or who is among one of the top five shareholders, or this person’s direct relative; (4) a person who has fulfilled one of the above conditions in the immediate last year; (5) a person who provides financial, legal, consulting or other similar services to the listed company or its subordinate enterprises; (6) any other person who has been specified in the listed company’s articles of association; (7) any other person who has been identified by the CSRC.  

Apparently, the CSRC has tried to impose a strict definition on the “independence” elements; those qualified independent directors must be free of conflicts of interest while carrying out their supervisory functions.

Professional Qualifications

In addition to the “independence” requirement, independent directors have to fulfill the professional qualification backgrounds as follows.

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226 See Section 3 of Guideline Opinions on the Establishment of an Independent Director System in Listed Companies
They have to: (1) be qualified as a regular director in line with relevant provisions of law and administrative rules; (2) be independent to meet the provisions of this Guideline Opinions itself\textsuperscript{227}; (3) possess basic knowledge of the operations of listed companies and be familiar with relevant laws, administrative rules and other rules and regulations; (4) possess at least five years’ work experience in dealing with legal, economic, or other professions necessary for his or her exercise of the power of an independent director; and (5) possess other qualifications that the company’s articles of association have specified\textsuperscript{228}.

**Powers and Responsibilities of Independent Directors**

Independent directors are to have the following powers: (1) to approve significant dealings with affiliates (quanlian ren) where the venture amount is more than RMB3 million or more than 5% of the net asset value of the company in accordance with the its most recent audit report; (2) to give advice on hiring or dismissing the company’s accounting firm; (3) to propose to convene interim shareholders’ meeting; (4) to propose to convene board meetings; (5) to engage outside auditors and consultants; and (6) solicit proxies before a shareholders’

\textsuperscript{227} Id., at Section 1 (2).

\textsuperscript{228} See Section 2 of Guideline Opinions on the Establishment of an Independent Director System in Listed Companies
meeting. All of the above powers may only be exercised while receiving consent from more than half independent directors.

Similar to the “Code of Corporate Governance for Listed Companies in China,” these Guidelines require that the independent directors bear the duties of good faith (chengxin) and due diligence (qinmian) toward the company as well as the entire body of shareholders and that they specifically concern themselves with the minority shareholders’ interests.229

Independent Directors on the Board

Listed companies are required by these Guideline Opinions to have at least two independent directors by June 30, 2002, and the independent directors should constitute at least one third of the board by June 30, 2003. 230 The above requirement must be included in the listed companies’ articles of association.

Independent Directors on Audit Committee

These Guideline Opinions also require that more than half of the members of the audit committee, the nomination committee as well as the compensation committee of the board must be independent directors.

1. Principles of Corporate Governance for Chinese Listed Companies

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229 Id., at Article 2, Section I.
230 Id., at Article 3, Section I
The CSRC released a draft of its “Principles of Corporate Governance for Chinese Listed Companies” for comments on September 11, 2001. These Principles are based on the OECD Principles of Corporate Governance, and were revised by proper principles drawn from specific foreign jurisdictions and China’s own domestic consideration.

Independence Requirements

An independent director may not have any position other than his or her position of independent director of the company. An independent director is required to be a person who does not have a relationship with the company or its controlling shareholders that might interfere his or her independent judgment.

Independent Directors on the Board

These suggestive principles stipulate that at least half of the directors should be independent while the chairman of the board of directors also plays the role of CEO.

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231 This document presumably referred to another two announcements: CSRC announcement of April, 2001 (Shanghai Securities News 2001) concerning the drafting of the “Basic Principles and Standards for the Corporate Governance Structure of Listed Companies in China” and an announcement of May 2001 concerning the impending promulgation of the “Guidelines for the Governance of Listed Companies”

232 According to Article 33 of Corporate Governance Principles

233 Id., at Article 32
Independent Directors on Audit Committee

For the compensation and assessment committee of the board, independent
directors are suggested to constitute a majority, and the chairman of this committee
must also be an independent director. As to the audit committee of the board, these
principles require at least one member to be an independent director and must be an
accountant as well.

m. Principles on Securities Companies’ Governance (Trial)

In order to accomplish better corporate governance, standardize the operation of
securities companies as well as the modern enterprise system, the CSRC announced
the trial version of the “Principles on Securities Companies’ Governance” on
December 15, 2003. These Principles were drafted in accordance with the Company
Law, Securities Law as well as other administrative laws and regulations for the
purpose of protecting the legal interests of shareholders, clients and all the involved
parties related to securities companies.234

Independence Requirements

The following people are not allowed to be independent directors: (1) employees
of the securities companies or other related companies or the employees’ direct

234 According to Article 1 of Principles on Securities Companies’ Governance (Trial)
relatives or major social relatives; (2) employees of shareholders holding more than a 5% shareholding or among the top 5 shareholding or the employees’ direct relatives or major social relatives; (3) natural person shareholders holding more than a 5% shareholding or their direct relatives or major social relatives; (4) people who provide financial, legal consulting services to the securities companies or other relevant parties or their direct or major relatives; (5) anyone who fulfills one of the above-mentioned conditions within the most recent one year; (6) directors in other securities companies; (7) other people prohibited in accordance with the articles of association; and (8) other people prohibited by the CSRC. In addition to the independence requirement, these principles require that independent directors have a basic knowledge of securities markets as well as the relevant law and administrative regulations. They should have at least five-years of work experience and they should be people of high integrity.

Independent Directors on Audit Committee

These principles require the board of directors to set up special committees for reviewing relevant dealings or the compensation of high-level managers and the

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235 *Id.*, at Article 39.
236 *Id.*, at Article 39.
coordinators of those committees have to be independent directors.  

Powers and Responsibilities of Independent Directors

Independent directors can: (1) propose that the board of directors or board of supervisors convene provisional shareholders’ meetings and board meetings; (2) to hire professional auditing institutions or consulting institutions based on the needs of their responsibilities; (3) provide independent opinions on the compensation plan and encouragement plan of directors and managers and other matters; and (4) provide independent opinions on major business transactions.

Independent directors should submit work reports in shareholders’ annual meetings and are liable if they fail to fulfill their responsibilities.

n. Guidelines for Internal Controls for Securities Companies

The CSRC issued a set of rules providing guidelines for the internal governance for securities companies on January 31, 2001. However, those Guidelines were annulled, and a new version of the Guidelines under the same name was in effect on Dec. 26, 2003. Similar to the old one, these new Guidelines merely mentioned briefly the demand for independent directors to “bring into full play the monitoring function of independent directors, in order to prevent manipulation by the controlling

\[^{237}\text{Id.}, \text{at Article 62 of the Principles.}\]

\[^{238}\text{Id.}, \text{at Article 42 of the Principles.}\]
239 See Art 11 of “CSRC’s Guidelines for Internal Controls for Securities Companies”

240 These Rules were issued to further pursue the “Several Opinions Regarding How the State Council Promote Revolution of the Capital Market and its Stable Development”, especially to protect the society public shareholders’ rights.

241 According to Article 1 and 2 of Section 2 of “Several Rules Regarding Strengthening Protection of Society Public Shareholders’ Rights”.

shareholders.”

o. Several Rules Regarding Strengthening Protection of Societal Public Shareholders’ Rights

These Rules Regarding Strengthening Protection of Societal Public Shareholders’ Rights were proposed on Dec. 7, 2004 in response to the revolution in the capital market and the stable development in China, according to the State Council in 2004.

Section 2 of these Rules is a complete section regarding the institution and operation of the independent director system. These Rules do not specifically stipulate the qualifications or proportion of independent directors; they merely state the independent discretion and expected powers and duties borne by independent directors and emphasize their obligations to concern themselves with public shareholders’ rights.

Powers and Responsibilities of Independent Directors

For significant dealings and the hiring or firing public accounting firms,
companies have to obtain the agreement of half of the independent directors.\footnote{Id., at Article 3 of Section 2.} Independent directors have to attend meetings of the board of directors in order to understand the operation of the company. They have to initiate investigations in order to obtain the necessary information to make the right decisions. Independent directors also have to submit annual reports to shareholders’ meetings and report their duty performance.\footnote{Id., at Article 5 of Section 2.} It is very interesting to note that these rules protect the full term of independent directors’ positions unless there exist proper supporting reasons.\footnote{Id., at Article 6 of Section 2.}

3. Implementation of Independent Director System in China

With a welcome and expecting heart, China has proclaimed numerous rules to encourage companies to install independent director systems to better protect minority shareholders’ rights and to attract more foreign investment. A random survey held in Hunan Province in 2004 researched the effectiveness of independent director systems. This survey took 22 listed companies as its research subject and found all of them have installed the independent director system.\footnote{The State Quo and Resolution of Independent Director System in Listed Companies, Full View Net, December 10, 2004.} According to the survey, 13
companies had more than one third of board occupied by independent directors. Among all the independent directors who were hired by those 22 companies, 53.6% held doctorate degrees and 88.4% held high-level titles. 77% of the subject companies believed that the importation of independent director system has greatly improved the company’s decision-making ability. However, 75% of the companies believed that the importation of independent directors did not offer significant help on balancing controlling shareholders’ powers and preventing the overpowering of internal controllers.

The survey shows very few positive and encouraging signals as to the implementation of the independent director system in China.

Apparently, while implementing independent directors system in China, the original organizational structures, the inherent rent-protection reaction and the deep-rooted rule of man culture will certainly influence the effectiveness of this foreign system. The pursuit of independent director systems in China does not seem successful due to several path dependency concerns and other problems.

**a. Path Dependency---Obstacles to Worldwide Corporate Governance**

**Convergence in China and Suggestive Solutions**

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246 Id., at 2.
247 Id., at 2.
248 Peerenboom, supra note 357, at 17
While there are numerous rules, regulations, and guidelines emphasizing the importance and significance of independent director system, something crucial had been lost on China in its importation of the system.

i. Absence of Audit Committees

According to a report from Shanghai Stock Exchange in 2000\(^\text{249}\), around 5.4% of its listed companies had installed professional sub-committees. The most common one is the investment and fund-circulation committee, followed by the audit committee, the financial management committee and the strategy committee. Among all those committees, the strategy committee and the corporate nature revolutionary committee\(^\text{250}\) are required to be composed of the most independent directors.

One can also easily find from the above sections that rules and regulations concerning the establishment of the independent director system that the “audit committees” have not been a widespread institution in Chinese corporate governance, whereas almost every set of rules in the U.S. repeatedly mention the significance of

\(^{249}\) Refer to the “The Result and Analysis of Questionnaires on Chinese Listed Company Corporate Governance” attachment from “Corporate Governance: International Experience and the Chinese Practice” released in “International Conference on Chinese Listed Companies” which held by Shanghai Stock Exchange on Nov. 2 and Nov. 3, 2000.

\(^{250}\)
the audit committee and its dispensable correlation with the independent director system. Principles, rules and acts from ALI, the NYSE, NASDAQ as well as SOX all require publicly-held companies or listed companies to have audit committees. These audit committees in the United States implement and support the oversight function of the board by reviewing companies’ financial data, their internal controls, and the independence of the corporation’s external auditors on a periodic basis. 251 In order to assure the independent good judgment from these audit committees, they should be consisted “solely” of independent directors.

Chinese rulers grant powers related to financial and accounting matters to their independent directors as well. However, it is hard for those independent directors to fully perform at their discretion. The problem for Chinese is that they do not forcibly require the institution of audit committees nor do they further require them to be made up “solely” of independent directors. The voice of their independent directors therefore might easily be diluted since they have at most one-third of the board according to the requirements of the Guideline Opinions on the Establishment of an Independent Director System in Listed Companies.

There have been several scandals in China occurring between companies and

251 Supra note 252 at d.
their outside (independent) auditors. One prominent instance occurred between Hongguang Enterprise and its outside auditor, Chengdu Asset Evaluation Firm. Chengdu Asset Evaluation revised its original capital report upon Hongguang Enterprise pursuant to Hongguang’s request. The other instance was found between Daching Cooperation Enterprise and Wanbang Attorneys at Law. Wanbang Attorneys at Law provided untrue legal opinions for Daching’s application for being listed on securities markets.\textsuperscript{252} According to relevant requirements of “Number Two of Content and Format Standard of Public Listed Company” (1999 Amendment): “The board of director shall guarantee that there exists no fake information, misleading description or major omission in the financial report. The directors are liable for the truthfulness, accuracy of the content.” Article 63 of the Securities Law has similar stipulation.\textsuperscript{253} A functional audit committee consisted of solely independent directors will definitely help the minority shareholders watch a company’s financial situation, and oversee the communication between the company and its outside auditors.

The path dependency we perceive here may come from rent-protection concerns.

\textsuperscript{252} Liao Li, \textit{Cases of Corporate Governance and Independent Directors}, Qing Hua University Publisher, Dec., 2003, at 19
\textsuperscript{253} \textit{Id.}, at 9
Since most of high-level executives are officials from government agencies, it does not seem that these incumbent management groups are ready to give up their sovereign powers to outside independent parties.\textsuperscript{254}

Chinese regulators should encourage their listed companies to operate several different professional committees, especially audit committees. In addition, the audit committee should be composed of at least a majority of independent directors. The audit committees will not only need to participate in companies’ financial and accounting affairs, they also have to review potential conflict-of-interest situations on an ongoing basis.

The Chinese regulators are suggested to promote the installation of audit committee on a function level rather than formal level before the market participants get familiar with the its mechanism. If either formal or functional changes are thwarted by path dependencies, a firm may opt for private ordering to amend its articles of incorporation to install audit commit, or to list on a domestic securities market or cross list on a foreign securities market which require the adoption of audit committee. While most of the high level executives realize the existence of audit

\textsuperscript{254} \textit{Reports on Yang-Tze River}, Securities Times, Jan.14, 2000 (reporting on how powerless independent directors had become and their decision to quit while the chairman of the board and general manager fight over powers)
committees will not expropriate their interests but enhance the overall company interests, they will voluntarily appreciate this system.

ii. Absence of a Definite Boundary between Independent Director System and Supervisory Board

The original model of CCL was derived from continental legal system’s two tier structure. It adopted a supervisory board to inspect the company’s operation and to investigate the company’s financial situation in an independent position. The Chinese board of directors and supervisory boards are elected by the shareholders’ meeting; and the board of directors are under the supervision of the supervisory board.

In 1997, China imported independent director system from the Anglo-American corporate governance. The supervisory board is theoretically in a position to fight for the stakeholders’ interests; whereas, the independent director system has been established to fight for the minority shareholders’ rights.

Article 52 and Article 118 of CCL stipulate that every limited company and

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256 Gu, supra note 81

257 CSRC’s “Several Rules Regarding Strengthening Protection of Society Public Shareholders’ Rights”
every company limited by shares shall set up a supervisory board which consists of at least three members. This supervisory board shall include shareholders’ representatives and an appropriate proportion of the employees’ representatives. A supervisor shall not play the roles of director, manager or chief financial officer concurrently. Under the chapter for limited companies, the supervisory board bears the following powers: (1) to inspect the company’s financial status; (2) to supervise directors’ or high-level managers’ conduct in their capacity to submit recall proposals against directors or high-level managers if there are violations of any law, any administrative regulations, the company's articles of association or the resolutions of shareholders’ meetings; (3) to request directors or high-level managers to rectify any of their conduct that may cause prejudice to the company; (4) to propose to convene interim shareholders’ meeting, to convene and preside over shareholders’ meeting when the board of directors refuse to convene and preside over shareholders’ meeting; (5) to submit proposals to shareholders’ meetings; (6) to initiate law suits against directors and high-level managers according to Article 152 of this Law; and (7) to exercise other rights as stipulated in the said company’s articles of association.\(^{258}\)

Article 55 and Article 119 of CCL also grant supervisors the power to attend the

\(^{258}\) Article 54 and Article 119 of CCL
meeting of board of directors as non-voting delegates and to hire accounting firms to assist his or her projects at the company’s expenses if something abnormal is found.

According to the “Guideline Opinions on the Establishment of an Independent Director System in Listed Companies”, strict restrictions regarding independence requirements ranged from the executive position to the percentage of shareholdings are imposed on independent directors. 259 This Guideline Opinions also request independent directors to fulfill certain professional qualifications such as backgrounds in law and economics. 260 The functions of independent directors mainly focus on overseeing a company’s financial situation 261 which is overlapped by some of the very important responsibilities of the supervisory board.

While the independent directors are to supervise the behaviors of internal directors who are performing executive, instrumental and control functions under the existing rules and regulations, the supervisory board is to supervise both independent directors’ and internal directors’ performance under the existing CCL. The supervisors apparently hold higher supervisory power than independent directors.

259 See Section 3 of Guideline Opinions on the Establishment of an Independent Director System in Listed Companies.

260 Id., at Section 2.

261 See Article 2, Section I of Guideline Opinions on the Establishment of an Independent Director System in Listed Companies.
since they holds the power to supervise the director’s (including independent
director’s) conducts, and it accepts authorization from the state to inspect on certain
issues related to the company. However, the independence requirement and
professional qualifications for independent directors in “Guideline Opinions” are
much stricter than what are required for supervisors in CCL. It is highly susceptible
that a less independent and professional supervisory board could efficiently and
effectively oversee the conducts of independent directors in current corporate
governance structure.

There are sweeping criticisms as to the co-existence of the supervisory board and
independent directors. Some scholars argue the necessity of independent director
system and suggest to strengthen the supervisory function of the supervisory board.
Some suggest the Chinese government may just simply eliminate the supervisory
board, moving one step further to transform this civil law system (focus on

262 Mingkang Gu, Will an Independent Director Perform Better Than a Supervisor? Comments on the
Newly Created Independent Director System in the People’s Republic of China, 6 J. Chinese and
Comparative Law 59, 74 (2003) (arguing the necessity of an independent director system, emphasize
the importance of strengthen the supervisory function of the supervisory board).

263 Chaobing, Xie, Research on Independent Directors Legal Institutions, August, 2004, at 466; Fan,
Ouyang, Discussion on Comparison Between Independent Directors and Supervisory Board, 8 Modern
Management Science (2003), Feng, Guo, Discussion on the Accomplishment and Innovation of

264 Id., at 466; Li, Yu and Jun, Fong, A New Thought on Resolution of China’s State Owned Enterprises
stakeholders’ interests) toward a common law system (focus on shareholders’ interests).

No matter what proposal the Chinese regulators propose, they surely would encounter both rent-protection concern and efficiency concern. It is predictable that resistance may come from incumbent supervisors who are not willing to give up or share their long-standing powers (“rent”) over corporate governance system. Also, the uncertainty and cost to restructure the corporate governance system may outweigh the efficiency of a new system.

Since China is in the early stage of adopting the independent director system, the author suggests China to carefully observe the application of this system in their own corporate governance, to have the convergence take place on a function level. Individual firms which are interested in transplanting the independent director system are suggested to go through private ordering process, and to have the incumbent supervisors understand the upcoming change will not take away their private interests but benefit the firm’s overall performance. If the Chinese government truly considers replacing the supervisory board with independent director system, they may also consider transplanting Public Company Accounting Oversight Board”

*and Corporate Governance Structure, Corporate Governance Structure: China’s Practice and the U.S. ‘s Experience, China People’s University Publisher (2000), at 159*
from the U.S. The SOX has created the “PCAOB” to oversee the effectiveness of those audit committees that are central to corporate governance in supervising financial affairs. The PCAOB, operating as a nonprofit corporation, independent of the government, is for justifiable confidence in audit committees' effective practice.266

iii. Lack of Effective Enforcement Authority for CSRC

Similar to the SEC, the CSRC in China plays the role of overseeing key participants in the securities world, including but not limited to the two stock exchanges, broker-dealers and investment advisors.267 The Shanghai and Shenzhen Stock Exchanges are both self-regulatory bodies subordinated to the CSRC. However, different from the SEC which is a political agency, the CSRC is a government branch which does not have independent power to regulate the securities markets. According to the PRC’s Article 179 and 180 of PRC’s Securities Law, the

265 Lawrence A. Cunningham, A New Product for the State Corporation Law Market: Audit Committee Certifications, 33 Boston College Law School Public Law and Legal Theory Research Paper Series (Draft March, 2004), 4 (quoting “PCAOB adopted Auditing Standard No. 2 to require external auditors to evaluate and the effectiveness of the audit committee’s oversight of a corporation’s financial reporting and related internal control. This evaluation will be part of the auditor’s new task, under SOA, of attesting to managerial assertions concerning the effectiveness of internal control. When Auditing Standard No. 2 was released for public comment as a proposed standard, the proposal appeared to require a separate and complete evaluation.”). See also Title 1, Section 1 of SOX.

266 Id., 3, (2004). See also Title 1, Section 1 (a) of SOA.

267 See Article 178, 179 and 180 of PRC’s Securities Law.
Securities Regulatory Organization has the duties and powers to supervise and manage the regulation of securities markets, and listed companies. Although it seems that they are given great power on regulating the securities markets and listed companies, it is under the supervision of the Chinese State Council. The CSRC is struggling within the regulatory paradox: to protect investors’ rights, or to regulate the market according to the state’s macro-economic control. Once the shareholders’ interests conflict with the government’s socialist market economy policy, the CSRC will inevitably need to purse the state’s commands since it is a government branch. Much to the shareholders’ disappointment, the CSRC is not able to have good independent judgment. It is therefore unlikely for them to be able to investigate misconduct independently. Only a very limited number of disciplinary actions will be taken against independent directors and corporations for their misconduct in China. It has taken China several decades to establish two functional stock exchanges and a central securities regulatory government agency. To have the CSRC become a totally independent authority from the state does not seem to be on the agenda in this wave of economic reform in China. It might be very costly, and of

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course the state would hardly give up their control. The inefficiency and rent-protection path dependencies in the enforcement authority of the CSRC will certainly play significant roles in interrupting Chinese corporate governance’s move toward a shareholder-oriented/dispersed ownership model.

In order to establish a healthy shareholder-oriented model to attract more investment, China needs to formally have its CSRC become totally independent of the state and to have its own enforcement without government intervention. A civil enforcement like in the U.S. corporate governance system needs to be accompanied with an independent body. In the United States, the SEC brings between 400-500 civil enforcement actions against individuals and companies that break the securities laws each year. 269 Typical breaches include insider trading, accounting or financial frauds, and false or misleading information supplied about securities and the companies that issue them. 270

iv. Lack of True Independence

Much literature has found that the independent directors are not able to protect minority shareholders’ interests from the potential devastation that can be caused by

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270 Id.
the controlling shareholders and management effectively since they are nominated by the controlling shareholders. Chinese regulators face a dilemma: if they give any stockholder the independent director nomination right without a minimum requirement of shareholdings, then a profusion of nominated candidates could give excessive power to controlling shareholders through a scattering of the votes of small shareholders. However, if only controlling shareholders are granted the nomination powers, then it does not seem to be possible for those controlling shareholders to take care of the minority shareholders’ rights. The CSRC initially asked for a 5% minimum shareholding requirement to be granted nomination rights according to Section 4 of the Draft Independent Director Opinion. And, it lowered the threshold to 1% in the final version of Independent Director Opinion. Although it seems that shareholders with minimum shareholdings of 1% are eligible to vote, it is still hard for minority shareholders to elect someone to represent their voices since the nomination procedure hardly protects minority shareholders’ rights. Controlling shareholders still nominate most of the candidates and minority shareholders have

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271 See e.g. Economic Daily (2001), FN 15 (ID in Chinese Corporate Governance)
272 See Economic Daily (2001)
273 See Sec. 4 of Draft Independent Director Opinion, the CSRC ask for the 5% minimum shareholding to have the right to nominate independent director candidate. See Sec. 4(1) of Independent Director Opinion, the CSRC lowered the threshold to 1%.
very few possibilities to vote for someone ideal in their minds, even though “the cumulative voting” is encouraged by the Corporate Governance Principles.274

The independent directors generally owe a duty of good faith (chêngxin) and diligence (qìnmiàn) to the company and shareholders according to the CSRC’s requirements. The CSRC requests the independent directors to act in a manner that he or she reasonably believes to be in or not opposed to the best interests of the corporation, pay special attention on the interests of small and medium shareholders, and clearly address that they are not to be influenced by major shareholders, controlling management, or others who have a crucial relationship of interest with the said company.275 The independent directors are to be the protector of minority shareholders’ interests to voice their needs and concerns, not the defender of the controlling shareholders’ or general social interests.

However, the independent directors may have already disappointed people’s high expectations. It is inevitable that independent directors selected through the deficit bias selection process could hardly play the role of an independent third party to watch and supervise the operation of a company, nor are they able to voice the minority shareholders’ concerns. They will very likely represent those who select

274 See Art. 29 of Corporate Governance Principles
275 Independent Director Opinion, Sec. 1 (2)
them for the board, i.e., the controlling shareholders. To change, the current selection procedure needs to calculate the cost to adopt the other set of rules, and needs the incumbent controlling shareholders to be willing to give up their “rent.” The path dependency regarding “efficiency” and “rent protection” will certainly be significant concerns in the adoption of a new system.

The author suggest those firms which recognize the importance of “true independence” to amend its articles of incorporation, or list on a securities market which adopt a selection system promoting true independence of independent directors.

v. Lack of Enforcement Power of Rules and Opinions

Concluding from the above overreaching introduction of rules and guideline opinions regarding independent directors, it seems that the Chinese regulators have determined to institute the independent directors system in their current corporate governance model. However, suggested by all of their names such as “Opinions,” ”Rules,” “Guidelines” as well as “Measures,” it is unlikely to be as strictly enforced as those which have been enacted into “Law” by the State Council. This is different from the U.S. practice in which Congress signed SOX into law. Those “Rules,” “Opinions” or others are not strictly mandatory legislation, even
though those public listed companies are “encouraged” but not “required” to implement it. No apparent sanctions have been suggested in any of the rules for a company’s failure to comply with the provisions requiring them to institute the independent director system.  

Literature has found that the changes in China were initiated primarily top-down brought on by government policies. The greater scope of market-oriented transactions those government policies promoted, the stronger the enhancement formal law would need. China is in the initial stage of promoting their policies related to the institution of an independent director system. It is understandable that the Chinese government needs more time to observe the operation of this system. Nonetheless, China has to realize that while a high-level of certainty is provided by its government policy and bureaucratic guidance, the international world demands to see a higher-level of certainty, such as that which could be provided by a set of well-defined enforceable applicable laws and formal legal institutions. To have the formal laws enacted duly needs great determination from the Chinese central

276 See supra note 8, at 21.
government. Maybe the government will encounter the crisis of inefficiency or rent protection for a short-term prospect. However, an accomplished formal legal system will surely bring in stable foreign investment in the long run.

b. Other Problems

i. Shortage of Qualified Independent Directors

According to Sec. 1(3) of the Independent Director Opinion, listed companies should have at least two independent directors by June 30, 2002, and such directors should constitute at least one third of the board by June 30, 2003.279 And, among those independent directors, at least one of them must specialize in accounting. Most of the Independent Directors in China are selected from the pools of either public figures such as well-known economists and governmental officials280 or academic professionals.281 A 2001 survey by the Shanghai Securities Exchange showed that only 0.3% of directors interviewed could be categorized as “independent”282 and other institutions claimed that only 314 eligible independent directors existed in the whole country.283 The other 2002 survey on the number and

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279 According to Article 109 of Company Law, stock companies should have five to nineteen directors.
280 These people are selected for the purpose of increasing the reputation of enterprises.
281 These people are selected for the purpose of professional opinions to companies.
283 Duli dongshi yu duli jianshi [Independent Directors and Independent Supervisors], Guangming
background of 1,100 listed companies appeared that 274 companies have called on a total of 511 independent directors or independent director candidates. 183 of those independent directors are college graduates, 108 of them hold a master degree, and 142 of them hold a PHD degree. Although the credentials of most nominated independent directors seem to be very strong, only one-fifth of them have accounting background. It is apparent that only very few of the independent directors fulfill the CSRC’s requirements.\textsuperscript{284} The shortage of qualified people leads to a phenomenon in which single person works in the capacity of independent director for several different companies. The quality of supervision and consultation will certainly decline under this circumstance.\textsuperscript{285}

Part III Conclusion

While Western capitalism is said to have its basis in the “rule of law,” the developing Chinese bureaucratic capitalism,\textsuperscript{286} characterized as free market under centrally command plan, is based on “rule of man.” Although there have been

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widespread arguments that the rule of law is conducive to economic growth, this assumption is challenged by China’s recent prodigious economic achievements. Opponents of the theory of global convergence of corporate governance disagree that all corporate governance regimes around the globe are converging toward the single system of a shareholder-oriented model of corporate governance and a dispersed ownership system. They further argue even whether the whole world is converging in the same direction. China may be an exception since its current economic achievements apparently do not result from the certainty brought by a clear and definite legal system, but from the planned commands brought by their autonomous government.

Is China moving toward shareholder-oriented and dispersed ownership model? Yes, convincing evidences are found in this dissertation to prove that China is indeed moving toward shareholder-oriented and dispersed ownership model regardless how their economic developments have achieved in the past couple decades. The establishment of the 1994 CCL indicated China’s determination to step into a shareholder-oriented model. The 2006 CCL amendment and the installation of legal institutions regarding independent directors affirmed that China had already started its

287 Randall Peerenboom, China’s Long March Toward Rule of Law, 450 (2002)
288 Supra note 198
journey to transition toward a shareholder-oriented model of corporate governance and a dispersed-ownership system. Although the market participants and government regulators are still struggling with efficiency or rent protection path dependencies and other problems, such phenomena is a strong sign showing that China indeed is moving toward a shareholder-oriented model/dispersed-ownership corporate governance structure.

Although it is proven that China is moving toward a shareholder-oriented model/dispersed-ownership corporate governance model, the unique “rule of man” path-developing process has made path dependency problems much harder to overcome than other “rule of law” countries. The unique “Chinese bureaucratic capitalism” has been using “clientelism” and “corporatism” as available options or partial substitutes for “rule of law.”

“Clientelism” refers to a close-knitted society in which personal and social networks (also known as guanxi in Chinese) are highly regarded. Horizontal clientelism is introduced as relationships among equal interest groups. Vertical clientelism, to some extent, advocates relationship between superiors and

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289 RP, China’s Long March Toward Rule of Law, 466
subordinates such as government agencies and private entities. This clientelism has gradually deepened the ultimate influence of the persons in power and further strengthened the power of “rent-protection” path dependency.

Corporatism has been asserted as a middle ground between Liberalism and Marxism. Liberalism promotes a state of weak government authority with strong self-regulatory private interest groups; whereas Marxism advocates a state of totalitarian or at least authoritarian with weak self-regulatory private interest groups. Corporatism is characterized by a strong central government authority with some private interest groups existing and enjoying a certain degree of autonomy. With the tradition of being a centralized, authoritarian country, the People’s Republic of China survives by maintaining an accomplished hierarchical system, also thanks to the influence of Confucianism. This single value system has made the efficiency-driven path dependency even harder to overcome.

In China, “business is subordinate to and depends heavily on ties with the

290 Id., 470
291 Howard J. Wiarda, Corporatism and Comparative Politics: The Other Great “Ism.” Armonk, NY: M.E. Sharpe.
292 Supra note 130, at 470
293 Chen Jianpan, Confucius as a Teacher, 266-271 (1990)
technobureaucracy to accomplish its (overall) goal”. The strong ties of clientelism and corporatism produce an active highly concentrated ownership structure in their newly-developed shareholding system. Majority of the ownership in Chinese stock markets have been constantly controlled by the State. The businessmen have to practice social networking in a highly concentrated ownership structure to enhance their business profits. The domestic market, which for a long time has been dominated by government’s discretionary blackbox-manipulation dealings and close-knitted social network, has been challenged as China has opened their door to attract more foreign investment.

China has tried to corporatize SOEs to reduce the power-abusing opportunities of government officials and has stipulated numerous rules and regulations to standardize the corporatization of their SOEs, amended their national company law, set up an independent director system in order to protect minority shareholders’ rights. Nevertheless, the obstacles caused by path dependency hinder their convergence toward the worldwide corporate governance standard.

294 Margaret Pearson, China’s New Business Elite: the Political Consequences of Economic Reform (Berkeley: University of California Press)
Although the Chinese government has had encountered significant path dependencies while transplanting various business laws and regulations, it firmly believes “rule of law” is the ground for economic growth.\footnote{Peerenboom, supra note 301 at 450} It also believes “law” will enable China to pursue economic development without democracy.\footnote{Jacques deLisle, 
Chasing the God of Wealth While Evading the Goddess of Democracy: Development, Democracy, and Law in Reform-Era China, Evading Democracy in China} Laws for China, is substitute of democracy.\footnote{Id.} The Chinese government monopolize over law-making initiatives. It has made up relatively clear and defined formal rules (constitutions, laws and rules) and informal constraints (norms, conventions and codes of conduct); however, an effective enforcement mechanism is needed in addition to rules and codes in order to set up an effective legal system work.\footnote{Douglass C. North, The Chinese Menu (for Development), WSJ, April 7, 2005, A14} How to effectively reduce the influence of path dependency in a “rule of man” market has become the toughest task for the Chinese government.

If we apply the theory discussed in Part I to Chinese current situation, the regulators first have to work things out at a functional level rather than a formal level. Instead of “whole-set” transplantation of those legal mechanisms to protect minority shareholders from Western corporate governance model, the Chinese government or
individual private firms may evolve a synonymous functional mechanism around its existing institutions at this early transformation stage. The Chinese regulators have formally enacted the company law included some protective measures for minority shareholders’ protection; however, those legal measures of independent directors are merely functionally installed. The author suggests Chinese government strengthen the concept of independence of independent director so as to place the concept of separation supervision from management into the minds of market participants. Chinese need to be trained since they are so used to being governed collectively either by one single value system either one big family (ancient China), or by the state (Communist Party) and practice “guan-xi” with those controlling groups.

One the other hand, the regulators must assure the controlling group that: (1) the independent director system will increase their wealth, and the increase will be greater than the loss of their private benefit of control; and (2) their private rights will not be expropriated after the installation of developed corporate governance system. To move toward shareholder-oriented/dispersed-ownership model and to strengthen the practice of independent director system, China needs to gradually change to a softer, societal version of corporatism\textsuperscript{301} which allows private interest groups to enjoy more

\textsuperscript{301} Randall Peerenboom, China’s Long March Toward Rule of Law, 470
self-regulation under a clear rule of law structure.