

ARTICLES

MINORITY PUBLIC SHAREHOLDERS IN CHINA'S CONCENTRATED CAPITAL MARKETS – A NEW PARADIGM?

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This article provides a detailed analysis of the role of public shareholders in firm monitoring and corporate governance in one of the world's most concentrated ownership environments—China's controlled capital markets. It moves beyond the existing literature to explore in a comparative fashion innovative and sometimes idiosyncratic ways by which public shareholders can be involved in firm monitoring and corporate governance. In so doing, this article sheds new light on the global shift in the role of public shareholders towards greater empowerment and governance participation. Contributing to comparative corporate governance literature, this article offers a new analysis of current and prospective developments in the Chinese market, which is of particular importance globally as this market becomes increasingly central to the world economy.

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INTRODUCTION

As a result of the Anglo-American focus on the separation between ownership and control at widely-held firms,¹ and the broad influence of this particular focus on corporate governance systems around the world, it is traditionally understood that most corporate governance design disempowers minority public shareholders. Indeed, the role of minority public shareholders in the corporate project is traditionally limited to that of mere suppliers of finance capital. In the last two decades, however, a new account describing "shareholder activism" has emerged with respect to widely-held Anglo-American-style markets, a narrative which focuses on the possibilities for empowerment of minority public shareholders.² The possibilities for such empowerment attend to their greater involvement in the firm and the capital market and can be divided into three main paths: (i) greater involvement in the monitoring of corporate insiders (whether through internal or external mechanisms); (ii) improved access to and the utilization of legal protections and remedies

¹ Frank Easterbrook & D. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983) (citing Adolf A. BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 129 (rev. ed., 1967)); *Ownership Matters*, THE ECONOMIST (Mar. 9, 2006), <http://www.economist.com/node/3603458> (describing the separation of ownership and control as "corporate capitalism" and as the underpinning of capitalism U.S.-style).

² The scholarship here is vast; see, e.g., the writings of Professor Bebchuk, especially, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1 (2008); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (depicting (traditional) institutional investors as promising activists); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1062, 1047-70 (2007) (explaining the disillusion from the traditional institutional investors' activism, yet reflecting similar hopes regarding hedge funds, as the new promising activists).

against oppression; and (iii) increased participation in the governance of the firm. In this article I focus mainly on the first and third paths,³ since the need to protect minority public shareholders through legal rights and remedies is not in contention even by those who advocate for their limited and passive role.⁴ The widely-accepted rationale for this new empowerment is economic,⁵ positing that increasing shareholder monitoring powers and governance participation will reduce agency costs, improve firm performance and shareholder value, and make capital allocation more efficient, thereby encouraging investment and the development of capital markets. As a result, many now consider minority public shareholders' involvement in monitoring and corporate governance a critical element in vibrant and efficient capital markets.

This same view is also increasingly established even in markets characterized by concentrated ownership—the typical ownership structure around the world⁶—where the existence of controlling or dominant shareholders and the absence of an active market for corporate control have traditionally thought to render minority public shareholder involvement less effective. Even in concentrated markets, it is increasingly recognized that minority public shareholders can, and sometimes should, become more influential corporate players.⁷ Thus,

³ That is, (i) greater involvement of minority public shareholders in the monitoring of corporate insiders and (iii) their increased participation in the governance of firms. Of course, the division suggested here is somewhat artificial as the paths are not completely separable. The second path—legal protections, for example, often merge with the third path—participation rights in the governance of firms, such as in the case of super majority votes or negative veto provisions.

⁴ Even scholars who hold the view that shareholders do not enjoy vested proprietary rights justify the protections of public shareholders as economically desirable. See Easterbrook & Fischel, *supra* note 1, at 403 (emphasizing the status of shareholders as the residual claimants and risk bearers); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (suggesting causality between protections of shareholders legal rights and the availability and cost of external finance).

⁵ Some studies provide empirical evidence to support a positive correlation between shareholder activism and firm performance. See Jonathan M. Karpoff, *The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings*, 44 *tbl.3* (Aug. 18, 2001) (unpublished manuscript), <http://ssrn.com/abstract=885365>. But there are many studies to the contrary. See, e.g., Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 177 n.8, 187–219 (reviewing studies that show no empirical evidence in support of the claim that activism improves long term performance).

⁶ Throughout this article, I use the terms “concentrated markets” and “controlled markets” interchangeably, referring to the market level in which the ownership of most public corporations is concentrated at the hands of (a) dominant or controlling shareholder(s). An individual corporation may have relatively concentrated ownership while operating in a widely dispersed market, and vice versa.

⁷ Indeed, even the European Union council, whose ownership structure of its member states feature concentrated ownership (but for the exception of the UK), saw an urgent need to empower shareholders by encouraging their participation through voting. See, e.g., Council Directive 2007/36, 2007 O.J. (L184/07) (EC) (more particularly, seeking to encourage cross-border shareholder participation); see also Dirk Zetzsche, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 J. CORP. L. STUD. 289 (2008) (suggesting ways to further mandate an effective regime for increased cross-

minority public shareholders in legal systems around the world are gradually empowered by mechanisms that substitute the powers of a market for corporate control. These substitute mechanisms are implemented primarily through enhanced minority shareholder participation rights⁸ and legal protection devices,⁹ which are embedded in corporate law and securities regulations or established through other institutional development in given markets.

This article focuses specifically on what is considered to be the plight of minority public shareholders in firms established and operating in the People's Republic of China ("PRC" or "China")—a highly concentrated and largely state-controlled capital market, where few would envision any minority shareholder empowerment whatsoever. This article looks at two questions with respect to the now globally-significant Chinese capital markets and the Chinese firms that access them: first, whether the above-described shift in the role and powers of minority public shareholders occurring world-wide, even in concentrated markets, is also evident in the PRC circumstance, normatively and in reality? Second, if the answer to the first question is "no", and yet such a change is considered desirable, then if and how will the same shift eventually take place under specifically Chinese circumstances?

Being perhaps the most concentrated and state-controlled market in the world, contemporary China presents a unique context for any consideration of minority public shareholder monitoring and governance participation. A decades-long process of "corporatization without privatization" in China, and the rise of what some have termed "state capitalism", have resulted in the Chinese Party-state's *de jure* and *de facto* control over the PRC's (and increasingly the world's) most significant listed firms.¹⁰ The ownership structure of Chinese firms and the control over the PRC capital markets have together created the basis for open oppression of minority public shareholders, and an environment where there is no market for corporate control, and thus no apparent possibility for real shareholder monitoring of insiders or controlling

border shareholder participation among European member states). Nevertheless, the skeptical approach concerning the effectiveness and desirability of minority public shareholders' involvement is of course even more relevant with regard to concentrated markets due to the existence of a controlling or a dominant shareholder.

⁸ Such as negative veto rights, super majority requirements, or mandatory participation of minority public shareholders in the approval of certain business decisions; various forms of minority public shareholder involvement in the process of directors' elections; their right to submit governance proposals to the board, etc. See, e.g., OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS 30-37 (2012), <http://www.oecd.org/daf/ca/50089215.pdf> (listing countries that have adopted provisions of minority negative veto rights).

⁹ Here I mainly refer to *ex-post* rights protecting devices such as group litigation, individual standing rights, and remedies against procedural violations which infringe upon shareholders' participation rights; as well as to other institutional substitutes discussed in this article (e.g., involvement by social organizations) that serve to implement minority public shareholders' rights and thus empower them towards greater involvement.

¹⁰ See Part I.A, *infra*.

shareholders. Moreover, it is commonly understood that the same structures and the legal environment within which they are situated likewise hinder conventional forms of minority public shareholder participation in corporate governance. In response to these easy presumptions about the Chinese markets and legal environment, in this article I seek to analyze alternative channels for minority public shareholder monitoring and corporate governance participation—both in existence and potential.

The existing literature on corporate governance in China tends to focus on the protections, or lack thereof, granted to minority public shareholders in PRC listed firms. In contrast, this article offers an analysis of minority public shareholder involvement in the monitoring and governance of Chinese listed firms. Moreover, this article is one of the first to analyze current and prospective changes in the ownership structures of Chinese listed firms, which can operate to empower minority public shareholders in the future. Finally, while existing analyses of the Chinese legal system commonly use the Anglo-American legal system as their comparative *modus operandi*, this article uses developments in non-Anglo-American, and thus far more concentrated, capital markets as the basis for its approach. In my view, a comparative analysis of market and legal systems between markets that share similar ownership structures is the more suitable and enlightening comparative approach, especially when analysts seek to identify more applicable legal policy and market reforms which are more likely to be realized.

I proceed as follows: Part I describes the prevailing concentrated ownership situation for most Chinese listed firms, focusing on the Chinese Party-state's control of most significant industrial and service enterprises. I examine the consequences of such control for minority public shareholders in PRC listed firms, and the implicated legal and regulatory responses. Part II analyzes mechanisms that can contribute to greater minority public shareholder involvement in firm monitoring and participation in the corporate governance of China's listed firms. First, I look at mechanisms that have emerged in other concentrated markets, and analyze if they can fit in the Chinese circumstances. Then, I explore China-specific prospects for a shift in the power and involvement of minority public shareholders in PRC listed firms. Here, I point to certain concrete developments in the PRC capital markets and the nature of Party-state control, which I expect to broaden and which may eventually lead to greater involvement of minority public shareholders even as China preserves its own model of "state capitalism". I identify two possible routes: a direct push by a CCP-led Party-state, motivated by China's unique political economy considerations; and, changes in the structure of Party-state control, entailing the development of a narrow market for corporate control.

The possibilities raised in this article for the future empowerment of minority public shareholders in China have global implications especially

as China's capital markets, as well as Chinese listed firms raising money on global capital markets, become increasingly central to investors world-wide. Furthermore, the analysis here provides an example of minority public shareholders' empowerment under extreme circumstances of ownership concentration and market control, which also have several important comparative (practical and theoretical) implications. First, the analysis reflects the need for concentrated markets, especially those in transitional or developmental states, to consider more mandatory and interventionist approaches towards the involvement of minority public shareholders in firm monitoring and governance. Second, it reflects that policy makers in concentrated markets may empower minority public shareholders for reasons outside those commonly offered by the shareholder democracy and market for corporate control discourses. For instance, increasing international competitiveness and the need for an appearance of modern capital markets, as well as the necessity to maintain internal political legitimacy, all serve in the process of empowering minority public shareholders in China. Third, and most importantly, while it is normally understood that control parties operate primarily to entrench their controlling position and thus hinder corporate minority-friendly legal reform, the Chinese example suggests that even corporate control parties themselves (here, Party-state controlling shareholders) may sometimes operate to diminish their own powers in the service of other goals (for example here, capital market growth, firm level international competitiveness, and unique political economy power struggles). In so doing, this article not only contributes to the existing literature on the development of China's corporate governance and capital markets—it also offers new contributions to the general corporate governance discourse and specifically to comparative inquiries about the shifting role of minority public shareholders world-wide.

I. MINORITY PUBLIC SHAREHOLDERS AND CHINA'S CONCENTRATED MARKET

The position of minority public shareholders in PRC listed firms operating under China's "state capitalism" is likely more problematic than similarly-placed shareholders in a paradigmatic concentrated capital market. China's corporate landscape does not only feature prevalent concentrated ownership, but in addition such concentrated ownership is in the hands of instruments of the PRC Party-state. In this Part, I first outline the dominant ownership structure evidenced in the Chinese capital markets and the implications for shareholder rights and empowerment arising from those structures. Then, I examine the existing allowances for minority public shareholders' monitoring and governance participation with respect to such Chinese companies.

A. *A Concentrated Capital Market with “Chinese Characteristics”—
Corporatization without Privatization and “State Capitalism”*

The great majority of listed Chinese companies have highly-concentrated ownership.¹¹ But simply describing the Chinese market as one with “concentrated ownership” does not tell the whole story. Most of China’s public companies are controlled and operated by various organs of the PRC Party-state,¹² the result of China’s three decades-long project of “corporatization without privatization.”

While many state-owned economies have gone through privatization as part of their economic and political transition,¹³ the PRC opted instead to restructure its traditional state-owned enterprises (SOEs) and develop a new capital market to finance such entities, while at the same time preserve ultimate Party-state control over the vast majority of its enterprises. Some economists have perhaps optimistically called this “gradual privatization,” as if an end result of complete privatization is inevitable.¹⁴ Most expert observers of China, however, agree that full privatization is not the end goal of the Chinese Party-state under any Chinese Communist Party (CCP)-led regime.¹⁵ Hence, while over several decades there has been some reduction in the state’s direct equity holdings in PRC firms, coupled with varying spurts of growth in small to medium enterprises often called “private”, these reductions in formal equity shares in the hands of the PRC Party-state do not amount to even a gradual reduction in control over the Party-state-operated assets.¹⁶

An important goal of the SOE corporatization process undertaken in the PRC in the late 1980s and early 1990s was the effort to raise equity

¹¹ For instance, during 2012, the largest shareholder in Chinese listed firms owned, on average, over one-third of the firm, and often more than 40% in state-controlled enterprises. Moreover, 57.28% of A shares in Chinese listed firms were held by “legal person” companies, which include primarily state enterprises (this is without considering state ownership through institutional investors and the National Social Securities Fund). Fuxiu Jiang & Kenneth Kim, *Corporate Governance in China: A Modern Perspective*, 32 J. CORP. FIN. 190, 192, 196 (2015).

¹² *Id.*

¹³ CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS (Masahiko Aoki & Hyung-Ki Kim eds., 1995) [hereinafter CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES].

¹⁴ Gérard Roland, *Political Economy Issues of Ownership Transformation in Eastern Europe*, in CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES, *supra* note 13, at 31, 47–49.

¹⁵ The term “Party-state” throughout refers to a one-party system in which one political party ultimately directs both the political process and the governance of the state.

¹⁶ Evidence for this view may be drawn from the PRC State Council and the CCP Central Committee’s recent guiding opinion. Zhonggong Zhongyang, Guowuyuan Guanyu Shenhua Guoyou Qiyue Gaige de Zhidao Yijian (中共中央、国务院关于深化国有企业改革的指导意见) [CPC Central Committee and State Council Opinion on Deepening the Guidance of State-Owned Enterprise Reform] (Aug. 24, 2015), http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm (emphasizing state ownership as the pillar of the Chinese economy and calling for greater party involvement and *not* greater privatization, as might be inferred from the title).

investment for SOEs from both Chinese and foreign investors in order to fund their operation.¹⁷ This required the transformation of China's SOEs from administrative entities that provided for all aspects of economic and social welfare (employment, health, education, retirement, etc.) into "modern" corporate establishments.¹⁸ The so-called "modern enterprise" was understood to be a better form for the (economically) efficient management of productive state assets, and the only enterprise form suitable for capital-raising.¹⁹ Notably, full privatization was never a goal, or even the means, for the policy-driven transformation of SOEs into modern enterprises. Thus, through the SOE corporatization process, non-production social functions were stripped out of the traditional SOE, and the core productive assets and human capital were assigned either to: (1) central and local-level state bodies (e.g., central, provincial, and municipal government organs with jurisdiction over a particular industrial sector or region) reorganized as corporate legal persons or holding entities with subsidiary holdings or (2) other existing PRC enterprises with "legal person" status, often companies or groups also controlled by non-central government bodies.²⁰ Later, many of the largest central and local government-controlled and now corporatized SOEs had their controlling equity assigned to what became the State-Owned Asset Supervision and Administration Commission (SASAC). SASAC is the central state asset management agency established in 2003 to act on behalf of the PRC state (or in the PRC idiom "all the people" (*quanmin*)) as the ultimate principal.²¹ These corporatized SOEs were the PRC firms

¹⁷ See generally STEPHEN GREEN, CHINA'S STOCKMARKET: A GUIDE TO ITS PROGRESS, PLAYERS, AND PROSPECTS 9-46 (2003).

¹⁸ The corporatization initiative distinguished between two main forms of organization, both of which entitle shareholders to limited liability: (a) A Limited Liability Company ("LLC") intended for a small and more closely held group of investors, similar to the close corporation form in the United States; and (b) A Joint Stock Limited Company, also known as "companies limited by shares" ("CLSs"), which may be a listed company or an unlisted company, although the assumption is that a company will be established as such with the intention to list in the future. See Gongsifa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1993), arts. 3, 9, 19, 20 (LLC form); arts. 3, 73, 74 (CLS form). The 1993 Company Law was revised wholesale in October 2005, and limited amendments were introduced in 2013. See Gongsifa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong. Oct. 27, 2005, effective Jan. 1, 2006, as amended, Dec. 28, 2013) [hereinafter *China Company Law* or *2006 Company Law*], available at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html. Unless noted otherwise, all references henceforth refer to the 2006 Company Law, as amended.

With respect to these modern, now legally established, forms of organizations, the article only addresses shareholders in public companies, meaning, shareholders in CLSs whose shares are listed for trade.

¹⁹ See Donald C. Clarke, *Corporate Governance in China: An Overview*, 14 CHINA ECON. REV. 494, 496-97 (2003).

²⁰ Harry G. Broadman, *The Business(es) of the Chinese State*, 24 World Economy 849, 861-64 (2001). For an extensive analysis of Chinese listed firms' group formation see, e.g., Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697 (2013).

²¹ Lin and Milhaupt, *supra* note 20, at 716, 734-36.

which, starting in the early 1990s, accessed domestic and global capital markets, even while an absolute control portion of the new corporation's shares continued to be held by the state or state proxies?²² The Chinese corporatization without privatization process therefore enabled the PRC Party-state to raise much needed capital, while increasing the pool of assets under its control?²³ Furthermore, until 2005, shares held directly or indirectly by the state were legally prohibited from being traded.²⁴ Thus, enterprises under Party-state control were able to raise extremely passive and/or disempowered capital, without any diminution of the Party-state's total governance authority over the state assets now formally owned by modern corporate entities.²⁵

Even after further legal and market developments in the decades that followed, such as the 2005 "split share structure reform" (which permitted the trading of formerly untradeable state shares),²⁶ and a more recent wave of M&A activity (framed by some scholars as part of a privatization process),²⁷ ultimate Party-state control remained and is still prevalent. Now such control is increasingly maintained through groups of holding companies at the top of traditional pyramid structures and extending down to listed companies with a public float.²⁸

As the dominant shareholders, and beyond direct ownership, Party-state institutions retain the ability to appoint group and subsidiary company management, and most often place Party members (advancing through a parallel Party *nomenklatura* system) as directors, supervisory

²² See Yingyi Qian, *Reforming Corporate Governance and Finance in China*, in CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES, *supra* note 13, at 215, 217.

²³ See Clarke, *supra* note 19, at 496–97.

²⁴ This changed only during the "split-share structure reform" starting in May 2005. Wenxuan Hou & Edward Lee, *Split Share Structure Reform, Corporate Governance, and the Foreign Share Discount Puzzle in China*, 20 EURO. J. OF FIN. 703, 709–710 (2014).

²⁵ Nicholas C. Howson, *Protecting the State from Itself?: Regulatory Interventions in Corporate Governance and the Financing of China's 'State Capitalism'*, in REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM 49, 52, 67 (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2015); Joseph P.H. Fan et al., *The Emergence of Corporate Pyramids in China* (Feb. 2005) (unpublished manuscript), <http://ssrn.com/abstract=686582>. More generally on the corporatization period, see Fang Liufang, *China's Corporatization Experiment*, 5 DUKE J. COMP. & INT'L L. 149, 224–28 (1994).

²⁶ Michael Firth et al., *Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 685 (2010).

²⁷ GREGORY C. CHOW, CHINA'S ECONOMIC TRANSFORMATION 83–86, 268–280 (2d ed. 2007) (on the growth of the non-state sector); GOING PRIVATE IN CHINA: THE POLITICS OF CORPORATE RESTRUCTURING AND SYSTEM REFORM IN THE PRC (Jean C. Oi ed., 2011); NICHOLAS R. LARDY, MARKETS OVER MAO: THE RISE OF PRIVATE BUSINESS IN CHINA 45–46, 59–123 (2014).

²⁸ For pyramid structures in China, see Guy S. Liu & Pei Sun, *The Class of Shareholdings and Its Impacts on Corporate Performance: A Case of State Shareholding Composition in Chinese Public Corporations*, 13 CORP. GOVERNANCE: INT'L REV. 46, 48 (2005) (finding ultimate government control in 81.6 percent of all public companies by the end of 2001). For more recent data, see Jiang & Kim, *supra* note 11.

board members, and senior executives. Those appointees in turn have full reign to manage business groups and individual firms in accordance with state and Party policy, separately from what might be in the best interests of the specific firm or its other shareholders.²⁹

An additional channel for Party-state control over listed firms and the capital market is achieved via its central position in other areas affecting the broader political economy of China, particularly the financial sector and labor markets. This broad involvement by the PRC Party-state has been described as China's model of "state capitalism."³⁰ In this article, I use this term to describe a system in which the Chinese Party-state directly or indirectly functions as the controlling shareholder of most significant PRC industrial groups and their domestic and globally-listed companies, as well as of the commercial and policy banks and financial industry firms, and at the same time acts as the market's regulator and enforcement institution.³¹

This multi-channel control can be exercised at both the firm and general market levels to the detriment of minority shareholders in specific firms, whenever any conflicts between the interests of the Party-state—economic, social, or political—and an individual firm (and its minority public shareholders) arise. Sometimes, of course, that Party-state interest can be benign—and so the PRC can use Chinese firms (or the groups within which they are embedded) to advance important social and political goals, even when those goals conflict directly with the interest of the firm as a whole or of the minority shareholders in the firm. For example, the PRC may wish to use firms to advance certain fiscal or production policies, lower unemployment, or address other social stability concerns, all before the more limited interests of firm efficiency or profitability (value to shareholders). At the same time, these structures can create opportunities for Party-state appointees to extract the private benefits of control seen across the world by unmonitored insiders, whereby they use their position to engage in tunneling, self-dealing, or the outright theft of corporate assets, to benefit themselves and their affiliates at the expense of minority shareholders and the firm.³²

²⁹ See Firth et al., *supra* note 26 (introducing how managers of firms were pressured politically to rush the implementation of a reform scheme, even when not in the best interests of their unit holders); Nancy Huyghebaert & Lihong Wang, *Expropriation of Minority Investors in Chinese Listed Firms: The Role of Internal and External Corporate Governance Mechanisms*, 20 CORP. GOVERNANCE: INT'L REV. 308, 311, 328 (2012) (measuring the costs of political control over directors—through labor redundancy—following approvals of related party transactions that serve the state's public interests).

³⁰ See, Lin & Milhaupt, *supra* 20, at 700 n.9.

³¹ Commentators have taken different views as to China's Party-state involvement in the economy. Some have argued against the characterization of the Chinese economy as "state-capitalism." See, e.g., LARDY, *MARKETS OVER MAO*, *supra* note 27 (considering the rapidly growing private business sector as a major driver of economic growth and employment in China today).

³² For general implications of corporate pyramid structure and ownership concentration, see Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual*

In addition to the potential exploitation of minority shareholders by the Party-state *qua* controlling shareholder or by its appointees, the incentives for minority exploitation are further exacerbated by the lack of an ultimate principal at the top of state-controlled pyramids. This is an aggravated version of the well-known "who monitors the monitor?" problem.³³ Because there is no ultimate principal who will benefit from the increased value that effective monitoring might generate, there is no specific controlling owner who would otherwise be incentivized to incur the costs of monitoring firm insiders.³⁴ Thus, even when the interests of the Party-state, in its capacity as a given firm's controlling shareholder, aligns with those of the minority shareholders, the lack of any ultimate human principal deprives the firm of any truly interested monitor, or at the most creates relative apathy among otherwise potential monitors.

B. Monitoring of Insiders and the Protection of Minority Shareholders in China

For corporate governance advocates, the PRC stands as one of the most challenging environments because it is among the world's most concentrated markets and yet is so central to the global economy. As in many other markets evidencing similar concentration, there is currently almost no hostile takeover activity and thus no market for corporate control in China. This means that the primary external monitoring mechanism celebrated with respect to Anglo-American-style capital markets is entirely absent in China. As noted above, in China the situation is even more aggravated because of the absent principal problem, which results in a pronounced lack of internal monitoring mechanisms as well. And so, at least one result of the "corporatization without privatization" program in China has been an open and unrestrained invitation to unmonitored insider opportunism and minority shareholder oppression,³⁵ in a transitional legal system which offers minority shareholders little in the way of protections much less remedies. Given the above, most analysts will then further assume that there is no policy or legal basis for minority shareholder participation in firms operating in the PRC.

Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights, in CONCENTRATED CORPORATE OWNERSHIP 295, 295 (Randall K. Morck ed., 2000). Specifically, for tunneling in the Chinese market, see Huyghebaert & Wang, *supra* note 29.

³³ See, e.g., Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 835-36 (1981) (discussing this question as part of the costs of the separation between ownership and control).

³⁴ Clarke, *supra* note 19, at 499: ("however, no matter how far up the chain of monitors we go, we never run into an ultimate principle... As a result, effective monitoring cannot take place because there is nobody in the chain of monitors with the appropriate incentives; nobody is entitled to the increase in asset value that effective monitoring would bring about.").

³⁵ Howson, *supra* note 25, at 53.

Notwithstanding the above and contrary to most common understandings of the Chinese situation, there is evidence of alternative mechanisms in the highly-concentrated Chinese capital markets that may act as partial substitutes for conventional internal corporate governance mechanisms and for a robust market for corporate control.³⁶ I canvas some of these mechanisms immediately below, and then consider whether they do indeed enable the monitoring of corporate insiders and some level of protection for minority public shareholders against exploitation—thus resulting in the empowerment of minority public shareholders in China.

1. Monitoring³⁷

In my view, the absence of common external monitoring mechanisms and the weakness of conventional internal monitoring mechanisms are in some ways compensated for by two mechanisms in China: the Party-state's (really the Party's) monitoring of control parties and corporate insiders directly and through the Party's personnel management system; and relatedly, how the capital markets themselves—even in the absence of a market for corporate control—impact upon the advancement of human agents inside the Party personnel system.

These somewhat *sui generis* monitoring mechanisms derive from the PRC's unique Party-state governance model. That structure embraces a unified (single) Party-state with Party governance institutions shadowing formal state structures, and a devolution of power from the center to local actors at various levels.³⁸ More than a decade ago, Professor Clarke lamented the absent principal problem outlined above, due to which state organs as dominant shareholders of publicly listed

³⁶ See, e.g., Nicholas C. Howson, "Quack Corporate Governance" As Traditional Chinese Medicine: The Securities Regulation Cannibalization of China's Corporate Law and a State Regulator's Battle Against Party State Political Economic Power, 37 SEATTLE U.L. REV. 667, 698, 701-07 (2014) (focusing on the role of the Chinese securities regulator).

³⁷ The main concern of this article is the shifting role of minority public shareholders as corporate governance players in China. Therefore, I only discuss specific monitoring mechanisms which directly involve shareholders, including monitoring of insiders by control parties and the traditional function of capital markets monitoring. Additional common external and internal monitoring mechanisms, however, are also known to be weak, or absent, in China. Specifically, listed firms in China, and even more so state-controlled firms, have little fear of bankruptcy. It is assumed that central and local governments, which rely on listed firms for social stability purposes (mainly through employment), will aid them before bankruptcy. Additionally, creditors tend not to monitor and banks continue lending to failing State-controlled firms. See, Jiang & Kim, *supra* note 11. For a comprehensive review of alternative institutions of corporate governance in China, outside of shareholders' involvement specifically, see Donald C. Clarke, *The Role of Non-Legal Institutions in Chinese Corporate Governance*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 168 (Hideki Kanda et al. eds., 2008).

³⁸ See generally KENNETH LIEBERTHAL & MICHEL OKSENBURG, POLICY MAKING IN CHINA: LEADERS, STRUCTURES, AND PROCESSES 135-168 (1990) (describing the hierarchical horizontal (territorial) and vertical (from central level down to localities) levels of authority within the Chinese government).

corporations in China seem “to either abuse their control or to fail to exercise it entirely.”³⁹ I assert, however, that where the controlling state shareholder fails to monitor the insiders in individual firms, the Chinese Communist Party and its institutions step in. The Communist Party and its human agents have various discrete incentives to actively monitor the activities of both formal state owners and the managers appointed by them, especially when formal state ownership and control is vested at non-central state levels. The central Chinese Communist Party has every incentive to restrain the accumulation of economic and political power at the local level, notwithstanding more than three decades of devolution in (the state’s) administrative authority in the service of economic development. Indeed, through the national Party personnel management system it has a ready tool to govern the career advancement path of local level Party (and state) officials who control or manage locally-promoted firms.⁴⁰ This Party system—far more unified and centralized than the formal state system which it stands behind—sets the criteria for personnel promotion through the Party hierarchy. Notably, economic development and firm performance are major evaluation criteria under this system. Said another way, the economic performance of state-controlled corporations—with performance measured by revenue growth, total profits, operating profits, investments in technological innovation, environmental protection, legal disputes, etc.—is an important factor in the Party’s evaluation of agents who are tasked with managing, and of officials tasked with monitoring such enterprises. This constitutes both a monitoring mechanism and an incentive for such officials to produce good results at corporatized SOEs.⁴¹

A recent example of how this works, and the connection between the CCP’s personnel management system advancement and corporate malfeasance, can be seen in the inspection of corruption and waste conducted by the Party’s internal disciplinary body—the Central Commission for Disciplinary Inspection (CCDI) at Sinopec Group, one of

³⁹ Clarke, *supra* note 37, at 185.

⁴⁰ Chih-shian Liou & Chung-min Tsai, *Between Hierarchy and the Market: Managerial Career Trajectories in China’s Energy Sector*, in CHOOSING CHINA’S LEADERS 124 (Chien-wen Kou & Xiaowei Zang eds., 2013).

⁴¹ See Zhongyang Qiye Fuzeren Xinchou Guanli Zanzing Banfa (中央企业负责人薪酬管理暂行办法) [Interim Measures for Remuneration Management for Central State-Owned Enterprise Executives] (adopted by the State-Owned Assets Supervision and Admin. Comm’n of the State Council, May 13, 2003, effective May 13, 2003), <http://en.sasac.gov.cn/n1408035/c1477199/content.html>; Zhongyang Qiye Fuzeren Jingying Yeji Kaohe zhanxin Banfa (中央企业负责人经营考核暂行办法) [Interim procedures on the Evaluation of the Financial Performance of Central SOE leaders] (promulgated by the State-Owned Assets Supervision and Administration Commission of the State Council, Dec. 28 2009, effective Jan. 1, 2010), http://www.gov.cn/flfg/2010-01/22/content_1517096.htm; Yubo Li et al., *A Survey of Executive Compensation Contracts in China’s Listed Companies*, 6 CHINA J. ACCT. RES. 211 (2013) (examining executive compensation contracts in Chinese listed firms, including a description of evaluation measures for executive performance in government-controlled listed firms).

the PRC's centrally-controlled energy conglomerates whose main subsidiary Sinopec Corp Ltd. is publicly traded on the China, Hong Kong, New York and London stock exchanges. Following the inspection, the president of Sinopec Group, Wang Tianpu, who was at the time also the general manager of its listed subsidiary, was accused of taking bribes and abuse of power and was put under further Party disciplinary proceedings. Wang was removed from his corporate positions, prosecuted under the criminal law, and expelled from the Communist Party.⁴² This is one recent example of the ways in which a highly "politicized" corporate governance system creates an alternative mechanism for monitoring corporate insider's conduct⁴³ and holding them accountable, thus creating deterrence.⁴⁴

The above-described mechanisms also have implications for the monitoring function of the capital markets (through public share prices), even with the absence of a functioning market for corporate control. While studies and recent market volatility have shown that the Chinese capital markets are not informationally or fundamentally efficient,⁴⁵ and thus share price movements are not strictly determined by an issuer's market performance, the public share price of a corporatized SOE will be taken into account for the Chinese Communist Party's personnel system evaluations. A drop in the share price of a PRC issuer, whether or not

⁴² Zhongyang Zhongguo Shihua Dangzu Guanyu Xunshi Zhenggai Qingkuang Tongbao (中 国 石 化 党 组 关 于 巡 视 整 改 情 况 的 通 报) [Circular of the Chinese Communist Party on the Inspection and Ratification in China Petroleum Chemical Corporations], (promulgated by the Central Commission of Disciplinary Inspection, Apr. 30, 2015), http://www.ccdi.gov.cn/yw/201504/t20150430_55638.html; Zhongguo Shiyouhuagong Jituangongsi Zongjingli Wangtianpu Shexian Yanzhong Weijiweifa Jieshou Zuzhidiaocha (中国石油化工集团公司总经理王天普涉嫌严重违纪违法接受组织调查) [Notice by the CCDI on the Disciplinary Investigation of Wang Tianpu] (promulgated by the CCDI, Apr. 27, 2015), http://www.ccdi.gov.cn/xwtt/201504/t20150427_55436.html; Zhongguo Shiyou Huagong Jituangongsi Yuan Dongshi, Zongjingli, Dangzuchengyuan Wangtianpu Yanzhong Weiji Bei Kaichudangji (中国石油化工集团公司原董事、总经理、党组成员王天普严重违纪被开除党籍) [Notice by the CCDI on Wang Tianpu's expulsion from the Party, September] (promulgated by the CCDI, Sept. 18, 2015), http://www.ccdi.gov.cn/xwtt/201509/t20150918_62038.html. On the consequent legal criminal prosecution, see *China to Prosecute Former Top Executives for Alleged Graft*, REUTERS (Sept. 29, 2016), <http://www.reuters.com/article/us-china-corruption-sinopec-idUSKCN11W0VX>.

⁴³ Nicholas C. Howson, *China's Restructured Commercial Banks—The Old Nomenklatura System Serving New Corporate Governance Structures?*, in CHINA'S EMERGING FINANCIAL MARKETS: CHALLENGES AND GLOBAL IMPACT 123 (M. Avery et al. eds., 2009).

⁴⁴ Without doubt, the internal mechanisms for monitoring, accountability, and deterrence have only operated more rigorously via the Party disciplinary enforcement actions and outside the formal criminal legal system during the present Anti-Corruption Campaign, which commenced with President Xi Jinping's ascension to power.

⁴⁵ See, e.g., Zhiwu Chen, *Stock Market in China's Modernization Process—Its Past, Present and Future Prospects* 40–41 (Yale Sch. of Mgmt. Working Paper, 2006) (on file with author) ("[T]he Chinese stock market as a whole has acted to determine stock prices in a way totally detached from the economic growth process."). Generally, on the "inefficiencies" in the Chinese stock markets, see Guoping Li, *China's Stock Market: Inefficiencies and Institutional Implications*, 16 *China & World Eco.* No. 6, 2008, at 81.

reflective of actual economic performance, may deny Party officials acting as firm managers' future advancement within the Party. This can serve to discipline the behavior of powerful corporate officials, while also incentivizing them to increase shareholder value even in an inefficient market. I realize of course that this could also lead to the opposite result by encouraging managerial misconduct, whether engaging in false or misleading disclosure to fraudulently prop up a public share price, or by being deferential to political commands.⁴⁶ While these risks are certainly present, I believe not enough attention has been given to the possible beneficial effects of CCP domination in the disciplining and accountability of firm managers.

2. PRC Listed Companies and Minority Shareholder Protections

As noted above, China's "corporatization without privatization" program was designed to allow the PRC's industrial enterprises to raise money in the domestic and global capital markets, while preserving a passive role for minority public shareholders. This conforms to the traditional view, which depicts minority shareholders in public firms—in both concentrated and widely-held markets—as mere suppliers of capital.⁴⁷ Pursuant to this view, minority public investors need only be protected—or seen to be protected—in a way that secures their expectations of investment return, and protects that future return (*e.g.*, against expropriation).⁴⁸ Through the entire course of China's program of economic "reform and opening up," PRC policymakers have recognized a relationship between formal legal protections and the ability of Chinese enterprises to attract capital and thus to contribute to economic development. This was evident even in the late 1970s with the promulgation of China's first business enterprise statute directed at attracting specifically foreign direct investment while ensuring against expropriation by the state.⁴⁹ Decades later, a similar concern can be

⁴⁶ See, for example, the Nanjing Textile Import & Export Co. fraud case mentioned in note 72, *infra*.

⁴⁷ *E.g.*, Stephen Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 604 (2005) (positing a contractarian view in which shareholders are only owners of a residual claim, not of the corporation itself); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967) (establishing a law and economics view of public shareholders as suppliers of capital).

⁴⁸ La Porta et al., *supra* note 4 (suggesting causality between protections of shareholders' legal rights and the availability and cost of external finance).

⁴⁹ The law, allowing foreign capital investments through Joint Ventures, was issued before any recognition in property rights or other legal institutional establishment. In the absence of such institutions, to ensure that the economic interests of foreign investors were met, the state had committed to protect the "rights" of foreign investors—specifically not to nationalize or expropriate joint ventures. *Zhongwai Hezi Jingying Qiye Fa* (中外合资经营企业法) [Sino-Foreign Equity Joint Venture Law] (promulgated by the Standing Comm. Nat'l

perceived in Chinese law and regulation but now with respect to the aggravated exploitation of the minority public shareholders (in now corporatized and listed firms) by inside controlling parties. This can be seen in the policy statements issued by the PRC's highest executive level of government, the State Council,⁵⁰ and the subsequent body of regulations issued by the Chinese securities regulator (the CSRC), many of which explicitly emphasize the protection of investors' interests for the promotion of stable and healthy capital market development.⁵¹

In 2006, the 1994 PRC Company Law was revised, wholesale, in line with this policy command,⁵² evidencing a more robust shareholder empowering approach.⁵³ Thus, in formal terms the statute as revised in 2006 creates or strengthens various mechanisms for the protection of shareholders' rights and interests, including, for example, explicit fiduciary duties for corporate directors, supervisory board members, and officers, a derivative lawsuit for shareholders, and certain buy back

People's Cong., July 1, 1979, effective July 8, 1979, as amended Mar. 5, 2001). http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200301/20030100062_855.shtml.

⁵⁰ For instance, a relevant State Council Opinion states:

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

Guanyu Tuijin Zibenshichang GaigeKaifang he Wendingshan de Ruoganyijian (关于推进资本市场改革开放和稳定发展的若干意见) [*Some Opinions of the State Council on Promoting the Reform, Opening and Steady Growth of Capital Markets*] (promulgated by the State Council, GuoFa (2004) No.3, Jan. 31, 2004), available at <http://www.asianlii.org/cn/legis/cen/laws/sootscoptroasgocm970>. See also, Guanyuzuo hao Guancheshishi Xiudinghou de Gongsifahe Zhengquanfa Youguangongzuo de Tongzhi (关于做好贯彻实施修订后的公司法和证券法有关工作的通知) [State Council Notice on Good Implementation of the Revised Corporate and Securities Law] (promulgated by the State Council, Guofa (2005) No. 62 Dec. 23, 2005), available at http://www.gov.cn/jgongbao/content/2006/content_212077.htm (the Opinion emphasizes to various levels of the government the necessity to implement the revised Company and Securities laws, which established mechanisms for the protections of corporate constituents, in order to promote capital market development). Moreover, Chapter IV of China's 2008 White Paper on promotion of the "rule of law" deals specifically with "Legal Systems Regulating the Order of Market Economy", which points to the need for "safeguarding the lawful rights and interests of corporate investors and stakeholders". Zhongguo de Fazhi Jianshe (中国的法治建设) [China's Efforts and Achievements in Promoting the Rule of Law] (promulgated by the Information Office of the State Council, Feb. 28, 2008), available at http://www.china.org.cn/government/whitepaper/node_7041733.htm.

⁵¹ For a list of these regulations, see Howson, *supra* note 36.

⁵² The *Company Law* was revised at the 18th meeting of the 10th National People's Congress of the People's Republic of China on October 27, 2005 and was last amended December 28th, 2013. Gongsifa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong, Dec. 29, 1993, revised, Oct. 27, 2005, amended, Dec. 28, 2013, effective Mar. 1, 2014), available at http://www.fdi.gov.cn/1800000121_39_4814_0_7.html.

⁵³ Howson, *supra* note 36, at 698, 701-07.

guarantees.⁵⁴ Perhaps most striking, the 2006 Company Law also adopted something like fiduciary duties for controlling shareholders, owed to the company and to other shareholders.⁵⁵

More importantly, the 2006 Company Law goes beyond the mere protection of basic shareholder rights, by also establishing mechanisms to enable public shareholder participation in listed firm governance, including: involvement in the composition of the board of directors;⁵⁶ decision power on numerous corporate matters including changes in the company's registered capital, bond issuances, re-organizations, dissolution and liquidation decisions, and bylaw amendments;⁵⁷ and even a supermajority requirement for the approval of certain fundamental transactions.⁵⁸ The PRC Company Law even allows a group of shareholders with a 10 percent or more equity interest in the firm to request a special shareholders' meeting, and enables shareholders holding at least 3 percent of the firm's equity to submit shareholder proposals to the board.⁵⁹

The formal provisions above raise an important question—how is it that China's national policymakers, who it is assumed might wish to maintain the power of incumbent control parties and the relative passivity of public investors, have adopted an approach in the PRC's corporate law statute which seems to empower public shareholders? Under a traditional law and finance view, the assurance of basic economic rights to public investors—*e.g.*, the ability to enjoy from equity appreciation, participation in profits and in the firm's residual in liquidation—should presumably suffice to secure investors' expectations of returns on investment. I believe there are two related answers as to why China seems to have gone beyond the assurance of basic economic rights for public investors.

First, the formal participation rights granted to shareholders under the 2006 Company Law are in effect rather narrow and do not operate to improve the position of *non-controlling* (thus *real* public, or minority) public shareholders. In my view, the "shareholder empowering" approach (a rhetorical characterization tied to the empowerment of collective action-challenged shareholders in widely-held firms *against corporate*

⁵⁴ 2006 Company Law arts. 22 and 147-150, 53(6) and 151, 152, 142, respectively.

⁵⁵ *Id.* arts. 20, 21.

⁵⁶ *See id.* arts. 37, 98, 99. These articles also enable written consent in lieu of convening an actual shareholders' meeting, reducing the costs of shareholders' participation.

⁵⁷ *See id.* arts. 37(7)-(10). These rules also apply to listed companies. *Id.* art. 99.

⁵⁸ The general rule for shareholder resolution is majority vote. *Id.* art. 103. Yet, some business decisions require approval by two-thirds of the voting rights of the shareholders in presence: bylaw amendments, changes in the registered capital of the company, resolutions concerning merger, split-up, dissolution, or change of the company form; as well as a decision to purchase or sell any important asset or to provide guaranties that exceed 30 percent of the company's total assets within a year. *Id.* arts. 103, 121. Yet, article 16, is the only article under the Company law that addresses directly the concern from abusive related party transactions, by requiring the approval of the majority of *disinterested shareholders* for guaranties given by the company to its controlling shareholder. *Id.* art. 16.

⁵⁹*Id.* arts. 101, 102.

managers) taken in the 2006 Company Law, serves in effect only to further empower the Party-state *qua* controlling shareholder of China's listed firms. General "shareholder empowerment" in the PRC circumstance means that the controlling shareholder will be the one to nominate and elect the subsidiary company's board members, who will in turn have singular power to appoint top management. Thus, the controlling shareholder will continue to govern the firm absolutely in a myriad of ways. For example, the controlling shareholder's appointed board members will set the agenda for shareholder meetings, and thereby be able to hinder any shareholder proposal from a 3% percent shareholder authorized under the 2006 Company Law. Similarly, since voting participation is not mandatory, and most Chinese legal norms do not call for recusal of controlling shareholder(s), any mandated supermajority requirement for the approval of certain transactions will usually be satisfied by the controlling shareholder alone.⁶⁰ In a related fashion, the admittedly more "enabling" approach taken in the revised 2006 Company Law, in contrast with a mandatory orientation, simply enables the parties to contract around the default rules (which really means enables the controlling shareholder to contract into even more robust control).⁶¹ Said another way, given the pyramidal holding structure prevalent for PRC firms and the almost non-existent bargaining power of minority shareholders—any "opt-in" governance arrangement that is specifically favorable to minority shareholders will not be adopted.⁶² Thus, as observed with respect to France, "an interventionist state, concentrated ownership, and shareholder-friendly law may be mutually reinforcing, especially when the state holds large blocks of stock in its own right."⁶³

Furthermore—and lest anyone think that whatever minority shareholder protections on offer (whether mandatory, or contracted-into) can or will be enforced—the relative lack of technical competence, decisional autonomy and political independence commonly thought to characterize the Chinese judiciary raises skepticism for the ability of non-controlling public shareholders to secure such rights. For example, Professors Clarke and Howson have shown that derivative lawsuits involving listed PRC companies are almost completely absent from the PRC People's Courts. They attribute this to the fact that publicly-listed

⁶⁰ Article 16 of the 2006 Company Law which specifically requires the approval of disinterested, thereby usually the non-controlling, shareholders, is a unique exception where the minority is granted a *de-facto* negative veto. *Id.* art. 16.

⁶¹ Howson, *supra* note 36, at 698, 701–07.

⁶² See, e.g., 2006 Company Law, *supra* note 18, art. 105 ("A shareholders' assembly may adopt a cumulative voting system to elect the directors or supervisors according to the bylaw or its resolutions.") (emphasis added).

⁶³ Luca Enriques et al., *The Basic Governance Structure: The Interests of Shareholders as a Class*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 55, 85 (Reinier H. Kraakman et al. eds., 2nd ed., 2009). As pointed later in this Article, the role of the French State in the development of its corporate environment presents an interesting comparison with the Chinese system. See Part II.A.4, *infra*.

company cases involve large plaintiff groups who actually seek the accountability of Party-state actors and institutions, and thus may affect “social stability” in a politically related context, discouraging or prohibiting court involvement.⁶⁴ Hence, the relative weakness of the courts and other institutions and their pronounced reluctance to adjudicate or enforce in such cases, curtails the system’s ability to restrain controlling shareholders or hold them accountable *ex post* as well.

My second answer to the fundamental question posed above is this: I argue that the expectations of foreign and PRC domestic investors alike are shifting, and no longer focus solely on the guaranty of basic economic rights, but now increasingly value governance participation in and of itself. I believe that the Chinese legislator and especially China’s capital markets’ regulator—the CSRC—is increasingly intent on responding to these broad investors’ expectations so as to encourage capital investment flow. This view coincides with a general shift I identify in global markets, whereby, even in concentrated markets, opportunities for participation by minority public shareholders are growing and increasingly regarded as essential by national market regulators for the development of vibrant capital markets.⁶⁵

How do these perhaps contradictory insights—enhanced powers for control parties in the Chinese scheme under the benign slogans of “shareholder-empowering” and “enabling” corporate laws *vs.* expectations from the investor side that go beyond the protection of basic economic rights—work together? My view is that the limited protections and/or governance participation rights granted to minority public shareholders under the *Company Law*, coupled with the inadequacy of *ex post* enforcement, do not necessarily mean that Chinese corporate governance

⁶⁴ Nicholas C. Howson & Donald Clarke, *Pathway to Minority Shareholder Protection: Derivative Actions in the People’s Republic of China*, in *THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH* 243, 254-257 (Dan W. Puchniak et al. eds., 2012); see also Nicholas C. Howson, *Corporate Law in the Shanghai People’s Courts, 1992-2008: Judicial Autonomy in a Contemporary Authoritarian State*, 5 *E. ASIA L. REV.* 303, 404-07 (2010).

⁶⁵ The shift is evident through academic discussions and market participants alike. For such shift in the U.S.-dispersed market, see the writings of Professor Bebchuk, especially in note 2, *supra*; Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 *HARV. L. REV.* 1784 (2005); Paul Rose, *The Corporate Governance Industry*, 32 *J. CORP. L.* 887 (2007) (describing the rising dominance of the Institutional Shareholder Services (ISS) firm and the growth of the proxy advisory sector in general); see also U.S. SEC Proxy Reform, 75 *Fed. Reg.* 56,668, 56,763 (Sept. 16, 2010) (facilitating shareholder director nominations). For evidence of such shift in concentrated markets, see, e.g., Miguel A. Ferreira et al., *Shareholders at the Gate? Institutional Investors and Cross-Border Mergers and Acquisitions*, 23 *REV. FIN. STUD.* 601, 601-03 (2010) (stating that “a more active international role of institutional money managers has taken cross-border portfolio investment to record levels, representing an unprecedented internationalization of the shareholder base of corporations worldwide”); Directive 2007/36/EC, of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, 2007 O.J. (L 184) 17; and other sources referred to in note 7, *supra*.

entirely lacks effective minority shareholder protections. Nor does it mean, I argue, that public investors in these PRC firms are condemned to eternal passivity. Rather, in my view, these insufficiencies open a route for other mechanisms and institutions to fill-in such gap and promote minority shareholders' empowerment in Chinese publicly-listed firms. These alternative mechanisms also suggest greater possibilities for minority public shareholders' *future* involvement in firm monitoring and governance participation.

What are these other mechanisms? Institutionally the Chinese securities regulator has intervened strongly in the realm of the *Company Law* (and part of the PRC Securities Law which governs corporate law) with a number of mandatory regulations that override what is only enabled in primary statutes.⁶⁶ The CSRC has put the protection of so-called "public" (*gongzhong*) shareholders at the forefront of its mission to develop "healthy" capital markets.⁶⁷ For instance, before the 2006 amendment of the *Company Law*, in 2004, the CSRC issued provisions promoting minority shareholder participation in listed firm governance through a public shareholder negative veto for certain corporate decisions.⁶⁸ The provisions mandate approval by the shareholders assembly with the support of at least 50% of the "general public shareholders" (understood to mean holders of publicly-listed shares not affiliated with the control group), for: matters that would have a material impact on them; any new issuance of stock or convertible debt to the public; rights offerings; major asset reorganization; repayment of any debt owed to the company by one of its shareholders; and any overseas listing by a significant subsidiary of the listed company.⁶⁹ This negative veto conferred on minority shareholders in listed firms by the CSRC and outside of PRC corporate and securities laws, presents a substantial mechanism for minority shareholder protection and an opportunity for minority participation in the governance of listed firms. The *CSRC 2004 Provisions* also urge firms to proactively seek to increase the presence of "general public shareholders" in shareholders' meetings, and to enhance participation rights by enabling the public solicitation of voting proxies, promote cumulative voting, etc.

Indeed, the mandatory rules set forth in the *CSRC 2004 Provisions* are but one example of how China's capital markets regulator recognizes the value of the appearance and reality of increased minority public shareholder involvement. Nonetheless, while the mandatory norms

⁶⁶ Howson, *supra* note 36 (offering reasons why the CSRC was allowed into such position).

⁶⁷ *Id.* at 697-99, 709-11.

⁶⁸ Guanyu Jiaqiang Shehui Gongzhonggu Gudong Quanyi Baohu de Ruogan Guiding (关于加强社会公众股股东权益保护的若干规定) [Provisions on Strengthening the Protection of the Rights and Interests of the General Public Shareholders] (promulgated by the Sec. Regulatory Comm'n, Dec. 7, 2004, effective Dec. 7, 2004), <http://en.pkulaw.cn/display.aspx?cgid=56204&lib=law> [hereinafter *CSRC 2004 Provisions*].

⁶⁹ *Id.* art. 1(1)(a)-(d) (referring to "general public shareholders group" (*shehui gongzhong gu gudong*)).

introduced by the CSRC might result in the empowerment of minority public shareholders toward fairer treatment, it should be noted that under current political economy conditions, they are probably not as effective in empowering them towards *active participation* in firms. The reasons for this are twofold, both of which only intensified following the recent 2015–2016 Shanghai market crash, and the consequent legal and Party-disciplinary enforcement procedures against CSRC leading officials, which discredited the agency and likely seriously wounded its authority.⁷⁰ First, the protection of minority public shareholders against exploitation creates different levels of tension within the PRC political economy than does the promotion of their active participation. If a higher level of CSRC intervention is required to establish public shareholder participation under the current PRC ownership structures and political economy, this might not be tolerated by other Party-state actors (including the control parties in listed firms). Indeed, the CSRC or any other state agency is more likely to enforce law, regulation or policy (or enforce them more rigorously), even against pure oppression or fraud, when minority shareholder rights are infringed upon by a non-Party-state controller.⁷¹ The recent fraud case involving Shanghai Stock Exchange-listed Nanjing Textile Import Export Corp., Ltd., is a good example. The firm is a state-controlled listed company with its primary (then, 35%) and controlling shareholder being the Nanjing Municipal branch of SASAC. The company falsified profits for five consecutive years, publicly disclosing non-existent profits of RMB 350 million (approximately USD 54 million). The fraud was designed to conceal losses which would have forced the company to de-list. In May 2014, the CSRC merely issued an administrative penalty decision against the company, subjecting it and several of its managers to minor fines, despite broad public calls for delisting and for a more rigorous prosecution of the fraud.⁷² If this is the common picture when the CSRC is called upon in

⁷⁰ Party disciplinary proceedings took place against Yao Gang—Vice Chairman of the CSRC—and Zhang Yujun—Assistant Chairman of the CSRC. See, e.g., Zhongyang Jiwei Jiancha Bu (中央纪委监察部) [CENTRAL COMMISSION FOR DISCIPLINE INSPECTION], Zhongguo Zhengquan Jiandu Guanli Weiyuanhui Dangwei Weiyuan, Fu Zhuxi Yao Gang Shexian Yanzhong Weiji Jiesshou Zuzhi Diaocha (中国证券监督管理委员会党委委员、副主席姚刚涉嫌严重违纪接受组织调查) [Investigation of Yao Gang, Member of the Party Committee and Deputy Chairman of CSRC, under Suspicion of Serious Disciplinary Violations] (Nov. 13, 2015), http://www.ccdi.gov.cn/jlsc/zggb/jlsc_zggb/201607/t20160704_83027.html. More formal institutional consequences in such directions can be seen in the removal of Xiao Gang—the Chairman of the CSRC—from his position following the crises: See, e.g., *China Removes Xiao as CSRC Head After Stock Market Meltdown*, BLOOMBERG NEWS (Feb. 20, 2016), <http://www.bloomberg.com/news/articles/2016-02-19/head-of-china-s-securities-regulator-to-step-down-wsj-reports>.

⁷¹ Henk Berkman et al., *Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 1391, 1393 (2010).

⁷² See Zhongguo Zhengjianhui Xingzheng Chufa Juedingshu (Nanjing Fanzhipin Jinchukou Fufen Youxian Gongsi, Dan Xiaozhong, Ding Jie Deng 13 Ming Zefuren) (中国证监会行政处罚决定书 (南京纺织品进出口股份有限公司、单晓钟、丁杰等13名责任人))

cases of minority public shareholder protection against pure oppression, it is likely that its powers to actively promote participation rights in such firms are even further hindered.

Second, the CSRC is but only one state-organ which occupies a position among other ministry-level organs—including listed firm control groups—with respect to control parties, PRC institutional investors and Chinese financial institutions. Overlapping authorities, for example, might make it difficult for the CSRC to mandate and enforce actual voting at shareholders' meetings by Party-state-tied institutional investors who in other systems are considered the ultimate candidates for action on behalf of minority public shareholders. This example suggests that there may not be a suitable market player able or willing to take up a regulatory or statutory invitation for enhanced participation, even when such is given.⁷³

II. NEW PARADIGMS—POSSIBILITIES FOR MINORITY PUBLIC SHAREHOLDERS IN CHINA'S CONCENTRATED CAPITAL MARKETS

Even if China's corporate governance system provides uniquely Chinese monitoring mechanisms and does at some level protect minority shareholders against exploitation, and even if China's controlling shareholder groups are somewhat restrained, an important question still remains: Are there Chinese actors, institutions, or practices which can enable the shift towards greater minority shareholder involvement that I have argued is evident in other global markets? In this section, I address that question from two angles: First, I examine whether examples from other concentrated markets apply to the Chinese circumstance. Second, I examine perhaps idiosyncratic ways in which China can advance minority public shareholder monitoring and governance participation, even in its highly-concentrated markets.

A. *Mechanisms from Other Concentrated Markets—Applicable to China?*

1. Overcoming a Conceptual Barrier

The idea of meaningful minority public shareholder involvement in the governance of PRC's corporatized SOEs might seem a non-starter in an authoritarian state like China where civil society is generally highly

[Administrative Penalty Decision (Nanjing Textile Import & Export Co., Shan Xiaozhong, Ding Jie and 13 Responsible Persons), Zhongguo Zhengquan Jiandu Guanli Weiyuanhui (中国证券监督管理委员会) [China Sec. Reg. Comm.] (Apr. 30, 2014), http://www.csrc.gov.cn/pub/zjhpublic/G00306212/201407/t20140707_257345.htm?keyword_s=%E5%8D%97%E4%BA%AC. The company was fined RMB 500,000 (approximately USD 76,000), and the individual managers were fined sums between RMB 300,000 – 30,000 (USD 46,000 – 4,600). *Id.*

⁷³ See Part II, *infra*.

constricted. Shareholder participation in corporate governance is traditionally linked to the shareholder franchise and what some describe as "corporate democracy"⁷⁴—concepts which seem wholly inapplicable in authoritarian regimes. Therefore, it could be argued that shareholder participation mechanisms seen in other concentrated markets, but which function in the embrace of liberal democracies, are conceptually irrelevant to China with its very different political and ideological environment.

However, minority shareholder empowerment (perhaps misleadingly associated with notions of "corporate democracy") does not necessarily align with constitutional democracy. It is facile and misleading to conflate representative political institutions with market institutions and efficiency concerns. Thus, what I argue is a global shift in which the increasing power of minority public shareholders is seen not as an end in itself dictated by democratic morality, but instead a means to a separate goal—higher allocative efficiency for the capital markets and better economic performance by firms.⁷⁵ If this is true, and understanding that the same goals pertain for markets and firms operating under concentrated ownership conditions,⁷⁶ then there should be no conceptual barrier to the possibility of enhanced minority public shareholder monitoring and governance participation even in firms operating under an authoritarian regime. In fact, China's policy makers clearly make just this distinction—permitting and encouraging economic liberalization in the service of national economic development, while at the same time impeding concomitant political or social liberalization.⁷⁷

⁷⁴ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) ("If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."); see also Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259 1260, 1269 (2009) (noting that shareholder activists refer to their actions as aiming to increase "shareholder democracy" by "increasing the efficacy of their voting right").

⁷⁵ Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 at 678–79 (2009) (citing Henry G. Manne, *The 'Corporate Democracy' Oxymoron*, WALL ST. J. (Jan. 2, 2007)) (referring to Manne's criticism of his proposals for greater shareholder empowerment); *id.* (citing Matthias Benz & Bruno S. Frey, *Towards a Constitutional Theory of Corporate Governance* 11–12 (June 14, 2006) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=933309) (referring to the opposite end of the debate that sees increase in shareholders' 'constitutional' rights as intrinsically desirable)).

⁷⁶ The implied position here that better economic performance can be achieved even in concentrated markets following an increase in public shareholder participation goes both ways. The inefficiencies involved in minority participation when there is a controlling or dominant shareholder, and arguments supporting the right of a controller to exercise "selfish control", can justify an opposite position. Since there is no unequivocal empirical proof one way or another, this article takes the former position in the Chinese context especially considering the costs of ownership concentration, and the vast potential for minority exploitation that is inherent to (pyramidal-)concentrated-ownership and is often unresolved by common monitoring and enforcement mechanisms.

⁷⁷ The question if this is a sustainable model of development that can be contained to the economic sphere is a different one which I discuss in a separate manuscript (*in progress*).

2. A "Lujiazui Walk"⁷⁸

One aspect of monitoring through the firm's public share price is constituted by the shareholders' exit from an investment, colloquially termed "voting with their feet" or "the Wall-Street Walk."⁷⁹ This market price mechanism has been shown empirically to have a disciplinary effect on firm management. In fact, just the credible threat of shareholders selling has a disciplinary effect, and provides groups of shareholders some traction in influencing management decisions, thereby amounting to a form of public shareholder monitoring.⁸⁰ Of course, that leverage is only amplified in a situation where there is a functioning market for corporate control, where mass selling decreases the price to a level at which a hostile acquirer can purchase control cheaply and then oust incumbent management. Yet, the firm's public share price and the theory of "exit" as a form of shareholder voice *cum* monitoring, operates as a disciplinary mechanism even without a threat of a hostile acquirer. Thus, there is no reason why the same principle should not also apply in concentrated markets without a market for corporate control. Without a doubt, a share price drop from mass shareholder defection has consequences for firm market value in these markets as well; and the relative success or failure of a corporation as measured by firm market value will almost certainly affect the reputation and/or advancement of corporate insiders. A controlling shareholder can be similarly affected by a threat of large scale defection of public investors (and the resultant decrease in market value), especially with regard to future capital raising. Moreover, where ownership is concentrated but control is organized through business groups, a reduction in the public valuation of a given firm in the group and the associated reputational harm caused to the control parties will have negative implications at the group level and on individual firms within the group. Hence, under conditions where there is sufficient liquidity in the public float of a controlled firm⁸¹—meaning the easy

⁷⁸ Lujiazui is the name of the new financial district in Shanghai. See, *Lujiazui*, WIKIPEDIA, <https://en.wikipedia.org/wiki/Lujiazui> (last modified Jan. 26, 2017).

⁷⁹ Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645 (2009) (distinguishing between overt activism and a threat of exist as a form of shareholder activism).

⁸⁰ Robert Parrino et al., *Voting with Their Feet: Institutional Ownership Changes Around Forced CEO Turnover*, 68 J. FIN. ECON. 3 (2003); Admati & Pfleiderer, *supra* note 79 (providing a model whereby the threat of exit by a large shareholder on the basis of private information can have a disciplinary impact on managers' decisions).

⁸¹ Most of the research on market liquidity is focused on widely held firms. See, e.g., Patrick Bolton & Ernst-Ludwig Von Thadden, *Blocks, Liquidity, and Corporate Control*, 53 J. FIN. 1, 2 (1998) (asserting that "the benefits of dispersion are mainly greater market liquidity and better risk-diversification"); Amir Rubin, *Ownership Level, Ownership Concentration and Liquidity*, 10 J. FIN. MARKETS 219 (2007) (examining the relationship between liquidity level to ownership concentration measured by insiders' ownership and institutional investors holding in U.S. listed firms). But see Marco Becht, *European Corporate Governance: Trading off Liquidity Against Control*, 43 EURO. ECON. REV. 1071, 1077 (1999) (asserting that "[f]or the United States, there is extensive empirical evidence . . .

availability of the shareholders' exit option or the credible threat of it—even firms in concentrated capital markets and their management can be disciplined by standard capital markets mechanisms such as public price, exit threats, etc., and even without a market for corporate control, thereby potentially subjecting them to pressures by minority public shareholders.

As I have described above, the political advancement of *nomenklatura* appointees to the management of China's corporatized and listed SOEs is directly influenced by the success of the firms they manage. There are various criteria to measure such success, including changes in market price and corporate value.⁸² Thus, one might think that even with respect to the PRC's listed SOEs, public shareholders can sell, or threaten selling to discipline even the *nomenklatura*-origin managers, and thereby influence or participate in corporate decision-making.

While the theory has much to commend it, I should note, however, the difficulties in this argument in the Chinese capital markets context: Despite the link between public share price and evaluation of management, minority public shareholders invested in PRC listed firms in many occasions cannot effectively utilize exit, or the threat of exit, as a disciplinary mechanism. Exit as a form of shareholder voice or empowerment presupposes a certain level of market sophistication and informational efficiency. It also assumes a high degree of reliable information flowing into the market, signaling to investors the relative desirability of a given investment, and at the same time reflecting investors' appraisal of past and future performance of the corporation. The Chinese capital markets do not function this way presently, as they are in many ways informationally inefficient. Share prices often seem to be driven not by economic considerations based on information disclosed into the market but instead by factors often unrelated to firm performance.⁸³ The response to the 2015 and 2016 stock crashes by the PRC central government—propping up share prices through massive mandated purchasing and blanket suspensions of trading⁸⁴—reflect the

that the number of shareholders is positively related to liquidity," but attempting to provide similar evidence for the German and Belgium markets); David A Lesmond, *Liquidity of Emerging Markets*, 77 J. FIN. ECON. 411 (2005) (examining liquidity of emerging markets on a macro level cross-country basis).

⁸² See *supra* notes 40 & 41 and associated text. Other evaluation criteria relate for instance to contribution to GDP growth, tax compliance, reduction in environmental footprint, the amount of social unrest created around corporate conduct (reflected for example through shareholder complaints, derivative suits, etc.).

⁸³ Chen, *supra* note 45, at 41. See generally Tarun Khanna & Krishna Palepu, *Emerging Market Business Groups, Foreign Intermediaries, and Corporate Governance*, in CONCENTRATED CORPORATE OWNERSHIP, 319 (Randall K. Morck ed., 2000) 265, 292-94 (citing Randall Morck et al., *The Information Content of Stock Markets: Why Do Emerging Markets have Synchronous Stock Price Movements?*, 58 J. FIN. ECON. 215 (2000)).

⁸⁴ By July 8, 2015, 1,300 listed firms—representing 45 percent of the market suspended trading to hold back share price decrease. See, *Almost Half of China's Firms Halt Trading*

limited impact of public shareholders' evaluation of firm value and capital market activity, while emphasizing the direct influence of a government policy on share price. Moreover, investment alternatives—namely other comparable listed PRC firms that evidence better performance or governance—are scarce, because the vast majority of these listed companies are also Party-state controlled firms.⁸⁵ This is one reason why public investors in China tend to invest alongside dominant Party-state shareholders, even if performance is lackluster or corporate governance breaches become apparent, preferring to benefit from the inside knowledge and relationships of the Party-state control party, rather than make much riskier investment decisions.

Hence, while the force of the capital market and thus a share price creates a kind of attenuated monitoring mechanism, it functions to that extent mainly through the Party personnel management system, while the function of a threat of exit a la "Wall Street Walk" by public shareholders is more limited. Nevertheless, whereas this is the current situation in the PRC, I expect it to gradually change in the future through changes in the structure of Party-state control of the economy, entailing the development of a partial market for corporate control. These suggested changes and their implications on minority public shareholders' ability to execute "exit" as a form of monitoring are discussed further below.⁸⁶

3. Institutional Investors in Concentrated Markets⁸⁷

In recent decades an increase in equity shares managed by institutional investment services and a corresponding narrative describing the possibilities for "shareholder activism" by such institutional investors in the widely-dispersed Anglo-American markets has led to rising expectations focused on institutional investors as the tool for greater minority public shareholder monitoring and governance participation.⁸⁸ In concentrated markets, however, the view of

as *Market Dives*, FRANCE 24 (July 8, 2015), <http://www.france24.com/en/20150708-almost-half-chinese-firms-suspend-trading-market-dives>.

⁸⁵ Chen, *supra* note 45, at 40–41 (studying co-movement levels among individual stocks, concluding that Chinese investors treated every stock the same, and that from investors' perspective the stocks were indistinguishable from one another).

⁸⁶ See Part II.B.2, *infra*.

⁸⁷ Here, the discussion concerning Chinese-listed firms refers only to listed "A shares," meaning shares of Chinese domestic companies that are traded on mainland stock exchanges (Shanghai and Shenzhen) in the domestic currency (Renminbi—"RMB").

⁸⁸ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (depicting the classical view of traditional institutional investors as promising monitors); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1042 & 1047–70 (2007) (explaining the disillusion from the traditional institutional investors' activism, yet reflecting similar hopes regarding hedge funds, as the new promising activists). Yet, the evidence concerning the actual involvement and contribution of institutional investors is

institutional investors has been less optimistic. This is because institutional investors in concentrated markets are often entwined within larger business groups, and in some cases even controlled by the listed firm whose public share float they manage.⁸⁹ Hence, institutional investors in concentrated markets can experience a conflict of interest and favor the interests of the dominant shareholders of their affiliate group over those of unaffiliated minority public shareholders, or otherwise just remain passive.⁹⁰ This kind of co-option within larger business groups in concentrated markets can affect the ability of institutional investors to participate effectively in corporate governance on behalf of minority public shareholders. Therefore, as some scholars have already noted, it seems clear that there must be an additional intervention for institutional investors in such concentrated markets to become active participants in monitoring and corporate governance on behalf of minority public shareholders.⁹¹ Examples of such required interventions include the adoption of a mandatory requirement for non-controlling shareholder board representation;⁹² the use of disinterested shareholders consent as a regulatory device⁹³ (e.g., minority veto rights ("majority-of-minority" approval requirements), super majority requirements, etc.⁹⁴) while at the same time compelling a minority blockholders' vote in potentially abusive circumstances.⁹⁵

inconclusive: See, e.g., Roberta Romano, *Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 187-219 (2001) (reviewing studies on shareholder proposals submitted by public pension funds in the United States and concluding an insignificant effect on firms' performance)); Gillan and Starks draw a similar conclusion following a survey of empirical studies concerning various forms of activism. *Id.* at 177 n.8 (citing Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, CONTEMP. FIN. DIGEST, Autumn 1998, 10, concluding that no empirical evidence supports the claim that activists improve long term market performance).

⁸⁹ Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691 (2012); (examining institutional investors voting patterns in the Israeli market).

⁹⁰ *Id.* at 711-13 (finding that institutional investors with potential business interests, or who are owned within a business group, are more likely to support proposals by insiders).

⁹¹ *Ib.*, at 713-14 (finding that: "it is legal intervention — rather than minority shareholders' voting power — that drives institutional investors to cast a vote.").

⁹² For an example from the Italian corporate law, see Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: An Empirical Analysis of Hedge Fund Activism in Italy and Germany, and Its Evolution*, 10 EURO. CO. & FIN. L. REV. 328, 350-54 (2013).

⁹³ Jennifer Hill, *Visions and Revisions of the Shareholder*, 48 AM. J. COMP. L. 39, 69-71 (2009) (discussing the idea of sbareholders voice as a regulatory monitoring device, screening questionable transactions in Australia—a dispersed market).

⁹⁴ For data on countries that adopted minority veto rights, see OECD, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS 30-37, <http://www.oecd.org/daf/ca/50089215.pdf>.

⁹⁵ See Zohar Goshen, *The Efficiency of Controlling Corporate Self-dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393 (2003) (arguing that corporate laws must incorporate some form of minority protection as a mandatory rule, and examining various such forms in different jurisdictions).

Israel is one example of a highly-concentrated market where the state regulator sought to increase institutional investor participation and power by addressing the passivity of institutional investors and their co-option within a larger, dominated, group and the potential conflict of interest resulting therefrom. A rule introduced into Israel's Company Law requires that "extraordinary" transactions between the company and its control party (including affiliates) be approved by the shareholders general meeting, provided that the approving majority votes will include a majority of disinterested (minority) shareholders participating in the meeting (abstentions not accounted).⁹⁶ At the same time, various financial laws and regulations mandate that institutional investors cast a vote in certain matters,⁹⁷ thereby leveraging shareholder consent into a regulatory device. In addition, in a recent law the Israeli legislature has taken action to mitigate the conflicts of interest often experienced by institutional investors.⁹⁸ The law establishes ownership limitations within business groups with respect to financial services institutions in a move designed to increase the independence of institutional investors from the highly-concentrated corporate pyramids prevalent in the Israeli market.

With respect to the PRC, several market conditions impede the ability of institutional investors to monitor as well as to significantly participate in firms' governance. The size of the industry is the first impediment. Currently most retail investors in the domestic capital markets manage their equity investments individually, and not through institutional investor accounts.⁹⁹ Institutional investor services are strictly

⁹⁶Alternatively, shareholder approval is considered granted if the total of objecting minority votes is lower than 2% of the total voting rights of the company. Either way, the minority approval requirement is in addition to an approval by a Supervisory Committee and by the Board of Directors. See Company Law, 5759-1999, § 275(a), 1 LSI 44 (Isr.). The "Interpretation" chapter in the Israeli Company Law defines an "extraordinary transaction": "a transaction not in a company's ordinary course of business, a transaction that is not undertaken in market conditions or a transaction that is likely substantially to influence the profitability of a company, its property or liabilities." *Id.* art. 1.

⁹⁷Hamdani & Yafeh, *supra* note 89, at 696-700.

⁹⁸A similar move was recommended by Hamdani and Yafeh in their article. *Id.*, at 695. Indeed, in a novel step, the Israeli legislator has recently adopted "The Law for the Decrease of Concentration and Increase of Competition". It aims to strengthen competition and curtail the excessive clout of a relatively small number of business groups over the Israeli economy by limiting pyramid groups to two holding layers and separating ownership of financial institutions from non-financial corporations. See Ido Baum et al., *What Is Israel's New Business Concentration Law and Why Should We Care?*, HAARETZ (Dec. 29, 2013), <http://www.haaretz.com/israel-news/business/1.565986>.

⁹⁹See SHANGHAI STOCK EXCHANGE STATISTICS ANNUAL 475 (2014); Shenzhen Zhengquan Jiaoyisuo Xinxi Guanli Bu (深圳证券交易所信息管理部) [INFORMATION MANAGEMENT DEPARTMENT OF SHENZHEN STOCK EXCHANGE], Shenzhen Zhengquan Jiaoyisuo Shichang Tongji Nianjian (深圳证券交易所市场统计年鉴) [SHENZHEN STOCK EXCHANGE FACT BOOK] 269 (2013), <http://www.szse.cn/UpFiles/largepdf/20150319145710.pdf> (reflecting a low number of institutional accounts compared to individual (retail) investors' accounts in the People's Republic of China (0.46% in SSE and 0.33% in SZSE, out of total stock exchanges accounts).

regimented, with limited investment choices. For example, pension funds are funded and managed by local-level Provincial and City governments and until very recently could only invest in national treasury bonds and deposits.¹⁰⁰ Similar investment limitations apply to the PRC's National Social Security Fund, which functions as the central government's social security reserve fund.¹⁰¹ As for mutual funds, in recent years there been a large increase in the number of mutual fund investors and the total scope of their equity investments. In 2012, 7.6% of all shares were held by mutual funds. Yet, at the firm level their holdings are marginal, e.g., for 2011 mutual funds held a median of 0.067% in firms.¹⁰² Scholars noted a short-term investment horizon as one implication of institutional investors' firm level small holding scope (and consequent lack of influence).¹⁰³ Nevertheless, there is no doubt that the institutional investment industry in China is growing. This should remain true especially after the 2015 and 2016 stock market collapses, and in light of recent administrative regulations issued by the State Council in August 2015, which allowed pension funds to invest up to 30 percent of their net assets in domestic equities.¹⁰⁴

An additional impediment is related to concerns regarding the competency of institutional investors—a relatively young industry in the PRC, such that institutional investors in China are simply not skilled enough to have a meaningful disciplinary effect on managerial power.¹⁰⁵ It was expected that the Qualified Foreign Institutional Investors

¹⁰⁰ See ROBERT C. POZEN, TACKLING THE CHINESE PENSION SYSTEM 3–6, 8 (2013), http://www.tandemsites.com/paulson/website/wp-content/uploads/2015/04/China-Pensions_Pozen_English_FINAL.pdf. Insurance funds and mutual funds have other restrictions. See Chao Xi, *Institutional Shareholder Activism in China: Law and Practice*, 17 INT'L CO. & COM. L. REV. 251, 252 (2006). However, in August 2015, new administrative rules were enacted by the State Council to allow pension funds to invest in equity securities: See, Guowuyuan Guanyu Yinfa Jiben Yanglao Baoxian Jijin Touzi Guanli Banfa de Tongzhi (Guofa (2015) 48 hao) (国务院关于印发基本养老保险基金投资管理暂行办法的通知 (国发 (2015) 48 号)) [*State Council Administrative Measures for Investment Management of Pension Funds*], Guowu Yuan (国务院), STATE COUNCIL (August 17, 2015), http://www.gov.cn/zhengce/content/2015-08/23/content_10115.htm

¹⁰¹ Information about the PRC National Social Security Fund is available on the NSSF website *About the National Council for Social Security Fund*, SOCIAL SECURITY FUND, http://www.ssf.gov.cn/Eng_Introduction/201206/t20120620_5603.html# (last visited Mar. 3, 2017).

¹⁰² Jiang & Kim, *supra* note 11, at 197 tbl.6, 211.

¹⁰³ *Id.*, at 211. (pointing to an average holding period of less than six months by mutual funds in 2011).

¹⁰⁴ See *State Council Administrative Measures for Investment Management of Pension Funds*, *supra* note 100, art. 36 & 37. This move was said to potentially contribute up to RMB 600 billion, managed by PRC pension fund, into the PRC domestic stock markets. See *China to Allow Pension Funds to Invest in Stock Market for the First Time*, The Guardian, August 23, 2015, <https://www.theguardian.com/world/2015/aug/23/china-to-allow-pension-fund-to-invest-in-stock-market-for-first-time>.

¹⁰⁵ Yongbeom Kim et al., *Developing Institutional Investors in People's Republic of China*, WORLD BANK, <http://documents.worldbank.org/curated/en/280421468743976037/pdf/302480CHA0develtitutional0investors.pdf>. For a more recent and more positive analysis of institutional investors in China, see Xi, *supra* note 100.

(QFII)¹⁰⁶ program would bring experience and professional skills that will influence the quality of domestic institutional investors and their market involvement levels.¹⁰⁷ The educational value of QFIIs, however, remained marginal. Limited by operational quota restrictions and their own limited level of governance participation, even QFIIs prioritize goals such as maintaining a strong relationship with Party-state controlling shareholders. They were found to often entrust controlling party-appointed directors to vote on their behalf,¹⁰⁸ instead of opting for action that might more directly maximize value for their unit holders and other minority shareholders.¹⁰⁹ It should nevertheless be noted that in recent years the Chinese government increased the QFII quota allotment several times, thus increasing the scope of authorized foreign institutional investors and potentially their influence.¹¹⁰

Given the likelihood of increased institutional investor market share, competency and sophistication, could they become major participants in listed firm corporate governance as has been the case in other markets? In my view, there remain considerable barriers relating specifically to China's political economy, which prevent institutional investors from becoming truly effective agents for minority public shareholders in the Chinese capital markets.

First, institutional investors in China are subject to close regulation, supervision and enforcement at a multitude of levels. Various competing central government ministry-level bodies regulate the industry: the CSRC, the China Insurance Regulatory Commission, the China Banking Regulatory Commission, National Council for Social Security Fund, and the State Administration of Foreign Exchange. This segregated regulatory and supervisory authority produces multiple, cumbersome, and often overlapping regulation of competing interests which likely

¹⁰⁶ The program was introduced in 2002, revised in September 2009 and once again in December 2012. A separate program was approved in 2011 to facilitate the use of Renminbi held outside mainland China for investments in the domestic market – Renminbi Qualified Foreign Institutional Investors. General information on the QFII and RQFII schemes, including summaries of important policy revisions and relevant quotas, is available on the Shanghai Stock Exchange website: *QFII & RQFII*, SHANGHAI STOCK EXCHANGE, <http://english.sse.com.cn/investors/qfii/scheme> (last visited Mar. 3, 2017). For convenience reasons, I will refer to these programs together as QFII.

¹⁰⁷ See generally Khanna & Palepu, *supra* note 83, at 319.

¹⁰⁸ OECD, CORPORATE GOVERNANCE OF LISTED COMPANIES IN CHINA: SELF-ASSESSMENT BY THE CHINA SECURITIES REGULATORY COMMISSION 39 (2011), <http://www.oecd.org/daf/ca/48444985.pdf>.

¹⁰⁹ See Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169, 190 (2004) (providing examples how these considerations may have led to the generally passive role of foreign institutional investors in Japan, South Korea, and Taiwan as well).

¹¹⁰ See *QFII & RQFII*, *supra* note 106, for quota information. See also QFII, CHINA SEC. REG. COMMISSION, [http://www.csrfc.gov.cn/pub/csrfc_en/OpeningUp/RelatedPolicies/QFII/201212/t20121210_217805.html](http://www.csrc.gov.cn/pub/csrfc_en/OpeningUp/RelatedPolicies/QFII/201212/t20121210_217805.html).

restrict institutional initiative and autonomy.¹¹¹ These regulatory system encumbrances may also function to hold back policy which the CSRC seek to promote as part of its broad efforts to empower minority shareholders, and which otherwise could have pushed harder for mandatory institutional participation.¹¹²

Most importantly, the ownership structure of PRC firms accessing capital in the Chinese and global capital markets is likely to inhibit institutional investor involvement in firm corporate governance. The conflicts of interest experienced by PRC institutional investors are particularly acute, since these investors are closely affiliated with SOE groups, group company insiders, and with key political players at various levels of the Party and state.¹¹³ The state capitalism model implies strong Party-state involvement in the capital markets not only through the control of listed companies, but also through the control of the financial industry (commercial banks, investment banks, and brokerages) and the major players in the investment sector.¹¹⁴ Thus, in the PRC, central organs of the Party-state have both administrative and regulatory control over the financial and investment sectors, but also absolute ownership and management control of the firms in these sectors. The PRC Party-state can therefore promote its interests *via* its controlling shareholder position in its subsidiary listed firms, and *via* state regulatory agencies and the legal system, but also through its controlling ownership position in most of China's fund managers, insurance companies and other public

¹¹¹ E.g. both the CSRC and the State Administration of Foreign Exchange are responsible for the administration of the QFII schemes. See *Shanghai Stock Exchange*, *supra* note 106; the CSRC and the China Insurance Regulatory Commission share administrative authority over the operation of pension insurance funds which are also securities investment funds; the authority of the China Banking Regulatory Commission to regulate and supervise the entire banking industry includes, *inter alia*, some authority interface with the CSRC's authority e.g., over mutual funds, since financial institutions often operate as securities companies.

¹¹² In fact, the CSRC requires disclosure of the votes of the ten largest public shareholders on certain issues discussed at a shareholders meeting. *CSRC 2004 Provisions*, *supra* note 68, art. 1.1(5). Yet, there is no affirmative duty of institutional investors to vote. Hence, without a corresponding mandatory vote, and given institutional investors' network affiliation described hereto, such requirement is more likely *discouraging* their vote altogether.

¹¹³ See Xi, *supra* note 100, at 258–63; Michael Firth et al., *supra* note 26, at 692, 699–704 (providing an interesting insight into institutional investors' decisions during the split-share structure reform, when mutual funds were pressured politically to accept compensation schemes to rush the implementation of the reform, even when not in the best interests of their unit holders).

¹¹⁴ See, e.g., LARDY, *supra* note 27, at 20–23 (measuring state control over the financial industry by asset-holding ratio (private bank assets account for only 17 percent of all bank assets, and a more limited scope is ascribed to institutional investors), and by the reshuffle of senior executives between state administration and the industry, for example, between the Central bank, to commercial banks and branches of the administration such as China Banking Regulatory Commission and the CSRC).

investment vehicles, securities companies and banks.¹¹⁵ This control model certainly poses difficulties for institutional investors to act autonomously from the larger Party-state groups with respect to the governance of specific listed firms. Hence, even if the market share of domestic institutional investors in China grows, that increase will not translate into any reduction in Party-state control or to any increase in participation by institutional investors in corporate governance for the benefit of minority public shareholders. Quite the contrary I argue.

This control structure makes the role of institutional investors in the PRC more conflicted than in other concentrated markets. Therefore, the solutions applied in other concentrated markets to empower institutional investors and address their passivity and conflicted position, may not work in the Chinese context. For example, the institutional investor industry embedded in the same Party-state system won't exercise even a formally granted minority veto against Party-state controlling shareholders (provided for in the CSRC 2004 Provisions).¹¹⁶ Likewise, an effort like the one taken by the Israeli legislator to disentangle institutional investors and other financial service firms from listed companies and their business groups¹¹⁷ is probably not a viable option in the Chinese case, because simply separating investment services institutions from corporate groups will not suffice to eliminate the complex conflicts of interest that exist. In China, real independence of institutional investors from the corporate group requires their independence from the Party-state, and thus more extreme privatization. It would entail an overhaul of the entire political economy— a sensitive reorganization of local-government powers over listed firms.¹¹⁸ This scenario is unlikely mainly because such an overhaul will eradicate the reasons for which the Chinese state-capitalism system was established in the first place and maintained thus far.¹¹⁹

Consequently, for these given political economy impediments, it seems that the primary route for institutional investors in China to become more involved in the interests of their unit holders will specifically require an increase in the segment of institutional investors not directly subject to control by the PRC Party-state. While the independence of domestic institutional investors from corporate groups

¹¹⁵ Kim et al., *supra* note 105; see also HONG KONG STOCK EXCHANGE, INSTITUTIONAL INVESTORS IN MAINLAND CHINA (2004), <https://www.hkex.com.hk/eng/stat/research/rpaper/Documents/IIMC.pdf>.

¹¹⁶ The ownership-market structure and the network of conflicting interests make it reasonable to assume that institutional investors, when involved, will take informal private negotiations as their preferred method.

¹¹⁷ See notes 89 & 99, *supra*, and associated text.

¹¹⁸ While not advocating for the possibility of privatization, Part B of this Article discusses some potential changes in the *form* of Party-state control over listed firms, which may influence the incentives of institutional investors in similar ways inducing them to greater market involvement.

¹¹⁹ See Howson, *supra* note 36, at 697.

and mainly from the Party-state is unlikely, there seems to be an increasing space for competition in the industry by foreign institutional investors outside and beyond the QFII quota system. In my view, this evolving space signals a shift in the central government powers over the financial industry, as well as the beginning of a reconceptualization of the role of the financial sector more broadly (which is to a large extent still perceived to be first and foremost a financing source at the service of corporatized SOEs). A few recent initiatives seem to be pointing and aiding in that direction:¹²⁰ The 2013 Shanghai Free Trade Zone experimenting a reduction of barriers for foreign investors' participation in the capital market.¹²¹ At the national level, the recent China—Hong Kong Stock Connect initiative and the Mutual Recognition of Publicly Offered Funds between Hong Kong and the PRC, are expected to bring more off-shore institutional investors and wider range of investment tools into the PRC domestic market outside the existing QFII system.¹²² Not only will this increase the activity of foreign institutional investors not embedded in business group affiliation and Party-state control, but the Chinese domestic market (both retail and institutional investors) will also get better exposure to investor protection, disclosure standards and monitoring practices from the Hong Kong market, and to potential positive implications of greater governance participation.

4. Minority Public Shareholder Participation Through Social Organizations

Non-governmental organizations (NGOs), non-profit organizations (NPOs), and other social organizations have emerged as significant stakeholders in several concentrated-ownership markets.¹²³ The

¹²⁰ As part of the new economic policy established at the 3rd plenum of the 18th CCP Congress, see *infra* note 156, China's policymakers are slowly increasing the role of the private sector in the financial-services market.

¹²¹ See *Policy Measures for the Capital Market to Support and Promote the Shanghai Free Trade Zone*, CHINA SEC. REG. COMM'N (Sept. 29, 2013), http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201311/t20131126_238765.html.

¹²² The mutual stock-connect initiative allows off-shore retail and institutional investors mutual stock market access between the SSE and the Hong-Kong Stock Exchange. The Mutual Recognition of Funds opened up an authorization process for off-shore funds eligibility to trade in the respective domestic market, thus increasing the accessibility of PRC and Hong-Kong investors to asset management funds registered in the Hong-Kong/PRC market, respectively. See SECURITY FUTURES COMMISSION, MUTUAL RECOGNITION OF FUNDS (MRF) BETWEEN THE MAINLAND AND HONG KONG (2015).

¹²³ See, e.g., Erede, *supra* note 92, at 370 (describing a decline in hedge fund activism in Italy and the raise of the "Assogestioni"—a nonprofit association who serves as a facilitator for minority shareholder minimum board representation and advocates stronger engagement of intermediaries in corporate governance); Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia*, 29 YALE J. INT'L L. 169 (2004) (discussing NPOs governance participation as shareholders, as one of the most important corporate law enforcement agents in South Korea, Taiwan, and Japan).

involvement of these players can take the form of public pressure on shareholders' and directors' voting, as well as direct intervention via ownership of shares and associated voting rights.¹²⁴ As shareholders, they can utilize their participation rights to influence corporate governance through actual voting, shareholder proposals, or trigger broader public attention through the press and *ex-post* legal claims accruing to shareholders. This involvement functions to discipline corporate insiders and control parties, enabling them to expose problems and push firms and their management to act in a more socially responsible manner. Other social organizations function solely to facilitate coalition-forming for public shareholders, especially where true institutional investors are absent. In the French capital markets, for example, "*associations d'actionnaires*" ("[public] shareholders' associations") have become influential institutions able to coordinate minority shareholder action, despite significant ownership concentration in French firms long supported by the government. The capital structures of France's most important firms evidences concentrated ownership business group dominated by elite families¹²⁵ — the result of "strategic" privatization of a formerly state-dominated economy — with continuing robust state intervention in the market.¹²⁶ One might observe, similar in a way to China,¹²⁷ that corporate governance in France has developed to formally empower shareholders but in a highly politicized environment, which results in the interests of dominant shareholders (elite families and the state itself) being mostly served.¹²⁸ Nevertheless, the French Commercial Code permits public shareholders with at least five percent of the voting rights and who have held their shares for more than two years to form "*associations d'actionnaires*" to act in concert to further the public shareholders' collective interest.¹²⁹ These associations pursue legal

¹²⁴ Emma Sjöström, *Translating Ideologically Based Concerns: How Civil Society Organizations Use the Financial Market to Protect Human Rights*, 6 INT'L J. OF ENV'T & SUSTAINABLE DEV. 153 (2007).

¹²⁵ Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON., 365 (2002).

¹²⁶ MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 65-70 (2003); Vivien A. Schmidt, *French Capitalism Transformed, Yet Still a Third Variety of Capitalism*, 32 ECON. & SOCIETY 526 (2003).

¹²⁷ It seems fair to say that France's capital market functions in the embrace of a kind of Social Democratic state-capitalism, Schmidt, *id.*, and is therefore of particular interest to the comparative analysis here forth with China.

¹²⁸ Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2954 (2012) (noting how the French "double voting rights system" is served to magnify the voting power of the state). See generally Luca Enriques et al., THE BASIC CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 55, 84-5 (Reinier H. Kraakman ed, 2d ed. 2009) (positing how the relationship between an interventionist state, concentrated ownership, and shareholder-friendly laws may promote the state's priorities).

¹²⁹ See CODE DE COMMERCE [C. COM.] [COMMERCIAL CODE] arts. L.225-103, L.225-105, L.225-230 to L.225-233, & L.225-252 (Fr.). See also Yaron Nili, *Missing the Forest from the*

remedies through litigation, and statutory and regulatory protections by lobbying the French regulators for minority shareholder-friendly corporate governance mechanisms. Scholars have argued that the coalition-building enabled by these associations has meaningfully strengthened minority public shareholder participation in the governance of French firms.¹³⁰

However, it seems unlikely that a role comparable to the one played by the French shareholders' associations is possible for Chinese social organizations in the capital markets governed by the PRC's authoritarian single party regime. The traditional reliance such social organizations place on law and legal institutions to enforce their rights, as well as their ability to publicly critique corporate misconduct through a relatively free financial press, make similar functions in China difficult. The Chinese People's Courts are not an independent branch of government, and are part of the Party-state bureaucracy. This means that the Chinese judiciary is weak, and in many cases lacks the technical competence, bureaucratic autonomy or political independence necessary for it to act as a vehicle for rights protection and enforcement for such social organizations, even if permitted, against far more powerful Party-state actors.¹³¹

Furthermore, one needs to understand the current state of "civil society" in China to assess the possibilities for Chinese social organizations, even as shareholders, as corporate governance participants in the PRC. The emergence of civil society, including citizens' access to rights-enforcing institutions, is a matter of some complexity in China. Suffice it to say that the Western notion of "freedom of association" is absent. Civil society and organizations, as well as the financial press, are largely confined to areas that do not pose a threat to central Party-state interests or can help the center keep local power in control.¹³² Indeed, while the financial press is becoming more autonomous and increasingly influential, it is still ultimately controlled by the Party, and will continue to be used to protect Party-state interests. A clear example of this orientation was what occurred in the wake of two recent stock market crashes in the PRC, where "disloyal" journalists were arrested for

Trees: A New Approach to Shareholder Activism, 4 HARV. BUS. L. REV. 157, 197-98 (2014) (discussing relevant sections of the French Code de Commerce).

¹³⁰ Carine Girard, *Success of Shareholder Activism: The French Case*, BANKERS, MARKETS & INVESTORS, Nov.-Dec. 2011. See also Nili, *supra* note 132, at 199 & n.229.

¹³¹ Howson, *supra* note 64, at 327-56.

¹³² See, e.g., BRUCE J. DICKSON, WEALTH INTO POWER: THE COMMUNIST PARTY'S EMBRACE OF CHINA'S PRIVATE SECTOR (2008); Donald C. Clarke, *The Private Attorney-General in China: Potential and Pitfalls*, 8 WASH. U. GLOB. STUD. L. REV. 241 (2009); Benjamin L. Liebman, *Changing Media, Changing Courts*, CHANGING MEDIA, CHANGING CHINA 150, 151 (Susan L. Shirk ed. 2011); Benjamin Van Rooij, *People's Regulation: Citizens and Implementation of Law in China*, 25 COLUM. J. ASIAN L. 116 (2012).

contributing to the market declines and state-owned media accused foreign forces for causing market volatility.¹³³

In addition to these limitations on the operations of the judicial system, the financial press and civil society at large, there also exists in China an embedded traditional cultural perception of the legal system as a coercive instrument of control and administration put in the hands of the state.¹³⁴ Thus, law and legal institutions operates so as to restrict any non-state institutions, much less social organizations, from taking the lead on the enforcement of private rights of any kind, and certainly the enforcement of private shareholders' rights against superior forces of the PRC Party-state. The exclusion of private rights holders from effective use of the formal legal system, coupled with a strong concern about the maintenance of social (and political) stability, are evident from the constraints applied on group litigation cases. These constraints deny securities law class actions outright, and radically minimize the number of corporate law derivative lawsuits, especially those involving Party-state controlled companies or their management.¹³⁵ In the words of Professor Clarke:

The notion that private citizens should be involved in law enforcement for public goals does not find a ready home in... [the] Chinese political culture. The state jealously guards its control over the machinery of coercion [I]t may be unwilling to allow [enforcement by private action] because of the perceived political risks of giving citizens too much control over the operation of the legal system.¹³⁶

In addition, a recent law for the supervision of overseas NGOs, which stands as a very broad reaching legal effort to regulate the activities of foreign NGOs in China, is yet another sign of the general prohibitive approach toward civil society and privately organized operations in China.¹³⁷ The law will likely deter any involvement of foreign NGOs in

¹³³ *China Is Trying to Blame Its Stock Market Crash on Journalists and Businessmen*, VICE NEWS (Aug. 31, 2015), <https://news.vice.com/article/china-is-trying-to-blame-its-stock-market-crash-on-journalists-and-businessmen>.

¹³⁴ See, for example, Liang Zhiping, *Explicating "Law": A Comparative Perspective of Chinese and Western Legal Culture*, 3 J. CHINESE L. 55 (1989); Derk Bodde, *Basic Concepts of Chinese Law: The Genesis and Evolution of Legal Thought in Traditional China*, 107 PROC. AM. PHIL. SOC'Y 375 (1963). Both sources emphasize the punitive and coercive aspects of the Chinese traditional legal system through an analysis of China's legal culture and the meaning of "Law."

¹³⁵ Howson & Clarke, *supra* note 64.

¹³⁶ Clarke, *supra* note 132, at 242-43 (concerning private litigation, but applicable to other private enforcement channels).

¹³⁷ Jingwai Fei Zhengfu Zuxhi Jingnei Huodong Guanli Fa (境外非政府组织境内活动管理法) [Law on the Management of the Activities of Overseas NGOs within Mainland China] (promulgated by the Standing Comm. Nat'l People's Cong., April 28, 2016, effective Jan. 1, 2017), available at http://www.npc.gov.cn/npc/xinwen/2016-04/29/content_1988748.htm [hereinafter *Overseas NGO Management Law*]. The law determines government control over the establishment and operations of any activities conducted by a foreign nongovernment organization in China. According to the law, foreign NGOs will have to

shareholder rights movement (including educational and research efforts by foreign shareholder-rights associations).

Hence, while some Chinese social organizations may now operate legally, they are extremely unlikely to be permitted any role in changing corporate governance practices. Opening this particular area to the involvement of civil society organizations would almost certainly put the PRC Party-state's control of the economy and the major firms which are embedded in it, into question, and thus jeopardize the same Party-state's social, political, and financial interests. Contrary to that, however, is the possibility that some form of a quasi-public institution will be established with the endorsement of the Party-state. A Party-state-sanctioned institution is vastly more likely to be permitted greater latitude to promote minority public shareholder interests, and overcome the stringent limitations on private enforcement. This option is explored further below.

5. Non-shareholder Constituencies

In many concentrated markets, corporate governance accommodates a role for stakeholders who are not shareholders of the firm. Under certain circumstances, the power conferred on such non-shareholder constituents can strengthen minority public shareholders.

The best known example of this accommodation is Germany.¹³⁸ While the capital structure of German firms has recently evolved in the direction of mixed ownership, concentrated ownership (and thus control) by large blockholders still predominates.¹³⁹ The German system nonetheless continues to place great emphasis on the interests of non-shareholder constituencies, and provide for their direct involvement in the affairs of the corporation, mainly through the two-tier board system and the mechanism known as "co-determination".¹⁴⁰ In Germany's large corporations, employees and shareholders elect equal numbers of representatives to the firm's supervisory board. The supervisory board

register and will be continuously inspected by the Public Security Bureau (the state police). See *Overseas NGO Management Law*, *supra*, Chapter II—"Registration and Filing" and Chapter V—"Supervision Management."

¹³⁸ For additional examples, see OECD, *CORPORATE GOVERNANCE FACTBOOK 77* tbl.4.8 (2015), <http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf> (specifying jurisdictions that have legal requirements to appoint employee representation on corporate boards).

¹³⁹ Goergen et al., *Recent Developments in German Corporate Governance*, 28 *INT'L REV. L. & ECON.* 175, 178-79 (2008).

¹⁴⁰ John W. Cioffi, *Restructuring "Germany Inc.": The Politics of Company and Takeover Law Reform in Germany and the European Union*, 24 *LAW & POL'Y* 355, 362-68 (2002) (revealing how the choice to preserve a "stakeholder" oriented corporate approach, rather than adopt pure shareholder wealth perception, despite growing dispersion and development of the capital market, emanated from various political power struggles and continued social obligation).

then appoints the members of the firm's "management board".¹⁴¹ Moreover, banks in Germany function not only as creditors, but also exert influence as direct and indirect shareholders, and in addition will act as something like trustees for the firm's minority public investors, often exercising the public minority's voting power by proxy.¹⁴² Consequently, even in the absence of direct or indirect shareholding, the interests of both labor and creditors are taken into account and those same constituencies are granted the right to be actively involved in firm governance.¹⁴³ As one of the richest economies in the world set in a social democratic political system, which also has historically weak securities markets and strong banks,¹⁴⁴ Germany seems to provide an interesting model for comparison with China. Indeed, while shareholding by financial institutions is slowly being liberalized, capital allocation in China is still overwhelmingly led by bank lending rather than by equity capital markets.¹⁴⁵ China's state-owned commercial banks act exclusively as creditors of listed companies because direct equity investment by commercial banks in non-financial business enterprises is prohibited.¹⁴⁶ Interestingly, this seems to be changing now as the Chinese government looks to solve onerous debt burdens seen at many of the PRC's large listed companies, and the central government encourages further rounds of debt for equity swaps through

¹⁴¹ Goergen et al., *supra* note 139, at 184–86.

¹⁴² The proxy-vote system in Germany provides banks with effective voting powers. *Id.*, at 178–186 (noting that historically the bank that owns shares in the listed firm is also the firm's main creditor).

¹⁴³ *But see id.* (pointing generally on regression in the scope of monitoring by large banks).

¹⁴⁴ See ROE, *supra* note 126, at 71.

¹⁴⁵ Zhiwu Chen et al., *The Asset Management Industry in China: Its Past Performance and Future Prospects*, J. OF PROF. MGMT., SPECIAL CHINA ISSUE, 2015, at 12 (showing continuing dominance of bank financing over equity financing, whereby equity financing stayed below 5% of total bank loans in quantity (measured 1991–2013)). See Christian Edelmann et al., *Asset Management in China*, OLIVER WYMAN (Aug. 2014), http://www.oliverwyman.com/our-expertise/insights/2014/aug/asset-management-in-china.html#_VmTbPa6rRE5 (noting that in 2014, the bulk of China's \$145 trillion financial assets were either bank deposits or low risk securities.)

¹⁴⁶ See Shangye Yinhang Fa (商业银行法) [Law on Commercial Banks] (adopted the Standing Comm. of the Eighth Nat'l People's Cong., May 10, 1995, and amended last on August 21, 2015) art. 43 (prohibiting such equity investment by commercial banks unless otherwise provided by regulation). Exceptions for the general prohibition were implemented by a Debt-for-Equity Swap Scheme during the late 1990's. See Nicholas C. Howson, *The AMC's Debt-for-Equity Swaps: Opportunities for Foreign Capital?*, CHINA BUS. REV., Sept. 2001, available at <https://www.paulweiss.com/media/1953321/32427.pdf>. A similar being considered by the Chinese government. See Wei Lingling, *China is Set to Allow Banks to Swap Bad Loans for Equity in Borrowers*, WALL ST. J., April 15, 2016, <http://www.wsj.com/articles/china-plans-debt-for-equity-swap-program-to-help-reduce-corporate-debt-1460649581>.

various schemes,¹⁴⁷ and for the first publicly celebrated time also through direct bank equity holdings.¹⁴⁸

At first glance, it also appears that China has adopted Germany's two-tiered board and co-determination mechanisms through the PRC's dual-board structure, mandating the establishment of both an Anglo-American style board of directors and a supervisory board with employee electors.¹⁴⁹ In my view however, and regardless of superficial similarities between China and Germany, the Chinese dual board structure is very different from Germany's mechanism, and is widely considered a failure. China's 2006 Company Law indeed mandates that firm employees elect one-third of the supervisory board members in Companies Limited by Shares and the general shareholders meeting elects the rest. However, there is no hierarchical relationship between the PRC's supervisory board and the board of directors. The supervisory board has no power whatsoever in respect of appointing the board of directors, which are elected by the general shareholders' meeting—which is, of course, dominated by the controlling shareholder. Admittedly several reforms have been instituted with respect to the composition of the board of directors of PRC firms – including a mandated “independent director” system and recommended cumulative voting¹⁵⁰—but none of them affect the sheer irrelevance of the supervisory board and its radical difference from its German inspiration. The only thing which might make the supervisory board relevant in Chinese firm governance is negative veto

¹⁴⁷ Evidence of this includes Premier Li Keqiang's recent announcement concerning an expected reform of the financial system that will, among others, employ market-oriented debt-to-equity scheme to reduce the leverage in enterprises. Lei Ying, *Li Keqiang: Reform and Improve the Financial System*, CHINA NETWORK (Mar. 16, 2016), http://www.china.com.cn/lianghui/news/2016-03/16/content_38038507.htm. Also, see the mention of pilot projects in which financial institutions will hold equity in enterprises, subject to the manners approved by law, in art. 10 of the CCP Central Committee and State Council *Opinions on Enhancing the Reform of Financial Investments System*, July 5, 2016. Guanyu Shenhua Tourongzi Tizhi Gaige de Yijian [关于深化投融资体制改革的意见], http://www.gov.cn/zhengce/2016-07/18/content_5092501.htm.

¹⁴⁸ A first publicly announced case of a debt-to-equity swap which resulted in direct bank equity holdings in an industrial company was approved in March, 2016, whereby a total of RMB 17.1 billion (USD 2.6 bn) worth of debt in China Huarong Energy Ltd – a shipbuilding company – was converted to shares and distributed among various banks and financial-institution creditors, resulting in the issuance of 14% equity shares to the Bank of China, which became the dominant shareholder in the company after the issuance. See, Lingling Wei, *China Regulators Speed Up Help for Banks on Bad Loans*, WALL ST. J. (March 13, 2016), <https://www.wsj.com/articles/chinese-regulators-speed-up-bad-loans-1457871782>; Angela Yu, *Bank of China to Become Largest Shareholder in Huarong Energy*, FAIRPLAY.IHS (March 10, 2016), <http://fairplay.ihs.com/commerce/article/4264126/bank-of-china-to-become-largest-shareholder-in-huarong-energy>. Note, however, to the best of the author's knowledge, article 43 of the Law on Commercial Banks was not yet amended, and neither other regulations were issued to formally enable direct equity holding by commercial banks.

¹⁴⁹ See 2006 Company Law, *supra* note 18, arts. 37(2), 117. Article 108 enables the board of directors in CLSs to include employees-elected representatives as well. *Id.*, art. 108.

¹⁵⁰ Notice on Issuing the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (promulgated by Sec. Regulatory Comm'n Aug. 16, 2001), http://www.csrc.gov.cn/pub/csrcen/newsfacts/release/200708/t20070810_69191.html

rights for the supervisory board, requiring supervisory board approval for certain board decisions, etc. Such voting empowerment of the supervisory board in Chinese law and regulation is entirely absent.¹⁵¹ Thus, instead of constraining the control party's power, or providing any kind of monitoring mechanism to benefit employees or minority shareholders, the Chinese dual board structure further entrenches control party domination of the firm.¹⁵² One might view the potential increase in PRC commercial banks' equity holdings in PRC firms (the plan to swap non-performing loans for equity in borrowers mentioned above), as an attempt to increase the monitoring capacity of shareholding-creditors. And yet, such financial institutions are still instruments of the PRC Party-state and continue to have interests rather different from the minority shareholders (demonstrated by the banks, qua creditors, restraint from pushing defaulted SOE-borrowers into bankruptcy).

Finally, one might be tempted to see in the PRC (as a "workers' state") empowerment of labor as a non-shareholder constituency, even separate from the co-determination role electing one-third of the firm's supervisory board. Here, I refer to the labor unions which are given a formal participatory role in every PRC firm notwithstanding the lack of any share-ownership.¹⁵³ However, labor unions in China are entirely subordinated to the Chinese Communist Party, and thus promote the interests of the PRC Party-state along with the board of directors, the Party Committee behind the board of directors, the supervisory board, senior management, the controlling shareholder, and the firm (as dominated by all of the foregoing).¹⁵⁴ Indeed, labor union representatives at PRC firms are actually hired by firm management and paid by the firm, meaning such representatives invariably have a close relationship with incumbent management, and are exceedingly unlikely to advocate a corporate governance agenda or specific decisions that are supportive of

¹⁵¹ The Supervisory board is authorized to examine the financial affairs of the company; to propose the removal of directors and senior managers who violated their duties, laws, regulations, company bylaws, or shareholders' resolutions, and in some cases initiate a derivative lawsuit following such violation; to demand the violators to rectify their actions; to propose a shareholder meeting or to assemble one where the board of directors fail to do so; and to put forward proposals at a shareholders meeting. The supervisory board members may also observe the meetings of the board of directors as non-voters. *2006 Company Law*, *supra* note 18, at arts. 52-54, 117-118, 152.

¹⁵² Especially since cumulative voting is currently not mandatory. *Id.* at art. 105; see also Donald Clarke, *The Independent Director in Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 161-62, 173-75 (2006) (discussing the supervisory board in Germany and the failure of the supervisory board mechanism in China).

¹⁵³ *2006 Company Law*, *supra* note 18, arts. 18, 108, 117 (establishing the grounds for union involvement and presence in every China domiciled company).

¹⁵⁴ The unions are members of the "All-China Federation of Trade Unions," which is the official union organization of the Chinese Communist Party. See generally Mary E. Gallagher & Baohua Dong, *Legislating Harmony: Labor Law Reform in Contemporary China*, in FROM IRON RICE BOWL TO INFORMALIZATION: MARKETS, WORKERS, AND THE STATE IN A CHANGING CHINA 36 (Sarosh Kuruvilla et al. eds., 2011), at 41-5.

oppressed minority shareholders, much less those that are contrary to the firm's control parties.¹⁵⁵

B. Idiosyncratic Mechanisms for Minority Public Shareholder Empowerment in China

My analysis thus far supports the view that minority public shareholders in the PRC are demoted to the role of passive providers of finance capital to the firms operating under China's state capitalism model. Unavailable for them are mechanisms and corporate governance institutions accessible to minority public shareholders in other markets (dispersed and concentrated alike)—ranging from a functioning market for corporate control to minority legal protections—which otherwise facilitate the ability of public shareholders to monitor and ultimately discipline management and influence the governance of firms. In the remainder of the article I want to suggest how other political economy and capital market developments—highly specific to the Chinese context, and which I expect will amplify with time—may eventually enable greater minority public shareholder involvement in the PRC. I explore, specifically, two possible developments of significance—CCP-led support of minority public shareholders' involvement in PRC firms, and the emergence of a partial market for corporate control that operates *within* the controlling apparatus.

1. Communist Party Policy and Empowerment of Minority Public Shareholders

Here I posit that the CCP, the real control party behind the PRC's formal state (and thus I term the PRC throughout a "Party-state"), might itself implement a policy that promotes greater consideration of the interests of minority public shareholders in PRC listed firms. This, I suggest, might happen notwithstanding what is conferred on such minority shareholders in statute and regulation, and the fact that the Party would be empowering such shareholders against other identities within its own controlling apparatus. In China, perhaps ironically, the design of the PRC "Socialist Market Economy" is firmly within the purview of the CCP Central Committee,¹⁵⁶ and thus the empowerment of minority shareholders in listed firms might be understood as an instrument of this agreed strategy for economic development. First, there is a good deal of political benefit accruing to the Party if it acts in support

¹⁵⁵ *Id.*

¹⁵⁶ See *Communiqué of the Third Plenary Session of the 18th Central Committee of the Communist Party of China*, (adopted Nov. 12, 2013), CHINA.ORG.CN, http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm (The plenum stated: "Establishing a unified, open, competitive and orderly market system is the basis for the market to play a decisive role in the allocation of resources.").

of openly exploited minority public shareholders who have few apparent remedies, which benefits would include enhanced grassroots legitimacy, something the CCP is desperately in need of.¹⁵⁷ Here, the CCP's need to maintain popular legitimacy (or at least the idea that markets work fairly) merges with the regime's equally urgent need to find new ways to encourage continuous investment in capital markets (especially after the crashes of 2015 and 2016, and direct state intervention to "save" those markets). Moreover, it has always been in the CCP's interest to preempt populist "mass" demands for any kind of rights, political or property protecting, and thus increased shareholder participation and protection that goes beyond the mere rhetorical may also reduce social (*qua* shareholder) unrest and capital markets declines (which leads to further social unrest). Second, and as mentioned above, many of the PRC's listed firms are controlled by local Party-state institutions, which often act contrary to the policy dictated by the central Party-state. In these cases, the center's acting in support of minority public shareholders in PRC listed firms would help the central Party-state monitor, and battle against the accumulation of local-level economic and political power. It is exactly this dynamic which has driven the central Party-state's empowerment of central state institutions in the anti-corruption, legal system, and press sectors. Under this conception, minority public shareholders, newly-empowered, would support the central Party-state in its governance of local-level political economic powers, much as the private right of action in other political economies creates private attorneys general that aid state enforcement.

Assuming the Communist Party in China does support some kind of minority public shareholder empowerment, there are various ways in which it can implement that goal including: straight policy direction; policy translated into statutory or regulatory norms; endorsement of a state-established quasi-public institution enabled to act for minority public shareholders; and direct action at the level of Party-state-controlled firms. Since any CCP-led overt policy shift would trigger immense resistance from Party-state-controlling shareholders at both central and local levels (and specifically the human agents who act for them and presently extract the private benefits of control), I see the latter two mechanisms as the most plausible.

¹⁵⁷ Shown for example by President Xi Jinping's ongoing and unprecedented anti-corruption campaign, reflective of the CCP's serious concern for legitimacy crisis emanating from the massive scope of corruption and abuse of power by members of the Party-state controlling apparatus. As of 2015, the campaign resulted with the formal indictment of more than 100,000 Party and State officials, and with many more CCP-applied disciplinary actions outside the formal legal system. The campaign included action against even most senior Party leaders, members of the CCP's highest decision-making organ—the Politburo Standing Committee.

Quasi-Public Institutions

For more than a decade, scholars observed the viability of using state-supported institutions to act on behalf of minority public shareholders, especially in Asia.¹⁵⁸ For instance, many scholars in the PRC, Greater China and abroad have raised the possibility of China using a mechanism similar to Taiwan's Securities and Futures Investors Protection Center (SFIPC), designed to overcome collective action problems and encourage minority public shareholder participation.¹⁵⁹ Indeed, one of the considered amendments to China's 2005 Securities Law, is the establishment of a government-sanctioned organization—a Securities Investors Protection Agency—that will act in advancement of public shareholders interests. It is postulated that the institution will hold minimum shares in PRC listed firms, and thus will have the ability to bring civil claims for violations of securities law and regulations in its own name on behalf of defrauded public investors (thus potentially constituting a form of securities group/"class" action) or through a derivative lawsuit.¹⁶⁰ Similarly, proposals in the draft amendment also point to the establishment of a National Securities Investor Compensation Fund, to help compensate public investors for unrecovered damages incurred due to securities violations and consequent court proceedings.¹⁶¹ Given the current and perhaps historical wariness in the PRC regarding civil society and autonomous institutions, a Party-state-endorsed shareholder representative institution is vastly more likely to overcome the barriers that more private institutional investors and social organizations face. Another option would be for the Party-state to sanction the operation of some form of a shareholder friendly "lobby," or investor awareness group, to pursue less formal, perhaps more investor-education-oriented, initiatives.¹⁶² Indeed, there is some evidence that ideas related to "government-organized NGOs" are actually in conformity

¹⁵⁸ Milhaupt, *supra* note 123, at 204–05.

¹⁵⁹ Endorsed and partially funded by Taiwan's securities regulator, the SFIPC holds 1,000 shares of each public company in Taiwan. The organization uses this position to strategically implement available corporate governance mechanisms to promote the interests of minority public shareholders. Specifically, the SFIPC files derivative and class-action suits against insiders, functions as a mediation center for investors' disputes, operates a protection fund to compensate unobtainable investors' losses, and is also authorized to enforce profit disgorgement cases. See Wang Wallace, W.Y. and Chen J., *Reforming China's Securities Civil Actions: Lessons from US's PSLRA Reform and Taiwan's Government Sanctioned Non-profit Organization*, 21 COLUM. J. ASIAN. L. 115 (2008).

¹⁶⁰ See China Securities Regulatory Commission, *Revised draft for proposed amendments to the PRC Securities Law*, arts. 144, 147 (informal copy on file with the author).

¹⁶¹ *Id.* arts. 141, 142. The operation and funding of which is unspecified in the draft, presumably these public-shareholder-interest organizations will be funded by a form of "tax" levied on Securities Companies, as in Taiwan's SFIPC model.

¹⁶² For example, one possible and already existing venue for that is the Securities Association of China—a nonprofit, defined as a "self-regulatory organization" but which functions under the guidance and supervision of CSRC and the Ministry of Civil Affairs. *Introduction to SAC*, SEC. ASS'N OF CHINA, http://www.sac.net.cn/en/About_US/Introduction_to_SAC (last visited Dec. 6, 2015).

with the Party's development plans.¹⁶³ Of course, the ability of these institutions to safeguard and promote the specific interests of minority public shareholders depends highly on the degree of independence they will enjoy in practice. Thus, for example, legal arrangements for independent funding (through e.g. a type of tax levied on securities companies) and the appointment of expert managers outside the Party-state bureaucracy are crucial for their success.

Firm Level Intervention

A more direct channel for the Party to act on behalf of minority public shareholders exists through the Party's formal and informal roles within PRC listed firms. The PRC Company Law itself explicitly confers a role on a Party Committee established within any PRC-domiciled company,¹⁶⁴ and thus creates a legal basis for Party involvement in listed firms' operations. Also, as noted above, the Party's personnel management system allows it to direct the corporate decision-making process through the appointment and advancement of directors and managers at state-controlled PRC listed companies.¹⁶⁵ Hence it is not impossible that the Party will use its authority through these venues to push for minority shareholder protection, and even for greater minority shareholders' participation in firm governance, if Party policy dictates the need for that. As pointed above, an imminent concern for grassroots Party legitimacy, inner power struggles within the Party-state hierarchy—especially the need to battle against intensifying local-level economic and political power—combined with an urgent need to find new ways to encourage continuous investment into the PRC capital markets, all suggest that the Party may opt for minority public shareholder empowerment even against identities within its own controlling apparatus (*qua* dominant shareholders).

2. Emergence of a Market for Corporate Control Within the Controlling Apparatus

A more conceivable scenario for a shift in the powers of minority public shareholders in China is through further organizational and legal reform, and the rise of something like a market for corporate control even in the concentrated PRC market.

For instance, wholesale amendment of the 2005 PRC Securities law is currently under discussion by the Chinese legislature.¹⁶⁶ This

¹⁶³ Jennifer Y.J. Hsu & Reza Hasmath, *The Local Corporatist State and NGO Relations in China*, 23 J. CONTEMP. CHINA 516 (2014).

¹⁶⁴ *China Company Law*, *supra* note 18, art. 19.

¹⁶⁵ See Part I.B.1 *supra*; Howson, *supra* note 25; Howson, *supra* note 43, at 143-5.

¹⁶⁶ The draft was considered by the Standing Committee of the 12th National People's Congress in April 2015, and is still under discussion. For additional information on the considered draft. See Zhuanjia Jianyan 《Zhengquanfa》 Xiuding Wanshou Dui Neimu

amendment is expected to include a new "registration" process for new issuers, a radical departure from the merit approval system currently in place,¹⁶⁷ which will likely substantially increase the number of listed issuers. This new registration process, however implemented, will come with a stronger private right of action for shareholders, and an increased emphasis on more accurate disclosure into the markets. These mechanisms in turn will necessarily give a new role for non-controlling shareholders in listed companies. It should be noted, however, that the prospect for the suggested amendment is currently vague, especially following the 2015-2016 market crash which halted, and in my view seriously jeopardized, any contemplated securities legal reform.¹⁶⁸

Far more important in my mind are ways in which a market for corporate control might develop in the PRC, and how that might in turn empower minority public shareholders. One way I believe such a market will develop even under conditions of state-controlled concentrated ownership is through the emergence of a *partial* market for corporate control within the controlling apparatus. Here I postulate about developments of alternative state capitalism structures which will continue to guaranty the PRC Party-state's dominance over the economy, but will alleviate the implications it has on minority public shareholders to some extent, specifically with regard to its corporatized listed SOEs. I will sketch out here two possible development paths in such direction:

Economic Disentanglement

Fracturing within the controlling apparatus might set the stage for an economic disentanglement in the current structure of firm ownership in the PRC, in a way that will have implications for a market for corporate control. In the current Chinese market, business groups are still mainly clustered in specific industries, and face a host of impediments in respect of investment or business activity outside of their specific industry or sector. Such impediments include: strict regulation of permitted "business scopes" (even for the largest conglomerates); specific franchise grants which creates monopoly-like opportunities; path dependency resulting from the corporatization without privatization process which produced firms tied to specific ministries and thus specific industrial sectors; PRC listed firms' historic dual share structure which allowed "state shares" to be transferred only to other state shareholders before 2006; the personnel appointment system for senior management that often reshuffle such personnel to different firms but in the same

Jiaoyi Deng Xingwei de Guifan (专家建言《证券法》修订 完善对内幕交易等行为的规范) [*Experts Advocate Amendments to Securities Law to Regulate Behaviors Such as Insider Trading*], Zhongguang Wang (中广网) [CNR] (June 12, 2015), http://china.cnr.cn/gdgg/20150712/t20150712_519173123.shtml.

¹⁶⁷ *Id.*

¹⁶⁸ Based on informal conversations between the author and Chinese academic colleagues which were involved in the amendment process.

industrial sector; and finally, Party-state direction of M&A and takeover activity.¹⁶⁹

However, notwithstanding these constraints and the resulting lack of competition between corporatized SOEs across sectoral lines, the Chinese Party-state is not monolithic and neither are the firms that it has established and controls. In fact, the PRC Party-state has a myriad of internal conflicts, expressed in competition between government agencies at the central and local levels, and between Party and State institutions at all levels. These conflicts reduce the capacity of the PRC Party-state to act in a unified manner with respect to policy generally, but also through the firms it dominates. As a result, the system often serves more particularistic interests, whether personal, institutional, local, or across "systems" (*xitong*).¹⁷⁰ While this of course leads to rampant self-dealing by firm insiders, at the macro level it also gradually leads to economic disentanglement of firms and business groups from the Party-state. A good example of this is the alienation of local government-controlled firms from the central Party-state. It is well known that China's economic success has boosted the power of local governments and of local government-promoted firms. Local officials in particular have enormous incentives to maximize economic growth in their jurisdictions, very often at the expense of national Party-state interests.¹⁷¹ As local-government controlled firms and their managers become ever-more invested in profit maximization,¹⁷² the more they compete with other PRC firms in their same region and nationally. Consequently, real mergers and acquisitions activity across industries and regions have been increasing.¹⁷³ Such increase of more market-oriented competitive M&A activity will induce, for example, the sales of distressed assets, which in turn contributes to

¹⁶⁹ See, Liou & Tsai, *supra* note 40; Howson *supra* note 43.

¹⁷⁰ See Lieberthal, *supra* note 38, at 141-142 (referring to "*xitong*" as an organizational concept describing vertical functional systems of hierarchy which comprise China's governing bodies).

¹⁷¹ See, e.g., Kenneth Lieberthal, *China's Governing System and Its Impact on Environmental Policy Implementation*, 1 CHINA ENV'T SERIES 3 (1997) at 4-6 (addressing the situation of conflicting interests and incentives related to the implementation of environmental policy).

¹⁷² See, e.g., Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators*, 59 AM. J. COMP. L. 227, 262 (2011) (analogizing Chinese state-controlled enterprises to private equity firms).

¹⁷³ See, for example, Barry Chen, *Chinese Mergers and Acquisitions: What's Next*, THE MANZELLA REPORT, July 1, 2015, <http://www.manzellareport.com/index.php/strategies-section/1014-chinese-mergers-and-acquisitions-what-s-next> (reporting on a number of 1,536 M&A transactions that were closed in 2014, the majority of which (65%) related to SOEs restructuring). See also a report by Dezan Shira & Associates, *Understanding Mergers and Acquisitions in China*, CHINA BRIEFING, 166, June-July 2016, <http://www.iberchina.org/files/2016/mergers-acquisitions-in-china.pdf> (reviewing latest M&A market trends including proportions and distributions across industries, and reporting an increase of 39% in inbound M&A deals from 2010 to 2015).

firms' asset fluidity, competition, and efficient operations.¹⁷⁴ The consequence of this form of greater market competition between local-government controlled but listed-firms will eventually, I suggest, bring to the emergence of a partial market for corporate control (still mainly within such controlling apparatus). This form of a market for corporate control, in turn, induces more efficient capital allocation which takes the interests and expectations of public shareholders under greater consideration. Such rising competition also implies the creation of investments alternatives, currently completely missing from the PRC capital markets, which in turn leverage the power of public shareholders.

A limited number of what is traditionally seen as takeover battles, provide few examples that the suggested form of a partial market for corporate control is indeed emerging: For instance, in 2012 locally state-owned Beijing Enterprise Group sharply increased its stake in China Gas Holding Ltd. – a Chinese company whose shares are listed on the Hong Kong exchange – thereby challenging a joint hostile takeover attempt by another state-owned conglomerate Sinopec (who was joined by privately owned ENN Energy Holdings Ltd.).¹⁷⁵ Similarly, in a recent bidding war, an apparently private Shenzhen-based real-estate conglomerate Baoneng Group, has gradually bought shares in China Vanke Co. Ltd. – the country's largest residential area developer whose shares are listed on the Shenzhen and Hong Kong exchanges – thereby overtaking state-owned China Resources Co. Ltd. as Vanke's new largest shareholder.¹⁷⁶ Vanke's incumbent managers have applied various anti-takeover measures to fend-off potential takeover by Baoneng, ultimately cooperating with a locally-owned SOE.¹⁷⁷

¹⁷⁴ Moreover, if implemented on a large scale, the Debt-for-Equity swap scheme currently being considered by China's policy makers will contribute to assets liquidity as well. See, notes 146–148, *supra*.

¹⁷⁵ Guo Aibing, *Beijing Enterprises Group Buys More Shares in China Gas*, BLOOMBERG (May 7, 2012), <http://www.bloomberg.com/news/articles/2012-05-07/beijing-enterprises-becomes-single-largest-china-gas-shareholder>.

¹⁷⁶ Li Xiang, *Vanke 'Ropes in Government Help' to Ward Off Biggest Shareholder Baoneng*, CHINA DAILY EUROPE (Dec. 22, 2015), http://europe.chinadaily.com.cn/business/201512/22/content_22769475.htm.

¹⁷⁷ For instance, Vanke's management first initiated a trade suspension on December 18, 2015, and renewed such suspension repeatedly until July 4, 2016, presumably to halt further purchase of shares by the hostile acquirer. See Report on Suspension of Trading Due to Major Capital Restructure, SHENZHEN STOCK EXCHANGE, June 15, 2016, available at <http://disclosure.szse.cn/finalpage/2016-06-15/1202368720.PDF>. In March 2016, the company applied what is known as a "white knight strategy" in which a strategic cooperation with an alternative friendly buyer (in this case a locally-owned SOE – Shenzhen Metro group) is sought out to fend-off a hostile acquisition. See Press Release, Vanke, Shenzhen Metro Group and Vanke Achieved a Strategic Cooperation (Apr. 13, 2016), available at <http://www.vanke.com/en/news.aspx?type=8&id=4260>. Very recently, in January 2017, Vanke's dominant state shareholder sold its shares to the same locally owned SOE – Shenzhen Metro Group – who acted as the white knight under the initial management's anti-takeover strategy. See Report on Registration of Transferred Shares, SHENZHEN STOCK EXCHANGE, Jan. 25, 2017, available at <http://disclosure.szse.cn/finalpage/2017-01-25/1203052214.PDF>.

Even if such scenario of economic disentanglement does not result in a market for corporate control *per se* (as control battles will still be confined to dominant players, for the most part still affiliated with the controlling apparatus), increased competition with a focus on shareholder value will hopefully also create competition over better corporate-governance norms.¹⁷⁸ The availability of better investment alternatives will empower minority public shareholders to greater monitoring and governance participation *at least* through strategic use of the stock market and threats of exit as a form of voice. To be sure, a continuation of the ongoing economic disentanglement and further administrative decentralization that will mitigate the current network of conflicting interests, directly affect the likelihood of these scenarios.

A Preferred-Golden-Share Reorganization Scheme

An additional route that can lead to the development of a partial market for corporate control, consequently empowering minority public shareholders in China to greater involvement in firm monitoring and governance participation, yet under still a form of state-capitalism, is a "Preferred-golden-share" reorganization scheme. Such scheme will introduce a mechanism analogue to the "Golden Share", in order to preserve desired state interests. A Golden Share is a special share given to a government organization with attached veto rights that vest upon certain events. This mechanism was utilized to preserve strategic government influence or control during a process of privatization in several transitional economies.¹⁷⁹

Two prominent forms of state Golden Shares can be found in comparative legal systems: (1) those tied with appointments rights that provide ongoing decision-making powers to their holder,¹⁸⁰ and (2) those with just veto rights on certain issues.¹⁸¹ Most Golden Shares do not come with economic rights and by that defer from a "Preferred Share" mechanism, which grants its owner priority during dividend allocation and in asset liquidation claims, but do not grant any participation right. Commonly, the mechanism is contractual, set in the firms' bylaws, and includes a sunset provision since the scheme is meant to address only a transitional phase until full privatization of the firm is accomplished.

The Preferred-golden-share mechanism contemplated here for the Chinese system requires mandatory reorganization of state-controlled holding groups, and should be mandated rather than based on a temporary *ad-hoc* contractual basis. Moreover, to be compatible with the

¹⁷⁸ See, e.g., Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

¹⁷⁹ Stefan Grundmann & Florian Moslein, *Golden Shares, State Control in Privatized Companies: Comparative Law, European Law and Policy Aspects*, EURO. L. & POL'Y ASPECTS, Apr. 2003, at 6.

¹⁸⁰ *Id.*, at 9-12 (e.g., France, Belgium, and Italy)

¹⁸¹ See *id.*, at 10 (e.g., Netherlands, Ireland, and Israel).

idiosyncrasies of the Chinese system, it would have to address problems arising from the current concentrated ownership structure while at the same time preserve Party-state interests—these are both pecuniary rights and other strategic interests. It is difficult to envision a situation in which Party-state bodies, especially at the local-government level, will freely withhold their economic interest as shareholders. It is more likely, however, that they will be willing to relinquish their control over day-to-day business decisions to professional management once granted a veto right that ensures their strategic interests. And so, the Preferred-golden-share mechanism envisioned here would be one that grants its state holder with both economic rights and a veto right over specific business decisions. Other decision-making powers will be left to directors and professional managers, whose *majority* appointment will be assigned to public shareholders, with a mandatory non-controlling (disinterested) shareholders appointment slates, thereby elevating minority public shareholders voice.

Indeed, as a holder of Preferred-golden-shares, the state will expect a veto in certain fundamental issues, including the right to veto a change in control. This will necessarily restrain the development of a full market for corporate control and will limit takeovers to those endorsed by the state. Nevertheless, such mechanism still creates the possibility for competition over corporate control which is currently largely absent. This mechanism is also consistent with the Party-state's need to preserve the ideological justification for its continuous control over the market, while satisfying inner-Party conservative views who otherwise criticizes privatization and "submission" to market forces. It is worth noting that, while there was a strong historic objection in China against the adoption of any legal mechanism that contradicts a "one share one vote" corporate principle,¹⁸² the State Council already laid the legal groundwork for such a development and the CSRC followed through.¹⁸³ This recent change might therefore be a sign of support for a novel restructuring scheme similar to the "Preferred-golden-share" mechanism contemplated here.

¹⁸² Nicholas C. Howson, *China's Company Law: One Step Forward, Two Steps Back?*, 11 COLUM. J. ASIAN L., 127, 158–61 (1997). *But see* Howson, *supra* note 53, at 684–88 (discussing quasi-class minority rights and the distinction between share *type* and share *class*, where share classes are prohibited).

¹⁸³ On November 2013, the State Council promulgated guidelines for launching a pilot program of preferred shares, see Guowuyuan Guanyu Kaizhan Youxiangu Shidian de Zhidao Yijian [国务院关于开展优先股试点的指导意见], *Guiding Opinions of the State Council on the Program of Preferred Shares*, STATE COUNCIL. GUO FA [2013] NO. 46, issued November 30, 2013. The CSRC followed with the promulgation of the *Measures for the Administration of the Pilot Program of Preferred Shares*, March 2014: See, Youxiangu Shidian Guanli Banfa [优先股试点管理办法], *Measures for the Administration of the Pilot Program of Preferred Shares*, CSRC ORD. NO. 97, issued March 21, 2014.

CONCLUSION

The long-held assumption that minority shareholders in listed firms are disempowered and generally passive is changing, in both concentrated and widely-held capital markets. Indeed, despite the absence of an active market for corporate control, minority public shareholders even in concentrated markets across the globe are enjoying increasing empowerment with respect to monitoring, participation in corporate governance, and shareholder protection against controlling party oppression.

In the case of China, however, corporatization without privatization and the continued embrace of state capitalism has so far constrained similar developments in the role of minority public shareholders. This is the current situation in the PRC despite a facially enabling and shareholder-empowering Company Law, and even mandatory rules imposed by the Chinese securities regulator to protect such minority investors. In this article, however, I have argued that there are real possibilities for a future shift in the role of minority public shareholders in Chinese listed firms, and even with respect to effective firm monitoring and participation in corporate governance. I identify two possible routes here: a direct push for greater minority public shareholder participation by a CCP-led Party-state, motivated by China's unique political economy considerations such as concerns about popular legitimacy and vibrant capital markets; and, changes in the structure of Party-state control of the economy, entailing increased competition among dominant Party-state shareholders and development of a narrow market for corporate control.

This article confirms impressions of a global shift towards greater empowerment of minority public shareholders, even in capital markets characterized by extreme ownership concentration. At the same time, it provides a comparative analysis of the current situation in China, and possibilities for the future, all of which are of great importance as China's capital markets and Chinese firms raising money on the global capital markets become increasingly central to the global economy.