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Worldwide Corporate Convergence Within A Pluralistic Business Legal Order: Company Law and the Independent Director System in Contemporary China

By CHI-WEI HUANG¹

I. Worldwide Corporate Convergence of Global Non-State Actors

A. Corporate Legal Regimes of Global Non-State Actors

The blurring of traditional boundaries puts a premium on creativity and constant vigilance. The corporate ecosystem of the 21st century is and will continue be characterized by such a blurring of once distinct boundaries: between public and private, foreign and domestic, insider and outsider, friend and foe. Corporations are freer to pursue opportunities to make profits wherever they can be found in the world and to exploit them according to the requirements of circumstance, not the blind dictates of tradition. The growing fluidity of vital business relationships will require constant vigilance and improvisation by all who are concerned.²

The transnational relationships that disregard borders, thus uniting power at the national and international levels, gradually lead

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to the development of one unified capitalist global system. The
global order of such a world consists of various territorial and
functional legal orders that, along with competition or cooperation,
regulate social and economic life. This phenomenon derives from the
fact that they pursue different goals and defend different interests.
De-territorialized legal orders, which allow corporations to pursue
their own interests beyond state borders by obtaining production
factors (labor and capital) and by selecting positive normative
environments (such as lenient environmental regulations) when it is
in their best interest to do so, are challenging the equilibrium
historically found within states. They thus challenge the capacity of
the state to serve as a conciliator of divergent interests.

Enterprises contribute to the development of multi-state legal
orders. A consistent, cooperating “New Business Order” has been
built globally to deal with the growing fluidity of the new, developing
business world. Taxes and tariffs will largely disappear, worldwide
accounting standards will develop, business and government will form
partnerships to create minimum privacy standards for commercial
transactions, and governments will sign multilateral agreements
delineating acceptable business practices. To comply with the New
Business Order, a “New Pluralistic Business Legal Order” developed;
it consists of a set of international laws and regulations
which define the type of corporate governance structure presently
agreed by most of the countries in the world to be the most efficient
and profitable system. However, as only some countries conform to
the New Pluralistic Business Legal Order, predictable and
unpredictable conflicts arise.

Corporate governance within this New Pluralistic Business Legal
Order provides a critical mechanism for containing risk, raising
capital externally, and regulating an organization’s economic
activities internally. Policy-makers are increasingly aware of the
essential role that good corporate governance plays in improving the

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4. Rob’e, Jean-Philippe (1992), Trade and Justice, Florence: Institut
Universitaire European.
5. A new legal order was built up to comply with the new world order; it
appears to be a set of internationalized laws or regulations that were agreed upon by
most of the countries in the world presently. However, in some developing countries
like China, where they are on their way toward fitting in the newly formulated legal
order, there are predictable and unpredictable conflicts with the New Pluralistic
Business Legal Order.
financial market's stability and in increasing investment incentives and economic growth within the New Pluralistic Business Legal Order.

This dissertation will, in Part I, introduce both the dominant corporate model and corporate ownership structure as well as the model for the most efficient corporate governance system under the New Pluralistic Business Legal Order, as promoted by the proponents of the theory of global convergence of corporate governance. Part II will argue how this phenomenon impacts China's corporate governance system during its ongoing economic and legal reforms, identify the path dependencies and other problems the Chinese corporate governance system has been encountering, and suggest measures to address these problems. Part III will conclude by exploring why the path dependencies are harder to overcome in China, a "rule of man" country, than in other "rule of law" countries.

B. Worldwide Corporate Governance Convergence

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

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

7. The OECD Principles of Corporate Governance were endorsed by OECD Ministries in 1999 and have since become an international milestone for parties involved in corporate governance.

8. In common law systems like the U.K. and U.S., the corporate governance forms focus on shareholders' interests rather than stakeholders' interests. The corporate governance forms in common law systems are regarded as "shareholder-oriented."

9. In civil law systems like China, Germany, Japan, and Taiwan, the corporate governance forms focus on stakeholders' interests rather than shareholders' interests. The corporate governance forms in civil law systems are regarded as "stakeholder-oriented."
i. Dominant Corporate Forms

Institutional differences in the essence of corporate governance, capital markets, and law exist around the globe. Since the purposes of corporate governance in the civil law and common law systems are different, shareholder-oriented forms and stakeholder-oriented forms have developed accordingly.

Various jurisdictions have defined the core functional features of the corporate form, widely accepted by large-scale worldwide companies, as the following: “(1) full legal personality, including well-defined authority to bind the firm to contracts and to bond those contracts with assets that are the property of the firm, as distinct from the firm’s owners; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management under a board structure; and (5) transferable shares.” Such characteristics “both individually and in combination, offer important efficiencies in organizing large firms with multiple owners that have come to dominate developed market economies.”

Protecting shareholder interests rather than the interests of stakeholders, like creditors, laborers, and consumers, became the major underlying reason for the implementation of the above-mentioned five characteristics of the corporate form. “Shareholder-oriented” form has thus prevailed over “stakeholders-oriented” form.

After years of experimenting, the “standard shareholder-oriented model” introduced and refined by scholars, businessmen, and government authorities has formalized. The primary elements of this consensus are: (1) the shareholder class should hold the ultimate control of the corporation; (2) when managers of the corporation make decisions, they should consider shareholder interests first; (3)

14. Id. at 440.
non-controlling shareholders’ rights are well protected against exploitation by the controlling shareholders; (4) the interests of creditors, employees, and consumers should be protected by contractual or regulatory means; and (5) shareholders’ interests are primarily based on the market value of the shares of public corporations. The share value will increase if a firm places all its shareholders’ interests above the interests of labor, politicians, management, or those of only the controlling shareholders.

**ii. Dominant Corporate Ownership Models**

When the boundaries of territories become vague, competition is created among companies by the interplay of various corporate governance regimes. The basic corporate ownership structures influence which economic and legal environments corporate governance regimes will provide the greatest advantages for their domestic companies. The two major models of corporate ownership are “dispersed-ownership” and “concentrated ownership, “which are often the major competitors in the market of corporate governance regimes.

The dispersed-ownership model is characterized by a diffused body of corporate ownership; whereas the concentrated-ownership model is characterized by a centralized body of corporate ownership. The dispersed-ownership model is generally accompanied by a stronger securities market than the concentrated ownership model. The securities markets in the dispersed-ownership model are also

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15. Id. at 441.
equipped with more adequate shareholder protection measures than those provided in the concentrated-ownership model. Scholars have found that dispersed ownership mostly exists in common-law systems since they are able to provide adequate protections to minority shareholders. The concentrated-ownership model generally is accompanied by weaker securities markets than the dispersed ownership model, however its typically strong bank systems and other professional institutions play a crucial supporting role in maintaining the healthy operation of the market. The companies in concentrated-ownership models greatly depend on the banks to provide them necessary capital.

The depth and liquidity of equity markets around the world is commonly attributed to common-law systems consistently outperforming civil-law system. If the finding is correct, it is not hard to imagine that civil-law countries are tempted to adopt rules of common-law legal systems to disperse their ownership structures to develop deeper and more liquid securities markets.

C. Worldwide Convergence Toward Shareholder-Oriented/Dispersed Ownership

i. Shareholder-Oriented/Dispersed Ownership

The prevalent trend across developed market jurisdictions has been a convergence toward a single, standard corporate structure. The essential legal features of the shareholder-oriented ideology are well established among developed market jurisdictions and noticeably dominate the development of worldwide corporate forms. A model that strives to increase long-term shareholder value has become the most competitive corporate governance theory among developed economies. As shareholders’ values are attracting the spotlight, established legal measures to protect shareholders’ rights have become an important indicator of a healthy and appealing corporate governance system. A series of examinations of worldwide corporate governance and ownership structures have concluded that there is a

19. See Coffee, supra note 18, at 642-43.
20. Id.
21. Id. at 643.
22. Id. at 644.
23. Id. at 645.
correlation among adequate legal protection of shareholders, dispersion of ownership, and strong securities markets. Several empirical studies suggest that a shareholder-oriented corporate body, with adequate legal protection for minority shareholders, will disperse its ownership structure and that this dispersed ownership structure will be able to generate more value in an equity market.

ii. Overarching Opinions

Opponents of the theory of global convergence of corporate governance argue that worldwide corporate governance regimes are not necessarily converging toward dispersed-ownership and shareholder-oriented models; they also doubt whether the globalization convergence process reflects U.S.-centric chauvinism. Some also hold suspicions about the superiority of the efficiency of the shareholder-oriented/dispersed ownership model. One of the weaknesses of the shareholder-oriented/dispersed ownership model is the model's overemphasis on shareholders' interests. This bias encourages management to focus on grabbing short-term gains for shareholders rather than focusing on a long-term plan for the company. This management prejudice is especially easy to observe when management levels consider merger and acquisition offers. In addition, the relatively decentralized ownership structure suggests that enterprises following the shareholder-oriented/dispersed ownership model may have an inferior ability to audit the performance of managers than those following the concentrated ownership model.

25. See La Porta et al., supra note 19, at 511-13; Rafael La Porta et al., Legal Determinants of External Finance, 52 J. Fin. 1131, 1149 (1997); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Law and Finance, 106 J. Pol. Econ. 1113, 1152 (1998).

26. "Shareholder-oriented" model refers to a model whose primary goal is to maximize the shareholders' interests to protect shareholders' rights.

27. "A shareholder who owns less than half the total shares outstanding and thus cannot control the corporation's management or single-handedly elect directors." Black's Law Dictionary 1408 (8th ed. 2004).

28. La Porta et al., supra note 19, at 512 (stating that designing an adequate legal system to protect minority shareholders' interests will enhance the effect of dispersion of ownership).


31. Jeremy Edwards & Klaus Fischer, Banks, Finance, and Investment in
Although there are debates on whether a global convergence toward the shareholder oriented/dispersed ownership model exists, there is nevertheless a worldwide tendency of countries to design corporate governance systems that can better protect minority shareholders as a way to create strong securities markets. Regardless of the degree of controlling shareholder opposition, minority shareholder constituencies will ultimately grow to “create” relatively stronger “lobby forces” for formal legal protections. A jurisdiction that adopts optimal legal protections for minority shareholders will help its domestic companies become more competitive in the global capital market. Equity markets develop more broadly and the value of such markets increases in countries with adequate minority shareholder protection. Alternatively, some scholars argue that the sequence may be reversed based on the examination of the early development of the New York Stock Exchange and the London Stock Exchange. They assert that in the late 19th century, dispersed ownership arose largely in the absence of strong minority shareholder protection. They also affirm that the constituency (here, minority, dispersed public shareholders) first arose before they could become an effective lobbying force, and then subsequently demanded legal reforms. Although views on the relevance of shareholder protection may differ, “the direction of causation” a dispersed ownership structure and a shareholder-oriented corporate law model are widely considered to be the best combination for corporate governance.

However, other scholars have argued that the inability to provide adequate legal protection to minority shareholders in civil-law systems leads to the development of dispersed ownership structures. Most companies would prefer to rely on more efficient access to venture capital markets, provided by strong securities markets in a dispersed ownership model, rather than borrow their capital from

32. La Porta et al., supra note 19, at 513 (stating how legal changes are implemented due to the lobby from the minority shareholders).
33. Id. at 511.
34. Id.
stable resources, such as banks, in a concentrated ownership system. A competitive corporate legal system must be able to connect to the global securities markets in order to develop limitless possibilities for their domestic companies to access the capital they need. That most large-scale international companies list on more mature securities markets proves the dispersed ownership model emerges victorious over the concentrated ownership model.

D. Obstacles to Worldwide Corporate Governance – Path Dependencies

Scholars constantly argue that the power of "path dependency" creates an obstacle as jurisdictions prepare themselves to converge toward the shareholder-oriented/dispersed ownership model. Even if we assume that market forces urge the predominance of the shareholder-oriented/dispersed ownership model, certain path-dependent forces might serve as strong obstacles in spite of market pressure. There is a great deal of scholarship categorizing path dependencies into different types, based on different concerns and perspectives. The author will categorize path dependencies, based on the benefiting party, into two types: (1) path dependency driven by efficiency for the firm's overall benefit; and (2) path dependency driven by "rent-protection" or "rent-seeking," for certain interest groups' benefit.

i. Efficiency-Driven Path Dependency

The effects of path dependency and the history of corporate transformation suggest that the existing legal and extra-legal institutions in a jurisdiction, on both a national level and a firm level, affect the adoption of the subsequent corporate legal structure.42

37. Coffee, supra note 36.
38. Coffee, supra note 18, at 641 (introducing assumption by Berle and Means that large-scale industries can only raise capital from accomplished securities markets with dispersed ownership); see also 649 (stating that stronger legal protection of minority shareholders implies higher stock prices).
39. The two major representing scholars are Lucian Arye Bebchuk and Mark Roe.
40. Bebchuk & Roe, supra note 19, at 131-32 (suggesting that path dependencies could not be removed by market forces).
41. 1-3 Principles of Corporate Governance: Analysis and Recommendations § 3.05, commentary (American Law Institute 2005).
42. Id. at 137-42 (addressing the efficiencies and corporate structures gained by
Efficiency is the first reason to be concerned. The development of ownership structures relies on the pattern of what the jurisdiction had at earlier points in time.\footnote{Id. at 153-57 (discussing corporate rules and efficiencies gained by development around these rules).} To make maximum profits without wasting time or resources, or to avoid the risks leading to any possible losses, firms might retain their original structures in consideration of efficiency under the following circumstances: (1) "sunk adaptive costs," i.e., once costs are sunk in the existing legal structure without any better alternatives, maintaining and continuing them is often efficient;\footnote{Id. at 137-139.} (2) "complementarities," in which costs are sunk in the professional institutions which are developed to facilitate the operations of the corporate structure and to maintain and continue them is often efficient;\footnote{Id. at 139.} (3) "network externalities," in which major ownership structures of other companies in the same jurisdiction will influence a firm’s decision on choosing its own ownership model;\footnote{Id. at 140.} (4) "endowment effects," in which players who have control over an existing structure may affect the total value that alternative structures would produce due to their valuation of having such control;\footnote{See also Marcel Kahan & Michael Klausner, \textit{Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases}, 74 \textit{WASH. L. Q.} 347, 350-53 (discussing learning and network externalities in corporate contracts); Mark A. Lemley & David McGowan, \textit{Legal Implications of Network Economic Effects}, 86 \textit{CALIF. L. REV.} 479, 562-86 (1998) (stating the network externalities will lead to appropriate amendments of internal corporate rules).} or (5) "multiple optima."\footnote{Bebchuk & Roe, \textit{supra} note 19, at 141.} Any of the above circumstances could cause a company to hesitate in changing its current ownership structure. Firms prefer to maintain the status quo since any change of the ownership structure might cause unexpected, additional transaction costs. They would rather maintain their original structure, which provides the identity of efficient ownership structure. The consideration of path dependency is for the firm’s overall benefit.

\textit{ii. Rent-Protection' Driven Path Dependency}

In addition to the efficiency considerations listed above, the other major consideration relating to a firm retaining an existing development around these structures); Id. at 153-57 (discussing corporate rules and efficiencies gained by development around these rules).
structure is “rent-protection,” or “rent-seeking.”  The efficiency consideration is viewed from the perspective of the firm’s overall benefit, whereas the rent-protection consideration focuses on the interests of a certain group of people in a firm. These groups of people control the decision-making power of the firm and extract private benefit from their positions. They are not only reluctant to change the status quo, but also try to create certain corporate rules favoring their individual interests in the firm.

The corporate rules which set up the legal structure of a company influence all aspects of a company’s operation. Once the corporate rules are adopted, firms suffer great transaction costs if they make changes in their corporate ownership models. This will then increase the difficulty of making changes and encourage the firm to stay on its current path.

### iii. Solutions

The efficiency consideration of firm-wide benefits and the rent-protection consideration of certain groups’ benefits serve as strong obstacles for jurisdictions intending to convert to another corporate form. Relevant literature suggests that the transformation of legal systems on a functional level rather than a formal level would make it easier to avoid the struggle with path dependency and create a better climate for corporate governance convergence to thrive. Such scholars suggest that self-regulation is frequently the primary functional substitute to mandatory legal regulation, since self-regulation can encourage and support business activities that formal legal systems cannot.

In addition, there are two other suggestions to persuade rent-protected controlling shareholders to take legal measures to protect

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49. Quoted from Professor David Skeel’s explanation, “In economies, a “rent” is a supracompetitive profit – more profit than in a competitive market. In the corporate context, scholars use the term to refer to the fact that controlling shareholders may be able to use their control to secure private benefits for themselves from the corporation (such as a high salary, or a lucrative contract with the corporation).

50. Bebchuk & Roe, supra note 19, at 139 (stating that the corporate rule could be able to decide which ownership structure to adopt, with or without controlling shareholders).

51. Id. at 142.

52. Gilson, supra note 18, at 338 (suggesting that convergence on functional level will be an effective alternative while convergence on formal level is too costly).

53. Coffee, supra note 18.
minority shareholders: (1) increasing the protective measures for minority shareholders will increase their own wealth and that this increase will be more valuable than their private benefit of control, i.e., the earnings from the reduced capital costs induced by the new rules will exceed their private benefits of control; and (2) those legal measures would protect their rights once they become minority shareholders.

E. The Chinese Puzzle

Recently, some have argued that strong securities markets and dispersed ownership are unlikely to develop in civil law countries (such as China) for the following three major reasons: (1) the lack of adequate minority legal protection, (2) the incapability of public shareholders to hold control, and (3) the political susceptibility of diffuse ownership in "social democracies." However, opponents have found that dispersed ownership has arisen in civil law countries in Europe. Some scholars even argue that the whole world is converging. China may be an exception since its economic achievements do not result from the certainty brought by a clear and definite legal system to support a shareholder-oriented/dispersed ownership model, but from the planned commands brought by its autonomous government. However, is China, a self-described "socialist market economy," moving toward the shareholder-oriented/dispersed ownership model to attract more foreign capital?

54. Bebchuk & Roe, supra note 19, at 130, 142-47 (explaining why some countries have dispersed ownership, but others do not; describing also the reason for controlling shareholders to insist to have the shares dispersed is that they are afraid of the possibility of losing their rents and not being able to take advantage of the gain created by the efficiency); Coffee, supra note 18, at 654; Hansmann & Kraakman, supra note 14 (suggesting that the shareholder-oriented model not only benefits controlling shareholders, but also benefits minority shareholders); La Porta et al., supra note 19.

55. John C. Coffee, Jr., The Rise of Dispersed Ownership: The Role of Law and the State in Separation of Ownership and Control, 111 Yale L. J. 1 (2001)(suggesting that most scholars that adequate protection of minority shareholders is the base of an efficient securities markets); at 33 ("stating how discussing how mergers of large corporations raised capitalization beyond the means of corporate raiders and, thus created more stable dispersed ownership.")

56. Gilson, supra note 18, at 338.

57. Coffee, supra note 55.

58. RANDALL PEERENBOOM, CHINA’S LONG MARCH TOWARD RULE OF LAW 451 (2002).

59. Article 1 of the CCL.
II. China's Convergence with Worldwide Corporate Governance

There is, surely, more than one route for China's economic development. The essential key to economic development is the formation of an institutional structure derived from the individual country's cultural institutions that supply appropriate incentives for growth, rather than to adopt a complete set of Western institutions. Although individual countries face new and different problems as their economies develop, the fundamental elements of developed economies are identical. The secret to developing a healthy economy is to selectively adopt efficient institutions from established economies. As what we have concluded in Part I, most of the established economies adopt the shareholder-oriented/dispersed ownership model. But how does this apply to China? How has China responded to the pressures of globalization? China is a country that has not yet installed clearly defined property rights and is still under the control of a communist dictatorship. However, the apparent deficiencies in the Chinese investment environment have hardly stopped its rapid economic growth in the past two decades. Some scholars believe that there could not be a meaningful encounter between the Chinese tradition and Western systems of law. Currently existing economic and political models do not apply well to China. Two features stand out while discussing the Chinese experience: "(1) While the institutions China employed are different from developed nations, the incentive implications were similar; and (2) China has been confronting new problems and pragmatically attempting new solutions." Is China converging toward the

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60. "Institutions" here refer to how human interactions (e.g., political, social and economic) are structured, as well as prevailing social frameworks. The institutions may be made up of formal rules (enactment of laws), informal constraints (norms, conventions and codes of conduct), and their enforcement characteristics.

61. Id.


64. North, supra note 59, at A14.

65. Id.
shareholder-oriented/dispersed ownership model? What legal institutions has China employed? What historical and infrastructural factors have shaped and influenced the institutions in China? What solutions has China introduced to transform itself? And finally, what can China do to solve the problems it faces in reforming corporate governance structure? Part II elaborates on this discussion.

A. Corporate Legal Regime of China – Company Law in China

i. General Information

a. Evolutionary History

Some permutation of a company law has been on the books in China since 1904.66 Several enactments came up in 1914 (Republican), 1929 (Nationalist), 1946 (Nationalist) and 1994 (Communist). The 1994 Company Law (hereinafter “CCL”) was an important milestone for corporate China. The most significant goal of the CCL was to restructure the organization and management of State-Owned Enterprises (“SOE”).

The CCL superseded provisional corporate regulations of the central government and the regulations of two municipalities. There were originally 11 Chapters and 230 Articles in the 1994 CCL. On October 27, 2005, the 18th Plenum of the 10th Chinese National People’s Congress passed an amendment of the CCL. Due to such amendment, which took effect on January 1, 2006, the CCL currently contains 13 Chapters and 219 Articles. On the same date, in the same meeting, the Chinese National People’s Congress also passed an amendment of PRC’s Securities Law, which is now comprised of 12 Chapters and 240 Articles.

b. Forms of Companies

There are two forms of companies in the CCL: the “limited liability company” and the “company limited by shares” (also known as a joint stock company). This distinction corresponds roughly to the British models of the private company and the public company67 or

66. It was in the Qing Dynasty in ancient China.
67. See HARRY G. HENN & JOHN R. ALEXANDER, Special Problems of Closely-Held Corporations, in LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 704 (3d student ed. 1983); see also Colin McFadyean, The American Close
the American model of the closely held corporation and the publicly held corporation. Limited liability companies are normally smaller corporations, as it is required that the number of their shareholders does not exceed fifty. According to Article 20 of the 1994 CCL, “a limited liability company is allowed to have only one shareholder if the shareholder is the state.” In the newest version of CCL, the above stipulation was eliminated. The definition of a wholly state-owned enterprise is found only in Article 65 of the 2006 CCL.

As opposed to the limited liability company, the company limited by shares must have more than two but less than two hundred shareholders. Companies limited by shares are allowed to issue their shares in public securities markets according to Article 121 of CCL, and Articles 12 and 13 of Securities Law.

The concept of “limited liability” is a fundamental concept in Western company law but is a relatively new idea to corporate China. The Chinese CCL regulators adopted principles of limited liability for corporate parallelism to Western systems, particularly the United States. The CCL stipulates that both of the legitimate company forms enjoy limited liability whereby the liability of shareholders is limited to the amount to which each shareholder has subscribed. The 1994 CCL did not contain reference to the idea of “piercing the corporate veil” or restrictions on shareholders’ limited liability immunity. However, the 2006 CCL amendment incorporates the “piercing the

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69. According to Article 24 of the CCL, a limited liability company shall be jointly incorporated by no more than fifty shareholders.

70. According to Article 65 of the CCL, “The term ‘solely state-owned company’ as mentioned in this law refers to a limited liability company established through investment solely by the state, for which the State Council or the local people's government authorizes the state-owned assets supervision and administration institution of the people's government at the same level to perform the functions of the capital contributors.”

71. Refer to Article 79 of the CCL.


73. A judicial act which imposes personal liability on otherwise immune corporate officers, directors, and shareholders for the corporation’s certain unlawful behaviors. See Sea-Land Services, Inc. v. Pepper Source, 993 F.2d 1309, 1311 (7th Cir. 1993).

74. Gu, supra note 81, at 11.
corporate veil” concept into Article 20. According to Article 20 of 2006 CCL, “[c]ompany shareholders who damage company or other shareholders’ rights by abusing their own rights shall be liable for the loss in accordance with the laws.”

c. Incorporation of Companies

The government’s operative attitude toward the incorporation of companies is highly regulatory and controlling. Companies need to fulfill the conditions set forth in either Article 23 (limited liability companies)\textsuperscript{75} or Article 77 (companies limited by shares)\textsuperscript{76} to incorporate in China. To establish a limited liability company, the entity must apply for incorporation registration by submitting a company registration application, along with the articles of incorporation and the capital verification certificate to the company registration authority to apply.\textsuperscript{77} To establish a company limited by shares, the entity must submit a registration application, along with the promoters’ meeting minutes, the articles of incorporation, the capital verification certificate, the office documents and identification evidence of legal representatives, directors and supervisors, the proof of legal person qualification or natural person identification of promoters, and proof of company’s residence to the company registration authority within thirty days of the promoters’ meeting.\textsuperscript{78}

Although the Chinese regulators have simplified the incorporation

\textsuperscript{75} The conditions of Article 23 of 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. Amended 2005) are: “(1) The number of shareholders accords with the quorum; (2) The amount of capital contributions paid by the shareholders reaches the statutory minimum amount of the registered capital; (3) The articles of association are worked out jointly by shareholders; (4) The company has a name and its organizational structure complies with that of a limited liability company; and (5) The company has a domicile.”

\textsuperscript{76} The content of Article 77 is very similar to Article 23, it just carries some more shareholding characteristics. Article 73 of CCL requires, “(1) The number of initiators meets the quorum; (2) The capital stock subscribed for and raised by the initiators reaches the minimum amount of the statutory capital; (3) The issuance of shares and the preparatory work accord with the provisions of the law; (4) The articles of association are formulated by the initiators, and are adopted at the establishment meeting if the company is to be launched by stock floatation; (5) The company has a name, and its organizational structure accords with that of a joint stock limited company; (6) The company has a domicile.”

\textsuperscript{77} See Article 30 of the CCL.

\textsuperscript{78} See Article 93 of the CCL.
process in the newest amendment, this relatively strict incorporation procedure is similar to the extraordinary requirements found in England and the U.S. until the early 1800’s.

d. Major Players in Chinese Corporate Governance

Except for wholly state-owned companies, which may operate differently from privately owned companies, the “shareholders,” the “board of directors,” and the “board of supervisors” are the three key actors on the stage of Chinese corporate governance. People may argue that the Chinese corporate governance structure is identical to Germany’s two-tier system, since both are equipped with a board of director and a board of supervisors. However, the practical

79. According to Article 19 and Article 73 of the 1994 CCL, the incorporation applications need to be approved first by the State Council or certain provincial governments before submitting the application for the company’s registration.

80. See Norman Lattin, Evolution of Anglo-American Corporations; Origin of the “Concession” Theory, in THE LAW OF CORPORATIONS § 54, at 174-76 (2d ed. 1971) (explaining that before the early 1800s, corporate organization limited liability was deemed a special privilege that was merely granted to business entities with distinct connection to industries related to public welfare, such as railroads, banks, or traders with foreign lands. Those requirements were viewed to unfairly benefit the rich and powerful as the Jacksonian populists sprang up. The “general corporation acts” which allowed the incorporation process become inexpensive and kept several basic filing requirements approachable to ordinary people was released accordingly. Really comprehensive “general corporation acts” came between the last quarter of the 19th century and the first quarter of the 20th. The Pennsylvania act was enacted in 1874, the New Jersey act or revision in 1896, the Delaware statute was completely overhauled in 1967 with amendments in 1968 and 1969. Many statutes drew suggestions from The Model Corporation Act of 1928).

81. Pursuant to Article 67 of the CCL, “A solely state-owned company shall not set up the shareholders' meeting, and the functions of the shareholders' meeting shall be exercised by the state-owned assets supervision and administration institution. The state-owned assets supervision and administration institution may authorize the board of directors of the company to exercise some of the functions of the shareholders' meeting and decide on important matters of the company, excluding those that must be decided by the state-owned assets supervision and administration such as merger, split-up, dissolution of the company, increase or decrease of registered capital as well as the issuance of corporate bonds. The merger, split-up, dissolution or application for bankruptcy of an important solely state-owned company shall be subject to the examination of the state-owned assets supervision and administration institution, and then be reported to the people's government at the same level for approval.”

positions of a supervisory board in China and Germany are very different. In Germany, the supervisory boards are on the top of a hierarchical system, they oversee the board of directors, and have the power to appoint and dismiss directors. In contrast, in China, although the newest amendments grant supervisory boards more power to supervise the board of directors, the supervisory boards are not situated in a higher position than the board of directors. Both the board of directors and the supervisory board are appointed and may be dismissed by shareholders.

ii. Shareholders

a. Powers

China, a civil-law country, defines “corporate governance” as a system to efficiently regulate relationships among all interested parties in a business organization, such as creditors, consumers, and business partners. However, due to the influence of Anglo-American corporate governance concepts, “shareholders” have been singled out as a particularly important group. Shareholders are considered the organ of supreme sovereign power of the corporation. Shareholders hold the following comprehensive decision-making powers according to Article 38 of the 2006 CCL: they (1) determine the company’s business policy and investment plan; (2) elect and change directors and supervisors who are not employee representatives and decide related matters regarding their remunerations; (3) review and approve the reports from board of directors; (4) review and approve the reports from the board of directors or supervisors; (5) review and approve the company’s annual financial budget plan and financial account plan; (6) review and approve plans regarding profit distribution and loss recovery proposals; (7) decide whether to increase or reduce the company’s registered capital; (8) decide whether to issue company bonds; (9) make decisions on general

84. According to Article 38 and Article 103 of the CCL.
85. Articles 37 and 99 of the CCL.
corporate form, e.g. whether to merge, split, or transform company forms, or to dissolve or liquidate; (10) amend the company's articles of incorporation; and (11) pursue other powers which are stipulated in the articles of association. Although some of the above powers resemble shareholders' rights in the United States, other powers, such as the powers "to approve plans on corporate profit distribution and loss recovery proposals," "to determine the directors' remuneration," and "to make resolutions on plans of bonds issuance," are reserved to the board of directors in the United States. It thus appears that the general meeting of shareholders has the power to make many managerial decisions. This institutional arrangement may work well in relatively small-scale limited liability companies with fewer shareholders. However, it may be an inefficient corporate structure mechanism for publicly held corporations which have to respond rapidly to a competitive and changeable market.

b. Rights

In addition to the managerial powers, the 2006 CCL amendment has granted shareholders the right to bring lawsuits under certain circumstances. Shareholders may initiate lawsuits with a resolution of a shareholders' general meeting or when the board of directors violates the law, administrative rules and regulations, or infringes upon the shareholders' rights. In addition to the above right to sue, which was adopted from the 1994 CCL, the 2006 CCL enlarged the range of shareholder rights to sue. For example, shareholders may now bring suit when shareholders and the company cannot reach an agreement to buy back shares held by the shareholders under certain circumstances. Further, shareholders may bring shareholders'
derivative suits, analogous to the shareholders' derivative rights suits under the U.S. corporate governance system. According to Article 152 of the 2006 CCL amendment, "directors, supervisors, high-level managers or other people that infringe on the company's benefits and other directors or supervisors that remain quiet during such infringement, the shareholders are eligible to initiate a lawsuit in his or her own name for the benefit of the company." This legislation also grants shareholders the direct right to sue when their legal interests are invaded by directors or high-level managers.  

iii. Directors

a. Qualifications

Like the 1994 CCL, the 2006 CCL amendments restrict who can be directors either in limited liability companies or in companies limited by shares. Those limitations are found in Article 147, which prevents the following people from becoming directors: (1) a person without legal capacity or with restricted capacity for civil acts; (2) a person sentenced to certain criminal punishments or deprived of his or her political rights for committing crimes of bribery, invading others' properties, or destroying the communist market economic order when no more than five years have elapsed since the enforcement dates; (3) a person who is the director, factory president, or manager of a bankrupt company due to his or her failure in management and was personally liable for the company's bankruptcy, when not more than three years have elapsed since the date of the bankruptcy; (4) a person who is a legal representative of a company or enterprise whose business license was revoked due to a violation of the law and was personally liable for such revocation, when not more than three years have elapsed since the date of the revocation of the business license; and (5) a person with a relatively large amount debt due but not yet paid off.

Two other differences between the 1994 and 2006 CCLs are worth noting. Article 58 of the 1994 CCL stipulated that government officials cannot be directors, supervisors or managers of companies, but there is no similar condition quoted in the 2006 CCL

91. Refer to Article 153 of the 2006 CCL amendments and Article 47 of PRC's Securities Law.
In the 1994 CCL, there was no requirement for independent directors in publicly held corporations. However, Article 123 of the 2006 CCL amendments clearly stipulates the need for listed companies to install independent directors, but leaves further definition and decisions to the State Council.

**b. Powers**

Pursuant to Article 45 of the 2006 CCL amendment, the board of directors of a limited liability company shall be composed of three to thirteen members and may contain several employee representatives. Pursuant to Article 109 of the 2006 CCL amendment, the board of directors of a company limited by shares shall be composed of 5 to 19 members and may contain several employee representatives. Should a limited liability company be invested in or established by two or more SOEs or two or more other state-owned investment entities, it shall include employee representatives on their board.

The board of directors shall be responsible for the shareholders’ meeting and shall exercise the following powers: (1) convene shareholders’ meetings and report its work to the shareholders’ meetings; (2) implement the shareholders’ meetings’ resolutions; (3) determine the company’s business plan and investment proposals; (4) formulate the company’s annual financial budget plan and financial proposals; (5) formulate the company’s profit distribution plan and loss recovery proposals; (6) formulate the company’s plan to increase or reduce the registered capital and issue company bonds; (7) propose the company’s merger, splitting, transformation and dissolution plans; (8) determine how to install the company’s internal management mechanism; (9) hire or fire the company’s manager, and hire or fire the company’s deputy manager or the responsible person for the company’s financial matters upon the recommendation of the manager, and determine their compensation; (10) formulate the company’s basic management system; (11) and other powers granted in articles of incorporation.

As such, the board of directors does not

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93. Refer to Article 45 of the CCL.

94. Refer to Article 47 (limited liability company) and Article 109 (company limited by shares) of the CCL.
seem to possess independent discretionary power, rather its powers are mostly to “implement” shareholders’ meetings’ resolutions, “formulate” and “propose” plans for shareholders’ meetings’ approval, and “report” to the shareholders. This legislation is much different from the U.S. Model Business Corporation Act, which requires that “all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.”

In addition to the overall differences between Chinese boards of directors and the U.S. director system, there also exist some trivial distinctions. For example, the CCL sets the minimum and maximum number of board directors, sets a maximum term of three years for directors, and allows absent directors to vote by proxy. On the other hand, the U.S. Model Business Corporation Act sets no concrete standards on the number of directors, sets a maximum term of one year for directors, and does not allow absent directors to vote by proxy.

iv. Duties

According to Article 63 of the 1994 CCL, directors, supervisors, or managers shall be liable for monetary damages if they violate laws, administrative rules, or provisions in the articles of incorporation while performing their duties and which thereby cause harm to the company. It is far from clear whether the 1994 CCL has imposed any duty of care on directors. However, the 1994 legislation does speak of a duty of loyalty for directors and introduces several related principles. Supporting provisions can be found in article 59 of the 1994 CCL: “directors and managers shall faithfully exercise their

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96. Articles 46 and 109 of the CCL.
97. Article 107 of the CCL.
98. Supra note 93, at § 8.03.
99. Id. at § 8.05.
100. Id. at § 8.20.
102. Id. at 82.
duties and shall not take advantage of their status and powers to look for their own interests;" as well in as article 61 of the 1994 CCL: directors and managers shall not run businesses in the same category as the company, for themselves or for others, or pursue activities which will damage their company’s interests. The income derived from the above activities shall belong to the company. Directors and managers shall not enter into contracts or dealings either on behalf of themselves or on behalf of the company except as (otherwise) provided for in the articles of association.

Both “duty of care” and “duty of loyalty” have much more concrete and strict enumeration in the China Securities Regulatory Commission’s (“CSRC”) “Required Conditions in Articles of Incorporation of Companies Listed Overseas.”

The 2006 CCL amendment has the same provision as the old Article 63. However, Article 148 of 2006 CCL imposes, in addition, a “duty of care” and a “duty of loyalty” on directors, supervisors and high-level managers. The 2006 CCL amendment does not provide a definition of the “duty of care,” but does retain content similar to that of Articles 59 and 61 of the 1994 CCL to illustrate the “duty of loyalty.” A significant difference is that in the new Article 149(5), directors or high-level managers “are allowed” to run businesses in the same category as the company, for themselves or others if “they have the agreement from the shareholders’ meeting,” whereas the same situation in the old Article 61 could “never be allowed” to happen.

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

103. See DAOJING WAISHANGSHI GONGSI ZHANGCHENG BI BEI TIAOKUAN [REQUIRED CONDITIONS IN ARTICLES OF INCORPORATION OF COMPANIES LISTED OVERSEAS] arts. 115, 116-121 (promulgated by CSRC) (Chi-Wei Huang trans.) (translation on file with author).


105. Refer to Articles 52 and 118 of the CCL.
v. Supervisors

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

vi. Qualifications

The supervisory board shall be composed of representatives of shareholders and the proper proportion of the company's employees. Company directors and high-level managers may not also serve as supervisors. In addition, supervisors shall avoid the negative implications indicated in Article 147.

vii. Powers

According to Article 54 of CCL, a supervisory board shall exercise the following powers: (1) inspect the financial status of the company; (2) supervise directors' or high-level managers' acts and submit recall proposals if they violate laws, administrative rules, articles of incorporation or shareholders' meetings' resolutions; (3) request directors and high-level managers to correct their acts if they damage the company's interests; (4) propose to convene interim shareholders' meetings if the board of directors does not convene and preside over the shareholders' meeting; (5) submit proposals to the shareholders' meeting; (6) initiate lawsuits against directors and high-level managers according to Article 152 of the CCL; and (7) such other responsibilities as listed in the articles of incorporation of individual companies. The term of office of the supervisors shall be three years, and a supervisor may serve consecutive terms if he/she is re-elected upon expiration.


107. See Article 52 and Article 118 of the CCL.

108. Id.

109. See Article 53 and Article 118 of the CCL.
viii. Duties

Unlike directors and high-level managers, supervisors only owe a certain level of fiduciary duty to the corporation and are subject to liabilities for breach.\textsuperscript{110} Supervisors are liable for the fake records, misleading description or major omission in public disclosed documents in PRC’s Securities Law.\textsuperscript{111} They are also prohibited to engage in insider-trading as directors.\textsuperscript{112}

Upon the establishment of independent directors, a struggle between supervisors and independent directors over their respective powers and duties emerged and continues to heat up. This will be further addressed in later chapters covering independent director.

ix. Conclusion

Considering China’s civil law background, the prevailing corporate form is very likely to retain many elements of the stakeholder-oriented model. Evidence can be found in Article 1 of the CCL: “This Law is formulated to protect the legal rights and interests of companies, shareholders and creditors, to safeguard the social and economic order and to promote the development of the socialist market economy.” This article discloses that the CCL anticipates promoting the interests of all involved parties, which are also known as “stakeholders,” rather than merely shareholders.\textsuperscript{113}

Nonetheless, the importation of a Westernizing shareholding system to China has helped to rectify a number of problems with Chinese enterprises’ corporate governance, in particular, the state of such enterprises’ balance sheets ahead of a public listing. Recently, numerous transformations and restructures of SOEs took place to adopt shareholding ownership system in corporate China.\textsuperscript{114}

\textsuperscript{110} See Article 148 and Article 150 of the CCL.
\textsuperscript{111} See Article 59 of the PRC Securities Law.
\textsuperscript{112} See Articles 73-74 of the PRC Securities Law.
\textsuperscript{114} Dow Jones Newswires, \textit{Bank of China is Restructured}, WALL ST. J., Aug. 25, 2004, at C4 (addressing that the state-owned Bank of China has become a shareholding company 100%-owned by state owned Central Huijin Investment Co. The Bank of China Shareholding Co., which was known as Bank of China among one of the four state-owned banks in China, was launched with a registered capital of 186.39 billion yuan (approximately $22.52 billion) and an equal number of shares on August 23, 2004. This bank was aiming for a domestic listing in 2005. Another formation of shareholding company ahead of Bank of China is China Construction Bank. Policy makers proposed to extend the pilot program to Industrial &
Although several basic statutes in the CCL make it look stakeholder-oriented, the introduction of other protection mechanisms for shareholders confirms the determination to establish a healthy shareholding system with a fairer allocation system in both SOEs and in privately owned enterprises ("POEs"). The worldwide corporate governance convergence has silently but effectively influenced the Chinese corporate governance system. More evidences can be found in several other rules intended to further strengthen minority shareholders' interests. What are the most important rules or mechanism? Are there path dependencies existing along the transforming process? What are the suggestive solutions? The author will further explain in Chapter 2.

III. Worldwide Corporate Convergence in China – Independent Directors in Contemporary China

A. Protective Measures of Minority Shareholders in China

A study conducted by the Shanghai Securities Exchange identifies the following problems for Chinese corporate governance:

1. irrational shareholding structure;
2. lack of independence of the board of directors;
3. inability of the board of supervisors to play its role;
4. relative weakness of the oversight role of creditors;
5. unlimited powers of key management personnel;
6. low level of transparency and professionalism in investment decisions;
7. lack of a market for corporate control;
8. lack of a market for management services;
9. skewed system of incentives;
10. lack of protection of interests of small shareholders;
11. lack of a system for accountability; and
12. lack of a shareholder and corporate governance culture.

The above items (1), (2), (3), (5), (6), and (10)

Commercial Bank of China and Agricultural Bank of China which are both heavily bad-debt-burdened; see also Sale of 25% Stake is Planned to Foreign Investors Before IPO, WALL ST. J., Jan. 11, 2005, at A17 (introducing that the municipal government-owned Bank of Beijing also announced an expectant deal of twenty five stake transfer between them and a ING Group NV).

115. Gongsi Zhiyi Zhiyin Chutai [First Guide to Corporate Governance Appears], ZHONGGUO JINJI SHIBAO [CHINA ECONOMIC TIMES], Nov. 6, 2000; Pamela Mar & Michael N. Young, Corporate Governance in Transition Economies: A Case Study of Two Chinese Airlines, 36 J. OF WORLD BUS. 297 (2001)(reporting that two publicly listed companies, China Southern Airlines an China Eastern airlines, both of whose shares are dominated by state. The state has the power to force these Airlines companies to buy unnecessary air crafts from the state). Qiangui Jiang, Gongsi Zhiyi
are all closely related to exploitation of minority shareholders’ rights. The significance of protecting minority shareholders’ rights, as the Shanghai Securities Exchange concluded, resulted mainly from a unique corporate shareholding structure with strong Chinese characteristics.

The typical feature of Chinese listed companies has been having a few dominant controlling shareholders who often hold unlisted state or legal-person shares as well as a group of scattered minority shareholders who possess a small portion of listed shares. Apparently, this concentrated ownership regime hardly experiences the “agency problem” that is comprehensively discussed by major American corporate governance literature.116 Nevertheless, Chinese listed companies are experiencing a severe problem of exploitation of minority shareholder rights. Under concentrated ownership structures, the board of directors that is dictated by certain dominant controlling shareholders will easily appropriate its powers to extract minority shareholders’ interests through means such as insider dealings, price manipulations, and so on. In China, the problems are even worse, since the controlling shareholders normally are the “state,” which holds the sovereign power of all administrative agencies in this Communist country. The state (as the controlling shareholder) might look to reach its own goals, such as fulfilling the countrywide full-employment policy or benefiting the state’s financial situation, rather than maximizing profits, which is the goal of regular shareholders.117 Such exploitation of minority shareholders’ interests will certainly discourage foreign investment in the Chinese securities markets. This phenomenon explains why firms without dominant state ownership have appeared to outperform firms with dominant state ownership in China.

In order to improve the current performance of the Chinese securities markets, the Chinese government adopted a series of legal

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117. Mar & Young (2001:297), who report that two publicly listed companies, China Southern Airlines an China Eastern airlines, both of whose shares are dominated by state. The state has the power to force these Airlines companies to buy unnecessary air crafts from the state. Jiang (2001) proposes that controlling state shareholder s voluntarily refrain from policies that might hurt minority shareholders’ right.
measures to protect minority shareholders against the controlling shareholders (which primarily refer to the state in China), to help disperse ownership so as to attract foreign investment. On December 9, 2004, the Chinese government announced sweeping reforming regulations on protecting minority shareholders’ rights, giving minority shareholders strong power to have their voices heard. The China Securities Regulatory Commission (hereinafter “CSRC”) further explained that significant corporate decisions on whether to proceed with major investment or fund-raising efforts will be decided by majority voting of public shareholders who attend the shareholders’ annual meeting. The rules are expected to water down the dominant voting power held by the state, representing nearly $500 billion of listed company equity in China.

The 2006 CCL amendment established the flagship protective measures for minority shareholders’ rights. One can examine the protective measures in the following aspects:

i. Shareholders’ Rights to Review

The 2006 amendment expands the shareholders’ rights to include reviewing the minutes of shareholders’ meetings, resolutions of the board of directors and supervisory boards, and the company’s accounting books.

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

According to Article 75, shareholders are allowed to request the company to acquire their shares: if the company has not distributed profits for five consecutive profitable years; if the company merges, separates or transfers primary properties; or if the company could be

118. See “Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohui de Ruogan Guiding” [Several Rules Regarding Strengthening Protection of Society Public Shareholders].
120. Id.
122. Refer to Article 34 of the CCL.
dissolved according to the articles of association. If the shareholders and the company cannot reach an agreement, the shareholders are allowed to bring a lawsuit.

**iii. Shareholders’ Rights to Request Dissolution**

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

**iv. Cumulative Voting Mechanism**

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

**v. Shareholders’ Derivative Suits and Direct Suits**

In addition to the managerial powers, the 2006 CCL amendment grants shareholders the right to bring lawsuits under different circumstances. Shareholders can initiate lawsuits when the resolution, or the procedures of a general shareholder or board meeting, violate the law, administrative rules or the articles of incorporation.\(^1\) The 2006 CCL amendment enlarges the range of shareholder rights to sue. Shareholders are allowed to bring lawsuits when (1) shareholders and the company cannot reach an agreement to buy back those shares held by the shareholders under certain circumstances;\(^2\) and (2) directors or high-level managers violate the laws, administrative regulations or articles of incorporation which infringe shareholders’ rights.\(^3\)

The shareholders also are allowed to bring shareholders’ derivative suits, analogous to the shareholders’ derivative rights under the U.S. corporate governance system. According to Article 152 of the 2006 CCL amendment, in cases where there are “directors, supervisors, high-level managers or other people that infringe on the company’s benefits and other directors or supervisors that remain quiet during such infringement, the shareholders are eligible to

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123. Refer to Article 22 of the 2006 CCL amendments. Similar content can be found in Article 111 of the 1994 CCL.
124. Refer to Article 75 of the 2006 CCL amendments.
125. See Article 153 of the 2006 CCL Amendments; see Article 210 of PRC Securities Law.
initiate a lawsuit in his or her own name for the benefit of the company.”

vi. **Independent Directors Requirement**

Article 123 of the 2006 CCL amendment requires listed companies to install an independent director system, but no stipulation regarding independent directors is addressed in the PRC’s (“People’s Republic of China”) Securities Law.

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

IV. **Independent Director System in China**

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

Since the independent director system has been widely introduced and practiced in all aspects of U.S. corporate governance, it proves insightful to review U.S. experience before observing the Chinese practice.
A. U.S. Experience

i. Role of U.S. Independent Directors

a. Protector of Shareholder Interests

The concept of independent directors in the United States can be tracked back to the early 1970s – to the bankruptcy incident of Penn Central Railroad Company. There were two emerging perspectives for independent directors during the evolution of the Anglo-American corporate legal system: protector of shareholder interests against management; and protector of broader social interests against the corporations as a whole. The former eventually prevailed over the latter in U.S. corporate law practice. Unlike consumers, since employees, creditors or suppliers of the company are capable of protecting themselves through contracting, shareholders are the only constituency whose investment is deeply sunk into the company and can hardly withdraw when something unfortunate happens.126

b. Substitute for External Regulation

As watchdogs, independent directors could be viewed either as a substitute for external regulation or as its implementer. In America, the independent director primarily plays the role of a substitute rather than an implementer of external regulation for corporations.127 Courts and legislatures normally do not involve themselves too deeply in the business decisions of corporate management. They leave considerable leeway for the board of directors with independent directors. In Delaware, even “fair scrutiny” (a fundamental, unobjectionable idea that promotes that business transactions between a corporation and a director should be on terms that are fair to the corporation) is not imposed on corporations as a substantive rule of law (or the Revised Model Business Corporation Act) if the transaction has obtained approval from the majority of independent directors after full disclosure.128

128. Id.
ii. Corresponding Laws and Rules

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

Among the three types of special committees, audit committees have gradually played a more and more important role over these past couple of decades. The audit committee is not required as a matter of state law, except in Connecticut. However, the Sarbanes-
Oxley Corporate Reform Act\textsuperscript{140}, the ALI's Principles of Corporate Governance, the Securities Exchanges Commission\textsuperscript{141} (hereinafter "SEC"), the NYSE,\textsuperscript{142} the NASDAQ Stock Market,\textsuperscript{143} the Business Roundtable Statement,\textsuperscript{144} the Business Roundtable's Corporate Governance and American Competitiveness,\textsuperscript{145} the Corporate Director's Guidebook,\textsuperscript{146} the Report on Overview Committees,\textsuperscript{147} the Report of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission)\textsuperscript{148} do have definite requirements or recommendations for largely held corporations to implement and support the oversight function of the board.\textsuperscript{149} Since the NYSE and the NASDAQ are self-regulatory bodies, they even have the right to prohibit companies from listing on their exchanges if the companies do not comply with the requirements.

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

\textit{a. Delaware General Corporation Law and Model Business Corporation Act}

1. Disinterestedness Requirements

A transaction-by-transaction approach on "conflicts of interest" was taken by the Delaware General Corporation Law (hereinafter “DGCL”) and the Model Business Corporation Act (hereinafter “MBCA”). The state corporate statutes focus on defining certain

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  \item \textit{Delaware General Corporation Law:}\n  \begin{itemize}
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\begin{itemize}
  \item \textsuperscript{141} Sec. 202 of H.R. 3763-29.
  \item \textsuperscript{142} Supra note 129, Article 303A.06 and 303.A.07.
  \item \textsuperscript{143} Supra note 130, at Rule 4350(d).
  \item \textsuperscript{144} Supra note 131, at 218-19.
  \item \textsuperscript{146} Supra note 133, at 1627.
  \item \textsuperscript{147} Supra note 134, at 1351-60.
  \item \textsuperscript{149} \textit{PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS} art. 3.05 cmt. at 104 (1994).
\end{itemize}
business transactions involving "conflicts of interest," such as transactions between a corporation and its directors or officers, or between a corporation and another business entity, in which one of its directors or officers has related interests or the business opportunities taken by the corporate officers might belong to the corporation – and provide certain scrutiny of whether those who made the decisions had conflicts of interest. One recent shareholders’ derivative action was initiated by the shareholders of Oracle Corporation, alleging insider trading by the corporation’s chief executive officer (hereinafter “CEO”), chief financial officer (hereinafter “CFO”), and two directors. The Court of Chancery of Delaware held that ties with the Special Litigation Committee (hereinafter “SLC”) were so substantial as to cause reasonable doubt about the members’ independence. The Court further explained that “assessing the independence of the corporation’s SLC required an examination of whether the SLC could independently make the difficult decision entrusted to it: whether the CEO, CFO and two directors should face suit for insider trading-based allegations of breach of fiduciary duty.”

The state statutes were actually designed to displace the common law rules on conflict-of-interest transactions. The common law ruling on conflicts of interest in many states in the late 19th century was absolute: Many dealings involving conflicts of interest could easily be rejected by the insistence of any stockholder. The common law rules made the transactions involving conflicts of interests defenseless. The person involved in conflict-of-interest dealings was supposed to be liable for returning the corporation to the status quo ante according to common law rules. The state statutes allow the existence of conflict-of-interest dealings if they fulfill certain conditions, such as the disclosure of the conflict-of-interest dealings or approval of these dealings by disinterested decision makers, whether directors or shareholders. Not having met the conditions does not necessarily indicate that the dealing is unlawful. It merely means that the common law rules might be applied by a court if any

150. Clarke, supra note 125, at 182.
152. Id. at 947. Ties among the Special Litigation Committee and directors to the university were, for example, being tenured professors and major benefactors.
153. See, e.g., Wardell v. R.R. Co., 103 U.S. 651, 658 (1881) (“The law, therefore, will always condemn the transactions of a party on his own behalf when, in respect to the matter concerned, he is the agent of others, and will relieve against them whenever their enforcement is seasonably resisted.”).
shareholder brings a suit. Examples could be found in both the DGCL and the MBCA.

Article 144 of the DGCL claims that a transaction is not void solely by a conflict of interest involved in a director's or an officer's standing on both sides if one of the following conditions is fulfilled: (1) the relevant facts of the dealing have been disclosed to the board and a majority of disinterested directors ratify in good faith; (2) the relevant facts of the dealing have been disclosed to the shareholders entitled to vote, and the shareholders ratify this dealing in good faith; or (3) the terms set forth in the transactions, as of the time the directors or the shareholders authorize it, appear to be fair to the corporation. It is important to note that the last provision of Article 144 provides that the vote of interested directors may be counted for the purpose of a quorum or a committee authorizing the transaction.

The MBCA is intended to deal with director conflicts of interest, leaving all other issues to the states' existing common law jurisprudence. The MBCA suggests that shareholders cannot demand damages, injunction, or any other remedy on the grounds of the existence of conflicts of interest that meet one of the following requirements: (1) sufficient disclosure was given, and approval from a majority of disinterested directors followed; (2) sufficient disclosure was given, and approval from a majority of disinterested shareholders followed; or (3) the terms set forth in the transaction at the time it occurs appear to be fair to the corporation.

The significant difference would be the distinct requirement of "disinterested directors" and "disinterested shareholders" as the only groups who are empowered to ratify the issues of self-dealing in MBCA, whereas the Delaware state government is more open regarding this requirement. Neither of them provides an absolute and general definition of "independence," however, or require rigid institution of an "independent director system." They instead make a transaction-by-transaction scrutiny on "full disclosure" or "disinterest" in particular conflict-of-interest dealings.

154. The Delaware statute does not explicitly require ratification by disinterested shareholders; however, this requirement has been spelled out by case law. See, e.g., Marciano v. Nakash, 535 A. 2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)2, permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").
b. American Law Institute’s Principles of Corporate Governance

1. Significant Relationship Requirements

In Article 1.34 of the ALI’s Principles of Corporate Governance, a clear explanation of "significant relationship" is given as follows: (1) the director is under the corporation’s employment within the two preceding years; (2) the director is an immediate family member of an officer or a senior executive within the two preceding years; (3) the director has involved certain monetary activities which exceeded $200,000 during the two preceding years; and (4) the director is affiliated in a professional capacity with a law firm or an investment banking firm to the corporation or has acted as a managing underwriter in an issue of the corporation’s securities within the two preceding years.

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

2. Independent Directors on the Board

The ALI suggests every large publicly held corporation should have a majority of directors who are free of any “significant relationship” with the senior executives on the board. The ALI also suggests that every publicly held corporation should have at least three directors who are free of any “significant relationship” with their senior executives on the board.

Article 1.23 also suggests that “[t]he audit committee should consist of at least three members, and should be composed exclusively of directors who are neither employed by the corporation nor were so employed within the two preceding years, including at least a majority of members who have no “significant relationship”

155. ALI, PRINCIPLES OF CORP. GOVERNANCE § 1.34 (1994).
156. ALI, supra note 153, § 1.34(a)(3)-(4).
157. ALI, supra note 153, § 1.34(a)(5).
158. “Large publicly held corporation’ means a corporation that as of the record date for its most recent annual shareholders’ meeting had both 2,000 or more record holders . . . of its equity securities . . . and $100 million or more of total assets . . . .” PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS art. 1.24 at 29 (1994).
159. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND
3. Powers and Responsibilities of the Audit Committee

According to Article 3.05 of the ALI’s Principles of Corporate Governance, “[e]very large publicly held corporation should have an audit committee to implement and support the oversight function of the board. The functions and powers of audit committees should include: (1) recommending the outside auditing firm, reviewing its compensation and its proposed engagement terms as well as its independence; (2) reviewing the assignment of the senior internal auditing executive, if any; (3) communicating between the external auditing firm, the board, and the senior internal auditing executive; (4) reviewing the corporation’s annual financial statements and documents prepared by the outside auditing firm in connection with the audit as well as reports of the internal auditing department; (5) considering the adequacy of the corporation’s internal controls in consultation with the outside auditing firm and the senior internal auditing executive; and (6) considering major changes and questions regarding appropriate accounting principles and practices to be used in the corporation’s financial statements.

c. Rules of the New York Stock Exchange

The NYSE, established in 1792, is one of the world’s leading and most technologically advanced equities markets and is under the oversight of the SEC. A broad spectrum of market participants, including listed companies, individual institutional investors and

RECOMMENDATIONS art. 1.34 at 34-35 (1994) (giving more information of the definition of “significant relationship”).

160. The roles of independent directors in major corporate governance principles, rules and legislation are introduced closely with the composition of audit committees. In addition to NYSE, both the American Stock Exchange (American Stock Exchange, LLC, Part 1 Original Listing Requirements, Section 121(B)) and NASDAQ (Supra note 130, at Schedule D) recommend or require their listed companies to equip with audit committees. The Business Roundtable Statement does give emphasis on the significance of three critical board committees which include the audit committee, and the audit committee was required to be composed entirely of non-management directors. Supra note 131, at 218-19. To the same effect are the Business Roundtable’s Corporate Governance and American Competitiveness (supra note 132, at 1627), the Corporate Director’s Guidebook (supra note 133, at 1627), the Report on Overview Committees (supra note 134, at 1351-60), as well as the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission) (supra note 146, at 40-41).
member firms participate in the business activities in this fair, open and orderly market to access the best possible price through the interplay of supply and demand. As of December 31, 2006, the NYSE and NYSE Arca were home to approximately 2,764 world-class issuers.¹⁶¹

1. Independence Requirements

Members of the audit committee cannot serve on the audit committee under the following circumstances: (1) employment: a member director is/was an employee of the company or any of its affiliates or its parent or predecessor within the three preceding years; (2) business relationship: a member director is a partner, controlling shareholder, or executive officer of an entity which engages in business activities with the company, or serves as a consultant for the company, unless the company’s board of directors made a business judgment that this business relationship will not impair this member director’s independence; (3) cross compensation committee: a member director serves as an executive of another entity where any of this company’s executives serve on such other entity’s compensation committee; (4) immediate family: a member director’s immediate family member is an executive officer of the company or its affiliates within the three preceding years.¹⁶²

2. Independent Directors on Audit Committees

The NYSE requires that each of its listed companies set up and maintain an audit committee which “shall consist of at least three directors, all of who have no relationship to the company that may interfere with the exercise of their independence from management and the company.”¹⁶³

3. Conflict of Interest

According to Article IV, Section 15 of the constitution of NYSE, no director shall participate in the deliberation or adjudication of any

matters in which he or she is personally interested.

4. Professional Qualifications

At least one of the audit committee members should be an expert in accounting or financial management.164

d. Rules of the NASDAQ

The NASDAQ is the largest electronic stock market in the United States. With approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. securities markets. Its listed companies are leaders across all areas of business, including technology, retail, communications, financial services, transportation, media and biotechnology. As with the NYSE, it also is under the supervision of the SEC.

1. Independence Requirements

According to Article 4200(a)(15) of the NASDAQ Marketplace Rules (the Securities Exchange Act of 1934,) the independent director is defined as “a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of directors.”165

164. Id. at Article 303A.07(a) commentary.

165. Following[0] is a detailed description of a person who shall not be considered an independent director: (1) a person employed by the company or by any parent or subsidiary of the company at any time during the past three years; (2) a person or his or her family member who accepted any payments from the company or its parent or subsidiary in excess of U.S. $60,000 during any period of twelve consecutive months within the three years preceding the judgment regarding independence, other than for the following reasons: (a) compensation for board of directors or board committee service; (b) payments from investments in the company's securities; (c) compensation paid to a family member who is a nonelective employee of the company or its parent or subsidiary; (d) profits under a tax-qualified retirement plan, or nondiscretionary compensation; (e) loans or payments from a financial institution, only on the condition that these loans or payments: (i) were made in the ordinary course of business; (ii) were made on substantially the same terms as those prevailing at the time for comparable transactions with the general public; (iii) did not involve more than a normal degree of risk or other unfavorable factors; (iv) were not otherwise subject to the specific disclosure requirements of SEC Regulation S-K, Item 404; (v) were not otherwise subject to the disclosure requirements of SEC Regulation S-K, Item 404; or (vi) were permitted under Section 13(k) of the Act[0]. NASDAQ, Inc., Marketplace Rules § 4200(a)(14) (2007), available at <http://nasdaq.
2. Independent Directors on Audit Committees

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

3. Independence Requirements for Audit Committees

In addition to the requirements of Article 4200(1)(14), independent directors serving on the audit committee are subject to additional, more stringent requirements under Rule 4350(d) and cannot serve if: (1) a director's family member is or was an executive officer of the company or its parent or subsidiary individual at any time during the past three years; (2) a director's family member is a partner, controlling shareholder, or executive officer of any entity to which the company made or from which the company received payments for property or services in the current or any of the past three fiscal years that exceed 5% the recipient's consolidated gross revenues for that year or $200,000, whichever is more, other than the following: (a) payments from investments in the company's securities; or (b) payments under charitable contribution matching programs; (3) a director of the listed company who is, or whose family member is, employed as an executive officer of another organization where at any time during the past three years, any of the executive officers of the listed company served on the compensation committee of such other entity; or (4) a director who is, or whose family member is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditing firm who worked on the company's audit at any time during any of the past three years.

An the case of an investment company, an “interested” director of an investment company is defined in Section 2(a)(19) of the Investment Company Act of 1940, rather than in his or her capacity as a member of the board of directors or any board committee.

complinet.com/nasdaq/display/display.html?rbid=1705&element_id=18> ("Family Member" means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.").
e. Sarbanes-Oxley Corporate Reform Act (2002)

The role of the independent director mechanism has a complete and aggressive description in the Sarbanes-Oxley Corporate Reform Act (hereinafter “SOX”), which was signed into law on July 30, 2002, along with rules proposed by two stock exchanges166 in the United States. The significance of the SOX, however, lies not in its invention of the concept of an independent director, but in its creation of a variety of mandatory corporate functions, the vast increase of their legal complexity, and the enhancement of the requirement of corporate judgment.167 The SOX, known as the corporate-oversight law, requires greater independence by corporate directors in order to solve the scandals at Enron, Tyco, WorldCom and elsewhere. The independent director mechanism was promoted by Sarbanes and by Arthur Levitt in 2002. This Act tried to prompt greater vigilance by the audit committees.

1. Independent Directors on Audit Committees

The SOX requires that an audit committee to review a company’s accounting practices, and that the committee be made up solely of independent directors.168

2. Independence (Disinterestedness) Requirements of Audit Committees

In order to be considered as independent directors to serve on an audit committee, a member of the audit committee may not receive “any consulting, advisory, or other compensatory fee” from the company, affiliate to the company, or any of its subsidiaries.169

3. Powers and Responsibilities of Audit Committees

The audit committee was established to audit the financial and accounting processes.170 This audit committee “shall be directly responsible for the appointment, compensation, and oversight of the

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166. New York Stock Exchange and NASDAQ.
169. Id. at § 301(m)(3)(B).
170. Id. at § 205 (amending Section 3(a) of the Securities Exchange Act of 1934).
work of any registered public accounting firm employed by the issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work and each such registered public accounting firm shall report directly to the audit committee.\textsuperscript{171}

The audit committee will need to “establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.”\textsuperscript{172}

The audit committee ought to supervise and ensure that the audit team not stay in its position longer than permitted.\textsuperscript{173} The audit committee has the authority to hire independent counsel and other advisers at company expense.\textsuperscript{174}

All those new responsibilities set forth in the SOX may require the audit committees to stay in contact with outside auditors on a regular, continuous basis, and committee members may expect to meet in continuous sessions sometimes.\textsuperscript{175}

4. Professional Qualification

In addition, the company must disclose whether at least one of those committee members is a “financial expert,” and if not, explain the reason.\textsuperscript{176}

\textit{f. Implementation of the Independent Director System in the United States}

The independent director system first obtained its clear definition in corporate America after it was signed into law as the SOX. The SOX has been considered the most comprehensive and powerful corporate reform act to date. Many criticisms thereafter,\textsuperscript{177}

\begin{footnotes}
\footnote{171. \textit{Id.} at § 301 (amending Section 10A of the Securities Exchange Act of 1934).}
\footnote{172. \textit{Id.} at § 301(m)(3)(4).}
\footnote{173. \textit{Id.} at § 203 (amending Section 10A of the Securities Exchange Act of 1934).}
\footnote{174. \textit{See} Hazard & Rock, \textit{supra}, note 165, at 1394.}
\end{footnotes}
however, have targeted the intention and efficiency of the SOX.\textsuperscript{177} The SOX was criticized as a U.S. Patriot Act which was driven by the political needs of the U.S. Congress to appear to be diligent in their incumbencies in response to the terrorist attacks of 2001.\textsuperscript{178} The SOX was designed to regulate in areas that have traditionally been left to state corporate law.\textsuperscript{179} The enactment of this Act may signal the birth of "the creeping federalization of corporate law,"\textsuperscript{180} since it dictates a one-size-fits-all process for testing internal controls for most public listed companies.\textsuperscript{181} This Act does not just passively "prohibit" conduct, but aggressively "mandates" the structure and operation of audit committees. The SEC has come under fire from the business community for its regulatory approach, causing it to host a roundtable discussion to "evaluate the implementation" of the SOX. The SEC's recent response signals that it would consider adjusting the relevant provisions of the SOX, if necessary.\textsuperscript{182}

One SOX reform is the requirement that independent directors sit on audit committees. These independent directors are completely independent, receiving no salary or fees from the company other than for service as directors. The SOX then says CEOs, who under another part of the law may be liable for criminal penalties for earnings misstatements, have no say in hiring the outside auditor. The audit committee is the agency responsible for hiring, overseeing and compensating the auditors, and the auditor must report directly to the committee, not company management. Serving on a board has lost much of its appeal as a wave of corporate scandals has made this old-time prestigious position increasingly risky, particularly considering ten former WorldCom and Enron directors agreed in recent tentative court settlements to shell out a total of $18 million and $13 million, respectively, from their own pockets to settle shareholder lawsuits.\textsuperscript{183}

\begin{thebibliography}{99}
\bibitem{178} \textit{Id}. at 1.
\bibitem{179} Notes from Professor David Skeel of the University of Pennsylvania Law School, March 18, 2005.
\bibitem{181} \textit{Id}. at 29.
\end{thebibliography}
Although the NYSE and NASDAQ have both proposed the facility of independent directors with relevant rules and regulations, there is no concrete evidence to show that companies with strong independent director boards will advocate more strongly for shareholder interests. A large-sample study even found that “firms with more independent boards are not more profitable; indeed, there were hints in the data that they perform worse than other firms.” Enron, an ironic illustration of this point, whose board was comprised of eighty-six percent independent directors, which would have complied nearly perfectly with the SOX. It is doubtful that the stricter the legal rules are, the more likely people will be well behaved. Even though those strict rules are presumed to be effective and helpful in supervising corporate governance, companies have their own discretion to choose not to be burdened by them. The number of companies that delisted their common shares from stock exchanges in order to avoid increased outside scrutiny tripled in 2003.

The “independence” issue is a debatable topic in the U.S. boardroom lately. The NYSE and NASDAQ have been imposing rules since 2004 to boost the requisite number of disinterested directors. The NYSE rules require a majority of all directors to be “independent,” as shall all directors on audit, nominating, compensation and corporate-governance committees. The definition of independent directors here refer to directors who are executives at entities that have significant business with the listed company they serve totaling more than $1 million, or two percent of the entity’s

184. Sanjai Bhagat & Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, 27 J. CORP. L. 231, 263 (2001-2002) (“[T]here is no evidence that greater board independence leads to improved firm performance. If anything, there are hints that greater board independence may impair firm performance. [R]esearch [does] not support the conventional wisdom favoring the monitoring board, with a high degree of board independence.”).

185. “Strapped for time, the board must trust and rely on management. The board can ask the auditors to check things, but even the auditors can’t spend enough time to prevent problems. What prevents problems very simply is management choosing to run a clean ship, period,” said T. J. Rodgers, the outspoken libertarian CEO of Cypress Semiconductor Corp. when he was interviewed by Insight Magazine.

186. Peter Loftus, Delisting Soared in 2003, Study Shows, WALL ST. J., Dec. 15, 2004, at B3F (referring to a study co-authored by professors from the Wharton School of the University of Pennsylvania and the University of Maryland’s Robert H. Smith School of Business).

revenue, whichever is greater. Nonetheless, a review of 150 corporate filings initiated by the Wall Street Journal highlights how exceptions and qualified independent directors under the rules limited their corporate governance effectiveness. Companies have made their own calls on defining "independence," regularly checking with exchanges to discuss specific directors. When it comes to particular cases, it is a matter of "disinterestedness." The DGCL, MBCA and SOX provide for judgment on an a case by case basis.

B. Chinese Practice

i. Role of Chinese Independent Directors

a. Protector of Shareholders’ Interests

Deriving from the civil law system, different from the common law system, China supposes to pay more attention on the interests of stakeholders than shareholders in the corporate governance structure. Since China borrows the independent director system from the Anglo-American corporate law system, however, the notion of the independent director as representing stakeholders is lost in the newly established Chinese independent director system. The independent directors in China are expected to act solely to protect shareholders’ rights instead of serving the broader social interests against the corporations as a whole.

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

188. Id.
189. Id.
190. Id.
191. La Porta et al., supra note 25.
192. CSRC, Notice on Release of Directive Opinions at §1.2.
shareholders' interests to voice their needs and concerns, not the
defender of the controlling shareholders' or general social interests.
The Chinese literature and statutes contain generalities about the
functions of independent directors, such as preventing corruption,
daring to ask sharp questions, and questioning the board's decisions
and management operation in order to ensure fair corporate
governance practice. For most of the discussions in China, the
independent director system is regarded as a special prescription of
medicine which is able to cure every disease that a company might
have.

b. Substitute for External Regulation

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

ii. Corresponding Rules and Guidelines

Both scholars who advocate the absolute effect of rule of law and
neoclassical economists alike have argued about whether rule of law
is an indispensable element of sustainable economic development. 193
For the past couple of decades, China has showed the world
prominent economic growth without either duly perfecting their
market mechanism or their domestic rule of law, leaving many
political scientists, economists and legal experts puzzled. 194 China has
been able to achieve phenomenal growth in the late 1990s thanks to it
distinct economic and political evolutionary history. 195 Nowadays, the
Chinese are not satisfied with their established accomplishments but
want to look for more outside investments.

193. PEERENBOOM, supra note 55, at 19 (citing generally KATHARINA PISTOR &
PHILIP A. WELLONS, THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN
ECONOMIC DEVELOPMENT, (1999); DOUGLASS C. NORTH, INSTITUTIONS,
194. Id. at 19 (citing Geoffrey MacCormack, The Traditional Chinese Penal Law
195. Id. at 19 (asserting that the Chinese economic growth has been attributed to
“cultural factors, a district form of Chinese capitalism, a guanxi (connection) based
rule of relationships, clientelism, and corporatism.”)
According to a 1997 World Bank report, “countries with stable governments, predictable methods of changing laws, secure property rights, and a strong judiciary saw higher investment and growth than countries lacking these institutions.” In order to attract higher investment, Chinese regulators are trying to make the investment environment more transparent and predictable.

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

a. Stock Exchange Rules

There are two stock exchanges in China: Shanghai and Shenzhen. The Shanghai Stock Exchange was founded on November 26, 1990, and went into operation on December 19 of the same year. The Shenzhen Stock Exchange was established on December 1, 1990. See, e.g., Oliver E. Williamson, The Economics of Organization: The Transaction Cost Approach, 87 Am. J. Soc. 548, 573-74 (1981); see also Oliver E. Williamson & William Ouchi, A Rejoinder, in PERSPciveS ON OrGANIZATION DESIGN AND BEHAVIOR 389 (Andrew H. Van de Ven & William F. Joyce eds., John Wiley & Sons 1981).


198. Clarke, supra note 125, at 146.

199. By “quasi-corporate China,” I mean a special transitional period for China which seems to drift inexorably toward a market economy model, but cannot avoid the struggle with the old planned economy model.

Compared to the Shanghai Stock Exchange, the Shenzhen Stock Exchange is considered a relatively small securities market bearing high risks. Both of these stock exchanges are non-profit-making membership institutions, directly governed by the CSRC. Their obligations are to legislate, supervise, self-regulate and standardize all of their listed companies under the PRC’s Securities Law. The most effective power reserved to the stock exchanges is to “delist” their listed companies if the companies break the rules of the two securities exchanges or the CSRC.

1. Shanghai Stock Exchange Rules

The Shanghai Stock Exchange issued Shangshi Gongsi Zhili Zhiyin Caoan [Listed Company Governance Guidelines Draft] (hereinafter “Shanghai Guidelines”) in November 2000. These Shanghai Guidelines were believed to provide a more refined version of the independent director system than the CSRC’s Shangshi Gongsi Zhangcheng Zhiyin [Guidelines for the Articles of Association of Listed Companies] of 1997.

2. Independent Directors on the Board

The Shanghai Guidelines require listed companies to have at least two independent directors. The independent directors should constitute at least twenty percent of the board of directors and at least thirty percent when the chairman of the board of directors and the general manager is the same person.

3. Independent Directors on the Audit Committee

The Shanghai Guidelines also stipulate that all subcommittees of the board of directors have to be composed (principally) of and

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203. See Article 178-180 of PRC Securities Law.
204. Clarke, supra note 125, at 211.
(chaired) by independent directors.  

While many significant expectations were imposed on the role of "independent directors" in these Shanghai Guidelines, it was surprising to find that there was no description of the independence or disinterestedness requirements of independent directors.

4. Shenzhen Stock Exchange Rules

The Stock Regulatory Office of Shenzhen promulgated the Shangshi Gongsi Duli Dongshi Zhidu Shishi Zhiyin [Guidelines for the Implementation of an Independent Director System in Listed Companies] in 2001. Although both the Shanghai and Shenzhen stock exchanges have their own stipulations about independent directors, their most recent rules regarding the institution and review of independent directors require them to follow the standards in the CSRC's Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu Zhiyin)s.

5. Regional Government Rules

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

b. Shenzhen Municipal Government

Guanyu Jinyibu Jiakuai Woshi Guoyu Qiye Gaige He Fazhan de Shishi Yijian [Opinion on Implementing the Further Acceleration of the Reform and Development of Shenzhen State-Owned Enterprises] was issued by the Shenzhen municipal government in January 2001. This Shenzhen opinion requested an appropriate proportion of independent directors to be added to the boards of state asset management companies.

c. Hebei Provincial Government

The "Provisional Measures for Standardizing the Governance of Company Legal Persons" (Guifan Gongsi Faren Jiegou Zhanxing  

207. Clarke, supra note 125, at 179.
Banfa) was issued by the Hebei Provincial Government in late 2001. The Hebei Measures require domestic companies to install independent directors, but leave the proportion of independent directors to be determined by the individual company's articles of association.\textsuperscript{208}

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

\textit{d. Guangzhou City}

The "State-Owner Capital Authorized Operation Institution Provisional Rules Governing Independent Directors" ("Guangzhou Shi Guoyu Zichan Shouquan Jinying Jigou Duli Guanli Guanli Zhanxin Banfa") were issued by Guangzhou City on December 30, 2001. These rules do have definite requirements for the professional background and independence of corporate directors.\textsuperscript{209} Under these rules, independent directors have powers that allow them to involve themselves deeply with the company's operations. Nevertheless, they are liable for company losses if those losses are caused by their misconduct.\textsuperscript{210}

\textit{C. "Guidelines for the Articles of Association of Listed Companies" (Shangshi Gongsi Zhangcheng Zhiyin)}

The development of securities markets in China led to the establishment of a centralized market regulatory body in 1978. The establishment of the State Council Securities Commission (hereinafter "SCSC") and the China Securities Regulatory Commission (hereinafter "CSRC") in October 1992 marked the official formation of this centralized market regulatory body. The SCSC is a state authority responsible for exercising regulations governing the centralized market. The CSRC is the executive agency of SCSC, responsible for conducting supervision and regulation of the securities markets in accordance with the relevant rules.

In March 1995, the State Council formally approved the CSRC

\textsuperscript{208} Art 19 of the "Guifan Gongsi Fanren Jiegou Zhanxing Banfa" ["Provisional Measures for Standardizing the governance of Company Legal Persons"].

\textsuperscript{209} Arts. 4 and 5, Guangzhou Shi Guoyu Zichan Shouquan Jinying Jigou Duli Dongshi Guanli Zhanxin Banfa [ "State Owned Capital Authorized Operation Institution Provisional Rules Governing Independent Directors"].

\textsuperscript{210} \textit{Id.} at Art. 6.
Organizational Plan thereby confirming CSRC to be a deputy-ministry rank unit directly under the State Council and the executive branch of the SCSC. In August 1997, the State Council decided to establish the securities exchange markets in both Shanghai and Shenzhen under the supervision of the CSRC. Offices of the CSRC commissioners were set up in these two municipalities. At the National Finance Conference held by the Central People's Government in November 1998, it was decided to reform the national securities regulatory body to directly supervise the local securities regulatory departments, and to place the securities organizations formerly supervised by the People's Bank of China under the centralized supervision of the CSRC. In April 1998, according to the State Council Reform Plan, the SCSC and the CSRC were merged to form one ministry-rank agency directly under the State Council. The power and the functions of the CSRC have been strengthened since the reform. A centralized securities supervisory system was thus established. The CSRC not only has the power to regulate and supervise, but also has the power to investigate or levy penalties for illegal activities related to securities and futures. The CSRC has issued several regulations regarding corporate governance for listed companies to follow and the independent director system has constantly been emphasized in those regulations. The Guidelines for the Articles of Association of Listed Companies ("Shangshi Gongsi Zhangcheng Zhiyin") (hereinafter "Guidelines") issued on December 16, 1997, was the first corporate governance regulation from the CSRC. In the Guidelines, the CSRC gives listed companies relatively clear guidance with respect to their articles of association. The listed companies whose articles of association diverge considerably from the Guidelines, must obtain approval of the CSRC.

i. Independence Requirements

The independent director requirement was does not figure prominently in the Guidelines. Article 112 is the only article which gives mention to independent directors. It states, "the company may elect independent directors according to its actual needs," and excludes "(1) shareholders or those employed by shareholding entities; (2) internal personnel of the company (such as the manager of an employee); (3) persons with self-interested relationship with

affiliates or management levels of the company" from independent director qualification.212

The Guidelines do not use any definite terms to require the institution of special committees, or to establish the proportion, qualifications, powers and duties of independent directors.

D. Central Government Rules

i. SETC/CSRC Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas (Guojia Jingji Maoyi Weiyuan Hui/Zhongguo Zhengjian Hui Guanyu Jin Yi Bu Cujin Jingwai Shangshi Gongsi Guifan Yunzou He Shenhua Gaige de Yijian)

The SET/CSRC Opinion were jointly issued by the CSRC and the State Economic and Trade Commission on March 29, 1999.213 Since 1990, the average amount invested in overseas merger and acquisition activities reached 200 million dollars and, in 2002, the amount climbed to 600 million dollars.214 This phenomenon triggered a need for the government to better regulate companies listed abroad. The SET/CSRC Opinions were established to require the ownership of companies listed abroad to be separated from the controlling body in its very first section.215 It is interesting to find that the SET/CSRC Opinions refer to “outside director” and “independent director” in the same section, which requests that overseas listed companies have at least two independent directors and that outside directors fill at least half of the board.

212. See Shangshi Gongsi Zhangcheng Zhiyin [“Guidelines on Articles of Association for Listed Companies”](promulgated by the CSRC, effective Dec. 16, 1997), Art. 112.
a. Independence Requirements

An "independent director" is defined as someone who is not a shareholder, and does not hold a position in the company. The term "outside director" is not defined.\(^{216}\)

b. Powers of Independent Directors

The SET/CSRC Opinions further request that any transactions between a company and its affiliates have to be approved by the independent directors before this transaction becomes effective.\(^{217}\) Additionally, the SET/CSRC Opinions grant independent directors the power to report relevant situations directly to the company’s shareholders’ meetings and the CRSC.\(^{218}\)

ii. Draft Rules for Companies Seeking Listing on a Secondary Board (Gongsi Erban Shangshi Guize Caoan)

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

a. Independence Requirements

The draft rules provide a relatively clear description of the qualifications of independent directors as people who were not (1) shareholders; or (2) directly related, or collaterally related within three kinship generations to company directors, supervisors, or officers, (3) directors, supervisors, or officers of affiliated enterprises; or (4) any person who was controlled the company.\(^{220}\) The draft rules did not provide for any obligations directors other than to attend

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216. Id. at § 6.
217. Id.
218. Id.
219. This prohibition originated from the special needs of controlling shareholders in family-controlled close corporations. Stroud v. Grace, 16 Del. J. Corp. L. 1588 (1991). (Unreported case)(The Delaware Chancery Court found that a corporate charter prohibiting their independent directors holding their stocks to be unusual, but not illegal).
board meetings.

**iii. “Code of Corporate Governance for Listed Companies in China” (Zhongguo Shangshi Gongsi Zhili Fagui)**

The CSRC and the State Economic and Trade Commission jointly issued the Code of Corporate Governance for Listed Companies in China” (Zhongguo Shangshi Gongsi Zhili Fagui) (“Code”) in accordance with the basic requirements of CCL, Chinese Securities Law, other relevant laws and regulations, and other commonly accepted standards of internal corporate governance on January 7, 2001. The Code is a supplemental explanation to the existing law. It is formulated to encourage the healthy development of the securities market in China.\(^{221}\)

**a. Independence Requirements**

The Code attributes significant attention to the subject of corporate directors. It indicates that independent directors, as well as their major shareholders, should be independent from the listed company, and that they may not hold any other position in the same company.\(^{222}\)

**b. Independent Directors on Audit Committee**

The Code requires that the audit committee, the nomination committee and the remuneration and appraisal committee be chaired by independent directors, and that the majority of the members of those committees be independent directors. It also requires that one independent director of the audit committee be an accounting professional.\(^{223}\)

It is worthwhile to note that the Code imposes duties of good faith and due diligence on independent directors. For instance, the Code specifically requests independent directors to concern

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\(^{222}\) See Id. at §49.

\(^{223}\) Id. at §52.
themselves with the interests of minority shareholders.\textsuperscript{224}


The CSRC issued its proposed “Measures on the Administration of Securities Companies” ("Draft Measures") for comment on June 20, 2001. The draft measures make a big improvement by introducing a concrete independent director system.

\textit{a. Independence Requirements}

This Draft Measures require that independent directors: (1) meet the conditions stipulated in the Company Law\textsuperscript{225}; (2) not be employees of an entity which holds the company's shares; (3) not be currently or in the last three years one of the company's employees; (4) not have any relationship of interest with any of the company directors, supervisors or senior managers or anyone who is liable for financial audits in the company; (5) not be employees of any entity which has significant relationship of interest with the company; (6) have at least five years of professional experience in either finance, law or accounting, and would be able to devote sufficient time and energy to perform the directors' duties; and (7) meet other conditions required by CSRC.

\textit{b. Independent Directors on the Board}

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

\textsuperscript{224} Id. at §50.
\textsuperscript{225} See Articles 57-58 of the CCL.
c. Powers and Responsibilities of Independent Directors

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

v. Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian)

Following the issuance of the experimental practices detailed above the CSRC issued its “Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies” [(Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian) on August 16, 2001. This document is the most comprehensive Chinese regulatory measures insofar as the regulation of independent corporate directors

a. Independence Requirements

The CSRC Guideline Opinion declared that an independent director shall not be: (1) a person who holds a position in the listed company or its subordinate affiliates, or his or her direct relatives or major special relatives (direct relatives refer to spouse, parents, or children; major special relatives refer to siblings, parent-in-law, daughter-in-law, son-in-law, and so on); (2) a person directly or indirectly holding at least 1% of the outstanding shares of the listed company or being among one of the top ten shareholders of the said listed company, or this person’s direct relatives; (3) a person who works under the employment of a legal person shareholder who holds at least 5% of the outstanding shares of the listed company or who is among one of the top five shareholders, or this person’s direct relative; (4) a person who has fulfilled one of the above conditions in the immediate last year; (5) a person who provides financial, legal, consulting or other similar services to the listed company or its subordinate enterprises; (6) any other person who has been specified
in the listed company’s articles of association; (7) any other person who has been identified by the CSRC.226

The CSRC imposes a strict definition on “independence,” limiting qualified “independent directors” to those who are free of conflicts of interest in carrying out their supervisory functions.

b. Professional Qualifications

Independent directors have to fulfill the professional qualification background requirement in addition to the independence requirement. The professional requirements are as follows: (1) director qualifications in line with relevant provisions of law and administrative rules; (2) independence to meet the provisions of this Guideline Opinion itself227; (3) possession of basic knowledge of the operations of listed companies and familiarity with relevant laws, administrative rules and other rules and regulations; (4) at least five years’ work experience in dealing with legal, economic, or other necessary background, for his or her exercise of the power of an independent director; and (5) possession of other qualifications that the company’s articles of association have specified.228

c. Powers and Responsibilities of Independent Directors

Independent directors have the following responsibilities: (1) approval of significant dealings with affiliates (quanlian ren) where the venture amount is more than RMB3 million or more than 5% of the net asset value of the company in accordance with the its most recent audit report; (2) advising on hiring and firing the company’s accounting firm; (3) proposing to convene interim shareholders’ meeting and board meetings; (5) engaging outside auditors and consultants; and (6) soliciting proxies before a shareholders’ meeting. All of the above powers may only be exercised while receiving consent from more than half independent directors.

Similar to the “Code of Corporate Governance for Listed

227. Id. at § 1(2).
228. Id. at § 2.
Companies in China," the Guideline Opinion provides that independent directors shall bear the duties of good faith (chengxin) and due diligence (qinmian) toward the company as well as the entire body of shareholders, and that they specifically concern themselves with minority shareholder interests.\textsuperscript{29}

d. Independent Directors on the Board

Listed companies were required by the Guideline Opinion to have at least two independent directors by June 30, 2002, and that the independent directors should constitute at least one third of the board by June 30, 2003.\textsuperscript{20} Moreover, the above requirement must be included in the listed companies’ articles of association.

e. Independent Directors on Audit Committee

The Guideline Opinion also requires that more than half of the members of the audit committee, the nomination committee, as well as the compensation committee of the board, be independent directors.

E. Zhongguo Shangshi Gongsi Zhili Zhuanze (Principles of Corporate Governance for Chinese Listed Companies)

The CSRC released a draft of its “Zhongguo Shangshi Gongsi Zhili Zhuanze” (“Principles of Corporate Governance for Chinese Listed Companies”)\textsuperscript{231} for comments on September 11, 2001. These Principles are based on the OECD Principles of Corporate Governance, and were revised by proper principles drawn from specific foreign jurisdictions and China’s own domestic consideration.

i. Independence Requirements

An independent director may not have any position other than his or her position of independent director of the company. Likewise, an independent director may not have a relationship with the

\textsuperscript{229} Id. at Article 1 § 2.
\textsuperscript{230} Id. at Article 3 § 1.
\textsuperscript{231} This document referred to another two announcements: CSRC announcement, on April 2001, concerning Zhongguo Shangshi Gongsi Zhili de Jiben Yuanze he ShuiZhun (Basic Principles and Standards for the Corporate Governance Structure of Listed Companies in China), and CSRC announcement on May 21 2001, concerning the impending promulgation of Shangshi Gongsi Zhili Zhiyin (Guidelines for the Governance of Listed Companies).
company, or its controlling shareholders, which might interfere with his or her independent judgment.\textsuperscript{232}

\textit{a. Independent Directors on the Board}

The principles stipulate that at least half of the directors should be independent if the chairman of the board of directors is also the CEO.\textsuperscript{233}

\textit{b. Independent Directors on Audit Committee}

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

\textbf{F. Principles on Securities Companies’ Governance (Trial) \textit{Zhengquan Gongsi Zhili Zhunzi (Shixing)}}

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

\textit{i. Independence Requirements}

The following people are not allowed to be independent directors: (1) employees of the securities companies or other related companies or the employees’ direct relatives or major social relatives; (2) employees of shareholders holding more than a 5% shareholding or among the top 5 shareholding or the employees’

\textsuperscript{232} Zhongguo Shangshi Gongsi Zhili Zhuanze [Principles of Corporate Governance for Chinese Listed Companies], at Art. 33.
\textsuperscript{233} \textit{Id.} at Art. 32.
\textsuperscript{234} According to Article 1 of “Zhengquan Gongsi Zhili Zhunzi (Shixing)” (“Principles on Securities Companies’ Governance (Trial)”).
direct relatives or major social relatives; (3) natural person shareholders holding more than a 5% shareholding or their direct relatives or major social relatives; (4) people who provide financial, legal consulting services to the securities companies or other relevant parties or their direct or major relatives; (5) anyone who fulfills one of the above-mentioned conditions within the most recent one year; (6) directors in other securities companies; (7) other people prohibited in accordance with the articles of association; and (8) other people prohibited by the CSRC. In addition to the independence requirement, these principles require that independent directors have a basic knowledge of securities markets as well as the relevant law and administrative regulations. Independent directors should also have at least five-years of work experience and be people of high integrity.

a. Independent Directors on Audit Committee

These principles require the board of directors to set up special committees for reviewing relevant dealings, compensation for high-level managers. The coordinators of those committees have to be independent directors.

b. Powers and Responsibilities of Independent Directors

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

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

235. Id. at Art. 39.
236. Id.
237. Id. at Art. 62.
238. Id. at Art. 42.
239. Id.
240. Id. at Article 42
G. Zhengquan Gongsi Nabu Kongzhi Zhiyin (Guidelines for Internal Controls for Securities Companies)

The CSRC issued a set of rules providing guidelines for the internal governance for securities companies on January 31, 2001. However, those Guidelines were annulled, and a new version of the guidelines, issued under the same name, came into effect on December 26, 2003. Similarly to the former guidelines, the amended version merely reiterates the demand for independent directors to "bring into full play the monitoring function of independent directors, in order to prevent manipulation by the controlling shareholders."241

H. Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohui de Ruogan Guiding (Several Rules Regarding Strengthening Protection of Societal Public Shareholders’ Rights)

The Rules Regarding Strengthening Protection of Societal Public Shareholders’ Rights (hereinafter “Rules”) were proposed by the State Council on December 7, 2004 in response to the reorganization and stabilization of the capital market in China.242

The Rules dedicate a section to the institution and the operation of the independent director system. The Rules do not specifically stipulate the qualifications or proportion of independent directors; they merely state the independent discretion and expected powers and duties borne by independent directors and emphasize their obligations to minority public shareholders.243

i. Powers and Responsibilities of Independent Directors

Major business decisions and the hiring and firing of public accounting firms, requires the agreement of half of the independent


242. These Rules were issued to further pursue the “Guowuyuan Guanyu Tuidong Ziben Shichang GGGaige Kaifang he Wending Fazhan de Ruogan Yijian” (“Several Opinions Regarding How the State Council Promotes Revolution of the Capital Market and its Stable Development”), especially to protect the society public shareholders’ rights (author’s translation).

directors. Additionally, independent directors are required to attend meetings of the board of directors in order to understand the operation of the company. Independent directors also have to submit annual reports to shareholders' meetings. Notably, the Rules protect the full term of independent directors' positions unless there exist proper supporting reasons.

I. Implementation of Independent Director System in China

China has proclaimed numerous rules to encourage companies to install independent director systems to better protect minority shareholders' rights and to attract more foreign investment. A random survey held in Hunan Province in 2004 researched the effectiveness of independent director systems. This survey took twenty-two listed companies as its research subject and found all of them have installed the independent director system. According to the survey, 13 companies had more than one third of board occupied by independent directors. The independent directors hired by those twenty-two companies are usually highly educated – 53.6% held doctorate degrees and 88.4% held other high-level educational titles. Seventy-seven percent of the subject companies believe that the importation of the independent director system has greatly improved the company's decision-making ability. However, seventy five percent of the companies believed that the independent director system did not offer significant help in balancing controlling shareholders' powers and preventing their undue influence on executive directors. This survey signals that the implementation of the independent director system in China has obtained moderate positive results.

Although the independent directors system is being implemented in China, the original organizational structures and the entrenched "rule of man" culture of China's corporate economy, will certainly

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244. See id. Art. 3, § 2.
245. See id. Art. 2 § 5.
246. See id. Art. 5, § 2.
247. See id. Art. 6, § 2.
248. The State Quo and Resolution of Independent Director System in Listed Companies, Quan Jing Wang (Full View Net), December 10, 2004.
249. Id. at 2.
250. Id.
hinder the efficacy of this foreign system. Overall, the pursuit of the independent director system has not been successful, due in part to these path dependency concerns.

V. Path Dependency – Obstacles to Worldwide Corporate Governance Convergence in China and Suggestive Solutions

While there are numerous rules, regulations, and guidelines emphasizing the importance and significance of independent director system, something crucial had been lost on China in its importation of the system.

A. Absence of Audit Committees

According to a 2000 report by the Shanghai Stock Exchange, around 5.4% of its listed companies had installed professional sub-committees. The most common one is the investment and fund-circulation committee, followed by the “audit committee,” the “financial management committee” and the “strategy committee.” Among all those committees, the strategy committee and the corporate nature revolutionary committee requires the highest proportion of independent directors.

One can note from the above listed rules and regulations concerning the establishment of the independent director system that, the “audit committee” is not a widespread institution in Chinese corporate governance. In contrast, almost every set of rules in the United States repeatedly mention the significance of the audit committee and its indispensable function of the independent director system. The principles and regulations of the ALI, the NYSE, the NASDAQ as well as the SOX all require publicly-held companies and listed companies to have audit committees. In the United States, these audit committees in the implement and support the oversight function of the board by reviewing companies' financial data, their internal controls, and the independence of the corporation’s external

auditors on a periodic basis.\textsuperscript{253}

In China as well, independent directors are charged with overseeing financial and accounting matters. However, it is difficult for those independent directors to perform these functions with much personal discretion. The main problems are that Chinese corporate governance does not require companies to have audit committees and further, it does not require audit committees to be made up "solely" of independent directors. Therefore, the leverage of independent directors is easily diminished as they can, at most, represent one-third of the board.\textsuperscript{254} Additionally, the path dependency described herein is due to rent-protection concerns. Most high-level executives are also officials of government agencies, incumbent management groups are not ready to subordinate their political clout to independent parties.\textsuperscript{255}

The path dependency we perceive here may come from rent-protection concerns. Since most high-level executives are officials from government agencies, these incumbent management groups do seem to be ready to give up their controlling powers to independent parties.\textsuperscript{256}

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

The Chinese regulators are suggested to promote the installation of audit committee on a function level rather than formal level before


\textsuperscript{254} See generally Guideline Opinion on the Establishment of an Independent Director System in Listed Companies; "Draft Measures on the Administration of Securities Companies, Draft for Comments" and "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies."

\textsuperscript{255} \textit{Huanghe Shijian Baodao [Reports on Yang-Tze River], ZHENGQUAN SHIBAO [SEC. TIMES]}, Jan. 14, 2000 (reporting on how powerless independent directors had become, and their decisions to quit while the chairman of the board and general manager fight over powers) (Chi-Wei Huang trans.) (translation on file with author).

\textsuperscript{256} Zhengquan Shibao, \textit{Huanghe Shijian Baodao [Reports on Yang-Tze River]}, Security Times, Jan. 14, 2000 (reporting on how powerless independent directors had become, and their decisions to quit while the chairman of the board and general manager fight over powers) translated by author.
the market participants get familiar with its mechanism. If either formal or functional changes are thwarted by path dependencies, a firm may opt for private ordering to amend its articles of incorporation to install audit commit, or to list on a domestic securities market or cross list on a foreign securities market which require the adoption of audit committee. While most of the high level executives realize the existence of audit committees will not expropriate their interests but enhance the overall company interests, they will voluntarily appreciate this system.

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

The original CCL was derived from continental legal systems’ two tier structure.\(^{257}\) It adopted an independent supervisory board, which inspects the company operations and investigates financial performance.\(^{258}\) In China, both the board of directors and supervisory board are elected by the shareholders and, the board of directors is supervised by the supervisory board.

In 1997, China imported the independent director system from Anglo-American corporate law. Under this approach, the supervisory board is, at least theoretically, in a position to fight for stakeholder interests; whereas, and the independent directors represent minority shareholders.\(^{259}\) Article 52 and Article 118 of CCL stipulate that every limited company, and every company limited by shares, shall set up a supervisory board consisting of at least three members. This supervisory board shall include shareholders’ representatives and an appropriate proportion of employees’ representatives. A supervisor shall not simultaneously act as director or high-level manager concurrently.\(^{260}\) Under the chapter for limited companies, the supervisory board bears the following powers: (1) to inspect the company’s financial status; (2) to supervise directors’ or high-level managers’ conduct in their capacity to submit recall

\(^{257}\) Corporate Governance in Europe: Report of a CEPS Working Party, 1995 CENTRE FOR EUROPEAN POLICY STUDIES 12, 17 (Belg.).

\(^{258}\) Gu, supra note 81.

\(^{259}\) CSRC’s “Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohui de Ruogan Guiding” (“Several Rules Regarding Strengthening Protection of Society Public Shareholders’ Rights”)(author’s translation). Stakeholders include any party involving with the company such as employees, debtors, customers and so on. Shareholders refer to those who hold the company shares.

\(^{260}\) Article 52 of CCL.
proposals against directors or high-level managers if there are violations of any law, any administrative regulations, the company’s articles of association or the resolutions of shareholders’ meetings; (3) to request directors or high-level managers to rectify any of their conduct that may cause prejudice to the company; (4) to propose to convene interim shareholders’ meeting, to convene and preside over shareholders’ meeting when the board of directors refuse to convene and preside over shareholders’ meeting; (5) to submit proposals to shareholders’ meetings; (6) to initiate law suits against directors and high-level managers according to Article 152 of this Law; and (7) to exercise other rights as stipulated in the said company’s articles of association. Article 55 and Article 119 of the CCL also grant supervisors the power to attend the meeting of board of directors as non-voting delegates and to hire accounting firms to assist in oversight at the company’s expense.

According to the “Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies,” strict restrictions regarding independence requirements are imposed on independent directors. This Guideline Opinion also request independent directors to fulfill certain professional qualifications such as backgrounds in law and economics. The functions of independent directors focus on overseeing a company’s financial situation, these functions overlap the responsibilities of the supervisory board.

Under the current CCL, independent directors are to supervise the behaviors of internal directors’ executive and implementational duties, and the supervisory board is to oversee both independent directors’ and internal directors’ performance. The supervisors apparently hold higher supervisory power than independent directors since they hold the power to supervise the directors themselves and they have state authorization to inspect certain company matters. However, the independence and professional qualifications requirements for independent directors, set out in the “Guideline Opinion,” are much stricter than what is required of supervisors under the CCL.

There exist sweeping criticisms of the co-existence of the
supervisory board and independent director system. Some scholars question the necessity of independent directors, suggesting instead that the supervisory function of the supervisory board ought to be strengthened. Others suggest the Chinese government should simply eliminate the supervisory board all together, thereby moving one step further from the civil law system (focus on stakeholders’ interests) toward a common law system (focus on shareholders’ interests).

No matter what Chinese regulators propose, they surely would encounter the obstacles of rent-protection and inefficiency. Resistance may come from incumbent supervisors who are not willing to give up or share their long-standing powers of the corporate system. Additionally, the uncertainty and the costs associated with restructuring the current system may well outweigh the efficiency of a new system.

Since China is in the early stage of adopting the independent director system, China should carefully monitor particular application of this system to its own corporate governance. The convergence toward a global standard should take place on a function level. Individual firms interested in transplanting the independent director system must make incumbent supervisors understand that these changes will not take negatively impact their interests, but benefit the firm’s overall performance. If the Chinese government is serious about replacing the supervisory board with independent director system, it should also consider transplanting the U.S. Public Company Accounting Oversight Board” (hereinafter “PCAOB”).

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


267. Id., at 466; Li Yu and Jun Fong, A New Thought on Resolution of China’s State Owned Enterprises and Corporate Governance Structure, Corporate Governance Structure: China’s Practice and the U.S.’ Experience, China People’s University Publisher (2000), at 159.

has created the PCAOB to oversee the effectiveness of those audit committees. The PCAOB, operating as a not for profit organization, infuses justifiable confidence into the efficacy of audit committee practices.\(^{269}\)

**C. Lack of Effective Enforcement Authority for CSRC**

Similar to the SEC in the United States, the CSRC in China oversees key participants in the securities world, including but not limited to the two stock exchanges, broker-dealers and investment advisors.\(^{270}\) The Shanghai and Shenzhen Stock Exchanges are self-regulatory bodies subordinated to the CSRC. However, in contrast to the SEC, which is a government agency charged with regulating the securities market, the CSRC does not have independent regulatory powers. According to articles 179 and 180 of PRC's Securities Law, the Securities Regulatory Organization has the duties and powers to supervise and manage the regulation of securities markets, and listed companies. Although this would make it seem that the CSRC is vested with great power, it functions under the direct supervision of the Chinese State Council. In effect this regulatory paradox makes protecting investor rights and regulating the market according to the state's macro-economic control a struggle for the CSRC. When shareholder interests conflict with that of the government's socialist market economy policy, the CSRC will inevitably pursue the state's commands. In this way, and much to shareholder disappointment, the CSRC is not able maintain its independent judgment. It is therefore an unlikely candidate for the effective investigation of misconduct. As a result, a very limited number of disciplinary actions are taken against independent directors\(^{271}\) and corporations in China.

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\(^{269}\) Cunningham, *supra* note 265, at 330; *see also* section 101(a) of the Sarbanes-Oxley Act of 2002.

\(^{270}\) See Articles 178-180 of the PRC Securities Law.

It has taken China several decades to establish two functional stock exchanges and a central securities regulatory government agency. To have the CSRC become a totally independent authority does not seem to be on the agenda in this wave of economic reform; this would be very costly, and of course, the state is hardly likely to give up its control. This aspect of the actual enforcement authority of the CSRC will certainly delay China's move toward the shareholder-oriented/dispersed ownership model.

In order to establish a healthy shareholder-oriented model to attract more investment, China needs to formally have its CSRC become totally independent of the state and to have its own enforcement without government intervention. A civil enforcement like in the U.S. corporate governance system needs to be accompanied with an independent body. In the United States, the SEC brings between 400-500 civil enforcement actions against individuals and companies that break the securities laws each year.\(^272\) Typical breaches include insider trading, accounting or financial frauds, and false or misleading information supplied about securities and the companies that issue them.\(^273\)

**D. Lack of True Independence**

Much of the literature on the topic of corporate governance agrees that independent directors are not able to protect minority shareholder interests\(^274\) effectively because independent directors are nominated by the controlling shareholders. Chinese regulators face a dilemma: if they give any shareholder the independent director nomination right without a minimum requirement of shareholdings, then a profusion of nominated candidates could give excessive power to controlling shareholders through a scattering of the votes of small shareholders; however, if they demand a minimum requirement of shareholding to the nomination right then most of the nomination rights will be held by those controlling shareholders. The CSRC initially requested a 5% minimum shareholder requirement for nominations\(^275\) rights according to Section 4 of the "Guidelines for

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273. Id.
274. See supra note 125.
275. According to Section 4 of the Guanyu Zai Shangsi Gongshi Zhidu de Zhidao Yijian (Zhengqiu Yijian Gao) [Guideline Opinion on the Establishment of an Independent Director System in Listed Companies (Draft for Comments)].
Introducing Independent Directors to the Board of Directors of Listed Companies". (Draft for Comments)]. However, it later lowered the threshold to 1% in the final version of [Guideline Opinion on the Establishment of an Independent Director System in Listed Companies]. Nevertheless, it is still difficult for minority shareholders to elect someone to represent their voices since the nomination procedure hardly protects minority shareholders’ rights. Controlling shareholders still nominate most of the candidates and minority shareholders have very few possibilities to vote for their preferred candidates, even though “the cumulative voting” is encouraged by the Corporate Governance Principles.276

Independent directors may have already disappointed people’s high expectations. It is inevitable that independent directors selected through the defective, and biased selection process could hardly play the role of an independent third party to watch and supervise the operation of a company, nor are they able to voice the minority shareholders’ concerns. They will very likely represent those who select them for the board, i.e., the controlling shareholders. To change, incumbent controlling shareholders need to be willing to give up their significant leverage. The concerns for “efficiency” and “rent protection” path dependency will certainly be significant in the adoption of a new system. While the Rules and Opinions do not have enforcement power, those firms that recognize the importance of “true independence” to amend its articles of incorporation or list on a securities market will adopt a selection system promoting true independence of independent directors.

E. Lack of Enforcement Power of Rules and Opinions

Chinese regulators have determined to institute the independent directors system in their current corporate governance model. However, as suggested by their titles – “Opinions,” “Rules,” “Guidelines,” “Measures,” etc. – it is unlikely that this profusion of instruments will be as strictly enforced as those which have been enacted into law by the State Council. This is different from the U.S. practice in which Congress signed SOX into law. Those “Rules,” “Opinions” or others are not strictly mandatory legislation, even though those public listed companies are “encouraged” but not “required” to implement it. No apparent sanctions have been

276. See supra note 232, at Art. 29.
suggested in any of the above documents for a company's failure to comply with the provisions requiring them to institute the independent director system.277

Changes in China were initiated primarily top-down, brought about by government policies. The greater scope of market-oriented transactions those government policies promoted, the more formal law was needed.278 China is in the initial stage of development of the independent director system. It is understandable that the Chinese government needs more time to observe the operation of this system. Nonetheless, China has to realize that while a high-level of certainty is provided by its government policy and bureaucratic guidance, the world demands to a higher-level of certainty, such as that which could be provided by a set of well-defined enforceable rules and regulatory institutions.279 To have the formal laws rather than rules, measures or guidelines regarding installation of independent director system enacted duly needs great determination from the Chinese central government. Maybe the government will encounter the crisis of inefficiency or rent protection for a short-term prospect. However, an accomplished formal legal system with a better supervisory system will surely bring in stable foreign investment in the long run.

F. Other Problems

i. Shortage of Qualified Independent Directors

According to section 1(3) of the Independent Director Opinion, listed companies should have at least two independent directors by June 30, 2002, and such directors should constitute at least one third of the board by June 30, 2003.280 Among those independent directors, at least one of them must specialize in accounting. Most of the Independent Directors in China are selected from the pools of either public figures such as well-known economists and governmental officials281 or academic professionals.282 A 2001 survey by the

277. Id. at note 8, §21.
279. Id.
280. According to Article 109 of Company Law, stock companies should have five to nineteen directors.
281. These people are selected for the purpose of increasing the reputation of enterprises.
282. These people are selected for the purpose of providing professional opinions
Shanghai Securities Exchange showed that only 0.3% of directors interviewed could be categorized as "independent," and other institutions claimed that only 314 eligible independent directors existed in the whole country. A 2002 survey on the number and background of 1,100 listed companies reported that 274 companies have retained total of 511 independent directors or independent director candidates. Of those, 183 independent directors are college graduates, 108 of them hold a master degree, and 142 of them hold a Ph.D. degree. Although the credentials of most nominated independent directors seem to be very strong, only one-fifth of them have accounting background. It is apparent that only very few of the independent directors fulfill the CSRC's requirements. The shortage of qualified candidates provides another reason why the same person may serve as "independent" director of several different companies. Given this reality, the quality of supervision and consultation offered by such persons, must surely decline.

VI. Conclusion

While Western capitalism is said to have its basis in the "rule of law," the developing Chinese bureaucratic capitalism, characterized as free market under central command, is based on "rule of man." Although there have been widespread arguments that the rule of law is conducive to economic growth, this assumption is challenged by China's recent prodigious economic achievements. Opponents of the theory of global convergence of corporate governance disagree that all corporate governance regimes around the globe are converging toward a single system, described above. They further
disagree on the existence of a global convergence. China may be an exception since its current economic achievements apparently do not result from the certainty brought by a clear and definite legal system, but from the centrally planned commands of an autonomous government.\textsuperscript{289}

Is China moving toward shareholder-oriented and dispersed ownership model? Yes, convincing evidence indicates that China is indeed moving toward shareholder-oriented and dispersed ownership model regardless of how its economic developments have occurred in the past couple of decades. The establishment of the 1994 CCL indicated China’s determination to embrace a shareholder-oriented model. The 2006 CCL amendment and the installation of legal institutions regarding independent directors affirmed that China had already started its transition to a shareholder-oriented model of corporate governance and a dispersed-ownership system. Although market participants and government regulators are still struggling with efficiency or rent protection path dependencies and other problems, there are strong indicia that China is indeed moving toward a shareholder-oriented model/dispersed-ownership corporate governance structure. Despite this progress, China’s “rule of man” path-developing process has made path dependency problems much harder to overcome than other “rule of law” countries. “Chinese bureaucratic capitalism” has been using “clientelism” and “corporatism” as available options or partial substitutes for “rule of law.”\textsuperscript{290}

“Clientelism” refers to a close-knitted society in which personal and social networks (also known as \textit{guanxi} in Chinese) are highly regarded. Horizontal clientelism consists of relationships among equal interest groups. Vertical clientelism, to some extent, advocates a relationship between superiors and subordinates such as government agencies and private entities.\textsuperscript{291} This phenomenon has gradually deepened the ultimate influence of the persons in power and further strengthened the power of “rent-protection” path dependency.

Corporatism has been asserted as a middle ground between Liberalism and Marxism.\textsuperscript{292} Liberalism promotes a state of weak

\begin{itemize}
\item \textsuperscript{289} Shanghai Stock Exchange Brief Introduction, \textit{supra} note 198.
\item \textsuperscript{290} See \textsc{Peerenboom}, \textit{supra} note 287, at 466.
\item \textsuperscript{291} \textit{Id.} at 470.
\item \textsuperscript{292} Howard J. Wiarda, \textit{Corporatism and Comparative Politics: The Other Great}
government authority with strong self-regulatory private interest groups; whereas Marxism advocates a state of totalitarian or at least authoritarian with weak self-regulatory private interest groups. Corporatism is characterized by a strong central government authority with some private interest groups existing and enjoying a certain degree of autonomy.\textsuperscript{293} With a tradition of being a centralized, authoritarian country, the People’s Republic of China survives by maintaining an accomplished hierarchical system, which can also be traced to the influence of Confucianism.\textsuperscript{294} This single value system has made the efficiency-driven path dependency even harder to overcome.

In China, “business is subordinate to and depends heavily on ties with the techno-bureaucracy to accomplish its (overall) goal”.\textsuperscript{295} The strong ties of clientelism and corporatism produce an active and highly concentrated ownership structure in the newly developed shareholding system. The majority of the ownership in Chinese stock markets has traditionally been controlled by the State. Businessmen have to network, socially and professionally, in a highly concentrated ownership structure to enhance their business profits. The domestic market, which for a long time was dominated by government’s discretionary black-box manipulation dealings and close-knit social network, has been challenged as China has opened their door to attract more foreign investment.\textsuperscript{296} China has tried to corporatize SOEs to reduce the power-abusing opportunities of government officials,\textsuperscript{297} has stipulated numerous rules and regulations to standardize the corporatization of their SOEs, has amended their national company law, and has set up an independent director system in order to protect minority shareholders’ rights. Nevertheless, the obstacles caused by path dependency hinder their convergence toward the worldwide corporate governance standard.

Although the Chinese government has encountered significant

\textsuperscript{293} See supra note 55, at 470.
\textsuperscript{294} CHEN JINGPAN, CONFUCIUS AS A TEACHER: PHILOSOPHY OF CONFUCIUS WITH SPECIAL REFERENCE TO ITS EDUCATIONAL IMPLICATIONS 266–271 (Foreign Languages Press 1st ed. 1990).
\textsuperscript{297} JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS, 58 (2003).
path dependencies while transplanting various business laws and regulations, it firmly believes “rule of law” is the ground for economic growth.\textsuperscript{298} It also believes that accountability will enable China to pursue economic development without democracy.\textsuperscript{299} For China, a legal structure is a substitute of democracy.\textsuperscript{300} However, the Chinese government holds a monopoly over law-making initiatives. The government has generated relatively clear and defined formal rules (constitutions, laws and rules) and informal constraints (norms, conventions and codes of conduct). However, an effective enforcement mechanism is needed in addition to rules and codes in order to ensure an effective legal system in practice not merely in theory.\textsuperscript{301} Reduction of the influence of path dependency in a “rule of man” market is China’s toughest task.

If we apply the theory discussed in Part I to the current situation in China, the government first must address and resolve the current problems at a functional level rather than a formal, legalistic level. Instead of “whole-set” transplantation of legal protections for minority shareholders from Western corporate governance model, the Chinese government or individual private firms may evolve a synonymous functional mechanism around its existing institutions at this early transformation stage. While the Chinese regulators formally enacted a company law which included some protective measures for minority shareholders, the legal measures with respect to independent directors are merely informally installed as guidelines, rules or measures rather than formally and functionally implemented. The Chinese government should strengthen the concept of independence of independent director so as to instill the concept of separation of supervision from management into the minds of market participants. The Chinese people need to be actively trained in effective corporate governance to counter the tradition of government by a collective value system, whether in the form of one big family in ancient time, or by the State in the present day.

One the other hand, regulators must assure the controlling group that: (1) the independent director system will increase their wealth,

\textsuperscript{298} Peerenboom, supra note 55, at 450.
\textsuperscript{299} Jacques deLisle, Chasing the God of Wealth While Evading the Goddess of Democracy: Development, Democracy, and Law in Reform-Era China, in DEVELOPMENT AND DEMOCRACY: NEW PERSPECTIVES ON AN OLD DEBATE, 252, 253 (Sunder Ramaswamy & Jeffrey W. Cason eds., 2003).
\textsuperscript{300} Id.
\textsuperscript{301} North, supra note 59, at A14.
and the increase will be greater than the loss of their private benefit of control; and (2) their private rights will not be expropriated after the installation of developed corporate governance system. To move toward shareholder-oriented/dispersed-ownership model and strengthen the practice of independent director system, China needs to gradually change to a softer, societal version of corporatism,\textsuperscript{302} which will allow private interest groups more self-regulation under a clear rule of law structure.

\textsuperscript{302} See supra note 55.