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Unraveling China's Capital Market Growth: A Political Economy Account

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UNRAVELING CHINA'S CAPITAL MARKET GROWTH: A POLITICAL ECONOMY ACCOUNT

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In memory of my grandmother, Raya (Raisa) Barhovik Skutel [1915-2011], who had seen many types of regimes in her lifetime and challenged them all.

T.G.O

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Table of Contents

INTRODUCTION

The conventional wisdom concerning capital market development would have us believe that dispersed ownership is the superior market structure for investors, while concentrated ownership is often correlated with lower capital market growth. Similarly, privatization of public firms is viewed as a necessary step for their success and surely for their global expansion. Private ownership is perceived as one of the preconditions for prosperous firms and deep capital markets, while state ownership and political influence are deemed to be impediments.

Four decades of economic development in China, however, indicate otherwise. China's capital market growth is quite striking—a sample of three randomly selected time-points over the last decade reflects a largely constant and significant increase in capital market growth, as measured by the number of firms listed and by total market capitalization.[1] Additionally, market capitalization as a ratio of GDP—an indicator that is used to assess over/under valuation of a certain market and implies investors' confidence—has been fast increasing and stabilized positively in recent years.[2] At the end of 2005, China's stock exchanges had 1,377 public companies with a market capitalization of 401.8 billion USD at a 17.5 ratio to GDP. In 2010, the number of listed firms reached 2,063 with a total market capitalization of 4.028 trillion USD and a market cap to GDP ratio of 66. By the end of 2017, China's capital market reached a striking 3,485 firms listed, with a total market capitalization of 8.7 trillion USD and a 71.2 ratio to GDP. Putting controversies on data reliability aside,[3] these figures,

[1] For simplicity reasons, unless stated otherwise, I use the singular term "capital market" in reference to both stock exchanges together.
Despite some spikes and downturns, since 2007, shifts in total market capitalization in China overall correspond with similar shifts in other global markets. *See Market Capitalization of Listed Domestic Companies (% of GDP)*, WORLD BANK, https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?locations=1W-CN-US-JP-DE (last visited May 24, 2019) (comparing total market capitalization of listed domestic companies with the same indicator at the world level, the United States, Japan, and Germany). A slow-down in new issuances since the last market turmoil in 2015 is worth mentioning. Yet the overall increase in the annual number of new issuances is maintained. For a comparable chart of Chinese IPOs both in China and abroad from 2013–2017, *see Number of Chinese Company IPOs Domestic and Abroad from 2013 to 2018*, STATISTA, https://www.statista.com/statistics/279616/number-of-chinese-company-ipos-in-the-country-and-abroad/ (last visited May 24, 2019).

[2] The data in this paragraph was collected from the World Bank database. *See Market Capitalization of Listed Domestic Companies (% of GDP)*, WORLD BANK, http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS?locations=CN (last visited May 24, 2019) (providing a graph specific to China). The market capitalization to GDP ratio is applied to estimate whether a certain market is over or undervalued and by implication reflects investors' sentiments and overall assessment of a given capital market. A ratio of market capitalization to GDP that is higher than 100 reflects an overvalued market, while ratios lower than 50 are said to reflect undervaluation.

[3] For example, data released by the China Securities Regulatory Commission in 2005 reports completely different figures: 1,381 listed companies, with a market capitalization of 1.06 trillion RMB (approximately 132 billion USD), standing for only six percent of China's GDP that year. *See* Donald C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 NW. J. INT'L L. & BUS. 131, 152-153 (2010).

while randomly selected, reflect an undeniable continuous upturn in the number of firms listed, total capital market value, and a growing confidence of investors in the Chinese market.

China's capital market growth also stands out when compared globally. As early as 2001, just ten years after China opened its stock exchanges, China's market capitalization was the largest among developing countries. Its market capitalization increased from being the twentieth in the world in 2005, representing only 1.17 percent of *global* market capitalization, to taking the second spot among all countries in 2016, when its market represented 10.1 percent of global stock market capitalization.[4] The achievements are worth noting at the individual firm level as well, where Chinese listed firms, and particularly corporatized listed SOEs, have established significant presence in global capital markets, a fact that has attracted broad attention. In 2018, China reached a record high of 120 Global Fortune 500 firms, second only to the United States with a gap of just 6 firms. Of course, this reflects mostly on a limited number of Chinese listed companies; 75 percent of these firms are formally state-owned, and many more have indirect state-ownership and control through holding groups and pyramid schemes. Several "privately-owned" firms on this list are also controlled by the Chinese Party-state without any state-ownership.[5] Still, the point stands; concentrated state ownership and political control do not stand in the way of business expansion, global reach, and capital market growth for Chinese firms.

Was there a reliable and effective legal system in place, the picture above would not have been so puzzling. Such a legal system could presumably overcome the multitude of structural predicaments that characterize public firm ownership in China, reduce the cost of doing business and raising capital, and thereby support and explain growth. Having such a system in operation would conform to many prevailing views in both law and development and comparative corporate governance. The rise of the public firm in China and the growth of its capital markets, however, had little to do with the surrounding legal framework.

When firms emerged in China in the mid-1980s, they did so with a shattered bureaucracy, an annihilated legal system, and a devastated isolated economy as their backdrop. They operated and issued securities through unregulated, informal markets that were not initiated by bottom-up private ordering pressures either. Later, when these firms were corporatized and issued their shares to the public, and laws and corporate governance institutions borrowed from corporate capitalism were promoted, the process was guided by political necessities rather than by economies of scale and demands of technological advancements. China's political economy had a determinant role on the

[4] Second only to the United States, whose market cap represents 36.3 percent of the global market capitalization. This is based on data compiled by BLOOMBERG and presented by BUSINESS INSIDER and BESPOKE. See Kim Iskyan, *China's Stock Markets Have Soared by 1,479% since 2003*, BUS. INSIDER (Nov. 6, 2016, 7:00 PM), http://www.businessinsider.com/world-stock-market-capitalizations-2016-11; *Which Countries Control the Global Stock Market?*, BESPOKE (Mar. 30, 2015), https://www.bespokepremium.com/think-big-blog/which-countries-control-the-global-stock-market/.

[5] *See generally* Curtis Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665 (2014). Haier Group, Huawei, and even Alibaba and Tencent are among the Fortune Global 500 firms that are thought to have strong ties with the Party-state.

design of corporate ownership and the consequent functions of the market. It also dictated how legal institutions will function.

The outcome of this process was an enabling, outwardly convergent, yet largely ineffective corporate governance system that facilitates opportunism by corporate controllers, corruption, and a capital market that is beholden to the Party-state. Indeed, for corporate governance advocates, China stands as one of the most challenging environments in terms of group concentration, managerial self-dealing, asset tunneling, and related-party transactions tied to corporate corruption. Yet, the allure of Chinese firms to domestic and outside investors is unquestionable.

The implications of this are quite striking. China fostered the growth of successful and globally competitive firms, and its capital markets advanced to take a spot among the world's most meaningful markets, despite weakly functioning "good" corporate governance institutions *and* strong "bad" ones.

To be sure, the remnants of developmental state attributes, mainly the support and protection some firms receive from the Party-state, can explain part of the success story.[6] There are also many ways to dispute and even to dismiss China's capital market growth.[7] While there is no one measure for "economic success," I take the above growth picture as my starting point. I do not presume to offer an economic explanation for China's capital market development or a path for what would be normatively desirable distant developments. Rather, my goal is more modest. I offer a theoretical account of China's capital market growth conundrum. Through an expository analysis of the rise of the public firm and the evolution of capital markets, I aim to expose the conundrum and postulate an explanation. This explanation, I propose, lies in China's political economy configurations and the shifts within this system.

Changes in the political equilibrium of economic decision making within the Party-state organization affected the interests of individuals, policy makers, and organs within the system, pushing them to design and employ idiosyncratic governance mechanisms that promote growth. The result is public firms and a capital market that continue to grow and prosper, even though they are governed in unusual ways and in pursuit of unconventional goals. China's political economy is therefore responsible for many of the market's infirmities, but also holds the key to its unprecedented success.

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[6] Mainly corporatized SOEs benefit from this. Common examples include access to credit on better terms from state-owned banks regardless of underlying conditions, protectionist licensing treatment, rescue-type intervention in share trade, and lax competition arrangements.

[7] Common criticisms are concerned with questions of the reliability of growth indicating data and posit that the data is based on value inflation or outright misleading information. Others argue that existing growth indications do not rise to their full potential that could have been achieved given a better legal framework. *See* the works of Franklin Allen in this space. *See, e.g.*, Franklin Allen et al., Dissecting the Long-Term Performance of the Chinese Stock Market (Mar. 13, 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2880021; Franklin Allen et al., Explaining the Disconnection between China's Economic Growth and Stock Market Performance (Jan. 31, 2015) (paper presented at the China International Conference in Finance, July 9-12 2015, Shenzhen), *available at* http://www.cicfconf.org/sites/default/files/paper_736.pdf

Chapter 1 presents the underlying conundrum surrounding China's capital market growth. It then tracks the historic background upon which the large public firm emerged in China and points to the use of alternative, largely experimental transitional mechanisms that governed the budding market.

Chapter 2 discusses the subsequent turn toward law and presents the formal institutional setting within which China's listed firms are currently embedded. The chapter reviews institutions and mechanisms, both internal and external to the firm, that are commonly associated with "good corporate governance" regimes and examines their function in China. It shows how political economy, including the continued grip of state capitalism, created structural and perhaps even conscious predicaments that undermine the function of traditional governance.

Chapter 3 offers an alternative resolution for China's law and capital market development conundrum, found within China's political organization and governance. It shows how political governance, in various forms that evolved throughout China's economic transition, has monitored, incentivized, and held accountable corporate control parties. Finally, it points to recent developments that expand and legalize the use of political governance in the corporate context. I refer to these developments as the "politicization of corporate governance," and consider their implications for firms, investors, and the role of the legal system in China.

CHAPTER 1: CHINA'S LAW AND DEVELOPMENT CONUNDRUM—A CAPITAL MARKET PERSPECTIVE

"It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is … national interest"[8]

Winston Churchill, BBC radio broadcast, 1 October 1939

Four decades of economic development in China are surrounded by a great puzzle: China was, and still is, able to achieve economic growth while not adhering to conventional views on economic develpment. [9] Throughout its economic transition, China strategically resisted policy measures that for decades were considered essential for economic growth, including rapid liberalization of monetary policy and trade, ownership privatization, a Western-style rule of law, and multi-party participatory governance.[10] These were strongly advocated by international policy organizations and reformers as the necessary policies for all growth-oriented economies.

China's growth trajectory also does not follow the widely accepted views about the role of legal institutions in economic development. These views attribute much of the economic growth prospect of any given system to the credibility and quality of its legal institutions.[11] China's economic success, however, occurred in the absence of many of the qualities commonly attributed to a well functioning legal system. This reality, which I call China's law and development conundrum, goes against fundamental economic and legal thought. Indeed, this conundrum spreads along a spectrum

[8] Winston Churchill, BBC Radio Broadcast (Oct. 1, 1939). Regarding the uncertainty surrounding Russia's expected choice between the Allies and Axis, Churchill stated, "I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest." *Id.*

[9] China's economic growth is hotly debated among economists. *See, e.g.*, Thomas G. Rawski, *Can China Sustain Rapid Economic Growth Despite Flawed Institutions?*, *in* IN SEARCH OF CHINA'S DEVELOPMENT MODEL – BEYOND THE BEIJING CONSENSUS 86-108 (Philip Hsu et al. ed., 2011) (and the references therein).

[10] Village elections as well as the rhetorical propaganda of "multi-party cooperation" and "consultative democracy," supposedly achieved through the presence of the Chinese People Political Consultative Conference (CPPCC) and its advisory legislative role, isn't exactly multi-party democracy—two thirds of its members are representatives of the Chinese Communist Party.

[11] *See, e.g.*, D. C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); Ronald Coase, *The New Institutional Economics*, 88 AM. ECON. REV. 72 (1998). North's seminal work refers to institutions as both *formal* and *informal* frameworks that shape human interaction. Similarly, Coase makes clear that the working of an economic system and its productivity depend on transaction costs that "depend on the institutions of a country: its legal system, its political system, its social system, its educational system, its culture, and so on … a complex interrelated structure." Nevertheless, their approach is mostly understood to address formal state-created institutions as the key determinants for economic growth, particularly those of property rights and contract enforcement.
See, e.g., Donald Clarke, *Economic Development and the Right Hypothesis: The China Problem*, 51 AM. J. COMP. L. 89, 90 (2003) (interpreting North's work and summarizing that "Productive capitalism needs formal adjudication, judiciary enforced contracts and inviolable property rights."). *See also* DANI RODRIK, ONE ECONOMICS, MANY RECIPES: GLOBALIZATION, INSTITUTIONS, AND ECONOMIC GROWTH 184 (2007) (labeling the institutional approach as 'property rights reductionism'— one that views the property rights protection as the end-all of development policy).

of dimensions, leaving academics, practitioners, and foreign policy makers puzzled. Within this broad spectrum, the success of Chinese publicly-listed firms and the domestic capital markets within which they operate is particularly striking and provides an excellent focal-point through which China's law and development conundrum is examined here.[12]

Capital markets and the firms that populate them are eminent components in any growth-oriented economy. Firms are the primary vehicle through which large scale production and commerce take place. Their publicly listed form enables an aggregation of wealth of "innumerable individuals under the same central control."[13] Capital markets, in turn, facilitate financing beyond relational-based exchange, making capital accessible and less costly for firms. They enable large scale share-trade between unfamiliar parties by facilitating information flow from firms to investors and back to decision makers within firms. This informational function is expected to ensure the allocation of capital to the most deserving firms (commonly referred to as efficient allocation of capital), thereby aiding their further growth. Both the public firm and capital markets are considered major steps in financial development and in economic development overall: the deeper the capital market is, the greater the prospect for further economic growth is assumed to be.[14]

It is argued that in order for the capital market to become larger and deeper, and to ensure efficient allocation of capital, it ought to be supported by legal institutions. This conventional wisdom claims to have identified the *particular* prescription that is best suited for capital market development, and by extension for economic growth.[15] While many controversies exist on various aspects within this paradigm,[16] the following propositions constitute the common understanding about corporate governance and capital market development today:

[12] Milhaupt and Pistor took an illuminating approach to the relationship between law and economic development through the corporate governance lens. The authors offered an analysis of several country-based case studies that question many of the conventional law and development theories. *See* CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW & CAPITALISM (2008).

[13] ADOLF A. BERLE & C. GARDINER, MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed. 1967).

[14] Note that this does not mean that capital markets are crucial for economic growth; the evidence for that is far from conclusive. Yet scholars are largely in agreement that growth can be expanded when capital market activity increases. For the claim that higher levels of financial development are positively associated with economic development, *see* Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 108 Q. J. ECON. 717 (1993). Specifically regarding the stock market, *see* Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth* (World Bank Policy Research, Working Paper No. 1690, 1999).

[15] Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131-1150 (1997) (connecting legal origin with the availability of external finance and the size of the capital market); Rafael La Porta et al., *Law and Finance,* 106 J. POL. ECON. 1113 (1998) (identifying investor protection indicators across countries and making connections between the ownership structure of public firms and these indicators); Rafael La Porta et al., *The Economic Consequences of Legal Origin,* 46 J. ECON. LITERATURE 285, 302 (2008) (providing a literature review of related studies).

[16] For general doubts as to the ability to produce all-inclusive indices, *see* Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263 (2008). For critics on specific elements within the Law and Finance approach, *see infra* note 21.

- State ownership and heavy statist or political intervention impede market development,[17] while privatization works better;[18]
- Dispersed ownership is more conductive to capital market development than concentrated ownership;[19] and finally,
- Law matters: legal institutions, particularly those associated with investor protections,[20] are needed to attract external finance and are thus crucial for capital market development.[21]

Strikingly, China misses the mark on all three points. The development process of China's public market presents a different story altogether and leaves its observers puzzled. The story suggests that at least under some circumstances, firms can develop and prosper while being subjected to state ownership and politicized control. It indicates that concentrated ownership can be associated with capital market growth. It also reflects that external financing might not be contingent on highly functioning legal institutions, and that public firms can thrive even under a legal system that enables profusion of related-party transactions and outright abuse of public shareholders. Capital markets, it

[17] Friedrich Hayek is known for developing a theory according to which legal systems with traditions that constrain government intervention (common law) are more compatible with a market economy than legal systems in which government power was more freely asserted (civil law). *See* Paul Mahoney, *The Common Law and Economic Growth: Hayek Might be Right*, 30 J. LEGAL STUD. 503 (2001). The argument is supported by various studies noted in La Porta et al., *The Economic Consequences of Legal Origin*, *supra* note 15.

[18] MAXIM BOYCKO ET AL., PRIVATIZING RUSSIA (1997) (arguing that in order to achieve economic growth, firms should be de-politicized and the state should be distanced from firm ownership through privatization). This was indeed the approach promoted by international policy organizations and applied via the privatization waves of the late 1980s and early 1990s across Eastern Europe, the former Soviet Union, and Latin America.

[19] La Porta et al, *supra* note 15. *See also* Rafael La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471 (1999) (inferring the same). *But see* Jeremy Edwards & Alfons J. Weichenrieder, *Ownership Concentration and Share Valuation*, 5 GER. ECON. REV., 143 (2004).

[20] This entire line of argument based on empirical reasoning has come to be known as the "Law and Finance" approach. *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON., 430 (2008). Another thread of this literature is the legal origin theory, grounded in the same articles by La Porta et. al, *supra* note 15, which posits that the laws of common law countries are more protective of outside investors than those of (particularly French-)civil law countries, and thus are more conductive to financial development. The original studies did not consider emerging markets or transitional economies, but subsequent research addressed this in support. *See, e.g.*, Simeon Djankov, et al., *The New Comparative Economics*, 31 J. COM. ECON. 595 (2003).

[21] Critiques of the Law and Finance approach and disagreements about the specific desirable elements are not lacking, but they all seem to hold that legal institutions and the availability of external finance are correlated. For questions as to the applied coding, *see* Holger Spamann, *Law and Finance Revisited* (Harvard Law Sch. John M. Olin Ctr., Discussion Paper No. 12, 2008) (re-coding the original data on shareholder and creditors rights based on different legal analysis and questioning LLSV's results). For conflicting evidence from a broader historical view, *see* Raghuram Rajan & Luigi Zingales, *The Great Reversal: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON 5 (2003) (suggesting that by historic accounts, LLSV's cross-country conclusions on the strength of the US stock markets versus weakness of continental European markets are misinformed). *See also* MILHAUPT & PISTOR, *supra* note 12, at 23-25 (positing how changing the period of time selected for the examined growth in different countries—common law and civil law countries—provides a different outcome). For claims as to the inability of menu legal institutions to achieve intended results in practice without appropriate adaptation to local conditions, *see* Daniel Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003); Bernard Black et al., *Methods for Multicountry Studies of Corporate Governance: Evidence from the BRIKT Countries*, 183 J. ECONOMETRICS 230 (2014) (empirically questioning the predictive power of "common elements" and offering country-specific governance indices). While not necessarily in critique of the Law and Finance approach, there is also controversy on the implied causality of legal establishment and market development. Most notably, *see* John Coffee, *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455 (1997) (stating that law tends to follow rather than precede economic change).

seems, can expand despite, and perhaps due to, "bad" corporate governance. Finally, and with no contradiction, the story does support the general view that law matters, but for a completely different reason. When legal institutions of corporate governance took form in China, they did not operate to secure the rights of public investors in firms, but rather to implement the agenda of the polity and consolidate its power. Thus, the importance of law to capital market development increased over time, but its instrumental nature remained.

Classification of China's Development Trajectory

To put China's development trajectory into context, it is valuable to first identify its stages. A common classification follows the stated shifts in economic policy, which are reflected in the pronouncements of the Chinese Communist Party (CCP) Congresses. These can be divided into three primary stages:

The first and early stage of economic transition, known as "Growing Out of the Plan,"[22] 1978–1989, started in December 1978 with the Third Plenum of the 11th Central Committee of the CCP, which announced a "Reform and Opening" economic-policy.[23] The focus of this early economic transition stage was on experimenting with various methods to increase productivity in the state sector and attracting foreign direct investments to the budding market. During the second stage of economic transition, known as the "Modern Reform Era," 1992–2007, the Party proclaimed the establishment of a "Socialist Market Economy." These years which formally started with the 14th Congress of the CCP, [24] saw a robust enactment of economic laws and central-state institutional establishment. Finally, the third and current stage of economic transition is known as the "Mixed Ownership Economy" stage. The term was coined by the 17th Congress of the CCP in 2007,[25] and explicitly announced as

[22] Political economist Barry Naughton coined the term to represent the period in which China gradually stepped out of the planned economy avoiding a grand political struggle. *See* BARRY NAUGHTON, GROWING OUT OF THE PLAN: CHINESE ECONOMIC REFORM, 1978-1993 (1995).

[23] *See* Zhongguo gongchandang di shiyi jie zhongyang weiyuanhui di san ci quanti huiyi gongbao (中国共产党第十一届中央委员会第三次全体会议公报) [Communique] (adopted and promulgated by the 3rd Plenary Session of the Eleventh Cong. of the Communist Party of China, Dec. 22, 1978, *available at* http://cpc.people.com.cn/GB/64162/64168/64563/65371/4441902.html.

[24] The Congress was held in October 1992; the economic plenum was held a year later. *See* Decision on Issues Concerning the Establishment of a Socialist Market Economy [hereinafter 14th Party Congress Decisions], *in* Zhongguo gongchandang di shisi jie zhongyang weiyuanhui di san ci quanti huiyi gongbao (中国共产党第十四届中央委员会第三次全体会议公报) [Communique] (promulgated by the 3rd Plenary Session of the Fourteenth Cong. of the Communist Party of China, Nov. 14, 1993), *available at* http://cpc.people.com.cn/GB/64162/64168/64567/65395/4441750.html.

[25] Hujintao zai zhongguo gongchandang di shiqi ci quanguo daibiao dahui shang de baogao (胡锦涛在中国共产党第十七次全国代表大会上的报告) [Report to the 17th Party Congress], (delivered by President Hu Jintao, Oct. 25, 2007) [hereinafter Report to the 17th Party Congress], *available at* http://cpc.people.com.cn/GB/64093/67507/6429847.html.

the current "stage" of China's economic transition during the 18th Congress of the CCP in 2013.[26] During this current stage, the Party plans to let markets play a more "decisive role" in the economy, and specifically to encourage the financial system and capital market activity while at the same time ensuring economic stabilization.[27]

Finally, a word of caution lest anyone be misled by this classification of transition stages: China is often referred to as a transitional economy but the fact that its economic trajectory went through various stages of transition does not make it one. A "transitional economy" implies a process toward an end goal, most commonly toward ownership privatization and a liberal market economy. Some economists have perhaps optimistically viewed China's development trajectory to represent "gradual privatization," as if an end result of complete privatization is inevitable.[28] Most expert observers of China, however, agree that full privatization is not the end goal of the Chinese Party-state under any CCP-led regime.[29] Hence, while over several decades there has been some reduction in the state's direct equity holdings in PRC firms, coupled with varying spurts of growth in small to medium enterprises often called "private," these reductions in formal equity shares do not amount to even a gradual reduction in control over the Party-state-operated assets. Accordingly, the term "transition" here refers only to the temporal aspect of the institutions discussed, without assuming any final results.

I. THE EMERGENCE OF FIRMS AND THE CAPITAL MARKET

To uncover China's law and capital market development conundrum, I provide an historical account of the emergence of firms and capital markets. This account focuses on two key elements: 1) the rise of the large (public) firm; and 2) the creation of capital markets in their narrow sense. The review reflects how during the first and second stages of economic transition, China did not conform with the common development assumptions mentioned above. China's public firms emerged and were able to expand with highly concentrated state ownership, and its capital markets evolved while relying mainly on transitional, often informal, experimental mechanisms. Only halfway into the development of firms and capital markets did a policy-guided embrace of corporate governance institutions seen in other successful economies begin. But even then, the introduction of these institutions was directed by political economy necessities—mainly, the concerns for Party-state

[26] Zhongguo gongchandang di shiba jie zhongyang weiyuanhui di san ci quanti huiyi gongbao (中国共产党第十八届中央委员会第三次全体会议公报) [Communique] (adopted and promulgated by the Third Plenary Session of the 18th Central Comm. of the Communist Party of China, Nov. 12, 2013) [hereinafter Communique 2013], *available at* http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm (partial English translation).
[27] *Id.*
[28] Gérard Roland, *Political Economy Issues of Ownership Transformation in Eastern Europe*, *in* CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES 31, 47-49 (Masahiko Aoki & Hyung-Ki Kim eds., 1995).
[29] The term "Party-state" refers to a one-party system in which one political party directs both the political process and the administrative governance of the state.

legitimacy and the need to reconsolidate economic power. Private economic activity and capital market efficiency were of lesser importance, consequently rendering the newly established laws and institutions powerless and irrelevant.

A. The Rise of the Large (Public) Firm

One of the first instigators for the rise of public firms in China was the economic autonomy that the central Party-state gradually granted to local level governments in order to advance economic growth. Limited discretion to make decisions concerning economic policy has resulted in various local economic initiatives. One such initiative was a party-sanctioned local experiment in the state sector with various forms of organizational ownership. It started in the mid-1980s at local-provincial levels and later expanded to be known as the national SOE (State-owned Enterprise) corporatization scheme. These experiments supplanted the nascent market forces; they were meant to incentivize economic activity in SOEs and to induce firms and their managers to adapt efficient measures to increase productivity. The corporatization experiment also took the place of the abrupt privatization approach that was common in other transitional economies.[30] It introduced organizational ownership under heightened control and an illiberal economic system.

As productivity increased and firms expanded, so did opportunities for abuse. Local economic power accumulated and introduced shifts in the delicate political equilibrium. Local experiments with enterprise reform were replaced by efforts of the central-state to reorganize and consolidate power over firms, including by the use of legal reforms and institutions. The rise of the public firm in China was thus strongly directed by political-economy. The result was Party-state control over a great number of China's most significant listed firms, one of the main attributes of China's state-capitalism today.[31] The following provides an overview of how the public firm emerged, business groups were created, and the Chinese Party-state became a dominant, often controlling, corporate stockholder.

[30] Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong*, 52 STAN. L. REV. 1731 (2000) (discussing mass privatization of large firms in Russia and its dire consequences).

[31] Commentators have taken different views as to China's Party-state involvement in the economy. Some have argued against the characterization of the Chinese economy as "state-capitalism." *See, e.g.*, NICHOLAS R. LARDY, MARKETS OVER MAO: THE RISE OF PRIVATE BUSINESS IN CHINA (2014) (considering the rapidly growing private business sector as a major driver of economic growth and employment in China today). Others, such as Lin and Milhaupt as well as contributors in Milhaupt and Liebman's edited volume, use the terms more freely. *See* Li-Wen Lin & Curtis Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697 (2013); REGULATING THE VISIBLE HAND?, (Curtis Milhaupt and Benjamin Liebman eds., 2016). I use the term to describe a system in which the Chinese Party-state directly or indirectly functions as the controlling shareholder of most significant PRC industrial groups and their domestic and globally-listed companies, as well as of the commercial and policy banks and financial firms, and at the same time stands behind the market's regulation and enforcement institutions.

1. Economic Decentralization and SOEs

Under Mao Zedong's command economic system (1949–1976), state-owned enterprises and by urban and rural collective enterprises carried out most economic activity in China.[32] The basic unit for economic and social life, in both the collectives and state-owned enterprises, was the *danwei*—the working unit—which was a political as well as an administrative institution. Bound to the *danwei* for life, workers relied on it to provide their entire social welfare needs, including everything from housing and food to entertainment. The *danwei* exercised economic, social, administrative, and political control on behalf of the party and state, extending the Party-state's presence and control to China's grassroots.

Above the working units, plant-level enterprises were organized into sectoral or geographical divisions, which were in turn assigned to various industrial bureaus.[33] Under administrative control and central planning, economic resource allocation was executed by fiats that were driven by political and social needs rather than by supply and demand. The *danwei* itself had no economic independence; instead, it was assigned production quotas and was funded through the state budget to reach the quotas. Demand for the products was guaranteed through fixed outlets, which were transferred by command to the other *danwei* units within a given state-owned or collective enterprise. All "profits" were remitted to the state, and there was therefore no need for a modern taxation system.[34] Under this economic and social reality, production units had no need for external capital. They had no incentive to seek new business opportunities, expand their production capacity beyond orders, or operate efficiently.

Starting in the early 1980s and continuing throughout China's long process of economic transition, reforms took place on a somewhat eclectic, trial-and-error basis of experimentation,[35] which was endorsed by the central Party-state.[36] Most economic policies were focused on state-owned enterprises and only gradually opened-up to the idea of private forms of ownership.[37] The primary

[32] Under Mao, limited private economic activity was allowed from time to time to the peasantry. Private agriculture activity made up a very small portion of rural labor input. Andrew C. Mertha, From "Rustless Screws" to "Nail Houses": The Evolution of Property Rights in China (unpublished manuscript) (on file with author).

[33] Theodore Groves et al., *China's Evolving Managerial Labor Market*, 103 J. POL. ECON. 873, 876 (1995).

[34] STOYAN TENEV ET AL., CORPORATE GOVERNANCE AND ENTERPRISE REFORM IN CHINA: BUILDING THE INSTITUTIONS OF MODERN MARKETS 10-11 (2002).

[35] Sebastian Heilmann refers to "experimentation under hierarchy" as a "process of policy generation that legitimizes local initiative while maintaining ultimate hierarchical control." Sebastian Heilmann, *Experience First, Laws Later: Experimentation and Breakthroughs in the Restructuring of China's State Sector*, *in* GOING PRIVATE IN CHINA: THE POLITICS OF CORPORATE RESTRUCTURING AND SYSTEM REFORM 95-118 (Jean Chun Oi ed., 2011); Sebastian Heilmann, *Experimentation under Hierarchy: Policy Experiments in the Reorganization of China's State Sector, 1978-2008* (Ctr. for Int'l Dev. at Harvard U., Faculty Working Paper No. 172, 2008).

[36] Heilmann, *Experimentation under Hierarchy*, *supra* note 35. *See also* YUEN YUEN ANG, HOW CHINA ESCAPED THE POVERTY TRAP (2016) (suggesting that the empowerment of local agents to experiment with innovative policy solutions was a major component in China's ability to "escape the poverty trap" despite weak legal institutions).

[37] With the exception of rural (mostly land related) reforms. Economic activity in rural areas and specifically in agricultural land had gone through different reforms that reflect different property rights arrangements. JANOS KORNAI, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM 74-79 (1992); TENEV ET AL., *supra* note 34, at 11.

goal of the experiments was to encourage more productive activity in state-owned enterprises. One of the first examples is the introduction of "shares" into enterprises. Although the term "corporatization" formally refers to the ownership organizational reform taken in SOEs in the 1990s, the process had started much earlier with experiments within collective enterprises in the countrysides, which later spilled over into state-owned enterprises.[38] Shares were issued and given primarily to enterprise employees. In 1986, the State Council released regulations permitting local governments to select a few large and medium-sized SOEs in their localities as formal pilots for shareholding experiments, thereby acknowledging share ownership assignment as a formal experiment and applying it more broadly.[39] However, the issued shares provided a fixed and guaranteed dividend cash payment much like a bank deposit and therefore did not create incentives to increase production.

Other ways to incentivize local governments to increase productivity during the early transition phase were dual-track pricing and fiscal contracting. These schemes permitted state enterprises to sell excess products at newly-emerging market prices, remit part of the profits to the local government, and retain the rest. In the early 1980s, local governments were delegated such rights over a great number of state assets. It is estimated that already by 1985 state-owned enterprises controlled by the central government accounted for only twenty percent of total industrial output of all enterprises at or above the township level. By 1994, state assets controlled by the central government were only thirty-five percent of *all* state assets.[40] In this environment, local governments have become largely dependent on their own generated revenues and less reliant on centrally allocated resources, thus creating dependence on local enterprises for revenue. This process has had meaningful implications for China's political structure and is one of the main catalysts for China's "Fragmented Authoritarianism" today.[41] As described by Lieberthal, the "decentralization of budgetary authority enabled many locales and bureaucratic units to acquire funds outside of those allocated through the

[38] The first local experiments with share issuance happened in the countryside before there was a formal acknowledgment of broad policy experimentation. For a detailed chronology of local initiatives and experiments with stock issuance and trading platforms, *see* CARL E. WALTER & FRASER J. T. HOWIE, PRIVATIZING CHINA: INSIDE CHINA'S STOCK MARKETS 21-22 (2006) (mentioning Provisional Management Measures that were released locally by the Shanghai Branch of the People's Bank of China in July 1984 as the first formal rules promulgated by a local government body to address the issuance of shares). The rules, known as the "Eight Articles" (Batiao) limited the issuance of shares to newly established "collective enterprises," excluding SOEs from the initial experiments. Yet, shares of collective enterprises could be held by SOEs or other collectives, as well as by specific types of individuals, excluding party officials. Peasants were permitted to invest in shares, and employees could (and were often encouraged to) purchase shares of the enterprise they worked at. As Walter and Howie state, this was done in an effort to protect SOEs and party officials from the new, politically charged, capitalist initiative.

[39] *See id.* (mentioning approval of share issuance to Liaoning Fushun No. 1 Brick Factory in January 1980 as the pioneering share issuance, followed by the issue of shares of Chengdu Shudu Office Building Co. Ltd. the same year, Shenzhen Baoan County United Investment Co. Ltd. share issuance in 1983, and Beijing Tianqiao Department Store Co. Ltd. share issuance in 1984).

[40] Shuhe Li & Peng Lian, *Decentralization and Coordination: China's Credible Commitment to Preserve the Market under Authoritarianism*, 10 CHINA ECON. REV. 161, 176-178 (1999).

[41] Kenneth G. Lieberthal, *Introduction: the 'Fragmented Authoritarianism Model' and Its Limitations*, *in* BUREAUCRACY, POLITICS, AND DECISION MAKING IN POST-MAO CHINA 1 (Kenneth G. Lieberthal & David M. Lampton eds., 1991).

central budget, which they could use to pursue their own policy preferences."[42] This was a shock to the political-economic equilibrium, creating new competition between localities and power shifts from the center.[43]

Beyond its implications on the allocation of administrative and economic decision-making authority within the Party-state system, economic decentralization also had direct implications on the organizational ownership of state assets. It shaped how firms were structured, business groups emerged, and how the capital market evolved more broadly. Salient among these, economic decentralization directly informed the ways industrial enterprises were managed.

Local governments started to create various schemes with the goal to increase production in the SOEs under their administrative management. Within each local government's administrative boundaries, officials were assigned to manage the state assets organized in SOEs. These appointed managers engaged in "Management Contract Responsibility" arrangements with their local governments. Many of these new arrangements involved performance targets, compensation plans, and control rights,[44] including, for example,[45] 1) contract-based arrangements between SOEs and their supervising government agency in which SOEs bargained for profit remittance targets, allowing the SOE to keep the surplus (in many cases, profits above target were distributed to workers and managers); 2) giving greater control to SOE managers over sales, pricing, production, and finally even on investments and labor decisions, in return for achieving profit remittance targets; and 3) when the central government introduced a share issuance system, managers and other senior employees received shares in their SOEs as an additional incentive to increase firm profitability.

Such arrangements allowed the managers to have growing discretion over the use of the enterprise's generated profits. The goal was to incentivize managers to perform better. Local government officials who were assigned to manage the SOEs were then able to use the retained profits and their broadened managerial discretion to expand the assets under their management.

To further their authority, many opted to create SOE subsidiaries such as collective enterprises and joint ventures. To these affiliated businesses, they often provided local government sponsorship and personal patronage. This new form of asset diversification helped local government officials to gain more autonomy from supervising central government agencies. Consequently, local government officials emerged as dominant business players and powerful decisionmakers in their jurisdictions.

The process of economic decentralization and these local experiments did not follow the globally advocated strategies for stimulating market development. They also functionally substituted

[42] *Id.* at 8.
[43] Susan Whiting, *The Cadre Evaluation System at the Grass Roots*, *in* HOLDING CHINA TOGETHER: DIVERSITY AND NATIONAL INTEGRATION IN THE POST-DENG ERA 101, 111 (Barry J. Naughton & Dali L. Yang eds., 2004).
[44] *See* Donald C. Clarke et al., *The Role of Law in China's Economic Development*, *in* CHINA'S GREAT ECONOMIC TRANSFORMATION 375, 415-416 (Thomas Rawski & Loren Brandt eds., 2008). *See generally* Li & Lian, *supra* note 40, at 176.
[45] Groves et al., *supra* note 33.

for traditional corporate institutions and formed the baseline for the rise of the Chinese public firm.[46] Another result, however, was the accumulation of local powers, which had several important negative effects.

First, strong local protectionism arose, and it guided economic and administrative decision making, including with respect to firms. Known aspects of economic protectionism are the approval of risky investment schemes often without solid feasibility checks and the influence of local government officials on the supply of bank loans to SOEs.[47] Another notable effect was on legal enforcement, which was tainted by selective enforcement in favor of local parties.[48] Protectionism also led to informal internal trade barriers that different provinces created against each other and which influenced the operation of firms by limiting cross-provincial business cooperation and curbing competition.

Second, such economic decentralization created the potential for conflicts of interest at various levels, between the administrative role of individual officials and their role as SOE managers, as well as between the central administration and the localities.[49] In addition, multiple overlapping government agencies had a say in monitoring various aspects of the operations of SOEs, including labor, production, and resource allocation. This led to burdensome multilevel bureaucratic interference with SOE management by various state agencies and Party agents with conflicting interests.[50] These lines of conflict created the concern that local officials (and SOE managers among them) would become less attuned to central government goals, and it made coordination between central and local government organs more challenging.

The central government was not blind to these concerns and tried to curb the developing ties between local administrative authority and economic power.[51] A separation between the government role and the commercial activities of SOEs was announced.[52] Under this approach, government and

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[46] *See* Clarke et al., *supra* note 44, at 415-416 (discussing managerial incentives as a functional substitution for corporate governance institutions).

[47] TENEV ET AL., *supra* note 34, at 20-21 (positing that the high level of nonperforming loans in the banking system creates a gap in incentives nowadays too).

[48] This influenced the wide spectrum of legal enforcement, including debt collections, bankruptcy, prosecution, and adjudication. Protectionism also tainted other administrative processes, such as business licensing, allocation of labor, credit financing, taxation, and profit retention privileges. Protectionism in the People's Court system emanated from other related factors; economic decentralization and local self-funding also meant that local governments were the ones to fund the operation of the judicial system in their locales. *See* Randy Peerenboom, *The Judiciary: In Search of Independence, Authority and Competence*, *in* CHINA'S LONG MARCH TOWARD RULE OF LAW 280, 311(Randy Peerenboom ed., 2002).

[49] Jean Oi, *The Role of the Local State in China's Transitional Economy*,144 CHINA Q, 1132, 1144-1145 (1995).

[50] Donald Clarke, *Corporate Governance in China: An Overview*, 4 CHINA ECON. REV. 494, 497-498 (2003).

[51] *See* Zhonggong zhongyang guanyu jingji tizhi gaige de jueding (中共中央关于经济体制改革的决定) [Decision on Reforming the Economic Structure] (promulgated by the Central Comm. of the Communist Party of China, 3rd Plenary Session of the Twelfth Central Committee, Oct. 20, 1984), art. 6 [hereinafter 1984 CCP Decision on Reforming the Economic Structure], *available at* http://cpc.people.com.cn/GB/64162/64168/64565/65378/4429522.html (showing noticeable beginnings of this shift).

[52] Howard Chao & Xiaoping Yang, *Private Enterprise in China: The Developing Law of Collective Enterprises*, 19 INT'L L. 1215, 1220 (1986) (citing several decisions that instructed party and government officials to resign either from their company

party officials were not allowed, at least not formally, to manage enterprises directly while also serving in other public posts. (This is not to be equated with the Anglo-American "separation between ownership and control," which was implemented later through corporatization.)

Over time, however, these steps to separate government from enterprises proved ineffective.[53] The separation seemed artificial and only added to existing operational difficulties. With little or no business or managerial knowledge, management appointees, now *former* government and military officials (members of the nomenklatura), were still conduits of the government unit that appointed them. Moreover, the appointing units continued to supervise the managers, a pattern that led to local corruption and capture. Unfamiliar with the new business reality, the supervising state agencies were caught unprepared, lacking the capacity to monitor their appointed agents.[54] The concern for conflicts of interest materialized. New economic opportunities along with broader managerial freedom brought wealth extraction and asset stripping in SOEs. Managers freely partook in value and asset transfers and were not held accountable for losses.[55]

By late 1980s, the relative inefficiencies of SOEs became a point of growing concern, especially in light of increasing competition from an emerging private sector (still mainly rural) and the limited penetration of foreign businesses.[56] By the mid-1990s, forty-one percent of China's SOEs suffered losses.[57] A new social layer of crony-capitalists began to emerge.[58] The former state officials and party members in their private capacity started to form a powerful interest group, whose members' personal interests gradually became directly invested in China's firms and have direct power over economic policy decisions. This process soon became the source of many of China's current corporate governance and capital market challenges.

posts or from their public one). This is not the situation nowadays, as senior executives in China's biggest SOEs often simultaneously hold important positions in the government and the party.

[53] *See* generally, 43Michael Irl Nikkel, *Chinese Characteristics in Corporate Clothing: Questions of Fiduciary Duty in China's Company Law*, 80 MINN. L. REV. 503, 518-520 (1995).

[54] Xue Liang Ding, *The Illicit Asset Stripping of Chinese State Firms*, 43 CHINA J. 1 (2000) (describing a "bleeding of the state sector" into the private hands of manager-appointees and officials assigned to supervise them).

[55] Dominic Ziegler, *The Honeycomb of Corruption—A Little Reform in the State Sector Has Proved A Dangerous Thing*, ECONOMIST, Vol. 355, Apr. 8, 2000, pp. CS8-CS10, *available at* https://www.economist.com/node/299621 ("reforms that have brought great complexity to the state sector's relations … 'managers of Chinese state firms essentially have ended up capturing a sizeable portion of the widely scattered public property'").

[56] Gary Jefferson, *Are China's Rural Enterprises Outperforming State-Owned Enterprises?* (World Bank China Series, Research Paper No. CH-RPS 24, 1993) (focusing on the rapid growth of Town-Village Enterprises as the critical element in China's economic transition success).

[57] *China Plans New Bankruptcy Law*, WALL STREET J., Dec 30, 1994, at A4.

[58] Kjeld Erik Brødsgaard, *Politics and Business Group Formation in China: The Party in Control?*, 211 CHINA Q. 624 (2012).

2. National Level Schemes

Asset stripping from SOEs, corruption, and capture were not rampant only within local governments but rather were carried out at all levels. Yet economic decentralization and the resulting accumulation of local powers were a main driving force behind the national level efforts that came next. The corporate form as an organizational ownership structure of SOEs was introduced and utilized as part of the central Party-state effort for national restoration to achieve both domestic consolidation and international competitiveness.

Facing the institutional challenges discussed above, central government agencies started to develop schemes for structural reform. The State Commission for the Reform of the Economic System (CRES), a national state agency under the direct authority of the State Council that was created to handle economic reform and granted the authority to design and issue relevant policies, undertook one of the best-known initiatives. The CRES, without any prior move by the national legislature or even the Party, introduced a national legal reform of business enterprises.[59] The two policy documents, known as the 1992 Normative Opinions, defined different legal forms of organization for equity share-based enterprises. The 1992 Normative Opinions also prescribed normative business standards in such companies, introducing for the first-time modern principles of corporate organization.[60] Despite being issued by an administrative state body rather than by a national legislator (the NPC or the State Council), the 1992 Normative Opinions are viewed as the first *de-facto* modern national business organization law.[61]

A few months later, the central Party-state picked up these agency-led efforts through two important enterprise organizational plans: i) the "modern enterprise system;" and ii) accelerating business groups.[62] These were meant to rebuild the troubled state sector while reconsolidating control over SOES.

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[59] Youxian Zeren Gongsi Guifan Yijian [Normative Opinions on Standards for Limited Liability Companies] (promulgated by the State Comm'n for Restructuring the Economic Systems, May 15, 1992), *available here* http://en.pkulaw.cn/Display.aspx?lib=law&Cgid=5740 [hereinafter Normative Opinion on LLCs 1]; Gufen Youxian Gongsi Guifan Yijian [Normative Opinions on Standards for Companies Limited by Shares] (promulgated by the State Commission for Restructuring the Economic Systems, May 15, 1992), *available here* http://en.pkulaw.cn/display.aspx?cgid=5738&lib=law [hereinafter Normative Opinion on CLSs] [hereinafter together 1992 Normative Opinions].

[60] For example, enterprise legal personhood, shareholders' limited liability, share ownership, transferability of shares, and formal separation between management and ownership. *See* Normative Opinion on LLCs 2, *supra* note 59, arts. 1, 22, 28, 30, 39, 41-42.

[61] Not having a formal status of law and being the "opinions" of an administrative commission, the status of these opinions was subject to debate. In retrospect, the State Council confirmed their effect as a ministry-level regulation. *See* Nicholas C. Howson, *China's Company Law: One Step Forward, Two Steps Back? A Modest Complaint*, 11 COLUM. J. ASIAN L., 127, 137 (1997).

[62] A parallel reform with much the same political consolidation purpose was the Tax Reform of 1994, which included methods to redefine the fiscal relationship between the central and local government and increase the center's fiscal control. S. B. Herschler, *The 1994 Tax Reforms: The Center Strikes Back,* 6 CHINA ECON. REV. 239 (1995).

i. The "Modern Enterprise System" — Corporatization and Share-Ownership

The Decisions of the 14th Party Congress announced a shift toward a "modern enterprise system."[63] This policy formally initiated a national process for SOE corporatization, in which a modern corporate form was adopted, although still on a probationary basis. By adopting the features of the modern corporation as the organizational form that had proven successful worldwide, it was hoped that productivity would increase and that efficiency would start to guide the management of state-owned enterprises.[64] Interestingly, however, several elements from the 1992 Normative Opinions, including standards for shareholder protections,[65] were not embraced by the CCP decision and were withdrawn in the enactment of the subsequent, and first, PRC Company law.[66]

Adopting the contours of a modern corporation in law reflected a formal acknowledgment of several corporate attributes, such as a separate legal personality, limited liability, transferability of rights, and separation of ownership from management, which was referred to as "scientific management."[67] Furthermore, it meant a (re)conceptualization of property rights ideas and specifically ownership interests through shares, even if this was still exercised mainly by the state on behalf of "all the people."[68] Indeed, as part of the corporatization initiative, share ownership rights in enterprises were formally recognized. The significance of this should not go unnoticed and is especially striking given that China's first Property Law was enacted only in 2007.[69] Ownership of financial assets and particularly the economic rights attached to it were still openly frowned upon at that time.[70] This had a simple ideological basis, as earnings from capital assets ran counter to the basic Marxist view of labor-based income. Thus, a share system that was taken beyond local experimentations and acknowledged in a formal national law had to be motivated by a strong national purpose. It is indeed well established among China commentators that the corporatization scheme was designed to attract

[63] *See* 14th Party Congress Decisions, *supra* note 24.
[64] Donald Clarke, *How China's Effort to Bring Private-Sector Standards into the Public Sector Backfired*, *in* REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM 35 (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2015).
[65] Howson, *supra* note 61 (comparing the 1992 Opinions and related documents with the 1993 Company Law).
[66] *See* Zhonghua Renmin Gongheguo Gongsifa [The Company Law of the People's Republic of China] (promulgated by the Standing Comm. of the Eighth Nat'l People's Cong., Dec. 29, 1993, effective July 1994) [hereinafter "1993 Company Law"]. The Company Law was later revised. *See infra* note 147.
[67] *Id.* arts. 3-7.
[68] Although all assets were possessed by the state in the traditional state-owned enterprises system, the corporatization process and share-ownership can be viewed as distinguishing between administrative possession and the recognition of the state (and state bodies) as a property share owner.
[69] Zhonghua Renmin Gongheguo Wuquanfa [Property Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Mar. 16, 2007, effective Oct. 1, 2007). On the controversies surrounding the enactment process, *see* Songyan Sui, *New Property Law Shakes Up China*, BBC NEWS (Mar. 8, 2007, 1:10 PM), http://news.bbc.co.uk/2/hi/asia-pacific/6429977.stm.
[70] Only in 2002, following Jiang Zemin's 2001 speech and the official proclamations of the 16th Communist Party Congress, were party members officially welcome to pursue investment-sourced income.

public finance to recover the failing state sector.[71] However, given the shifts in China's political-economic equilibrium, it was also an act of consolidating control over business organization.

In the process of corporatization, SOEs as industrial-ministerial or provincial-line state agencies were converted from their former organization into one of the corporate forms recognized under the newly enacted Company Law. The law distinguished between three main corporate forms of organization: (1) a Limited Liability Company (LLC) (*youxian zeren gongsi)* intended for a small and more closely held group of investors, similar to the close corporation form in the United States; (2) a Joint Stock Limited Company, also known as a "company limited by shares" (CLS) (*gufen youxian gongsi)*, which may be a listed company or an unlisted company, although the assumption was that a company will be established with the intention to list in the future; and (3) a Wholly State-Owned Limited Liability Company (*guoyou duzi gongsi*), a special type of LLC wholly owned by a state body. [72]

As part of their reorganization, the corporatized SOEs had to shed their social welfare functions and maintain only their productive assets and human capital. [73] These newly created legal entities were then either grouped under (1) central and local-level state bodies (e.g., central, provincial, and municipal government organs with jurisdiction over a particular industrial sector or region), which were now reorganized as holding companies with subsidiary "legal person" holdings; or (2) organized with other existing PRC enterprises (such as collectives and other companies that were also controlled by non-central government bodies) and given a "legal person" status.[74]

The controlling shares of these corporations were issued to the industrial ministry or to other national and local government units from which the corporation was created. The structural outcome of this corporate organization process was the consolidation of the productive assets and human capital of traditional state-owned enterprises and their vesting in several now-corporatized SOEs in which the central or the local government now had shares.

It was assumed that the new corporate shareholding capacity of the state would eliminate conflicts between the various state agencies involved in the firms' operations since they would have one vehicle, the shareholder vote, to promote their goals.[75] In addition, the corporate form was not only thought to be better suited for efficient management but was also essential in order to make external equity financing possible.

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[71] To establish this conclusion, scholars present the percentage of listed firms originated from SOEs. For example, Clarke brings sources to show how at the end of 2000, of the 1,088 listed companies on both exchanges, over 900 were originally traditional state-owned enterprises. At the end of 2001, out of 1,160 listed companies, approximately 1,103 were originally traditional state-owned enterprises. Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 131 (2006).

[72] For the LLC form, *see* 1993 Company Law, *supra* note 66, arts. 3, 9, 19, 20. For the CLS form, *see id.* arts. 3, 73, 74. For the wholly state-owned LLC form, *see id.* arts. 3, 64.

[73] The social welfare functions were transferred to "social affairs units" (*shiye danwei)* under relevant ministries. *See* DALI L. YANG, REMAKING THE CHINESE LEVIATHAN: MARKET TRANSITION AND THE POLITICS OF GOVERNANCE IN CHINA (2004).

[74] Harry G. Broadman, *The Business(es) of the Chinese State*, 24 WORLD ECON. 849, 860-863 (2001). For an extensive analysis of Chinese listed firms group formation, *see* Lin & Milhaupt, *supra* note 31.

[75] For a critique, *see* Clarke, *supra* note 50, at 497-500 (noting how the same state entity can still seek multiple, sometime conflicting goals and how the state still in practice kept exercising its control not only through its shareholding capacity).

While formally initiated at the national-level by the new Company Law of 1993, the corporatization scheme was implemented gradually and by experimentation first. By the mid-1990s, the State Council selected 100 large and medium size SOEs for a pilot program. The SOEs that were corporatized as CLSs could now raise equity investments from domestic and foreign investors and assign them shares in return. From this point onward, while companies with dominant state ownership were still colloquially called SOEs, it is more accurate to refer to them as state-controlled companies.

A survey of 2,343 pilot enterprises conducted by the State Statistical Bureau in 1997 revealed that 85 percent of the enterprises had corporatized into one of the legal corporate forms. Among these, 39 percent adopted the wholly state-owned form, 23 percent adopted the LLC form, and another 23 percent adopted the CLS form.[76] By the end of 2000, over 80 percent of all state-owned enterprises surveyed were transformed into corporations, and over 1,200 large enterprises were restructured specifically as CLSs.[77]

While the restructuring effort was carried out successfully and the corporatized firms quickly attracted outside financing (see below), in practice, however, the contribution of this process to management quality, accountability, and efficiency was limited. One of the main reasons was the cognizant design of the share structure in the corporatized SOEs.

Strategically refraining from privatization, the newly corporatized SOEs that turned to equity financing were required to maintain a third of their shares as state shares. These shares were classified as common but untradeable shares and could be owned only by state entities. Another third of the newly issued shares were reserved for *legal persons*. These were also common but untradeable shares and were only transferable to other legal persons with appropriate approvals that included price determination.[78] During that time, China's economic laws determined that legal persons were domestic organizations with formal legal personality, which meant that the definition in practice excluded individuals.[79] Moreover, since purely private businesses were at that time few in number, legal persons de-facto meant enterprises that were state-owned or state affiliated. This diversification of different types of common shares practically meant that about two-thirds of a listed company's shares were directly and indirectly held by organs of the state. It also meant that only about a third of the company's shares—the public float—were transferable.[80] This system isolated state shares from market forces and had implications on the valuation of listed companies. Most important, the potential disciplinary role of the capital markets on the insiders of the firms was curtailed from the start.

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[76] He Jun, *An Empirical Study on the Governance Structure of Listed Companies* [Shangshi Gongsi Zhili Jieguo de Shizheng Fenxi. (Jingji Yanjiu)], 5 ECON. RESEARCH. J (1998).

[77] TENEV ET AL., *supra* note 34. Unfortunately, the source does not mention the total number of firms surveyed and therefore the percentage of CLS corporatization in SEOs is unclear.

[78] Wenxuan Hou & Edward Lee, *Split Share Structure Reform, Corporate Governance, and the Foreign Share Discount Puzzle in China*, 20 EUR. J. FIN. 703, 709 (2014).

[79] The Economic Contract Law of the People's Republic of China, adopted at the 4th session of the fifth National People's Congress, December 13, 1981, effective July 1, 1982, was enacted to govern agreements between domestic "legal persons." Those at that time were legal entities restricted to the state sector, SOEs and/or collectives. The law was amended in 1993 to include all domestic registered and licensed business entities (still, not individuals).

[80] Fuxiu Jiang & Kenneth A. Kim, *Corporate Governance in China: A Modern Perspective*, 32 J. CORP. FIN. 190 (2015).

The share composition started to change after the split-share structure reform was announced in 2005.[81] State-owned shares and legal-persons' shares were, in principle, gradually subjected to market discipline. Today, legal person shares are held by entities such as industrial enterprises (mostly SOEs), holding companies, non-bank financial institutions, and research institutions. These legal person shares are largely still indirectly controlled by the state.

Yet, even today, making state and legal person shares tradable does not mean these shares are suddenly being traded. State ownership in significant cases is retained. Either state bodies do not trade their shares in practice[82] or they trade their shares through a private placement to another state-owned or affiliated enterprise. Alternatively, in many instances and often following policy directives, state ownership is reduced but control is maintained through mergers and acquisitions, diversification to subsidiaries and holding groups, and group formation. While these methods are globally-common business strategies,[83] they resulted in the entrenchment of voting control at the hands of the state and its affiliates while reducing equity ownership and accountability for losses.[84]

ii. Business Group Formation

Another key effort that the central Party-state took to reconsolidate control over SOEs was the acceleration of business group formation. As early as 1987, the CRES encouraged SOEs to organize as "business groups" (*qiye jituan).*[85] In its Opinions for the Establishment and Encouragement of Business Groups [The Business Groups Opinions],[86] the enterprise group was defined as a multi-level organizational structure, with various circles of enterprises tied together by a charter and by shared organizational features, yet each with corresponding autonomy.[87] This organizational structure

[81] A self-assessment study conducted by the CSRC and China's State Economic and Trade Commission before the share-structure reform was launched found that seventy-seven percent of China's controlling shareholders in a study that included 1,175 listed firms could be considered state entities, while in about a third of the companies a single-state shareholders held more than half of the shares. *See* Clarke, *supra* note 3, at 148 n. 58.

[82] *Id.*

[83] Another business strategy to raise capital is to leverage the firm. Debt capital does not require the state to give up control nor dilute its ownership interests and has become an acute problem especially for local-level SOEs. Kun Su, *The Inner Structure of Pyramid and Capital Structure: Evidence from China*, 9 ECON.: THE OPEN-ACCESS, OPEN-ASSESSMENT E-J., 1 (2015) (finding that multiple layers of pyramid structure increase a "leverage effect" and the motivation of the ultimate owner to expand debt financing).

[84] *See* discussion *infra* Chapter 2.

[85] Lin & Milhaupt, *supra* note 31, at 714.

[86] The Opinions on the Establishment and Development of Business Groups, issued by the State Commission on Restructuring the Economy and the State Economic Commission, recognized Business Groups as a "multi-level organizational structure" with separate legal personality. *See* Guanyu Zujian he Fazhan Qiye Jituan de Jidian Yijian (关于组建和发展企业集团的几点意见) [Opinions on the Establishment and Development of Business Groups] (promulgated by the Nat'l Econ. Sys. Reform Comm'n & the Nat'l Econ. Comm'n, Dec. 16, 1987) [hereinafter Business Groups Opinions], *available at* http://www.chinalawedu.com/falvfagui/fg21829/31802.shtml.

[87] *Id.*

expanded in the following years until it turned into a national goal.[88] The creation of national business groups eventually applied systematically along former ministerial or sectorial line bureaus.[89]

During corporatization and the introduction of a share system, group companies were also the corporatized SOEs that issued shares and raised equity capital from the public—the business group's publicly listed firm. These, in many cases, became China's national champions. Other enterprises under the same core company within the group provide related services to support the main corporatized listed firm, such as research and development or education subsidiaries, the group's finance company, and other service entities (subsidiaries or affiliated firms) that expand the group's network through contractual arrangements.[90]

Today, the picture that has emerged is one of an intricate layered network of dozens of related companies within business groups in specific industrial sectors. Enterprise groups must register as such,[91] a status that grants their various entities opportunities for preferential taxes, stock listing, and government contracts.[92] Entities within the group are tied to a parent "core" company, above which the state presides. The core company functions as the holding company in the group. The main production enterprise within the group is the "group company"—the unit to which most of the state assets as well as economic and production activities were funneled through the corporatization process.

The policy of accelerating business group formation was meant to encourage competition, prevent monopoly, promote technological progress, and improve economic efficiency through, among other ways, economies of scale.[93] In many key industries, however, and especially after state assets were restructured under the national State-owned Assets Supervision and Administration Commission (SASAC) and its local branches—which hold controlling or full ownership interests at the core parent company—group formation actually led to monopolistic and oligopolistic group power.[94] Since the reorganization of state assets in groups meant carving corporations out of industrial-sector ministries and agencies, groups from inception were de facto confined to certain geographical areas or to a certain step in the production chain within a given industry.[95] Thus, while

[88] Lin & Milhaupt, *supra* note 31, at 714.
[89] Brødsgaard, *supra* note 58, at 627-628.
[90] For the various entity components of the national business groups in China, *see* Lin & Milhaupt, *supra* note 31, at 717-721.
[91] The Business Group Opinions were further developed with the issuance of Qiye Jituan Dengji Guanli Zhanxing Guiding (企业集团登记管理暂行规定) [Provisional Rules on Business Group Registration] (promulgated by the St. Council, Sept. 1, 2006, effective Jan. 1, 1997). For a comprehensive review on their function today, *see* Lin & Milhaupt, *supra* note 31, at 712-720.
[92] Lin & Milhaupt, *supra* note 31, at 714.
[93] Business Groups Opinions, *supra* note 86, art. 5. *See also* Brødsgaard, *supra* note 58, at 627-628; Lin & Milhaupt, *supra* note 31, at 714.
[94] For example, in energy, petroleum, telecommunications, and chemicals industries. Milhaupt & Zheng, *supra* note 5, at 690-691, n.129.
[95] This is the case particularly for central-state held groups in strategic industries. One of the examples most commonly referred to in the literature, is the asset reorganization and corporatization of the Ministry of Petroleum Industry. *See id.* at 692.

they were theoretically competing with parallel groups, they in fact accumulated market dominance in their designated roles.

While the group structure may have limited the development of domestic competition, it contributed to China's competitive abilities in the global market. As noted by Lin and Milhaupt, the government encouraged business group formation to foster the growth of national champions as engines of development.[96] Finally, the national endorsement of business group formation had an additional important goal, to aid the Party-state in "streamline[ing] control over the economy."[97] In theory, by reducing information and coordination costs, national-level vertically integrated groups are able to transmit and implement economic policy more easily, serving and amplifying central-level control.[98]

Notwithstanding these aspirations, policy makers acknowledged several concerns from the very beginning of this strategy in the late 1980s. The Business Groups Opinions cautioned against potential conflicting interests not only between various levels of group member companies but also between different levels of the state. The Business Groups Opinions emphasized that groups should not operate in ways that would damage national interests.[99] However, concerns have materialized at both levels: the group system furthered local-level networks, and it concentrated economic and administrative power in the hands of a few national champions and their leaders. At least from a domestic perspective, it seems that the endorsement of business group formation backfired.

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[96] Lin & Milhaupt, *supra* note 31*,* at 699 ("One highly distinctive characteristic of state capitalism in China is the central role of about 100 large, state-owned enterprises (SOEs) (*guoyou qiye)* controlled by organs of the national government in critical industries … These globally significant SOEs are China's national champions."). *See id.* at 714, n. 51 (noting that the creation of national champions was explicitly recognized as a goal of the central government in 1996 in the Outline Report on the Ninth Five-Year Plan of National Economy and Social Development and the Perspective and Goals of 2010. See Guanyu Guomin Jingji He Shehui Fazhan "Jiu Wu" Jihua He 2010 Nian Yuanjing Mubiao Gangyao Ji Guanyu "Gang Yao" Baogao De Jueyi (关于国民经济和 社会发展"九五"计划和 2010 年远景目标纲要及关于《纲要》报告的决议) [Outline Report on the Ninth Five-Year Plan of National Economy and Social Development and the Perspective and Goals of 2010) (promulgated by the Nat'l People's Cong., Mar. 17, 1996). *See also* Lin & Milhaupt, *supra* note 31, at 712 (noting that the encouragement of business group formation is a common strategy in many other countries, and is often used to fill institutional voids, and reduce transaction costs of administrating economic policy).

[97] Lin & Milhaupt, *supra* note 31, at 714.

[98] There are, however, several articles that suggest the opposite view. *See* Joseph P. H. Fan et al., *Institutions and Organizational Structure: The Case of State-Owned Corporate Pyramids*, 29 J. L. ECON. & ORG. 1217 (2013) (arguing that local government organizational pyramids are designed to minimize political costs of state interference, further suggesting that this was implemented by local governments in an effort to assign them more credibility to nonintervention vis a vis investors); Kun Su et al., *Pyramidal Structure, Risk-Taking and Firm Value: Evidence from Chinese Local SOEs*, 26 ECON. TRANSITION 401 (2018) (viewing business group formation as a form of decentralization that was aimed to reduce political influence on firms by increasing intervention cost along the layers of the pyramid); Min Zhang et al., *Pyramidal Structure, Political Intervention and Firms' Tax Burden: Evidence from China's Local SOEs*, 36 J. CORP. FIN. 15 (2016) (looking at the influence of state-pyramids on corporate tax burden, finding that state-pyramidal layers are significantly and negatively associated with effective tax rates, which the authors argue indicates that group pyramids formed to protect local state-owned enterprises from political intervention). It should be noted that Lin and Milhaupt focused on national level groups under SASAC, thus the views on the use of business groupism might not be in contradiction. Either way, scholars would probably agree that at the local level, the endorsement of business groups had increased decentralization and added to conflicting interests.

[99] Business Groups Opinions, *supra* note 86, art. 13.

During the first few years of the scheme, the national-level endorsement of business groups boosted empire-building by the localities and widened the divide between central-level and local-level economic power. Local governments had used the opportunity to create pyramid-layered business groups that dissociated them from central government control.[100] This form of economic disentanglement from central control through local-group organization is an aspect of the shifts in China's political economy that carries implications today.[101] Also, with respect to national-level groups, since many of the most important national champion groups were converted from previous industrial ministries, there was a strong political pressure to maintain their rank within the bureaucratic hierarchy.[102] As a result, these business groups and the general managers of many of their corporatized SOEs still enjoy a status equivalent to that of a minister or vice minister in the state's hierarchical bureaucracy. This makes supervision over them by state administrative bodies charged with tensions and battles over authority.

In sum, the policy endorsement of business group formation has been a significant contributor to China's rising economic power, particularly in the international front. However, it has also amplified the conflicts of interest between the various authorities of the state, both horizontally and vertically. Furthermore, business group formation also intensified conflicts at the group level itself. Having to consider group-level implications, the core company and its controlling state-owner became further alienated from the shareholders' interests in each firm within the group.[103]

B. The Formation of Capital Markets (in their narrow sense)

Capital market institutions operate to reduce the costs of raising external finance. This is achieved primarily by facilitating transactions in a large number of securities simultaneously, making information easily available to potential and existing investors, and reducing the costs of monitoring. Importantly, capital markets promote efficiency by allocating capital to the most deserving firms. Capital markets in China, however, evolved primarily to serve other functions. The following review examines how capital markets, in their technical, narrow sense, formed in China, focusing on the primary mechanisms through which stocks were issued and traded and the institutions that were created to govern them.

[100] *See* sources in *supra* note 98 (positing that this was also a form for the local governments to attract investors by committing through the pyramid structure to less government interference).
[101] In previous work, I suggested how such economic disentanglement from the central Party-state may eventually empower public investors through a budding form of a market for corporate control. *See* Tamar Groswald Ozery, *Minority Public Shareholders in China's Concentrated Capital Markets—A New Paradigm*, 30 COLUM. J. ASIAN L. 1, 45-48 (2016).
[102] Brødsgaard, *supra* note 58, at 612.
[103] *See* discussion *infra* Chapter 2.

Like the creation of corporations, capital market activity in China was initiated informally on an experimental basis, which was later broadened by provisional national schemes before finally being formalized. Also similar to the making of the corporate form, the justification for establishing formal nation-wide capital markets lay primarily in their function as a financing tool for SOEs.[104] While the stock markets were formally active since 1990, in the second half of that decade, the state started to support the system of public share issuance explicitly when searching for alternatives to bank lending. Commentators attribute this to the pressing need to rescue the troubled state sector, which became deeply indebted at that time.[105] This shaped stock market development ever since as a platform to finance the restructuring of SOEs, rather than as a marketplace that promotes efficient allocation of capital. The implications extend to the present, as clearly seen through frequent Party-state measures in keeping stock prices up in order to sustain the value of corporatized SOEs. As with the emergence of the public firm, the levers of the capital markets have been moved by shifts in power dynamics as central Party-state institutions made efforts to regain full control over the emerging market.

1. Share-Offering Platforms

The first share offerings in Chinese entities after the initiation of market reform were tested offshore on the Hong Kong exchange or conducted informally by local institutions. This occurred during the second half of the 1980s. The initiators were local financial institutions, mainly local bank branches, special economic zones, securities companies, and local OTC trading centers.[106] The State Council approved the establishment of formal securities exchanges in Shanghai and Shenzhen on June 2, 1990. The new Shanghai Stock Exchange opened on December 19, 1990 and was followed by the opening of the Shenzhen Stock Exchange in July 1991. Even after the two stock exchanges began to operate, informal local trading continued in major cities.[107] The management of the two formal stock exchanges remained in the hands of their respective local governments through "municipal securities commissions" in cooperation with the local branches of the People's Bank of China. Each stock exchange was therefore effectively an administrative unit, integrated into the operation of its local government. Local officials from the various municipal bureaus were involved in all aspects of the stock exchange's operations—from the selection of which enterprises would be corporatized, through the approval of share issuance, to the listing process itself.[108] Moreover, given the absence of unified guidance on how to operate the exchanges, the stock exchanges largely operated on a trial-and-error basis. This practice, naturally, allowed much room for local discretion and protectionism.

[104] STEPHEN GREEN, CHINA'S STOCKMARKET: A GUIDE TO ITS PROGRESS, PLAYERS AND PROSPECTS 20-25 (2003).
[105] Clarke, *supra* note 3, at 151-152.
[106] For a detailed account on local experimentation with share offerings, *see* WALTER & HOWIE, *supra* note 38.
[107] *Id.* at 27.
[108] *Id.* at 29-30.

In 1992–1993, along with the enactment of a law for corporations, the central Party-state started to centralize its control over the two stock exchanges. These efforts included consolidating the regulatory and supervisory authority over the operation or the exchanges, as well as gaining control over the issuance process itself. This latter effort was intended through the design of a quota system, addressed below. The main motive, as described by Walter and Howie, was the fear from losing control over the development process to local officials, who promoted issuances in selected corporations and consequently accumulated substantial economic and administrative power through the emerging capital markets. The authors describe a "share fever" in both exchanges and a specific incident of over-subscription in Shenzhen, which created great disappointment among potential investors and provoked public riots against local protectionism. This led to the establishment of two national securities market regulators, the State Council Securities Commission and China's Securities Supervision and Management Committee.[109] The State Council subsequently issued a provisional "law" on securities, which set temporary mechanisms for share listing.[110] This temporary yet important document set the procedures for share issuance, trading, and disclosure by CLSs, prohibited insider trading practices, and established civil and criminal liability for securities violations for the first time. Honing their new national authority, the security regulators issued a complementary set of temporary rules,[111] which prohibited securities fraud and specifically addressed insider trading and other misconduct in the budding stock markets.[112]

The efforts to consolidate authority over the securities market culminated with the adoption of a national law for securities.[113] Substantively, the 1998 Securities Law only supplemented the prior 1993 Provisional Regulations on Share Issuance. Organizationally, however, it was extremely meaningful as it centralized the regulatory authority and control over the stock exchanges and over the development of the securities markets more broadly, under the authority of one ministry-level

[109] Both institutions were founded in October 1992 and consolidated under China Securities and Regulatory Commission (the CSRC) following the enactment of the Securities Law in 1998. *See infra* note 113.

[110] Gupiao Faxing Yu Jiaoyi Guanli Zanxing Tiaoli [Provisional Regulation on the Administration of Issuance and Trading of Stocks] (promulgated by the St. Council, Apr. 22, 1993) [hereinafter The Provisional Regulations on Share Issuance].

[111] Interim Procedures on the Management of Stock Exchanges (promulgated by the Securities Comm'n of the St. Council, July 7, 1993), art. 4, *available at* http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200211/20021100050789.shtml ("Stock exchanges are subject to the management of the local people's governments and the supervision and control by the China Securities Supervision and Control Committee" [a body under the Securities Commission of the State Council (SCSC) which preceded the CSRC.]); Jinzhi Zhengquan Qizha Xingwei Banfa (禁止证券欺诈行为暂行办法) [Provisional Measures for the Prohibition of Securities Fraud] (approved by the St. Council, Aug. 15, 1993, promulgated by the SCSC, Sept. 2, 1993) [hereinafter The 1993 CSRC Provisional Measures Against Fraud], *available at* http://baike.baidu.com/view/434690.htm.

[112] HUI HUANG, INTERNATIONAL SECURITIES MARKETS: INSIDER TRADING LAW IN CHINA (2006).

[113] Zhonghua Renmin Gongheguo Zhengchuan Fa [Securities Law of the People's Republic of China] (promulgated by the 6th Meeting of the Standing Comm. of the 9th Nat'l People's Cong., Dec. 29, 1998, amended Oct. 27, 2005, and Aug. 31, 2014, effective Aug. 31, 2014), *available at* http://en.pkulaw.cn/display.aspx?cgid=233280&lib=law [hereinafter 1998 Securities Law].

state agency—the China Securities and Regulatory Commission (CSRC).[114] The CSRC has been exclusively responsible for China's securities regulation ever since.

2. The Quota System

Another important effort to reconsolidate central state control over the stock market took the form of a quota system, which was officially in place from 1993 until 2000. This effort backfired, however, and only amplified regional powers.

The quota system was a national effort to administer the process of share issuance and control its scope. It was intended to ensure that the newly available external finance would be funneled to selected state-owned companies, while controlling supply and thereby keeping prices of newly offered shares high.[115] Technically, this administrative governance mechanism was based on a defined preapproved national pool of shares to be issued. The size of the national pool was determined annually by the central government through the People's Bank of China. Provincial governments (in the case of local firms) or central ministries (in the case of firms owned by a central ministry) then negotiated with their respective branch of the securities regulator on their allocated quota. Similarly, they bargained about which firm they would eventually recommend to the center for share issuance. After reaching an agreement, a request was submitted to the central securities regulator, which decided how to allocate the national pool between the regions and ministries. The central authority also decided which of the recommended companies would then enter a formal review process toward their initial public offerings. Each such company had to go through an individual approval process, during which information about the company was considered as well as its rule-obedience record.[116] In their account of the quota system, Pistor and Xu point out that the central authority approved the firms recommended to it in most cases. This, they suggest, indicates that from the outset, the real power was in the hands of the local governments and the ministries in selecting the firms to begin with.[117]

As a side note, while the term quota system refers only to the mechanism for the selection of IPO issuers, the pricing of IPOs also went through similar transitional administrative governance methods. Initially, the relevant government level directly determined the price for an IPO issuance. Toward 1995, pricing started to be based on consultation and bidding between the issuing company,

[114] (Robin) Hui Huang, *The Regulation of Insider Trading in China: A Critical Review and Proposals for Reform*, 17 AUSTL. J. CORP. L. 281, 284 (2005).
[115] *See generally* Donald Clarke, *The Role of Non-Legal Institutions in Chinese Corporate Governance*, *in* TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA (Hideki Kanda et al. eds., 2009).
[116] For a detailed account, *see* Katherina Pistor & Chenggang Xu, *Governing Stock Markets in Transition Economies: Lessons from China*, 7 AM. L. & ECON. REV. 184 (2005).
[117] *Id.* at 197-198.

its underwriters, and the relevant local authority. It was only toward 2005 that the price for IPO issuance started to rely on open market inquiry and evaluation.[118]

As for quality control, in the absence of market price mechanisms to evaluate companies, the quota system was also intended to provide quality-guided administrative selection. This was designed by including incentives at both regional and company levels that were supposed to ensure an effective evaluation of companies prior to their selection. Regions whose selected companies performed well after their shares were issued were awarded larger future quotas. Companies that performed badly were subject to potential delisting, which could reduce the region's future quota. The purpose was to incentivize firms and local government officials to pass their recommendations to the center based on collected and verified information, and thereby to identify "more [rather] than less viable firms" as the potential issuers.[119]

Commentators note several positive results of this administrative system, concluding that it was an important transitional mechanism that facilitated share-issuances in the absence of advanced capital market mechanisms. The quota system induced some level of information exchange and disclosure in the newly emerging capital market, a valuable factor in the absence of mandatory information disclosure standards and enforcement. Intense bargaining between the center and local governments encouraged interregional competition. Furthermore, it also introduced capital market growth measures as a basis for administrative decision making for future quotas, which presumably incentivized local officials to keep a watchful eye on firms in their region.

At the same time, however, the implementation of the selection process within the quota system quickly became crooked. Increasingly motivated by personal considerations and selection biases, the system intensified local protectionism. The incentives and accountability methods described above backfired. Since local officials personally benefited from the image of better-performing companies, they had little incentive to press for reliable disclosure. Instead, they were prone to turn a blind eye to inaccurate reports or even actively assist firms in committing fraud.[120] Moreover, the system did not address matters of information disclosure in the post-IPO stage. It became clear that this transitional mechanism should end and be replaced by a formal approval process for IPOs with more transparent, impartial listing standards and disclosure rules for secondary trade. In that sense, the enactment of the 1998 Securities Law was the beginning of a turn from a rather arbitrary administrative system of share issuances to a more centralized and formal governance. In

[118] On the various transitional methods for IPO price determination, *see* Chen Su & Jing Yu, *Market-Oriented Reform of China's IPO System and Information Disclosure Regulation*, *in* THE CHINESE STOCK MARKET VOLUME I: A RETROSPECT AND ANALYSIS FROM 2002 39 (Cheng Siwei & Ziran Li eds., 2014).
[119] Pistor & Xu, *supra* note 116.
[120] *Id.* at 199-200.

2001, the CSRC issued new measures for the administration of IPOs, which formally ended the quota system.[121]

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This review reveals the process through which public firms emerged in China, including the use of transitional mechanisms that had a meaningful influence on how capital markets sprouted. Absent any other institutional framework, public firms developed through a process of local experimentation followed by national administered expansion that was guided by political necessities. Political economy, then, rather than economies of scale or technological progress, motivated the creation of the public corporation. Then, when formal national schemes kicked in, they were likewise designed primarily with political functions— the need to reconsolidate economic and administrative control by the central Party-state and to finance China's struggling state sector. The rise of the public firm and the formation of capital markets therefore reflect the limited yet marginally increasing role of law in the early stages of China's capital market development and the presence of political determinants.

[121] Measures for the Administration of New Share Issuance by Listed Companies (promulgated by the China Sec. Regulatory Comm'n, Feb. 25, 2001), *available at* http://www.asianlii.org/cn/legis/cen/laws/mftaotlcins697/ (partial English translation). Note, however, that the actual implementation of the Quota System persisted until 2003.

CHAPTER 2: CHINESE LISTED FIRMS AND THE PUBLIC SHAREHOLDER "CLASS"—A STRUCTURED PREDICAMENT

A "political farce under the pretext of law"?[122]

China's Foreign Minister Wang Yi, July 2016

Political economy was a major driving force at the dawn of the public corporation in China, as shown in Chapter 1. Transitional, informal, and often locally-initiated government experiments – rather than the law – directed firms and capital market activity.

Yet the limited role for legal institutions at this stage might also be explained as reflecting the early stage of market development. Many countries walked a similar path, in which they were able to initiate a capital market where firms raised capital from investors even in the absence of a supporting legal system by using functional substitutions. Entrepreneurs and investors in emerging markets seem to be less deterred than expected by low-quality legal institutions.[123] Even in the most advanced markets, some scholars argue, the law followed rather than led capital market development, which was instead instigated by bottom-up resourcefulness.[124]

Comparative experience from transitional economies also reflects that during early stages of economic transition, the state may be particularly vulnerable to rent-seeking behavior. Unregulated areas and nascent financial markets enable state capture more freely, allowing more opportunities for officials and their affiliates to capture the state for private benefit.[125] Alternative substitutions, especially informal ones, are often ambiguous and arbitrary and thus cannot fully avoid the infirmities that are created during the early stages of transition. Indeed, the trajectories of developing and

[122] Hannah Beech, *China Slams the South China Sea Decision as a 'Political Farce,* TIME (July 13, 2016), http://time.com/4404084/reaction-south-china-sea-ruling/ (quoting China's Foreign Minister Wang Yi in response to the final award of the Permanent Court of Arbitration in the South China Sea case).

For the tribunal's award, *see* Tribunal Award on Jurisdiction and Admissibility, South China Sea (Phil. v. Chin.), P.C.A. Case No. 2013-19, 19-28 (Jul. 12, 2016). *See also* Permanent Court of Arbitration, Case View, https://www.pcacases.com/web/view/7, accessed June 11, 2017.

[123] Alvaro Santos, *The World Bank's Uses of the "Rule of Law" Promise in Economic Development*, *in* THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL 253, 282-290 (David Trubek & Alvaro Santos eds., 2006). *See also* Mariana Pargendler et al., *In Strange Company: The Puzzle of Private Investment in State-Controlled Firms*, 46 CORNELL INT'L L.J. 569 (2013).

[124] *See* Coffee, *supra* note 21 (arguing for private ordering by entrepreneurs and the stock exchanges in the United States prior to regulatory action); Mahoney, *supra* note 21 (for preempting private regulatory action by the NYSE); Yoshiro Miwa & Mark J. Ramseyer, *The Value of Prominent Directors: Corporate Governance and Bank Access in Transitional Japan*, 31 J. LEGAL STUD. 273 (2002) (Firms in early twentieth century Japan created corporate governance arrangements by private ordering—they hired prominent industrialists to their board. This functioned as a quality signal to the market in the absence of legal arrangements.).

[125] Black et al., *supra* note 30; Karla Hoff & Joseph E. Stiglitz, *The Creation of the Rule of Law and the Legitimacy of Property Rights: The Political and Economic Consequences of a Corrupt Privatization*, (Nat'l Bureau of Econ. Research, Paper No. 11772, 2005).

transitional economies have caused many observers to believe that local substitutions can only go so far.[126] The status of the financial system is often treated as a proxy for such a turning point. Robust capital markets, particularly, are said to require high-quality, reliable, and perhaps internationally familiar investor protection mechanisms and disclosure standards that only developed legal institutions seem to provide.

Conceptually, this is also the point where development scholars meet corporate governance convergence proponents. In the corporate and capital market literature, globalization is said to push firms and markets into a competitive Darwinist mode, in which they either adjust or perish.[127] The pressures of international competitive capital and product markets are thought to cause firms and markets to adapt their governance in pursuit of the most efficient corporate rules and structures. Absent such adaptation, suboptimal firms and markets will fall behind. In a competitive global market, therefore, convergence is viewed as an inevitable step for any growth-oriented economy.[128] In the process of adaptation, corporate laws, practices, and structures will become more congruent, ultimately converging into one optimal model—mainly, that of Anglo-American (really American) corporate capitalism.[129]

This convergence discourse now distinguishes between formal convergence and functional convergence.[130] The dominant view predicts that functional convergence will occur first behind a formal curtain that persistently holds back legal change. [131] A process of bottom-up pressures breeding functional convergence will at a certain point bring a more formal reform. [132]

Both the development approaches and corporate governance theories thus hold that even where functional substitutions provided enough assurances for market economic activity to sprout, more conventional institutions of corporate governance should, and will, take their place at a certain

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[126] *See generally* Ricardo Hausmann et. al, *Growth Accelerations*, 10 J. ECON. GROWTH 303 (2005). *See also* Kevin Davis & Michael J. Trebilcock, *The Relationship between Law and Development: Optimists versus Skeptics*, 56 AM. J. COMP. L., 895, n. 162 (2008) (citing Michael Trebilcock & Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 VA. L. REV. 1517, 1554-65 (2006) and the references therein).

[127] Coffee, *supra* note 21.

[128] The opposing view of consistent divergence is identified with path dependence theories. *See, e.g.*, Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (proposing a theory of path-dependence that explains persistent divergence in corporate systems); Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV., 1145 (1998) (suggesting that convergence, even when efficient, will be limited due to internal political economy).

[129] Representative for this view are Henry Hansmann and Reinier Kraakman. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001) (arguing that around the world corporate systems are converging toward a single, shareholder-oriented model).

[130] In my view, in this discourse, formal convergence has conceptually aligned with transplant strategy and no longer represents a slow gradual process of adaptation in (formal) laws. The perception of convergence as a gradual adaptation process is represented in the idea of functional convergence alone.

[131] Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001) (formal variations and persistence will remain but will be overshadowed by functional convergence). Bebchuk and Roe elaborate potential reasons for this, such as path dependency, sunk costs and political rejection. *See* Bebchuk & Roe, s*upra* note 128.

[132] John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641 (1999); Coffee, *supra* note 21.

point in the development process. Accordingly, the prevailing view regarding China too was, and still is, skeptical as to the country's ability to sustain capital market growth without developing the institutions that are identified with corporate capitalism. [133] Some evidence on the passing efficacy of local-managerial incentive schemes as functional substitutes supports this view.[134]

At first glance, China's capital market development during the second stage of transition (the Modern Reform Era, 1992–2007) seems to follow this understanding. During the late years of this stage, corporate governance took a more structured, investor-oriented turn through regulatory action by central state authorities. China's policy makers have formally embraced many of the institutions traditionally identified with corporate capitalism. This turn was not abrupt, but rather evolutionary. The growing market and the various political needs and motivations co-evolved along with the rising legal system, which together determined how firms and the capital market would develop.

I. A TURN TOWARD LAW AND LEGAL INSTITUTIONS—CONVERGENCE WITH CORPORATE CAPITALISM

As seen earlier, the opportunities and interests of a new variety of economic actors within the Party-state system started shifting when market economic activity was enabled. This echoed back into the system, as policy-makers—troubled by the shifts in internal political-economy—turned to legal construction to achieve a reconsolidation of power. By the early 2000s, an increasing body of national-level economic laws and regulations gradually replaced the probationary mechanisms used earlier.[135] Central-state agencies and institutions were created and given regulatory and supervision authority over various aspects of the financial market.[136] This shift in the use of the legal system to govern firms and the capital markets exemplifies a more general proclaimed turn toward law during the 15th Central

[133] *See generally* IN SEARCH OF PROSPERITY: ANALYTIC NARRATIVES ON ECONOMIC GROWTH (Dani Rodrik ed., 2003). With respect to China specifically, *see* ASIFMA, CHINA'S CAPITAL MARKETS: NAVIGATING THE ROAD AHEAD (2017), *available at* https://www.asifma.org/wp-content/uploads/2018/07/china-capital-markets-final-english-version.pdf; Minxin Pei, CHINA'S TRAPPED TRANSITION: THE LIMITS OF DEVELOPMENTAL AUTOCRACY (2006); Yingi Qian, *How Reform Worked in China*, *in* IN SEARCH OF PROSPERITY: ANALYTIC NARRATIVES ON ECONOMIC GROWTH 297 (Dani Rodrik ed., 2003); Thomas G. Rawski, *Will Investment Behavior Constrain China's Growth?*, 13 CHINA ECON. REV. 370 (2002).

[134] Existing evidence suggests that local managerial incentives functioned relatively well during early stages, when they had a positive effect on profitability, total factor productivity, and return on equity. However, with increasing liberalization during the 1990s, managerial incentives seem to have lost their functional contribution to efficiency. *See* Clarke et al., *supra* note 44, at 416.

[135] It should be noted, however, that an "experimentation first" strategy is still the approach used to introduce new economic measures into the market.

[136] A few examples include the CSRC (founded 1998), SASAC (founded 2003), China's Banking Regulatory Commission (CBRC, founded 2003), and the China National Development and Reform Commission (NDRC, founded 2003).

Party Congress,[137] in which the CCP declared a move toward a Chinese-type "rule of law."[138] This was also when the Central Party Congress first used the term "corporate governance" as part of its economic reform planning.[139]

In the following years, problems within the troubled state sector were accompanied by new external and domestic pressures to adopt national corporate governance standards. In 2001, a wave of worldwide corporate scandals did not skip China. A number of large Chinese corporations were involved in accounting fraud and market manipulation, causing losses to many investors and also reflecting badly on China's state asset management system.[140] As one commentator noted: "These events provided the needed crash for legal change. Disappointed investors started to demonstrate in front of the CSRC building."[141] Together with the effect of the Asian financial crisis and the global competition that China started facing following its 2001 WTO accession, these events led to extensive discussions about corporate governance and induced the formal embrace of many Western corporate governance institutions into the market.[142]

The CSRC took a lead role in this turn. As part of the efforts at the time to consolidate economic and administrative authority, the CSRC was given the administrative and political latitude

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[137] On the intensification of legal construction efforts during that time, *see* William P. Alford, *A Second Great Wall? China's Post-Cultural Revolution Project of Legal Construction*, 11 CULTURAL DYNAMICS 193 (1999). *See generally* Perry Keller, *Sources of Order in Chinese Law*, 42 AM. J. COMP. L. 711 (1994).

[138] See Report to the 15th Party Congress (delivered by President Jiang Zemin, Sept. 12, 1997), Ch. VI (Reforming the Political Structure and Strengthening Democracy and the Legal System) [hereinafter Report to the 15th Party Congress], *available at* http://academics.wellesley.edu/Polisci/wj/308S/Readings/jzm15CCP.htm ("Govern[ing] the country according to law and making it a socialist country ruled by law.").

[139] *See* JANE FU, CORPORATE DISCLOSURE AND CORPORATE GOVERNANCE IN CHINA 5 n.55 (2010) (referring to the CPC's Central Committee Resolution on Major Issues Regarding SOEs Reform and Development in the *"Announcement of the fourth Plenary Session of the Fifteenth CCP National Congress*").

[140] *See* Y. L. DUAN, LUNDA GUDONG GUQUAN LANYONG JI SHILI [ABUSING MAJORITY SHAREHOLDER CONTROL: THEORY AND PRACTICE] (2001) (summarizing various fraud cases, including the Yorkpoint Science & Technology stock scheme, the fall of Daqing Lianyi, Dong Fang Electronics, PT Hong Guang, Monkey King A, Lantian shares, Yi'an Technology, Yin Guangxia, and Zhengzhou Baiwen).

[141] Zhiwu Chen, *Capital Markets and Legal Development: The China Case*, 14 CHINA ECON. REV. 451, 464 (2003).

[142] This is not to say that the customary ideas and elements that are generally packaged within the "corporate governance" discourse were not considered in China before corporate governance formally penetrated the political and legal consciousness. To the contrary, some ideas, even some that are conventionally seen as "Anglo-American" in nature (such as shareholder-centrism and fiduciary duties), were in fact considered even before the establishment of the 1993 Company Law and long before their formal adoption in the 2005 Company Law. Interestingly, the penetration of these ideas, like many market developments in China, also happened on experimental levels or by institutions that are not responsible for primary law making. *See, e.g.*, Nicholas C. Howson, *The Doctrine That Dared Not Speak Its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence*, *in* TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 193 (Hideki Kanda et al. eds., 2008) (describing how Anglo-American corporate fiduciary duties were first introduced in China in the early 1990s to serve the limited number of PRC issuers accessing foreign capital markets, first by an administrative letter to the Hong Kong Exchange, and later by special supplementing provisions that were not included in the Company law itself). *See also* Nicholas C. Howson, *Corporate Law in the Shanghai People's Courts, 1992-2008: Judicial Autonomy in a Contemporary Authoritarian State*, 5 EAST ASIA L. REV. 303 (2010) [hereinafter Howson, *Corporate Law in the Shanghai People's Courts*] (finding judicial implementation of doctrines resembling derivative suits, veil-piercing, and fiduciary duties by the Shanghai People's Courts before explicit authority was granted to courts in these matters, and even before such doctrines had a formal legal basis).

to form national-level corporate governance schemes.[143] One of its first steps in this direction was its 2001 Code of Corporate Governance for Listed Companies. The Code was intended to improve the "modern enterprise system," standardize behavioral rules for directors, supervisors, and senior managers, and clarify shareholders rights. The Code was largely based on the OECD Principles of Corporate Governance. Among its provisions, it stipulated disclosure and voting standards for related-party transactions, specified duties that controlling shareholder owe to the company and other shareholders, required the disclosure of controlling shareholders' interests (including the ultimate controller), and emphasized the independent operation of the company from its controlling shareholders, including the introduction of a cumulative voting system for the election of directors and an independent directors scheme.[144] Still, like many other corporate governance codes around the world, the Code presented guiding principles that were mostly broad and vague with no accountability measures for violators. It described best practices from which firms were left to choose.[145]

The highest government organs—the NPC and the State Council—also issued several proclamations and legal amendments, which clearly reflected the formal acceptance of a law and finance-style approach to corporate governance.[146] In 2005, the 1993 PRC Company Law was revised

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[143] *See* Nicholas C. Howson, *"Quack Corporate Governance" As Traditional Chinese Medicine: The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against Party State Political Economic Power*, 37 SEATTLE U.L. REV. 667 (2014). For discussion on public enforcement and regulatory action by the CSRC, *see also infra* pp. 94-97.

[144] Code of Corporate Governance for Listed Companies in China (promulgated by the China Sec. Regulatory Comm'n and the State Economic and Trade Comm'n, Jan. 7, 2001), *available at* http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.html.

[145] For example, the first chapter of the code outlines shareholders' rights with neither explanations of these rights, nor of what would be a fair treatment of these rights and how a violation would be handled. Another example is the requirement of independent directors in listed companies. Article 49 requires companies to establish an independent director system in accordance with other relevant rules. While article 52 does specify further that listed firms' audit and compensation committee should include a majority of independent directors, they are not granted any special voting powers. *Id.* arts. 49, 52.

[146] For instance, a relevant State Council Opinion states:

> The quality of listed companies must be upgraded. The quality of listed companies is the source of value for securities market investment…We should improve the structure of corporate governance of listed companies, and by following the requirements of the modern corporate system, form a check and balance mechanism among the power organ, the decision-making organ, the supervisory organ and corporate managers… We should regulate the acts of controlling shareholders and prosecute those committing acts to damage the interests of listed companies or those of small and medium-sized shareholders…

Guanyu Tuijin Zibenshichang Gaigekaifang he Wendingfazhan de Ruoganyijian (关于推进资本市场改革开放和稳定发展的若干意见) [Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets] (promulgated by the St. Council, Jan. 31, 2004), *available at* http://www.asianlii.org/cn/legis/cen/laws/sootscoptroasgocm970/. *See also* Guanyuzuohao Guancheshishi Xiudinghou de Gongsifahe Zhengquanfa Youguangongzuo de Tongzhi (关于做好贯彻实施修订后的公司法和证券法有关工作的通知) [State Council Notice on Good Implementation of the Revised Corporate and Securities Law] (promulgated by the St. Council, Dec. 23, 2005), *available at* http://www.gov.cn/gongbao/content/2006/ content_212077.htm (the Opinion emphasizes to various levels of the government the need to implement the revised Company and Securities laws, which established mechanisms for the protections of corporate constituents, in order to promote capital market development). Moreover, Chapter IV of China's 2008 White Paper on promotion of the "rule of law" deals specifically with "Legal Systems Regulating the Order of Market Economy," which points to the need for "safeguarding the lawful

wholesale,[147] evidencing a shareholder empowering approach through more robust governance rights. Formally, the revised statutes created various mechanisms for the protection of shareholders' rights and interests, and strengthened other protections. These included enacting explicit fiduciary duties of corporate directors, supervisory board members, and officers; requiring nomination of independent directors in listed companies; enabling a derivative lawsuit for shareholders; and providing certain buy-back guarantees for shareholders.[148] Perhaps most striking, the 2005 Company Law also adopted something like fiduciary duties for controlling shareholders toward the company and other shareholders.[149] At the same time, the Securities Law and the PRC Criminal Law were revised as well, and together the laws introduced much-needed recourse for injured shareholders as well as criminal liability based on securities law claims.[150] This framework provided the tailwind for the CSRC to take a stronger approach to investor protection through several administrative regulations, which the commission issued in the following years.[151]

These developments might be mistaken for convergence with Western corporate capitalism. If the governance of Chinese firms and the functioning of the capital market indeed converged with corporate capitalism's prescribed recipes for investor protections and capital market growth, then China's capital market growth and the domestic and global success of its firms could be explained on the basis of this belated convergence. This conclusion, based on facially similar investor-protecting laws and institutions, would be a mistake. An examination of one regulatory action will illustrate how seemingly convergent norms are divergent in both function and intent.

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rights and interests of corporate investors and stakeholders." Zhongguo de Fazhi Jianshe (中国的法治建设) [China's Efforts and Achievements in Promoting the Rule of Law] (promulgated by the Information Office of the St. Council, Feb. 28, 2008), *available at* http://www.china.org.cn/government/whitepaper/ node_7041733.htm.

[147] The prior 1993 Company Law was revised at the 18th meeting of the 10th National People's Congress of the People's Republic of China on October 27, 2005 and was last amended December 28, 2013. Gongsifa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993, rev'd Oct. 27, 2005, last amended Oct. 26, 2018, effective Oct. 26, 2018) [hereinafter "the Company Law" or "2005 Company Law"], *available at* https://www.pkulaw.com/en_law/aec0c211a78989e9bdfb.html?keyword=company%20law . The 1998 Securities Law was amended at the same time. *See supra* note 113.

[148] 2005 Company Law, *supra* note 147, arts. 22, 122, 142, 147-150, 151, 152.

[149] *Id.* arts. 20, 21.

[150] Gonghua Renmin Gongheguo Xingfa Xiuzheng An (liu) (中华人民共和国刑法修正案（六）) [6th Amendments to the Criminal Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., June 29, 2006) [hereinafter Amendments to the Criminal Law], *available at* http://www.npc.gov.cn/englishnpc/Law/2008-01/02/content_1388005.htm. The amended provisions relevant here are amendments to articles 161, 162, 163, 169, 182 that set criminal liability in cases of (respectively) false reporting, and non-disclosure that leads to "serious damages to the interests of shareholders or any other person"; concealing or disposing of company property "so that serious damages are caused to the interests of the creditors or any other persons"; and the use of corporate position for personal gain, including accepting bribes and commissions in various forms (separate standard and procedure for criminal liability was set for public servants in state owned corporations); violation of fiduciary duties by directors, supervisors, or senior managers of a listed company, or by a controlling shareholder or actual controller (as well as when the controller instigated other corporate officers to such violation) that have caused "serious loss to the interests of the company"; and manipulation of the securities or futures market.

[151] For a partial list, *see infra* pp. 94-97. For a fuller account, *see* Howson, *supra* note 143, at 698, 701-707.

Shareholder Empowering Regulatory Action

The 2005 Company Law defines the shareholders' assembly as the company's main authority with an extensive list of powers.[152] It goes beyond the mere protection of basic shareholder rights by enabling direct shareholders' governance participation through the shareholders' meeting, with the following powers:[153] 1) to determine the company's operating guidelines and investment plans; 2) to elect and replace directors and supervisors (except for the representatives of the employees) and to decide their remuneration; 3) to approve reports of the board of directors; 4) to approve reports of the supervisory board; 5) to approve annual financial budget plans and accounts; 6) to approve plans for profit distribution and loss recovery; 7) to decide on changes to the registered capital; 8) to approve the issuance of corporate bonds; 9) to adopt resolutions on a corporate merger, division, change in the company's form, dissolution or liquidation; 10) to amend the bylaws; and 11) to exercise other powers provided for in the bylaws. For certain fundamental transactions, a supermajority shareholder approval is required.[154]

A review of the law further shows that the powers conferred on the shareholders' assembly even go much beyond these enumerated authorities. A resolution by the shareholders' general meeting is also required in other situations that are mentioned throughout the law. A shareholders' approval is required, for example, to execute the limited circumstances in which the company can purchase its own shares.[155] Their approval is required for the company to guarantee the debt of a shareholder or actual-controller. Other "important matters" might also require a decision by the shareholders (e.g., "to transfer or accept any significant assets").[156] Moreover, even a decision on the issuance of new shares is not reserved to the board and can be decided by the general meeting.[157]

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[152] 2005 Company Law, *supra* note 147, arts. 37, 98, 99. This appeared even in the 1993 Company Law: article 37 for LLCs and article 102 for CLSs. *See* 1993 Company Law, *supra* note 66, arts. 37, 102.

[153] *See* 2005 Company Law, *supra* note 147, arts. 37(7)-(10). These rules also apply to listed companies. *Id.* art. 99. These articles also enable written consent in lieu of convening an actual shareholders' meeting, reducing the costs of shareholders' participation.

[154] The general rule for a shareholder resolution is majority vote. *Id.* art. 103. Yet, some business decisions require approval by two-thirds of the voting rights of the shareholders present: bylaw amendments, changes in the registered capital of the company, resolutions concerning merger, split-up, dissolution, or change of the company form; as well as a decision to purchase or sell any important asset or to provide guarantees that exceed thirty percent of the company's total assets within a year. *Id.* arts. 103, 121. Article 16, the only article in the law that addresses directly the concern about abusive related party transactions, requires the approval of the majority of *disinterested shareholders* for guarantees given by the company to its controlling shareholder. *Id.* art. 16.

[155] Note the circumstances requiring the shareholders' assembly approval were narrowed down in the recent amendment by shifting approval in some of the circumstances to the board. Compare the 2005 Company Law before and after its 2018 amendment. *Id.* art. 142.

[156] *Id.* art. 104. *See also id.* art. 124 (requiring a shareholders' meeting in situations where the number of disinterested board members are insufficient). Interestingly, the law even states the possible involvement of the shareholders' meeting in the hiring and dismissal of the company's accounting firm. *Id.* art. 169. The shareholders' meeting has the ability to demand the presence of a director, supervisor, and senior manager at its meeting, and such office holders have a duty to answer shareholders' inquiries presented there. *Id.* art. 150.

[157] *Id.* art. 133.

Individual shareholders are given an expansive right to information and document inspection,[158] as well as individual standing rights to approach the People's courts on procedural or substantive grounds.[159] Additionally, the 2005 PRC Company Law allows a group of shareholders with a ten percent or more equity interest in the firm to request a special shareholders' meeting and enables shareholders holding at least three percent of the firm's equity to submit shareholder proposals to the board.[160]

It clearly appears as though China's policy makers had opted for an empowering, shareholder-oriented corporate governance. The prescribed rights reflect an invitation for hands-on engagement in corporate decision making that seems far beyond the powers conferred on shareholders in other systems, even those in U.S. and U.K. corporate laws—the origins of shareholder-primacy notions.[161] Judged solely based on the provisions above, contemporary China offers one of the most robust shareholder-empowering corporate statutes in the world.

In practice, however, this facially shareholder-empowering regulatory framework does little to empower *public* shareholders or restrict the behavior of corporate control parties against them. The formal participation rights granted under the Company Law apply generally to the "shareholder class" and do not operate to improve the position of *non-controlling* (thus *real* public or minority) public shareholders. While this arrangement may have worked in widely-held markets, in a concentrated market, true commitment to outside investors should have carried mandatory provisions,[162] specifically tailored to minority public shareholders.[163] The shareholder-empowering approach taken

[158] *Id.* art. 97.

[159] On procedural violation grounds, *see id.* art. 22. For alleged violation of a shareholder's right for information, *see id.* art. 33. For a form of appraisal related to specific circumstances in which the company buys back the shareholder's shares, *see id.* art. 74. For derivative suits, *see id.* art. 151. For individual lawsuits against directors or managers, *see id.* art. 152. *See also id.* art. 183 (requesting a dissolution in court).

[160] *Id.* arts. 101, 102.

[161] For example, in the United States, under the Model Business Corporation Act and Delaware General Corporation Law (DGCL) all corporate powers are vested with the board of directors, and the corporation is managed under their broad discretion, which has been expanded by the courts. According to the DGCL and the corporate laws of many other states, directors are nominated by the existing board and shareholders only have the right to vote on such nominees at the annual meeting. Generally, for shareholders to propose their own nominees they need to initiate an expensive proxy contest. In addition, in staggered board firms, the ability of shareholders to remove directors without cause is limited. There are only a handful of matters that require shareholders' approval: amendments to the corporate charter (as opposed to bylaws, which can be amended by the board of directors), and mergers, consolidation, or a sale of all or substantially all assets. Shareholders may convene a special shareholders' meeting only if the company's bylaw permits them to do so, and a shareholder proposal is generally nonbinding. *See* Delaware General Corporation Law, Del. Code tit. 8 § 101-398. *See generally* Model Bus. Corp. Act (AM. BAR ASS'N, 2002).

[162] For theoretical support for this approach, *see* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393 (2003) (arguing that corporate laws must incorporate some form of minority protection as a mandatory rule and examining various such forms in different jurisdictions).

[163] For examples of mandatory approaches in comparatively concentrated markets, *see infra* notes 280, 335-336 (discussing audit and compensation committees in Israel). On mandatory non-controlling shareholders board representation in Italy, *see infra* note 296. On compelling institutional shareholders' vote on certain matters in Israel, *see infra* notes 255, 279.
For general data on countries that adopted minority veto rights, *see* OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS (2012), *available at* http://www.oecd.org/daf/ca/50089215.pdf. More generally on the use of disinterested shareholders' consent as a regulatory device in a dispersed market (Australia), *see* Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 69–71 (2009).

in China serves in actuality only to further the Party-state as the controlling shareholder. The controlling shareholder will continue to govern the firm absolutely in a myriad of ways. For example, absent mandatory cumulative voting on board elections, the controlling shareholder will be the one to nominate and elect the company's directors, who in turn have singular power to appoint top management. The controlling shareholder's appointed board members will set the agenda for shareholder meetings and thereby be able to hinder any shareholder proposals from a three percent shareholder technically authorized under the Company Law. Similarly, since voting is not required and the law does not call for recusal of a controlling shareholder(s) vote, the controlling shareholder alone will usually satisfy any mandated supermajority requirement for the approval of certain transactions.[164] This is especially likely since no quorum is required to convene a shareholders meeting, and only the votes of those attending the meeting are counted.

In addition, the admittedly more "enabling" approach taken in the revised Company Law[165] enables the parties to contract around the default rules. This means that the 2005 amendment enables the controlling shareholder to contract into an even more robust control. Given the almost nonexistent bargaining power of minority shareholders, which is intensified by the pyramidal holding structure prevalent for many PRC issuers, any "opt-in" governance arrangement that is favorable to minority shareholders will not be adopted. Thus, as observed elsewhere, "an interventionist state, concentrated ownership, and shareholder-friendly law may be mutually reinforcing, especially when the state holds large blocks of stock in its own right."[166]

Furthermore, lest anyone think that whatever minority shareholder governance rights are on offer can or will be enforced (whether mandatory or contracted-into), other structural impediments—grounded in China's political economy—cast a large shadow of doubt as to the ability of public shareholders to secure these rights.[167]

Finally, at a conceptual level, there is also divergence in the notions of shareholder primacy. In the Chinese context, shareholder primacy stands for completely different ideas than those of corporate capitalism. With the 1993 Company Law, when state-owned firms populated the market, the emphasis was on the authority of the shareholders' assembly as a collective, representing the interests of the public, rather than on the shareholders' interests as individuals. Some elements in the

[164] For a list of matters that require supermajority consent, *see supra* note 154. A unique exception where the minority *de-facto* is granted a negative veto is in article 16 of the 2005 Company Law, which requires the approval of a majority of *disinterested* shareholders for decisions to provide a guarantee to a shareholder of the company or to its actual controller. *See* 2005 Company Law, *supra* note 147, art. 16.

[165] On the shift toward an enabling system in the 2005 Company Law amendment and the contrast with mandatory CSRC orientation, *see* Howson, *supra* note 143, at 698, 701–07.

[166] Luca Enriques et al., *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 55, 85 (Reinier H. Kraakman et al. eds., 2nd ed. 2009) (saying the same with respect to France).

[167] For a discussion on these institutional and structural predicaments, *see infra* Chapter 2, Section III.

2005 Company Law still resonate with this approach.[168] In particular, the preamble to the amended Company Law and Article 5 state the company's obligation to social morality, mandate social responsibility, and point to the accountability of the company to the general public.[169] These articles reflect a much-criticized view of the company law as still speaking largely to state-owned firms.[170] Some commentators even suggested that China's shareholder primacy approach resembles its hierarchical political governance, in which the NPC is the source of authority for all lower governance levels.[171] While this view is baffling as it overlooks the ultimate authority of the Party (in both the corporate and the governmental contexts), it certainly reflects the divergence from corporate capitalism notions. The consequences go beyond just theory. The divergence carries real implications for decision making and accountability. For instance, to whom are fiduciary duties owed?[172]

Relatedly, the widely accepted association of shareholder-primacy with the notion of shareholder value (maximization of market share price) under corporate capitalism is not the norm in China.[173] In the Chinese context, shareholder-primacy, through the shareholders' assembly, instead reflects the primacy of the controlling shareholder's goals and interests, whatever they are in a given situation.

Despite the formal recognition of shareholders' rights and the apparent borrowing of conventional corporate governance mechanisms, most of these institutions fail to perform their supposed functions. Investor protections remain weak in practice, and corporate governance has been deployed in ways that run counter to market efficiency. Notably, implementation is not hindered due to the lack of appropriate local adaptations, as may have been the case for other transplants around the world.[174] Indeed, a number of commentators praise China's corporate governance framework as the product of a well-thought out, decades-long, intellectual sifting and cherry-picking process.[175] The

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[168] Junhai Liu, *Experience of Internationalization of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work?*, 107 EUR. BUS. L. REV 114 (2015) (interpreting the modern corporate law as meaning that "the power of the corporations shall be from the shareholders, for the shareholders and by the shareholders.").

[169] 2005 Company Law, *supra* note 147, art. 5 (When conducting business operations, a company shall comply with the laws and administrative regulations, social morality, and business morality. It shall act in good faith, accept the supervision of the government and general public, and bear social responsibilities.).

[170] *See generally* Donald Clarke, *Blowback: How China's Efforts to Bring Private-Sector Standards into the Public Sector Backfired*, *in* REGULATING THE VISIBLE HAND 29 (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2016).

[171] Liu, *supra* note 168, at 114.

[172] There are multiple options implied by the 2005 Company Law. Article 149 along with articles 148, 150, and 151 with the derivative suit therein, posit the option of fiduciary duties owed to the company. Article 151 suggests accountability to the shareholders' assembly. Article 152, however, seems to be focused on the infringement of shareholders' interests (as individuals), raising a private right of action against directors and senior managers. Finally, the preamble and article 5 add the duties of the company, and by extension its representatives, to the general public. *See* 2005 Company Law, *supra* note 147, arts. 5, 148-152.

[173] Clarke, *supra* note 170, at 42 ("A special Chinese twist in the doctrine of shareholder primacy appears here, however: it is *not* the same thing as maximization of share value. If that is what the state shareholder wants, then there is no divergence. But if the state shareholder wants the SOE to pursue other goals, then the SOE may do so.").

[174] Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, 1 EUR. BUS. ORG. L. REV. 59 (2000); Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. TRANSITION 325 (2000).

[175] The adaptation to local conditions is reflected not only in the selection of various provisions from different legal systems, but also through some uniquely Chinese characteristics adopted in the 1993 Company Law and maintained throughout its

mechanisms borrowed were not blindly-transplanted, but instead were carefully selected and tailored to the preexisting political infrastructure.

In short, traditional corporate governance institutions in China are weak by design. China's own political economy trumped the new laws and corporate governance mechanisms, just as it had created and then trumped the preceding provisional local arrangements. This time around, the source within China's political economy that is responsible for this conscious weakness can be found in the regime's state-capitalism attributes. China's state-capitalism ascended during this transitional stage and has trapped a growing crowed of public shareholders in what I call a "structured predicament." As a result, instead of monitoring insiders and protecting investors, the existing framework gives corporate control-parties a license to expropriate with impunity.

II. "CHINESE-STYLE" STATE CAPITALISM AND ITS CONSEQUENCES FOR PUBLIC SHAREHOLDERS

A. The State as an Ultimate Controller—Consequences for Public Investors

As seen earlier, the Party-state advanced the organizational features of the public firm in China—a corporatized non-privatized legal entity embedded within a group structure—to increase value in SOEs and push back against rising local autonomy. The result was the creation of pyramid holding groups, within which many of China's listed SOEs currently reside and on top of which Party-state organs preside as dominant, often-controlling, shareholders that operate through powerful human agents as corporate insiders. This organizational structure presents insurmountable monitoring challenges and abundant opportunities for the abuse of public shareholders, affecting both their governance and economic rights. Furthermore, this ownership structure perpetuates itself. It helps entrench controlling parties and supports state-capitalism, through which firms can be harnessed in pursuit of national and political goals, as well as for the personal interests of their control-parties (corporate insiders and agents assign to supervise on behalf of the state *quo* controlling shareholders).

amendments. Examples include the "social-economic order" in the preamble and article 1 in both laws, the institution of legal representative, the dual board structure, and more. *See* Robert C. Art & Minkang Gu, *China Incorporated: The First Corporation Law of the People's Republic of China*, 20 YALE J. INT'L L. 273, 275 (1995) (on the idiosyncratic legal representative concept); Xinhe Cheng & Zhenghua Li, *The Application of Comparative Law to Chinese Economic Legislation*, 3 ASIA PAC. L. REV. 150, 152 (1994). Some Chinese commentators see this cherry picking from different systems as a unique Chinese model. *See, e.g.*, Wei-Wei Zhang, *The Allure of the Chinese Model*, N.Y. TIMES (Nov. 1, 2006), http://www.nytimes.com/2006/11/01/opinion/01iht-edafrica.3357752.html. For a similar choice of words, *see* Suisheng Zhao, *The China Model: Can It Replace the Western Model of Modernization?*, 19 J. CONTEMP. CHINA 419, 424 (2010) ("What makes the Chinese model unique is that the communist regime has safeguarded its own policy space as to when, where and how to adopt Western ideas.").
Some even track this model back to the Qing dynastic 1904 corporate law. *See, e.g.*, Liu, *supra* note 168, at 112.
But see Liufang Fang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 260 (1995) (critiquing the 1993 Company Law for lack of its "contextualization to the lay of the land").

1. Excess Opportunities for Self-Dealing by Agents

By turning in the early 1990s to the modern corporate form with its separation between ownership and control, China's policy makers sought to cure mushrooming self-dealing and asset stripping in SOEs. As commentators note, however, this was an ill-fitting importation of a problem rather than a solution:[176] "[Yet] calls for government-owned enterprises to be independent of government 'interference' are calls for nothing short of utter nonaccountability for management."[177] The separation of ownership and control during corporatization imported the paradigm vertical agency problem into a system with an already complex range of idiosyncratic institutional monitoring challenges.

Corporate theory suggests that when ownership is concentrated, the main beneficiary of any value increase in the firm is the controlling shareholder. With abundant inside information, controlling shareholders can also efficiently preempt market reactions by identifying managerial slack early and simply replacing badly performing managers. The controlling shareholder is therefore the corporate constituent that is most incentivized and best situated to monitor corporate insiders. Under state corporate control, however, no ultimate *real* principal exists at the top of the state's holdings. This structural predicament became known as the "absentee principal" or the "absent owner" (*suoyouzhe quewei*).[178] There is no real principal who would personally benefit from monitoring and thus no one with the incentive to monitor. This situation creates relative apathy toward corporate misconduct on the part of government officials, the representatives of the controlling-state shareholder. Consequently, firms in China became controlled by unmonitored powerful insiders (*neibu ren kongzhi)*.[179] Vast self-dealing took place not only by the insiders themselves but also by the agents assigned by the state to supervise them.[180] The modern corporate form, therefore, became conductive to corruption as well.

The absence of a real ultimate principal with enough incentives to monitor on behalf of the state was presented as one of the primary reasons that led to the establishment of SASAC in 2003.[181] SASAC was designed to replace various state-asset management enterprises with a unified national,

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[176] TEEMU RUSKOLA, LEGAL ORIENTALISM 190 n.43 (2013).

[177] Clarke, *supra* note 50, at 498 (suggesting that a more appropriate reform would have been one that focuses on managers' accountability to the state as a shareholder, rather than a reform that increased management autonomy).

[178] *Id.* at 499.

[179] *See* Hui (Robin) Huang & Juan Chen, *Takeover Defenses and Its Regulation in China: Comparative and Empirical Perspectives*, (work in progress manuscript) (on file with author).

[180] *See* Clarke, *supra* note 71, at 148 ("a 2002 study of corporate governance by the CSRC and the SETC revealed, on the basis of self-reporting alone, that forty percent of listed companies engaged in related-party transactions with their top ten shareholders."). *See also* Nicholas C. Howson & Donald Clarke, *Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China*, *in* THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243, 248, 254-257 (Dan W. Puchniak et al. eds., 2012) (" 'Tunneling' by individual insiders and controlling shareholders, both state and non-state, by means of related-party transactions is notorious; in 2002 tunneling by controlling shareholders was estimated at 96.7 billion yuan, equivalent to the total amount of money raised in stock markets in the same year.").

[181] *See Main Functions*, SASAC, https://web.archive.org/web/20170831013424/http://en.sasac.gov.cn/n1408028/n1408521/index.html (last visited May 24, 2019).

ministry-level agency.[182] It was assigned to shoulder the State Council's role as a controlling corporate shareholder by exercising shareholder governance rights.[183] The assigned governance rights are at least in principle more extensive than those granted to shareholders by the Company Law.[184] In their account of SASAC's governance rights, Lin and Milhaupt note that the board of directors, the standard corporate governing body, seems entirely missing in some of the firms controlled by SASAC.[185] Additionally, SASAC was formally granted vast authority to restructure, regulate, and supervise the companies under its control. These combined powers arguably gave the agency strong influence on the reorganization of entire industries.[186]

Despite its extensive governance rights assigned in the SOE Assets Law,[187] SASAC faces strong resistance from various interested parties. SASAC shares its administrative powers with other national-level ministries with a say in relevant industries.[188] It can also face strong resistance from the firms it supervises and facially controls, some of which are also ministry-level, economically-powerful industry behemoths.[189] Most importantly, SASAC exercises its governance powers, and particularly its control rights in management, in the shadow of an overall Party control.[190] This shadow control by the CCP is achieved through various means, including: 1) the closely-followed recommendations of the CCP's Organization Department on the appointments of senior corporate managers in leading

[182] Several Asset Management Companies preceded the establishment of SASAC. The Asset Management Companies (AMC) was run by an Asset Management Agency under the supervision of the Ministry of Finance. They were assigned the task of recovering non-performing loans owed to China's four state banks. For details, *see* Ben S. C. Fung & Guonan Ma, *China's Asset Management Corporations* (Bank for Int'l Settlements, Working Paper No. 115, 2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=846288. *See also* Nicholas C. Howson, *The AMC Debt-for-Equity Swaps: Opportunities for Foreign Capital*, CHINA BUS. REV., Sept.-Oct. 2001, at 56.

[183] The formal capacity of SASAC to act as the shareholder on behalf of the state was established in law only six years after the agency was created. *See* Zhonghua Renming Gonghe Guo Qiye Gouyou Zichan Fa (中华人民共和国企业国有资产法) [Law of the People's Republic of China on the State-Owned Assets of Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009) arts. 1, 3 [hereinafter SOE Assets Law], *available at* http://en.pkulaw.cn/display.aspx?id=7195&lib=law.

[184] A few examples: 1) SASAC has the power to propose directors and supervisors to the shareholders' meeting in any "state invested enterprise" regardless of the ratio held by the state. *Compare id.* arts. 5, 22(3), 24, *with* 2005 Company Law, *supra* note 147, arts. 37(2), 39, 101, 102.

2) SASAC is granted a formal veto right on the transfer of state-assets of any state-invested enterprise, regardless of its actual holding ratio in such enterprise. *See* SOE Assets Law, *supra* note 183 § 5 (Transfer of State-owned Assets) (particularly art. 51). *See* Lin & Milhaupt, *supra* note 31, at 743 n.135 (noting the need for SASAC's approval of share transfer in a subsidiary).

3) Beyond conventional company law fiduciary obligations, the SOE Assets Law specifically includes a fiduciary obligation that directors, supervisors, and senior managers owe not only to the company, but specifically to the state as a shareholder. *See* SOE Assets Law, *supra* note 183 arts. 26, 71 (determining directors, supervisors and senior management's liability for actions that causes losses of state-owned assets, including administrative liability when such office holders are also state functionaries).

[185] Lin & Milhaupt, *supra* note 31, at 738 n.121 (noting that by the end of 2012, only 51 of the core parent companies of the 117 national business groups had established a board of directors).

[186] For extensive analysis of SASAC in support of this view, *see id.*

[187] *Supra* notes 183-184.

[188] Lin & Milhaupt, *supra* note 31, at 726.

[189] *Id.* at 736.

[190] *Id.* at 737-738 (referring to this relationship as "a highly institutionalized sharing arrangement between the Party and SASAC.").

firms; 2) the training of most senior SOE managers through the Party school and training system; and 3) the Party personnel evaluation system. More recently, this control has been formalized and institutionalized into the governance of corporatized SOEs and firms more generally,[191] a change that is further undermining the corporate capacity and administrative authority formally reserved to SASAC.

Even after the reorganization under SASAC, the Party-state regularly promotes multiple, often conflicting goals that its agents on the ground must balance.[192] Despite the common perception that the Chinese Party-state operates as a unitary political organization, not only are there various interest groups at different levels of the state, but the interests of the Party itself might differ from those of state agencies and officials (at least when looking beyond senior levels of government positions in which the overlap of Party and state leadership roles is less common).[193]

Therefore, despite SASAC's formal role in the organizational chain, it seems that its corporate capacity is an empty box, to be filled by whichever interested party (a ministry, Party-state organ, or individuals) is most invested in the situation and has the most political-economic power in each case. Assigning a central state agency as a controlling shareholder did not solve, and perhaps cannot solve, the problems that arise from the lack of an ultimate real principal. It only mirrors the institutional challenges already within China's political economy.

In the crossroads of these competing forces are the corporate insiders and Party-state individuals who stand to gain from the disarray of conflicting institutional interests. Indeed, no matter how many layers are added to the institutional arrangement, since the state (and the Party) is an abstract collective, it must necessarily operate through human agents.[194] State corporate-control in China, therefore, features the same type of self-dealing concerns that the paradigm agency analysis envisages, yet it amplifies the problem by reproducing the links (agents) in the chain that can exploit the situation while weakening those with direct incentives to limit it. This is an exacerbated form of the well-known corporate monitoring predicament— "who monitors the monitors?,"[195] which is extended in China to multiple layers of agents inside and outside the firm.

2. Heightened Opportunities for Abuse by Controllers

As if these features of state-corporate control in China are not challenging enough, corporatized SOEs face further difficulties due to misaligned interests between their various shareholders. This includes conflicts within the state itself and also between the state as the controlling

[191] *See* discussion *infra* Chapter 3, Section III.
[192] Clarke, *supra* note 50, at 498.
[193] I develop this further in Chapter 3, Section I.
[194] Clarke, *supra* note 50, at 497-500. Clarke expressed this with respect to older forms of state asset management organization and before the reorganization under SASAC, but the substantive claim still stands.
[195] *See, e.g.*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers*, STAN. L. REV. 819, 835-836 (1981) (discussing this question as part of the costs of the separation between ownership and control).

shareholder and the "class" of public shareholders. To the extent that the state is able to incentivize its agents—both the officials assigned to monitor corporate insiders, and the professional managers appointed to operate corporatized SOEs—to pursue the state's goals rather than their own selfish interests, the benefits to the firm and its other shareholders might still be marginalized. Whichever goal ends up being prioritized, it will not necessarily align with the most efficient and productive business conduct.

Thus, even under an assumption of benevolent, well-coordinated, state asset management, the state as a controlling shareholder may direct the firm in pursuit of objectives that simply run counter to the interest of the firm as a profit-maximizing business. Examples of this in China include the use of state-controlled firms to advance geopolitical goals without sound expectations for economic return;[196] harnessing management control to enforce broad social and political agendas,[197] or to accelerate the implementation of market-structure reforms;[198] using state-controlled firms to implement special social tasks;[199] and, as recently seen, to influence or even control capital market volatility.[200]

This phenomenon is not unique to the Chinese state's corporate control. There are many examples of governments using their corporate role to advance goals that a profit-oriented shareholder would probably avoid.[201] The reasons for this are not always clear since governments could

[196] Many investments of Chinese companies in Africa are said to be first and foremost designed to gain a national foothold in the continent and control over natural resources. Moreover, the use of controlled firms for geopolitical goals is clear from the robust transaction activity around the Belt and Road initiative. Many of the projects are criticized for being economically senseless but nevertheless pass corporate governance approvals (even in private firms). *See* Jenni March, *The Rise and Fall of a Belt and Road Billionaire*, CNN (Dec. 2018), http://www.cnn.com/interactive/2018/12/asia/patrick-ho-ye-jianming-cefc-trial-intl/. By the end of 2016, China's SOEs contributed sixty percent of China's outbound investments, playing an important role in China's ambitious Belt and Road Initiative. *See* Wendy Wu, *How the Communist Party Controls China's Industrial Titans*, SOUTH CHINA MORNING POST (June 17, 2017, 9:01 AM), http://www.scmp.com/news/china/economy/article/2098755/how-communist-party-controls-chinas-state-owned-industrial-titans.

[197] Clarke, *supra* note 71, at 140-141, 149 (pointing to the use of state corporate-control in the enforcement of state policies on birth control among employees).

[198] Michael Firth et al., *Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 685, 692, 699–704 (2010) (reflecting that SOEs' managers during the split-share structure reform easily passed generous compensation schemes, due to pressures to implement the reform quickly, even when the scheme was against the firm's economic interests).

[199] There are numerous instances of state-controlled firms being called upon to assist the government in a broad array of social tasks, from the Beijing Olympic Games and the Shanghai World Expo, to assistance in the Party-state's natural disaster management schemes. *See* Jiangyu Wang, *The Political Logic of Corporate Governance in China's State-owned Enterprises*, 47 CORNELL INT'L L.J. 631, 663 (2014) ("According to a *Xinhua* report, twenty four hours after the Qinghai Yushu earthquake hit on April 14, 2010, China's big SOEs, including the state-owned airlines and airports, energy companies, telecoms, transportation firms, medical companies, and agricultural trading companies, were called upon by the CCP Central Committee and the State Council (*Dangzhongyang, Guowuyuan*) to participate in the rescue efforts by providing services and materials.").

[200] During the 2015-2016 market downturn, buy-sale orders by state-controlled insurance firms and financial institutions were directed by the Party-state to control market decline. Gabriel Wildau, *China's 'National Team' Owns 6 Percent of Stock Market*, FIN. TIMES, (Nov. 25, 2015), https://www.ft.com/content/7515f06c-939d-11e5-9e3e-eb48769cecab.

[201] *See generally* IAN BREMMER, THE END OF THE FREE MARKET: WHO WINS THE WAR BETWEEN STATES AND CORPORATIONS? (2010); ALDO MUSACCHIO & SERGIO G. LAZZARINI, REINVENTING STATE CAPITALISM: LEVIATHAN IN BUSINESS, BRAZIL AND BEYOND (2014); Curtis Milhaupt & Mariana Pargendler, *Governance Challenges of Listed State-Owned Enterprises Around the World: National Experiences and a Framework for Reform*, 50 CORNELL INT'L L.J. 473 (2017); Curtis

presumably utilize other tools to reach the same results. Yet, states in their shareholding capacity have harnessed their corporate control to maintain high employment levels in certain firms or industries.[202] In some cases, governments have directed corporate decision making to uphold strategic control of specific industries (e.g., via strategic planning of M&A),[203] or fixed sale prices through their corporate influence in order to curtail inflation,[204] or to ensure sufficient domestic availability of essential products.[205]

It is well established that controlling shareholders can promote their interests more easily by enlarging their voting control relative to their cash flow rights.[206] This can be done through deploying legal structures, such as pyramidal ownership, dual-class shares, cross-shareholdings within business groups, voting agreements, and other business arrangements.[207] The result (and often the aim) of these ownership structures is the dissociation of public investors from governance, which allows the controller to extract private benefits of control more freely.[208]

Increasing the state's voting control disproportionately to its cash flow rights was actively pursued in China throughout its market transition to the present day—from the inception of its

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Milhaupt & Mariana Pargendler, *RPTs in SOEs: Tunneling, Propping, and Policy Channeling*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 6 (Luca Enriques & Tobias Tröger eds., 2019) (suggesting a distinction between tunneling, propping and policy channeling). Following Milhaupt and Pargendler's analysis, most of the examples cited here would be considered policy channeling.

[202] As was the case in Israel, where the state intended to execute its golden share veto right to block a merger of Israel Chemicals Ltd. with the Canadian Fertilizer Potash Corp., due to expected negative effects on the local workforce. *See* Yoram Gavison, עסקת פוטאש-כיל [*Potash-ICL Deal*], MARKER (Oct. 31, 2012, 12:25 AM), https://www.themarker.com/markets/1.1853965. Potash Corp. dropped its bid before the transaction was brought to approval. *See Canada's PotashCorp Drops Takeover Bid for Israel Chemicals*, HAARETZ (Apr. 25, 2013, 4:09 PM), https://www.haaretz.com/israel-news/business/potashcorp-drops-bid-for-icl-1.5239707). For an English source that emphasizes the political and social motives behind the position of the Israeli government, *see* Pav Jordan, *Israel Wants Details on Potash Corp. Bid for Israel Chemicals Ltd.*, GLOBE & MAIL (Nov. 2, 2012), https://www.theglobeandmail.com/globe-investor/israel-wants-details-on-potash-corp-bid-for-israel-chemicals-ltd/article4893258/.

[203] As in the Israel Chemicals Ltd. example. *Id.*

[204] As in the case of fuel prices charged by Brazilian Petroleum company Petrobras. Milhaupt & Pargendler, *RPTs in SOEs*, *supra* note 201, at 6.

[205] As in the case of Coal India price control policy below market prices and against public investor's objections. *See* Clarke, *supra* note 170. On the Brazilian Petrobras and Brazilian Eletrobras contractual overpayments to the government on various rights and services, *see* Milhaupt & Pargendler, *RPTs in SOEs*, *supra* note 201, at 3.

[206] Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholding*, 57 J. FIN. 2741 (2002); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81 (2000).

[207] *See* Lucian A. Bebchuk et al., *Stock Pyramids, Cross-ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000).

[208] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1645 (2006) ("increased productivity accrues to shareholders in proportion to their equity, while private benefits of control are allocated based on governance power."). *But see* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J., 560 (2016) (suggesting that entrepreneurs value corporate control because it allows them to pursue their vision the way they see fit, rather than necessarily to reap private benefits at the expense of public shareholders).

With respect to China, *see* Guohua Jiang et al., *Tunneling through Inter-Corporate Loans: The China Experience*, 98 J. FIN. ECON. 1 (finding that the use of intercorporate loans by controlling shareholders to siphon funds from publicly listed companies is most severe in firms where the controlling shareholders' controlling rights are larger than their ownership (cash flow) rights).

corporatization process with SOEs that raised passive equity capital while keeping state shares non-tradable,[209] through the reorganization of these firms into larger pyramid holding groups, and to the recent waves of M&A activity that reduced the number of state-controlled businesses but enhanced their scope.[210] When it was completed, the Chinese Party-state—including central and local governments, ministries, and other state bodies—retained, and in fact leveraged, its ultimate control over the majority of listed companies.[211]

Instead of relaxing ownership structures in ways that would better align the interests of the state with those of other shareholders, the Party-state has recently opted to further reinforce the gap through its mixed-ownership scheme.[212] This economic scheme, branded as a plan to "privatize" Chinese listed firms through a blend of private and state ownership,[213] only deepens the dissociation further and entrenches the state as a controlling-minority shareholder in many such "privatized" firms.

One might argue that the state's pursuit of these goals is no different than actions by private controlling shareholders, which are common around the world. In both cases, the controller uses the firm to facilitate private benefits of control (pecuniary or nonpecuniary).[214] When this is done at the expense of the firm and its other shareholders, such as through outright theft or by related-party transactions that are not at arms-length,[215] the extraction is equally exploitive,[216] whether carried out by a state or by a private shareholder.

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[209] Clarke, *supra* note 50, at 496-497; Nicholas C. Howson, *Protecting the State from Itself? Regulatory Interventions in Corporate Governance and the Financing of China's 'State Capitalism'*, in REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM, 49 (Benjamin Liebman & Curtis Milhaupt eds., 2015).

[210] CHINA AND THE GLOBAL FINANCIAL CRISIS: A COMPARISON WITH EUROPE 5-6 (Jean-Pierre Cabestan et al. eds., 2002) (pointing out that between 2003 and 2010, the total number of SOEs dropped from 159,000 to 114,500, but the total assets of 121 large national SOEs managed by SASAC increased from 3 trillion to 20 trillion yuan).

[211] Joseph P. H. Fan et al., The Emergence of Corporate Pyramids in China 6-9, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=686582. For a more general discussion of the market structure and state dominance during the corporatization period, *see* Liufang Fang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 224-228 (1995).

[212] On the current promotion of a "mixed ownership economy," *see supra* note 27 and accompanying text.

[213] Defined as: "cross-shareholdings by, and mutual blends of, state-owned capital, collective capital, and non-public capital." 2013 Communique, *supra* note 26. This was followed by detailed CCP decisions to guide central and local state organs (including the NPC and the State Council on its various ministries) on how to implement and pursue the mixed ownership goal. Zhonggong Zhongyang Guanyu Quanmian Shenhua Gaige Ruogan Zhongda Wenti de Jueding (中共中央关于全面深化改革若干重大问题的决定) [Decision on Certain Major Issues Concerning the Comprehensive Deepening of Reform] (promulgated by the Central Comm. Communist Party China, Nov. 15, 2013) [hereinafter The 3rd Plenum Decisions of 2013], *available at* http://cpc.people.com.cn/n/2013/1115/c64094-23559163.html. For critical analysis, *see* DANIEL ROSEN ET AL., AVOIDING THE BLIND ALLEY: CHINA'S ECONOMIC OVERHAUL AND ITS GLOBAL IMPLICATIONS (2014).

[214] For the distinction between pecuniary and nonpecuniary benefits that controlling shareholders may extract at the expense of minority shareholders, *see* Gilson, *supra* note 208, at 1661-1667.

[215] For the different aspects of related-party transactions, *see* Luca Enriques et al., *Related-Party Transactions*, *in* ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier Kraakman et al. eds., 3rd. ed. 2017).

[216] The value extraction by corporate controlling shareholders received the name "Tunneling." For the seminal works on tunneling, *see* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003); Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV 22 (2000).

While this argument has conceptual merits, some practical differences are notable. First, empirical research points to the prevalence of tunneling in Chinese state-controlled firms relative to other firms.[217] The use of intra-group transfers, such as through loan guarantees,[218] which allocate resources from publicly-listed firms to private related parties, is particularly prevalent in China.[219] This suggests that there is something in the nature or the structure of state control in China that is different and more conductive to tunneling. Perhaps it is the multiple complex layers within the institutional structure that intensify conflicting interests as discussed above; perhaps the absentee principal; and perhaps it is the combination of these features that invites more opportunities for abuse from all directions.

Second, state controlling shareholders differ from private ones in the externalities of their actions on public shareholders. State controlling shareholders often have only an attenuated eye to profits. The persistent choice of the state to maintain control over various industrial firms rather than to diversify its investments as a passive equity investor raises at least a strong presumption that its reasons for maintaining control are not for profits only.[220] Moreover, while the same might sometimes also be true for private controlling shareholders, a rational private investor will strive to maximize her own economic value (or that of her affiliates). Private investors that seek to use the corporation for other goals are quickly pushed by existing statutes (or case law) to pursue these goals through alternative forms of business organization.[221]

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[217] M. Jian & T. J. Wong, *Propping through Related Party Transactions*, 15 REV. ACCT. STUD. 70 (2010) (finding that abnormal related sales propping done for the benefit of the controller is more prevalent among state-owned firms and in regions with weaker economic institutions); Jiang et al., *supra* note 208 (discussing the scope of abuse by controlling shareholders through the use of intercorporate loans to siphon billions from hundreds of Chinese listed companies during the 1996–2006 period, and its significant economic consequences in firms); Qiao Liu & Zhou (Joe) Lu, *Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunneling Perspective*, 13 J. CORP. FIN. 881 (2007) (suggesting evidence that controlling shareholders use earnings management to tunnel); Winnie Qian Peng et al., *Tunneling or Propping: Evidence from Connected Transactions in China*, 17 J. CORP. FIN. 306 (2011); Kun Su et al., *Ultimate Ownership, Risk-taking and Firm Value: Evidence from China*, 23 ASIA PACIFIC BUS. REV. 10 (2017) (examining risk taking and ownership structure in Chinese listed firms, results show that the presence of ultimate controlling shareholder and the divergence between its control right and cash flow right, through pyramid structures, lead to lower corporate risk-taking and firm value); Kun Wang & Xing Xiao, *Controlling Shareholders' Tunneling and Executive Compensation: Evidence from China*, 30 J. ACCT. & PUB. POL'Y, 89 (2011) (tunneling by controlling shareholders reduces the pay-performance sensitivity of executive compensation and suggesting that controlling shareholders have less interest to strengthen pay for performance measures due to their ability to extract value through private benefits of control).

[218] Nan Jia et al., *Coinsurance within Business Groups: Evidence from Related Party Transactions in an Emerging Market*, 59 MGMT. SCI. 2295 (2013).

[219] Henk Berkman et al., *Expropriation Through Loan Guarantees to Related Parties: Evidence from China*, 33 J. BANKING & FIN. 141 (2009).

[220] At least by accepted theories of risk diversification through diversified portfolio investments.

[221] The development of benefit corporations, nonprofit enterprises, and social purpose organizations reflects this. Especially in the United States, where SEC rules for shareholder proposals limit their substance and influence, and where case law developments around Dodge v. Ford precludes controlling shareholders from disregarding firm value maximization in pursuit of other, even socially value-maximizing, objectives. *See* Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 163 (2008) (critiquing Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163 (2008).

To maximize her private benefits, a private controller will deploy control either to self-deal or to monitor. In both scenarios, the controller first needs to make sure that the firm is sufficiently successful for value extraction. An increase in the general pie enlarges the delta that is then available for unequal distribution through e.g., connected transactions. When the controller has enough "skin in the game," [222] even a rapacious controller will be interested in increasing value and thus in monitoring corporate insiders to some degree. The interests of a private controller, therefore, align with those of public shareholders at least to the point that enables self-enrichment.

When the state is the controlling shareholder, however, and aside from the self-dealing by its agents, the state often exerts its control for purposes that have only an attenuated link to economic value.[223] Recent evidence on corporate tax compliance in SOEs suggests that tax functions as a form of "dividend" to state controlling shareholders and as an excess cost to other shareholders. [224] Presumably, the state has low motivation to distribute dividends since it has other, perhaps more socially legitimate routes, such as taxes, to extract corporate value at the expense of public shareholders and the firm. Furthermore, as opposed to the portion that a private controller can extract, the expropriation by the state is not capped by the general corporate pie. The state can, and does, find ways to stream funds to its controlled firms when needed through cross-subsidizing firms [225] and from the deep pocket of its citizenry. The use of the corporate form by the state as a controlling shareholder thus does not depend on the value of the corporation. The link between the financial strength of the invested firm and the scope of "private benefits" available for extraction by the state is weak. One might argue that the state will be able to "take" more from a more profitable firm. It is also the case that for various reasons (not necessarily pecuniary) the Party-state is greatly committed to preventing a decline in the value of state assets. But as the evidence so far shows, this alone does not induce the state as shareholder to increase corporate *monitoring*.[226] Instead, so far, other methods to prevent the decline of value in state assets were applied more firmly.[227]

Finally, even when the Party-state as a controlling shareholder prioritizes economic value-maximizing in firms, it differs from private investors in its investment approach. The state as controlling shareholder is bound to aim at a pie that is far beyond that of a specific firm. The

[222] Albert H. Choi, *Concentrated Ownership and Long-Term Shareholder Value*, 8 HARV. BUS. L. REV. 53 (2018).

[223] For examples, *see supra* notes 196-205. There are of course examples in which a state controlling shareholder would act as a profit maximizing investor, increase the pie, and then take care of distribution. In these cases, such as in the Singaporean model of the State Holding Company Temasek or in various Sovereign Wealth Funds, the state is involved as a relatively passive investor, and its actions as a shareholder are economically oriented.

[224] Providing an agency cost analysis for tax compliance or avoidance in SOEs, the authors also found that their results are particularly pronounced for locally versus centrally-owned SOEs and during the year of SOE term performance evaluations. *See* Mark Bradshaw et al., *Agency Costs and Tax Planning when the Government is a Major Shareholder*, J. ACCT. & ECON. (forthcoming 2019).

[225] Lin & Milhaupt, *supra* note 31, at 745.

[226] In Chapter 3, I discuss how, while this commitment did not bring the state to monitor effectively, it is part of the reasons that recently induced the Party to fill-in the monitoring void within firms.

[227] For instance, by inducing state-controlled firms and financial institutions to rescue a declining stock market following recent market decline. *Supra* note 200.

corporatization process and the subsequent group formation led to the state systematically holding ownership of stocks in competing companies within the same industry. With its cross-industry ownership, the state adopts a broad view of profits that expands beyond a single firm across industries and the market at large.[228] Thus, even as a profit-oriented investor, when adopting an industry-level ("portfolio level") perspective, the Chinese state looks beyond the benefit of a specific firm. Some firms will be sacrificed for others, according to the state's relative ratio or following "portfolio-level" goals.[229]

Viewing the state as a profit-oriented investor with holding positions in firms across industries suggests significant implications beyond firm-level governance as well. These include implications for market competition, an issue that recently caught the attention of scholars through the phenomenon of common ownership.[230] The major difference here, of course, is that the Chinese Party-state, in contrast to ordinary institutional investors as common owners, has much larger stakes (or de-facto control) and takes up an active position in its invested firms.[231] This reality makes both concerns— competition and the potential disregard for firm-level interests— more pressing.[232]

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[228] Lin & Milhaupt, *supra* note 31, at 745 (referring to the organizational ownership structure under SASAC: "These realities suggest that the central-SOE sector as a whole, rather than individual firms, is of greatest concern to SASAC in carrying out its governance responsibilities… the practice of rotating top managers among firms in the same industry makes a good deal of sense if maximizing shareholder wealth at individual firms is less important to the controlling shareholder than building up a number of globally competitive firms in critical industries.").

[229] Much like the conflicting interests of an index fund that currently trouble American scholars, albeit not as a passive investor. *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Nov. 28, 2018), https://corpgov.law.harvard.edu/2018/11/28/index-funds-and-the-future-of-corporate-governance-theory-evidence-and-policy/.

[230] The theory suggests that when investors have multiple holdings in firms within the same sector, they will adopt an industry level view and will encourage, explicitly or implicitly, anti-competitive practices at the expense of consumers and the public good more generally. *See* George S. Dallas*, Common Ownership: Do Institutional Investors Really Promote Anti-Competitive Behavior*?, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Dec. 2, 2018), https://corpgov.law.harvard.edu/2018/12/02/common-ownership-do-institutional-investors-really-promote-anti-competitive-behavior/#more-112996.

[231] The U.S. Department of Justice Antitrust Division and the Federal Trade Commission define common ownership as "the simultaneous ownership of stock in competing companies by a single investor, where none of the stock holdings is large enough to give the owner control of any of those companies." *See* OECD, HEARING ON COMMON OWNERSHIP BY INSTITUTIONAL INVESTORS AND ITS IMPACT ON COMPETITION – NOTE BY THE UNITED STATES (2017), *available at* https://one.oecd.org/document/DAF/COMP/WD(2017)86/en/pdf.

[232] This point is different from the "agency costs of state-capitalism," which was raised by Milhaupt and Pargendler based on Gilson and Gordon's "agency cost of agency capitalism." These accounts speak to the conflict of interests between the holding entity and its ultimate beneficiary. In the Chinese case, the state acts on behalf of "all the people." While this comparison is fascinating, I believe that the state, even as a shareholder, does not have a corporate-style "fiduciary obligation" to the Chinese people per se. The Chinese people, as the theoretical ultimate beneficiaries of state ownership, did not electively entrust their economic and governance rights with the state the way that record holders entrust their investment with an institutional intermediary (state-owned pension and social security funds excepted). Such a relationship thus cannot be addressed by the agency theory alone. A different framework, possibly involving public ownership theories, is required. That concern is outside the scope of this project. *See* Ronald Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Milhaupt & Pargendler, *Governance Challenges of SOEs*, *supra* note 201, at 5. For an additional account of the agency costs of institutional investors, *see* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

The analysis above does not imply any normative claim against state ownership in and of itself, nor against Chinese state ownership specifically. It can certainly be the case that state corporate control has benefited the Chinese economy, its market development,[233] and Chinese society at large. Rather, the point here is that the state's corporate control in China, under the current organizational structure, is particularly alarming for public shareholders. It combines the ills of dispersed ownership with the perils of controlling shareholders and amplifies them through every link of the organizational chain. Public shareholders in China may be losing on all fronts.

B. The Party-State's Financial and Capital Market Control

Apart from its position as a shareholder, the Party-state's control is felt in the infusion of its interests into the Chinese capital market through its central position in other areas that affect corporate business, particularly the financial industry and labor market. The Party-state implements this control through its several roles, as a regulator, enforcer, and often owner of the main players in these fields. This picture is frequently described as Chinese "state capitalism."[234] It is a system in which the Party-state directly or indirectly functions as the controlling shareholder of most significant industrial groups and their domestic and globally-listed companies, as well as of the commercial and policy banks and financial industry firms, and at the same time acts as the market's regulator and the main enforcement institution.[235] A study by Lin and Milhaupt shows the various ways through which the Party-state controls the debt market. In the bond market, for example, bond issuers are primarily organs of the central or local governments, thereby circumventing a national level prohibition against local government debt issuance by using special financing vehicles.[236] The Party-state's dominance in the debt market is felt not only in the identity of bond issuers but also throughout the entire network of market intermediaries. The underwriting industry, despite having a relatively large number of players, which entails more competition, reveals the absolute dominance of state-owned financial intermediaries. The main banks, securities companies, and other financial institutions conduct the underwriting activity, and the great majority of them are owned by the state. At the time of the study,

[233] Recall that the law and finance approach that links investor protections with capital market and economic development is contradicted by China's conundrum.

[234] *See generally* REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM (Benjamin Liebman & Curtis Milhaupt eds., 2015); Lin & Milhaupt, *supra* note 31, at 697 n.9.

[235] Commentators have taken different views as to the Party-state involvement in the economy. Some have argued against the characterization of the Chinese economy as "state-capitalism." *See, e.g.*, LARDY, *supra* note 31 (considering the rapidly growing private business sector as a major driver of economic growth and employment in China today).

[236] Local Government Financing Vehicles issue 36.8 percent of the total outstanding corporate debt instruments. Central SOEs controlled typically by SASAC issued 28.6 percent, and local SOEs controlled by local SASAC branches issued 21.7 percent of the total. Facially private enterprises issued only 12.7 percent of all outstanding corporate bonds. *See* Li-Wen Lin & Curtis Milhaupt, *Bonded to the State: A Network Perspective on China's Corporate Debt Market* 20-21 (European Corp. Governance Inst., Law Working Paper No. 327/2016, 2016), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2810209.

out of all financial institutions that perform underwriting activity with at least two percent of the underwriting market, only one (Minsheng Bank) was not state owned, and even it maintained a close reciprocal relationship with the government.[237] Similarly, Lin and Milhaupt found that in the credit rating industry, which is also seemingly competitive, the state owns the majority of firms (five out of nine agencies).[238] The potential for conflicts of interest and "partisan rating" is clear. As most bond issuers are politically connected to the Party-state, credit ratings are skewed upwards[239] and thus do not perform well as reputational intermediaries.[240]

This Party-state control over debt financing resources affects the availability of alternatives to equity financing and increases its control over the capital market overall. Considering only the shareholding capacity of the Party-state does not provide a complete picture of China's state capitalism and its implications for the capital market. The Chinese Party-state is omnipresent in every market element: from outright trading suspensions in the capital market; through a licensing regime that can be exercised to limit the operation of certain market players; geopolitical changes that bring stricter or laxer M&A and antitrust norms, which affect business conduct and profitability; through monetary control over the repatriation of funds by SAFE (the State Administration of Foreign Exchange); and finally, even to protectionist legal enforcement in commercial cases.

The implications for public shareholders—their status and the role they can play in the capital market—derive from the complete array of Party-state economic control and not merely from its position as a shareholder. The remainder of the chapter addresses the implications of China's state capitalism on the functioning of traditional corporate governance institutions.

III. ANALYSIS OF CONVENTIONAL GOVERNANCE MECHANISMS

As seen thus far, China's political economy and the continued embrace of state capitalism have created a structured predicament in which public shareholders are disempowered and subject to open exploitation by various corporate control parties. Howson describes the situation as "a ready invitation to opportunism, 'tunneling', minority shareholder exploitation and oppression."[241] In this section, I will examine whether traditional monitoring and disciplining mechanisms can overcome this structural predicament.

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[237] *Id.* at 21-22.
[238] *Id.* at 22-23 (also pointing out that sixty percent of all rated corporate bonds were rated by a state-owned rating agency). However, on expectations for future regulation that will open-up credit rating to foreign agencies, *see* Miller Matthew & Umesh Desai, *China's Move to Open Up for Global Rating Agencies May Lift Debt Credibility*, REUTERS (Dec. 8. 2016, 6:27 AM), http://www.reuters.com/article/us-china-ratings-idUSKBN13X168.
[239] Lin & Milhaupt, *supra* note 236, at 34-35.
[240] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 802-803 (2001).
[241] Howson, *supra* note 209, at 6.

Foundational corporate law theories view the public corporation as a capital-raising vehicle.[242] By the same account, corporate governance in public firms (including securities regulation) should be designed to facilitate the development of the capital market as a dynamic and efficient capital allocation mechanism whereby capital is allocated to the most deserving firms. Striving for efficiency, capital markets and corporate governance regimes should minimize the costs of monitoring corporate control parties. These costs emanate from the separation between the owners of the corporation and those who control it, and their potential conflicting interests—which constitute the basic premise of modern public firm theory.[243] Following this approach, it is asserted that corporate governance should focus on mechanisms that will prevent the exploitation of investors by those who control their investment, or, in positive terms, on "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[244] If investors' expectations for a fair game are met, the theory goes, they will be reassured and encouraged to continue investing. This will keep the cost of financing low and will promote a vibrant capital market with minimal monitoring costs. It follows that potential exploitative behavior by corporate control parties (insider management and controlling shareholders) can be minimized by an array of monitoring mechanisms gathered under the umbrella of the system's corporate governance regime.

The remainder of this chapter examines traditional mechanisms of corporate governance and their operation in China. By traditional mechanisms, I mean the mechanisms that are conventionally assigned a monitoring and disciplining role in corporate governance, whatever their contribution to firm/market value is. For each mechanism, I describe its assigned role under the conventional understanding and then evaluate if and how it functions in China, and whether it serves the interests of public shareholders. These traditional mechanisms fall into two categories, firm-internal and external monitoring mechanisms, as follows:[245]

Internal Governance Mechanisms:

- *Shareholders* (institutional investors, other shareholder coalitions)
- *Other Internal Governing Bodies* (board of directors, independent directors, supervisory board)
- *Other Corporate Constituents* (employees, creditors, consumers, managers)

[242] Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).
[243] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 n.1 (1983) (citing BERLE & MEANS, *supra* note 13, at 129).
[244] *See generally* Michal Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 737 (1997). For different approaches to corporate governance, *see* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985) (presenting a broader institutional economics contractarian view). *See also* Stuart L. Gillan, *Recent Developments in Corporate Governance: An Overview*, 12 J. CORP. FIN. 381 (2006) (presenting a broad, inclusive approach).
[245] For the previous appearance of some parts of the following review, *see* Groswald Ozery, *supra* note 101.

External Monitoring Institutions:

- *External Markets* (the market for corporate control, capital market, product market, managerial labor market)
- *Gatekeepers* (lawyers, accountants & underwriters, the financial press)
- *The Legal System* (public enforcement—the CSRC, stock exchanges; private enforcement— the People's Courts system)

A. Internal Governance Mechanisms

1. Shareholders

The failure of monitoring by the state as a controlling shareholder calls attention to the issue of monitoring by other shareholders, whether public individual shareholders or blockholding coalitions.

In contrast to controlling shareholders and blockholders, dispersed shareholders have information asymmetries, collective action problems, and incentives to free-ride others. These make it difficult and uneconomical for shareholders with few shares to monitor corporate control parties.[246] Individual public shareholders therefore typically take passive holding positions. Yet, dispersed shareholders may form coalitions that increase their ability to monitor and discipline corporate insiders in various ways. [247] Through aggregate action, they are potentially able to collect enough votes to make specific corporate governance proposals, challenge the decision-making of incumbent managers, and even oust underperforming managers and take control of the firm.[248]

In firms with controlling shareholders, public shareholders, even when building coalitions, are generally unable to assemble enough votes to contest control directly. Yet, they can still engage in governance and have some monitoring functions when acting in concert.

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[246] Stephen Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 604 (2005) (positing a contractarian view, in which shareholders are only owners of a residual claim, not of the corporation itself); Easterbrook & Fischel, *supra* note 243.

[247] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

[248] *See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003) (providing an example of shareholder participation effort in the context of a contested election battle—"proxy fight"); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (providing an example for shareholder accumulating votes and submitting a precatory proposal to influence company business strategy and board composition).

i. Institutional Investors

Over the last few decades, shifts in shareholder composition, particularly in widely-held markets, have raised expectations for greater public participation through institutional investments.[249] Although the views on institutional investors' actual engagement in governance and contribution to firm value are far from conclusive,[250] it certainly seems that the recent accumulation of corporate power and potential for activism by institutional investors is transforming the corporate governance landscape.[251]

Certainly, the degree of involvement by institutional investors depends on the country's political economy, including the applicable regulatory framework, the sophistication of the financial industry, and the extent to which such institutional investors have been co-opted.[252] When a controlling shareholder exists, the power of institutional investors to influence corporate decision making and monitor effectively is limited from the outset. The presence of institutional investors is

[249] For the canonical view, *see* Black, *supra* note 247 (depicting traditional institutional investors as promising monitors); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (suggesting a model by which institutional investors are affecting "the passivity story"). For a more recent perspective, *see* Kahan & Rock, *supra* note 247, at 1042, 1047–70 (explaining the disillusionment about the traditional institutional investors' activism, yet reflecting similar hopes regarding hedge funds as new, promising activists).

[250] For views supporting institutional investors' activism, *see* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (empirically testing and refuting the claim that activists' interventions by hedge funds are costly to firms and their shareholders in the long term); Marco Becht et al., *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2933-2971 (2017) (finding that incidents of activism and their contribution to return is greater with high institutional ownership, particularly with respect to U.S. institutions); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and other Private Investors*, 64 J. FIN. 187, 187-229 (2009) (examining the success rate of activist campaigns by Hedge funds, VC funds, PE funds, and individual investors).

For the opposing views, *see, e.g.*, John C. Coffee Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016) (arguing that engagement by activist hedge funds has costly externalities on long term firm investment); Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, CONTEMP. FIN. DIG., Autumn 1998, at 10 (concluding that no empirical evidence supports the claim that activists improve long term market performance); Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 YALE. J. ON REG. 174, 187–219 (2001) (reviewing studies on shareholder proposals submitted by public pension funds in the United States and finding an insignificant effect on firms' performance).

[251] For recent reports on the rise of institutional investors' ownership in the United States and its potential implications on governance, *see* Bebchuk et al., *supra* note 232, at 91, 92-93; Gilson & Gordon, *supra* note 232, at 865; John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, (Harvard Pub. Law, Working Paper No. 19-07, 2018), https://ssrn.com/abstract=3247337.

[252] Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 24–25 (2008) (discussing the conditions that made the United Kingdom a more favorable jurisdiction for shareholder participation through institutional investors, compared to the United States).

more limited,[253] tied to the state,[254] or co-opted within a group of dominant shareholders.[255] In these markets, while institutional investors are technically able to overcome apathy and collective-action problems that hold back monitoring by dispersed shareholders, they rarely have the incentives to do so. Scholars have begun to explore the complexity of internal agency problems that affect the power and function of institutional investors, even in dispersed markets.[256] Such agency issues are exacerbated where institutional investors are entwined with larger business groups through business relations and ownership, as is the case in many concentrated markets. In some cases, institutional investors are even controlled by the listed firm whose public share float they manage.[257] This increases their support for incumbent insiders without accountability to their ultimate beneficiaries. This situation has prompted several scholars and policy makers to propose more mandatory intervention in concentrated markets that seek to promote public shareholder engagement through institutional investor stewardship.[258]

With respect to the PRC, the institutional investment industry experiences all the general predicaments that impede the ability of institutional investors to monitor and engage in governance, and then some. The limited scale of the industry is one of these impediments. According to reports by China's stock exchanges, most retail investors manage their equity investments individually and not through institutional investor accounts. Out if their total accounts, the Shenzhen Stock Exchange and the Shanghai Stock Exchange respectively report that 0.33 percent and 0.46 percent are institutional accounts compared to individual (retail) investors' accounts.[259]

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[253] Only a small scope of institutional investment, measured by assets under management, was noted for Portugal, Greece, Spain, Turkey, Poland, and other OECD countries. *See* OECD, THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE 112 (2011); Miguel A. Ferreira & Pedro Matos, *The Colors of Investors' Money: The Role of Institutional Investors Around the World*, 88 J. FIN. ECON. 499, 524–30 (2008) (providing data on institutional ownership by country).

[254] Such as in China (see the discussion that follows). Regarding India, *see* Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*, 1 INT'L REV. FIN. 161, 166 (2000).

[255] Such as in Israel, France, Korea, Singapore, and Brazil. For the Israeli case, *see* Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691 (2012). For France, *see* Carine Girard, *Success of Shareholder Activism: The French Case*, BANKERS, MARKETS & INVESTORS, Nov.-Dec. 2011, at 26. *See generally* Stuart Gillan & Laura T. Starks, *Corporate Governance, Corporate Ownership, and the Role of Institutional Investors: A Global Perspective*, (Weinberg Ctr. for Corp. Governance, Working Paper No. 2003-01, 2003), http://ssrn.com/abstract=439500.

[256] Bebchuk et al., *supra* note 232; Bebchuk & Hirst, *supra* note 229; K. A. D. Camara, *Classifying Institutional Investors*, 30 IOWA J. CORP. L. 219, 223, 241 (2004).

[257] Hamdani & Yafeh, *supra* note 255.

[258] *Id.* at 711-14 ("it is legal intervention—rather than minority shareholders' voting power—that drives institutional investors to cast a vote" … "Institutional investors tend to be active primarily when legally required to do so."). For recent efforts in the EU, *see* Directive 2017/828, Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132) 1, *available at* https://publications.europa.eu/en/publication-detail/-/publication/9b871b38-3d20-11e7-a08e-01aa75ed71a1/language-en. *See generally* Goshen, *supra* note 162 (arguing that corporate laws must incorporate some form of minority protection as a mandatory rule and examining various such forms in different jurisdictions).

[259] These reports might be somewhat misleading as some institutional investors hold individual accounts. For the relative number of individual and institutional accounts *See* SHANGHAI STOCK EXCHANGE, SHANGHAI STOCK EXCHANGE STATISTICS ANNUAL 475-6 (2014), *available at* http://www.sse.com.cn/aboutus/publication/yearly/documents/c/tjnj_2014.pdf (in Chinese); INFORMATION MANAGEMENT DEPARTMENT OF SHENZHEN STOCK EXCHANGE, SHENZHEN STOCK EXCHANGE MARKET FACT BOOK

The scope of institutional investment services in China is still strictly regimented with limited investment choices. For example, pension funds are funded and managed by local-level provincial and city governments and until very recently could only invest in national treasury bonds and deposits.[260] Only in late 2015 did the State Council permit pension funds to invest in equity securities.[261] Similar investment limitations apply to the PRC's National Social Security Fund, which functions as the central government's social security reserve fund.[262] As for mutual funds, in recent years there has been an increase in the number of mutual funds and their total equity investments. In 2012, mutual funds held 7.6 percent of all shares. Yet at the firm level, their holdings are still marginal. In 2011, mutual funds held a median of 0.067 percent in firms.[263] Scholars note a short-term investment horizon as one factor in institutional investors' firm level small holdings[264] and lack of influence. Their strategy is to invest speculatively and hold shares for short periods of time. The investment pattern of institutional investors is thus similar to that of individual investors, making them similarly unlikely to monitor. Still, there is no doubt that the institutional investment industry in China is growing.[265] This should remain true especially after the 2015 and 2016 stock market collapses, when institutional investors were instructed to increase their positions.

An additional impediment relates to competency issues in the industry, which is relatively young and not yet skilled enough to have a meaningful effect on managerial powers.[266] The Qualified

269 (2013) [hereinafter Shenzhen Stock Exchange Fact Book], *available at* https://web.archive.org/web/20170722151420/http://www.szse.cn/UpFiles/largepdf/20150319145710.pdf (in Chinese). *But see* Clarke, *supra* note 3 , at 147, 154 ("official and unofficial investment funds often use (legally or illegally) individual accounts.").

260 *See* ROBERT C. POZEN, TACKLING THE CHINESE PENSION SYSTEM 3–6, 8 (2013), *available at* https://www.brookings.edu/wp-content/uploads/2016/06/31-reforming-chinese-pension-system-pozen.pdf. Insurance funds and mutual funds have other restrictions. *See also* Chao Xi, *Institutional Shareholder Activism in China: Law and Practice*, 17 INT'L COMPANY & COMM. L. REV. 251, 252 (2006).

261 The new rules allow pension funds to invest up to thirty percent of their net assets in domestic equities. Guowuyuan Guanyu Yinfa Jiben Yanglao Baoxian Jijin Touzi Guanli Banfa de Tongzhi (Guofa (2015) 48 hao) (国务院关于印发基本养老保险基金投资管理办法的通知 (国发 （2015） 48 号)) [State Council Administrative Measures for Investment Management of Pension Funds] (promulgated by the St. Council, Aug. 17, 2015) [hereinafter State Council Administrative Measures for Investment Management of Pension Funds], http://www.gov.cn/zhengce/content/2015-08/23/content_10115.htm.

262 For general information, *see* QUANGUO SHEHUI BAOZHANG JIJIN LISHI HUI [NATIONAL COUNCIL FOR SOCIAL SECURITY FUND], http://www.ssf.gov.cn (last visited May 25, 2019).

263 Jiang & Kim, *supra* note 80, at 197 tbl.6, 211.

264 *Id.* at 211 (pointing to an average holding period of less than six months by mutual funds in 2011). Previous research had pointed to even shorter holding periods (one to two months). *See* Clarke, *supra* note 3, at 154-155.

265 *See* State Council Administrative Measures for Investment Management of Pension Funds, *supra* note 261, arts. 36, 37. This move was said to potentially contribute up to RMB 600 billion, managed by the PRC pension fund, into the PRC domestic stock markets. *See* Phillip Inman, *China to Allow Pension Funds to Invest in Stock Market for the First Time*, GUARDIAN, (Aug. 23, 2015, 3:39 PM), https://www.theguardian.com/world/2015/aug/23/china-to-allow-pension-fund-to-invest-in-stock-market-for-first-time.

266 Yongbeom Kim et al., *Developing Institutional Investors in People's Republic of China*, (World Bank, Country Study Paper No. 30248, 2003), http://documents.worldbank.org/curated/en/280421468743976037/pdf/302480CHA0deve1titutional0investors.pdf. For a more recent and more positive analysis of institutional investors in China, *see* Xi, *supra* note 259.

Foreign Institutional Investors (QFII)[267] program was expected to bring experience and professional skills that would improve the quality of domestic institutional investors and their market involvement levels.[268] The "educational" value of QFIIs, however, remained marginal. Confined by operational quotas and informational asymmetries due to operating in a foreign system, QFIIs have prioritized maintaining a strong relationship with Party-state controlling shareholders. QFIIs often entrust the controller's appointees to vote on their behalf,[269] instead of opting for direct action that might maximize value for their unit holders and other minority shareholders.[270] It should nevertheless be noted that in recent years the Chinese government has increased the QFII quota allotment several times.[271]

Other recent initiatives outside the QFII system were taken in a similar direction. The 2013 Shanghai Free Trade Zone included various experiments with a reduction of barriers to foreign investors' participation in the capital market.[272] At the national level, the recent China–Hong Kong Stock Connect initiative and the Mutual Recognition of Publicly Offered Funds between Hong Kong and the PRC were designed to increase investments by off-shore institutional investors and to introduce a wider range of investment tools into the PRC domestic market.[273] These recent initiatives will presumably somewhat increase the activity of foreign institutional investors that are less embedded in business group affiliations and Party-state control than domestic institutional investment firms. On the margins, increasing the scope of authorized foreign investors might, with time, bring more engagement by institutional investors, as hoped for.

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[267] The program was introduced in 2002, revised in September 2009, and once again in December 2012. A separate program was approved in 2011 to facilitate the use of Renminbi held outside mainland China for investments in the domestic market – Renminbi Qualified Foreign Institutional Investors. General information on the QFII and RQFII schemes, including summaries of important policy revisions and relevant quotas, is available on the Shanghai Stock Exchange website. *QFII & RQFII*, SHANGHAI STOCK EXCHANGE, http://english.sse.com.cn/investors/qfii/what/ (last visited May 13, 2019). For ease of reference, I will refer to these programs together as QFII.

[268] *See generally* Tarun Khanna & Krishna Palepu, *Emerging Market Business Groups, Foreign Intermediaries, and Corporate Governance*, *in* CONCENTRATED CORPORATE OWNERSHIP 265, 319 (Randall K. Morck ed., 2000).

[269] OECD, CORPORATE GOVERNANCE OF LISTED COMPANIES IN CHINA: SELF-ASSESSMENT BY THE CHINA SECURITIES REGULATORY COMMISSION 39 (2011), *available at* http://www.oecd.org/daf/ca/48444985.pdf.

[270] *See* Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169, 190 (2004) (providing examples of how these considerations may have led to the generally passive role of foreign institutional investors in Japan, South Korea, and Taiwan as well).

[271] *See supra* note 267. *See also QFII Investment Quota to be Increased by 50 Billion U.S. Dollars*, CHINA SEC. REG. COMMISSION (Mar. 4, 2012), http://www.csrc.gov.cn/pub/csrc_en/OpeningUp/RelatedPolices/QFII/201212/t20121210_217805.html.

[272] *See Policy Measures for the Capital Market to Support and Promote the Shanghai Free Trade Zone*, CHINA SEC. REG. COMMISSION (Sept. 29, 2013), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201311/t20131126_238765.html.

[273] The mutual stock-connect initiative allows off-shore retail and institutional investors mutual stock market access between the SSE and the Hong Kong Stock Exchange. The Mutual Recognition of Funds opened up an authorization process for off-shore funds to trade in the respective domestic markets, thus increasing the access of PRC and Hong Kong investors to asset management funds registered in the Hong Kong/PRC market, respectively. *See Mainland-Hong Kong Mutual Recognition of Funds*, SECURITY FUTURES COMMISSION, https://www.sfc.hk/web/EN/faqs/mainland-hong-kong-mutual-recognition-of-funds.html (last visited May 25, 2019).

Given the likelihood that the market share, competency, and sophistication of institutional investors in China will increase in the foreseeable future, the question then arises whether the industry *could* become meaningful in corporate governance and, if so, *how*. Can institutional investors in China become actively involved in the governance of listed firms, and might they actively monitor corporate insiders at least to the extent that they do so in other concentrated markets? In my view, other impediments established in China's political economy will continue to stand in the way of a more active and influential institutional investors industry.

The following factors will likely prevent institutional investors from becoming true stewards of public shareholders' interests in the Chinese capital markets. First, institutional investors in China are subject to close regulation, supervision, and enforcement at several administrative levels. Various competing central government ministry-level bodies regulate the industry: the CSRC, the China Insurance Regulatory Commission, the China Banking Regulatory Commission, National Council for Social Security Fund, and the State Administration of Foreign Exchange. This divided regulatory and supervisory system produces multiple, cumbersome, and often overlapping regulations and competing interests that limit institutional investors' initiative and autonomy.[274] It may also hold back policies that the CSRC would have otherwise promoted and that might have encouraged institutional investors to be more engaged. For example, it likely impedes any potential intention to require cumulative voting or to mandate voting by institutional investors on certain matters, as seen in other concentrated markets.[275]

Most importantly, China's state capitalism attributes are likely to inhibit institutional investor engagement in governance going forward as well. Even compared to other concentrated markets, the conflicts of interest experienced by PRC institutional investors are particularly acute. Firms in the institutional investors industry are closely affiliated with SOE groups, publicly listed firms, and their senior insiders through ownership and contractual arrangements, as well as with key political players

[274] For instance, both the CSRC and the State Administration of Foreign Exchange are responsible for the administration of the QFII schemes. *See QFII & RQFII* , *supra* note 267. The CSRC and the China Insurance Regulatory Commission share administrative authority over the operation of pension insurance funds that are also securities investment funds. The authority of the China Banking Regulatory Commission to regulate and supervise the entire banking industry includes some authority interface with the CSRC's authority over mutual funds, since financial institutions often operate as securities companies.

[275] The CSRC requires disclosure of the votes of the ten largest public shareholders on certain issues discussed at a shareholders meeting. *See* Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohu de Ruogan Guiding (关于加强社会公众股股东权益保护的若干规定) [Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders] (promulgated by the Sec. Regulatory Comm'n, Dec. 7, 2004), art. 1.1.(5) [hereinafter CSRC 2004 Provisions], *available at* http://shlx.chinalawinfo.com/ newlaw2002/slc/slc.asp?db=chl&gid=56204. Yet, there is no affirmative duty of institutional investors to vote (a duty that regulators in other markets, e.g., Israel, require for certain matters). The CSRC could, potentially, push for a corresponding mandatory vote. Without such a requirement and given institutional investors' network affiliation described above, a requirement to disclose the votes is more likely to discourage the vote of these public shareholders altogether.

at various levels of the Party-state system.[276] Furthermore, the Party-state is strongly involved in the capital market not only through its control of many listed companies, but also through its control over the financial industry and the major players in the investment sector. Besides the state's direct ownership in financial firms and securities companies,[277] another way the Party-state exercises control over the industry is through the reshuffling of senior executives between firms in the industry and between firms and the administering state organs.[278]

Thus, in the PRC, central organs of the Party-state have not only both administrative and regulatory control over the financial and investment sectors, but also absolute ownership and management control of the firms in these sectors. The PRC Party-state is therefore able to advance its interests through its controlling shareholder position in its subsidiary listed firms, through state regulatory agencies and the legal system, and also through its controlling ownership position in most of China's fund managers, insurance companies and other public investment vehicles, securities companies, and banks.[279]

This control model certainly poses barriers to institutional investors acting autonomously from the larger Party-state apparatus. The solutions applied in other concentrated markets, through which institutional investors are empowered and their conflicts are somewhat overcome,[280] are simply irrelevant in the Chinese context. For example, the institutional investor industry embedded in the Party-state system will not exercise even a formally granted minority veto against Party-state

[276] *See* Firth et al., *supra* note 198 (providing an interesting insight into institutional investors' decisions during the split-share structure reform, when mutual funds were pressured politically to accept compensation schemes to rush the implementation of the reform even when not in the best interests of their unit holders); Xi, *supra* note 260, at 258–63.

[277] *See, e.g.*, LARDY, *supra* note 31, at 20–23 (measuring state control over the financial industry by asset-holding ratio, finding that private bank assets account for only seventeen percent of all bank assets, and ascribing a more limited scope to institutional investors).

[278] For example, transfers of executives between the central bank, commercial banks, and branches of the administration such as China Banking Regulatory Commission and the CSRC. *See* Nicholas C. Howson, *China's Restructured Commercial Banks—The Old Nomenklatura System Serving New Corporate Governance Structures?*, *in* CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES AND GLOBAL IMPACT 123 (Martha Avery et al. eds., 2009).

[279] Kim et al., *supra* note 266. *See also* HONG KONG STOCK EXCHANGE, INSTITUTIONAL INVESTORS IN MAINLAND CHINA (2004), *available at* https://www.hkex.com.hk/eng/stat/research/rpaper/Documents/IIMC.pdf.

[280] Such as negative veto rights, super majority requirements, mandatory participation of minority public shareholders in certain business decisions, minority public shareholder involvement in directors' elections, and their right to submit governance proposals to the board. *See, e.g.*, OECD, *supra* note 163, at 30–37 (listing countries that have adopted various forms of minority negative veto rights). Israel is one example of a highly-concentrated market where the state regulator sought to increase institutional investor participation and power by addressing the passivity of institutional investors and their co-option within a larger, dominated group and the potential conflict of interest resulting therefrom. Israel's Company Law requires that an "extraordinary" transaction between the company and its control party (including affiliates) be approved by the shareholders' general meeting, provided that the approving majority votes will include a majority of disinterested (minority) shareholders participating in the meeting (abstentions not counted). The minority approval requirement is in addition to an approval by an audit committee and by the board of directors. *See* Company Law, 5759-1999, § 275(a),1 LSI 44 (1999). At the same time, various financial laws and regulations mandate that institutional investors cast a vote in certain matters, thereby leveraging shareholder consent into a regulatory device. Hamdani & Yafeh, *supra* note 255, at 696–700.

controlling shareholders, such as the one provided for in the CSRC 2004 Provisions.[281] Likewise, an effort like the one recently taken in Israel in which business groups were structurally and actively required to disentangle—separating institutional investors from industrial firms—is not a viable option in the Chinese case.[282] Separating the affiliation of asset management institutions from corporate groups in China will not suffice to eliminate their complex conflicts of interest. Real autonomy and independence of institutional investors from the corporate groups would require their detachment from the Party-state. This scenario is unlikely. Such an overhaul would contradict the reasons for which the Chinese state capitalism system was established in the first place and maintained thus far. Hence, even if the market share and proficiency of domestic institutional investors in China grows, that increase will not translate into any reduction in control by corporate insiders or any increase in real stewardship and governance engagement by institutional investors in the cases where it is needed the most.

ii. Coalition-Building Shareholder Monitoring

Nongovernmental organizations, nonprofit organizations, and other social organizations are emerging as significant stakeholders in several concentrated markets.[283] These players are often involved in governance indirectly, by instigating broad public attention that puts pressure on controlling shareholders and directors and by lobbying regulators for public shareholder–friendly corporate governance mechanisms. In some systems, social organizations may facilitate coalition-building share-ownership for public shareholders, especially where institutional investors are less prominent. In this capacity, they may actively participate in governance by exercising their associated governance rights through voting, submitting shareholder proposals, and taking advantage of ex-post legal claims.[284] Their involvement can discipline corporate insiders and control parties, expose problems, and push firms and their management to act in a socially responsible manner.

[281] CSRC 2004 Provisions, *supra* note 275, art. 1.1.(5). The ownership-market structure and the network of conflicting interests make it more reasonable to assume that institutional investors, when involved, will take informal private negotiations as their preferred method.

[282] In a novel regulatory step, the Israeli legislature adopted "The Law for the Decrease of Concentration and Increase of Competition." It aims to strengthen competition and curtail the excessive clout of a relatively small number of business groups over the Israeli economy by limiting pyramid groups to two holding layers and separating ownership of financial institutions from non-financial corporations. *See* Ido Baum et al., *What Is Israel's New Business Concentration Law and Why Should We Care?*, HAARETZ (Dec. 29, 2013, 12:03 PM), http://www.haaretz.com/israel-news/business/1.565986.

[283] *See, e.g.*, Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EUR. FIN. L. REV. 328, 350–54, 370 (2013) (describing a decline in hedge fund activism in Italy and the rise of the "Assogestioni"—a nonprofit association that serves as a facilitator for minority shareholder minimum board representation and advocates stronger engagement of intermediaries in corporate governance); Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169 (2004) (discussing NPOs governance participation as shareholders as one of the most important corporate law enforcement agents in South Korea, Taiwan, and Japan).

[284] Emma Sjöström, *Translating Ideologically Based Concerns: How Civil Society Organizations Use the Financial Market to Protect Human Rights*, 6 INT'L J. ENV'T & SUSTAINABLE DEV. 153 (2007).

In the French capital market, for example, *associations d'actionnaires* ([public] shareholders' associations) have become influential institutions able to coordinate minority shareholder action, despite significant ownership concentration in French firms long supported by the government. The French Commercial Code permits public shareholders with at least five percent of the voting rights and that have held their shares for more than two years to form *associations d'actionnaires* to act in concert to further public shareholders' collective interests.[285] Scholars have argued that coalition-building efforts enabled by these associations have meaningfully strengthened minority public shareholder engagement in the governance of French firms.[286]

It is unlikely, however, that a role comparable to the one played by the French shareholders' associations is possible for Chinese social organizations in the capital markets governed by the PRC's authoritarian, single party regime. The need for social organizations to be able to rely on law and legal institutions to enforce their rights, as well as an ability to publicly critique corporate misconduct through a relatively free financial press, are functions that are not readily available in China. The Chinese People's Courts are not an independent branch of government and are part of the Party-state bureaucracy. This means that the Chinese judiciary is weak and, in many cases, lacks the technical competence, bureaucratic autonomy, or political independence necessary for it to act against far more powerful Party-state actors.[287]

Furthermore, one must understand the current state of civil society in China in order to assess the possibilities for Chinese social organizations, even as shareholders, as corporate governance participants in the PRC. The emergence of civil society, including citizens' access to rights-enforcing institutions, is a matter of some complexity in China, but clearly the Western notion of freedom of association is absent. Civil society and social organizations, as well as the financial press, are largely confined to areas that do not threaten central Party-state interests or that can help the center keep local power in control.[288]

In addition to these limitations on the judicial system, the financial press, and civil society at large, there also exists in China an embedded traditional cultural perception that the legal system is a coercive instrument of control and that administration is to be reserved to the state.[289] As Clarke puts

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[285] *See* CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] arts. L.225-103, L.225-105, L.225-230-L.225-233, L.225-252 (Fr.). *See also* Yaron Nili, *Missing the Forest from the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157, 197-98 (2014) (discussing relevant sections of the French CODE DE COMMERCE).

[286] Girard, *supra* note 255. *See also* Nili, *supra* note 285, at 199, n.229.

[287] Howson, *Corporate Law in the Shanghai People's Courts*, *supra* note 142, at 327-356. I discuss the People's Courts more extensively below.

[288] *See, e.g.*, BRUCE J. DICKSON, WEALTH INTO POWER: THE COMMUNIST PARTY'S EMBRACE OF CHINA'S PRIVATE SECTOR (2008); Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASH. U. GLOBAL STUD. L. REV. 241 (2009); Benjamin L. Liebman, *Changing Media, Changing Courts*, *in* CHANGING MEDIA, CHANGING CHINA 150, 151 (Susan L. Shirk ed., 2011); Benjamin Van Rooij, *People's Regulation: Citizens and Implementation of Law in China*, 25 COLUM. J. ASIAN L. 116 (2012); Benjamin Van Rooij, *The People vs. Pollution: Understanding Citizen Action against Pollution in China*, 19 J. CONTEMP. CHINA, 55 (2010).

[289] *See, e.g.*, Derk Bodde, *Basic Concepts of Chinese Law: The Genesis and Evolution of Legal Thought in Traditional China*, 107 PROC. AM. PHIL. SOC'Y 375 (1963); Liang Zhiping, *Explicating "Law": A Comparative Perspective of Chinese and Western Legal Culture*,

it, "The notion that private citizens should be involved in law enforcement for public goals does not find a ready home in… [the] Chinese political culture. The state jealously guards its control over the machinery of coercion…."[290] Thus, law and legal institutions operate so as to restrict any non-state institutions, especially social organizations, from taking the lead on the enforcement of private rights of any kind. This is certainly the case when they are asked to enforce private shareholders' rights against superior forces of the PRC Party-state.

The exclusion of private rights holders from effective use of the formal legal system, coupled with a strong concern about the maintenance of social and political stability, are evident in the constraints applied on private enforcement through group litigation. These constraints deny securities law class actions outright and radically minimize the number of corporate law derivative lawsuits, especially those involving Party-state controlled companies or their management.[291] Thus, while some Chinese social organizations may now operate legally, they are extremely unlikely to be permitted any meaningful role in disciplining and monitoring corporate control parties.[292]

2. Other Internal Governing Bodies

i. Board of Directors

The board of directors plays a central role in corporate governance and is defined as the main internal governance body in many modern corporate laws.[293] The board appoints senior managers, makes major policy decisions and approves others, and generally oversees the operations of the firm. Elected by the firm's shareholders, the directors' oversight replaces a more costly and harder-to-coordinate monitoring by shareholders.

In controlled firms, however, and more generally in concentrated markers, board independence and its commitment to *all* shareholders is challenged on both operational and normative levels. The firm's controlling or dominant shareholders dictate the election of board members in controlled firms. This is clearly the case in China. The Company Law requires listed firms, as well as other CLSs in the PRC, to have at least five directors on their board and no more than nineteen.[294]

3 J. CHINESE L. 55 (1989). Both sources emphasize the punitive and coercive aspects of the Chinese traditional legal system through an analysis of China's legal culture and the meaning of "Law."

[290] Clarke, *supra* note 288, at 242–43 (concerning private litigation, but applicable to other private enforcement channels).

[291] Howson & Clarke, *supra* note 181, at 254-257.

[292] A possibility remains that some form of a quasi-public institution will be established with the endorsement of the party-state. A party-state-sanctioned institution is vastly more likely to be permitted greater latitude to promote minority public shareholder interests. For my previous exploration of this option, *see* Groswald Ozery, *supra* note 101.

[293] For examples in the United States, *see, e.g.*, Delaware General Corporation Law, Del. Code tit. 8 § 141. *See also* Model Bus. Corp. Act § 8.01 (AM. BAR ASS'N, 2002). Conversely, according to the PRC corporate law, the shareholders' assembly is defined as "the company's organ of power." 2005 Company Law, *supra* note 147, art. 98.

[294] 2005 Company Law, *supra* note 147 art. 108. Articles 46-48 stipulate the board's powers. *See id.* arts. 46-48.

The shareholders' meeting elects and dismisses the directors, and also has the power to decide on matters regarding their salary and other compensation.[295] Majority rule – and thus decisions by the controller or by dominant shareholders – generally determines the results of the shareholders' meetings, including decisions respecting directors..

Most board members, and the board of directors as an organ of internal governance, therefore lack independence and are largely captured by the controlling shareholders who appointed them. This weakness of oversight by boards of directors in controlled companies is especially significant when corporate malfeasance is done by the controlling shareholders or their affiliates in the firm. To address this concern, some systems have opted to guarantee minority shareholder board representation through different means, such as cumulative voting.[296] China's Company Law, however, includes only an optional cumulative voting provision.[297] The Code of Corporate Governance actually does require listed firms with a dominant shareholder that owns more than thirty percent of the votes to have cumulative voting for the selection of directors and supervisors.[298] However, as mentioned earlier, the Code is rarely enforced and merely offers a standard setting. Surprisingly, a recent study found that a large majority of PRC listed firms have included cumulative voting in their articles of association. Yet, the formal adoption of cumulative voting in these firms had only limited implication in practice.[299] Firms either did not exercise their cumulative voting mechanisms or the implementation did not bring more independence to the board through minority shareholder representation for other reasons.

In sum, board members in China often turn a blind eye or even cooperate with insiders' misconduct when it occurs under the cover of the controlling shareholder's support or acquiescence. When board members do monitor management, they do so to protect the interests of controlling shareholders. Their incentives and ability to represent *all* shareholders are undermined. Such weakness emphasizes the importance of having other strong internal monitoring governance bodies, such as independent directors and audit committees, as well as a strong ex-post accountability regime.

ii. Independent Directors

Over the last two decades, particularly following the wave of corporate scandals of the early 2000s, independent directors have become an important element of corporate governance and the

[295] *Id.* arts. 37, 99.
[296] Non-controlling shareholders' board representation is required in Italy. *See* Erede, *supra* note 283, at 350–54.
[297] 2005 Company Law, *supra* note 147, art. 105. ("A shareholders' assembly *may adopt* a cumulative voting system to elect the directors or supervisors according to the bylaw or its resolutions.") (Emphasis added.).
[298] Code of Corporate Governance for Listed Companies in China (promulgated by the China Securities Regulatory Commission and the State Economic and Trade Commission, Jan. 7, 2001), art. 31 [hereinafter Code of Corporate Governance], *available at* http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69223.html.
[299] Chao Xi & Yugang Chen, *Does Cumulative Voting Matter? The Case of China: An Empirical Assessment*, 15 EUR. BUS. ORG. L. REV. 585, 585-613 (2014).

focus of corporate legal reform in many countries.[300] While legal systems use different terms and definitions for this internal governance institution,[301] independent directors in all systems share a prescribed capacity to monitor corporate control parties (either generally or with respect to specific transactions).

This development in corporate governance did not bypass China. China's Company Law contains a general and obscure provision about independent directors, leaving the matter to secondary regulation.[302] Among the various relevant rules,[303] the most pertinent and comprehensive set of rules is the CSRC-issued 2001 Independent Directors Guidance for Listed Firms (here, Independent Director Guidance, or the Guidance).[304] Per the Guidance, one-third of the total number of directors on the board of any listed company should be independent, with at least one independent director being an "accounting professional."[305] Listed companies are required to include independent directors in their articles of association.[306]

The Guidance imposed on independent directors "a duty of good faith and due diligence and care to the firm and all its shareholders."[307] They "shall protect the overall interests of the company

[300] In the United States, the main relevant governance reforms include the 2002 Sarbanes-Oxley Act, the 2003 revisions in NYSE and Nasdaq listing rules, and the 2010 Dodd-Frank Act. *See generally* Ronald W. Masulis et al., *Directors: Older and Wiser, or Too Old to Govern?* (European Corp. Governance Inst., Finance Working Paper No. 584/2018, 2018), https://ssrn.com/abstract=3284874. A greater role for independent directors is reported in the United Kingdom following the release of the Cadbury Report, and similar trends are observed in Japan in the same period. For a review of this trend, *see* Clarke, *supra* note 71, at 150-175.

[301] For a complete analysis, *see* Clarke, *supra* note 71.

[302] 2005 Company Law, *supra* note 147, art. 122. ("A listed company shall have independent directors. The concrete measures shall be formulated by the State Council."). This provision applies specifically to publicly listed firms and not to joint stock companies more generally.

[303] For the current legal framework, *see id.*; Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies, (promulgated by the China Sec. Regulatory Comm'n., Aug. 16, 2001) [hereinafter Independent Directors Guidance], http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.html; Code of Corporate Governance, *supra* note 298, which includes "best practices" guidance with no specific number of independent directors nor specific powers prescribed for conflicted transactions); CRSC 2004 Provisions, *supra* note 275; CSRC Guidelines for the Articles of Association of Listed Companies (2016 Amendment) (promulgated by China Sec. Regulatory Comm'n, Sept. 30, 2016), *available at* http://www.csrc.gov.cn/pub/csrc_en/laws/rfdm/DepartmentRules/201804/P020180427331974952658.pdf (which in article 96 limit the number of "inside directors" to no more than fifty percent of all directors, but define them as those who concomitantly serve as executives or employee representatives—therefore opting not to refer to their independence from other controlling parties); Shangahi gongsi duli dongshi luz hi zhiyin ([上市公司独立董事履职指引) [Guidelines for the Performance of Duties by Independent Directors of Listed Companies] (promulgated by the China Association for Pub. Companies (CAPO), Sept. 12, 2014) (a national self-regulatory nonprofit organization, supervised by the CSRC, that issues recommended best practices to listed firms).

[304] Independent Directors Guidance, *supra* note 303. The Guidance was, and still is, the most detailed effort to establish the institution of independent director in Chinese listed companies, but it was not the first. There had been prior initiatives at various administrative levels—local governments, central ministries, stock exchanges, and the CSRC itself—of various scopes and varying degrees of commitment. For a complete review, *see* Clarke, *supra* note 71, at 175-201. Clarke's review shows how the CSRC in its draft and prior efforts actually aimed to establish a far more rigorous independent director mechanism that would have had broader and more specific powers in the firm than those finally established by the Guidance.

[305] Independent Directors Guidance, *supra* note 303, art. I.3.

[306] *Id.*

[307] *Id.* art. I.2.

and shall be especially concerned with protecting the interests of minority shareholders from being infringed."[308] To that end, the Guidance limits the number of firms in which an independent director can hold a similar concomitant position to five, and emphasizes their independence from the "influence of the company's major shareholders, actual controllers, or other entities or persons who are interested parties of the listed company."[309] From this it seems clear that the CSRC took the position that an independent director should serve the interests of the company while protecting particularly public shareholders and being free from the influence of any interested party.

Various powers are formally conferred upon independent directors. They are given a role in the auditing, nomination, and compensation board committees, of which they should constitute at least half of the members "when such committees are set up."[310] They are given the power to approve major related party transactions before such transactions are submitted to board discussion.[311] They can propose engagement with an accounting firm to the board and propose that the board of directors call a special shareholders' meeting or a meeting of the board. Independent directors can appoint outside auditors and consultants, and they can solicit proxies before a shareholders' meeting is held.[312] None of these powers are binding except perhaps the power to approve major related party transactions. The binding effect of that approval is also questionable considering that non-compliance requires merely a disclosure.

Independent directors are also required to offer an opinion on certain matters, including decisions on the appointments, dismissals, and remunerations of other directors and senior managers. An opinion is also required on any event that the independent director considers to be detrimental to the interests of minority shareholders.[313] Where the matter is subject to public disclosure by other laws

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[308] *Id.*

[309] *Id.* The "Independence Requirement" is further made clear, in article III:

"III. Independent directors shall meet the "independence" requirements:

A person may not hold the position of the independent director in any of the following circumstances:

1. a *person who holds a position in the listed company or its affiliated enterprises, their direct relatives and major social relations* (direct relatives refer to their spouse, father, mother and children etc.; major social relations [these are also based on familial ties] refer to their brothers, sisters, father-in-law, mother-in-law, daughter-in-law, son-in-law, spouse of their brothers, sisters, and their spouse's brothers and sisters etc.);

2. a *person who holds more than 1 percent* of the outstanding shares of the listed company *directly or indirectly, or the natural person shareholders of the 10 largest shareholders of the listed company, or such shareholder's direct relative;*

3. a person who *holds a position in a unit which holds more than 5 percent of the outstanding shares of the listed company directly or indirectly, or of the unit which ranks as one of the 5 largest shareholders of the listed company, or such employee's direct relative;*

4. a person meeting any of the three above-mentioned conditions in the immediate proceeding year;

5. a *person providing financial, legal or consulting services to the listed company or its subsidiaries*;

6. a person stipulated in the articles of association;

7. a person determined by the CSRC."

Id. art III. (Emphasis added.)

[310] *Id.* art. V.4.

[311] *Id.* art. V.1.a (defining "Major related party transactions" as transactions with related parties in whose "total value exceeds RMB three million or 5 percent of the company's net assets audited recently").

[312] *Id.* art. V.4.1.b-f.

[313] *Id.* art. VI.

("1. Apart from carrying out the above-mentioned duties, the independent director shall provide the independent opinion on the following matters to the board of the directors or to the shareholders' meeting:

and regulations, their opinion should also be disclosed, and where consensus was not reached, their opinions should be disclosed separately.[314] While these disclosure provisions seem relatively far reaching and might lead independent directors to perform their role in earnest, they might also cause them to suppress their judgment, side with their peers to reach a consensus, or simply default to a no-comment opinion for fear of retaliation by the interested parties.

Existing evidence shows that most companies have followed the Guidance with respect to the appointment of independent directors and made relevant bylaw amendments.[315] This fact alone, however, does not say much about the directors' performance of the above roles in practice or the practice the institution brings to shareholders and corporate governance more generally. Given that the Guidance has been in effect for almost two decades, these aspects can now be tested.[316] The empirical studies on this subject have produced vague and often conflicting results.[317] There is general theoretical skepticism about the ability of independent directors to effectively perform their oversight

a. Nomination, appointment or replacement of directors;
b. Appointment or dismissal of senior managers;
c. Remuneration for directors and senior managers;
d. Any existing or new loan borrowed from the listed company by or other funds transfer made by the company's shareholders, actual controllers or affiliated enterprises that exceeds RMB three million or 5 percent of the company's net assets audited recently, and whether the company has taken effective measures to collect the amount due;
e. Events that the independent director considers to be detrimental to the interests of minority shareholders;
f. Other matters stipulated by the articles of association.")

[314] *Id.* arts. VI.2, VI.3. The Guidance does not make clear whether the identity of each independent director should be disclosed along with her/his opinion.

[315] Clarke, *supra* note 71, at 200.

[316] Clarke's review includes the limited empirical research that was available at the time, which mainly examined the characteristics of independent directors (educational and professional background and their salary).

[317] Here is a sample of relevant empirical studies:
Juan Ma & Tarun Khanna, *Independent Directors' Dissent on Boards: Evidence from Listed Companies in China*, 37 STRATEGIC MGMT. J. 1547 (2016) (examining 24,212 independent directors' opinions disclosed between 2001 and 2010 and identifying scarce instances of dissent (only in 119 individual cases). The study concludes that independent directors would generally defer to top management and that dissent is more likely when there is an "end game" situation in the firm); Xuesong Tang et al., *The Effectiveness of the Mandatory Disclosure of Independent Directors' Opinions: Empirical Evidence from China*, 32 J. ACCT. & PUB. POL'Y 89 (2013). (suggesting that independent directors' "NO" opinion, signals negatively to public shareholders, affecting firm value); Lihong Wang, *Protection or Expropriation: Politically Connected Independent Directors in China*, 55 J. BANKING & FIN. 92 (2015) (based on 7,487 firm observations between 2003 and 2012, the author suggests that politically connected independent directors—an independent director who is a former government official or a current or former member of the People's Congress / CPPCC— enlarge the magnitude of related-party transactions with the controlling party in both listed privately controlled firms and listed local SOEs. Notwithstanding, the author also concludes that a large fraction of politically connected independent directors increases firm value in Chinese-listed, privately controlled firms but is detrimental to firm value of listed SOEs, especially those under local-government control); Karen Lin et al., Voice or Exit? Independent Director Decisions in an Emerging Economy (Oct. 22, 2012) (SSRN paper), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166876 (examining independent directors' opinions and resignation notices by Chinese listed firms between 2005 and 2009. The authors find that the likelihood of an opposing or dissenting opinion by an independent director is low (only 179 of a sample of 47,052 opinions, or 0.38 percent of all opinions). In contrast, the authors also find that voluntary resignation by an independent director is a more common event (1.8 percent of independent directors resigning before the end of their appointment each year). The authors conclude that independent directors are more likely to resign than to dissent when they have private information about adverse corporate events.).

role, particularly where controlling shareholders exist.[318] Similarly, the debate around the practical contribution of this institution to corporate governance and firm performance is unsettled elsewhere as well.[319] With respect to China, the value brought by independent directors to shareholders and the functional efficacy of this monitoring mechanism are questionable.

Upon inspection of the Guidance and other related legal frameworks,[320] three major impediments clearly stand in the way of making independent directors effective monitors in China. First, controlling or dominant shareholders can ultimately elect the independent directors.. According to the Guidance, the board of directors, supervisory board, and shareholders who independently or jointly hold more than one percent of the shares may nominate independent directors.[321] The shareholders' meeting then votes on and elects the nominees are by majority vote. The very nature of the independence of independent directors is therefore dubious, particularly with respect to future decisions when they might feel that they owe their election to a particular shareholder. The complex network of business, social, and political ties surrounding listed firms in China, and the identity of the controlling shareholder, commonly a state body,[322] only make the availability of true independent directors more scarce.[323] For example, despite the procedures set in the Guidance, a recent study found that the chairman of the board in firms, usually the representative of the controlling shareholder, "handpicks" nearly all independent directors from his or her own social network.[324]

Second, under the current legal framework, there seems to be no positive motivation for independent directors to fulfill their intended roles, nor are there any legal consequences for directors or firms that violate the Guidance. While the general fear of liability under fiduciary duties and procedures established in the 2005 Company Law may motivate independent directors,[325] these general incentives are the same as those of inside directors. Nothing is provided to make them act differently.[326] In addition, the binding power of the Guidance is unclear. As a matter of black letter

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318 Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271 (2016) (noting that both the election and retention of independent directors largely depends on the controlling shareholder).

319 *See generally* Ronald W. Masulis & Emma Jincheng Zhang, *How Valuable are Independent Directors? Evidence from External Distractions*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 22, 2018), https://corpgov.law.harvard.edu/2018/05/22/how-valuable-are-independent-directors-evidence-from-external-distractions/ ("empirical assessments of the value of independent directors are decidedly mixed, leaving the value of independent directors an important unsettled question in the literature").

320 *See supra* note 303.

321 Independent Directors Guidance, *supra* note 303, art. IV.1. Before elections, proposed nominees should first be approved by the applicable branch of the CSRC. *Id.* art. IV.3.

322 The independence criteria are focused on independence from natural persons, not institutions. *See id.* art. III.

323 A striking example of this can be seen in a statement of the dean of Changjiang School of Business about his service as an independent director. Clarke, *supra* note 170, at 43 ("I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state.").

324 Ma & Khanna, *supra* note 317, at 1549.

325 On the firm's right to sue on violations of fiduciary duties, *see* 2005 Company Law, *supra* note 147, art. 151. For shareholders' standing with respect to violations of any law, administrative regulation, or bylaws that damaged shareholders' interests, *see id.* art. 152.

326 Clarke, *supra* note 71, at 209-210.

law, the failure to comply with the Independent Directors Guidance (or any other provision pertaining to independent directors under the relevant legal framework[327]) does not seem to constitute illegality or lead to any specific formal enforcement by the CSRC. The CSRC may pressure companies to comply in various soft power-ways, and the general fear of delisting might also encourage compliance, but the Guidance itself does not prescribe any administrative sanctions. This ambiguity concerning enforcement practically renders the implementation of the Guidance selective and leaves it in the hands of firms and their controlling insiders. There is no reason to assume that dominant or controlling shareholders would selectively appoint truly independent supervisors over their heads, particularly given the mixed evidence on the effect of the mechanism on market value.

It is still possible that the pressure of the reputation market could incentive independent directors, once selected, to monitor on behalf of public shareholders.[328] The market for independent directors is likely much sounder today than it was when the Guidance was established, and reputation can play a significant role. However, a recent study that examined independent directors' dissents found that dissent rates dropped drastically after 2006. Independent directors thereafter generally deferred to top management.[329] While the authors did not offer any causal inferences, it is possible that this was a result of a regulatory change. The inclusion of the independent director mechanism in the 2005 Company Law, or possibly the parallel reform that exposed previously-untradeable state shares to market forces for the first time, could have pushed independent directors to be less confrontational, perhaps fearing retaliation by corporate control parties. The evidence of their decreasing dissents might thus reflect that gaining the support of internal corporate control parties substitutes for reputation in the external labor market for future appointments.

Finally, nothing since the Independent Directors Guidance was established has changed the fact that the "requirements" in the Guidance are not mandatory. Firms can still avoid being considered "violators"—and thus avoid repercussions—simply by disclosing their failure to implement. A failure to comply with any of the provisions does not automatically invalidate a decision.[330]

Given the above, it seems that despite the adoption of the institution itself in most listed firms in China today and regardless of its potential effects on market value, independent directors generally do not function to secure the interests of public investors or monitor against corporate malfeasance by corporate control parties.

[327] *See* s*upra* note 303.
[328] I discuss the reputation and managerial labor market as external monitoring institutions below.
[329] Ma & Khanna, *supra* note 317, at 1550.
[330] Independent Directors Guidance, s*upra* note 303, art. V.3 ; Clarke, *supra* note 71, at 194.

iii. Supervisory Board

The PRC's dual board structure combines an Anglo-American style board of directors and a German style supervisory board. In addition to the board of directors, any joint stock company must have a board of supervisors with employee electors. At first glance, it seems that the structure is a transplant of Germany's two-tiered board and co-determination mechanisms.[331] However, the Chinese dual board structure is very different from Germany's mechanism and is widely considered to be a failure. China's 2005 Company Law does mandate that firm employees elect one-third of the supervisory board members and the general shareholders' meeting elects the rest.[332] However, unlike its German inspiration, not only is there no hierarchical relationship between the PRC's supervisory board and the board of directors, but these two supposed monitoring bodies also lack independence from the controlling shareholder. The supervisory board has no power whatsoever with respect to appointing the board of directors, who are elected by the general shareholders' meeting—which is, again, dominated by the controlling shareholder.

Legal reforms and various regulations that have been instituted over the years concerning the governance of PRC listed firms did not even try to correct the sheer irrelevance of the supervisory board. Some options that could have made the supervisory board more relevant to firm governance include granting negative veto rights or requiring the approval of the supervisory board for certain board decisions. Any attempt to empower this institution, which theoretically is supposed to have a supervising function, is entirely missing from both laws and regulations.[333] Thus, instead of constraining the power of control parties or providing any kind of monitoring mechanism that would benefit employees or public shareholders, the Chinese dual board structure further entrenches the power of those dominating the firm.[334]

iv. Audit Committee and/or Other Special Committees

Some legal systems have installed special committees to address intrinsic power imbalances in the ownership structure of firms in their market. These committees are often involved in the approval

[331] I discuss the German board structure further below under both the Creditors and Employee Monitoring subsections.
[332] 2005 Company Law, *supra* note 147, arts. 53, 117, 188. Moreover, article 108 enables the board of directors in CLSs to have employees-elected representatives as well. *Id.* art. 108.
[333] The supervisory board is authorized: to examine the financial affairs of the company; to propose the removal of directors and senior managers who violated their duties, laws, regulations, company bylaws, or shareholders' resolutions, and under certain conditions initiate a derivative lawsuit following such violation; to demand that the violators rectify their actions; to propose a shareholder meeting or to assemble one where the board of directors fail to do so; and to put forward proposals at a shareholders meeting. The supervisory board members may also observe the meetings of the board of directors as non-voters. *Id.* arts. 52-54, 117-118, 152.
[334] Especially since cumulative voting is currently not mandatory. *Supra* note 297 and the accompanying text. *See* Clarke, *supra* note 71, at 161–62, 173–75 (discussing the supervisory board in Germany and the failure of the supervisory board mechanism in China).

process for suspicious transactions, in which conflicts of interests are inherent and the independence of traditional governing bodies is compromised. In Israel, for example, the company law mandates the creation of an audit committee with both independent directors and a majority of outside directors, as well as a compensation committee, in every listed firm.[335] The audit committee is entrusted with auditing the conduct of management and with approving certain related-party transactions. When the transaction is essential or an extraordinary transaction, as defined in the law, the approval process is more stringent, and the audit committee basically receives power to veto the transaction even before it is brought to the board. The same committee is also charged with ensuring that a competitive pricing negotiation process was followed in related-party transactions. Israel's recently-introduced compensation committee is tasked with creating compensation guidelines as well as with approving the compensation of high-ranking company officers. It is required to re-evaluate its guidelines and update them as need be, at least once every three years. All outside directors are required to serve on the compensation committee, and they must comprise the majority of the committee's members.[336]

The Israeli regulator designed these mechanisms to handle the inherent conflicts and power imbalances within Israel's capital market, in which firms' ownership reflects strong controlling shareholders and, until recently, concentrated business groups. In contrast with this regulatory action, China's company and securities laws and regulations do not mandate the creation of similar audit committees or other special committees. As mentioned earlier, independent directors are given a role in the board's auditing, nomination, and compensation committees "if such committees are set up," in which case they should constitute at least half of the members.[337] Thus, internal auditing, including scrutiny of related-party transactions, is left in the hands of the internal governing bodies and is therefore tainted with the problems pertaining to those bodies.[338]

3. Third-Party Corporate Constituents

In many concentrated markets, corporate governance accommodates a role for stakeholders who do not own any equity interest in the firm. Such non-shareholder constituents have some disciplinary power over corporate insiders. While these constituents monitor in their own interest, their interests sometimes coincide with those of public shareholders.

335 *See* Company Law, 5759-1999, § 114, 115, 117, 118(a), 118(b) 1 LSI 44 (1999).

336 For further details on these committees, *see* Itai Fiegenbaum & Amir Licht*, Corporate Law of Israel*, *in* THE LAW OF ISRAEL 10 (Christian Walter et al. eds., 2019) (noting that, "In addition to these statutorily mandated committees, recent court decisions have facilitated the adoption of ad-hoc 'Special Independent Committees'. Purporting to rely on customs and precedents from Delaware courts […].").

337 *See supra* note 310.

338 External institutions (such as the CSRC and the Stock Exchanges) scrutinize related party transactions and financial auditing but the review in this section refers only to the role of intra-firm governing institutions.

i. Creditors

Creditors are perceived to have both the ability, through contractual loan covenants, and incentive to monitor corporate conduct. Since their earnings are based on interest rates and on the firm's residual assets upon liquidation, which both depend on the firm's financial stability, they would like to see the firm maximizing its value. Therefore, conventional wisdom goes, creditors monitor corporate conduct toward this goal. This aligns their interests with those of shareholders to some degree as long as the firm is not facing insolvency. By the same logic, high leverage is known to discipline managers since high levels of debt lead to close monitoring by creditors.[339] In addition, political economies in different systems have created an institutional setting in which creditors own shares in listed firms, thereby aligning the interests of creditors and shareholders more directly.

It is important to distinguish between various types of creditors, which can be roughly classified into external debt providers, such as banks and other loan-providing financial institutions, and corporate bond holders. While the interests of these creditors are similar, their characteristics differ in ways that affect their ability to monitor. For example, corporate bond holders' access to information largely depends on the efficacy of information disclosure in a given market. Widely dispersed corporate bond holders' ability to monitor often depends on third-party intermediary institutions, such as trustees, underwriters, and credit rating agencies. In addition, in order for corporate bond holders to have any disciplinary effect on corporate conduct, they need a well-functioning, liquid debt market through which they can trade their bonds. Finally, since bond issuance agreements are mainly based on boilerplate provisions and rarely provide covenants that involve bond holders in the governance of corporations, corporate bond holders largely depend on ex-post legal enforcement to have their rights protected.

On the other hand, external debt providers, such as banks can establish effective information disclosure processes in their loan agreements and are less dependent on other intermediaries. They are better positioned to negotiate for loan covenants that will require their consent for certain corporate acts, thus giving them more direct monitoring capacity. Banks typically also have enough incentive and means to monitor without the need for coalition building. Finally, while banks do sometimes require the help of enforcing institutions (especially for liquidation proceedings), they are less dependent on them and can rely on their financial position and reputation market sanctions in a repeat-transaction environment.

The best-known examples of systems that have encouraged corporate monitoring by financial institutions as external debt providers are those of Japan and Germany. In both systems this was achieved through parallel equity stakes that large financial intermediaries held in firms. Furthermore, in both systems, the role of financial intermediaries in corporate governance was guided by certain

[339] Michael C. Jensen, *The Eclipse of the Public Corporation*, 67 HARV. BUS. REV. 61 (1989) (concerning the governance power of debt through LBOs).

industrial organizational structures and the local political economy that buttressed their preferred monitoring position. In Japan, cross-holding ownership structures within Japanese post-war conglomerates, the horizontal Keiretsu, relied on a main bank to provide each business group with credit, while holding concomitant shares in the borrowing firms. This has historically positioned the main banks at an informational advantage to monitor poor performance in industrial firms.[340]

In Germany, despite some decrease in ownership concentration,[341] there is still a continued emphasis on the interests of third-party stakeholders, including creditors, which are given a path for direct involvement in the affairs of the corporation. This is achieved mainly through the two-tier board system and the mechanism known as "co-determination."[342] As part of this corporate governance institution, employees and shareholders elect equal numbers of representatives to the supervisory board of large corporations. The supervisory board then appoints the members of the firm's "management board." [343] Since banks in Germany function not only as creditors, but also exert influence as direct and indirect shareholders, and in addition act as something like trustees for public investors, banks often de facto exercise the public shareholders' voting power by proxy.[344] This includes the vote on the selection of supervisory board members and, by extension, management board members. Consequently, the banks' monitoring role as creditors is enhanced through a parallel shareholder (and proxy) position,[345] which gives them access to information and positions them to engage, and sometimes even control, the decision-making process.

As one of the richest economies in the world set in a social democratic political system, which has historically strong banks and weak securities markets,[346] Germany offers an interesting model for comparison with China. Indeed, in China too, while shareholding by financial institutions is slowly being liberalized, capital financing is still overwhelmingly led by bank lending rather than by equity capital markets.[347] As opposed to Germany or Japan, however, China's state-owned commercial banks

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[340] Masahiko Aoki, *Controlling Insider Control: Issues of Corporate Governance in Transition Economies*, *in* CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES 3 (Masahiko Aoki & Hyung-Ki Kim eds., 1995); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, YALE L.J. 871, 871-906 (1993) (yet suggesting an alternative, more complex analysis in which bank monitoring is one component of a complex contractual governance system that monitors the production process); Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 L. & SOC. INQUIRY 425 (2001); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

[341] Marc Goergen et al., *Recent Developments in German Corporate Governance*, 28 INT'L REV. L. & ECON. 175, 178-79 (2008).

[342] John W. Cioffi, *Restructuring "Germany Inc.": The Politics of Company and Takeover Law Reform in Germany and the European Union*, 24 L. & POL'Y 355, 362-68 (2002) (revealing how the choice to preserve a "stakeholder" oriented corporate approach, rather than adopt a pure shareholder wealth one, despite growing dispersion in the capital market, emanated from various political power struggles and continued social obligations).

[343] Goergen et al., *supra* note 341, at 184–86.

[344] The proxy-vote system in Germany provides banks with effective voting powers. *Id.* at 178-186 (noting that historically the bank that owns shares in the listed firm is also the firm's main creditor).

[345] *But see id.* (noting some regression in the scope of monitoring by large banks).

[346] *See* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 71 (2003).

[347] Zhiwu Chen et al., *The Asset Management Industry in China: Its Past Performance and Future Prospects*, J. PROF. MGMT., SPECIAL CHINA ISSUE, 2015, at 12 (showing continuing dominance of bank financing over equity financing, whereby equity financing stayed below five percent of total bank loans in quantity (measured 1991–2013)). *See* Christian Edelmann et al.,

act exclusively as creditors of listed companies because direct equity investment by commercial banks in nonfinancial business enterprises is generally prohibited.[348]

Historically, and to a large degree today, Chinese banks have been conduits of the state and based their lending decisions on political guidance rather than on sound financial considerations. Being connected to the state, therefore, China's main banks lack a "monitoring culture" as well as incentives to monitor.[349] One result is the low default rate of distressed companies, which distorts the market to not reflect risk properly.[350] In fact, an important critique of the design of China's company law is that it emphasizes creditors' protection against "their own misguided lending decisions" rather than enlisting the help of banks in monitoring corporations.[351] Even more striking is the finding that banks continue to lend to firms even in the face of clear cases of continuous tunneling by controlling shareholders.[352]

There are some recent signals that the Party-state is now willing to consider direct equity holding by commercial banks in nonfinancial business enterprises. The Chinese government looks to solve onerous debt burdens seen in many of the PRC's large listed companies, and the central government encourages further rounds of debt-for-equity swaps through various schemes.[353] While China enlisted asset management companies (AMCs) to recapitalize the banks' non-performing loans

Asset Management in China, OLIVER WYMAN (Aug. 2014), http://www.oliverwyman.com/our-expertise/insights/2014/aug/asset-management-in-china.html#.VmTbPa6rRE5 (noting that in 2014, the bulk of China's $145 trillion financial assets were either bank deposits or low risk securities).

[348] *See* Zhongguo Renmin Gongheguo Shangye Yinhang Fa (商业银行法) [Law of the People's Republic of China on Commercial Banks] (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, last amended Aug. 29, 2015), art. 43 [hereinafter Law on Commercial Banks], *available here*: https://www.pkulaw.com/en_law/c42fffd534ac8f10bdfb.html (prohibiting such equity investment by commercial banks unless otherwise provided by regulation). Exceptions to the general prohibition were implemented by a debt-for-equity swap scheme during the late 1990s that allowed indirect equity holding through AMCs. *See infra* note 354 (based on Howson, *supra* note 182). A similar scheme intended to handle non-performing loans and extreme corporate leverage was in the making in recent years. *See* Lingling Wei, *China is Set to Allow Banks to Swap Bad Loans for Equity in Borrowers*, WALL STREET J. (Apr. 15, 2016, 12:40 AM), http://www.wsj.com/articles/china-plans-debt-for-equity-swap-program-to-help-reduce-corporate-debt-1460649581. *See also infra* note 353.

[349] Clarke, *supra* note 115, at 175-176.

[350] By the late 1990s, the financial system was insolvent due to an extreme level of bank lending to failing SOEs and consequent levels of non-performing loans. GREEN, *supra* note 104, at 22. Yet, despite several efforts to rehabilitate and restructure the system, the phenomena of "bad debt" and "soft budget constraints" continue to threaten China's financial strength and resilience (especially from the provincial level down).

[351] Clarke, *supra* note 115, at 176, n.17.

[352] Meijun Qian & Bernard Y. Yeung, *Bank Financing and Corporate Governance*, 32 J. CORP. FIN. 258 (2015).

[353] Evidence of this includes Premier Li Keqiang's announcement concerning an expected reform of the financial system that would, among other aspects, employ market-oriented debt-to-equity schemes to reduce the leverage in enterprises. Lei Ying, *Li Keqiang: Yao Gaige Wanshan Jinrong Jianguan Tixi*, [*Li Keqiang: Reform and Improve the Financial System*], CHINA NETWORK (Mar. 16, 2016), http://www.china.com.cn/lianghui/news/2016-03/16/content_38038507.htm. *See also* Guanyu Shenhua Tourongzi Tizhi Gaige de Yijian (关于深化投融资体制改革的意见) [Opinions on Enhancing the Reform of Financial Investments System] (promulgated by the CCP Central Committee and St. Council, July 5, 2016), art. 10, http://www.gov.cn/zhengce/2016-07/18/content_5092501.htm (mentioning pilot projects in which financial institutions will hold equity in enterprises).

in the past,[354] the AMCs were not found to be effective monitors, since they suffer many of the weaknesses found in the banking system itself—the political clout of the debtor's business group and their own government ownership.[355] But now, for the first publicly celebrated time, direct bank equity holdings were implemented through a debt-equity swap in China Huarong Energy Ltd.[356]

It will be interesting to see if the set of incentives directing the banks' role will change following the expected increase in their direct equity holdings. If applied on a large scale, this could better align the interests of Chinese banks, as creditor-shareholders, with those of public shareholders. It might push banks, as equity-investing creditors, toward real financial monitoring, thus leading to more disciplined management of distressed assets and better risk allocation.

The obvious caveats in this scenario should be noted. Due to the clashing power hierarchy between national firms and leading banks, it is unlikely that the banks will be permitted to have a dominant equity position in firms where a strong central or local state controlling shareholder already exists. Without a dominant position, marginal bank holding will most likely not create enough incentives for the bank to monitor against existing powerful, often politically connected, corporate control parties. Furthermore, and paradoxically, since most banks belong to the state, even if permitted to hold a dominant equity position in firms, there is no reason to believe that the bank will be any different than other state-affiliated controlling shareholders. Thus, theory aside, financial institutions are still instruments of the Party-state and continue to be guided by interests that are different from those of public minority shareholders.

As for the corporate bond market in China and its potential monitoring capacity, there is a similar if not identical political factor. While China's bond market is currently the third largest bond market in the world, trailing only the United States and Japan in 2014, most of the bond market is comprised of government bonds and financial institutions' bonds. Only ten percent of the entire bond

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[354] Four AMCs were created in 1999, carved out of the big four banks to purchase the respective bank's non-performing loans. Organized as wholly state-owned corporations held by the Ministry of Finance, these "non-bank financial institutions" issued their own bonds to the banks to fund the purchase of the non-performing loans, which were then converted to equity. The Ministry of Finance directly guaranteed the AMC bonds. It was intended that AMCs would act to discipline the poorly performing corporations and push for their restructuring when needed. For further review, *see* Howson, *supra* note 182.

[355] Clarke, *supra* note 115, at 177.

[356] The first publicly announced case of a debt-to-equity swap that resulted in direct bank equity holdings in an industrial company was approved in March 2016, whereby a total of RMB 17.1 billion (USD 2.6 bn) worth of debt in China Huarong Energy Ltd (a shipbuilding company) was converted to shares and distributed among various banks and financial-institution creditors, resulting in the issuance of fourteen percent equity shares to the Bank of China, which became the dominant shareholder in the company after the issuance. *See* Lingling Wei, *China Regulators Speed Up Help for Banks on Bad Loans*, WALL STREET J. (Mar. 13, 2016, 8:23 AM), https://www.wsj.com/articles/chinese-regulators-speed-up-bad-loans-1457871782. *See also* Angela Yu, *Bank of China to Become Largest Shareholder in Huarong Energy*, FAIRPLAY (Mar. 10, 2016, 10:43 AM).

To the best of my knowledge, however, article 43 of the Law on Commercial Banks was not yet amended, and neither were other regulations issued to formally enable direct equity holding by commercial banks. *See* Law on Commercial Banks, *supra* note 348, art. 43.

market were corporate bonds in 2014.[357] While this does not necessarily preclude the monitoring capacity of corporate bond holders, it does suggest that considering the large scope of debt financing versus equity financing and the sheer size of bank loans within it,[358] the influence of bond holders is marginal.

In addition, recent data suggests that the main corporate bond holders in China are commercial banks holding sixty-three percent of corporate bonds as of 2014, while individuals represent only two percent of corporate bond holders.[359] If this is correct, then the common bond holders in China are the same credit financiers that provide corporate loans—China's banks, sharing the same characteristics and facing the same impediments to monitoring. Here too firms are shielded through implicit or explicit guarantees by the state.[360] In a cyclical manner, the failure of the general debt market to default distressed firms causes bond holders, as other creditors, to price their risk on the basis of other considerations, such as political connections, rather than on the financial stability of the debtors. This low-risk environment lowers the cost of debt financing and erases creditors' motivation to monitor.

ii. Employees

The embrace of co-determination in China reflects an ambivalent approach toward employee board representation. On the one hand, employee board representation has been an enduring feature

[357] In 2002, the corporate bond market represented only 2.8 percent of the total bond market. *See* Kim et al., *supra* note 266, at 27-30. *But see* HONG XIE, A CHANGING BOND LANDSCAPE IN CHINA (2014) [hereinafter S&P 2014 REPORT], *available at* https://www.spindices.com/search/?query=landscape+china&Search=Go&sortType=Relevance&resultsPerPage=25&ContentType=Research (pointing out that government bonds and policy bank–issued bonds comprised seventy percent of the entire bond market as of September 2014, corporate bonds comprised ten percent, and various financial institutions–issued bonds comprised twenty percent). *But see* Lin & Milhaupt, *supra* note 236, at 2, 7, 15-16 (noting that the measures for "corporate bond" in China include different types of debt instruments, including those issued by local government financing vehicles, therefore reducing the actual size of true corporate issued bonds even further. According to the authors, in 2016, there was a substantial spike in the issuance of corporate bonds after a more lenient approach by the CSRC that started permitting issuance of corporate bonds by unlisted firms. Yet, the authors measured corporate bonds in 2016 to account for nineteen percent of the outstanding balance of the bond market.).

[358] *See supra* note 347.

[359] The remainder is held mostly by non-bank financial institutions. *See* S&P 2014 REPORT, *supra* note 357, at 3. However, note that Lin and Milhaupt present different classification ratios for bond holders as of 2016: 32.2 percent of all outstanding corporate debt instruments are reported to be held by trusts and other non-financial institutions—the vast majority of which are owned by local governments or by SOEs, while the national commercial banks hold 25.4 percent of all outstanding corporate bonds according to the authors. The ratio of individual bond holders and other instruments within the shadow banking system is less clearly differentiated. *See* Lin & Milhaupt, *supra* note 236, at 23-24.

[360] The first bond default was recorded in 2014. The number of firms (mainly private) allowed to default has grown since but is still small due to implicit guarantees mostly from local governments. For an analysis of recent default and near-default cases, *see* Lin & Milhaupt, *supra* note 236, at 37-47 (suggesting that the "no-default norm may begin to unravel as the Chinese economy slows").

of Chinese company law and survived throughout its various legal reforms.[361] China's Company Law still mandates that firm employees elect one-third of the *supervisory* board members of CLSs and the general shareholders meeting elects the rest. Thus, without any share-ownership requirement, China's co-determination legal provision could presumably give rise to engagement in governance by employee-constituents.[362] While the interests of employees and public shareholders might not always align, both share a general interest in maximizing firm revenue. For employees, it provides job security and can lead to higher salaries; for shareholders, it offers higher profits through dividends or share price increase. Both constituent groups should therefore strive to minimize value-reducing activities through monitoring against management waste, abuse, and corruption.[363]

On the other hand, as mentioned in the context of the supervisory board, the law takes only an enabling approach concerning representation of employees on the board of directors itself. Moreover, absent a hierarchical relationship between the supervisory board and the board of directors, the Chinese dual-board structure is largely failing, and with it, the co-determination mechanism loses its bite. Even within the supervisory board, while employees have a voice in the election of one-third of its members, the reminder two-thirds are appointed by the same body that appoints the regular board members: the shareholders' assembly—thus, the controlling shareholder. Therefore, instead of monitoring the controllers' power, the Chinese dual-board structure, and the employees-constituent's representative within it, further enhances it.[364]

One might expect to see in the PRC, as a "workers' state," some empowerment of labor as a non-shareholder constituency, even separate from the co-determination role. Labor unions are given a formal participatory role in every PRC firm notwithstanding the lack of any share-ownership.[365] However, labor union representatives at PRC firms are actually hired by firm management and are paid by the firm and therefore invariably have a close relationship with incumbent management. Furthermore, the labor union organization itself is entirely subordinated to the CCP[366] and thus promotes the interests of the PRC Party-state, as do the board of directors, the party committee behind the board of directors, the supervisory board, senior management, the controlling shareholder,

361 Compare 1993 Company law, *supra note 66*, art. 52 leaving the ratio of worker's representatives to be determined in the articles of associations, with the 2005 Company law and its various amendments, *supra* note 147, art. 51.
362 2005 Company Law, *supra* note 147, arts. 18, 108, 117.
363 Pargendler et al., *supra* note 123, at 585.
364 Especially since cumulative voting is currently not mandatory. 2005 Company Law, *supra* note 147, art. 105. *See* Clarke, *supra* note 71, at 161–62, 173–75 (regarding the supervisory board in Germany and the failure of the supervisory board mechanism in China).
365 2005 Company Law, *supra* note 147, arts. 18, 108, 117 (establishing the grounds for union involvement and presence in every China domiciled company). Article 18 states the following "…when making a decision on restructuring or any important issue relating to business operations, or to formulate any important bylaw, a company shall solicit the opinions of its labor union, and shall solicit the opinions and proposals of the employees through the assembly of the representatives of the employees or in any other way." *Id.* art. 18.
366 The unions are members of the "All-China Federation of Trade Unions," which is the official union organization of the Chinese Communist Party. *See generally* Mary E. Gallagher & Baohua Dong, *Legislating Harmony: Labor Law Reform in Contemporary China*, *in* FROM IRON RICE BOWL TO INFORMALIZATION: MARKETS, WORKERS, AND THE STATE IN A CHANGING CHINA 36, 41-5 (Sarosh Kuruvilla et al. eds., 2011).

and the firm itself. Labor unions and their representatives in firms are thus exceedingly unlikely to advocate an agenda that is supportive of oppressed minority shareholders, much less one that goes against the control parties of the firm.

iii. Consumers

Here I consider customers as constituents of a firm, while putting aside questions of corporate social responsibility[367] and related normative claims about the purpose of the corporation.[368] The underlying assumption here is that the consumer-base of a firm can potentially monitor corporate insiders. This is the case simply because consumers are able to push firms to produce more value, e.g., reduce costs or improve quality, through consumer behavior and litigation.

Theoretically, the performance of the stock market and consumers' behavior and consumption levels are mutually related. Research conducted in Western, liberal markets found that an increase in overall market share prices boosts consumer confidence in the economy, leading consumers to spend more.[369] In turn, consumers' behavior in various forms, including quality monitoring and social criticism, affects the profitability of firms and induces further growth. [370]

When looking at the Chinese consumer market, it becomes clear that consumer power is increasing along with shifts in the sources and scope of economic growth. With the increase in average wages and the economic shifts from low-income manufacturing industries to higher-earning services and technology-based industries, Chinese consumption is expected to continue to grow at an annual

[367] For shareholder value maximization, *see* Milton Friedman, *The Social Responsibility of a Business to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), *available at* http://umich.edu/~thecore/doc/Friedman.pdf; Jensen & Meckling, *supra* note 244. For critiques of this premise, *see* LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012); Steve Denning, *The Origin of 'the World's Dumbest Idea': Milton Friedman*, FORBES (June 26, 2013, 11:37 AM), https://www.forbes.com/sites/stevedenning/2013/06/26/the-origin-of-the-worlds-dumbest-idea-milton-friedman/#751ddb18870e.

[368] Some recent analysis calls for an alternative "costumer capitalism," whereby managers should be first and foremost concerned with increasing costumers' satisfaction. This claim holds as a way of creating shareholders' value as well. *See* Roger L. Martin, *The Age of Customer Capitalism*, HARV. BUS. REV., Jan-Feb 2010, https://hbr.org/2010/01/the-age-of-customer-capitalism. *See also* Shlomit Azgad-Tromer, *The Case for Consumer-Oriented Corporate Governance, Accountability and Disclosure*, 17 PA. J. BUS. L. 227 (2014) (calling for an expansion of the scope of corporate law and firms' accountability towards the inclusion of consumers interests as corporate stakeholders).

[369] For empirical research on EU countries, *see* W. Jos Jansen & Niek J. Nahuis, *The Stock Market and Consumer Confidence: European Evidence*, 79 ECON. LETTERS 89 (2003) (referring also to previous empirical research regarding the U.S. market). The opposite direction—that is, the correlation between consumer behavior to stock market price—is far more established. *See, e.g.*, Gerard J. Tellis & Joseph Johnson, *The Value of Quality*, 26 MARKETING SCI. 758, (2007) (examining changes in stock market return following consumers' quality review). *See also infra* note 370.

[370] Elizabeth Demers & Baruch Lev, *A Rude Awakening: Internet Shakeout in 2000*, 6 REV. ACCT. STUD. 331, 331-59 (2001) (finding that nonfinancial measures, such as the products' reach to costumers, explain the share price of Internet companies); Sunil Gupta et al., *Valuing Customers*, 41 J. MARKETING RES. 7, 7-18, (2004) (suggesting a model in which value based on costumers is a strong determinant of firm value).

rate of nine percent during the coming few years.[371] Commentators have predicted that this level of increase in China's consumer market will continue even considering an overall economic slow-down of GDP growth to 5.5 percent below official targets.[372] More importantly, the characteristics of China's consumer base are changing toward the upper-middle-class household and more sophisticated consumers.

Despite this continuous growth in China's consumer base, the limited available research on the relationship between the stock market and consumption in China shows a weak link between capital market performance and consumer behavior.[373] This might suggest that the level of consumerism is not influenced by market trends and share performance. It may partially derive from the small number of investors relative to population. Unofficial estimates show that less than seven percent of urban Chinese invest in the capital market.[374] Or perhaps the limited scope of available income that retail investors put into the capital markets (four percent of household assets) might explain the attenuated relationship between consumerism and capital markets in China.[375]

Still, the change in the characteristics of consumers suggests that Chinese consumers will become more sophisticated, demanding more value, and therefore perhaps start being more engaged with firms and their products. Provided there is an institutional framework that would enable such engagement, consumer activism could be on the rise. A rising volume of consumers' complaints either on social media, other press, or through formal courts proceedings would inflict reputational harm on a company and its managers, and may reduce profits and market price.[376] The main impediments to consumers' activism effectuating a disciplinary mechanism for better firm and managers' performance are intertwined with the current institutional setting of the press and group and representative litigations in China.[377]

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371 Youchi Kuo, *3 Great Forces Changing China's Consumer Market*, WORLD ECON. F. (Jan. 4, 2016), https://www.weforum.org/agenda/2016/01/3-great-forces-changing-chinas-consumer-market/.

372 *Id.*

373 *Id.*

374 *See* Arthur R. Kroeber, *Making Sense of China's Stock Market Mess*, BROOKINGS (July 13, 2015), https://www.brookings.edu/opinions/making-sense-of-chinas-stock-market-mess/ (whereas, according to the same source, in the United States estimates go up to fifty percent of the population).

375 Only four percent of private household asset allocation in China is invested in stocks and mutual funds. *See* Evelin Cheng, *Chinese Investors are Putting Their Money in a Lot of Places: That Rarely Means Stocks*, CNBC NEWS (Aug. 15, 2018, 1:00 AM), https://www.cnbc.com/2018/08/15/chinese-investors-are-picking-other-assets-over-stocks.html.

376 Mushrooming lawsuits following the introduction of consumer-rights laws even allowed press reports to be submitted as evidence of the merits of a case. Craig S. Smith, *Chinese Discover Product-Liability Suits*, WALL STREET J. (Nov. 13, 1997) (also stating that "In the three years since China's consumer-rights laws took effect, liability lawsuits have risen to more than half a million annually.").

377 The weaknesses of the media in contemporary China are discussed below as part of the discussion of market gatekeepers. The court system and specifically the status of group and representative litigations will be discussed as part of the legal system.

iv. Managers (ownership and compensation incentives)

Allocating shares to managers and setting performance-based incentives[378] are designed to optimize managers' performance and better align their interest with those of shareholders.[379] These methods were used extensively during various stages of corporate reform in China to incentivize managers to increase firm productivity and profitability.[380]

Nonetheless, recent empirical research found that managerial ownership in China is relatively insignificant, and managerial ownership plays a limited governance role.[381] Managers' small percentage of ownership in China, it is argued, leaves ample incentives for the insiders to expropriate, as the value from expropriation is greater. Higher levels of managerial ownership exist in situations where the managers are also the dominant or controlling shareholders, which entrench managers and give rise to the tunneling of value through their shareholding capacity.

Concerning performance-based incentives, empirical research shows that until 2007 managers in SOEs were not better compensated than managers of other types of firms, even though SOEs were much larger and continuously growing corporations.[382] This started to change in 2007. The scholars conducting the research suggest that the change derived from the fact that many large SOEs went through IPOs in the mid-2000s, subsequently raising their managerial compensation, which was tied to salary levels in the government before the offering.[383] In addition, the authors point to a CSRC document that was released in December 2005 calling for SOEs to adopt incentive mechanisms to motivate managers' performance. Despite these changes, performance incentive measurements remained limited due to explicit and implicit caps on the compensation of managers. Such caps are in place presumably to avoid social unrest over individuals' capital accumulation (the issue of rising crony-capitalism), as well as to reduce the undisciplined use of operational costs that bite into the

[378] Jensen & Meckling, *supra* note 244.

[379] Philippe Aghion et al., *The Behaviour of State Firms in Eastern Europe, Pre-Privatisation*, 38 EUR. ECON. REV. 1327 (1994) (pointing to the importance of reforming the managerial incentive system for successful economic transition in former socialist economies); Kevin J. Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS (Orley Ashenfelter & David Card eds., 1999) (surveying relevant empirical literature). *See also* Takao Kato & Cheryl Long, *Executive Compensation, Firm Performance, and Corporate Governance in China: Evidence from Firms Listed in the Shanghai and Shenzhen Stock Exchanges*, 54 ECON. DEV. & CULTURAL CHANGE 945 (2006) (referring to both pieces).

[380] For empirical research on various methods of managerial incentives in China (such as profit responsibility contracts and profit retention methods) *see* Kato & Long, *supra* note 379, at 948 (providing references).

[381] Jiang & Kim, *supra* note 80, at 197 table 5, 206 and the references therein.

[382] Chong-En Bai & Lixin Colin Xu, *Incentives for CEOs with Multitasks: Evidence from Chinese State-owned Enterprises*, 33 J. COMP. ECON. 517 (2005).

More generally on lower incentives for bureaucrats, *see* Oliver E. Williamson, *Public and Private Bureaucracies: A Transaction Cost Economics Perspective*, 15 J.L. ECON. & ORG. 306 (1999).

[383] Jiang & Kim, *supra* note 80, at 199 table 8, 203. (specifically mentioning the Industrial Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, China National Petroleum Corporation, China Railway, Shenhua China, and Aluminum Corp of China).

profitably of SOEs.[384] Moreover, despite a dramatic increase in managers' compensation in recent years, the authors find that compensation is still modest in China compared to other countries.[385]

Other incentives for managers in China are informal pay benefits,[386] such as on-the-job consumption that was found to exceed the average executive pay by two to fifty times,[387] hidden payments, and nonpecuniary benefits. The latter includes particularly the prospect of professional advancement to higher ranking positions in the government or the Party.[388]

The evidence of the power of such benefits to incentivize better performing managers is inconclusive. Some studies show that certain nonpecuniary benefits and "hidden payments" with no specific disclosure obligations,[389] such as travel allowances, business entertainment expenses, housing, office expenses, and overseas training, correlate with better firm performance in SOEs.[390] These findings suggest that in Chinese state-controlled listed firms, nonpecuniary benefits and the hope for future promotions in the Party-state system substitute for managerial ownership and compensation in terms of their incentivizing power.[391] Another study found that hidden on-the-job consumption does not correlate, or has a significant negative correlation, with company earnings in SOEs.[392]

Either way, while these components influence managerial conduct one way or the other, they do not align their interests with those of public shareholders specifically. Thus, while they may have a disciplinary effect on managers to conform with the goals of the supervising Party-state authority or controlling state-shareholder, it is not necessarily a goal that increases firm value or otherwise serves the interests of the firm and all its shareholders.

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[384] Xuequan Mu, *China Ties SOE Employees' Salaries to Profitability*, CHINA DAILY (June 4, 2015, 9:45 AM), http://www.chinadaily.com.cn/business/2015-06/04/content_20907244.htm.

[385] *See* Jiang & Kim, *supra* note 80, at 203 (reporting that in 2012 the median compensation for top managers of SOEs was 470,000 RMB, which was equal roughly to USD 77,000).

[386] Li-Wen Lin, *Behind the Numbers: State Capitalism and Executive Compensation in China*, 12 U. PA. ASIAN L. REV. 140 (2016) (discussing informal pay practices and how they are detached from formal pay disclosures by listed firms in China, particularly SOEs).

[387] Yang Rong, *Research on Executive Compensation of Listed Companies of Monopolistic Industries — Based on Perquisite Consumption*, 5 FUDAN J. (SOCIAL SCIENCES ED.) 133 (2011), *available at* http://en.cnki.com.cn/Article_en/CJFDTOTAL-FDDX201105017.htm (in Chinese) (based on data of 1,320 listed companies monopolistic industries examined between 2002 and 2009).

[388] Jiang & Kim, *supra* note 80, at 207; Kato & Long, *supra* note 379. I discuss this elaborately in Chapter 3.

[389] *Shrouded in Mystery: Chinese Executive Compensation and the Numbers Behind the Numbers*, WHARTON U. PA.: KNOWLEDGE@WHARTON (May 14, 2012), http://knowledge.wharton.upenn.edu/article/shrouded-in-mystery-chinese-executive-compensation-and-the-numbers-behind-the-numbers/.

[390] Pattarin Adithipyangkul et al., *Executive Perks: Compensation and Corporate Performance in China*, 28 ASIA PACIFIC J. MGMT. 401 (2011); Hongbin Cai et al., *Eat, Drink, Firms, Government: An Investigation of Corruption from the Entertainment and Travel Costs of Chinese Firms*, 54 J.L. & ECON. 55 (2011).

[391] Jiang & Kim, *supra* note 80, at 207.

[392] Donghua Chen et al., *Regulation and Non-pecuniary Compensation in Chinese SOEs*, 2 ECON. RES. J. 92 (2005), *available at* http://en.cnki.com.cn/Article_en/CJFDTotal-JJYJ200502009.htm (in Chinese).

B. External Monitoring Institutions

1. External Markets

i. The Market for Corporate Control

For widely-held firms, the market for corporate control is considered one of the strongest monitoring corporate governance mechanisms.[393] The market for corporate control is generally understood to function as follows. Managers who run the corporation poorly or systematically disadvantage equity investors will cause shareholders to sell their shares, with a resulting decline in share price. This will in turn increase the cost of raising new capital and will make the firm a target for takeovers by those who believe they can run it better. These potential insurgents will use the opportunity to acquire shares cheaply, gain control, and oust the existing management.[394] Where there is a market for corporate control, inefficient behavior or self-dealing by incumbent managers therefore jeopardizes the position of these insiders, so that the market functions as an ongoing discipline and accountability mechanism.

In concentrated markets, however, there is usually no active market for corporate control.[395] In such markets, the controlling shareholder elects its own nominees to the board of directors and is able to direct management absolutely. If the controlling shareholder is unsatisfied with the performance of its appointees, it will simply replace them. There is no possibility for other shareholders to oust the controlling shareholder's strong ownership position in the controlled firm.[396] Any change in corporate control in these markets will have to obtain the consent of existing controlling parties. This also implies that when inefficient management stays in place, maximizing performance is presumably not the primary goal of the controlling shareholder. Alternatively, in this

393 The market for corporate control was first described in the seminal article by Henry G. Manne. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965).

394 The change of control can be affected in various ways: via a direct purchase through mergers or acquisitions or by the purchase of shares in the open market, or by replacing incumbent directors through proxy contests. In any of these ways, control over the firm shifts, and incumbent insiders will be replaced. *Id.*

395 *But see* John Armour et al., *The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 273–85 (2011) (examining the prospect for hostile takeover regimes in China, Brazil, and India); Goergen et al., *supra* note 341 (discussing block trades as a market for partial control in Germany).

396 *See* John Armour & Brian R. Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds* 12 (European Corp. Governance Inst., Law Working Paper No. 136, 2009), http://papers.ssrn.com.proxy.lib.umich.edu/sol3/Papers.cfm?abstract_id=1489336 (asserting that "influence-driven activism is unlikely to be deployed where dispersed ownership is lacking," yet, providing examples of how such influence is nevertheless possible in certain cases despite an existence of a dominant shareholder (albeit within the U.S. market)).

scenario, the controller has other means to maximize her returns on investment that are not shared with all shareholders.

As in many other markets evidencing similar concentration, there is currently almost no hostile takeover activity, and thus no market for corporate control, in China. Nevertheless, there is some evidence that the Chinese market is developing a weak form of a market for corporate control, as limited takeover activity is surfacing in recent years. I hypothesized elsewhere on the possibility that a *partial* market for corporate control is currently underway within China's controlling apparatus—that is, between groups of powerful and politically connected firms.[397]

Fracturing within the political controlling apparatus might set the stage for an *economic disentanglement* in the current structure of firm ownership in the PRC in a way that will have implications for a market for corporate control. In the current Chinese market, business groups are still mainly clustered in specific industries and face a host of impediments regarding investment or business activity outside of their specific industry or sector. Such impediments include strict regulation of permitted "business scopes"; specific franchising grants that create monopoly-like opportunities; path dependency resulting from the corporatization without a privatization process that produced firms tied to specific ministries and thus specific industrial sectors;[398] PRC listed firms' historic dual share structure before 2006 that allowed "state shares" to be transferred only to other state shareholders;[399] the personnel appointment system for senior management with reshuffling of senior managers within the same industry;[400] and finally, Party-state direction and heavy regulation of M&A and takeover activity.[401]

Notwithstanding these constraints and the resulting limited competition between corporatized SOEs across sectoral lines, the Chinese Party-state is not monolithic, and neither are the firms that it has established and controls. In fact, the PRC Party-state has a myriad of internal conflicts, expressed in competition between government agencies at the central and local levels, and between party and state institutions at all levels. Nor does the Party itself lack contradictions, as conflicts exist as well within the various levels of the Party organization and among its individuals. These conflicts reduce the capacity of the PRC Party-state to act in a unified manner with respect to policy generally, or

397 Or, in firms in which the party-state has no interests, mostly within the SME market. *See* Groswald Ozery, *supra* note 101, at 56-62.

398 *See* Chapter 1, Section I.A.2.i *supra*

399 *See* Chapter 1, Section I.A.2.i *supra,* and note 78 *supra.*

400 *See* Howson, *supra* note 278; Chih-shian Liou & Chung-min Tsai, *Between Hierarchy and the Market: Managerial Career Trajectories in China's Energy Sector*, *in* CHOOSING CHINA'S LEADERS 124 (Chien-wen Kou & Xiaowei Zang eds., 2013).

401 Mainly through: 1) required review by the Ministry of Commerce and its approval related to acquisitions and mergers affecting market concentration (equal to an antitrust review); 2) approval by SASAC for mergers and acquisitions involving state assets; 3) approvals by additional ancillary authorities as required according to the industry, business scope, and the involvement of foreign investors (e.g., SAFE, NDRC, SAIC); and most importantly 4) a review by the CSRC, through its designated "M&A and Restructuring Examination Committee," which has a broad authority to regulate and handle all issues related to mergers and acquisitions of listed companies (including takeovers, and dispute resolutions in cases of hostile takeovers and the use of defensive tactics). *See* Huang & Chen, *supra* note 179.

through the firms it dominates. As a result, the system often serves more particularistic interests, whether individual, institutional, local, or across "systems" (*xitong*).[402]

While this of course leads to rampant self-dealing by firm insiders, at the macro level it also gradually leads to economic disentanglement of some firms and business groups from the Party-state. This is especially striking in the alienation of local government-controlled firms from the central Party-state. China's economic success has boosted the power of local governments and local government–promoted firms. Local officials have enormous incentives to maximize economic growth in their jurisdictions, very often at the expense of national Party-state interests.[403]

As local government–controlled firms become ever more invested in profit maximization for their own benefit,[404] the more they try to compete on market share with other PRC firms in their same region and nationally. Mergers and acquisitions activity across industries and regions has been increasing.[405] More market-oriented competitive M&A activity can induce the sales of distressed assets, which in turn can contribute to competition and to firms' efficient operation.[406] The consequence of this form of greater market competition between local government–controlled but listed firms might eventually bring about a partial market for corporate control between dominant blockholders (still mainly among such controlling parties).[407]

A limited number of hostile takeover battles provide examples that this form of a partial market for corporate control is indeed emerging: For instance, in October 2003, the management of ST Meiya (a textile company traded at the time on the Shenzhen stock exchange) applied defensive tactics to push against a change of control in the company,[408] which essentially resulted in the transfer of shares from one state-owned shareholder to another. In this case, the dominant shareholder of ST Meiya—Heshan State Assets Management Bureau, a city-level state asset management office—had signed a share transfer agreement to sell a 27.49 percent stake to the private Wanhe Group. It appears

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402 KENNETH LIEBERTHAL & MICHEL OKSENBERG, POLICY MAKING IN CHINA: LEADERS, STRUCTURES, AND PROCESSES 135, 141-142 (1990) (referring to "*xitong*" as an organizational concept describing vertical functional systems of hierarchy that comprise China's governing bodies).

403 *See* Kenneth Lieberthal, *China's Governing System and Its Impact on Environmental Policy Implementation*, 1 CHINA ENV'T SERIES 3, 4-6 (1997) (addressing the situation of conflicting interests and incentives related to the implementation of environmental policy).

404 *See* Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators*, 59 AM. J. COMP. L. 227, 262 (2011) (analogizing Chinese state-controlled enterprises to private equity firms).

405 *See* Barry Chen, *Chinese Mergers and Acquisitions: What's Next*, MANZELLA REP. (July 1, 2015), http://www.manzellareport.com/index.php/strategies-section/1014-chinese-mergers-and-acquisitions-what-s-next (reporting on a number of 1,536 M&A transactions that were closed in 2014, the majority of which (sixty-five percent) related to SOEs restructuring). *See also* Dezan Shira & Associates, *Understanding Mergers and Acquisitions in China,* CHINA BRIEFING, 166, June-July 2016, *available at* http://www.iberchina.org/files/2016/mergers-acquisitions-in-china.pdf (reviewing latest M&A market trends including proportions and distributions across industries, and reporting an increase of thirty-nine percent in inbound M&A deals from 2010 to 2015).

406 Moreover, if implemented on a large scale, the debt-for-equity swap scheme that is currently ongoing will contribute to asset fluidity as well. *See supra* notes 348-356.

407 *See* Groswald Ozery, *supra* note 101, at 56-62.

408 *See* Huang & Chen, *supra* note 179, at 30-31.

that this move was taken without any involvement of ST Meiya's managers, thus presumably raising alarms for their jobs. Incumbent managers obtained the support of the firm's employees (after finally making delayed payments),[409] and together they opposed the transaction. The main justification for their "anti-takeover" action was that the intended transfer would be harmful to the firm's long-term interests since the acquirer operated in an entirely different industry and was not competent to run the company. Indeed, following these pressures, and despite its contractual obligations, the local government shareholder terminated the share transfer agreement. Instead, it made an agreement with another acquirer that was favored by the management to sell 24.99 percent of its shares. Interestingly, the second acquirer, Guanxin Foreign Trade, one of China's largest import-export enterprises, is a state-owned company.[410] In its public announcement, ST Meiya mentioned that since the new acquirer is state-owned, its "operational mechanisms are not so different" than those of ST Meiya, which was a major consideration for choosing them as the acquirer.[411]

Other "hostile" efforts and defenses reflecting signs of a partial market for corporate control within China's political economy are reflected in more recent cases. In 2012, locally state-owned Beijing Enterprise Group sharply increased its stake in China Gas Holding Ltd., a Chinese energy company whose shares are listed on the Hong Kong exchange, thereby challenging a prior hostile takeover attempt by another state-owned conglomerate, Sinopec. Sinopec, a state-controlled national champion, had joined with a privately owned, politically connected firm, ENN Energy Holdings Ltd.[412] Similarly, in a more recent bidding war, Baoneng Group, an apparently private Shenzhen-based real estate conglomerate, gradually bought shares in China's largest residential area developer, Vanke Co. Ltd. The gradual acquisition by Baoneng Group overtook state-owned China Resources Co. Ltd. as Vanke's new largest shareholder. [413] Vanke's incumbent managers have applied various anti-takeover measures to fend off a potential takeover by Baoneng, ultimately cooperating with another local-government-owned SOE.[414]

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[409] *Id.*

[410] Wanhe Group, the original private acquirer, tacitly consented to the termination of its acquisition agreement, without any disclosed compensation, even though their contractual rights were violated.

[411] Aibing Lu & Wenxiang Yao, *ST Meiya "feichang supei" Wanhe binghai fan shougou an* [*The Anti-takeover Case of Defeating ST Meiya and Wanhe's "Extremely Fast Match"*], XINHUANET, (Dec. 9, 2003), *available at* http://news.xinhuanet.com/stock/2003-12/09/content_1220874.htm.

[412] Guo Aibing, *Beijing Enterprises Group Buys More Shares in China Gas*, BLOOMBERG (May 7, 2012, 12:01 AM), http://www.bloomberg.com/news/articles/2012-05-07/beijing-enterprises-becomes-single-largest-china-gas-shareholder.

[413] Li Xiang, *Vanke 'Ropes in Govt Help' to Ward Off Biggest Shareholder Baoneng*, CHINA DAILY EUROPE (Dec. 22, 2015, 7:27 AM), http://europe.chinadaily.com.cn/business/2015-12/22/content_22769475.htm.

[414] The antitakeover tactics included Vanke's management first initiating a trade suspension on December 18, 2015 and renewing the suspension repeatedly until July 4, 2016, presumably to halt further purchase of shares by the hostile acquirer. *See* SHENZHEN STOCK EXCHANGE, REPORT ON SUSPENSION OF TRADING DUE TO MAJOR CAPITAL RESTRUCTURE (June 15, 2016, *available at* http://disclosure.szse.cn/finalpage/2016-06-15/1202368720.PDF. In March 2016, the company applied a "white knight" strategy in which a strategic cooperation with an alternative friendly buyer (in this case a locally-owned SOE, Shenzhen Metro group) was sought out to fend off a hostile acquisition. *See Shenzhen Metro Group and Vanke Achieved a Strategic Cooperation*, VANKE (Apr. 13, 2016), http://www.vanke.com/en/news.aspx?type=8&id=4260. In January 2017, Vanke's dominant state shareholder sold its shares to the same locally owned SOE, Shenzhen Metro Group,

These latest events certainly signal an adversarial shift in business conduct and perhaps a more general market-oriented approach by the firms operating in China's capital markets. Yet, for a corporate control market to have a disciplinary effect on managers, it must cultivate enough competing control parties. The examples above illustrate how a potential hostile acquirer will find it difficult to acquire control (or a significant block) without the cooperation of an insider, either management or a dominant blockholder.

An attenuated market for corporate control between dominant blockholders is bound to face a challenge from China's legal framework. Current regulations provide dominant shareholders with the power to block acquisitions in certain circumstances even without equity control. A supermajority (two-thirds) shareholder approval is required for certain corporate decisions, such as the approval of mergers or major asset restructuring.[415] The CSRC 2004 Provisions apply this two-thirds approval requirement to additional issues, including the sale of major assets, restructuring, and share issuance.[416]

Perhaps even more relevant in this context are China's 2006 Securities Law and the CSRC 2006 Takeover Measures that subject takeovers to a mandatory bidding mechanism.[417] Under this regulatory framework, creeping acquisitions are substantially restricted by a disclosure requirement at the five and twenty percent thresholds.[418] Furthermore, any acquirer of a listed company (outside investor or inside shareholder) exceeding a thirty percent ownership threshold must undergo a mandatory tender offer to further increase its stock ownership.[419] Another significant provision is Article 33 of the Takeover Measures, which prohibits the use of certain takeover defenses without an approval by the shareholders' meeting.[420] This provision gives dominant stockholders a veto power

which acted as the white night under the initial management's anti-takeover strategy. *See* SHENZHEN STOCK EXCHANGE, REPORT ON REGISTRATION OF TRANSFERRED SHARES (Jan. 25, 2017), *available at* http://disclosure.szse.cn/finalpage/2017-01-25/1203052214.PDF.

[415] 2005 Company Law, *supra* note 147, arts. 103, 121.

[416] CSRC 2004 Provisions, *supra* note 275, arts. 88, 96.

[417] *Zhonghua Renmin Gongheguo Zhengchuan Fa* [Securities Law of the People's Republic of China] (promulgated by the Standing Comm. Nati'l People's Cong., Dec. 29, 1998, amended Oct. 27, 2005, last amended Aug. 31, 2014), arts. 88, 96 [hereinafter 2006 Securities Law], *available a*t https://www.pkulaw.com/en_law/e3a5d596aa075797bdfb.html.

The CSRC 2006 Takeover Measures elaborate the bid process. *See* Shangshi Gongsi Shougou Guanli Banfa (上市公司收购管理办法) [Measures for the Administration of the Acquisition of Listed Companies] (promulgated by the China Sec. Regulatory Comm'n., July 2006, effective Sept. 1, 2006, amended Aug. 27, 2008, amended Feb. 14, 2012) [hereinafter CSRC 2006 Takeover Measures]. *See also* CSRC Decision on Amending Article 62 and Article 63 of the Measures for the Administration of the Acquisition of Listed Companies (promulgated by the China Securities Regulatory Comm., Dec. 29, 2011) (amending the CSRC 2006 Takeover Measures).

[418] *See* CRSC 2006 Takeover Measures, *supra* note 417, Part II ("Disclosure of Interests") (particularly articles 12-17).

[419] 2006 Securities Law, *supra* note 417, arts. 88, 93, 96. *See also* CSRC 2006 Takeover Measures, *supra* note 417, arts. 22, 23 (stipulating the same). These provisions also distinguish between a "general tender offer"—when a purchaser intends to acquire all of the shares of a company—and a "partial tender offer" – when a purchaser intends to acquire only part of the shares. *See also id.* arts. 26, 35 (stipulating the "equal treatment" and minimum price consideration for all shares of the same class sold). Interestingly, the acquirer can ask the CSRC for an exemption form the bidding process. *See id.* arts. 62, 63.

[420] *See id.* art. 33 ("During the period between the issuance of the alert by the acquirer and completion of the takeover offer, … the board of directors of the target company may not, without the approval of the shareholders' general meeting, materially affect the company's assets, liabilities, interests or business results through the disposal of company assets, investment in third parties, adjusting the company's core business, providing security, taking out loans, etc."). What the

over the adoption and employment of anti-takeover defenses and turns any possible control battle into a battle between powerful existing blockholders.[421]

Taken together, even if a supply of competing dominant blockholders is developing and can form an attenuated market for corporate control, the existing regulatory framework increases the cost of acquisitions and has a chilling effect on potential acquirers, likely limiting them to China's biggest or most politically connected firms. The development of a partial market for corporate control in China, if it is indeed underway, can have some disciplinary effect against managerial misconduct. It is possible that even a weak and partial market for corporate control will open up greater investment alternatives that are currently completely missing from the PRC capital markets, which would in turn empower public shareholders to at least vote with their feet.

ii. The Capital Market (Debt & Equity Markets)

a. Debt Market[422]

The theory of the benefit of debts in reducing agency costs suggests that the use of debt in the capital structure of a firm can discipline managers. [423] Creditors, concerned about the firm's financial stability, will require high interest or stringent covenants in their loan agreements. Once debt is granted, failure to pay off the debt will push the firm into bankruptcy quicker. Alternatively, creditors might refuse giving credit to the firm altogether. In that case, the cost of capital for an inefficient or poorly run firm becomes higher. Debt financing, therefore, keeps managers on their toes to ensure enough cash flow exists.

Many Chinese listed firms have high debt financing ratios,[424] and yet debt is not likely to have a strong disciplinary effect on managers. Chinese banks tend to lend to state-owned firms, large firms, and politically connected firms regardless of their financial stability.[425] It is assumed that central and local governments, which rely on employment by listed firms for social stability, will come to a firm's aid before it reaches bankruptcy. Banks commonly prefer to have nonperforming loans on their statements rather than initiate bankruptcy proceeding. As Clarke summarizes, "because banks are still

"etc." at the end of the article stands for is unclear, but opens up the need to approve any material decision in this period with the shareholders' meeting.

421 For an account of the regulatory and practical impediments to takeovers in China, *see* Hui (Robin) Huang, *The New Takeover Regulation in China: Evolution an Enhancement*, 42 INT'L L. 153 (2008); Huang & Chen, *supra* note 179.

422 In my reference to "debt market," I do not differentiate between credit and bond-based debt. As mentioned, most bond holders in China are typically the common loan providers—China's commercial banks.

423 Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); Jensen, *supra* note 339.

424 Recent estimates suggest a median debt ratio of fifty percent among non-financial Chinese listed firms. *See* Jiang & Kim, *supra* note 80, at 203.

425 *Id.* at 208.

often required to lend for political reasons, the result is that corporate management has been subject to the discipline neither of the credit market when seeking a loan nor of lender monitoring after obtaining it."[426] Listed firms in China, and especially state-controlled firms, have little fear of bankruptcy. This makes the debt market's penalty for poor management minimal and reduces, if not eliminates, monitoring and the disciplinary effect of debt financing.[427]

b. Equity Market

Current indicators of China's capital market growth is brought in the introduction. The data reflects a continuous growth relative to the domestic economy as well as to other global capital markets. Yet an increase in market capitalization, impressive as it is, does not say much about the role the stock markets play in China's corporate governance system. This is especially so since the share price of Chinese listed companies is not a good signal for real firm value, as many China-specific empirical accounts found.[428] If this is indeed the case, then the monitoring effect that a vibrant stock market has on corporate insiders is removed, or at least significantly reduced, when it comes to the Chinese stock markets.

Nevertheless, the Chinese stock market does have an attenuated monitoring capacity, albeit exercised in a very idiosyncratic way. Some theoretical qualifications should be mentioned first on how equity markets are believed to discipline corporate insiders elsewhere. Stock market monitoring is carried through the market firm's stock performance as reflected in the firm's public share price. This stock market and firm value indication is influenced by shareholders' exit, colloquially termed

[426] Clarke, *supra* note 115, at 176.
[427] Jiang & Kim, *supra* note 80, at 208.
[428] While with respect to all markets there are various metrics to assess real firm value, stock market price being one indication, there is usually a high correlation and predictive power between various metrics of firm performance (e.g., P/E ratio, ROE, ROI indicators) and the firm's stock price. It is widely accepted in the relevant literature, however, that this is not the case for China. *See* Gul Ferdinand et al., *Ownership Concentration, Foreign Shareholding, Audit Quality, and Stock Price Synchronicity: Evidence from China*, 95 J. FIN. ECON. 425, 425-442 (2010) (showing higher synchronicity for firms where the largest shareholder is affiliated with the government, concluding that stock prices are less reflective of firms' specific information for these companies); Randall Morck et al., *The Information Content of Stock Markets: Why do Emerging Markets have Synchronous Stock Price Movements?*, 58 J. FIN. ECON. 215 (2000) (examining country level synchronicity and finding that stock price movements are more synchronous in emerging markets than in developed markets, attributing the difference to uninformed trade. The authors report that China has the second highest synchronicity among forty sample countries); Zhiwu Chen, Stock Market in China's Modernization Process—Its Past, Present and Future Prospects 40-41 (Yale Sch. of Mgmt. Working Paper, 2006) (on file with author) (studying co-movement levels among individual stocks, concluding that Chinese investors treated every stock the same; from the investors' perspective the stocks were indistinguishable from one another). *See also* Yujuan Zhao, *The Relationship Between Share Price Gains, Corporate Performance and Risk*, 5 IBUSINESS 110 (2013); William T. Allen & Han Shen, *Assessing China's Top-Down Securities Markets*, (Nat'l Bureau of Econ. Research., Law and Economics Working Paper No. 16713, 2011.
For recent evidence suggesting contesting views on the level of informational inefficiency in China's capital market, *see infra* note 433.

"voting with their feet" or "the Wall-Street Walk."[429] This market price mechanism has been shown empirically to have a disciplinary effect on firm management. In fact, even the credible threat of shareholders selling has a disciplinary effect on management. This function of the stock market is believed to provide groups of shareholders some traction in influencing management decisions, thereby amounting to a form of public shareholder monitoring.[430] Of course, this governance leverage is only amplified in situations where there is a functioning market for corporate control, whereby mass selling decreases the price to a level at which a hostile acquirer can purchase control cheaply and then oust incumbent management. Still, in a vibrant stock market, the firm's public share price operates as a disciplinary mechanism even without a threat of a hostile acquirer.

There is no a priori reason why the same principle should not also apply in concentrated markets without a market for corporate control. Without a doubt, a share price drop from mass shareholder defections has consequences for firm market value in these markets as well. Similarly, the relative success or failure of a corporation, as measured by firm market value, will almost certainly affect the reputation and/or advancement of corporate insiders in controlled firms too. A controlling shareholder can be similarly affected by a threat of large-scale defection of public investors and the expected decrease in market value, especially regarding the cost of future capital. Finally, where ownership is concentrated but control is organized through business groups, a reduction in the market value of a given firm in the group and the associated reputational harm caused to the control parties can have negative implications at the group level and on individual firms within the group. Hence, under conditions where there is sufficient liquidity in the public float of a controlled firm[431]—meaning an easy availability of exit for shareholders or the credible threat of it—even firms and their managers in concentrated capital markets can be disciplined by standard capital markets mechanisms such as market share price and exit threats.

While the theory has much to commend it, there are difficulties in this argument when applied to China's capital markets. The theory about the disciplining effect of the market price presupposes a certain level of market sophistication and informational efficiency. It also assumes that a certain

[429] Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645 (2009) (distinguishing between overt activism and a threat of exit as a form of shareholder activism).

[430] *Id.* (providing a model whereby the threat of exit by a large shareholder on the basis of private information can have a disciplinary impact on managers' decisions); Robert Parrino et al., *Voting with Their Feet: Institutional Ownership Changes Around Forced CEO Turnover*, 68 J. FIN. ECON. 3 (2003).

[431] Most of the research on market liquidity is focused on widely held firms. *See* Patrick Bolton & Ernst-Ludwig Von Thadden, *Blocks, Liquidity, and Corporate Control*, 53 J. FIN. 1, 2 (1998) (asserting that "the benefits of dispersion are mainly greater market liquidity and better risk-diversification"); Amir Rubin, *Ownership Level, Ownership Concentration and Liquidity*, 10 J. FIN. MARKETS 219 (2007) (examining the relationship between liquidity level to ownership concentration measured by insiders' ownership and institutional investors' holdings in U.S. listed firms). Some studies attempt to examine liquidity in concentrated markets as well. *See* Marco Becht, *European Corporate Governance: Trading off Liquidity Against Control*, 43 EUR. ECON. REV. 1071, 1077 (1999) (asserting that "[f]or the United States, there is extensive empirical evidence . . . that the number of shareholders is positively related to liquidity" and attempting to provide similar evidence for the German and Belgian markets); David A Lesmond, *Liquidity of Emerging Markets*, 77 J. FIN. ECON. 411 (2005) (examining liquidity of emerging markets on a macro level, cross-country basis).

volume of reliable information is flowing into the market, signaling to investors the relative desirability of a given investment and, at the same time, reflecting investors' assessments of past and future performance of a given firm. The Chinese capital markets do not function this way presently, as they are in many ways informationally inefficient. Share prices often seem to be driven not by economic considerations based on information disclosed in the market but instead by factors unrelated to firm fundamentals,[432] suggesting that the market does not allocate capital efficiently.[433]

This does not mean that movements in the share price do not influence managers, but they are simply one factor in the assessment of the firms' success and in the evaluation of managers' performance that are weighted by the relevant bodies of the Party-state. Although incentive-based compensation plays a marginal role in motivating managers of state-controlled firms to perform better,[434] this does not mean that these managers are not penalized for poor performance. The advancement of *nomenklatura* appointees within the management ranks of China's corporatized and listed SOEs is directly influenced by the success of the firms they manage. While in the past empirical research showed a low correlation between managers' turnover and firms' market performance, this has been changing. There is greater consideration today for market price monitoring in the assessment of SOE managers.[435] Of course, the prospect for advancement in the CCP hierarchy motivates successful performance as well. While not much is known about the details of this internal monitoring mechanism, it is known that the public share price of a corporatized SOE is taken into account for Chinese Communist Party personnel system evaluation. A drop in the share price of a PRC issuer, whether or not reflecting actual economic performance, may block firm managers' future advancement within the Party.[436]

Despite this link between public share price and the evaluation of managers and their professional and political advancement, it is important to emphasize that there are also other non-market criteria used to measure the firm's success and managers' performance.[437] More importantly, it is not the stock market per se that disciplines managers. Public shareholders in PRC firms in many

[432] *See supra* note 428. *See generally* Khanna & Palepu, *supra* note 268 (citing Randall Morck et al., *The Information Content of Stock Markets: Why Do Emerging Markets have Synchronous Stock Price Movements?*, 58 J. FIN. ECON. 215 (2000)). For more recent claims for poor capital market performance, *see* Allen et al., Dissecting the Long-term Performance of the Chinese Stock Market, *supra* note 7 (positing that China's domestic stock market performs poorly and is disconnected from the overall economic growth, and suggesting several institutional explanations for that, mainly inefficient IPO mechanisms and corporate governance problems).

[433] Importantly, new research suggests that this view of the Chinese capital market is outdated. *See* Jennifer N. Carpenter et al., *The Real Value of China's Stock Market* (Bank of Fin. Instit. of Econ. in Transition, Discussion Paper No. 2/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3106656 (arguing that since the reforms of the mid-2000s, China's stock market became informationally efficient. Stock prices, they argue, reflect future firm profits and are linked to firm fundamentals in ways that are consistent with other large economies).

[434] *See supra* Chapter 2, Section III.A.3.iv.

[435] Jiang & Kim, *supra* note 80, at 207.

[436] I elaborate on these mechanisms further in Chapter 3.

[437] Other evaluation criteria include contribution to GDP growth, tax compliance, reduction in environmental footprint, and the amount of social unrest created around corporate conduct (reflected, for example, through shareholder complaints and derivative suits). I elaborate on the various evaluation criteria in Chapter 3. Section II. *Infra.*

cases cannot effectively utilize exit, or the threat of exit, as a disciplinary mechanism. The response to the 2015 and 2016 stock crashes by the PRC central government, during which share prices were propped up through massive mandated purchase orders and blanket suspensions of trade,[438]reflects the limited impact of public shareholders' own assessment of firms compared to the direct influence of government policy on market share prices.

In addition, alternative investments in PRC listed firms that evidence better governance and potential for better performance are scarce. The high percentage of listed firms that are ultimately controlled by state affiliates leaves investors with little choice but to hold shares in those firms.[439] This is one reason why public investors in China tend to invest alongside dominant Party-state shareholders, even if performance is lackluster or a corporate governance violation becomes apparent. Instead of relying on information for performance evaluation and voting with their feet accordingly, many prefer to rely on the inside knowledge and relationships of the Party-state control party.

Hence, the factor of share prices through the capital market creates an attenuated monitoring mechanism, but it functions mainly through the Party personnel management system, while the disciplinary effect of massive sales (or threats of a "Wall Street Walk" exit) by public shareholders is much more limited.

iii. The Product Market

According to theoretical law-and-economics accounts supported by empirical research in Western developed markets, inefficient firms are eventually eliminated through a natural selection process in the product market. Competitive pressures in the product market, therefore, restrain tunneling and mismanagement by corporate insiders and compensate for weak corporate governance.[440]

In China, import-export limitations have been gradually reduced, and competition in the product market is constantly increasing between state-controlled firms and between state-controlled

[438] By July 8, 2015, 1,300 listed firms, representing forty-five percent of the market, suspended trading to hold back share price decrease. *See Almost Half of China's Firms Halt Trading as Market Dives*, FRANCE 24 (July 8, 2015, 4:19 PM), http://www.france24.com/en/20150708-almost-half-chinese-firms-suspend-trading-market-dives.

[439] MUSACCHIO & LAZZARINI, *supra* note 201 (pointing to seventy percent of overall Chinese stock market capitalization represented by firms that are ultimately controlled by state organs). For other sources supporting the inference of the absence of investment alternatives, *see also supra* note 428.

[440] Xavier Giroud & Holger M. Mueller, *Corporate Governance, Product Market Competition, and Equity Prices*, 66 J. FIN. 563 (2011) (suggesting that competitive pressures in the product market can mitigate the agency costs of weak governance); Oliver D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366 (1983) (finding that product market competition reduces managerial slack); Klaus M. Schmidt, *Managerial Incentives and Product Market Competition*, 64 REV. ECON. STUD. 191 (1997) (finding that in markets with increased competition there is an increased probability that firms with high costs will become unprofitable and reach liquidation; this "threat of liquidation effect" was found to induce managers' work discipline).

firms and private firms.[441] This raises the possibility that the product market will become a significant external corporate governance institution in China.

Despite the promising disciplinary role of product market competition in China, a few cautions should be noted reflecting a preliminary assessment of the possible directions that competition in a growing product market can take in China, based on past studies and current market trends.[442] First, constant change in China's economic and institutional infrastructure makes it harder for market forces to signal out inefficient firms and eliminate them fast enough. In a rapidly evolving market, it is possible that the disciplinary force of the product market actually becomes weaker rather than stronger, at least until institutions are able to adjust. Another possible path for development in the product market views increasing market competition as an opportunity for misconduct, rather than as a disciplinary mechanism. Lacking reliable enforcement institutions, corporate misconduct will be carried out to gain a competitive edge.[443] As is often pointed out, a large number of firms in China operate outside the rules of the market and the legal system, at a time when violations of IP rights, product quality, and safety standards can still be advantageous to them. The turning point in the development trajectory when such violations will become more harmful to firms and their insiders than useful, could be rather far away. Finally, even if market competition works as the law and economics theory predicts and increasingly disciplines insiders' misconduct in the Chinese market, some firms, particularly those affiliated with state entities, remain shielded from competition. In certain industries and regarding specific firms, monopoly power is intended or at least accepted.[444] The potential disciplinary effect of the product market is therefore limited at the outset to certain market segments and firms.

iv. Managerial Reputation and Labor Market

In a well-cited paper, Fama argued that career prospects induce managers to operate efficiently. Managers' concerns for their reputation and future careers, as well as competition in the managerial

[441] John McMillan & Barry Naughton, *How to Reform a Planned Economy: Lessons from China*, 8 OXFORD REV. ECON. POL'Y 130 (1992).

[442] Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants*, 52 CESIFO ECON. STUD. 415 (2006) (product market competition is unlikely to be an important governance mechanism in China given institutional deficiencies). *But see* Jiang & Kim, *supra* note 80, at 213 (suggesting that product market competition in China can discipline managers because they do not want to "lose face" when compared to benchmark competitive firms and managers).

[443] Hongbin Cai et al., Does Competition Encourage Unethical Behavior? The Case of Chinese Corporate Profit Hiding (2005) (conference paper - The First Asia Corporate Governance Conference, Shanghai, China, 2005), *available at* https://hub.hku.hk/bitstream/10722/114986/1/Content.pdf?accept=1 (finding that competition encouraged Chinese firms to hide profits for tax reasons).

[444] For market entry restrictions that effectuate monopoly-like powers for certain firms in China, *see* Wentong Zheng, *Transplanting Antitrust in China: Economic Transition, Market Structure, and State Control*, 32 U. PA. J. INT'L L. 643, 660–663 (2010).

labor market, push them to perform better and eliminate unnecessary risky behavior.[445] Similarly, it is argued that sanctions of shaming and moral disapproval by the public threaten reputational harm and operate as a disciplinary force in corporate governance.[446]

With respect to China, with the development of the financial market and as professional education improves, the supply of professional managerial talent is constantly growing. The labor market for top managers in listed firms is no longer confined to inexperienced bureaucrats and ex-military. Organs of the Party-state evaluate SOE managers, and the Party's Organization Department dictates the appointments of senior managers in significant firms. These appointments and career decisions are not merely bureaucratic processes; market performance is increasingly considered in the appointment, evaluation, and promotion of Party-state managerial appointees. A study conducted during the early managerial reforms in SOEs (1980-90s) found that the allocation of managers in SOEs was already responding to nascent market forces. Managers were subjected to more frequent review, were demoted, or even fired for poor performance.[447] In more recent studies, reputation through relation-based exchanges was found to have an important contribution to China's economic development even outside communal settings.[448] Another study reflects the importance of reputation for monitoring and disciplining managers in China, through evidence of public criticism in China's stock exchanges and public shaming funneled by the media.[449] Together, these studies indicate that reputational sanctions, and by extension the labor market for managers, bolster capital market activity.

This is true, yet some limitations should be noted. While growing in size, sophistication, and experience, the managerial labor market for senior positions is still confined to a specific pool of people. Competition is narrow since appointments are limited to candidates with certain backgrounds or to those already fostered within specific business groups or state organs. In state-controlled companies, these are often the fortunate officials and party members whose names are listed on the Organization Department personnel lists.[450] Political science research documents how the top of these lists became occupied by the children of the older generation politicians, often called China's "princelings"—*taizi dang*, the princes of the party (or literally, the princes' party).[451] The managerial labor market for state-controlled firms is largely confined to this closed knit layer of cronies.

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445 Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).
446 David A. Skeel, *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2011).
447 Groves et al., *supra* note 33.
448 Franklin Allen et al, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 59 (2005) ("corporate governance mechanisms, such as those based on reputation and relationships … support the growth of the private sector").
449 Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, COLUM. L. REV. 929, 973-976 (2008).
450 Liou & Tsai, *supra* note 400.
451 CHENG LI, CHINA'S LEADERS: THE NEW GENERATION 127-175 (2001); Jeremy Page, *Children of the Revolution*, WALL STREET J. (Nov. 26, 2011), https://www.wsj.com/articles/SB10001424053111904491704576572552793150470. *See generally* Ting Chen & James Kai-sing Kung, *Busting the "Princelings": The Campaign Against Corruption in China's Primary Land Market*, 134 Q. J. ECON. 185 (2018).

This should not imply that there isn't fierce competition between the members of this class, but it does mean that the demand and supply for managers in many listed firms is not only quantitatively limited, but also that the appointments are often motivated by factors outside professional performance assessment. While this has not yet been examined empirically, it appears that the managerial labor market within the Party-state's institutional infrastructure can incentivize managers to perform better and discipline their actions, but not in a way that is guided by efficiency considerations alone. Other political-economy considerations often guide the appointment, evaluation, and promotion of managers in many listed firms and particularly in state-controlled firms.[452] This changes the traditional corporate governance function of reputational sanctions and managerial labor market in China.

2. Gatekeepers

i. Lawyers, Accountants, and Underwriters

Corporate governance theory prescribes an important monitoring role to third-party gatekeepers. Lawyers, accountants, underwriters, and other third-party market gatekeepers are repeat market players whose reputation depends on their ability to monitor effectively and expose corporate mismanagement. Because third-party gatekeepers have a legally reserved role in certain corporate activities, they have access to information that gives them the capacity, and often the obligation, to monitor. Moreover, since their future earnings depend on their reputation, they are presumed to also have an incentive to monitor even without the stick of collateral liability. It is commonly believed that incentives for monitoring by third-party gatekeepers (or the sanctions for failing to do so) outweigh the potential gains from cooperating with corporate wrongdoing and mismanagement.[453]

The research on the role of third-party gatekeepers in the enforcement of China's corporate governance and capital market regime is fairly limited. With respect to underwriters, pervasive state ownership and Party-state control over the industry place underwriters in China in a conflicted position and weaken their monitoring capacity.[454] There is also doubt as to their professional capability to monitor. In a 2008 article, Clarke presents the view that the legal and accounting professions in

[452] While presenting the importance of reputational sanctions on firms and capital markets activity in China, Liebman and Milhaupt found a more limited applicability of such sanctions with regards to state-owned firms. *See* Liebman & Milhaupt, *supra* note 449, at 964-996.

[453] For a full account of the enforcement role played by gatekeepers in corporate governance, *see* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

[454] *See* the discussion of underwriters as part of the Party-state's control in the financial industry and capital markets generally in Section II.B. *supra*. *See also* Chao Chen et al., *The IPO Underwriting Market Share in China: Do Ownership and Quality Matter?*, 46 J. BANKING & FIN. 177 (2014); Bill B. Francis et al., *Political Connections and the Process of Going Public: Evidence from China*, 28 J. INT'L MONEY & FIN. 696 (2009).

China were not yet equipped to play an effective gatekeeper role.[455] Lawyers and accountants at the industry level still lack the professional capability and the independence needed to expose complex financial fraud. A shortage of qualified accounting firms and the (albeit narrowing) shortage of trained lawyers shrink the potential importance of good reputation in these industries. Recent accounting scandals involving Chinese firms investigated by the U.S. Securities and Exchange Commission suggest that this has not improved much since.[456]

With limited reputational rewards and with little policing against wrongdoing gatekeepers, third-party gatekeepers are less incentivized to monitor corporate control parties. Under the current institutional setting in China, they often have more to gain from cooperating with corporate malfeasance than from monitoring and exposing it.

ii. Financial Press

The financial press is known as a meaningful "watchdog" against corporate malfeasance, taking up an important role as an external corporate governance mechanism in many systems around the world. By exposing corporate wrongdoing and disseminating information, an active financial press also facilitates the monitoring role of other institutions, such as the stock market, reputation, and public and private enforcement.[457] Transparency and objectivity are the cornerstone of an effective financial press. These are preconditioned on the financial press' ability to be independent from various interested parties.

Sources of information and media platforms in China are growing constantly, creating increased competition in an industry that until recently was open only to the state. This opens up access to information and potentially leads to competition on the quality and accuracy of the news as well. The academic literature points to the rise of the Chinese media as a social influencer in recent decades, and its growing role within the Chinese legal system. Moreover, it shows that the commercialization of media and expanded editorial discretion leads to some[458] critical reporting.[459]

The same literature also reports that these platforms are still controlled, and in many cases owned, by the Party-state through various means. Formal licensing and content regulation govern the field and impose entry barriers, while libel laws as well as formal and informal Communist Party policy

[455] Clarke, *supra* note 115, at 181-182.
[456] *See SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents*, U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 3, 2012), https://www.sec.gov/news/press-release/2012-2012-249htm.
[457] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 798-799 (2000).
[458] For the idea that the press has a supervising role over citizens in China, *see* Benjamin Liebman, *The Media and the Courts: Towards Competitive Supervision?*, CHINA Q. 833, 847 (2011) (suggesting that the press is competing with other horizontal institutions on a "supervising" authority).
[459] Benjamin Liebman, *Watchdog or Demagogue? The Media in the Chinese Legal System*, COLUM. L. REV. 1, 1-41 (2005).

through local propaganda departments direct content management.[460] Most influential among these are informal rules directing editorial decision making, which are said to control the targets and the subject matter of reports, as well as to limit true investigative journalism to jurisdictions outside the location where the media is operating.[461]

Thus, while the financial press is becoming more autonomous and increasingly influential, it still lacks independence from the most important interested party—the CCP. Media reports are still ultimately subject to Party scrutiny and will therefore continue to be used first and foremost to maintain Party-state legitimacy or advance its other priorities. Two recent examples of this can be viewed in the cherry-picking and timed coverage of officials accused in the anti-corruption campaign[462] and the state-promoted media campaign in the wake of the two recent stock market crashes. In the latter case, state-controlled media covered extensively the arrest of "disloyal" journalists for their contribution to market-price declines, and "foreign forces" were blamed for market volatility.[463] In both examples, it is clear that the press assumes a disciplinary role and can bring light on corruption and other corporate abuse, but in a controlled and guided manner that can easily be directed to strengthen the current regime.

3. The Legal System

i. Public Enforcement — The CSRC

It seems that the China Securities Regulatory Commission (CSRC) has put the protection of so-called "public" (*gongzhong*) shareholders at the forefront of its mission. The CSRC has stepped into aspects of internal governance that are traditionally reserved to the Company Law. It has done so not only by issuing recommended best-practices, such as the 2001 Code for Corporate Governance, but also by enacting a number of *mandatory* regulations that override what is only enabled in the primary statute.[464]

For instance, even before the 2005 amendment of the Company Law, the CSRC issued the Guidance for Independent Directors discussed earlier, which required listed firms to amend their

[460] *Id.* See also Liebman, *supra* note 458, at 845 (noting the use of libel laws as means of media control, as well as the use of defamation litigation to protect local interests).
[461] Liebman, *supra* note 459, at 41-56.
[462] This was reflected in the scope of anti-corruption investigations on which news items were published as opposed to a much higher number of investigations and the vast nation-wide coverage of the case of Bo Xilai, which was presumably to achieve populist legitimacy for the move. *See Anti-Corruption by the Numbers*, CHINA LAW TRANSLATE (Apr. 16, 2014), http://www.chinalawtranslate.com/corruption-by-the-numbers/?lang=en.
[463] *China Is Trying to Blame Its Stock Market Crash on Journalists and Businessmen*, VICE NEWS (Aug. 31, 2015), https://news.vice.com/article/china-is-trying-to-blame-its-stock-market-crash-on-journalists-and-businessmen.
[464] Howson, *supra* note 143 (offering reasons as to why the CSRC was allowed this position).

bylaws and appoint independent directors to their boards.[465] Around the same time, it enacted rules that were designed to make the decision-making process with respect to the sale, exchange, or purchase of major assets independent from the controlling shareholders of the firm.[466] Perhaps most reflective of the CSRC's investor protection orientation are the CSRC 2004 Provisions, which promoted minority shareholders participation in governance through a public- shareholders' negative veto on certain corporate decisions.

The 2004 Provisions required approval by the shareholders' assembly (with the support of at least fifty percent of the "general public shareholders," understood to mean holders of publicly-listed shares not affiliated with the controlling parties) for the following matters: issues that would have a material impact on public shareholders; any new issuance of stock or convertible debt to the public; rights offering; major asset reorganization; repayment of a debt by a shareholder; and any overseas listing by a significant subsidiary of the listed company.[467] This negative veto conferred on non-controlling shareholders in listed firms outside primary law is a meaningful mechanism for minority shareholder protection and provides an opportunity for their participation in governance. The CSRC 2004 Provisions also urge (not require) firms to proactively increase the presence of public shareholders in shareholders' meetings and to enhance their participation by enabling solicitation of voting proxies and cumulative voting.

The rules set forth in the CSRC 2004 Provisions are only one example of how China's capital markets regulator is increasingly intent on responding to broad investors' expectations in order to encourage the flow of capital to the market.[468] However, granting protections and guaranteeing protections are two separate things.[469] While the CSRC was allowed leeway for regulatory action, its power to enforce its policies has been curtailed by design. Many CSRC rules do not set forth any enforcing mechanisms and leave remedial measures to be set by primary laws.[470] Without prescribing administrative sanctions or remedies for violations of these rules, CSRC enforcement is largely

[465] Independent Directors Guidance, *supra* note 303. For discussion, *see supra* note 304.

[466] Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Guanyu Shangshi Gongsi Zhongda Goumai, Chushou, Zhihuan Zichan Ruogan Wenti de Tongzhi (**中国证券监督管理委员会关于上市公司重大购买、出售、置换资产若干问题的通知**) [Notice of the China Securities Regulatory Commission on Several Issues Concerning Major Purchases, Sales and Exchanges of Assets by Listed Companies] (promulgated by the China Sec. Regulatory Comm'n., Oct. 12, 2001, effective Jan. 1, 2002), *available at* http://en.pkulaw.cn/display.aspx?cgid=38021&lib=law.

[467] CSRC 2004 Provisions, *supra* note 275, arts. 1(1)(a)–(d) (referring to the "general public shareholders group" ("*shehui gongzhong gu gudong*")).

[468] Examples of regulatory activism by the CSRC are numerous. For details on more recent regulatory action by the CSRC, including its 2007 three-year campaign that examined the implementation of corporate governance norms in Chinese listed firms, *see* OECD, CHINA COUNTRY STUDY: SELF-ASSESSMENT AGAINST THE OECD PRINCIPLES OF CORPORATE GOVERNANCE (2011), *available at* http://www.oecd.org/dataoecd/43/52/46931890.pdf.

[469] Gongmeng Chen et. al, *Is China's Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions*, J. ACCT. & PUB. POL'Y (2005).

[470] The 1993 Company Law, which was in force when many of the CSRC rules were enacted, only addressed declaratory remedies or cease and desist orders for violations of shareholders rights. *See* 1993 Company Law, *supra* note 66, arts. 111, 150.

discretionary. In that endeavor, the CSRC has to navigate the myriad of tensions and power conflicts within the PRC political economy.

Public enforcement by the CSRC, particularly against insiders and other controlling parties in state-controlled firms, is not welcomed by powerful Party-state organs and is often held back. Consequently, publicly listed state-controlled enterprises enjoy more lenient enforcement of facially uniform legal standards.[471] The CSRC, like other state agencies, is more likely to enforce laws, regulations, or policies (or enforce them more rigorously) against violators that are unaffiliated with the Party-state apparatus than against those that are affiliated, even in clear cases of oppression or fraud.[472] One example is the fraud case involving Nanjing Textile Import Export Corp., Ltd. The firm was an SSE-listed company with the Nanjing Municipal branch of SASAC as its controlling shareholder (at 35 percent). The company falsified and publicly declared a total of RMB 350 million (approximately USD 54 million) of profits for five consecutive years. The fraud was designed to conceal losses that would have forced the company to de-list. In response, the CSRC merely issued an administrative penalty and minor fines against the company and several of its managers. This was despite broad public calls to apply delisting norms and to enforce more rigorous sanctions, as was the case for other, presumably less-politically connected firms.[473]

Pressures on the CSRC are bound to come from other sources as well. As mentioned, the CSRC is but one state-organ with an authority over the variety of firms that are active in the capital market. It shares the same hierarchical position as some of the most powerful listed groups and also with other ministry-level state organs that take part in regulating and supervising some of the same firms. Overlapping authorities, as well as regulatory competition, make it difficult for the CSRC to enforce its own prescribed shareholder protections in conflicted cases.[474]

Finally, while the norms and mandatory provisions of the CSRC sometimes result in the empowerment of public shareholders to receive fairer treatment, their overall contribution depends on the relative power of the CSRC within the political infrastructure at any given time. The position of the CSRC within China's administrative and political hierarchy has weakened since the 2015–2016 market crash. Subsequent legal enforcement and Party disciplinary procedures were taken against CSRC leading officials. These developments have discredited the agency and wounded its authority

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471 Henk Berkman et al., *Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 1391, 1393 (2010); Allen & Shen, *supra* note 428.

472 Henk Berkman et al., *supra* note 471.

473 *See* Zhongguo Zhengjianhui Xingzheng Chufa Juedingshu (Nanjing Fanzhipin Jinchukou Fufen Youxian Gongsi, Dan Xiaozhong, Ding Jie Deng 13 Ming Zefuren) (中国证监会行政处罚决定书（南京纺织品进出口股份有限公司、单晓钟、丁杰等13名责任人）) [Administrative Penalty Decision (Nanjing Textile Import & Export Co., Shan Xiaozhong, Ding Jie and 13 Responsible Persons), Zhongguo Zhengquan Jiandu Guanli Weiyuanhui (中国证券监督管理委员会) [China Sec. Reg. Comm.] (Apr. 30, 2014), *available at* http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201407/t20140707_257345.htm?keywords= percentE5 percent8D percent97 percentE4 percentBA percentAC. The company was fined RMB 500,000 (approximately USD 76,000), and the individual managers were fined sums between RMB 300,000 – 30,000 (USD 46,000 – 4,600). *Id.*

474 *See* the discussion of Institutional Investors *supra* pp. 53-59.

within China's political economy.[475] Recently, the CSRC, along with other state institutions, has apparently pulled back from capital market governance to make way for more direct involvement by party institutions.[476]

ii. Stock Exchanges – Self Regulatory Institutions

As private (or semi-private) institutions that are commonly owned by their own members, stock exchanges have direct incentives to have well-governed firms. Self-regulation by stock exchanges, therefore, commonly constitutes a meaningful mechanism for monitoring and disciplining firms and their control parties.[477] The New York Stock Exchange, for example, promoted rules that ensured investors' protection in the U.S. market at a time when formal laws and institutions were missing. [478] Several concentrated and emerging markets have similarly recognized the potential of stock exchange self-regulation and allowed for the emergence of designated exchanges with higher disclosure and minority protection requirements, alongside their traditional and path-dependent listing arrangement. In Brazil, the "Novo Mercado" segment of the Sao Paulo Stock Exchange was developed to enable companies to voluntarily commit to better minority shareholder protections. The Brazilian arrangement reduced pressures for comprehensive legal reforms and enabled the adoption of governance mechanisms that otherwise would have been thwarted by existing interest groups. [479] Additionally, some systems – including China's – allow firms to cross-list their shares in other markets, which presumably offer better corporate governance. Cross-listing in these markets, the argument goes, enables firms to commit themselves voluntarily to higher investor protection standards in exchange for broader reach to capital and tapping new markets.[480]

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[475] Party disciplinary proceedings took place against Yao Gang, vice chairman of the CSRC, and Zhang Yujun, assistant chairman of the CSRC. *See, e.g.*, Zhongyang Jiwei Jiancha Bu (中央纪委监察部) [Central Commission for Discipline Inspection], Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Dangwei Weiyuan, Fu Zhuxi Yao Gang Shexian Yanzhong Weiji Jieshou Zuzhi Diaocha (中国证券监督管理委员会党委委员、副主席姚刚涉嫌严重违纪接受组织调查) [Investigation of Yao Gang, Member of the Party Committee and Deputy Chairman of CSRC, under Suspicion of Serious Disciplinary Violations] (Nov. 13, 2015), *available at* http://www.ccdi.gov.cn/jlsc/zggb/jlsc_zggb/201607/t20160704_83027.html. More formal institutional consequences in this direction can be seen in the removal of Xiao Gang, the chairman of the CSRC, from his position following the crises: *See China Removes Xiao as CSRC Head After Stock Market Meltdown*, BLOOMBERG NEWS (Feb. 20, 2016, 7:47 AM), http://www.bloomberg.com/news/articles/2016-02-19/head-of-china-s-securities-regulator-to-step-down-wsj-reports.

[476] *See infra* Chapter 3.

[477] Mahoney, *supra* note 21.

[478] Coffee, *supra* note 21.

[479] Ronald J. Gilson et al., *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2010) (discussing Germany's Neuer Market and Brazil's Novo Mercado).

[480] Most research supporting this theory, known as the "legal bonding hypothesis," is focused on foreign listings on U.S. markets. Coffee, *supra* note 132, at 641; William A. Reese Jr. & Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings,* 66 J. FIN. ECON. 65 (2002).
Yet, limited but notable exceptions reflecting on bonding with other markets show that the motivations for cross listing are numerous and are not necessarily those of self-commitment to advanced governance standards. *See* Jaiho Chung et al.,

In terms of promoting investor-friendly norms through "private regulation," China's stock exchanges have been relatively active. The two national stock exchanges produced rules for disclosure and voting procedures that preceded regulatory efforts. Furthermore, they were the first to offer comprehensive corporate governance guidelines. Indeed, in October 2000, preempting the CSRC Code for Corporate Governance, the Shanghai Stock Exchange released a draft set of corporate governance guidelines for all listed companies.[481] Anglo-American corporate governance norms[482] heavily influenced these guidelines, which set forth shareholder rights, high disclosure standards, and duties on directors and managers. Perhaps most notably, in 2006, both SSE and SZSE created a detailed chapter in their listing requirements on the approval and disclosure process of related-party transactions in all listed firms,[483] something that the national regulators have still failed to do. A year later, the SSE launched its SSE Corporate Governance Board (CG Board). The CG Board is a special listing index with governance rules that seek to prevent public shareholder abuse. Firms included in the index are required to disclose conflicts of interest relating to controlling shareholders, including with respect to dividend distribution, related-party transactions, and board appointments. This resembles the efforts of some stock exchanges in other markets, which enable firms to signal commitment to more stringent investor protection norms within the same capital market.[484]

In terms of the sanctions applied by the stock exchanges for violations of their rules and their overall disciplinary power, the research is limited. The 2006 amendment of the Securities Law broadened the authority of the stock exchanges and granted them powers that until then had been reserved to the CSRC alone: to accept listings, suspend trade, and delist companies. Despite the amendment's defining them as self-regulatory organizations, the stock exchanges are still in fact conduits of the CSRC. The traditional view of stock-exchanges as self-regulatory bodies that rely on private, member-run, independent governance is not applicable to China.[485] Nevertheless, commentators believe that China's stock exchanges have an important enforcement role through various reputational sanctions.[486] Observing and analyzing a total of 109 cases of public criticism

Is Cross-Listing a Commitment Mechanism?: The Choice of Destinations and Family Ownership, 23 CORP. GOVERNANCE 307 (2015) (empirically examining destinations for cross-listing and hypothesizing on firms' motivations in selecting a destination for cross-listing); Nicholas C. Howson & Vikramaditya S. Khanna, *Reverse Cross-Listings - The Coming Race to List in Emerging Markets and an Enhanced Understanding of Classical Bonding*, 47 CORNELL INT'L L.J., 607 (2014) (proposing a theoretical account for a budding phenomenon they refer to as "reverse cross-listing" on emerging markets).

[481] Fu, *supra* note 139, at 11.

[482] Primarily on U.S. corporate governance principles, the 1999 OECD Principles of Corporate Governance, and the UK Combined Code. *See id.*

[483] Rules Governing the Listing of Stocks on the Shanghai Stock Exchange (promulgated by the Shanghai Securities Exchange, May 19, 2006), Ch. 10 ("Related-Party Transactions") [hereinafter SSE Listing Rules]. The Shenzhen Securities Exchange installed a similar listing rule at the same time.

More detailed implementation guidelines followed the SSE Listing Rules. Guidelines for the Implementation of Connected Transactions of Listed Companies on the Shanghai Stock Exchange (promulgated by the Shanghai Securities Exchange, May 1, 2011.)

[484] For example, the Brazilian Novo Mercado and Germany's Neuer Markt. *See* Gilson et al., *supra* note 479.

[485] Liebman & Milhaupt, *supra* note 449, at 945-947.

[486] The authors note the following sanctions at the exchange's disposal, in order of severity: oral warnings, letters of oversight and supervision, notices of criticisms, and public criticisms. Other sanctions are to deem individuals to be

issued by China's stock exchanges against 89 different companies between 2000 and 2006, Liebman and Milhaupt found that public shaming initiated by stock exchange sanctions has significant effects on firms and their insiders (measured by abnormal stock price returns). Interestingly, it was also found that the majority of all sanctioned companies (58 percent) were private listed firms, in contrast to the higher ratio of state-ownership of listed firms in the market as a whole at that time.[487] The authors conclude that China's "stock exchanges have carved out a meaningful, if limited, self-regulatory role for themselves despite severe institutional constraints on their independence."[488]

As meaningful as the stock exchanges may be for corporate governance, they are in no way autonomous institutions. They can exercise their regulatory role only within the confines allowed by the CSRC, which in itself is restrained by the various elements within China's political economy. China's stock exchanges, therefore, while no doubt important to market discipline, do not have enough influence on firms and the corporate governance culture on their own.

iii. Private Enforcement —The People's Courts System

The most shareholder-empowering legal standards and even explicitly mandatory provisions can be easily evaded absent reliable enforcement institutions. I have reviewed the main challenges for administrative enforcement by the CSRC and the limited latitude of self-regulatory institutions. The situation with respect to China's People's Court system is unsurprisingly similar.

The approach to private securities litigation in China has not been particularly welcoming, despite some positive shifts since the turn toward law in the early 2000s. As in many other systems around the world, an American-style securities law class action is not recognized under the current legal framework in China.[489] A private right of action based on a securities law claim can take the form of either an individual action or a joint action.[490] The latter is available for claims in which the number of plaintiffs is fixed at the time of filing or when the court decides to adjudicate several individual suits together for particular reasons.[491] Individual actions also do not have a free pass to courts. In the early

unsuitable to serve as senior managers or directors in listed companies, and to order companies to remove their secretaries. *Id.* at 947-948.

487 *Id.* at 964-966 (proposing various interpretations to these findings).

488 *Id.* at 983.

489 *See generally* Xin Tang, *Protecting Minority Shareholders in China: A Task for both Legislation and Enforcement*, *in* TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 141 (Curtis Milhaupt ed., 2008) (explaining key points in the discussion around class action in China).

490 *See* Zuigao Renmin Fayuan Guanyu Shenli Zhengquan Shichang Yin Xujia Chenshu Yinfa De Minshi Peichang Anjian De Ruogan [Guiding Provisions of the Supreme People's Court Concerning the Acceptance and Trial of Civil Compensation Securities Suits Involving Misrepresentation] (effective Feb. 1, 2003) [hereinafter 2003 SPC Circular]) (incorporating article 54 of the PRC Civil Procedure Law and by implication rejecting article 55 of the same law which governs class actions).

491 For a detailed analysis of the differences between the Chinese joint action and a more recognized (U.S.-style) class action, *see* Hui (Robin) Huang, *Private Enforcement of Securities Law in China: A Ten-Year Retrospective and Empirical Assessment*, AM. J. COMP. L. 757 (2013).

2000s, from a complete rejection of private litigation claims based on securities law, courts moved to accepting some claims, but subject to substantive and procedural limitations.[492] Primary among these limitations is the narrow scope of underlying claims accepted, which is limited to misrepresentation-based claims, as well as a requirement that a claim will be heard only following an adverse finding in public enforcement procedures (administrative penalty or a criminal procedure).[493]

This narrow path has been available to injured investors since 2003, under a Supreme People's Court (SPC) internal policy that was issued to guide lower People's Courts on the adjudication of civil securities claims pertaining specifically and only to misrepresentation claims.[494] Policy statements issued by the SPC as well as its judicial interpretations are non-binding and are formally considered to be guiding in nature. Still, scholars have noted that in practice these documents have been accepted as authoritative within the judicial system.[495] Practically, this means that without an SPC-issued guidance, lower courts will not hear claims based on other securities law claims. A formal legal basis for private securities litigation was acknowledged in the 2005 Securities Law revision, but there as well private litigation seems to have been limited to misrepresentation-based claims.[496] In an informal 2007 statement, the vice-president of the SPC guided lower courts to also accept cases based on insider trading and market manipulation claims.[497] This is similarly implied in a more recent SPC and CSRC joint opinion on matters related to disputes in securities.[498] Yet, as Huang pointed out, very few such

[492] For more information on the relevant Supreme People's Court circulars and background on private securities litigation in China, *see id.* at 760-761 (citing the following circulars: Zuigao Renmin Fayuan Guanyu she Zhengquan Minshi Peichang Anjian Zan Buyu Shouli de Tongzhi [The Notice of the Supreme People's Court on Temporary Refusal of Filings of Securities-Related Civil Compensation Cases] (Sept. 21, 2001); Zuigao Renmin Fayuan Guanyu Shouli Zhengquan Shichang Yin Xujiachengshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [The Notice of the Supreme People's Court on Relevant Issues of Filing of Civil Tort Dispute Cases Arising from Misrepresentation on the Securities Market] (Jan. 15, 2002); 2003 SPC Circular, *supra* note 490.

[493] For a review of additional procedural hurdles embedded in the 2003 SPC Circular, *see* Guiping Lu, *Private Enforcement of Securities Fraud Law in China: A Critique of the Supreme People's Court 2003 Provisions Concerning Private Securities Litigation*, 12 PACIFIC RIM L. & POL'Y J. 781 (2003) (elaborating on procedural provisions regarding standing, jurisdiction, and other prerequisites which the author argues make private action based on securities law "very hard").

[494] *See* 2003 SPC Circular, *supra* note 490.

[495] Randy Peerenboom posits that through this activity the courts perform a "quasi-legislative activity." Taisu Zhang argues that the SPC have been expanding its judicial interpretation capacity through Guiding Cases, a process that gives the SPC a "stare decisis-like authority to select cases." Peerenboom, *supra* note 48; Taisu Zhang, *The Pragmatic Court: Reinterpreting the Supreme People's Court of China*, 25 COLUM. J. ASIAN L. 1, 8 (2012).

[496] Although the revised Securities Law acknowledges the compensation liability of an inside trader and of traders who conducted market manipulation (when it resulted in losses for investors), it has not yet provided the legal basis for private civil litigation based on such claims. Therefore, investors injured by such actions are left to rely on general tort or contract law claims. *See* Nicholas C. Howson, *Punishing Possession - China's All-Embracing Insider Trading Enforcement Regime*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 327, 341-342 (Stephen Bainbridge ed., 2012).

[497] *See* Huang, *supra* note 491, at 761 n.11.

[498] Zuigao renmin fayuan zhongguo zhengquan jiandu guanliweiyuanhui guanyu quanmian tuijin zhengquan qihuo jiufen duoyuan huajie jizhi jianshe de yijian (最高人民法院 中国证券监督管理委员会 关于全面推进证券期货纠纷多元化解机制建设的意见) [Notice of the China Securities Regulatory Commission and the Supreme People's Court on Accelerating the Construction of Diverse Mechanisms for Securities and Futures' Disputes] (promulgated by the Supreme People's Court and the China Sec. Regulatory Comm'n, Nov. 13, 2018), art. 13 [hereinafter SPC & CSRC Joint Opinions], *available at* http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201811/t20181130_347505.html ("For civil disputes arising from illegal acts such as false statements, insider trading, and manipulation of the market, the people's courts need to declare legal rules through judicial decisions…").

cases have since been brought based on these claims, and most cases are rejected or withdrawn due to lack of SPC guidance on how to adjudicate them.[499]Furthermore, the recent SPC and CSRC joint document and subsequent provincial courts' opinions reflect that the People's Courts system is ever more intent on pushing securities claims away from courts into alternative dispute resolution mechanisms.[500]

With respect to a private right of action based on governance claims established in the PRC Company Law, the 2005 revision took an important step to protect the rights of shareholders with judicial remedies. These included the enactment of several liability provisions and shareholder access to courts: liability for shareholders that abused the interests of the company or of other shareholders, with compensation set as a remedy for the company and other shareholders' losses;[501] shareholders' standing to enforce their legally-granted preemptive rights in courts;[502] an access to a type of appraisal by the court in certain cases where shareholders are bought out by the company;[503] an option to ask the court to revoke certain decisions for legal and procedural violations;[504] standing rights against directors and managers for violations that have injured shareholders;[505] and finally, the ability to file a derivative suit on behalf of the company.[506] In August 2017, the SPC issued the No.4 Judicial Interpretation of the Company Law[507] to clarify some of these provisions and guide lower courts when adjudicating claims based on violations of the Company Law. Although it remains to be seen to what extent the No.4 Interpretation will help facilitate adjudication in these cases, prima facie at least, it seems that it did not resolve many of the most criticized hurdles that stand in the way of potential derivative suit plaintiffs.[508]

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[499] Huang, *supra* note 491, at 761 n.11.

[500] SPC & CSRC Joint Opinions, *supra* note 498. The Shanghai Financial Court was apparently the first to formally develop an alternative dispute resolution mechanism for securities law disputes, which received the title "Model Judgment Mechanism." The Beijing Higher People's Court followed recently with a similar model on a trial basis. Under this mechanism, a securities law dispute (practically limited to misrepresentation claims) may be selected as "a model case" for other "parallel" cases belonging to the same group securities disputes, to be deliberated in principle in mediation, based on the model case's fact-finding process and legal analysis. The first application for approval of a model case was submitted March 21, 2019. *See* Regulations of the Shanghai Financial Court on the Model Judgment Mechanism for Securities Disputes, January 16, 2019 https://mp.weixin.qq.com/s/lM6Y7VOG9YiOlPEYZHLMhQ; Beijing Higher People's Court trial Opinions on the Fair and Efficient Handling of Group Securities Disputes According to Law [Jinggao Fafa, 2019, No. 243], April 23, 2019 https://mp.weixin.qq.com/s/P7_NNPhA2HukvpBf60Kogw

[501] 2005 Company Law, *supra* note 147, arts. 20, 21 (determining similar liability and requiring compensation from corporate controllers and insiders who have injured the interests of the company by taking advantage of their affiliations).

[502] *Id.* arts. 34, 71-72.

[503] *Id.* art. 71(3).

[504] *Id.* art. 22.

[505] *Id.* art. 152.

[506] *Id.* art. 149, 151.

[507] PRC Judicial Interpretation No. 16, 2017, Supreme People's Court Judicial Interpretation No.4 of the PRC Company Law (promulgated by the Judicial Comm. of the Supreme People's Court, Dec. 5, 2016, effective Sept. 1, 2017), *available at* http://www.court.gov.cn/fabu-xiangqing-57402.html. Prior SPC interpretations of the Company Law were issued in March 27, 2006 (No.1); May 5, 2008 (No. 2); and December 6, 2010 (No. 3).

[508] For example, with respect to the financing of derivative litigation and the recovery right from the company, the SPC No.4 Interpretation clarifies that the recovery right is only for reasonable costs—without clarification of what this means, and only when the suit was successful. *See id.* arts 23-26.

Shielding the rights of public shareholders with liability provisions and access to courts are of course significant and vital steps in any system that aims to protect investors, but it can hardly ensure implementation. The first impediment to overcome in applying the remedies formally granted to shareholders is the absence of a body that can act on behalf of dispersed investors as a group. Institutional investors in China are captured within a network of state ownership and control, and other coalition-building efforts are restricted.[509] In prior work, I have discussed the option of Party-endorsed organizations that could act on behalf of minority public shareholders. Other Asian countries provide for similar forms of government-backed shareholder coalitions.[510] Scholars in the PRC, Greater China, and abroad have raised the possibility that China would adopt a mechanism similar to Taiwan's Securities and Futures Investors Protection Center (SFIPC).[511] Similarly, one of the recently considered draft amendments to China's Securities Law included a proposal to establish a government-sanctioned organization—the Securities Investors Protection Agency—to support the rights of public shareholders. It was postulated that the institution would hold minimum shares in PRC listed firms, through which it could exercise standing rights in its own name to bring civil claims for securities law violations on behalf of defrauded public investors.[512] Other proposals in the draft amendments contemplated a National Securities Investor Compensation Fund, which would help compensate public investors for unrecovered damages from securities violations and consequent court proceedings.[513] Given the current and historical wariness in the PRC regarding civil society and autonomous institutions, I believe that shareholder-representative institutions endorsed by the Party-state are vastly more likely to overcome the barriers that private coalition-building efforts face than private efforts would be.[514] These draft amendments of the Securities Law, along with any state-backed form of shareholder coalition-building, however, are currently stalled.

Perhaps the most serious barriers that limit the formally granted access to courts are institutional impediments within the judicial system itself. Three main impediments are frequently mentioned in the literature: the professional inadequacies of judges, particularly in commercial and business law matters;[515] the courts' lack of authority to develop "case law" due to various reasons,

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509 *See* the discussion above in monitoring by Other Shareholders.

510 Milhaupt, *supra* note 128, at 204–05.

511 Endorsed and partially funded by Taiwan's securities regulator, the SFIPC holds 1,000 shares of each public company in Taiwan. The organization uses this position to strategically implement available corporate governance mechanisms to promote the interests of minority public shareholders. Specifically, the SFIPC files derivative and class-action suits against insiders, functions as a mediation center for investors' disputes, operates a protection fund to compensate unobtainable investors' losses, and is also authorized to enforce profit disgorgement cases. *See* Wen-Yeu Wang Wallace & Jianlin Chen, *Reforming China's Securities Civil Actions: Lessons from US's PSLRA Reform and Taiwan's Government Sanctioned Non-Profit Organization*, 21 COLUM. J. ASIAN. L. 115 (2008).

512 *See* Revised Draft for Proposed Amendments to the PRC Securities Law (promulgated by the China Sec. Regulatory Comm'n), arts. 144, 147 (informal copy on file with the author).

513 *Id.* arts. 141, 142. The operation and funding of the compensation fund is unspecified in the draft; presumably these public-shareholder-interest organizations would be funded by a form of tax levied on securities companies, as in Taiwan's SFICP model.

514 Groswald Ozery, *supra* note 101, at 41-44.

515 Professor Gu Weixia provides a comprehensive review of the state of affairs of the judiciary in China. Weixia Gu, *The Judiciary in Economic and Political Transformation: Quo Vadis Chinese Courts?*, 1 CHINESE J. COMP. L. 303 (2013).

including their relative position within the administrative hierarchy, a general social distrust in the courts' system,[516] and the limited role historically reserved to courts as a legal institution; and finally, the court system's capture within the existing political economy, which leads to its complete lack of independence. Howson's noteworthy analysis distinguishes between the People's Courts' competence; their institutional autonomy, defined in the PRC context as "the ability of the judicial institution to act with its own institutional authority"; and their political independence, defined as "the ability of courts and judicial officers to act independently from, and against the interest of, political or military power."[517] Gu adds an additional, valuable layer of analysis that distinguishes between the institutional independence of the judiciary as a whole and the independence of decision making by individual judges. The former is compromised due the way courts are administratively accountable to the corresponding level of the People's Congress and funded by the corresponding local People's Government, while the latter is compromised due to individual judges' job insecurity that stems from their terms of office, the political nature of their appointment, and the politically-infused structure of their professional evaluation.[518]

These barriers are felt particularly when controversial cases arise. These are cases that pose potential threats to the legitimacy of the Party-state system, based not only on their substantive matter but also on the identity of the litigants. Cases in which investors' claims are against state-controlled companies and affiliated defendants, claims potentially pertaining to a large number of litigants, or simply those that reflect badly on either the Party or the state (central or local governments) are often pushed away by the courts. Howson and Clarke have shown that derivative lawsuits involving listed PRC companies are almost completely absent from the People's Courts. They attribute this (among other barriers to derivative litigation[519]) to the fact that cases involving publicly-listed firms commonly include large plaintiff groups and often seek the accountability of Party-state actors and institutions. Thus, according to the authors, these cases are potentially sensitive because they may affect social stability in politically related contexts, and they are therefore discouraged or prohibited:[520]

> In most cases, it [the controlling shareholder] either is or is closely connected to a governmental entity or Party organization. This means that there is a higher likelihood that a shareholder lawsuit or a derivative suit involving a corporatized entity, especially a politically privileged one that has been allowed to access the public capital markets, will, in substance, be

[516] The Congressional-Executive Commission on China reports "over 68 percent of surveyed judges identified local protectionism as a major cause of unfairness in judicial decisions." *Judicial Independence in the PRC*, CONGRESSIONAL-EXECUTIVE COMMISSION ON CHINA, https://www.cecc.gov/judicial-independence-in-the-prc (last visited May 25, 2019). *See also* Yuhua Wang, *Court Funding and Judicial Corruption in China*, 69 CHINA J. 43 (2013) (examining the setting and practice of courts' funding and their perceived judicial corruption).

[517] *See* Howson, *Corporate Law in the Shanghai People's Courts*, *supra* note 142, at 327-329 (discussing cases from the Shanghai People's Courts reflecting more and less autonomy).

[518] Gu, *supra* note 515, at 313.

[519] *See supra* note 508.

[520] Howson & Clarke, *supra* note 180. *See also* Howson, *Corporate Law in the Shanghai People's Courts*, *supra* note 142, at 404–407.

> directed at a Party group, the state, a state-affiliated agency, or the agent of any of these. The claim will therefore be politically sensitive—something that is likely to affect the willingness and ability of judicial institutions to accept the lawsuit and hear the underlying claim.[521]

On the other hand, a recent study by Ang and Jia found that disputes relating to politically-connected firms are primarily those that do reach the courts' doorsteps.[522] The research was conducted on disputes involving private firms but might still suggest that connected parties rely (and know that they can rely) on their political connections to influence the court to rule in their favor. Either way, whether cases involving connected listed firms are likely to be rejected by the courts or to be decided in the connected party's favor, it is not good news for public investors. Both options clearly show that political economy has a determinant effect on the operation of legal institutions and supplants the enforcement of legal rights.

A non-independent court system imbedded within the Party-state bureaucracy cannot work to check and balance the power of corporate control parties over minority investors. Given that the court system is formally and functionally a branch of government enmeshed within the broader hierarchical network, it has an even a greater impartiality challenge when the control parties are at an equal or higher position within the Party-state hierarchy—exactly the occasions where checks and balances on abuse of power are most needed.

There have been efforts in the past few years to reform the People's Court system.[523] The institutional structure was changed so as to centralize the management and funding of local courts at the level of the provincial governments (rather than by lower-tier local authorities) and to create cross-jurisdictional courts.[524] Yet, to my understanding, these efforts focus on centralizing control over the judicial system, not reducing it. The reforms focus on increasing professionalism and curbing local protectionism, and most changes are limited to curbing courts' dependence on immediate local governments. These efforts may result in more autonomy in some lower-level cases, but nothing in these efforts aims to increase the independence of the court system from the Party-state apparatus more generally, nor to strengthen the autonomy of judges.

The institutional setting, legal framework, and academic research overall portray the People's Court system as a weak legal institution that is unable and unwilling to enforce legal rights against the various elements in China's controlling apparatus, be they the listed units of China's national champions and their corporate control parties, or the local governments as shareholders and their

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[521] Howson & Clarke, *supra* note 180, at 247.

[522] Yuenyuen Ang & Nan Jia, *Political Connections and Use of Courts in Dispute Resolution: A Survey Analysis of Chinese Private Firms*, 76 J. POL. 318 (2014) (on a dataset of 3,900 private firms, the authors show that politically-connected firms (firms with government-appointed senior managers) are more likely to adjudicate in courts in case of a dispute, as opposed to firms that are not politically-connected, which prefer other forms of dispute resolution).

[523] *See generally China Issues White Paper on Judicial Reform of Chinese Courts*, CHINA DAILY, (Feb. 27, 2017, 2:29 PM), http://www.chinadaily.com.cn/china/2017-02/27/content_28361584_3.htm.

[524] Carl Minzner, *Legal Reform in the Xi Jinping Era*, 20 ASIA POL'Y 4, 7 (2015).

appointees. The courts' pronounced reluctance to adjudicate in such cases curtails the system's ability to restrain corporate control parties *ex ante* and to hold them accountable *ex post* as well.

* * *

This chapter has presented the institutional setting within which Chinese listed firms are embedded and showed how this, along with China's continued embrace of state capitalism, has resulted in a structured predicament for public shareholders. There is a broad range of conventional corporate governance mechanisms that are commonly entrusted with monitoring and disciplining firms and their control parties, and China's corporate governance framework appears to include many of these traditional mechanisms, implying an investor-friendly approach. When examined up close, however, the internal governance mechanisms are clearly captured by institutional barriers and conflicting interests. Market institutions are similarly weak or altogether missing. Taken together, corporate governance institutions in China are not designed to monitor insiders and protect investors against abuse, nor to promote efficient allocation of capital. Rather, they are clearly aimed at ensuring other goals: entrenching existing controllers and guaranteeing the continuous flow of outside capital to state-controlled and otherwise politically affiliated PRC listed firms.

CHAPTER 3: THE GREAT REVERSAL: POLITICIZATION OF CORPORATE GOVERNANCE IN CHINA

Considering the rise of public firms in China and the corporate governance framework described in chapters 1 and 2, China's capital market growth conundrum can be stated thus: China succeeded in fostering the growth of appealing and globally competitive firms, and its capital markets advanced to take a spot among the world's biggest and most meaningful markets, despite weakly-functioning "good" corporate governance institutions *and* strong "bad" ones.

What can explain this law and development conundrum? The answer lies within; the growth of China's public firms and the domestic capital markets within which they operate did not happen despite bad institutions, but because of them. This is not to say that concentrated state ownership and political control did not produce costs. Rather, along with its many obstructions, China's political economy also motivated the development of governance mechanisms that are perhaps idiosyncratic but are apt to overcome its own growth-impeding elements. Thus, alongside the formal embrace of weakly-functioning traditional corporate governance institutions, a parallel and much stronger political governance system operated in the shadows. This system, rooted in China's unique governance structure, monitored corporate control parties, was perceived to hold them accountable, and often in fact did so. The political governance system combatted theft, asset stripping, and corruption, and thereby fulfilled some of the functions of traditional corporate governance institutions. This alternative governance system provided assurances that helped firms grow and kept the cost of capital sufficiently low for capital markets to develop.

China's capital markets developed to function in different ways than expected compared with capital markets elsewhere. Corporate control parties were perhaps effectively monitored by political governance, but they were incentivized to abide by standards that are not necessarily the maximization of firm value. Capital markets flourished, but with efficient allocation of capital as a marginal directive.

The political economic explanation still stands today, when side by side with the continuous growth of public firms, the threats to Party-state unity have now intensified and again destabilize the political-economic equilibrium. Facing rising concerns about its legitimacy, the Party-state is ever more reliant on its ability to sustain growth. Yet, instead of aligning with global best practices and development assumptions, its institutional response still goes against conventional law and development predictions. China's policy makers are opting for intensified political governance. Perhaps most strikingly, this shift is occurring through the formal institutionalization of political control. The Party is exercising an ever more expansive and transparently direct role in market economic activity, through what some may view as a cynical use of the legal system. Public firms in present day China are progressively being governed by what I call a politicized corporate governance.

Conventional internal-governance institutions are undermined by political institutions that are imported into firms, and the disciplinary role of markets is being supplanted in a similar fashion. Legalized into corporate governance, this recent shift toward a politicized corporate governance reflects a formal retreat from outwardly conventional, arguably convergent, corporate governance, back to a loose form of the old divergent planned economy, now openly and "legally" declared.

The legalization of CCP institutions and political measures under the law perpetuates a path-dependent instrumentalist view of the *role* of law in China. Yet it also illuminates a meaningful fact—the *importance* of law, that is, even within its utilitarian function, has evolved. Despite justified reasons for alarm about these recent developments, perhaps in its institutionalized and legalized form, a politicized corporate governance may still offer some benefits.[525]

I. POLITICAL-ECONOMY AND FIRM GOVERNANCE IN CHINA

Symbiotic interaction between the business sector and the polity is a well-recognized element within any regime's political economy. Businesses impact governments through lobbying and other forms of political participation.[526] In the opposite direction, geopolitical affairs, domestic politics, and the political views of individuals inside the firm exert influence on the internal governance of firms, and perhaps even on their performance.[527] At the same time, ironically, the prevailing legal analysis about corporate organization and capital market development still largely disregards political-economic conditions.[528] Institutions of corporate governance and political economy are treated distinctively, detached from one another. As observed in criticism by Milhaupt and Pistor, the legal

[525] A quasi cost-benefit analysis of a politicized corporate governance is offered below. *See infra* Chapter 3, Section III.

[526] Ike Mathur & Manohar Singh, *Corporate Political Strategies*, 51 ACCT. & FIN. 252 (2011) (offering a literature review discussing corporate political participation); Randall Morck et al., *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LIT. 655 (2005) (discussing economic entrenchment in markets held by elite groups as a political-economy problem that creates functionally inefficient capital markets); Pierre-Yves Néron, *Business and the Polis: What Does It Mean to See Corporations as Political Actors?*, 94 J. BUS. ETHICS 333 (2010).

[527] M. K. Chin et al., *Political Ideologies of CEOs: The Influence of Executives' Values on Corporate Social Responsibility*, 58 ADMIN. SCI. Q. 197 (2013); Joseph P. Kalt & L. Adel Turki, *Political, Social, and Environmental Shareholder Resolutions: Do They Create or Destroy Shareholder Value?*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (June 17, 2018), https://corpgov.law.harvard.edu/2018/06/17/political-social-and-environmental-shareholder-resolutions-do-they-create-or-destroy-shareholder-value/; Dimitrios Gounopoulos et al., The Consequences of Political Donations for IPO Premium and Performance (Nov. 19, 2018) (unpublished manuscript), *available at* https://ssrn.com/abstract=3181171.

[528] For notable exceptions, *see* Marco Pagano & Paolo Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005 (2005); Mark J. Roe & Massimiliano Vatiero, *Corporate Governance and Its Political Economy*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 56 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018); Ben Ross Schneider, *A Comparative Political Economy of Diversified Business Groups, or How States Organize Big Business*, 16 REV. INT'L POL. ECON. 178 (2009). For other works by Mark Roe that analyze the determinant role of political economy in corporate organization and capital market development in the United States and in social democratic systems, *see* MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (2002); MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

system is viewed in these endeavors as "a fixed and politically neutral institutional endowment."[529] The prevalent clean divide between law, markets, and politics that have guided legal harmonization efforts around the world throughout the last decades seems perplexing, almost naïve, when confronted with the Chinese context. A political-economic explanation for China's capital market growth removes any doubt about the interconnectedness between politics, law, and economic development outcomes. In doing so, it challenges yet another paradigm thought about the determinants of corporate organization and capital market development.

Surprisingly, however, even the relevant literature on China, while not overlooking the role of politics in corporate governance and capital market development, tackles political economy only narrowly. The studies so far have explored particular attributes within the political-economic system, but no study provided a political economic framework. For example, financial studies have paid significant attention to the potential effects of relational business exchange and of political connections on firm performance.[530] Franklin Allen and coauthors attributed much of China's business growth to the role of non-bank financial intermediaries and their reliance on relationship networks and reputation. While relational incentives, according to the authors, substitute for poor legal mechanisms and support finance in the private sector, the authors reject a similar conclusion for the public market (mainly because they reject the notion that the capital market in China is successful to begin with).[531] A few law scholars explored similar directions. Milhaupt and Zheng attribute the success of large firms in China, regardless of their ownership, to their fostering of connections to the state. Capturing the government by their growth potential, these firms were able to extract economic rents while preventing the state from enacting rules that would limit their advantages.[532] Howson's work on China's publicly-listed but state-owned and managed commercial banks addresses the political accountability system in firms. Based on a collection of media interviews with industry officials and senior managers of China's state-controlled commercial banks, Howson unveils a corporate governance regime that takes form through the Party organization, despite the formal powers bestowed on traditional governance institutions.[533]

To the best of my knowledge, however, no previous study so far has offered a systemic account of China's political economy and its determinant role in corporate organization and capital

[529] *See generally* MILHAUPT & PISTOR, *supra* note 12, at 1-14.

[530] *See, e.g.*, Joseph P. H. Fan et al., *Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms*, 84 J. FIN. ECON. 330 (2007) (treating political connections as a proxy for government interference in firms and examining the effect on post-IPO market performance); Joseph D. Piotroski & Tianyu Zhang, *Politicians and the IPO Decision: The Impact of Impending Political Promotions on IPO Activity in China*, 111 J. FIN. ECON. 111 (2014) (examining the effect of provincial-level political promotions on the pace and scope of IPO activity in China).

[531] Franklin Allen, *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57 (2005); Franklin Allen et al., (2018) *Understanding Informal Financing*, J. FIN. INTERMEDIATION (forthcoming), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3369996.

[532] Milhaupt & Zheng, *supra* note 5.

[533] Howson, *supra* note 278, at 145 ("It is not—as the corporate form might make us think—directors and senior officers held accountable to shareholders. Instead, China's banks (and other SOEs) evidence *nomenklatura* accountable to the Party system, the same system that governs the nominal controlling shareholder of the banks: the state.").

market development. Additionally, my analysis moves away from treating political configurations as constant. Taking a view that economic development, and particularly capital market development, is a continuous, iterative process, my political-economic framework accounts for the shifts and movements that not only shaped the process of development upon initial economic reforms but continue informing it still. In so doing, my analysis explains the growth of firms and capital markets *throughout* China's transition and perhaps into the future.

A. Baseline Configurations

Known as China's "Fragmented Authoritarianism," the unique political structure of the Chinese Party-state has been a focus of extensive research. The governance structure in China is that of a unified, single Party-state with Party institutions shadowing formal state structures, and a devolution of power from the center to local actors at various levels.[534] Lieberthal's analysis is the most recognized description, positing that "authority below the very peak of the Chinese political system is fragmented and disjointed. The fragmentation is structurally based and has been enhanced by reform policies…"[535]

The fragmented authoritarianism analysis on its prolific progeny describes the Chinese Party-state system as a network of power hierarchies within which administrative and economic decision-making authority is allocated. Authority and responsibility in the system are delegated from the central state downward vertically to provincial and lower levels of government, as well as horizontally between state ministries with different, often competing, functional responsibilities.[536] Each level within this complex network of administrative state organs is duplicated by a Party organization that operates in tandem. The Party exercises ultimate control over the entire Party-state system in various ways, including its control over China's main armed forces (the Chinese People's Liberation Army and, more recently, the People's Armed Police), its control over the appointment and promotion of Party and state officials (through the Organization Department of the Communist Party of China), and finally through party education and discipline (enforced among other organs by the Central Commission of Discipline Inspection).

Several commentators have relied on the dynamics within China's fragmented authoritarianism network to explain the country's overall economic development.[537] Whether

[534] *See generally* LIEBERTHAL & OKSENBERG, *supra* note 402 (describing the hierarchical horizontal (territorial) and vertical (from central level down to localities) levels of authority within the Chinese government).
[535] Lieberthal, *supra* note 41, at 8.
[536] Paul Hubbard, '*Fragmented Authoritarianism' and State Ownership*, EAST ASIA FORUM (Jan. 23, 2017), http://www.eastasiaforum.org/2017/01/23/fragmented-authoritarianism-and-state-ownership/.
[537] From the 1990s, following the fragmented authoritarianism analysis, a prolific body of literature emerged to explain how components within China's Party-state network were incentivized to promote economic growth. For a synopsis of the wealth of theories, *see* ANG, *supra* note 36.

describing these dynamics as the practice of "market-preserving authoritarianism,"[538] "Chinese-style federalism,"[539] "experimentation under hierarchy,"[540] local governments' "directed improvisation,"[541] or "local states' corporatism,"[542] commentators share the view that since economic reforms began, sub-national government levels and the state officials appointed on their behalf have become invested in their local economies as direct economic actors. This shift in the political-economic equilibrium — the allocation of administrative and economic decision-making power within the Party-state system— resonated across the entire network and brought counterbalancing measures. It impacted the direct incentives that different components (organizations and individuals) within the network had to promote economic growth. The levers that facilitated this shift were primarily administrative: the dual-track pricing and the fiscal contracting mechanisms, the cadre evaluation system, and management contract responsibility arrangements, mentioned earlier.[543]

The same political-economic reasoning, so far applied generally, can explain the rise of firms and capital market development specifically as well. Bearing responsibility for the economic success or failure of the enterprises under their administrative and political authority, local government organs and individuals guaranteed property rights and created the assurances needed to attract investors during the first decades of economic transition.[544] Thus, as seen in Chapter 1, changes in China's political-economic equilibrium when economic reforms ensued, enabled locally-developed governance solutions that have functioned in lieu of the institutions traditionally entrusted with capital market development (mainly, certain investor protections founded in legal rules).

Further changes in the equilibrium may also affect the incentives of Party-state organs and individuals to continue to provide these assurances. Indeed, as seen in the previous chapter, the attempts to reconsolidate economic authority with the central state during the second transition phase

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[538] Shuhe Li & Peng Lian, *Decentralization and Coordination: China's Credible Commitment to Preserve the Market under Authoritarianism*, 10 CHINA ECON. REV. 161 (1999) (positing that economic decentralization and autonomy for local governments, on the one hand, and coordination and political control by the center, on the other, operated in tandem. This promoted competitive market behavior at local levels, while mobilizing resources and institutions by the center to support the market and the legal system.).

[539] *See, e.g.*, Yuanzheng Cao et al., *From Federalism, Chinese Style to Privatization, Chinese Style*, 7 ECON. TRANSITION 103 (1999) (observing economic decentralization and local experimentation as elements of federalism, a form of "federalism Chinese style"); Gabriella Montinola et al., *Federalism, Chinese Style: The Political Basis of Economic Success in China*, 48 WORLD POL. 50 (1995).

[540] *See supra* note 35 (providing various sources by Sebastian Heilmann) (Enabling local experimentation under the confines of hierarchical political control, tensions and political conflicts were avoided, and consensus was built on the main directions of economic reform.).

[541] ANG, *supra* note 36, at 49-89 ("directed improvisation," achieved through feedback loops between vague central command that produced adaptive response at the localities and fed back to the center, was a key in China's ability to adapt effectively; market-supporting institutions evolved from local improvisation, while the central leadership empowered (as opposed to controlled) ground-level actors).

[542] Jean C. Oi, *The Role of the Local State in China's Transitional Economy*, 144 CHINA Q. 1132 (1995) (suggesting that Chinese local governments operate as a corporate-like group organization. Local officials in each hierarchy manage the enterprises within their jurisdiction like directors and executives. A meaningful role is reserved to the Party secretary at each level to overhead operations and assess performance.)

[543] *See supra* notes 40-46 and the discussion of economic decentralization therein.

[544] Clarke et al., *supra* note 44, at 400-422.

(1992–2007) directly affected ownership structures, firm governance, and the use of the legal system. In turn, during the last decade, the incentives to promote economic growth and the *explicit* allocation of economic (and to some extent even administrative) decision making authority are shifting within the Party-state system once again. Increasingly, the element within the system that is best incentivized to push for investment and growth is the Chinese Communist Party itself and its functionaries.[545] The explanatory power of China's fragmented authoritarianism is therefore very much alive, but the focus is now changing. Relatedly, the use of functional corporate governance substitutes has not receded but only shifted away from local governments' initiatives with central states' balances, to overt political governance.

B. Political Equilibrium Shifts Focus

A key premise in the fields of financial economics and corporate governance is that incentives matter for the behavior of economic actors. If in early reform eras, the organs within the political structure best incentivized to exercise and guarantee property rights in firms were local governments and their officials, in later stages this shifted to the central government, which had vested interests in its emerging national champions and other industrial policies. Efforts were made to reconsolidate authority regarding the growth of firms and capital market development within the agencies of the central state. However, in recent years, power tensions and shifts in the interests of the polity, driven in part by the CCP's intensifying legitimacy crisis, have caused the Party to assert economic (as well as administrative and social) control more directly and transparently over firms and the market.

As a unitary political leadership body, the central Chinese Communist Party organization strongly pronounces its commitment to economic growth.[546] Beyond the rhetoric, many observers of China believe that the legitimacy of the Communist Party rule in China today hangs on its ability to sustain economic growth.[547] Economic growth has become the main basis for the Party's legitimacy,

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[545] I address the notion of separation between the Party and the State below.

[546] The Communist Party Constitution specifically lists economic development as a central task of the Party and "all other work of the Party subordinate to and serve this task." Modernization and bringing the per-capita GDP to levels of "moderately developed economies" are also mentioned as strategic objectives. *See* Zhonggua Gongchandang Zhangcheng (中国共产党章程) [The Constitution of The Communist Party of China] (promulgated by the Nat'l Cong. of the Communist Party of China, Oct. 24, 2017), Preamble [hereinafter The CCP Constitution], *available at* http://www.pkulaw.cn/. More generally, *see* Gilson & Milhaupt, *supra* note 404.

[547] *See, e.g.*, Zachary Keck, *Chinese Elites: The Real Threat to the Communist Party*, DIPLOMAT (Jan 28, 2014), https://thediplomat.com/2014/01/chinese-elites-the-real-threat-to-the-communist-party/ (emphasizing the challenge in rebalancing the economy while maintaining benefits for the political elite); David Shambaugh, *The Coming Chinese Crackup*, WALL STREET J. (Mar. 6, 2015, 11:26 AM), https://www.wsj.com/articles/the-coming-chinese-crack-up-1425659198 (pointing to China's economic "systemic traps" and Xi's reform efforts as one of the indicators to the regimes vulnerability and instability); Joshua Stowell, *An Economic Downturn in China is the Greatest Threat to Chinese Domestic Security—How Long Can the Social Contract in China Endure?*, GLOBAL SECURITY REV. (May 28, 2018) https://globalsecurityreview.com/degree-chinas-internal-stability-depend-economic-growth/; https://globalsecurityreview.com/threats-legitimacy-power-chinese-communist-party/ (viewing "sustained economic growth" as a new mandate of heaven).

on the one hand, and one of the main threats to its political unity and hold on power, on the other. The Party has direct interests in keeping employment and production levels high, building strong global champions, and preserving high state assets' value. Additionally, the success of China's firms, particularly its state-controlled firms, helps maintain the Party's legitimacy both domestically and abroad.[548] On top of that, increasing social gaps and the prominence of lavish crony capitalists among its members, many of them linked to corruption, generate social criticism and reduce the usefulness of ideology as an instrument of control,[549] posing further legitimacy threats. Finally, in addition to these general legitimacy concerns, the ability of the CCP to exert control over the state's administrative system and the individuals operating it is weakening as their economic incentive to defy unitary discipline increases.[550] The consequences of the prior three decades of devolution in administrative and economic authority in the service of economic development still loom large[551] and destabilize the central Party-state organization.[552]

Bearing these complex realities in mind, the Party's incentives to promote growth while closely supervising and even restraining the power accumulated by components within its own system, particularly at local levels, becomes clear.[553] Its control over firms and the financial system is a tool that checks all the boxes toward this goal. Intensifying its grip over firms and the capital market can ease the legitimacy concerns, facilitate monitoring and restraining potential political rivals, allow a controlled-growth process around preferred industrial policies, and showcase the merits (or soft power) of the Party-state system domestically and internationally.

This also explains the shift in equilibrium whereby the Party's recent reassessment of its role comes at the expense of state institutions. The power of central state administrative institutions—

[548] *See generally China Goes Global*, 9 INT'L J. EMERGING MARKETS 162 (2014); Joshua Stowell, *Global Shifts in Geopolitical Trends*, GLOBAL SECURITY REV. (Apr. 2, 2018), https://globalsecurityreview.com/global-shifts-geopolitical-trends/.

[549] Lieberthal, *supra* note 41.

[550] Andrew G. Walder, *The Quiet Revolution from Within: Economic Reform as a Source of Political Decline*, *in* THE WANING OF THE COMMUNIST STATE: ECONOMIC ORIGINS OF POLITICAL DECLINE IN CHINA AND HUNGARY 1 (Andrew G. Walder ed., 2004) (arguing for political decay in the Party-state system attributed to economic reforms).

[551] Andrew Peaple, *Think Local When It Comes to China's Debt*, WALL STREET J. (Dec. 31, 2018, 10:25 AM), https://www.wsj.com/articles/think-local-when-it-comes-to-chinas-debt-11546269929?mod=wsj_harvard2. For local protectionism, *see* Houze Song, *Provincial Snapshot—Liaoning: The Smothering Effects of Local Protectionism*, MACROPOLO, (Mar. 6, 2018), https://macropolo.org/provincial-snapshot-liaoning-smothering-effects-local-protectionism/ (on the connection between protectionism, local-government champions, and competition in Liaoning Automakers industry).

[552] *See supra* notes 40-46 and the discussion of economic decentralization therein.

[553] Following popular criticism against dubious investment activity by privately held Chinese companies abroad, Xi Jinping declared financial stability to be a matter of national security. While this can be cynically viewed as an excuse to simply exert control over private actors, this step seems motivated, at least partially, by a genuine concern for financial stability—protecting public investors in highly leveraged firms operating dubious investments abroad and responding to the mass protests against them. Minxin Pei, *Xi Jinping's War on Financial Crocodiles Gathers Pace—Beijing Will Pass off a Politically Motivated Purge as Though Regulatory Enforcement*, FIN. TIMES (June 25, 2017), https://www.ft.com/content/19810ea2-5814-11e7-80b6-9bfa4c1f83d2. *See also* Lucy Hornby, *Chinese Crackdown on Dealmakers Reflects Xi Power Play*, FIN. TIMES (Aug. 9, 2017), https://www.ft.com/content/ed900da6-769b-11e7-90c0-90a9d1bc9691. ("The regulators' argument that shadow banking posed a national risk found an unlikely ally in China's security apparatus. Ordinary people who had lost money in high-interest products have taken to the streets in every province over the past few years. Nothing captured the interest of the Communist party like a mass protest.").

such as SASAC, the CSRC, and state anti-corruption enforcement agencies—seems to be declining, while the CCP's involvement in various aspects of corporate governance is increasing. In the last decade, the CCP has been the institution that provides assurances to investors. It does so through its own functional substitutes for conventional monitoring and accountability. The new politicized corporate governance system, explained below, is also somewhat less opaque and signals the Party's commitment to growth to the different constituents in the capital market. Given these circumstances, a degree of alignment of interests between the Party and corporate stakeholders, even public investors, is forming.[554]

The CCP's commitment to growth and its incentives to take a more direct role with respect to firms does not necessarily mean that it now has an interest in promoting changes that benefit investors specifically, but it is a possibility.[555] This idea is certainly counter-intuitive. First, it may be taken to suggest that individuals within the Party suddenly prioritize the "greater good" and will forgo opportunities to enrich themselves for the sake of developing more efficient, deeper capital markets. Second, it suggests that the Party can overcome the self-capture that inhibited the state in this area and thus also implies that the Party and the state are distinct.

Indeed, many individuals within the political apparatus have personally enjoyed private benefits from their clout or direct control of publicly listed firms[556] through rent extraction, asset tunneling, self-dealing, and other corporate malfeasance. A path-dependent corporate control in China is certainly established on strong interest groups politics within the controlling apparatus.[557] Incumbent controllers have both the incentives and the power, through direct and indirect political authority, to reject true reforms that could reduce their opportunities to extract rents and/or private benefits of control.[558] This almost impels us to assume that the controlling apparatus would reject

[554] Mary Gallagher uses the expression "alliance of convenience" to describe the convergence of interests between the central government and workers in China. *See* MARY GALLAGHER, AUTHORITARIAN LEGALITY IN CHINA: LAW, WORKERS, AND THE STATE 6 (2017). Here, I suggest a similar alliance is forming between the CCP and capital markets investors. While as pointed out by Prof. Gallagher, the alliance of the central government with workers has supported the mobilization of workers and their empowerment to enforce their own rights, in the capital market sphere a similar alignment seems so far to only shift the mandate of power from state institutions to the Party. Private individuals are still excluded from fully utilizing their rights. *See* the discussion on coalition-building shareholder *monitoring supra* Chapter 2 pp. 59-61.

[555] Victor Nee & Peng Lian, *Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism*, 23 THEORY & SOC'Y 253, 273 (1994) ("analysts need to pay attention to the organizational health of the communist party") (attempting to explain why communist rule initiates reform, suggesting that the increase in opportunism and decline in commitment to the party threatens the political organization).

[556] Cheng Li, *China's Midterm Jockeying: Gearing Up for 2012 (Part 4: Top Leaders of Major State-owned Enterprises),* CHINA LEADERSHIP MONITOR, Winter 2011, *available at* https://www.hoover.org/research/chinas-midterm-jockeying-gearing-2012-part-4-top-leaders-major-state-owned-enterprises (tracking the top leaders of some major 130 companies in China, their demographic background, the fortune of their businesses, and their career path in both business and government).

[557] Bebchuk & Roe, s*upra* note 128 (depicting a role for interest groups politics as one of many causes of path dependence).

[558] *See generally* MANCUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL RIGIDITIES (1982) (suggesting a theory on the resistance of the established economic and political elite to growth-promoting reforms); Raghuram Rajan & Luigi Zingales, *The Great Reversals*: *The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003) (for a similar interest groups theory in the financial market development context, in which incumbents oppose development reforms since these would breed internal competition); Lucian Bebchuk, *A Rent-*

reforms that would reduce its ability to extract value.[559] Nonetheless, while these individuals might not be motivated nor deterred by state legal institutions, they are certainly concerned about their political future. Since the Party organization is now creating substantial pressures to adopt market-growth approaches, and political advancement is aligned with growth and greater efficiency goals, as is increasingly the case,[560] then compliance with this Party-led reform is simply a way to protect their vested interests.

Of course, and as the term "the Party-state" reflects, separating the Chinese state from the CCP is artificial in many respects. Many of the positions in the government overlap with positions within the Party, and the Party directs and controls the administrative system in many ways. However, while 95 percent of civil servants in China (county level and above) are CCP members, there are many more Party members who do not serve as government officials.[561] There are millions of members that at least theoretically (and perhaps superficially) are concerned with the political stability of the regime, but detached from the state's interests. More importantly, while the overlap between the Party and the state is certainly present for senior positions, it does not feature as strongly among lower-level officials and party members. This means that while the interests of the central state and the Party align to a great deal, the conflicts of interests between central and local governments create a de-facto distinction between what is formally viewed as *the state* but is really mainly local governments, and the Party organization. At the individual level, this can create a sense of solidarity or submission to the Party-state, even with a sense of alienation from the government (local). Party-line education contributes to this. This misalignment may explain why individuals could be incentivized to cooperate with the goals advanced through the Party organization, while not being equally cooperative with goals promoted through the state's administrative hierarchy.

More concretely, it is the Party organization, rather than the state, that controls the appointment and promotion of individuals in the Party-state system. Through its Organization Department, the Party organization at each level of the state's hierarchy, including in corporatized SOEs, directs the careers, and therefore the reputation and economic prosperity, of the individuals in the system. Added to that are the coercive methods of the Party that induce accountability through

Protection Theory of Corporate Ownership and Control (Nat'l Bureau Econ. Research, Working Paper No. 7203, 1999) (for a theory of rent protection influences on corporate ownership and control).

[559] Jinglian Wu, *China's Economic Reform: Past, Present and Future*, 1 PERSPECTIVES 5 (2000) (arguing that the vested interests of political and social elite in the old system lead them to hinder reform and restructuring).

[560] *See* Alex Bryson et al., *How Much Influence Does the Chinese State Have over CEOs and Their Compensation?*, *in* INTERNATIONAL PERSPECTIVES ON PARTICIPATION 1 (Jaime Ortega ed., 2014) (finding that the State's influence extends beyond SOEs into many privately-owned firms and that incentive schemes are typical in these firms and include contracts linking CEO pay directly to firm performance); Canan C. Mutlu et.al., *Corporate Governance in China: A Meta-Analysis*, 55 J. MGMT. STUD. 943 (2018) (arguing that the quality of monitoring in state-owned corporations became more strongly related to firm performance).

[561] About 6.45 percent of the overall population in China are members of the Chinese Communist Party, about 90 million people in 2016. *See Chinese Communist Party (CCP) Members as a Share of the Chinese Population from 2007 to 2017*, STATISTA, https://www.statista.com/statistics/250090/share-of-chinese-communist-party-ccp-members-in-chinese-population/ (last visited May 23, 2019).

discipline and fear governance. All these factors together make the Party organization stand out from state institutions and perhaps induce firms and their control parties to submit more easily to goals, growth performance or others, when these are advanced by the Party organization directly.

II. THE POLITICIZATION OF CORPORATE GOVERNANCE — LEVERS OF CCP'S POLITICAL GOVERNANCE IN FIRMS

It is a commonplace to criticize China's political involvement in firms and the capital market. This dovetails with the common expectations for China's future convergence with more market-oriented governance standards. Instead, in recent years, China offers a complete deviation from these orthodox views towards further politicization of corporate governance. Especially since Xi Jinping rose to power, political involvement in corporate governance has been extended far beyond any scope seen since the economic transition began. This political involvement has passed beyond the "normal" overarching shadow control that the CCP has in the economy, beyond its influence over corporate stakeholders (managers and employees), and even beyond the puppeteering of managerial appointments in large state-controlled firms. An absorption (or even a takeover) of internal corporate governing bodies by CCP institutions and a similar replacement of external market monitoring by the Party's disciplinary enforcement is now under way and already reflected in law. In these recent developments, the Party has claimed a mandate over corporate decision making much more directly and transparently. In this environment, the corporate form and the legal system itself are ever more easily harnessed to advance the Party-state's agendas, whether these are national industrial policy goals, social and ideological targets, or sustainable economic growth.

A. The CCP's Intra-Firm Governance Capacity: Personnel Management & Party Committees

The Party has ready tools at the firm level to monitor and steer corporate control parties. Its ability to intervene in corporate decision making is nestled in the Party's institutionalized intra-firm presence, as well as in its control over corporate management. Both routes have recently been formalized and broadened.

1. CCP Control Over Management

Authority over the management of personnel in the Party-state system was always one of the main mechanisms that guaranteed the CCP's central control over the state apparatus and society at large. This includes authority over the appointment, promotion, transfer, and removal of leadership

positions throughout the Party-state system. The CCP's control over the Party and state apparatus thus extends from the center through provincial organizations and down to the level of deputy bureau chiefs in the counties. The main facilitators of this management control are the nomenklatura system, conducted by the CCP Central Organization Department and its local branches,[562] and the cadre evaluation system, conducted by the administrative bureaucracy and directed by the party organization.[563] Both of these personnel management mechanisms apply with respect to leadership positions in state-owned holding companies and their state-controlled subsidiaries as well, including some of their listed subsidiaries, whether they are traded domestically or off-shore.

The nomenklatura system has roots in Soviet communism. It prescribes a list of Party and state positions and the closed group of elite political members that can potentially be appointed to fill these positions. The list details positions that are directly appointed by the CCP Organization Departments (the Organization Department of the Central Committee and the Party Committee Organization Department within SASAC), as well as those that can be appointed, dismissed, or transferred by other state bodies but with the Party's prior approval.[564] With respect to state-controlled firms, the list not only includes the potential appointees for the positions of party secretary and deputy secretary assigned at the top of the enterprise's Party committee, but also the potential appointees for senior managerial positions in these firms, including the chairman of the board and president, the CEO, and in some firms also other senior positions, such as the chief financial officer and chief legal counsel.[565] The appointment of the CEO in (at least) the largest fifty-three corporatized SOEs is[566] vested with Party organs despite the formal prescriptions in the Company Law and the SOE Assets Law that assign such authority to the firm's internal governance bodies (the board of directors or SASAC, respectively).[567] This appointment process explains why the general managers of some of the

[562] John P. Burns, *Strengthening Central CCP Control of Leadership Selection: The 1990 Nomenklatura*, 138 CHINA Q. 458 (1994).
[563] Ganbu Kaohe Zhidu (干部考核制度), commonly referred to as the "cadre evaluation system," "cadre responsibility system," "personnel appointment and evaluation system," "target responsibility system," and more. *See* Zhen Wang, Who Gets Promoted and Why? Understanding Power and Persuasion in China's Cadre Evaluation System, (unpublished manuscript presented at the Annual Meeting of the American Association for Chinese Studies, October 11-13 2013, New Brunswick, New Jersey), *available at* https://aacs.ccny.cuny.edu/2013conference/Papers/Zhen%20Wang.pdf.
[564] Kjeld Erik Brødsgaard, *Politics and Business Group Formation in China: The Party in Control?*, 211 CHINA Q. 624, 633 (2012).
[565] Feng Liu & Linlin Zhang, *Executive Turnover in China's State-Owned Enterprises: Government-Oriented or Market-Oriented?*, 11 CHINA J. ACCT. RES. 129 (2018). (The authors, however, find that executive turnover changes according to the level of direct ownership and control by the government. The reliance on bureaucratic and political appointment is weaker in firms with indirect state ownership, for which open recruitment is a growing trend.). *See also* Burns, *supra* note 562, at 468, 474-491 (providing a full list of all economic enterprises).
[566] Kjeld Erik Brødsgaard, *Can China Keep Controlling It's SOEs?*, THE DIPLOMAT (Mar. 5, 2018), https://thediplomat.com/2018/03/can-china-keep-controlling-its-soes/.
[567] *See* Brødsgaard, *supra* note 564, at 639 (providing details from interviews on how the process of CEO selection and appointment is done in practice and the negotiations between the CCP Organization Department, SASAC, and the board). *See also* Lin & Milhaupt, *supra* note 31, at 737-743 (for how this differs from more conventional corporate appointment rights and procedures). For a recent example of the allocation of nomination and appointment authorities of general managers between SASAC and the board, *see yangqi Zongjingli you Guoziwei renming gaiwei timing renming quanjiao Dongshihui* [*The General Manager of the Central Enterprise Was Appointed by the State-Owned Assets Supervision and Administration Commission to Be Nominated to the Board of Directors*], CHINA ECON. DAILY (Jan 22, 2018), http://www.ce.cn/xwzx/gnsz/gdxw/201801/22/t20180122_27848290.shtml (loose title translation).

corporatized SOEs enjoy political clout and administrative status that is equivalent to that of a minister (or vice minister) or of a provincial governor in the state's bureaucracy.[568]

The cadre evaluation system has a more contemporary origin. It was created in the late 1970s and early 1980s to rebuild China's shattered bureaucracy after Mao's era and was one of the fundamental elements of reforms in China's administrative system. The cadre evaluation system is used to evaluate party leaders and cadres in leading positions at local levels of the government.[569] It is based on performance criteria, which are set by the CCP Organization Department and applied by the immediate superior level of the relevant party or government units.[570] The results of the evaluation guide the decisions about officials' appointment, promotion, transfer, and removal, and thus directly affect their career trajectories.

This management control system also impacts the behavior of corporate control parties and other insiders. Howson notes how "the real powers behind the firm are not monitored by the shareholder at all, but instead by a separate and superior Party organization."[571] Some of the implications of this political governance system extend even to firms without any state ownership. It operates mainly at two levels.

First, the performance of enterprises is inspected as an evaluation criterion. Overall economic development and firm performance are measured by revenue growth, total profits, operating profits, investments in technological innovation, environmental protection, legal disputes (for fear of social unrest), and more. These are taken as factors in the assessment of both officials assigned to monitor enterprises[572] and agents appointed to manage state-controlled firms.[573] This incentivizes local Party-state officials and managers to seek good economic results, motivates them to monitor against (or avoid getting involved in) fraud and embezzlement, and discourages other corporate scandals that may

[568] Brødsgaard, *supra* note 564, at pp. 624-648.

[569] Prior to the introduction of the cadre evaluation system, Party and state officials were appointed and promoted based on loyalty to Party leaders and other political considerations.

[570] For a description of the system's mechanics, *see* ANG, *supra* note 36, at 110 ("Through the cadre evaluation system, each level of government designs a report card for leaders (party secretary and state chiefs) at the next lower level. Each year, the higher level issues an internal formal document, typically restricted from public view, which specifies a list of targets that subordinated leaders are expected to deliver in that particular year. Points are assigned to each target, usually totaling one hundred points. To set up competitive pressures, local leaders are ranked relative to their peers annually.").

[571] Howson, *supra* note 278, at 143.

[572] *See* Zhongyang Qiye Fuzeren Xinchou Guanli Zanxing Banfa (中央企业负责人薪酬管理暂行办法) [Interim Measures for Remuneration Management for Central State-Owned Enterprise Executives] (promulgated by the State-Owned Assets Supervision and Admin. Comm'n of the St. Council, May 13, 2003), *available at* http://en.sasac.gov.cn/n1408035/c1477199/content.html; Zhongyang Qiye Fuzeren Jingying Yeji Kaohe zhanxin Banfa (中央企业负责人经营考核暂行办法) [Interim Procedures on the Evaluation of the Financial Performance of Central SOE Leaders] (promulgated by the State-Owned Assets Supervision and Admin. Comm'n of the St. Council, Dec. 28 2009, effective Jan. 1, 2010), *available at* http://www.gov.cn/flfg/2010-01/22/content_1517096.htm.

[573] Yubo Li et al., *A Survey of Executive Compensation Contracts in China's Listed Companies*, 6 CHINA J. ACCT. RES. 211 (2013) (examining executive compensation contracts in Chinese listed firms, including a description of evaluation measures for executive performance in government-controlled listed firms).

lead to social unrest. By implication, to some degree this also deters against stakeholder abuse that could result in litigation, environmental scandals, and labor disputes.

Second, there is a substantial overlap between China's business elite and its political elite, and the career advancement trajectories in both are highly interconnected.[574] SOE executives who have become local government and party leaders are a sizable and increasing group.[575] In turn, experience in provincial government is a primary stepping stone to central party leadership,[576] to which many of these individuals aspire.[577] In a sense, China's rising crony-capitalism as it is embedded in its unique governance structure means that corporate conduct, firm performance, and the political trajectory of its elite are interdependent.[578] This is true even for managers who are not currently subject to the cadre evaluation system directly but have ambitions to enter the Party-state system. These incentives are therefore relevant to corporate insiders regardless of the existence of any type of state-ownership in the firm.[579] Viewed somewhat optimistically, this element in China's political-economy can incentivize corporate control parties and insiders to perform better and even to increase productivity and firm value.[580]

The CCP's personnel management system is thus a political institution with monitoring and incentivizing corporate governance functions.[581] It operates outside any mechanisms provided by traditional corporate governance institutions or framework established in law. This Party system is also far more centralized than the formal state system behind which it stands.

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[574] Bruce Dickinson's book discusses the incorporation of China's capitalists into the political system (terming this "crony-communism"). BRUCE DICKINSON, WEALTH INTO POWER: THE COMMUNIST PARTY'S EMBRACE OF CHINA'S PRIVATE SECTOR (2008).

[575] Brødsgaard, *supra* note 564, at 639-641 (pointing to the representation of industrial business groups in the CCP Central Committee, and tracing eighteen corporate leaders who were appointed to high-rank government positions).

[576] Cheng Li & Lucy Xu, *The Rise of State-Owned Enterprise Executives in China's Provincial Leadership*, BROOKINGS (Feb. 22, 2017), https://www.brookings.edu/opinions/the-rise-of-state-owned-enterprise-executives-in-chinas-provincial-leadership/ (noting that provincial governors and party secretaries appointed following their leadership roles in SOEs comprise sixteen percent (10 out of 62) of all provincial-level leaders, which demonstrates a rapid growth in this group during Xi's regime). Within the 18th Central Committee, seventy-six percent of Politburo members served previously as provincial chiefs.)

[577] *See, e.g.*, Hongbin Li, et al., E*conomic Returns to Communist Party Membership: Evidence from Urban Chinese Twins*, 117 ECON. J. 1504 (2007) (examining economic return of party membership).

[578] Li & Xu, *supra* note 576. For a specific application of this in the energy sector, *see* Liou & Tsai, *supra* note 400.

[579] Bryson et al., *supra* note 560 (finding that government involvement in the appointment of senior management extends beyond state-owned firms into privately owned firms and across all industrial sectors).

[580] Jerry Cao et al., *Political Promotion, CEO Incentives, and the Relationship between Pay and Performance*, MGMT. SCI., May 2018, *available at* https://www.researchgate.net/publication/324958863_Political_Promotion_CEO_Incentives_and_the_Relationship_Between_Pay_and_Performance (finding that the likelihood of CEOs in Chinese SOEs to receive political promotion is positively related to firm performance and that CEOs with higher likelihoods of political promotion have lower pay levels, and concluding that political career concerns substitute for monetary incentives).

[581] Downs and Meidan suggest that part of the motivation behind the reshuffling of top executives in the national oil industry by the CCP in 2011 was to improve corporate governance in these firms. Erica Downs & Michal Meidan, *Business and Politics in China*: *The Oil Executive Reshuffle of 2011*, CHINA SECURITY, 2011, at 3.

Having emphasized the corporate monitoring and incentivizing functions of China's political governance, some limits should be recognized. First, with respect to incentivizing officials tasked with supervising firms, the portrayal of China's SOE corporatization process and further organizational reforms under SASAC exposed the weaknesses in monitoring by the state in its shareholding capacity. This suggests that China's personnel management system currently in place is not as effective at discouraging corporate wrongdoing as it is with more explicit performance evaluation criteria. For example, the system is successful at making local governments pursue research and development opportunities for their region or bring their GDP figures up, but not as much at promoting good corporate governance practices. One explanation could be that the personnel management system mobilizes officials to monitor firms in their region only within the narrow confines of its defined evaluation criteria. Corporate value maximization or production efficiency are not specifically enumerated but rather are ancillary to other targets.

Second, with respect to incentivizing corporate insiders tasked with managing, to the extent that the personnel management system is effective in governing the conduct of corporate insiders, it does not necessarily follow that the direction pursued is toward firm value. It can instead direct managers to pursue proxies of success (e.g., growing bigger not better), avoid risks at all costs, or even toward fraudulent reporting. Additionally, other political concerns are tunneled through this system and influence business decisions.[582] The managers, aspiring for careers in the Party-state system, will opt for business decisions that they believe serve the Party-state's goals in each context.[583]

Thus, the personnel management system functionally substitutes for traditional corporate governance to a degree. It does so mainly by an overall push for firms and insiders to be profitable and invest in innovation, as well as by deterring against undesirable conducts. However, in order to fully induce monitoring and incentives that lead specifically to greater operational efficiency or firm value maximization, these would have to be expressly advocated through the system as specific criteria by which officials and corporate control parties are assessed. While these specific goals are certainly not at the top of the CCP priority list, there is some indication for their stronger advancement recently.

Judging by the Party-state leadership's rhetoric, the Party's policy emphasis is moving in this direction. In October 2016, a meeting of the Politburo Standing Committee with several leading SOE leaders was dedicated to the subject of "building the role of the Party within SOEs." In this meeting, President Xi stated that SOEs should become important forces in implementing CCP decisions and enhancing China's national power. Beyond this, Xi stressed that the development of SOEs—including specifically, improved corporate profitability, competitiveness, and preserving or increasing the value of state assets—should become a criterion in evaluating the performance of Party organizations. Xi also called to better define the Party's power and responsibilities with respect to SOEs' decision-

[582] *See* Bryson et al., *supra* note 560 (also finding that where the government is involved in the appointment of senior level managers, whether in state-owned or privately owned firms, managers have less decision making autonomy).
[583] For further discussion on these "agency-costs"-type concerns, *see supra* Chapter 2, Section II.A.

making and supervision against corruption, embezzlement and other corporate malpractice.[584] The release of the SOE Reform Guiding Opinions[585] and more recently the PRC Supervision Law [586] repackage these goals in a legal framework by giving the party-organization specific governance capacities with respect to firms, as both a distinct internal corporate stakeholder and an external disciplinary and accountability institution.[587]

2. Formal Stakeholder Capacity: Corporate Party Committees

The Party's presence in firms is felt through its involvement with various stakeholders in the firm, such as trade unions, the Communist Youth League, and other mass groups and organizations formed within the corporate structure.[588] Yet the Party also has a distinct corporate stakeholder capacity of its own, which facilitates the performance of the Party's monitoring functions and other goals. This capacity is addressed by several articles in the Constitution of the CCP.

Article 29 stipulates that a primary Party Organization (also known as the Party Committee) will be formed in every enterprise, whether state or privately owned, where there are at least three full members of the Party. Article 31 grants this intra-firm political institution a designated monitoring role: to make sure that "Party and non-Party cadres strictly observe the law and administrative discipline and the financial and economic statutes and personnel regulations of the state and that none of them infringe on the interests of the state, the collective or the masses."

Article 32 further stipulates: For public-sector firms: "In a state-owned or collective enterprise, the primary Party organization acts as the political nucleus and works for the operation of the enterprise. The primary Party organization guarantees and *oversees* the implementation of the principles and policies of the Party and the state in its own enterprise and *backs the meeting of shareholders, board of directors, board of supervisors and manager* (factory director) in the exercise of their functions and powers according to law. … and *participates in making final decisions on major questions* in the enterprise.]" For private-sector firms: "In a non-public economic institution, the primary Party organization carries out the Party's principles and policies, *provides guidance* to and *oversees* the enterprise in observing the laws and regulations of the state, exercises leadership over the trade union, the Communist Youth League

584 *Xi Stresses CPC Leadership of State-Owned Enterprises*, CHINA DAILY (Oct. 12, 2016, 11:25 AM), http://www.chinadaily.com.cn/china/2016-10/12/content_27035822.htm.

585 Zhonggong Zhongyang, Guowuyuan Guanyu Shenhua Guoyou Qiye Gaige de Zhidao Yijian (中共中央、国务院关于深化国有企业改革的指导意见) [CPC Central Committee and State Council Opinion on Deepening the Guidance of State-Owned Enterprise Reform] (Aug. 24, 2015) [hereinafter "SOE Reform Guiding Opinions," or "Guiding Opinions"], *available at* http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm.

586 *See infra* note 654.

587 I elaborate on the external disciplining and accountability functions of Party governance below.

588 For the relationship between trade unions and the CCP, *see supra* Chapter 2, p. 75.

organization and other mass organizations, rallies the workers and office staff around it, safeguards the legitimate rights and interests of all quarters and *stimulates the healthy development* of the enterprise."[589]

At the top of this intra-firm Party organization, the Party appoints a party secretary and deputy secretary as the senior political leadership roles within the firm. In many corporatized SOEs, the role of the party secretary often conflates with other senior corporate positions, such as the chairman of the board of directors or the firm's general manager.[590]

In addition to these constitutional provisions, the PRC Company Law prescribes a role for a Party Committee in any PRC-domiciled company[591] and thus gives a legal basis for Party involvement at the firm level if the Party so chooses. This makes clear that a political presence in firms is not new.[592] A stakeholder capacity was long established by the CCP Constitution and was included in the PRC Company Law at least since its 2005 revision.[593] Under this legal framework, however, the functions of the Party committee were undisclosed. Its relation to the formal corporate governance structure was opaque,[594] and it was not deployed systematically beyond several meaningful state-controlled firms.

Recently, the requirement to establish an intra-firm Party organization was reaffirmed as statutory, and the CCP and the State Council jointly issued a "guidance" clarifying the operations of this political institution.[595] Despite its somewhat misleading title, this guidance is an obligatory document that applies to all SOEs,[596] which in this context are enterprises with state assets, including wholly state-owned firms and state-controlled firms, and also firms in which the state is a minority shareholder. Indeed, the Guiding Opinions make clear that establishing a Party organization and carrying out Party work is a prerequisite for enterprises with mixed ownership.[597] The corporate governance roles of the Party organization explicated by this document extend far beyond political

589 The CCP Constitution, *supra* note 546, art. 32 (italics added).
590 On the overlap between Party elite and business elite, *see* Downs & Meidan, *supra* note 581; Li, *supra* note 556.
591 2005 Company Law, *supra* note 147, art. 19 ("The Chinese Communist Party may, according to the Constitution of the Chinese Communist Party, establish its branches in companies to carry out activities of the Chinese Communist Party. The company shall provide necessary conditions to facilitate the activities of the Party.").
592 This is the case even with respect to private businesses as well. In 1999, three percent of private businesses had a designated party organization. In 2012, the number reached thirteen percent. At the time, Zhejiang province declared that all private firms with more than eighty employees had established a Party organization. *See How the Communist Party is Trying to Expand its Influence in the Private Sector*, THE ECONOMIST (Jan. 28, 2012) p. 43, (printed edition).
593 Article 19 of the Company Law remained the same throughout the law's revisions. 2005 Company Law, *supra* note 147. The article has roots in the 1993 Company Law, in which Article 17 states: "The grass roots organizations of the Communist Party of China in a company shall carry out their activities according to the Constitution of the Communist Party of China." 1993 Company Law, *supra* note 66, art. 17. Note that intra-firm Party organization, however, was not included in the earlier 1992 Normative Opinions. *See* 1992 Normative Opinions, *supra* note 59.
594 Howson, *supra* note 278, at 140-141 (extrapolating some details on the existence and operation of a Party Committee in China's Bank of Communication from a media interview with the bank's chairman).
595 SOE Reform Guiding Opinions, *supra* note 585. For example, article 1 states: "the Party organizations of SOEs shall enjoy a more solid statutory position in corporate governance, and fully display their core political role...".
596 The title of the SOE Reform Guiding Opinions is misleading in another way. The State Council *and* the CCP issued these opinions. Thus, where the document stands as a source of formal law is somewhat unclear. However, whether it is viewed as an administrative regulation or a Party decree, its mandatory application as a normative document is unquestionable. For a review of sources of positive law in China, *see* Keller, *supra* note 136.
597 SOE Reform Guiding Opinions, *supra* note 585, art. 7(24).

and social responsibilities that would perhaps be expected for a body of this nature. They encompass a direct and now explicit role in corporate monitoring and decision making, specifically addressing the need to raise operational efficiency through the Party organization among other goals. (As an anecdote, the Guiding Opinions mention operational efficiency fourteen times. Party ideology is mentioned two times, education two times, and corruption five times.)

3. The Party Organization Internal Corporate Governance Functions—Recent Developments

The SOE Reform Guiding Opinions are full of what most Western observers would view as complete contradictions. The document claims to resolve some of the most acute problems in the management of SOEs and remove "institutional obstacles," and identifies economic development as its central task. Its rhetoric emphasizes corporate autonomy and market-led governance in SOEs.[598] Yet one of the main mechanisms to achieve this, according to the Guiding Opinions, is to enhance Party leadership over SOEs.[599] Thus, while the autonomy of internal corporate governance bodies is repeatedly emphasized,[600] at the same time so is the utter lack of independence of these bodies from the Party's intra-firm institution — the Party committee.

This political dependence is grounded on three paths:

1) an openly-declared and legitimized authority granted to the Party organization with respect to personnel management, including recommending, assessing, and nominating candidates for leading corporate positions (directors and managers);[601]

[598] Section 1, Article (2) Basic Principles states the goal: "to promote SOEs to become independent market players in the true sense where they engage in autonomous operations, make profits and assume losses independently, bear risks on their own, practice self-discipline and pursue self-development pursuant to the law." Article (3) Main Objectives states: "to fine-tune the market-oriented mechanisms featuring the survival of the fittest under which SOEs engage in autonomous and flexible business operations, and promote and demote internal management personnel, employ and let go staff members, and increase and cut remunerations according to market practices." *Id.* arts. 2-3.

[599] This appears as part of Section 1, Article (1) Guiding Thoughts, SOE Reform Guiding Opinions. *Id.* art. 1.

[600] Article (8) states: "give full play to the decision-making role of the board of directors, the supervisory role of the board of supervisors, the operation and management role of the management, and the core political role of the Party organization of a SOE, and effectively resolve the phenomenon where the boards of directors of certain enterprises exist only in name and decisions are solely made by top leaders, so as to achieve standardized corporate governance. In addition, it is vital to effectively enforce and safeguard the lawful exercise of the rights to make material decisions, select and appoint personnel, distribute remunerations, etc. by the board of directors, and guarantee the operational autonomy of the management. No government department and agency may intervene unless authorized by law." *Id.* art. 8.

[601] This authority is scattered along the provisions. Here are a few apt examples: Article (9): "It is important to combine the principle of Party management of cadres with the requirements that the board of directors of a SOE shall be selected pursuant to the law, that the board of directors shall select persons in charge of operations and management in accordance with the law, … Superior Party organizations and State-owned assets regulatory authorities shall strengthen the management of SOE leaders according to their respective scope of management, broaden the channels for personnel recommendation, assess and nominate candidates in accordance with applicable provisions, and go through selection and appointment procedures strictly as required." Article (25): "reinforce the responsibilities of the Party organization of an enterprise in the selection and appointment, training and education, management and supervision of the enterprise's leaders, support the board of directors to select persons in charge of operations and management." *See id.* at arts. 9, 25.

2) encouraging cross-representation of board members and supervisory committee members with members of the firm's Party committee,[602] and setting a formal assimilation of the position of the chairman of the board with that of the Party secretary as the default.[603]

3) setting the explicit capacity of the Party organization as one of the firm's internal governing bodies, with the authority to oversee, audit, and assess major corporate decisions.[604]

What is clear from this is the Party's utilization of the corporate *legal form* itself and the legal system more generally. Corporatized SOEs are viewed not only as a ready venue through which Party leadership can be disseminated (upon different corporate stakeholders such as workers, investors, and consumers),[605] but also as a legal vehicle through which the Party now legitimizes its economic involvement in firms. From a practical point of view, now that the Party's corporate clout has been openly established, any legal requirement that procedural decision making will follow the *law* only emphasizes the weakening of traditional corporate governing bodies. Thus, the Party has practically hijacked corporate governance in these firms, and it has done so with the help of the legal system.

Other institutional measures to sidestep traditional corporate governance bodies have been taken in the past, particularly through the SOE Assets Law.[606] Yet the Guiding Opinions offer something significantly different. The Guiding Opinions practically import the Party's personnel management system (nomenklatura appointments and cadre evaluations) formally into corporate governance.[607] Moreover, the scope of involvement in internal governance that was authorized by

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[602] Similar promotion of cross-representation and assimilation of political and corporate roles existed previously only with respect to central enterprises under SASAC. It was internally promoted by the Organization Department and Party Committee within SASAC and thus not part of the SOEs Assets Law or a formal SASAC administrative regulation. *See* Guanyu Jiaqiang he Gaijin Zhongyang Qiyedang Jian Gongzuo de Yijian (关于加强和改进中央企业党建工作的意见) [Opinions of the Organization Department and Party Committee of SASAC Concerning Strengthening and Improving the Party Construction Work in the Central Enterprises] (promulgated by the Org. Dep't Communist Party of China & Party Comm. SASAC, Oct. 31, 2004), §2 art. 5, *available at* here.

[603] SOE Reform Guiding Opinions, *supra* note 585, art. 24 ("uphold and improve the leadership framework featuring two-way access and cross-representation, allow members of a SOE's Party organization leadership…to be included in the board of directors, the board of supervisors or the management … and, engineer an appropriate cross-representation between members of the management of a SOE and those of its Party organization leadership. In principle, a SOE shall set the position of the chairman of the board of directors separately from the position of the general manager, and its Party secretary and chairman of the board of directors shall generally be served by the same person.").

[604] *Id.* arts. 21, 23, 24. This alone can naturally lead risk-averse corporate managers to at least consult with the Party organization before making any corporate decision that might be considered meaningful.

[605] *See id.* art. 2 (Basic Principles) ("The Party's leadership over SOEs shall be upheld. This is the political direction and principle that must be held fast to in deepening SOE reform. It is critical to enforce the guidelines of comprehensively tightening Party discipline, give full play to the core political role of the Party organizations of enterprises, build up the leadership teams of enterprises, innovate grass-roots Party building work, carry out the campaign to build clean Party governance in an in-depth manner, continue to wholeheartedly rely on the working class, and safeguard the legitimate rights and interests of workers...").

[606] *See* Lin & Milhaupt, *supra* note 31, at 743-744 (referring to SASAC "super control rights" granted by the SOE Assets Law beyond any control rights SASAC otherwise has as a shareholder based on the Company Law).

[607] It should be noted that the level of intervention as well as the criteria for performance assessment vary according to the industry in which the business operates and not according to the level of state shareholding. For SOEs belonging to "major industries and key fields concerning national security or national economic lifeline," performance evaluation criteria include various national interests. For enterprises outside these key fields but still with state shareholding and even a

the SOE Assets Law was far narrower than what is now covered under the Guiding Opinions and entrusted to the Party committee.[608] Furthermore, these two normative documents advance different interests. The SOE Assets Law is focused on enabling state involvement mainly in decisions that can have an impact on the value of state assets. In contrast, the Guiding Opinions advance Party-state interests more broadly, encompassing industrial policy goals, social and ideological targets, and sustainable economic growth.

Most importantly, the organ authorized to engage in corporate governance is different as well. The SOE Assets Law regulates the state's capacity as a shareholder. Thus, the added authority that the law assigns to the state in corporate decision making[609] is confined to its shareholding capacity and exercised formally through the shareholders' assembly following defined corporate procedures, and therefore subject to potential scrutiny.[610] The Guiding Opinions, on the other hand, legalize the omnipresent authority of the Party over firms by granting it a distinct corporate stakeholder capacity that is otherwise not regulated and is not subject to any transparent procedural (or other) checks and balances. The CCP itself, beyond any traditional shareholder role the state may have, becomes a legal corporate constituent with unique interests and a distinct capacity to convey, direct, and monitor the ways these interests will be pursued:

> The core political role of the Party organizations of SOEs shall be fully displayed. It is critical to unify the efforts to strengthen Party leadership with those to improve corporate governance, include the overall requirements on Party building into the articles of association of SOEs, make clear the statutory role of the Party organizations of SOEs in their corporate governance structures, and innovate the channels and means for the Party organizations of SOEs to play their core political role.[611]

As noted above, the open door for the CCP to have a corporate committee presence is old news. However, the Guiding Opinions take China's politicized corporate governance to a new operative level. They clarify the goals that this political governance institution should advance in firms and elucidate in some detail its organization, operation, and governance relations with other corporate institutions. Moreover, corporatized SOEs are also required to have this inserted in their governing

controlling stake, the assessment seems more market-oriented and emphasizes appreciation in the value of state-owned assets. *See* SOE Reform Guiding Opinions, *supra* note 585, § 2 art. 5, § 4, art. 14.

608 *Compare id.*, *with* SOE Assets Law, *supra* note 183, art. 22 (3) (whereby SASAC or similar state shareholding bodies are authorized with "*Proposing* the director and supervisor candidates to the shareholders' meeting"), *and* SOE Assets Law, *supra* note 183, art. 24 ("*assess*[ing] the candidates…to be appointed or proposed…"), *and* SOE Assets Law, *supra* note 183, art. 27 ("determine the standards of remuneration for the managers … appointed by it.").

609 *See* the discussion in the text accompanying notes 186-187 and my reservations in notes 188-192.

610 Articles 13, 30, and 33 of the SOE Assets Law make clear that the state in its shareholder capacity will follow shareholder deliberation and voting even with respect to major corporate decisions. *See* SOE Assets Law, *supra* note 183, arts. 13, 30, 33. Only in limited circumstances, and only when the state is a sole or controlling shareholder, should the issues first be reported or approved by the relevant department of the local people's congress. *See id.* arts. 24, 25. Moreover, monitoring functions are granted to the state-shareholding body itself and mentioned in the context of the right to appoint an external audit firm to audit the company's financial reports. *See id.* arts 63-67.

611 SOE Reform Guiding Opinions, *supra* note 585, art. 24.

documents, a change that entails public disclosure and that would have been the purview of shareholders under the Company Law.[612] In so doing, the operation of a Party committee inside firms is disclosed to foreign and domestic corporate stockholders and to the market at large. It is still too early to tell what this will signal to investors and how it will be perceived by the market. A greater Party-state commitment to economic growth, greater monitoring against rampant corruption and expropriation, a more direct platform to advance industrial policies through the corporation, or political suppression are only some of the ways that investors could interpret this move, and each could affect the market differently.[613]

While the economic effects are still to be seen, publicly-listed firms, and not only national champions, are complying with the requirement.[614] Before the introduction of the Guiding Opinions, the Company Law provision on corporate Party committees was often overlooked, especially among corporatized SOEs that are listed in foreign markets.[615] Recent reports indicate that more firms are now complying with the requirement and amending their bylaws.[616]

The case of Tianjin Realty Development Group Co. Ltd. (Tianjin Realty) illustrates how firms have treated these new Guiding Opinions in practice and the limited ability of investors in corporatized SOEs to resist them.[617] Tianjin Realty, whose shares are listed for trade on the SSE, is the listed arm of the Tianjin local government's commercial real estate development division. In January 2017, Tianjin Realty called a special shareholders' meeting to approve amendments in its Articles of Association following the CCP and State Council's Guiding Opinions. Among other

[612] According to Article 37 of the 2005 Company Law, revisions in the bylaws are under the authority of the shareholders' meeting. Article 18 requires a company to solicit the opinions of its employees through their labor unions when drafting an important bylaw provision. 2005 Company Law, *supra* note 147, arts. 18, 37.

[613] I discuss these different options and the available empirical studies below. *See infra* Chapter 3, Section III.A.

[614] Examples include FAW Group Corp., whose Shenzhen-listed subsidiaries FAW Car and FAW Xiali Automobile Co., Ltd. both added a section of "Party Building" to their bylaws stating that the Party Committee in the firm will oversee work related to production and management of the company, and that their board of directors should consult with the Party Committee before deciding on major issues. Similar bylaw revisions were disclosed by Sinoma Science & Technology Co., Ltd. and by Zhonghang Electronic Measuring Instruments Co., Ltd., also listed for trade on the Shenzhen Stock Exchange. *See* Greg Levesque, *China's Evolving Economic Statecraft*, THE DIPLOMAT (Apr. 12, 2017), https://thediplomat.com/2017/04/chinas-evolving-economic-statecraft/; Mark Schlarbaum, *Xi Boosts Party in China's $18 Trillion State Company Sector*, BLOOMBERG NEWS (July 7, 2016, 5:00 PM), https://www.bloomberg.com/news/articles/2016-07-07/xi-boosts-party-say-in-china-s-18-trillion-state-company-sector.

[615] The application of the Guiding Opinions extends to Chinese firms listed in Hong Kong, which previously were able to avoid establishing Party committees in practice and are now required to establish Party institutions in their articles of association. Shirley Yam, *Regulators' Silence on Communist Party Presence in Listed State Companies is Deafening*, SOUTH CHINA MORNING POST (July 22, 2016, 5:07 PM), http://www.scmp.com/business/article/1993277/regulators-silence-communist-party-presence-listed-state-companies. o

[616] *Supra* note 614. Moreover, with respect to off-shore listed firms, a Hong Kong–based media website recently reported that in the past eighteen months, 123 Hong Kong-listed Chinese firms amended their articles of incorporation to implement the Guiding Opinions and expand the authority of their Party Committees. Sun Leqi, *yu 120 Zhongzigu sheli Dangwei quanli kong lingjia Dongshihui* [*More than 120 Chinese Stocks Set Up Party Committee Power to Overthrow the Board of Directors*], APPLE DAILY (Sept. 26, 2018), https://hk.finance.appledaily.com/finance/realtime/article/20180926/58722466.

[617] Alice Yan, *Chinese Company Shareholders Vote 'No' to Corporate Role for Communist Party*, SOUTH CHINA MORNING POST (Jan. 14, 2017, 8:00 AM), http://www.scmp.com/news/china/policies-politics/article/2062061/chinese-company-shareholders-vote-no-corporate-role.

elements, the proposed amendment included the following: establishing a (apparently new to the company) Party committee within the firm and determining the position holders that would serve on the committee; adding a requirement to solicit the opinions of the Party committee and its leaders before making major corporate decisions; allowing the Party committee to be involved in any decision of the board of directors regarding the appointment, dismissal, and remuneration of senior managers; and allowing the Party committee to carry out additional supervisory, auditing, and disciplinary responsibilities.[618] The proposed amendment was rejected by the shareholders after only 62.5 percent of shareholders present in the meeting approved the change, which required a two-thirds approval.[619] At the time of the meeting, the Tianjin local government only held approximately 25 percent of the shares. The company's minority shareholders (those having below 5 percent equity) fiercely voiced their objection—90 percent of those present voted against the amendment. And yet the company held another extraordinary shareholder meeting only a few months later, at which the shareholders miraculously reversed their vote, and the amendment was approved almost unanimously (99.8 percent).[620]

The Tianjin Realty case is an example of the reduction in the power and relevance of traditional corporate governing bodies against the obligatory nature of the Guiding Opinions. Presumably, corporate organs within a firm will be similarly powerless against the actions of the Party organization once one is installed. This raises the question of whether this political institution and its members could be held accountable for corporate decisions that they directed but went awry, and by whom? Given that *state* enforcing institutions do not have even a formal authority over Party organizations,

[618] *See* Tianjin Real Estate Development (Group) Co., Ltd., *Disclosure of Information Report on the 2017 First Extraordinary General Meeting of Shareholders*, SHANGHAI STOCK EXCHANGE (Jan. 5, 2017), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2016-12-30/600322_20161230_1.pdf.

[619] *See* Tianjin Real Estate Development (Group) Co., Ltd., *Announcement of Resolutions of the First Extraordinary General Meeting of 2017*, SHANGHAI STOCK EXCHANGE (Jan. 5, 2017), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2017-01-07/600322_20170107_1.pdf.

[620] Tianjin Real Estate Development (Group) Co., Ltd., *Announcement of Resolutions of the Second Extraordinary General Meeting of 2017*, SHANGHAI STOCK EXCHANGE (May 6, 2017), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2017-05-06/600322_20170506_1.pdf. A few weeks before the second extraordinary meeting, the local state shareholder started increasing its holding in the company and also declared its intentions to increase its holding by at least three percent within the next year. Given that the local government only held twenty-five percent of the votes and that the vote required a two-thirds supermajority, this was likely a signaling move of what was to come rather than a true effort to secure the missing votes. Tianjin Real Estate Development (Group) Co., Ltd., *Announcement of the Largest Shareholder Increase Shareholding Plan*, SHANGHAI STOCK EXCHANGE (Apr. 5, 2017), http://static.sse.com.cn/disclosure/listedinfo/announcement/c/2017-04-05/600322_20170405_1.pdf.
Although the two proposed amendments were phrased slightly differently, substantively they were the same. For the exact wording, *compare* Tianjin Real Estate Development (Group) Co., Ltd., *2017 First Extraordinary General Meeting of Shareholders*, SHANGHAI STOCK EXCHANGE (Dec. 30, 2016), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2016-12-30/600322_20161230_1.pdf (preparatory material for the first meeting), *with* Tianjin Real Estate Development (Group) Co., Ltd., *2017 Second Extraordinary General Meeting of Shareholders*, SHANGHAI STOCK EXCHANGE (Apr. 27, 2017), http://www.sse.com.cn/disclosure/listedinfo/announcement/c/2017-04-27/600322_20170427_1.pdf (preparatory material for the second meeting).

including in their corporate capacity,[621] the institutionalization and regularization of Party committees only substantiates a law-based-governance approach but not legal accountability. It is safe to assume that Party committee members will not be subject to any review or enforcement by either the CSRC, the People's Court system, or the Procuratorate. Clearly any accountability measures will be external to both the firm and the legal system, and would have to derive from the political organization itself. This could explain why the CCP's disciplinary apparatus is now becoming more involved in corporate supervision, a matter that I address next.

The obligatory nature of the Guiding Opinions and the absence of internal and external real checks and balances over the Party committee are certainly disconcerting. Yet there is still much that is unknown about how Party committees will function and how they will be accepted by corporate constituents. Investors, for example, might value them negatively but remain invested for the lack of better structured alternatives in the Chinese market. Or, it may well be that investors will be indifferent to this institution, the way they have been oblivious to the governance in Chinese firms many times before, even when facing disclosures of corporate malpractice and sheer fraud.[622] On the other hand, Party committees might be added to the list of unconventional institutions that provide reliable assurances, secure investors' confidence, and support further growth.

B. The CCP's External Corporate Governance Capacity—Monitoring and Accountability through Disciplinary and Enforcement Functions

Another form of the recent politicization of corporate governance in China is the substitution of external market monitoring and legal enforcement with another system external to the firm—the disciplinary and accountability institutions of the CCP. Enforcement of political and social discipline is one of the cornerstones of the CCP's control over its 90 million members and 4.5 million grassroots organizations.[623] In the last decade, and especially since Xi rose to power, the Party's disciplinary inspection and enforcement efforts have been intensified, not only toward social control in general,

[621] *See* Yam, *supra* note 615 (taking this question further by expressing concerns about the ability of foreign regulators to hold these CCP corporate institutions accountable for their actions and mentioning the potential conflict of laws in cases of Chinese subsidiaries incorporated off-shore).
[622] GREEN, *supra* note 104, at 118-153; Howson, *supra* note 278, at 150-151.
[623] In 2016, the CCP employed approximately 26 million members as public officials or staff. Numbers are drawn from Cheng Li, *China's Midterm Jockeying: Gearing Up for 2012 - Part Five: Party Apparatchiks*, CHINA LEADERSHIP MONITOR, Summer 2011, *available at* https://www.hoover.org/research/chinas-midterm-jockeying-gearing-2012-part-five-party-apparatchiks; *China – Statistics & Facts*, STATISTICA, https://www.statista.com/topics/753/china/ (last visited May 23, 2019) (providing statistical information from Xinhua News Agency).

[624] but also specifically with respect to firms and their insiders.[625] Corporatized SOEs and their group structure organization are being harnessed to facilitate the Party's disciplinary efforts.

Campaign-style enforcement against corruption and embezzlement of state assets is the main feature relevant here.[626] The Party's focus on enforcement against corporate corruption is achieved through two main paths. The first is aligned with the recent expansion of the CCP's intra-firm corporate governance functions discussed above. Here, the corporate governance role of an intra-firm Party committee was formalized, specifying the discipline-inspection roles that a corporate Party committee should perform within its firm. The second is by intensifying the CCP's drive against corporate corruption externally. In doing so, the CCP strengthens enforcement against corruption *by harnessing* corporatized SOEs and corporate governance more generally.[627] The Party is utilizing the corporate legal form to gain access to information and to detect, punish, and prevent corruption.

This change in discipline and enforcement strengthens the CCP's overall market control while also fortifying its new legal mandate in the realm of corporate governance. The strains this may place on managerial discretion, risk taking, and possibly on firm performance are to be expected, but the positive effects this could have on firms and their stakeholders are less apparent and should be noted as well. Moreover, while a political disciplinary institution cannot replace external markets and enforcement functions completely (e.g., party discipline does little in the way of promoting efficient allocation of capital as external markets do, nor addresses individual stakeholders' grievances as legal institutions are expected to do), still the interests of the Party and firms could be mutually served provided that this form of external oversight and accountability is subject to some operational constraints.[628]

1. Party Discipline and Anti-Corruption Work

i. Party-Level Incentives to Combat Corruption

Having change-averse individuals within the administrative and political controlling apparatus who have thrived economically based on their affiliation with corporatized SOEs (whether or not they

[624] By 2016, the anti-corruption campaign had led to 100,000 prosecutions, including prosecution of many high-level officials for their business conduct. On the scope related to SOEs, *see infra* notes 669, 679.
[625] *See* Samson Yuen, *Disciplining the Party—Xi Jinping's Anti-Corruption Campaign and Its Limits*, CHINA PERSP., no. 3, 2014, at 41 (pointing out how Xi's campaign is different from previous anti-corruption campaigns in that respect).
[626] On the rationale behind a "campaign-style enforcement," *see* Andrew Wedeman, *Anticorruption Campaigns and the Intensification of Corruption in China*, 14 J. CONTEMP. CHINA 93 (2005).
[627] The causality here is hard to determine and requires empirical research. Is it that the CCP tries to detect corruption and happens to find it in corporatized SOEs due to, perhaps, their group structure, the high-level position suspects involved, or crony-capitalism? Or, is it that the Party indeed targets corporatized SOEs and their group structure, perhaps due to the reasons I emphasize next? I take the latter view and offer the rationale behind it but cannot support it empirically.
[628] This is discussed further below, where I address the potential contributions of a politicized corporate governance.

themselves engaged in corruption)[629] raises the question of who would be incentivized to enhance external supervision over firms and their insiders. Furthermore, why would a political disciplinary system succeed where the legal system has failed? Here, I believe, corruption holds key answers. Rampant corruption in China, facilitated through China's crony capitalists and intensified by corporatized SOEs and their affiliated business network, poses substantial threats to Party unity and legitimacy. These threats, which intensify the more growth is pursued and economic leeway enabled, unites Party-state leaders around a common goal—their political survival.

Since economic reforms began, China has endured a reputation for widespread corruption.[630] Perhaps inevitable to an economic transition,[631] corruption is often viewed as a major impediment to the growth of businesses and an unfavorable condition for development.[632] This has been a common understanding even though the evidence for it, at least with respect to China, is inconclusive at best.[633] However, aside from a general economic motivation to minimize potential negative effects on growth and development, enforcement against corruption in China is highly political in nature.[634] Anti-

[629] The People's Bank of China estimated that between the mid-1990s and 2008, 16,000 to 18,000 Chinese officials and executives at state-owned companies took a total of $123 billion from companies (presumably illegitimately). *And the Winner Is*, ECONOMIST (Jan. 21, 2012), https://www.economist.com/special-report/2012/01/21/and-the-winner-is ("State capitalism often reinforces corruption.").

[630] The Corruption Perception Index, published by Transparency International, ranked China 77 out of 180 country spots in 2017. This is a much-improved position from the country's rank in 1995 (when the Index was established), when China ranked one above Indonesia, which was the most corrupt country in the world. Importantly, this Index does not measure actual corruption, but rather perceptions about corruption according to various indices. For the Index, *see Measuring Corruption*, TRANSPARENCY INT'L UK, http://www.transparency.org.uk/corruption/measuring-corruption/#.Wue3JYjwY2y (last visited May 23, 2019). Despite what may be an improvement, many still perceive corruption to be endemic to contemporary China, with some referring to it as an "epidemic." Andrew Wederman, *The Intensification of Corruption in China*, 180 CHINA Q. 895 (2004) (referencing Michael Johnston & Yufan Hao, *China's Surge of Corruption*, 6 J. DEMOCRACY, no. 4, 1995, at 80; Minxin Pei, *Will China Become Another Indonesia?*, FOREIGN POL'Y, Autumn 1999, at 94; Hilton Root, *Corruption in China: Has It Become Systemic?*, 36 ASIAN SURV. 741 (1996)).

[631] Kim Lane Scheppele, *The Inevitable Corruption of Transition*, 14 U. CONN J. INT'L L. 509 (1999).

[632] Paolo Mauro, *Corruption and Growth*, 110 Q.J. ECON. 681 (1995) (finding that corruption has a significant negative effect on the ratio of investment to GDP); Mo Pak Hung, *Corruption and Economic Growth*, 29 J. COMP. ECON 66 (2001) (finding that one unit increase in the corruption index reduces the growth rate by 0.545 percentage points. Also finding that corruption reduces the share of private investments.).

[633] This perception is rather deeply rooted even though the Chinese economy has performed remarkably well since reforms ensued. *See supra* note 630. *See also Xi's Crackdown on Corruption 'Will Help Boost China's Economy'*, SOUTH CHINA MORNING POST (Nov. 3, 2017, 12:04 PM), http://www.scmp.com/news/china/policies-politics/article/2118245/xis-crackdown-corruption-will-help-boost-chinas-economy. For an exception to this view revealing empirical evidence to the contrary, *see* Chiung-Ju Huang, *Is Corruption Bad for Economic Growth? Evidence from Asia-Pacific Countries*, 35 NORTH AM. J. ECON & FIN. 247 (2016) (examining corruption and growth in thirteen Asia-Pacific countries during the 1997–2013 period and finding a significant positive correlation between corruption and economic growth in South Korea and China). At the other end of the spectrum, there is also a view that it is the fight against corruption that contributes to the economic slow-down in China. *See, e.g.*, Huan Jun Chan & Xueling Lin, *Corruption Clean Up is Top Reason for China's Slowdown: Former Central Banker*, CHANNEL NEWSASIA (July 27, 2017, 8:46 PM), https://www.channelnewsasia.com/news/asia/corruption-clean-up-is-top-reason-for-china-s-slowdown-former-ce-7928988 (citing a former PBOC policy maker); JieYang, *Is Anti-graft Anti-growth? Weighing the Economic Impact of the Anti-corruption Campaign*, ECONOMIST (Aug. 2, 2014), https://www.economist.com/news/china/21610316-weighing-economic-impact-anti-corruption-campaign-anti-graft-anti-growth. For a more comprehensive overview on the complex relationship between corruption levels and economic growth, *see* ANDREW WEDEMAN, DOUBLE PARADOX: RAPID GROWTH AND RISING CORRUPTION IN CHINA (2012).

[634] MELANIE MANION, CORRUPTION BY DESIGN: BUILDING CLEAN GOVERNMENT IN MAINLAND CHINA AND HONG KONG (2004) (analyzing the (former) system of anti-corruption in China, suggesting that it is influenced and captured by

corruption campaigns have been used to consolidate power by new leadership[635] and to suppress factional power struggles between political rivals within the Party-state system.[636]

In addition to these political and economic motivations in combating corruption, public criticism of corrupt officials also seems to fuel enforcement against corruption. Criticism against corrupt officials is on the rise, especially with increasing gaps in income distribution.[637] Public criticism is a concern primarily because it reflects badly on the Party-state's own integrity and viability,[638] and alienates the Party from the people. Research has shown that while public opinion in China functions differently than it does in liberal democracies, it is nevertheless a meaningful consideration[639] and has an impact on the design of CCP-directed reforms.[640] Public opinion was found to be a major motivator in anti-corruption campaign enforcement specifically, and even in subsequent criminal procedures.[641]

The Party itself declares that corruption is an imminent threat to the regime's stability,[642] Party unity, and legitimacy.[643] The need to combat corruption is repeatedly emphasized by Party leadership

local Party leaders, and suggesting that this led to its failure); Lin Zhu, *Punishing Corrupt Officials in China*, 223 CHINA Q. 595 (2015) (arguing that anti-corruption campaigns have been applied selectively and for political purposes).

635 A strategy taken by China's leaders, Hu Jintao and Jian Zemin, long before Xi, to establish their new leadership following transitions. Xi's anti-corruption campaign is known to be a continuous but more pervasive effort that systematically penetrates leadership layers not touched before, including the highest ranks of the Party-state system, leaders of the strongest national champions and financial industry, as well as military leaders.

636 David Barboza, *Politics Permeates Anti-Corruption Drive in China*, N.Y. TIMES (Sept. 3, 2009), https://www.nytimes.com/2009/09/04/business/global/04corrupt.html; Andrew Wederman, *Xi Jinping's Tiger Hunt and the Politics of Corruption*, 13 CHINA RES. CTR., no. 2, Oct. 15, 2014, *available at* https://www.chinacenter.net/2014/china_currents/13-2/xi-jinpings-tiger-hunt-and-the-politics-of-corruption/; Jing Rong Goh et al., Force Behind Anti-Corruption: Evidence from China (January 12, 2019), *available at* http://dx.doi.org/10.2139/ssrn.3227368 (examining the political considerations behind anti-corruption investigations and subsequent political punishment).

637 Luan, *China Focus: Income, Corruption Top Concerns for Two Sessions: Polls*, XINHUA (Mar. 4, 2015, 8:14 PM), https://web.archive.org/web/20180220164857/http://www.xinhuanet.com/english/2015-03/04/c_134037974.htm (reporting public polls that show corruption as the second most concerning issue in China, following income distribution. This news report also reveals that corruption was voted by the public among the three most concerning issues for the past ten years.).

638 Wederman, *supra* note 630.

639 GALLAGHER, *supra* note 554.

640 Yun Sun, *Chinese Public Opinion: Shaping China's Foreign Policy, or Shaped by It?*, BROOKINGS (Dec. 13, 2011), https://www.brookings.edu/opinions/chinese-public-opinion-shaping-chinas-foreign-policy-or-shaped-by-it/.

641 Ira Belkin, *Justice in the PRC: How the Chinese Communist Party Has Struggled with Managing Public Opinion and the Administration of Criminal Justice in the Internet Age* (NYU Sch. of Law, Pub. Law & Legal Theory, Research Paper Series Working Paper No. 18-01, 2018).

642 *China Must Root out Corruption or Communist Party Will Be Erased from History, Graft-Buster Warns*, SOUTH CHINA MORNING POST (Nov. 11, 2017, 12:03 PM), http://www.scmp.com/news/china/policies-politics/article/2119431/china-must-root-out-corruption-or-communist-party-will.

643 For example, President Xi Jinping's expositions stating that corruption if not treated "will inevitably lead to the downfall of the party and the state" (wangdang wangguo). *China's Xi Amassing Most Power since Deng Raises Reform Risk*, BLOOMBERG NEWS (Dec. 30, 2013, 10:07 PM), https://www.bloomberg.com/news/articles/2013-12-30/china-s-xi-amassing-most-power-since-deng-raises-risk-for-reform.

and was incorporated in the Constitution of the CCP.[644] Anti-corruption efforts and their high-profile results are continuously reported to the public through state-owned media.[645]

ii. Corruption and Relevant Institutions

Under the existing framework, corruption is one of several offenses by officials that are forbidden by different PRC laws and CCP rules.[646] Yet the fine lines that define corruption and distinguish it from other forms of economic malfeasance by officials are unclear.[647] It is often interpreted broadly to capture many different forms of "improper" behavior by state officials and Party members.[648] In

[644] *See* The CCP Constitution, *supra* note 546, Preamble.

[645] Daniel C.K. Chow, *How China's Crackdown on Corruption Has Led to Less Transparency in the Enforcement of China's Anti-Bribery Laws*, 49 U.C. DAVIS L. REV. 685 (2015) (discussing media coverage but arguing that while new laws and media coverage have increased transparency, the Party's strengthened control actually leads to less transparency in enforcement against corruption).

[646] For the main laws, *see* Civil Servant Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., Apr. 27, 2005; amended Sept. 1, 2017), art. 53, *available at* http://en.pkulaw.cn/display.aspx?id=23929&lib=law; PRC Anti-Unfair Competition Law (promulgated by the Standing Comm. Nat'l People's Cong., Nov. 4, 2017, effective Jan. 1, 2018), *available at* http://en.pkulaw.cn/Display.aspx?lib=law&Cgid=304262. The new law sets out clear parameters for commercial bribery. *See China's New Anti-Unfair Competition Law Redefines Bribery*, NORTON ROSE FULBRIGHT (Nov. 2017), http://www.nortonrosefulbright.com/knowledge/publications/158149/chinas-new-anti-unfair-competition-law-redefines-bribery.

See also Amendments to the Criminal Law, *supra* note 150, arts. 91, 163, 165-169, 385-389. Section 3 is dedicated to "Offenses Against Companies and Enterprise Management Disorder" and includes various actions within the context of enterprises and other institutions, including companies, that result in improper demand of receipt of gains. In particular, article 163 addresses, among others, situations whereby personnel performing public duties in state-owned companies and enterprises, and personnel assigned by state-owned companies and enterprises to non-state-owned companies gain personal benefits in the course of their affiliation with an enterprise. Article 165 handles the use of enterprise for personal gain by corporate insiders (directors and managers) in SOEs. Article 166 is focused on situations within SOEs whereby work personnel used their position for private gains and caused harm to state interests. Articles 167-169 focus on the criminal accountability of "people directly in charge of state-owned companies" for events that caused great damages to national interests. Articles 385 – 389 connect these actions with the crimes of embezzlement and offering or accepting bribes. Interestingly, with respect to corruption in the form of embezzlement (appropriating, stealing, or swindling public money or property, article 382 of the PRC Criminal Law), article 91 defines "public property" as property owned by the state, including private property that is being managed, used, or transported by state-organs, and state-owned corporations and enterprises. This means that embezzlement in joint ventures or in corporatized SOEs where the state has only a minority stake (or even no ownership, apparently), is still considered embezzlement of public property.

The connection between the use of public authority for private gains and the bribery offense was made clearer by *Notice No. 33 of the Supreme People's Court and the Supreme People's Procuratorate on Issuing the Opinions on Issues concerning the Application of Law in the Handling of Criminal Cases of Commercial Briberies* (Nov. 20, 2008). Furthermore, the 2011 amendment to the Criminal Law amended Article 164, which penalizes employees of PRC companies who bribe foreign officials and is known as China's own foreign corrupt practices act.

See also Zhonghua Renmin Gongheguo Jiancha Fa (中华人民共和国监察法) [The Supervision Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 20, 2018) [hereinafter PRC Supervision Law], http://www.npc.gov.cn/npc/xinwen/2018-03/21/content_2052362.htm, art. 11(2), listing corruption among the "duty-related violations" that a Supervisory Commission is entrusted to investigate and enforce against, together with "bribery, abuse of power, neglect of duty, power rent-seeking, tunneling, practice of favoritism and falsification, as well as the waste of state assets.").

[647] As clearly reflected from the variations in the provisions of the various laws and regulations above. *See supra* note 646.

[648] Wederman, *supra* note 630, at 897, 901-903 (pointing out how the authorities assigned to handle official malfeasance (including corruption) extended their authority in practice beyond the list of actions defined in Chinese law and Party rules

the context of corporatized SOEs, I treat corruption as the illicit use of public authority (by either Party member or state official, or their employees and assignees) for private gain, in the course of their formal or informal affiliation with corporatized SOEs.

Until recently, corruption cases involving corporatized SOEs typically resulted in separate administrative and criminal enforcement proceedings through the various agencies of the state (including the People's Procuratorate, and SASAC and CSRC in embezzlement cases),[649] as well as in parallel Party disciplinary enforcement measures applied to Party members.

The Party's oversight and enforcement, often considered "extra-legal," is directed by the Central Commission for Disciplinary Inspection (CCDI), which performs both oversight and enforcement roles, following a framework established in various inner Party norms and disciplinary codes of conduct applicable to Party members.[650] Inner Party disciplinary methods are known to be harsher than investigative and enforcement devices under the legal system. The methods applied by the Party's extra-legal system do not have to comply with transparency and predictability standards nor with due process required under the law. Known as *Shuanggui*, the CCDI is authorized to perform undeclared inner-Party detentions, involving investigations techniques that are often undisclosed and for prolonged durations (forced disappearances) with no ability for legal representation. The *Shuanggui* system is widely criticized for being opaque and brutal.[651]

The state's supervisory system has formal authority to oversee state institutions and civil servants, including with respect to corruption, following the framework established under the legal system.[652] The monitoring functions were until very recently led by supervisory bureaus under the State Council (the executive government), including the Ministry of Supervision and its local supervisory bureaus, as well as various Bureaus for Corruption Prevention at the national and local

to also include categories such as "privilege seeking" or the "use of authority for private gain."). Notably, however, the recently enacted Supervisory Law seems to provide the necessary legal basis for authority over these offenses as well.

649 For examples of cases pursued by SASAC and the legal system, *see* Wei Chen, *1 ge yue 12 wei Gaoguan Luoma—shangshi Gongsi neibu jianguan lingren danyou* [*The Fall of 12 Senior Managers in One Month—Insider Supervision of Listed Companies is Worrisome*], CAIJING DAILY (Feb. 5. 2005, 10:19 AM), http://finance.sina.com.cn/stock/stocktalk/20050205/10191351494.shtml.

650 President Hu Jintao promulgated the primary normative framework on January 12, 2004. *Zhonggong Zhongyang banbu Dang nei jiandu tiaoli he jilu chufen tiaoli* [*The Central Committee of the Chinese Communist Party of China Promulgated Inner-Party Supervision and Disciplinary Regulation*], PEOPLE'S DAILY ONLINE http://www.people.com.cn/GB/shizheng/8198/32062/index.html ;http://www.people.com.cn/GB/shizheng/1026/2346251.html. Earlier versions of inner Party supervision regulations are documented for early stages of reforms as well. *See* Dongmei Xu, *Dang nei jiandu tiaoli chutai qian qian hou hou* [*Regulations on Inner Party Supervision Came before and after*], PEOPLE'S DAILY ONLINE (Jan. 4, 2004), http://www.people.com.cn/GB/shizheng/1026/2278488.html (tracking the various stages of trial inner party supervision regulations since 1987). Most recently, following the 18th Party Congress, the CCP Central Committee issued new disciplinary regulations that are considered much stricter and more comprehensive. *See infra* note 675.

651 *See generally* Flora Sapio, *Shuanggui and Extralegal Detention in China*, 22 CHINA INFO. 7 (2008).

652 For the main relevant laws, *see supra* note 646.

levels.[653] The legal system (People's Procuratorate and the People's Courts) carried out enforcement, subject to the rules of procedural justice.

Recently, however, these institutions went through a fundamental structural reform, which stands as additional indicia of the political-economic equilibrium shift I identified earlier. In this reform, the various state institutions assigned to battle corruption in the state sector were merged and are now centralized under the National Supervisory Commission and its local-level commissions, whose operations are now established under a new law—the PRC Supervision Law.[654] The new Commission also integrates the National Audit Office, the Supreme People's Procuratorate's anti-corruption unit, and the CCDI. The new commission thereby has an all-encompassing authority to not only supervise and investigate, but also sanction misconduct of both Party and state agents.[655] This new agency is a Party-led state organ. In the administrative governance hierarchy, it is situated directly under the National People's Congress, but the new Commission's chief sits on the CCP Politburo Standing Committee. Thus, a new enforcing legal institution[656] was created with an administrative position in the state-hierarchy that is equal, and some argue higher, to that of the Supreme People's Court and the Supreme People's Procuratorate.[657] The CCDI, now under the Supervisory Commission, performs all investigatory powers, including with respect to violations by state functionaries. It is also authorized to directly apply sanctions for administrative violations and minor legal violations. At least formally, corruption cases involving criminal offenses (such as bribery, embezzlement, and seeking improper gains) still must be transferred to the People's Procuratorate and the People's Courts, and pursued according to the criminal law *following* a CCDI investigation and *in addition* to any disciplinary sanctions the CCDI applies.[658]

This of course sparked broad concerns among human rights groups, lawyers, and academics.[659] Commentators argued that this new legal institution was a tool through which the Party was brought into the law, rather than under the law, as there seem to be no real checks and balances on its powers.

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[653] Yuen, *supra* note 625.

[654] PRC Supervision Law, *supra* note 646.

[655] *Id.* arts. 15-18, 41, 43.

[656] Legal positivism at least would consider the Supervisory Commission a "new legal institution."

[657] The creation of the Supervisory Commission faced opposition by Chinese legal scholars, who argued that the new institution would violate the PRC Constitution since it would be a new Party body whose powers exceed those of legal system institutions and as such will be above the law. Chris Buckley, *In China, Fears That New Anticorruption Agency Will Be Above the Law*, N.Y. TIMES (Nov. 29, 2017), https://www.nytimes.com/2017/11/29/world/asia/china-xi-jinping-anticorruption.html.

[658] Before the recent institutional reform, there was a similar reliance in corruption cases involving criminal offenses. For data from before the structural reform, *see* Yuen, *supra* note 625, at 45 n.35 ("The majority of officials placed under investigation are described as 'having violated both Party discipline and the law (weiji weifa 违纪违法)'") (pointing out that of 67 cases released between May and June 2014, Xinhua reporters found that 47 cases violated both Party discipline and the law, 17 cases violated Party discipline only, and three cases violated the law only). For a description of authority under the structural reform, *see* Jeremy Daum, *Unsupervised – Initial Thoughts on the Supervisory Law*, CHINA LAW TRANSLATE (Nov. 9, 2017), https://www.chinalawtranslate.com/en/unsupervised/.

[659] *See, e.g.*, Buckley, *supra* note 657; Zongzhi Long, *Wanhan Jiancha Fa Zhong zhiwu fanzui diaocha zhidu de ba xiang jianyi* [*Eight Suggestions for Perfecting the System of Crime Investigations under the Supervision Law*], POL. & L. (forthcoming), *available at* https://mp.weixin.qq.com/s/oBJrzR4fWRVS_8karZtZyg.

(For example, the rank of the new commission is higher than that of the Ministry of Public Security (police), and its powers apply on members of the People's Congress—its own nominating body.)[660] There is also support for the government's formal view, opining that such legalization in fact represents an enhancement of rule of law in China.[661] Either way, it seems accurate to describe the state supervisory organs as being absorbed under a now legalized form of the CCDI, rather than the other way around, since the leadership of the CCDI is now assigned to lead the new National Supervisory Commission, and its scope of authority is in line with Party investigative powers and methods.[662] This also means that under the new Supervisory Commission, Party investigative norms and methods (albeit, under the guise of the legal system with a new and now "legalized" name, *liuzhi*, "detention in custody," traditionally applied as administrative detention outside the criminal legal system) is given a free rein to perform anti-corruption work.[663]

This consolidation of anti-corruption powers also has direct implications on corporatized SOEs. The recent institutional reform expands the scope of Party anti-corruption and disciplinary authority and methods over additional millions of public sector organizations and individuals, many of whom are not party members.[664] Corporatized SOEs and their state-appointed managers and other functionaries are now formally included as well.[665] This change also potentially subjects all employees of SOEs that could be viewed as civil servants or as performing public roles to CCP disciplinary enforcement.[666] Note that the term "SOE" is interpreted broadly and often includes firms in which the state has even a minority equity stake, thus potentially further broadening the scope of individuals under CCP disciplinary supervision as well.[667]

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[660] *Id. See also* Daum, *supra* note 658.

[661] *See, e.g.*, Criminal Practice, *Thoughts on Issues Related to Supervisory Committee Liuzhi*, WECHAT (Apr. 16, 2017), https://mp.weixin.qq.com/s/4oMQiA8vshxWENRV7-mAtA.

[662] On the shift and consolidation of powers under the Supervisory Commission, thus under central CCP control, *see* Jinting Deng, *The National Supervision Commission: A New Anti-Corruption Model in China*, 52 INT'L J.L. CRIME & JUST. 58 (2018).

[663] *See* the various threads of interpretation and discussion on this subject on the ChinaLaw blog: https://hermes.gwu.edu/cgi-bin/wa?A2=CHINALAW_percent3be6ee03af_percent2e1711&X=D6555913969718A6F9; https://hermes.gwu.edu/cgi-bin/wa?A2=CHINALAW;e753c272.1711.

[664] Jun Mai, *How China's New Anti-Graft Super Body Will Work, and Why Calling a Lawyer Won't Be an Option*, SOUTH CHINA MORNING POST (Nov. 17, 2017, 9:31 AM), http://www.scmp.com/news/china/policies-politics/article/2120175/how-chinas-new-anti-graft-super-body-will-work-and-why.

[665] PRC Supervision Law, *supra* note 646, art. 15.

[666] *Id.* (especially article 15 (1) & (6)).

[667] While the Supervision Law itself does not define the term SOEs, this broad interpretation is reflected in the SOE Reform Guiding Opinions. *See id.* Moreover, the SOE Assets Law refers to state *invested* enterprises. *See* SOE Assets Law, *supra* note 183.

SOEs in many other occasions are viewed by Chinese authorities in the broader sense to include enterprises with state capital. *See, e.g.*, Criminal Code, *Guojia tongji ju guanyu dui guoyou gongsi qiye rending yijian de han*, *Guo Tong Han [2003] 44 hao* [*National Bureau of Statistics Opinions on the Recognition of State Owned Companies* [2003] No. 4], WECHAT (Sept. 9, 2017), https://mp.weixin.qq.com/s?__biz=MzIzNTg5MDU5Mg==&mid=2247483940&idx=2&sn=e5f35bf2b76b81944f841d6000398c2a&chksm=e8e170ebdf96f9fd6c4f00093f5df8124d88c15f1dfc20dce44e368f75801695e8b539a84654&mpshare=1&scene=21&srcid=0925SXZAhbMNO75u65uaPVHi#wechat_redirect. By the Bureau's interpretation, SOEs can be divided into: 1) (narrow sense SOEs) enterprises in which the state has wholly state-owned enterprises; 2) (broad sense SOEs) state-controlled enterprises (direct or indirect ownership, including by agreement, of more than fifty percent of the

Thus, while the personnel management system discussed earlier serves as an incentivizing force for corporate control parties to improve corporate performance and results, Party disciplinary enforcement, especially in its new, institutionalized form, plays a role of monitoring and deterring corporate wrongdoing by blurring the organizational lines between political enforcement against corruption and legal enforcement of corporate wrongdoing, and by creating fear governance throughout the firm and its network of affiliates.

2. Harnessing Corporatized SOEs in the Battle against Corruption

China's crony capitalism, the overlap between its business and political elites,[668] amplifies opportunities for corruption and increases the volume of cases in which corrupt conduct is exercised through, or simply involves, firms and corporatized SOEs, thus making corporatized SOEs key venues for corruption.[669] Moreover, corruption through corporatized SOEs amplifies reputational damages to the Party-state system more than other corruption cases in several dimensions.

Not only is the number of corruption cases involving corporatized SOEs relatively high, but the "quality" or substance of these cases is alarming as well. In many of these cases, corruption also entails the waste of public resources and economic loss to the state through embezzlement.[670] As opposed to other cases of corruption where officials are usually on the supply side, here the Party-state may find itself on both sides of the corrupt conduct, perhaps even at the same time. The supply

shares, or such ownership of less than fifty percent of the shares where no larger shareholder is present, or where there is a larger shareholder but control rights are vested with the state according to agreement); and 3) (broad sense SOEs) enterprises with state capital in which the state is not a controller.

[668] On the relationship between China's private sector elite members and Party-state officials and resulted corruption, *see China's Graft-Busters Investigate Sinopec Chief Wang Tianpu*, SOUTH CHINA MORNING POST, http://www.scmp.com/news/china/policies-politics/article/1778090/chinas-graft-busters-investigate-sinopec-chief-wang.

[669] Statistical data shows that throughout 2016 (from December 2015 to November 30, 2016), there were 1458 cases of criminal violations in business enterprises with 1827 individual offenders involved. Out of these cases, 203 cases involved state-owned enterprises and 1255 cases involved private enterprises, accounting for 13.9 percent and 86.1 percent of cases, respectively. 12.9 percent of cases involving SOEs also involved individual offenders. The number of individual offenders in these cases reached 236 individuals. 87.1 percent of the total number of cases involving private enterprises also involved individual offenders, for a total number of 1691 individual private offenders involved.
The more striking and relevant figures, however, are the ones detailing the type of criminal offenses involved: the most common crimes committed in SOEs are corruption and bribery crimes, 229 cases, accounting for 78.2 percent of the cases (but 90.3 percent in 2015); while with respect to private enterprises, corruption and bribery crimes accounted for 170 of the cases, 9.9 percent (but 15.3 percent in 2015) only.
Other crimes committed in SOEs (/private enterprises), were "crimes against socialist market economic order" accounting for 9.6 percent (/58.7 percent); and property infringement, accounting for 7.5 percent (/24.3 percent) of cases.
(The remaining percentages seems to represent miscellaneous criminal offenses not described in the data.)
For the full report, *see* Yuanhuang Zhang, *2016 Zhong guo qi ye jia xing shi feng xian fen xi bao gao* [*2016 Chinese Enterprises Criminal Risk Analysis Report*], 26 J. HENAN POLICE C., no. 4, 2017, at 17.

[670] *The Honeycomb of Corruption – A Little Reform in the State Sector Has Proved a Dangerous Thing*, ECONOMIST (Apr. 6, 2000), https://www.economist.com/node/299621 (pointing to data on the misuse of state funds and assets generally and in various industries).

side (officials using their authority to receive private gains from corporatized SOEs) and the demand side (corporate control parties and insiders appointed by the state, who are willing to bribe officials to gain advantages in transactions) are held by agents of the Party-state in one capacity or the other. As one commentator recently put it: "For the past three decades, the state has always been directly involved in running businesses. Corruption, tunneling, shirking, malfeasance, nepotism, and collusive or conspicuous wrongdoing—basically any type of misconduct imaginable—has occurred in the government's direct or indirect business operations. As a result, anti-corruption drives have always been a major theme and a common expectation of the public."[671] These cases often involve high-level Party-state figures and glorified crown jewel firms. Corruption at these levels reinforces public perceptions against the Party-state uniformly (as body-politic). Tainting the success of these crown jewels with corruption inflicts doubts on the viability of China's economic growth and the regime itself.

Adding more complexity in the context of corporatized SOEs, the lines of what constitutes "the use of public authority" become vague (e.g., think of the corporate power of a firm's Party secretary), and the illicit conduct itself is likely harder to detect. Corporate wrongdoing often requires coordination or at least acquiesces by top managers or board members.[672] Research on corporate fraud has found that connectedness levels within the firm, and especially appointment-based connectedness, increase the likelihood of wrongdoing and helps conceal violations.[673] Agents of the Party-state are often highly connected (if not the same person) with corporate control parties and insiders who can easily coordinate and conceal their actions. Given the weakness of traditional monitoring mechanisms, they can even do so while at the same time formally complying with corporate law and procedures, such as approval requirements for related-party transactions.

Finally, corruption through corporatized SOEs amplifies threats in another dimension. The use of some of China's most important corporatized SOEs for personal gains empowers the individuals involved and can create powerful rivals within the Party and facilitate factions.

These reasons suggest that corruption related to corporatized SOEs is a particular threat to the Party-state. The motivations behind the battle against corruption are strengthened when corporatized SOEs are involved. At the same time, corporatized SOEs can be subjected to greater control and can disseminate anti-corruption detections and potentially strengthen enforcement.[674]

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[671] Deng Feng, *Indigenous Evolution of SOE Regulation*, *in* REGULATING THE VISIBLE HAND? 3, 9 (Curtis Milhaupt & Benjamin Liebman eds., 2016).

[672] Vikramditya Khanna et al., *CEO Connectedness and Corporate Fraud*, 70 J. FIN. 1203 (2015) (examining the implications of appointment-based and network ties-based CEO connectedness to senior managers and board members, on the likelihood of fraud and the detection of fraud in the US market).

[673] *Id.* Note, however, that the authors' research specifically examines cases of corporate fraud and with respect to CEOs in the US market. Nevertheless, the implications seem valid in any corporate wrongdoing, including corruption, and in other markets with high connectedness. Here, connectedness within a Chinese corporatized SOE is especially high due to overlapping positions and the overall influence of the personnel management system.

[674] Statistical data shows a 12.1 percent decline in criminally prosecuted corruption cases from 2015 to 2016 with respect to SOEs and only a 5.4 percent decline for private enterprises. This gap may support an argument that supervision and

This combination explains the rationales behind harnessing corporatized SOEs and the corporate group organization to facilitate anti-corruption efforts.

i. Anti-Corruption Work and Its Effect on Corporate Insiders

Several signals suggest that the CCP is intensifying its anti-corruption enforcement efforts with respect to firms and corporatized SOEs specifically. The first is a change in the normative framework—the norms that guide the conduct of Party members and according to which its enforcing institutions operate. The Central Committee of the CCP revised its inner-party disciplinary norms twice in the last few years.[675] The revisions included specific provisions that deal with various misconducts by Party members and state employees in the course of their business involvement and positions within SOEs.[676] The CCDI as well formally dedicates a specific section of its "investigative work plan" to central SOEs and financial institutions.[677]

Another signal for this recent focus is the change in practices that reflect an increase in the number of corruption investigations related to corporatized SOEs. Immediately after President Xi's anti-corruption campaign began and over a short period of eighteen months, 124 executives in SOEs

enforcement against corruption is more effective with respect to SOEs. There could be other explanations, of course, such as issues pertaining to the reliability of the data involving SOE, or that there was a shift to resolve such matters in SOEs outside the criminal legal system.

[675] The former document was in place since 2004. *Supra* note 650. A new comprehensive framework was revised twice since the 18th Party Congress. For the revisions, *see Zhongguo Gongchandang jilu chufen tiaoli "Xiuding Jiedu" "Yan" zai nar?* [*Interpretation of the "Regulations on Disciplinary Actions of the Communist Party of China": Where is "Strictness"?*], XINHUANET (Oct. 21, 2015, 7:53 PM), http://www.xinhuanet.com/politics/2015-10/21/c_1116897613.htm. *See also* Zhonggong Zhongyang yinfa "Zhongguo Gongchandang jilü chufen tiaoli" (中共中央印发, 中国共产党纪律处分条例) [Regulation of the Communist Party of China on Disciplinary Measures] (promulgated by the Central Comm. Communist Party of China, Oct., 21, 2015, effective Jan. 1, 2016), *available at* http://www.xinhuanet.com/2015-10/21/c_1116897567.htm. This was recently replaced by another normative document of the same title, effective October 1, 2018. *See Zhingging Zhongyang Yinfa "Zhongguo Gongchandang jilu chufen tiaoli"* [*The Central Committee of the Communist Party of China Issued the "Regulations on Disciplinary Measures of the Communist Party of China"*], XINHUANET (Aug. 26, 2018, 10:33 PM), http://www.xinhuanet.com/politics/2018-08/26/c_1123331165.htm [hereinafter CCP Disciplinary Measures].

[676] *See id.* Ch. VIII (Acts Violating the Rules of Integrity and Self-Discipline), arts. 88-101, Ch. X (Disciplinary Actions for Violations of Work Discipline), arts. 121-127 (articles 88, 89 (engagement in profit making activities in violations of laws and regulations while doing business; buying, selling, or investing in stocks and other securities; establishing a company or investing in shares offshore; undertaking compensated intermediary activities; holding securities of a non-listed enterprise; other violations related to profit making activities. Including the use of power to benefit the business activity of family and friends), article 90 (the wrongful influence of business activity of family and friends in the execution of officials' duty), article 91 (the responsibility of "leaders" for violations conducted by state organs and enterprises under their responsibility); article 126(2) (violations of regulations by leading cadres during which the officials have interfered with market economic activity and caused a negative effect, including interference with major business activity of state owned enterprises: restructuring, merger, bankruptcy, asset valuation, property rights transfers, major project investments).

[677] *See* CCDI, http://www.ccdi.gov.cn/special/jdbg3/zyhgjjj/ (last visited May 23, 2019).

were investigated for corruption through the Party disciplinary system.[678] Media reports also indicated that SOEs and their insiders have been "targeted."[679]

A particularly interesting method taken by the CCDI to expose corrupt corporate insiders and Party-state leaders is its use of the business-group organization and its access to intra-firm governance. It appears that the CCDI has applied targeted "inspection tours," starting with lower level enterprises within a business group, collecting information, and building an "evidence" line while climbing up the group ladder until it reaches the top leadership.[680] To facilitate this tactic, it steers the group's internal governance, which often means enlisting the help of Party institutions at the group or firm level. Until recently, anti-corruption work and other disciplinary inspection within central SOEs were in the hands of internal disciplinary teams (*qiye jiwei- jijian zu*).[681] These teams were either formally dispatched by SASAC (for certain corporatized SOEs) or were self-organized by firms under SASAC's encouragement and guidance. Either way, SASAC trained and supervised them with CCDI guidance. The Party criticized this intra-firm disciplinary mechanism for lacking real powers within the corporate and administrative hierarchy.[682] To rectify this, the SOEs Reform Guiding Opinions assign the lead authority over disciplinary inspection to the firm's Party committee. This has shifted supervision and investigative authorities from SASAC-organized intra-firm supervisory teams to the firm's Party committee, a legalized yet political corporate-institution. This recent move surely opens a more direct route for CCDI involvement in firms.

The role of the intra-firm Party committee with respect to discipline inspection was reinforced as one of the main responsibilities of this corporate governing body.[683] Meaning, aside from its new and expanded roles in corporate decision making discussed earlier, the Party committee is also the

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[678] Angela Meng, *A Quarter of Chinese SOEs Executives Investigated for Corruption Work in Energy Sector*, SOUTH CHINA MORNING POST (Apr. 28, 2015, 3:45 PM), http://www.scmp.com/news/china/policies-politics/article/1778702/quarter-chinese-soe-executives-investigated-corruption.

[679] *Id. See also* Frank Fang, *Anti-Corruption Campaign Targets China's State-Owned Enterprises*, EPOCH TIMES (Feb. 20, 2015), https://www.theepochtimes.com/anti-corruption-campaign-targets-chinas-state-owned-enterprises_1256832.html (reporting that the CCDI had marked twenty-six central SOEs as targets for next round of investigations); Lucy Hornby, *China Anti-Corruption Drive Targets Sinopec—Oil Group Among Several State-Owned Enterprises to Face Probe*, FIN. TIMES (Dec. 4, 2014), https://www.ft.com/content/f0cc6d0a-7b82-11e4-a695-00144feabdc0. *See also* my comment with respect to the decline in criminally prosecuted cases related to SEOs *supra* note 674, a decline that might derive from a parallel increase in alternative enforcement measures with respect to these firms.

[680] This is not a comprehensive empirical observation, but rather one based on my impression from CCDI investigations covered by media reports and CCDI pubic announcements.

[681] On the work and training of such inspection teams, see *Guozi wei juxing Zhongyang Qiye jiwei shuji jijian zu zhang perixun bankai banshi* [*The State-Owned Assets Supervision and Administration Commission Held the Opening Ceremony of the Central Enterprise Disciplinary Committee Secretary and the Discipline Inspection Team Leader Training Class*], SASAC (Apr. 1, 2012), http://www.sasac.gov.cn/n2588020/n2877928/n2878219/c3747868/content.html; *Guozi wei juban Zhongyang Qiye jiwei shuji (jijian zuzuzhang)* [*The State-Owned Assets Supervision and Administration Commission Held a Training Course for the Secretary of the Central Enterprise Disciplinary Committee (the Leader of the Discipline Inspection Team)*], SASAC (Mar. 21, 2013), http://www.sasac.gov.cn/n2588020/n2877928/n2878219/c3747633/content.html.

[682] *See* Xiangfu Meng, *Guoqi jijian jiguo yaodanghao "zhuomuniao"* [*State-Owned Enterprises Disciplinary Inspection System Should Serve as "a Good Woodpecker"*], NAT'L PEOPLE'S REPUBLIC CHINA CEN. DISCIPLINE INSPECTION COMMISSION (June 26, 2018), http://www.ccdi.gov.cn/yaowen/201806/t20180626_174459.html.

[683] SOE Reform Guiding Opinions, *supra* note 585, art. 1(3).

leading organ within the firm assigned to party line education, disciplinary inspection work, forming an intra-firm accountability system (linked to firm-assessment), investigating the conduct of enterprise leaders, strengthening tour inspections in SOEs, and basically facilitating the work of external anti-corruption institutions (i.e., CCDI).[684] In the context of corporate corruption, therefore, the Party committee therefore functions as a type of a Trojan horse or a whistleblower for the Party.

Another factor that facilitates the work of CCDI within corporatized SOEs and their business groups is the corresponding roles that some high-level CCDI agents have within major firms and/or state institutions. For example, Chen Chaoying, a CCDI Standing Committee member, was dispatched by the CCDI to be the chief external inspector over SASAC. He also has a high position within China's newly established National Supervisory Committee and is a member of SASAC's own internal Party committee.[685]

The points above reflect how the use of the corporate form and SOE group organization make the CCDI's work in monitoring and enforcing against corporate corruption a highly collaborative network.[686] Recent cases demonstrate this vividly.

ii. Recent Cases

In examining the ways that the corporate group is being utilized to facilitate work against corruption, the following patterns seem common. The CCDI starts its probe with a "disciplinary tour," during which it dispatches investigators into a specific state-controlled group and presumably activates the Party committees within firms in a systematic search for corruption ("crackdown" in the media). The "evidence" collected leads to the investigations of several subsidiaries within the group and its affiliates, including private firms. The investigation includes interrogations of corporate employees, individual business affiliates, and finally corporate insiders. The primary targets are often high-level public figures with parallel positions at the group organization.

Examples of how this works are the targeted probes in one of China's most valuable sectors—energy. By targeting two of its most important corporate groups, the CCDI opened a hornet's nest

[684] Although the CCDI is not mentioned formally. *See id.* art. 7(26) ("The Party organizations of SOEs shall earnestly perform their duties as the primary players responsible, while their disciplinary inspection agencies shall effectively perform supervisory responsibilities." It includes a fanfare instruction to "keep using the thinking and methods of the rule of law to fight corruption, fine-tune anti-corruption institutions and systems, strictly enforce the provisions against formalism, bureaucracy, hedonism and extravagance, and strive to build effective mechanisms where enterprise leaders dare not to, are not able to, and do not want to, engage in corrupt practices.").

[685] His biography is available under the "Leadership of SASAC" webpage. *See* http://en.sasac.gov.cn/n1408028/n1408570/c8860160/content.html.

[686] Recent discipline and inspection work reports in both SASAC and specific SOEs also reflect this. *See Zhuwei jijian jianchazu yaowen* [*News of the Discipline Inspection and Inspection Team*], SASAC, http://www.sasac.gov.cn/n2588020/n2877928/n2878219/index.html (last visited May 23, 2019); *Yewu Gongzuo* ["*Business Work*"], SASAC, http://www.sasac.gov.cn/n2588020/n2877928/n2878221/index.html (last visited May 25, 2019).

that led to the exposure and punishment (both disciplinary and legal enforcement) of several corrupt Party members and state officials at the national and local levels, as well as senior business executives.[687] One of the cases is that of Jiang Jiemin, who rose through the ranks of the oil industry to head China's biggest oil business, China National Petroleum Corporation (CNPC), [688] and was appointed as the head of SASAC. The pursuit of Jiang (which some opined was motivated by his ties with Zhou Yongkang, a political rival of Xi)[689] involved the detention, investigation, and punishment of dozens of senior managers in the parent holding-company CNPC, its listed subsidiary PetroChina, and even in private affiliated firms.[690] A similar inspection was taken thereafter into another of China's centrally controlled energy champions, Petroleum & Chemicals Corporation (Sinopec Group) and its main listed subsidiary, Sinopec Corp Ltd.. The inspection into Sinopec Group led to the detention of managers in several subsidiary firms,[691] finally reaching the president of the group, Wang Tianpu. Wang, who chaired the Group's board at the time and was also the general manager of its listed subsidiary, was put under Party disciplinary proceedings for taking bribes and abuse of power. Wang was removed from his corporate positions, expelled from the Communist Party, and eventually prosecuted under criminal law.[692]

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[687] Meng, *supra* note 678; *Former China Energy Chief Jiang Jiemin Jailed for Corruption*, BBC NEWS (Oct. 12, 2015), https://www.bbc.com/news/world-asia-china-34503469 (presenting a "family tree" style illustration of the cases involved in this investigation into the oil industry).

[688] Jeremey Page et al., *China Probes Former Oil Company Head*, WALL STREET J. (Sept. 1, 2013, 2:56 AM), https://www.wsj.com/articles/china-probes-former-oil-company-head-1378018593.

[689] Willy Lam, *With Zhou's Circle Down, Xi's Purge May Turn to Hu*, Jamestown Brief, Vol. 14, No. 13, 3 July 2014, https://jamestown.org/program/with-zhous-circle-down-xis-purge-may-turn-to-hu/.

[690] The proceedings against private affiliated firms are worth noting since they instigated from, and likely rely on, evidence obtained during the political disciplinary enforcement process, thus reflecting the high collaboration between the Party and state enforcing institutions. Donny Kwok & Charlie Zhu, *PetroChina Supplier Wison Says Record Seized, Can't Contact Chairman*, REUTERS (Sept. 18, 2013, 8:49 PM), https://www.reuters.com/article/uk-wison-cfo-idUKBRE98I01120130919 (in which the chairman and subsidiary executives of HK listed private firm Wison Engineering Services Co Ltd., a major supplier of PetroChina, were investigated as part of the Chinese corruption investigation in PetroChina and its parent company CNPC). In March 2014, Wison's founder, primary shareholder, and chairman of the board was formally arrested. He was accused of conspiracy to commit a "tender-offer fraud," as well as for offering bribes for state officials. In August, 2015, he was found guilty for offering bribes. Brian Spegele, *Wison Engineering Says Chinese Police Arrested Chairman*, WALL STREET J. (Mar. 10, 2014, 11:45 PM), https://www.wsj.com/articles/wison-engineering-chairman-hua-bangsong-was-arrested-by-chinese-authorities-1394425858; *PetroChina Supplier Wison Says Found Guilty of Bribery in China*, REUTERS (Aug. 5, 2015, 9:41 PM), https://www.reuters.com/article/wison-petrochina-idUSL3N10H08120150806.

[691] Such as the case of Xue Wandong, the vice-chairman and CEO of Sinopec Oilfield Services Corp who was detained and investigated by the CCDI and dismissed from his role in Sinopec immediately. *See* Hornby, *supra* note 679.

[692] Zhongyang Zhongguo Shihua Dangzu Guanyu Xunshi Zhenggai Qingkuang Tongbao (中共中国石化党组关于巡视整改情况的通报) [Circular of the Chinese Communist Party on the Inspection and Ratification in China Petroleum Chemical Corporations], (promulgated by the CCDI, Apr. 30, 2015), *available at* http://www.ccdi.gov.cn/yw/201504/t20150430_55638.html; Zhongguo Shiyouhuagong Jituangongsi Zongjingli Wangtianpu Shexian Yanzhong Weijiweifa Jieshou Zuzhidiaocha (中国石油化工集团公司总经理王天普涉嫌严重违纪违法接受组织调查) [Notice by the CCDI on the Disciplinary Investigation of Wang Tianpu, April] (promulgated by the CCDI, Apr. 27, 2015), *available at* http://www.ccdi.gov.cn/xwtt/201504/ t20150427_55436.html; Zhongguo Shiyou Huagong Jituangongsi Yuan Dongshi, Zongjingli, Dangzuchengyuan Wangtianpu Yanzhong Weiji Bei Kaichudangji (中国石油化工集团公司原董事、总经理、党组成员王天普严重违纪被开除党籍) [Notice by the CCDI on Wang Tianpu's Expulsion from the Party, September] (promulgated by the CCDI, Sept. 18, 2015), *available*

Similar recent probe targets include firms in the healthcare sector, commercial and investments vehicles operating off-shore (state-controlled as well as private),[693] and currently, the financial sector. Some recent cases against ostensibly private firms, such as Dalian Wanda, Fosun International, HNA Group, and Anbang Insurance, emphasize how Party-led disciplinary enforcement influences and determines the operations of state enforcement actions in the private sector as well. Some commentators posit that these purges serve multiple purposes, including cleaning and improving the financial system, enforcing against dubious business practices, and "getting rid of tycoons with dubious political loyalties" at the same time.[694] These cases reflect that a CCDI investigation has ripple effects throughout the investigated group and its web of affiliates. They also reflect that Party-led enforcement receives a high-level of collaboration from state institutions. For example, SASAC, CSRC, and the China Banking Regulatory Commission assisted in confiscating documents, freezing bank accounts, stopping the trade in shares of firms under investigation, and other measures.[695] This assistance is given even before the case formally reaches the legal system. We can assume that this inter-agency cooperation will further increase after the recent consolidation of authority under the National Supervision Commission.

Consequences within firms are also apparent. Once the Party's disciplinary inspection apparatus has signaled that an individual is suspected of a disciplinary violation, whether this has been disclosed to the public or not, the individual will be removed or forced to step down from his corporate positions. This happens in many cases before any legal accusation has been made and regardless of any proof of damage to the corporation or its stakeholders. Disciplinary punishment by the Party (e.g., admonition, a downgrade in rank, revoking their parallel Party positions, and finally expelling them from the Party altogether) will also often precede criminal charges.[696] In these cases,

at http://www.ccdi.gov.cn/xwtt/201509/t20150918_62038.html. On the consequent legal criminal prosecution, *see China to Prosecute Former Top Executives for Alleged Graft*, REUTERS (Sept. 29, 2016, 5:40 AM), http://www.reuters.com/article/us-china-corruption-sinopec-idUSKCN11W0VX.

693 One example of an investigation of a state-owned commercial firm is the case of Song Lin, the former chairman of China Resources, a Hong Kong based trading company and one of China's largest state-owned enterprises, who was accused of power abuse in corporate dealings and was arrested in April 2014. The Party removed Lin from his positions in the firm and the Party. Two years later, he was charged under criminal law. James T. Areddy & Laurie Burkitt, *China Communist Party Ousts Chairman of Major State-Owned Firm*, WALL STREET J. (Apr. 22, 2014, 1:34 PM), https://www.wsj.com/articles/communist-party-fires-song-lin-chairman-of-china-resources-holdings-as-corruption-fight-expands-1398187916; Choi Chi-yuk, *Song Lin, Former Chairman of China Resources, is Formally Charged with Corruption,* SOUTH CHINA MORNING POST (Dec. 8, 2016), https://www.scmp.com/news/china/policies-politics/article/2052971/song-lin-former-chairman-china-resources-formally. For other examples of SOE executives investigated for corruption and released from their corporate role, *see 9 Chinese SOEs Slammed for Discipline Violations,* XINHUA (JUNE 17, 2015), http://www.china.org.cn/china/2015-06/17/content_35840376.htm. Examples of investigations against private firms that seem to also entail Party disciplinary investigative work include Dalian Wanda, Fosun International, HNA Group, and Anbang Insurance. *See* Lucy Hornby et al., *Big China Companies Targeted over 'Systemic Risk'*, FIN. TIMES (June 23, 2017), https://www.ft.com/content/23c8ba54-5710-11e7-9fed-c19e2700005f.

694 Minxin Pei, *Xi Jinping's War on Financial Crocodiles Gathers Pace*, FIN. TIMES (June 25, 2017), https://www.ft.com/content/19810ea2-5814-11e7-80b6-9bfa4c1f83d2.

695 *Id.* Wison Engineering Services Co Ltd. bank accounts were frozen, and the trade in its shares was suspended.

696 Brian Spegele &Wayne Ma, *Wison Engineering Says Chinese Police Arrested Chairman; Hua Bangsong Is Accused of Bribery, According to Oil-Services Firm*, WALL STREET J. (Mar. 10 2014, 11:45 PM), https://www.wsj.com/articles/wison-engineering-

we can see further examples of the connection between China's personnel management system and the Party's disciplinary assessment.

Thus, while corporatized SOEs and the web of affiliated businesses surrounding them might be especially prone to corruption and other corporate malfeasance, the use of the same organizational structure facilitates anti-corruption efforts and expands the Party's enforcement reach into the market more broadly. In this process, the separation between political and legal enforcement against certain corporate offenses becomes blurry, so that the Party performs many of the monitoring, accountability, and deterrence functions otherwise provided by external markets and legal institutions.

III. POLITICIZED CORPORATE GOVERNANCE IN CHINA—A VIABLE ALTERNATIVE?

More than a decade ago, scholars lamented the "absentee principal" problem in China, due to which state organs as dominant shareholders of publicly listed firms seem to "either abuse their control or fail to exercise it entirely."[697] We have seen, however, that where dominant shareholders, legal institutions, and even market mechanisms fail, institutions of the Chinese Communist Party fill in the void. These sui generis institutions are claiming an increasingly overt role in corporate governance, replacing to a degree both internal and external monitoring mechanisms. The evolving nature of these institutions makes a full judgment of their effects impossible, but some early assessments can be made.

Conceptually, the daylight takeover of the powers of corporate governing bodies by political institutions is alarming, not only for those who believe in market liberalism of any degree but even for those who support economic interventionism and developmental state governance. The perils of a politicized corporate governance go beyond those that are commonly expressed about state ownership.[698] They include concerns about having an unruly economic control in the hands of a political Party and essentially in the hands of a limited number of individuals. In this case, the political party is above the law, and thus the powers of the individuals operating therein are bound only by internal checks and balances offered within the political system itself (as opposed to the common misconception that Party members lack any checks and balances whatsoever). As a conceptual matter, this politicization therefore manifests the rejection of the rule of law, as the term is normally understood, in the realm of corporate governance specifically.

There could be firm-level practical concerns as well. The recent developments formally shifted an unrestrained power from corporate insiders to corporate Party committee members. It is possible that the individuals operating therein will use their powers in ways that add favoritism, arbitrariness,

chairman-hua-bangsong-was-arrested-by-chinese-authorities-1394425858 ("Neither Mr. Jiang nor several other oil executives removed from their posts in recent months have been formally charged.").

[697] Clarke, *supra* note 3, at 197.

[698] The effect of state-ownership on firm value and performance in China is still inconclusive. For various studies on the matter and the controversy, *see* Clarke, *supra* note 71, at 139-143.

and simply misguided enforcement into the system, not to mention the fact that human rights can be easily subjugated in the process of political enforcement. Moreover, now that the Party has more direct access to corporate decision making and is a distinct stakeholder irrespective of the state's role as a shareholder, new conflicts of interests and additional institutional costs could emerge within firms more markedly.[699] Managers, now formally directed through Party committees (or simply being the same person), could continue facilitating exploitation of public shareholders for political goals, but now in broad daylight.

It should be noted, however, that these firm-level concerns, while justified, are not substantially different from those that have materialized under corporate organization in China so far and before the recent overt politicization. These firm-level concerns, if they were to materialize, would be nothing new.

What is different in the recent politicization is the reversal from the apparently convergent corporate-capitalism governance model toward a version of a planned market economy, in which Party institutions are openly deployed within and outside firms, ready to act on command. A tightly controlled corporate environment and the awareness to a closer Party presence will impact managerial discretion and will likely create fear governance that was less present when Party control was in the shadows. Fear governance could lead to risk-averse management. Concerned with political surveillance and retribution, managers could become paralyzed.[700] If this does indeed occur, not only would this prevent value-increasing transactions, but it could also have a chilling effect on developing market forces, such as the managerial labor market, product market competition, and innovation. These effects would lead to further market inefficiencies, stagnation in business expansion and in capital market development,[701] and would slow down general growth. Some would argue that we may already see signs of that in the lower growth rates in China during the past few years.

These firm and market-level concerns are indeed valid, but there are also counter measures in the recent politicization drive, mainly the incentivizing force of the personnel management mechanisms. While the risks of political intervention are rather straightforward and recognized, not enough attention is given to a similarly possible scenario in which China's politicized corporate governance could result in added value and serve the interests of firms and the market. The general wisdom has dismissed this possibility by the simple doubt that the Party will choose to exercise its power in ways that benefit firms and their stockholders,[702] and by the assumption that interest group politics influence reforms only in one specific direction. Yet the opposite possibility should be

[699] The opposite could happen as well, since less opaque Party presence could facilitate better information flow. *See* further discussion *infra* in Chapter 2, Section III.A. Relevant empirical studies noted in *infra notes* 724-726.

[700] On the influence of anti-corruption enforcement on policy makers, *see* Daniel Bell, *China's Corruption Clampdown Risks Policy Paralysis*, FIN. TIMES (May 2, 2017), https://www.ft.com/content/293d3b2a-2f1c-11e7-9555-23ef563ecf9a.

[701] Jamil Anderlini, *China's War on Graft Leads to Drop in Outbound Investment*, FIN. TIMES (Sept. 22, 2014, https://www.ft.com/content/58d0cb22-421b-11e4-a9f4-00144feabdc0.

[702] *But see* Gilson & Milhaupt, *supra* note 404 (providing a refreshing discussion of the possible economic commitment of some dictatorships and authoritarian governments to growth).

recognized as well and is perhaps more plausible when one considers the complex interests of the Party and its functionaries in promoting strong and appealing capital markets. As shown time and time again with respect to decisions in economics,[703] firm governance,[704] and public policy,[705] incentives' alignment matters—even if these incentives are structured in idiosyncratic ways. As presented throughout this work, a certain alignment of interests between the political controlling apparatus and firms and their stakeholders (including shareholders) is forming. This alignment of interests may be the source for further growth-supporting, even if political, institutions. Especially given the economic results of unconventional governance in China so far, the possible positive effects of a politicized corporate governance should be explored. A politicized corporate governance could have positive effects for both firms and the market, and even for the role of law in China.

A. Potential Positive Effects at the Firm and Market Levels

As a practical matter, the level of Party involvement in corporate decision making will depend on the type of firm or the specific situation. The SOE Reform Guiding Opinions prescribe a different scope of involvement for particular industries, types of firm, and situations.[706] Thus, while all firms with state investments are compelled to formally install political institutions into their internal governance system, the active political involvement in daily decision making will likely be limited in most firms. The daily situation for most firms would thus remain as it was; managers will be controlled indirectly through decisions on their career path while being relatively free to handle operations. These firms will continue to be operated the way their managers believe could best promote their future careers in the Party-state system, much as it was under Party shadow control before the recent politicization.

In firms or situations where the Party committee will opt to exercise its corporate powers more fully—which are now likely larger in number than before the recent developments in politicization, but still limited—the costs of coordination would presumably decrease. Party-state goals will be articulated more frequently through the Party committee and will be less opaque and less open to managers' interpretation. Despite the possible effects of risk-averse managers and the rising costs of conflicts between shareholders, this can lower the costs of monitoring insiders.

Furthermore, and as seen throughout the development process, in its efforts to keep the value of state assets high and the cost of capital low, the Party has repeatedly steered capital market activity ex-post in order to remedy share-price declines. This has had broad market implications. Unnecessary

[703] Oliver Williamson, *Transaction Cost Economics: How it Works; Where It Is Headed*, 146 DE ECONOMIST 23 (1998).
[704] Martijn Cremers et al., *Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry*, 44 J. FIN. & QUANTITATIVE ANALYSIS 1345 (2009).
[705] Carolyn Heinrich & Gerald Marschke, *Incentives and Their Dynamics in Public Sector Performance Management Systems*, 29 J. POL'Y ANALYSIS & MGMT. 183 (2010).
[706] *See supra* note 607 and the accompanying text.

market-level effects could perhaps be prevented through a tailored and more controlled intervention from within firms, ex-ante.

Putting the uncertainties of greater involvement of corporate political institutions in daily decision making aside, three main changes still stand: 1) under the recent politicization, personnel evaluation is expressly linked with economic performance; 2) disciplinary enforcement, assisted by firm-internal Party committees, will increase, which will likely spill over to enforcement against corporate wrongdoing more generally; and, 3) the awareness among corporate constituents and potential investors of the presence and the roles of Party members deployed within firms will likewise increase. These changes point to some important contributions that a politicalized corporate governance offers to firms and the capital market through aligning interests, enforcement and deterrence, and a market-commitment-signaling mechanism.

With respect to personnel evaluation and economic performance: The tightening link following the recent politicization between economic performance measures in firms and the career trajectory of individuals that manage or supervise them[707] points to an increasing alignment of interests between firms, their stockholders, and corporate control parties. While studies and recent market volatility have shown that the Chinese capital markets are not informationally or fundamentally efficient,[708] and thus share price movements are not strictly determined by an issuer's market performance, the public share price of a corporatized SOE will be taken into account for personnel evaluation and likely more now than ever before. A drop in the share price of a PRC issuer, whether or not reflective of actual economic performance, may deny Party members who are firm managers from future advancement within the Party-state. This can serve to discipline the behavior of powerful corporate officials and also incentivize them to increase shareholder value even in an inefficient market. The opposite results, in which managers are incentivized to further misconduct, whether engaging in false or misleading disclosure to prop up a public share price or being more deferential to political commands,[709] are also possible, of course. Still, this development is striking, especially considering the starting point. Not long ago, capital market investment-based revenues were frowned upon,[710] and only a little more than a decade ago, state ownership and the managers of state-controlled firms were still shielded from the disciplinary effects of the capital market.[711] The attributes that were so strongly rejected in the past are now embraced and even harnessed by the Party.

This aspect of a political governance in firms and the capital market illuminates how the capital markets themselves—even in the absence of a market for corporate control—can affect the

[707] *See supra* notes 560, 580-587 and the discussion therein.
[708] *See, e.g.*, Chen, *supra* note 428 ("[T]he Chinese stock market as a whole has acted to determine stock prices in a way totally detached from the economic growth process."). Generally, on the "inefficiencies" in the Chinese stock markets, *see* Guoping Li, *China's Stock Market: Inefficiencies and Institutional Implications*, 16 CHINA & WORLD ECON., no. 6, Nov.-Dec. 2008, at 81.
[709] *See, e.g.*, the Nanjing Textile Import & Export Co. fraud case mentioned in note 473, *infra*.
[710] *See supra* note 70.
[711] *See supra* notes 77-81.

advancement of human agents inside the Party-state personnel system and vice versa, thereby having a disciplinary function on corporate insiders that mitigates shareholders' concerns.[712] It also highlights the interdependence of political institutions and market development in China.

With respect to disciplinary enforcement and its externalities: More stringent disciplinary enforcement against corporate corruption and asset embezzlement removes bad managers. It could also spill over to market monitoring and enforcement more generally,[713] raise the overall level of compliance, and deter others from additional forms of corporate misconduct, such as self-dealing, waste, and fraud. Anti-corruption tour inspections in corporate groups could also decrease the number and scope of undesirable related-party transactions, which are presently extremely frequent within SOE business groups.[714] Corporate wrongdoings not only siphon firm value and harm the state and other shareholders, but also raise the cost of capital in the economy and hinder growth. In these respects, political disciplinary enforcement and its deterrence effect would benefit firms and capital market growth. Enforcement has a more direct effect on firms and insiders that participate in the Party-state system and on those that aspire for such careers. Yet, its deterring effect also diffuses to the network of private affiliates surrounding them and can have implications on the market at large.[715]

In terms of a market-signaling effect: While the possibility that investors will view greater politicization negatively cannot be ruled out, the opposite seems more plausible. Since it appears that investors in the Chinese market are not dissuaded by state ownership and control,[716] there is no reason to believe that they will assess greater Party control as potentially more abusive of their rights and will refrain from investing. The primary concern of public investors today is not the expropriation of their property rights by the Party-state, but rather their abuse by corporate insiders and rogue officials. The politicization of corporate governance is therefore instead likely to signal to investors that the Party-state is committed to economic growth and that self-dealing, related-party transactions, and corruption are now kept at bay by a strict enforcer. Particularly since the capital market in China is informationally

712 This part draws heavily on my prior work in. *See* Groswald Ozery, *supra* note 101.

713 As exemplified in recent Party-led enforcement actions against suspicious investment activities off-shore, which has been said to be motivated by concerns for the stability of the financial system. Tom Mitchell et al., *Wang Qishan: China's Enforcer*, FIN. TIMES (Jul. 24, 2017), https://www.ft.com/content/d82964ba-6d42-11e7-bfeb-33fe0c5b7eaa ("The larger economic policy goal behind Mr. Wang's investigations, the official explains, is to 'stop using the financial system as an economic growth lever.'") (referring to cases of speculative asset and stock pricing bubbles whereby business managers used the financial system and listed companies under their management to drive up share prices and enrich themselves and others – e.g., the allegations against private businessman Xiao Jianhua.).

714 *See supra* notes 217-219 and the accompanying text.

715 For the indirect effect of sanctions on non-punished peer firms in China, *see* Francesco D'Acunto, *Punish One, Teach a Hundred: The Sobering Effect of Punishment on the Unpunished* (University of Chicago, Becker Friedman Institute for Economics Working Paper No. 2019-12, 2019).

716 As mentioned in the section "Equity Markets," *supra* pp. 86-89, investors prefer investing alongside Party-state dominant shareholders. *See also* Charles Calomiris et al., *Profiting from Government Stakes in a Command Economy: Evidence from Chinese Asset Sales*, 96 J. FIN. ECON. 399 (2010) (documenting negative market responses to unexpected announcements on sales of government shares in listed SOEs and conversely a positive effect following relevant policy cancellation. The authors argue that the benefits of political ties outweigh efficiency costs of state-shareholdings.).

inefficient,[717] suppliers of capital look for alternative sources of information about corporate performance instead of stock price and accounting measures. In this sense, political institutions are filling a crucial signaling "intermediary" role in an environment where information is scarce and unreliable.[718] A politicized corporate governance thus can increase market confidence and provide the assurances needed for investors to supply capital even in an environment of continued limited transparency.

Available Evidence

The evidence of the economic effects of the politicization of corporate governance (intra-firm governance through political institutions and external monitoring and accountability through anti-corruption enforcement) is presently very limited, as these changes are still unfolding. A few recent studies examine the economic effects of the anti-corruption campaign, and they largely corroborate my hypotheses. A 2018 study examined the characteristics of firms investigated between 2012 and 2015 as part of the anti-corruption campaign. The study constructed a sample of 150 Chinese listed firms in which top executives were investigated. Eighty-seven percent of the investigated firms were found to be state-owned firms. The authors found that firms with characteristics that are commonly associated with poor governance, such as self-dealing and inefficiencies, were more likely to be investigated. This suggests that the anti-corruption campaign has enforcement spillovers on corporate wrongdoing more broadly and indeed captures firms with weak governance. The authors also found that the likelihood of investigation is negatively associated with managerial connections with top Party-state leaders (less so with connections to the local-government), reflecting the parallel force of political motivations in place.[719] Another recent study examined the effects of corruption on entrepreneurial activity in China. The authors found that corruption may stifle entrepreneurial activity and by implication economic growth by increasing the rents of a few established connected firms and decreasing the ability of small entrepreneurial firms to grow and compete. The study also found that this negative effect was mitigated by the anti-corruption campaign, concluding that the anti-corruption campaign is an effective "step forward towards" entrepreneurial market-entry, efficient allocation of

[717] *See* the discussion about the Equity Market as monitoring mechanism and the sources therein (including reservations) *supra* Chapter 2, pp. 86-89.

[718] Miwa and Ramseyer discuss how in twentieth century Japan, monitoring and quality certification by reputable industrialists recruited to the boards of Japanese firms compensated for informational inefficiencies in the market. *See* Miwa & Ramseyer, *supra* note 124.

[719] John M. Griffin et al., Is the Chinese Anti-Corruption Campaign Authentic? (Dec. 19, 2018) (paper presented at the 29th Annual Conference on Financial Economics & Accounting 2018), *available at* https://ssrn.com/abstract=2779429 (Despite these results, the authors also found that anti-corruption campaign enforcement did not result in greater information transparency nor increased foreign direct investments.).

resources, and ultimately sustained growth.[720] A third study linked the anti-corruption campaign with an additional aspect of increased competition—the availability of credit. According to this study, CCDI investigations improve the access of non-SOE firms (defined by the authors as firms in which the largest ultimate shareholder is neither a central nor local government entity) to credit. The authors posit that anti-corruption enforcement reallocates credit from less-productive SOEs to more productive non-SOEs.[721]

With respect to the signaling effect I alluded to above, two recent studies performed an event-study methodology that tracked cumulative abnormal returns of Chinese listed firms following different announcements in Xi's anti-corruption campaign. The results show that the overall stock market responses to announcements of CCDI inspections were significantly positive.[722] One of these studies looked at firms that are listed both in China and on the Hong Kong stock exchange, concluding that the expectation of reduced corruption adds value to listed firms overall in both markets.[723] A third study examined the effect of the anti-corruption campaign on market reaction concerning what the authors call "relational spending" (measured by business entertainment expenses). The authors found a weaker effect of relationship spending on share-price crash risk following the anti-corruption campaign. They posited that the anti-corruption campaign reduced information opacity and minimized investors' perception of risks from relationship spending and concluded that the campaign contributes to monitoring. [724]

The possible effect on information flow in the capital market is controversial, however. One study has found that firms in inspected provinces are more likely to withhold negative information during anti-corruption inspections, suggesting that the information environment is weakened.[725] Conversely, another study found that when the anti-corruption campaign is carried out against government

[720] Mariassunta Giannetti et al., *The Externalities of Corruption: Evidence from Entrepreneurial Firms in China* (European Corporate Governance Institute, Finance Working Paper No. 536/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2897558 (among the findings of the study: 1. "entertainment expenses"—a common measure of potential corruption and a way for control parties to siphon private benefits of control— in big firms decreased following Xi's anti-corruption campaign; 2. anti-corruption measures have alleviated barriers for small businesses and made it easier for them to compete; 3. following Xi's anti-corruption campaign, state subsidies for R&D became significantly positively associated with future innovation (higher innovative efficiency and lower influence of corruption-related expenditures); Mariassunta Giannetti & Xiaoyun Yu, *The Impact of Xi Jinping's Anti-Corruption Campaign on Small and Incumbent Firms in China*, CEPR POL'Y (Oct. 30, 2017, https://voxeu.org/article/anti-corruption-and-entrepreneurial-activity-china.

[721] Bo Li et al., *China's Anti-Corruption Campaign and Credit Reallocation from SOEs to NonSOEs* (PBCSF-NIFR, Research Paper No. 17-01, 2017, rev'd July 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2908658.

[722] Haoyuan Ding et al., Equilibrium Consequences of Corruption on Firms: Evidence from China's Anti-Corruption Campaign (Dec. 7, 2017) (working paper presented at the NBER-CCER Conference 2018), *available at* http://papers.nber.org/conf_papers/f100913.pdf.

[723] Chen Lin et al., 2016. *Anti-Corruption Reforms and Shareholder Valuations: Event Study Evidence from China* (National Bureau of Economic Research, Working Paper No. 22001, 2016, rev'd 2018), https://www.nber.org/papers/w22001 (The study also identified different impact levels depending on prior market liberalization. Firms in capital markets that are better set to allocating recourses efficiently experienced higher cumulative abnormal returns.).

[724] Hu, Li, Duncan, Xu, Corporate Relationship Spending and Stock Price Crash Risk: Evidence from China's Anti-Corruption Campaign (Feb. 3, 2019) (on file with author).

[725] Xiaping Cao et al., *Anti-Corruption Campaigns and Corporate Information Release in China*, 49 J. CORP. FIN. 186 (2018).

officials in a certain municipal level, firms in the same jurisdiction experience a long-run decrease in risks associated with share-price crash. The authors posit from this that the information environment in which businesses and the capital market operates has improved.[726] The contradictory results about improved information only add validity to the signaling effect of political enforcement. Whether or not the anti-corruption action improves information availability, this form of enforcement by political institutions signals commitment to the market and substitutes for limited or questionable information.

The anti-corruption campaign as an element in the recent politicization of corporate governance has another, more unexpected, result. It seems to have a direct effect on the corporate conduct of multi-national U.S. firms.[727] A recent U.S. SEC report found a surge in China-domiciled whistle-blowers with respect to misconduct in multinational and U.S. firms, which is presumably related to China's anti-corruption efforts.[728] Strikingly, a politicized corporate governance in China is contributing to the implementation of the Dodd-Frank Wall Street Reform!. This effect on foreign domiciled firms and on investors outside of China indicates the possible positive externalities of a politicized corporate governance in China, even when the consideration of investors' interests and market efficiency were incidental among the many motivations behind its development.

B. Legalizing Political Institutions—Contribution to the Role of Law

As we have seen, Party monitoring and accountability institutions are embedded into the corporate legal system rather than being kept in the realm of extra-legality. This reaffirms the instrumentalist role law and jurisprudence play in contemporary China, no doubt, but it also reflects the rising significance of law in Chinese society and for Party functions specifically.

The CCP certainly did not *need* the legal system to grant it influence and even control over firms and the market. Similarly, the CCP could certainly handle corporate corruption outside the legal system, just as it had previously. Unlike the practical necessity that guided the establishment of legal institutions during the first and second stages of economic transition, which was motivated by the need to attract capital to the SOEs, reconsolidate economic and administrative control, and satisfy commitments in the global market, the current choice to enshrine political governance in law must find an explanation elsewhere. The use of a legal framework here provides a layer of protection that

[726] Yunsen Chen et al., *Does Crackdown on Corruption Reduce Stock Price Crash Risk? Evidence from China*, 51 J. CORP. FIN. 125 (2018).
[727] Matthew S. Erie, *Anticorruption as Transnational Law: The Foreign Corrupt Practices Act, PRC Law, and Party Rules in China*, AM. J. COMP. L. (forthcoming), *available at* https://ssrn.com/abstract=2971092. (discussing how the overlapping systems of anti-corruption in the United States and China form a transnational law compliance system).
[728] Andy Rickman, *How China and the US Are Emboldening Whistle-Blowers in the Fight Against Corporate Corruption*, SOUTH CHINA MORNING POST (Nov. 27, 2017, 12:38 PM), http://www.scmp.com/comment/insight-opinion/article/2121681/how-china-and-us-are-emboldening-whistle-blowers-fight.

stabilizes the Party and normalizes it as a legitimate governance system.[729] As the CCP has no intention to situate itself under the law, it has found another legitimatizing path using the law to establish its political governance upon firms and the market.[730]

The implications of this for the legal system itself and for the role of law are controversial. Some view it as a second-best beneficial step. Having a clearer and out-front framework for Party influence can be a positive development for legality in China.[731] Here, for example, enforcement against corporate corruption by political institutions under the guise of law adds transparency and popular trust not only in the Party but also in the legal system. Others, in contrast, see these developments as merely window dressing, pointing to the underlying fact that the Party is still above the law. Lacking any real checks and balances on Party power, there will always be room for extra-legality, protectionism, and abuse of power. Some, such as Minzner, have even opined that these developments represent a step back from legality: "This removes the fig leaf of a divide between the party and the state. … Instead of it being a step toward imposing greater legal constraints, I think it arguably represents the partial absorption of the legal system by the party apparatus."[732]

In my view, the concerns about having a certain apparatus above the law are justified but they should not overshadow the importance of the recent legalization of political influence, which I believe go beyond positivists attitudes. Establishing a rule of law as perceived in Western liberal democracies was never on the agenda. The legal system in China cannot be expected to advance the functions prescribed to it in liberal societies. It can only be expected to advance the functions designed for it in the Chinese context. Pointing at the recent steps as a retreat from the ideals of rule of law does not add much and is blind to the true meaning of these developments; the importance of law is increasing

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729 Framed by Liebman in a different context as a matter of "populist legality," the instrumentalist approach toward the legal system serves the need for positive public opinion by "aligning outcomes with perceived dominant social norms." *See* Benjamin Liebman, *A Return to Populist Legality? Historical Legacies and Legal Reform*, *in* MAO'S INVISIBLE HAND: THE POLITICAL FOUNDATIONS OF ADAPTIVE GOVERNANCE IN CHINA 165 (Sebastian Heilmann & Elizabeth J. Perry eds., 2011). A similar related concept is Gallagher's "authoritarian legality." *See* GALLAGHER, *supra* note 554.

730 This reality is echoed in policy propaganda to strengthen "stabilization efforts," a palatable ongoing rhetoric that is expressed to justify enhanced Party leadership through the use of law. *See, e.g.*, Report to the 17th Party Congress, *supra* note 25, Ch. 6 ("Unswervingly Developing Socialist Democracy"):

> "坚持依法治国基本方略，树立社会主义法治理念，实现国家各项工作法治化，保障公民合法权益；坚持社会主义政治制度的特点和优势，推进社会主义民主政治制度化、规范化、程序化，为党和国家长治久安提供政治和法律制度保障"

This excerpt translates:

> We must uphold the rule of law as a fundamental principle and adopt the socialist concept of law-based governance to ensure that all work of the state is based on the law and that the legitimate rights and interests of citizens are safeguarded. We must maintain the features and advantages of the socialist political system and *define institutions, standards and procedures* for socialist democracy *to provide political and legal guarantees of lasting stability for the Party and the country*. [italics added]

731 The views here were expressed more generally with respect to the recent legality of political governance in China, but they apply by implication specifically to the politicization of corporate governance. *See, e.g.*, Taisu Zhang & Tom Ginsburg, *Legality in Contemporary Chinese Politics*, 59 VA. J. INT'L L. (forthcoming 2018), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3250948.

732 Buckley, *supra* note 657 (Carl Minzner expressing his views on the (draft) Supervision Law).

even as it retains its instrumentalist role. This should not be viewed as a step backward, rather, as a step in a different direction. From a law and development perspective, these recent developments stand as the most contemporary affirmation of the iterative dynamics between law, economic development, and political economy.

CONCLUSION

With modern, successful firms that operate globally and a capital market that is the second largest in the world, corporate governance in China has long passed the point of an "adjust or perish" prognostic. Yet its firm governance and capital market functions maintain strong idiosyncrasies that go against many fundamentals in economics and legal thought. These idiosyncrasies are products of the underlying configurations of China's political economy and the shifts within it. Political economy in China has a determinant role on the ways corporate ownership is organized, firms operate, and the capital market functions. It is responsible for many of the infirmities in the Chinese market, yet at the same time also holds the key for China's puzzling growth.

Inspecting China's development conundrum through a political-economic lens reveals that there is a parallel governance system at work in China that is distinct from the legal or administrative governance system advanced by the state. This parallel system is actively present at every level of society, the administrative state, and the economy. Likewise, it has governance oversight, participation, and accountability functions at the individual enterprise and business group levels, by which it impacts upon the behavior of firms and their insiders. Political institutions supplant many of the oversight functions traditionally provided by firm internal-governance bodies. Political institutions also supply external monitoring and accountability, buttressing legal enforcement and the monitoring functions of weak markets. In doing so, this politicized corporate governance system credibly signals the regime's commitment to growth and provides assurances against various forms of investor abuse. These assurances, despite their political nature, seem to reduce the cost of capital and attract external finance, thereby supporting the growth of firms.

China's political economy therefore supports firms and capital market growth in ways that go beyond developmentalist industrial policies and the attributes associated with state-controlled economies (such as state capture by cronies, fostering connections with entrepreneurs, largesse, and protectionism). It produces a novel form of governance that mobilizes political and economic incumbents to advance reforms and to curb their own abusive behavior.

This resolution for China's law and capital market development conundrum brings forth new possibilities on the menu of what is now an obsolete convergence/path-dependency discourse. The politicization of corporate governance not only counters convergence predictions in showing how systems can "diverge back", in form, but also challenges path-dependence theories in showing how systems evolve, in function, even within fixed institutional confines. China's capital market development compels us to view development as an iterative mode of constant change.

* * *

Capital market development is an iterative process, a mutual interaction between politics, legal response, and economic outcomes. In this process, corporate governance can be advanced in ways and for reasons that are fundamentally different from those offered by corporate capitalism. Different systems of governance are possible, while the system applied must be able to adjust to change. A responsive corporate governance system that aligns itself with shifts in a dynamic political economy can enjoy greater legitimacy and be followed through. Such a system can survive even if its configurations are strikingly unfamiliar and patently political.

Economic development and the growth of the large public firm are not conditioned on one specific menu of rules, legal or otherwise. Public firms can prosper even under heavy state ownership and political control. Capital markets can develop and thrive with concentrated ownership and even while bearing functions that divert from efficient allocation of capital. External finance will flow to where the opportunities are, provided that effective assurances exist—no matter their form or original motive—to fend off exploitative forces.

China's capital market development is a potent example of this fact. Its political-governance system allows just enough flexibility to develop coordinated responses to the changing interests and demands within its own political-economic equilibrium. This enables the system to provide the needed growth stability while deflecting political and economic incursions, and to survive even at the price of lesser efficiency.