The Protection Of Minority Shareholders In
The Chinese Listed Companies

Graduation Thesis

13 June 2014

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Prologue

I would like to make several remarks on the first page of this thesis. This thesis is written for the Master of Law degree. The main reason why I choose this topic is not only because I am very interested about the legal theory and research of corporate governance, but also because I am lucky to have the chance to work in the Chinese listed company and wittiness the real practice of the corporate governance as well as the problems existing in the Chinese listed company. This thesis will discuss the development, current circumstances, legislation, problems of as well as my suggestions on the corporate governance in relation to the protection of minority shareholders in Chinese listed companies from the perspective of both expropriation the legitimate rights and interests of minority shareholders by majority shareholders and insider trading and the protection of minority shareholders based on data, legal texts, cases as well as my analysis.

This thesis will try to answer two main questions: (1) How the legitimate rights and interests of minority shareholders expropriated and infringed by majority shareholders and insider trading; and (2) How to protect minority shareholders from legislative and judicial perspectives in Chinese listed companies?

This thesis will be divided into five parts. The part I is an overview of both the agency problems and corporate governance framework of Chinese listed companies. Then, the part II will introduce and analyze the conflicts between majority and minority shareholders, in particularly, in the related party transactions. The part III will give a brief analysis of serious situation of insider trading having a negative influence on minority shareholders protection in China. The part IV will first introduce and analyze the independent director as the mechanism on minority shareholder protection and its insufficient enforcement in reality. This part will also introduce and analyze the shareholder private securities
litigation and the shareholder derivative litigation as the mechanism on minority shareholder protection and the relevant deficiencies and barriers regarding enforcement of them from legislative and judicial perspectives in China. At last, in the part V I will make the conclusions and my suggestions of the corporate governance in relation to the protection of minority shareholders in Chinese listed companies.
Part I General Introduction

1 Corporate governance

As far as I understand, to a great degree, corporate governance is viewed as a series of mechanisms through which minority shareholders and creditors protect their interests and rights against expropriation by the majority shareholders and managers of the enterprise.¹ A stable and efficient corporate governance mechanism, which is crucial to the orderly development of the company and the balance of different parties related to the company, can assist the investors, especially minority shareholders, to obtain more accurate and transparent information, thus, provide a solid protection to the investors. It is feasible for the corporations to meet the demands and expectations of investors as well.²

2 Agency problems in the corporate governance

Nowadays, the comparative corporate governance has already developed to one of the most crucial and dominant methods regarding to the corporate governance theory all over the world.³ The comparative methods can help us to have a better understanding of the agency problems in the corporate governance. Generally, the agency problems in the corporate governance can be divided into three categories: vertical agency problem, horizontal agency problem and the problem between company and other

¹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny, “Investor protection and corporate governance” (2001) RWP01-017, P4
³ Clarke, Donald C., “Nothing But Wind”? The Past and Future of Comparative Corporate Governance” (2010) American Journal of Comparative Law Vol. 59 No. 1, P75
stakeholders. I will focus on discussing vertical agency problem and horizontal agency problem, because the latter agency problem is unrelated to protection minority shareholders issue.

2.1 Vertical agency problem

To some extent, when ownership structure of corporate is dispersed in some countries, incumbent managers have much capability and power to manipulate their companies without appropriate monitor management from controlling shareholders, such as the UK and the US. Therefore, in American legislation, policymakers regard dealing with so-called vertical agency problem effectively as a vital problem. The main conflicts exist between the shareholders and managers.

2.2 Horizontal agency problem

On the contrary, when ownership structure of corporate is concentrated in some countries, conflicts between majority shareholders and minority shareholders, which is so-called horizontal agency problem, become principal issues instead of vertical agency problem, such as Germany. Moreover, majority shareholders have both the capability and motivation to restrict and monitor the senior officers’ and directors’ behavior. Meanwhile, majority shareholders emphasize their influence on the Board of Directors and maximize their interests at the expense of the interests of minority shareholders in these ownership-concentrated countries.

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6 Idem
3 Agency problems in Chinese corporate governance

The agency problems also have a significant influence on the corporate governance of Chinese listed companies. Even if above-mentioned two types of agency problems can exist at the same time, only one can be regarded as principal issue either at dispersed ownership or concentrated ownership structures in the world. Nevertheless, these double agency problems coexist in China. ⁷ Due to the economic reform and other historical or political reasons, concentrated ownership is viewed as one of the most obvious features in the Chinese listed companies. In China, minority shareholder protection is viewed as significant objective feature to corporate governance and securities market. Nevertheless, in reality, the right and interests of minority shareholders in Chinese listed companies are not sufficiently protected caused by diversified reasons including but not limited to above-mentioned two types of agency problems. Hence, dealing with the agency problems properly can promote the development of corporate governance of Chinese listed companies and maintain the stabilization and fairness of securities market.

4 The development of China’s corporate governance

The establishment and development of China’s corporate governance have been more than 30 years accompanying with State Owned Enterprises (“SOEs”) reform and private enterprises progress which can be classified into four phases. ⁸

At the first phase from 1978 to 1984, the State Council released several rules and regulations in respect of remodeling the organization and management system of

⁷ Idem
enterprises aiming at empowering more permission to SOE managers to engage in operation and business affairs. This adjustment played a significant role on relationship between the state and its enterprises. The direct administrative governance over the SOEs was gradually substituted by both direct governance and economic motivation simultaneously which was regarded as dispersal right mechanism at the beginning of economic reform.  

Next phase from 1984 to 1992, both the readjustment concerning the model of benefit allocation and confirmation with respect to the management accountability mechanism in SOEs were regarded as the prominent achievements of reform. The state and corporations started to share the benefits after taxation in the large and medium-sized SOEs. Moreover, “Management Accountability Mechanism” was put into effect.

The third phase from 1993 to 2003, the central government had already recognized that the market economy played a vital role on fostering sustainable economic growth and maintaining the steady society. Therefore, setting up a modern enterprise mechanism can be classified accurately in regard to ownership, rights and responsibilities in SOEs. Furthermore, the first Company Law was enacted in 1993, which facilitated formation of the modern enterprise mechanism and was regarded as the significant foundation of China’s corporate governance. After entry into the World Trade Organization (“WTO”), China emphasized much attention on the corporate governance in accordance with the relevant international principles and intended to foster the rapid development of Chinese listed companies.

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9 Idem, P13-14
10 Idem, P1
11 Idem, P15
12 The Chinese Company Law (1993), issued by Standing Committee of the National People's Congress, adopted on 29 December 1993 and became effective on 1 July 1994
The last phase from 2004 till now, government policymakers intended to handle with relevant historical restrictions to development of listed companies such as abusive administrative interference.\textsuperscript{14} However, after this three-decades effort, there are still a huge number of constraints and problems left for the corporate governance of listed companies that are difficult to abolish or change promptly and thoroughly. For instance, extensive related-party transaction has an adverse effect on protection the interests of minority shareholders in China. Enhancing the sufficient protection for minority shareholders is regarded as a significant feature of good corporate governance.

5 Corporate Governance Framework

The Organization for Economic Co-operation and Development ("OECD") as a global organization has advocated that a series of complex relationship between shareholders, directors and its board, governance and other stakeholders shall be comprised in the corporate governance, which provides the fundamental guidance concerning improving the corporate governance of listed company both in common law countries and civil law countries such as China.\textsuperscript{15}

5.1 The framework of Chinese listed company

There are two forms of companies in China: the Limited Liability Company and the Joint Stock Limited Company. The Chinese listed company is defined as a Joint Stock Limited Company whose shares are listed and traded on a stock exchange. Certain requirements need to be fulfilled before the Joint Stock Limited Company goes public.

\textsuperscript{14} Idem, P16
\textsuperscript{15} OECD, "principles of corporate governance" (2004) OECD Publishing, p11
In accordance with a series of relevant law and regulations, including but not limited to Chinese Company Law 2005 (“Chinese Company Law”)\(^\text{16}\) and Chinese Securities Law\(^\text{17}\), there are a set of specific provisions in respect of the organizational structure and other essential issues which provide a vital foundation for formulating and developing the corporate governance framework of listed company.

The shareholders are entitled to obtain profits, appoint the directors and managers and participate in major decision in respect of operation and business activities of company and so on. The shareholders’ general meeting, which is the unit of authority of the company, comprised by all the shareholders. The major issues shall be decided through shareholders’ general meeting. There are several crucial functions exercised by shareholders’ general meeting. For instance, shareholders’ general meeting will enact the business plan and investment strategy of the company. The shareholders’ general meeting can be classified into two types including annual general meetings which will be held once a year within 6 months according to the end of the former accounting year and interim general meetings.

The Board of Directors is the practical fulfillment unit of the company. In the case of authorization from shareholders’ general meeting, the Board of Directors can make decision regarding operation and management issues. The directors should own professional knowledge, skill and capacity in order to accomplish their responsibilities and duties. The board of directors should be loyal to shareholders. The Board of Directors may establish several specific committees including auditing committee, remuneration and appraisal committee and so on. Under the authority

\(^{16}\) The Chinese Company Law (2005), issued by Standing Committee of the National People's Congress, adopted on 27 October 2005 and became effective on 1 January 2006. The Chinese Company Law (2005) introduced some major amendments to the previous regulation. The latest amendment was made in December 2013 and became effective on 1 March 2014, which focus on the abolishment of minimum register capital requirement and simplify the company registration procedure

\(^{17}\) The Chinese Security Law, issued by Standing Committee of the National People's Congress, adopted on 29 December 1998 and the latest amendment was effective on 29 June 2013
from the Board of Directors, the chairman of the Board of Directors can fulfill a portion of power in case the board of directors is inter-sessional. Independent Directors mechanism is compulsory for listed company. The independent directors should take the independent supervision responsibility for the listed company and act in good faith and due diligence to all the shareholders. The secretary of the board of directors is regarded as a senior officer who takes charge of typical work including disclosing information to the public investors and preparing for the shareholders’ general meeting. The management is accountable to the Board of Directors, and is responsible for maintaining and managing the company orderly and steadily.

The supervisory board is responsible for supervision the behaviors of directors, managers and other senior officers in respect of breaching law or administrative regulations and Articles of Association of the companies. Relying on their professional knowledge or working experiences, the Supervisors should supervise the relevant personnel and inspect financial documents independently. The performance of the directors and the supervisors should be submitted to the shareholders’ general meeting.

To make it more clearly, the current organizational structure of Chinese Listed companies can be shown as below:
6 The introduction of Chinese Stock Exchange market and the achievements of Chinese listed company

It is worth to note that the China Securities Regulatory Commission ("CSRC") is a ministry-level unit directly under the State Council and regulates China's securities and futures markets with the purpose of maintaining their operations orderly and steadily in accordance with relevant laws and regulations, which is located in Beijing.

The first Chinese Stock Exchange market, so-called the Shanghai Stock Exchange, was founded and organized in Shanghai in 1990. It is directly subject to CSRC and


19 The China Securities Regulatory Commission ("CSRC") is comprised of 18 departments, and sets up 2 offices for securities regulation in Shanghai and Shenzhen respectively. Further details please refer to http://www.csirc.gov.cn/pub/csirc_en/about
was engaged in SOEs reform. The second Chinese Stock exchange market, so-called the Shenzhen Stock Exchange, was established in Shenzhen at the end of 1990 which has a self-regulated legal entity supervised by CSRC. From 1990 till now, the Stock exchange markets have experienced five diverse phases including establishment, trial, specification, transition and remodeling. Experiencing more than two decades rapid development of capital market, the mature scale and masses of listed companies replace former small market size and few listed companies.

In accordance with the statistical data provided by China Association For Public Companies (“CAPCO”), as of the end of 2011, the number of listed companies increased to 2342 in China. During the period 1995 to 2011, the average growth rate of total capital was 28% and the total capital rose up to RMB 3.6 trillion (approximately €0.4 trillion) with increasing growth of size of listed companies. The total market capitalization reached RMB 21.48 trillion (approximately €2.685 trillion) which ranked the third all over the world. The relevant statistical data has shown as follow:

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20 Further detail regarding Shanghai Stock Exchange please refer to http://english.sse.com.cn
21 Further detail regarding Shenzhen Stock Exchange please refer to http://www.szse.cn/main/en
22 CAPCO is a National self-regulatory organization and non-profit social organization. CAPCO is a legal entity and directly governed by CSRC. For further detail on the CAPCO please refer to http://www.capco.org.cn/zhuanti/cjz/xfzzd.html
23 All figures have been converted RMB/€ based on a currency exchange rate of 8:1, chosen for convenience based on the 2013 annual average.
24 The statistical data are provided by CAPCO. For further detail on the data please refer to http://www.capco.org.cn/zhuanti/cjz/xfzzd.html
Experiencing more than 30 years of economic reform, the Chinese GDP growth rate

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25 Graph by the Author, based on data from the official website of the CAPCO, For further detail Please refer to http://www.capco.org.cn/zhuanti/cjz/xi_fzzd.html

26 Idem.
maintains above 7% in the last few years and pursues its stronger developing trend and speed. Meanwhile, China has already achieved a series of prominent results both at economic and social fields. After entry into the WTO in 2001, China has an increasing number of opportunities to participate into global trade and market at wider fields. Through multinational trades in the recent years, the majority of Chinese enterprises have faced the cooperation and competition with foreign enterprises. It is inevitable for those enterprises to improve their corporate governances so as to meet the challenges by reason of economic globalization trend. In addition, good corporate governance is attractive to investors to invest in the listed companies and set up the confidences on securities market. However, those remarkable economic and social achievements also bring forth a plenty of difficulties and problems which have a negative influence on developing and reforming the corporate governance of Chinese listed companies. To a large extent, Lacking of adequate protection for the right and interests of minority shareholders in the Chinese listed companies will result in the adverse effect both to development of companies themselves and securities market. As a result, both policymaker and legal scholars should take this situation into severe consideration and deal with it effectively.
Part II
The conflicts between majority and minority shareholders

7 The legal framework of shareholders’ rights in China

There is a widespread view that protection the interests and rights of minority shareholders is a vital standard to assess corporate governance of listed company in the concentrated-ownership countries. As I have mentioned above, after entry into the WTO, China has more incentive to improve the corporate governance of company and accepts a plenty of significant concepts and principles from international organizations such as OECD. OECD has developed the vital principles concerning the corporate governance in order to provide extensive protection for minority shareholders so as to enhance them confidence avoiding or mitigating conflicts and expropriation by majority shareholders directly or indirectly. Hence, these guidelines and principles have a significant influence from legislative and judicial perspectives in china.

On the purpose of providing sufficient protection for the minority shareholders, it is inevitable for policymaker to constraint the expropriation by the controlling shareholders and authorize more power to the minority shareholders simultaneously. I will illustrate current legal system related to this aspect as bellow.

The main and crucial law and regulations on protection for shareholders especially for minority shareholders regulated by Chinese Company Law, Chinese Security Law and

7.1 The basic rights of shareholders under Chinese Company Law

The shareholders of the company, either the majority shareholders or minority shareholders, are entitled to some basic rights. The shareholders who hold the same kind of shares have the equal rights and should take the equal responsibilities and obligations. Relying on the number of shares by each shareholder held, he or she has the right to obtain dividends and profits from the company.

According to Article 34 of Chinese Company Law, the shareholders are entitled to make a proposal or question to the company and supervise the management and operation of company. In addition, the shareholders have the right to inspect the significant documents, including but not limited to financial and accounting reports, resolutions of a shareholders’ general meeting, resolution of meetings of the board of directors, resolutions of meetings of the supervisory board, articles of association and list of shareholders. According to Article 22 of Chinese Company Law, as to any resolution of a shareholders’ general meeting or the board of directors, it can be judged to invalidity by a People’s court due to breach any law or administrative regulations, when the shareholders make a written request to a People’s court. Furthermore, any holding procedures or voting way for a shareholders’ general meeting or the meeting of the board of directors can be withdrawn by a People’s court due to breach any law or administrative regulations or article of association, when the shareholders make a written request to a People’s court within 60 days foregoing resolutions made.

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The shareholders’ general meeting is the most crucial form to express the interests demanding of the shareholders. To make sure of the protection of shareholders’ interests, the equitable position and right in respect of attending and holding a shareholders’ general meeting are necessary. According to Article 103 of Chinese Company Law, all the shareholders will be informed the detail schedule concerning a shareholders’ general meeting before it holds. The shareholders are entitled to authorize a proxy to attend shareholders’ general meeting on behalf of themselves. In addition, the shareholder who individually or unitedly own at least 3% shares of the company are entitled to submit temporary motion to the board of directors 10 days before beginning the meeting. According to Article 102 of Chinese Company Law, in case the board of directors or the supervisory board cannot perform their duties regarding holding a shareholders’ general meeting, the shareholders who individually or unitedly own at least 10% shares of the company over 90 days are entitled to hold a shareholders’ general meeting depending on their rights.

Although the majority shareholders or minority shareholders are equal to enjoy these rights, in my opinion, the minority shareholders can make the best use of these rights to protect their interests when the company is manipulated by the majority shareholders.

7.2 Special legal mechanisms on the obligation and right of shareholders
7.2.1 **Restriction in respect of providing security to shareholder or his or her actual controller**

In case the company intends to provide security to a shareholder or his or her actual controller, the related resolution should be pass at a shareholders’ general meeting. Furthermore, the foregoing shareholder will not participate in voting procedure. Only obtaining a majority of the voting rights by the other shareholders attending at the shareholders’ general meeting will be valid.

7.2.2 **Restriction on related transaction**

In accordance with Article 79 of the Guidance on Listed Company Articles of Association (2006 Revision), the related shareholder who is participating in a transaction, he or she shall not vote at the shareholders’ general meeting regarding this matter.

7.2.3 **Litigation brought by shareholders representatives**

In order to protect the interests of shareholders, they are entitled to bring litigation against the violators on behalf of the company. In accordance with Article 152 of Chinese Company Law 2005, in case a director or senior officer violates Article 150 of Chinese Company Law 2005, the shareholder who individually or unitedly own at least 1% shares of the company over 180 days are entitled to require the supervisory board by written form to file suit before a People’s court. Furthermore, in case a supervisor violates relevant Articles of Chinese Company Law 2005, foregoing
shareholders are entitled to require the board of directors by written form to file a lawsuit before a People’s court. In case foregoing the supervisory board or the board of directors refuse to file a lawsuit after receiving the written request, or does not file suit after receiving the written request within 30 days, or without prompt lawsuit the company may suffer harm, the foregoing shareholders are entitled to file a lawsuit in their own names before a People’s court on the purpose of protecting interests of the company. In case the legitimate rights and interests of the company are infringed by a third party resulting in loss of the company, the foregoing shareholders are entitled to file a lawsuit in terms of the aforesaid procedure.

In addition to the above-mentioned derivative litigation, the shareholders can also bring suit in their own names in case of any infringement to their rights. According to Article 153 of Chinese Company Law 2005, in case a director, supervisor or senior officer breaches any law, administrative regulations or the Article of Association of the company causing loss to the shareholders, the shareholders can file a lawsuit before a People’s court.

### 7.2.4 Fiduciary obligation of controlling shareholders

Meanwhile, the Chinese Company Law 2005 and other relevant regulations established a fiduciary obligation for controlling shareholders to restrict its power and decrease the possibility of abusing right.

To be more specifically, according to the Article 20 and 21 of Chinese Company Law 2005, the shareholders are prohibited to abuse their rights infringing the interests of company or other shareholders. In case the shareholder who abuses his or her shareholder rights results in any damage or loss for the company or other shareholders, he or she will take a liability for compensation.
In accordance with the Article 21 of Chinese Company Law 2005, the controlling shareholder, actual controller, director, supervisor or senior officer are prohibited to infringe the interests of the company by taking advantage of his or her affiliated relationship. In case any person breaches it, he or she shall be liable for the loss raised and make compensation.

As regarding to the listed company, further rules have been published. In accordance with the Article 19 of Code of Corporate Governance for Listed Companies in China\textsuperscript{29}, the controlling shareholders should act in good faith toward the listed company and other shareholders. When the controlling shareholders execute their rights, they should comply with the laws and regulations. Any behavior related to infringing the interests of company or other shareholders should be prohibited, such as by means of assets restructuring wrongfully. Moreover, the controlling shareholders are forbidden to acquire additional profits by virtue of their controlling positions.

8 Conflicts between majority and minority shareholder

Although the corporate governance has been enhanced and legal position of minority shareholders has been improved gradually, the predominant phenomenon in respect of expropriation of minority shareholders by majority shareholders can still be indicated by a huge number of reports. There is widespread view that when the majority shareholders intend to seek private benefit relying on controlling the boards of directors and management, they will expropriate the interests of the listed company and minority shareholders. In Simon Johnson’s view, such expropriation is regarded as “tunneling”. Tunneling can be defined as the majority shareholders transfer the

\textsuperscript{29} The Code of Corporate Governance for Listed Companies in China, issued jointly by China Securities Regulatory Commission and State Economic and Trade Commission, adopted on 7 January 2001
assets or cash from the company to themselves or those who are controlled by majority shareholders. The related party transaction is viewed as one of the most serious and universal problems, which has a negative effect on protection the interests of minority shareholders and steady development of listed companies all over the world.

It is necessary to understand the concept of related party transaction as well as its diversified forms in practice. There is no denying that it is difficult to make an accurate definition to a related party transaction and classify all the forms of it due to the complex social and historical reasons. Thus, I would like to define and summarize a related party transaction by myself through legislative interpretation in China.

8.1 The legal framework of regulating related party transaction in Chinese listed company

In accordance with chapter 9 and 10 of Rules Governing the listing of Stocks on Shanghai Stock Exchange and Rules Governing the listing of Stocks on Shenzhen Stock Exchange, a related party transaction is defined as transfer assets or resources between the listed company or its controlled subsidiary and its related party. As to the forms of the related party transactions, the majority of them can be illustrated as follow: (i) Buying or selling assets; (ii) External investment (including entrust finance, entrusted loans); (iii) Providing financial support; (iv) Offering guarantee; (v) Leasing into or out of assets; (vi) Entrust or the entrusted management of assets and business;

31 Rules Governing the listing of Stocks on Shanghai Stock Exchange, issued by Shanghai Stock Exchange, became effective in January 1998, the latest amendment was effective in December 2013
32 Rules Governing the listing of Stocks on Shenzhen Stock Exchange, issued by Shenzhen Stock Exchange, became effective in January 1998, the latest amendment was effective in July 2012
(vii) donating assets or accepting donating; (viii) Restructuring creditor's rights and debt; (ix) Signing a licensing agreement; (x) Transferring or obtaining research and development projects; (xi) Purchasing raw materials, fuels and impetus; (xii) Selling products and commodities; (xiii) Providing or accepting labor services; (xiv) Consigning sales or trusting sales; (xv) Making saving and loans from a related party’s financial company; (xvi) Joint investment with a related party.

Meanwhile, a related party can be classified into related legal persons and natural persons. It is worth to note that the majority situations both applied to legal persons and natural persons as well. The Rules Governing the listing of Stocks on Shanghai Stock Exchange has classified the main situations could happen when either regarding to a related legal person or a natural person.

For the related legal persons, the main situations could be: (i) The listed company is directly or indirectly controlled by the legal person or other organization; (ii) In excess of 5% shares of listed company are owned by the legal person or other organization; (iii) The listed company and its controlled subsidiaries are controlled directly or indirectly by a natural person who belongs to other legal person or other organization, the listed company and its controlled subsidiaries are controlled directly or indirectly by a natural person who is a director or senior officer of other legal person or other organization.

As to the related natural persons, the main situations could be: (i) In excess of 5% shares of listed company are owned by the natural persons; (ii) The director, supervisor and senior officer of the listed company; (iii) The director, supervisor and senior officer of the related legal persons; (iv) The person is a close family member of the person who is applied to first and second subsection in this paragraph.
8.2 The negative effect of a related party transaction in China

8.2.1 The negative effect on Chinese listed company

Over-reliance on related parties make the listed company lose "self-generated" capability due to an increasing number of related party transactions. Nowadays, most related party transactions happen in the listed companies. Meanwhile, purchasing and selling products takes up the majority of related party transactions. Purchasing raw materials from related parties and selling products to the same parties will lead to over-reliance on related parties. Those listed companies, on the contrary, will loss their competences in the market and confront huge business risks owing to the single selling structure and restricted management autonomy.

The performance evaluation of listed companies loses an objective basis because of the related transaction. The purchasing price and selling price between listed companies and their related parties are random, since they can apply negotiated price and cost-plus method and so on. Without clear explanation between foregoing methods and market price, it is difficult for outside investors to make a objective assessment of enterprise value.

A related party transaction has become a vital tool for a related party, especially for controlling shareholders, tunnelling the companies. Providing fund and guarantee mutually between the listed companies and their related parties is regarded as main form of a related party transaction. There are diversified forms of expropriation by a related party. For instance, the related party purchases products from the listed company without payment during a long period, or a related party requires the listed
company to pay in advance before selling raw materials. Listed companies are possible to lose their solvencies in the future owing to a huge accounts receivable and accounts prepaid in the balance sheets.

### 8.2.2 The negative effect on minority shareholders

The controlling shareholders can take advantage of holding majority voting rights to make decision concerning a related party transaction of listed companies, so the controlling shareholders could gain the additional profits from a related party transaction by infringing the interests of the listed companies and minority shareholders, such as transferring profits to related persons and restructuring the assets illegally. Inflated stock prices will lead to minority shareholders follow the trend blindly, and they will go down the drain at eventually. As to the State-Own shareholder of State-Owned listed company, the interests of State and self-interest of State-Own stock may not always in consistent with each other. For instance, controlling shareholders who represent the State may sell State-Owned assets at a lower price resulting in infringing the state interests and the state assets.

### 8.3 Case study: The main forms of related party transactions of tunnelling the company by the controlling shareholders in practice.
8.3.1 Purchasing at a lower price and selling at a higher price in order to earn profits

First, the controlling shareholders sell raw materials to the listed companies at a higher price and purchase products at a lower price from listed companies. Then the controlling shareholders sell those products at a market price obtaining huge profits. Take a famous case in China for example, in 2001, when Chujun Gu became the controlling shareholders of Hisense Kelon Electrical Holdings Company Limited (Stock Code: 000921) (“Kelon company”) which is a company listed in the Hong Kong Exchange Stock in 1996 and Shenzhen Exchange Stock in 1999 respectively, he required Kelon company to purchase a huge number of Greencool refrigerant at very high prices from Greencool Refrigerant (china) Co., Ltd. which is a controlling subsidiary of the company owned by Chujun Gu. The purchasing price is 12 times higher than former refrigerant used in Kelon company. Shortly after completing two orders, Chujun Gu continued to require both Kelon company and its two subsidiaries to purchase Greencool refrigerant which amount to RMB 300 million (approximately € 37.5 million) in total. According to the internal staff from Kelon company, the Greencool refrigerant purchased by Kelon company is enough for next 10 years.  

8.3.2 The Expropriation of funds and assets of listed companies

In general, the controlling shareholders borrow directly from listed companies without interests or default payments in order to misappropriate the funds of listed companies.

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33 Teng Xiaoli, “Related-Party Transaction and Controlling Shareholder’s Tunneling Behavior of Listed Companies” (2005), Zhejiang University Master Graduation Thesis, p14
for free, which has been viewed as the dominating approach of tunneling the interests of listed company and expropriation of the minority shareholders. In terms of relevant statistics data, misappropriation of funds by controlling shareholders happened in 70% of the listed companies which were in deficit for two consecutive years. Expropriation funds by controlling shareholders is regarded as one of most vital reasons concerning business failure in delisting of listed companies.  

To be more vividly, listed companies are regarded as cashiers by the controlling shareholders, because they can get cash from the companies whenever and as much as they want. There is a typical case happened in China. The China Resources Sanjiu Medical & Pharmaceutical Co.,Ltd. (Stock Code: 000999) is a company listed in the Shenzhen Exchange Stock in 2000. RMB2.5 billion (approximately € 312.5 million) of cash, which represented 96% of total net assets of this listed company, was withdrawn by its majority shareholders Shenzhen Sanjiu Yaoye Co.,Ltd.  In accordance with statistics regarding related party transactions provided by Shenzhen Exchange Stock in 2002, the listed companies lent about RMB22 billion (approximately € 2.75 billion) cash to their related parties. In addition, the amount of the controlling shareholders borrowed was RMB 9 billion (approximately € 1.13 billion) that represented 40% of total borrowing money. The following table will indicate more relevant figures regarding a variety of forms of related party transactions.  

<table>
<thead>
<tr>
<th>Types of transactions</th>
<th>Total amount RMB billion</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases and sales goods</td>
<td>183.5</td>
<td>72.1%</td>
</tr>
<tr>
<td>Controlling shareholders involved</td>
<td>70.8</td>
<td>38.6%</td>
</tr>
<tr>
<td>Purchases and sales of assets other than</td>
<td>8.1</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

---

34 Idem
36 Idem.p318-320
<table>
<thead>
<tr>
<th>Goods</th>
<th>Percentage</th>
</tr>
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<tr>
<td><strong>Controlling shareholders involved</strong></td>
<td>4.4</td>
</tr>
<tr>
<td>Providing and accepting employment services</td>
<td>6.6</td>
</tr>
<tr>
<td>Controlling shareholders involved</td>
<td>1.6</td>
</tr>
<tr>
<td>Property rentals</td>
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<tr>
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<td>Credit facilities</td>
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<tr>
<td>Controlling shareholder involved</td>
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<tr>
<td>Guarantees and undertakings</td>
<td>21.3</td>
</tr>
<tr>
<td>Controlling shareholder involved</td>
<td>9.8</td>
</tr>
<tr>
<td>Management service agreement</td>
<td>1.4</td>
</tr>
<tr>
<td>Controlling shareholder involved</td>
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<tr>
<td><strong>Others</strong></td>
<td>9.9</td>
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<tr>
<td>Controlling shareholder involved</td>
<td>5.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>254.5</td>
</tr>
<tr>
<td><strong>Controlling shareholder involved</strong></td>
<td>101.8</td>
</tr>
</tbody>
</table>

**Chart 4**

In addition, a great number of listed companies and their controlling shareholders have chaotic and disordered relationships on several aspects, including but not limited to occupation of funds, staff position, business process, corporate personnel management and transferring funds. As a result, the heavy burden of loss may be transferred to the listed companies from their controlling shareholders. Furthermore, the listed companies may confront default payments regarding the related party transactions from their controlling shareholders. For instance, Henan Lotus Flower Gourmet Powder Co., Ltd. (Stock Code: 600186) is a company listed in the Shanghai Exchange.

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*Idem*
Stock in 1998 whose expropriation of funds reached up to RMB 1 billion (approximately € 125 million), including selling products RMB6.67 million (approximately € 833,750), and loan RMB978.51 million (approximately € 122.3 million) by its controlling shareholder Lotus Flower Group, Inc. As a consequence of this expropriation, this listed company is deemed as underperformed and deficit for two consecutive years in 2003 and 2004.  

Furthermore, the controlling shareholders may acquire the position of de facto control depending on assets restructuring and misappropriate the funds of listed companies by using their controlling positions. As we can see from the following typical case. The China Sichuan International Cooperation Co., Ltd. (Stock Code: 600852), a company listed in the Shanghai Exchange Stock in 1994, whose net asset was RMB367 million (approximately € 45.88 million) before restructuring assets in 1998, and its negative asset accounted to RMB60 million (approximately € 7.5 million) in 2004. As a result, China Sichuan International Cooperation Co., Ltd. delisted in 2005 due to expropriation by its controlling shareholder through assets restructuring.  

The original purpose of asset restructuring, as a mean of capital operation, is to enable listed companies to optimize resource allocation and improve their market competitiveness. However, throughout processes and results of reorganization of assets, a huge number of realistic cases indicate that the controlling shareholders “make best use of” unequal asset replacement, equity transfer and other means in order to expropriate the assets of listed companies and infringe the rights and interests of minority shareholders.

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38 Teng Xiaoli, “Related-Party Transaction and Controlling Shareholder’s Tunneling Behavior of Listed Companies” (2005), Zhejiang University Master Graduation Thesis, p16
39 Idem p16-17
8.3.3 Cashing at a high price through a related party transaction

The controlling shareholders can gain high price difference through selling their low-quality assets to listed companies at a high price or selling the intangible assets to listed companies at a premium. Admittedly, owing to the lack of uniform regulations for assessment procedures and approaches of the intangible assets value, it is doubtful and uncertain to evaluate the procedures and approaches of transferring intangible assets in respect of legitimacy and authenticity. Hence, it is not difficult for controlling shareholders to transfer their trademarks at high price on the purpose of expropriating the interests of listed companies and minority shareholders.

For instance, Shanxi Coking Co., Ltd. (Stock Code: 600740) is a company listed in the Shanghai Exchange Stock in 1996 which raised dramatically the trademark license fee from RMB20,000 (approximately € 2500) up to RMB 6.07 million (approximately € 758,750) annually. Shanxi Coking Coal Group Co., Ltd., as the controlling shareholder, owned the trademark right of “FeiHong”. However, the controlling shareholder was suffering loss for the past several years, and it largely relied on the trademark license fee. In fact, this real market value of trademark is much less than the huge license fee based on the evaluation appraisal by professionals. As a result, Shanxi Coking Coal Group Co., Ltd. continues to operate its company and expropriate large sums of cash from the listed companies at the expense of interests of minority shareholders. 40

In another typical case, Guizhou ChiTainHua Co., Ltd. (Stock Code: 600227), a company listed in the Shanghai Exchange Stock, purchased a set of equipment valued RMB 15.65 million (approximately € 1.96 million) from its controlling shareholders.

40 Idem p17-18
at RMB 220 million (approximately € 27.5 million) with a premium rate of 13.3% in 2000. This set of equipment was imported 30 years ago, however, the latest evaluation of the equipment increased to RMB 22.124 million (approximately € 2.77 million) in the evaluation report. After acquisition, Guizhou ChiTainHua Co., Ltd. was in debt to the extent of RMB 1 billion (approximately € 125 million), but its controlling shareholder decreased in debt by foregoing deal. 41

8.3.4 Providing loan guarantee

Acquiring huge loan guarantee from listed companies in order to obtain loan from banks is regarded as one of the commonly used methods regarding expropriation by controlling shareholders. In the event that those controlling shareholders fail to repay debts, the listed companies will become a "scapegoat". Since 1990s, owing to no mandatory disclosure requirements in law, listed companies provided loan guarantee to their majority shareholders in the "underground". An increasing number of loan guarantee affairs gradually exposed which attracted investors and regulators’ high attention. The severe situation is that listed companies provided substantial guarantees for their majority shareholders or parent companies who attempted to obtain funds from banks.

This has been changed by several relevant notices promulgated by CSRC in 2000. In these notices, the listed companies are not allowed to make use of assets in order to provide loan guarantee for their shareholders, a subsidiary undertaking of shareholders or personal debt. Though situation of providing guarantee decreased gradually, it does not disappear completely. Providing fund and guarantee mutually between the listed companies and their majority shareholders leads to a guarantee ring. Providing fund and guarantee mutually between individual listed company or for the

41 Idem p18
controlling shareholders or related parties within the guarantee ring results in a large number of loans acquired by controlling shareholders. With the decreased performance of companies and other relevant companies or funds being siphoned off, a large number of listed companies went into bad debts. As a result, banks went into bad debts and confronted severe business risks. Therefore, the majority shareholders achieved their aims of acquiring loans from banks at the expense of interests of listed companies and minority shareholders eventually.

According to statistics, the amount of illegal guarantees provided by listed companies for their majority shareholders reaches RMB 41.6 billion (approximately € 5.2 billion) in 2004. Based on the annual reports published by 836 listed companies in Shanghai Exchange Stock in 2004, 483 companies, which representing 57.78% in total, provided guarantees for others. Furthermore, while the amount of illegal guarantees provided by 148 listed companies reaches to RMB 23.883 billion (approximately € 2.99 billion).

8.4 Analysis of reasons of tunneling by majority shareholders in China

According to the contractual theory of the corporation, in the case of complete contracts, the purposes between controlling shareholders and minority shareholders, shareholders and creditors and other stakeholders are consistent, therefore, there would be no conflict of interests. Nevertheless, it is impossible to acquire complete information in actual economic activities, thus a complete contract does not exist as well. Under the incomplete contract condition, the controlling shareholders hold the

42 Idem p18-20
vital voting rights and acquire much more information comparing with minority shareholders. They can easily take advantage of the acquired information to expropriate the interests of listed companies and minority shareholders with the purpose of gaining private benefits. Meanwhile, due to the highly concentrated ownership structure and corporate governance of Chinese listed companies, there is widespread view that controlling shareholders manipulate related party transactions seriously and expropriate the interests of listed companies and minority shareholders. I will elaborate the main reasons in the following sections.

8.4.1 The controlling shareholders are eager to seize assets and funds of listed companies resulting from the formational mechanism of listed companies

Accompanying with SOEs reform and private enterprises progress, outside investors are allowed to acquire a small percentage of ownership from SOEs. While, the majority of Chinese listed companies are resulted from reform of former SOEs. Most of the former SOEs are under poor management and heavy burden. With the purpose of be listed in the Stock Exchange, many SOEs stripped and packaged quality assets from the total assets of group companies and those group companies generally existed as controlling parent companies.

Nominally the listed company is an independent economic entity and legal entity, however, in many cases, the listed company and its controlling shareholders are not seperated strictly in respects of personnel, finance and resources due to the incompletion and limitaiton of the SOEs reform. It is common that the controlling shareholders appoint executives and other senior officers accompanying with cross office worker directly. In addition, since financial policies of listed companies had to
be formulated and agreed by their controlling shareholders, the listed companies also lost their financial independence. Moreover, the funds had to be deposited in the account of financial departments of controlling shareholders. Also, listed companies and controlling shareholders had a cross relationship regarding both sites of production and business operation and land use rights. Some listed companies even do not have their own independent purchasing departments, and they rely their production and selling matters on their controlling shareholders. A large number of listed companies still rent production equipments and facilities from their controlling shareholders.

Therefore, some listed companies are highly depend on their controlling shareholders, and their business and operation were subject to total control of their controlling shareholders simultaneously. It is inevitable for such listed companies and their controlling shareholders to do the related party transactions under the circumstances above-mentioned.

Before the reform, the social functions of SOEs are highly emphasized in China and the economic potential and ability of SOEs are not fully addressed. The enterprises not only provide products and services, but also take charge for providing basic necessities for their workers. After the reform, many high-quality assets had been stripped and packaged from SOEs into the listed companies in order to ensure that they can be “listed” in the Stock Exchange. As a result, a large number of non-profit assets concerning employees welfare facilities remain in the hand of controlling shareholders. The controlling shareholders take advantage of those high-quality assets to list in the Stock Exchange with the purpose of attracting the maximum amount of invest funds, and then they can make use of the funds raised from the securities market to rescue their own urgent needs. That is the reason why those controlling shareholders are eager to seize assets and funds of listed companies at the beginning of listing.
8.4.2 The main reason of expropriation: the special ownership structure of Chinese listed company

Because of historical reasons and Chinese special economic situations, the majority of Chinese listed companies are restructured from SOEs. In order to ensure the controlling positions of the State, either in the form of owned by the State directly or owned by the State-Owned legal entity indirectly, nearly all the Chinese State-Owned listed companies are dominant by the State, which means the State is the majority shareholder. Therefore, those Chinese listed companies have a highly concentrated ownership structure accompanying with a small portion of tradable shares in the securities market.

In the case of highly concentrated ownership structure of listed companies, the majority shareholders hold vital voting rights, and they play a decisive role on significant decisions such as the election of the Board of Directors. Moreover, they can appoint directly their own directors and control the cash flow of the company. Thus, in the case of highly concentrated ownership structure, the majority shareholders actually master and control the listed companies. Currently, the majority shareholders of listed company are mainly State-Own shareholder or State-Owned Legal-person Shareholder who are highly likely to seek their private benefits by virtue of their superior control of listed companies.

It is worth to note that the common stocks in Chinese listed companies can be divided into tradable shares and non-tradable shares. The majority shares owned by governments, state agencies and SOEs, which is viewed as State-Owned shareholder, has the mission to keep the dominant position by State. In China, apart from the above mentioned institutions, other enterprises which owns State shares are named as State-Owned Legal-person Shareholders. Shares owned, either by State-Owned
shareholder or State-Owned Legal-person Shareholders, are not permitted to trade in the securities market. The remainder of shares are allowed to transfer to outside investors including institutional investors and individual investors. The non-tradable shares represented 63.51% of all common stocks according to the latest available date till February 2005. Due to the non-tradable shares, the majority shareholders are unable to gain benefits from stock price appreciation.

In general, the legal income of controlling stake consists of dividend income and high investment return without expropriation by majority shareholders. High investment return depends on both improved performance and market value of the shares. However, there is a prevalent situation that the majority of Chinese listed companies are deemed as lacking long-term investment value. Under this assumption, it is unrealistic for majority shareholders to expect satisfied dividend income. Although the price of tradable shares is far higher than the non-tradable shares owned by State-Owned shareholder and State-Owned Legal-person Shareholders, it is impossible for State-Own shareholder and State-Own Legal-person Shareholders to gain the same benefits as tradable shareholders by dealing on the secondary stock market. This situation, so-called “same share with different rights” and “same share with different interests” has a negative influence on majority shareholders to achieve the investment value. Thus, it is unsurprised for majority shareholders to recover losses through other channels such as related party transactions. In other words, the majority shareholders infringe the interests of listed companies by abusing their controlling positions in order to maximize their own interests. Accompanying with increasing expropriation of assets from listed companies, the business and operation of listed companies will be adversely affected. The dividend income and investment return for all the shareholders will decline accordingly. In case the expropriation of interests of listed companies is greater than

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decrease of dividend income and investment return, majority shareholders can gain huge benefits at the expense of interests of listed companies and minority shareholders.

Even worse, State-Owned shareholder and State-Owned Legal-person Shareholders do not have to worry about both the share price declining dramatically and losing controlling positions of listed companies if there is any misconduct. Therefore, the majority shareholders have less concerns, or more motivations you may say, to gain benefits in any other methods such as tunneling.

8.4.3 Another reason for expropriation: Imperfect internal corporate governance of listed companies

Because of imperfect internal corporate governance of listed companies, there is a serious concern on insider control, either in theory or in practice. It is difficult for many listed companies to be truly separated from their parent companies in terms of personnel, management, financial and even production and business aspects. According to the statistics provided by Shanghai Exchange Stock, the board members in 92% of all listed companies have concurrent jobs in their majority shareholders’ companies at the same time. Meanwhile, nearly 40% of all listed companies’ chairmans of the Board hold the same positions in their majority shareholders simultaneously. Thus, executives of listed companies become the insiders with controlling rights. They can control the production and operation of listed companies and participate in related party transactions as well.45 It is necessary to recognize that the collusion between the majority shareholders and managements of listed companies, including the managements who are appointed directly by the majority shareholders.

Therefore, the majority shareholders take advantage of insider control to expropriate the interests of listed companies and infringe the rights and interests of minority shareholders.

The imperfect internal corporate governance leads to unreasonable operation mechanism of the General Meeting, the Board of Directors and Board of Supervisors. For instance, the related party transactions matters have not been approved by General Meeting or the Board of Directors; the related shareholders do not withdraw from voting during the voting procedure; or, the independent directors and Board of Supervisors fail to perform their duties regarding supervising the related party transactions matters.

I will explain further regarding insider trading problem, as well as the function and problems of the independent director mechanism in the following parts.

8.4.4 The imperfect legal system of supervision

Admittedly, every coin has two sides. On one hand, the fair related party transaction is beneficial for the development of listed companies. On the other hand, the majority of shareholders can take advantage of related party transaction as a tool to expropriate the interests of listed companies and minority shareholders as well. Thus, related party transaction can be permitted, but restricted by legislation in each country all over the world. In China, unfair related party transactions exist widespreadly in the listed companies’ business activities, and they have a negative effect on the development of listed companies. Although there are several relevant laws and regulations regarding related party transactions in China as mentioned above, compared with the good regulated laws and regulations in developed countries, there is much room for Chinese legislation regarding the related party transactions to improve.
With the exception of legislation, some self-regulated organizations such as Stocks Exchange have already formulated policies to supervise the related party transaction all around the world. For instance, Shanghai Exchange Stock and Shenzhen Exchange Stock have already revised the regulations regarding the related party transaction recently. In accordance with Rules Governing the listing of Stocks on Shanghai Stock Exchange and Rules Governing the listing of Stocks on Shenzhen Stock Exchange, the definition of related party transaction has been extended, and the related shareholder and related director have also been defined. Meanwhile, the disclosure standards of related party transaction has been revised. Nevertheless, in comparison with other well-developed exchange stocks, both Shanghai Stock Exchange and Shenzhen Stock Exchange are still lack of sufficient and efficient mechanism to constrain the related party transaction. Here I have a good example to make the comparison in respect of relevant regulations of related party transaction between the HongKong Stock Exchange and Shanghai Stock Exchange and Shenzhen Stock Exchange.

According to the rules of Shanghai Stock Exchange and Shenzhen Stock Exchange above-mentioned, if a listed company and the related legal person make a related party transaction (except for providing guarantee) in respect of the amount between RMB 3 million (approximately € 375,000) and RMB 30 million (approximately € 3.75 million), and the amount accounting for 0.5%-5% of the absolute value of latest net assets of listed company, the listed company shall disclose in time without report to Shanghai Stock Exchange or Shenzhen Stock Exchange. In comparision, in Hongkong, if the amount of a related party transaction is between HKD 1 million (approximately € 100,000)\(^\text{46}\) and HKD 10 million (approximately € 1 million), and amount accounts for between 0.3%-3% of the absolute value of latest net assets of listed company, the listed company shall disclose and report to HongKong Stock Exchange.

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\(^{46}\) All figures have been converted HKD/€ based on a currency exchange rate of 10:1, chosen for convenience based on the 2013 annual average.
Exchange in time.  

In Shanghai and Shenzhen, if the amount of a related party transaction (except for providing guarantee, receiving cash donation, simply relieving compulsory debt of listed company) surpasses RMB 30 million (approximately € 3.75 million) and amount accounts for over 5% of the absolute value of latest net assets of listed company, the related director should withdraw from voting at the procedure of voting. Moreover, the related shareholder should not participate in the voting. In comparison, if the amount of a related party transaction surpasses HKD 10 million (approximately € 1 million) and amount accounts for over 3% of the absolute value of latest net assets of listed company, the related shareholder should not participate in the voting according to the rules in Hong Kong Stock Exchange.  

Through the above comparison, it is apparent that the regulation regarding the threshold of amount concerning non-routine related party transaction applied by Hong Kong Stock Exchange is much lower than the amount (one third) applied by Shanghai Stock Exchange and Shenzhen Stock Exchange. Thus, the regulation is more stringent and thus provides more protection on the interests of non-related shareholders under the supervision by the Hong Kong Stock Exchange.  

47 Biqin Xie & Yihong Jiang, “Jurisprudence, listing rules and related party transaction- H-share companies and A-share companies as examples”, PS-6  
48 Idem.  
49 Idem.
Part III Insider Trading in China

9 Insider trading in China

In this chapter, I will focus on the insider trading in China. It is not hard to understand that insider trading has an adverse influence on both development of corporate governance of listed companies and minority shareholders’ protection, thus China has already established the regulatory regime for prohibition it. However, in practice, insider trading is still common and becomes much more complex and difficult to detect in China. The reasons are complex and diverse.

9.1 Insider trading has a negative influence on minority shareholders protection

There is a popular view that insider trading has a severely adverse influence in respect of securities market, listed companies and outside investors especially minority investors around the world. The most vital reasons can be indicated as follow:

9.1.1 Damage to the company

Firstly, insider trading damages the reputation of the company. When a company's insider takes advantage of material non-public information for securities transactions, the company's public investors are most likely to consider that they are not fairly treated. Thus, they may lose confidence to the company's management and company itself, and the company's reputation will be adversely affected as well. It is worth to note that the company's reputation has a significant impact on its stock price. As a
public investors, due to relatively limited financial resources, the time commitment, lacking of professional skills and information advantage as institution investors, they are willing to buy stocks from good reputation of companies in order to reduce the investment risk. In case a company's reputation has been damaged by insider trading, a large number of public investors refuse to buy its stock.

Secondly, insider trading affects the company's efficiency. The information has the most direct impact on the company's stock price, however, because of insider trading, the stock prices can not be accurately and appropriately reflected in the securities market. In order to gain more interests, insider may attempt to delay in releasing material non-public information. Accompanying with those material non-public information be delayed in releasing, the difference between the market price of stock and the actual value of the company's shares will be enlarged obviously. When Lower-level employees make use of material non-public information to trade, they have incentive to delay in reporting and conveying information to their upper level on the purpose of gaining long-term profit. Thus, the top management are unable to make decisions timely owing to lacking those information, and eventually the company’s operating efficiency will be affected adversely.

9.1.2 Infringement to the investors particularly minority investors

The insider trading will mislead the public investors and infringe their interests. Because of randomness of insider trading, it is difficult for those investors who has ever suffered by those harm to recognize which company exists insider trading. If insider tradings are too rampant to control, investment costs and unpredictable investment risk will generally increase. Ultimately, investors will lose confidence in respect of the fairness and profitability of securities market.
9.1.3 Damage to benefits and efficiency of securities market

Under the strong securities market, investors can access to reliable and valuable public information equitably. Moreover, investors believe that insiders of companies will not cheat them. Nevertheless, information mechanisms and trust mechanisms, as two cornerstones of securities market, could be eroded and destroyed fundamentally by insider trading. Some investors will completely withdraw from stock market and most of them will reduce transactions in order to prevent risks from insider trading. As a result, the capital returns and economic benefits will be reduced. The order of operation concerning the securities market and the entire financial market will be disrupted by artificial fluctuation of share price.

9.2 The regulatory regime for prohibition insider trading in China

Protecting the interests of investors is widespread viewed as essential goal of Securities Law or Act among all over the world. It is well-known that US is the pioneer who enacted the relevant regulations regarding prohibition of insider trading. In accordance with Securities Act of 1933 and Securities Exchange Act of 1934, the anti-fraud regulation had been established, including section 16(b) and 10b-5 which are deemed as significant principles of US legislation. Fundamentally, a variety of relevant information of securities needs to be disclosed timely and accurately on the stock market, and the interests of investors can be protected sufficiently under the enforcement of above-mentioned two Acts in US. In China, the relevant regulations

51 Idem.
regarding insider trading substantially relied on foreign legislation and experience especially the US.\textsuperscript{52} Experiencing more than two-decade development of securities market, China has gradually set up a regulatory regime for prohibition insider trading.

Firstly, in accordance with Article 142 of the Chinese company law, the directors, supervisors and senior officers of a listed company should not transfer their shares holding in their companies within one year from the time of listing shares on the securities market. Moreover, any aforementioned people should not transfer the shares within six months, when they leave the companies. This provision can be viewed as an indirect measure to hinder insiders from trading.

Secondly, CSRC takes charge of prohibiting insider trading with the purpose of maintaining the fairness of securities market and ensuring public investors’ confidence on securities market. In accordance with Article 67 and 75 of Chinese Security law, the inside information can be defined that any non-public information regarding the business operations or financial matters of a company in security trading activity or having a vital effect on the market price of the securities of the company. Furthermore, these types of information are deemed as inside information, listed as follow: (i) In case any major event may substantially affect stock price for trading and is not public, the listed company should submit a report to CSRC and Stock Exchange on the purpose of disclosing those information; (ii) Any plan regarding dividend distribution and capital increase; (iii) Any major change regarding ownership structure of a company; (iv) Any major change regarding to the guarantee of a company’s debts; (v) The major asset which is sold, abandoned or mortgaged concerning business operations of a company will exceed 30\% of the value of asset once; (vi) The company may assume compensation liability for significant damage owing to the conduct of any director, supervisor or senior officer; (vii) Any plan or program concerning acquisition of listed company.

Thirdly, it is important to define the scope of persons who can access to the inside information in order to prohibit those people from illegal trading relying on the information access advantages. In accordance with Article 74 of Chinese Security law, the insiders can be classified into several groups: (1) The directors, supervisors and senior officers of an issuer; (2) Any shareholder holds more than 5% of the share and the directors, supervisors and senior officers, and the actual controller of the company and the directors, supervisors and senior officers; (3) The directors, supervisors and senior officers of a company which is controlled by an issuer; (4) Any person can access to relevant inside information by virtue of his or her position and employment relationship with the company. Thus, it is apparent to recognize that above-mentioned group is still related to traditional corporate insiders. In addition, apart from those traditional corporate insiders, there are two other groups which should be prohibited as well. One is the functionary official who works for securities institutions and other person who takes charge of issuance and trading of securities in terms of his or her legal responsibility. The other one is the person working for underwriter, sponsor, stock exchange, securities registration, clearing and trading service organizations including but not limited to lawyers, accountants and consultants.

Fourthly, in accordance with Article 73 and 76 of Chinese Security law, any person who is able to access to inside information on securities trading or any person who acquired inside information illegally should be prohibited from securities trading by virtue of information advantage. Moreover, those above-mentioned people can not buy or sell any relevant securities, disclose such information or provide suggestion to any other person regarding trading relevant securities before those information release to the public.

53 Idem, P308
9.3 The actual serious situation of insider trading in China

Although China has already established the regulatory regime for prohibition insider trading, it is necessary to recognize that insider trading is a severe problem which has an adverse influence on both development of corporate governance of listed companies and minority shareholders’ protection in practice. The Chinese securities market develops rapidly and maintains a bull market within two periods: 1996-2000 and 2006-2010. In the meantime, the insider trading occurs at a high rate during above-mentioned two periods. One of the most significant reasons is that a huge number of investors were willing to invest in a bull market leading to unstable and active share prices. Thus, there were an increasing number of opportunities for private speculative business including insider trading. The other essential reason is that it is difficult for regulatory or administrative securities institutions to detect those insider trading because of the unstable and active share prices. To some extent, the insiders had much more incentive to deal transactions relying on information asymmetry.

In terms of the table below, it is worth noting that traditional corporate insiders, including directors, senior officers above-mentioned, still represented 70% in the entire cases. Admittedly, there is a trend that an increasing number of individual insiders involve in insider trading cases instead of more people combination nowadays. Therefore, the insider trading problem becomes much more complex, and it is difficult to detect in those secret cases.

<table>
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54 Idem, P318-319
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<tr>
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<tr>
<td>Total</td>
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</tr>
</tbody>
</table>

Chart 5

9.4 Analysis of reasons of insider trading in China

In terms of fiduciary duty theory, the directors, supervisors, managers and other staff have a agency and appointment relationship with their companies. They have a so-called fiduciary duty for both company and its shareholders. In case there is interests conflict between them and shareholders, they should not confront the interests of shareholders owing to this fiduciary duty. For instance, in case they take advantage of inside information to trade any securities including sale and purchase, ultimately all of the profits which obtain from those insider trading should belong to their companies. In addition, in case those above-mentioned personnel disclose inside information to any other person for the sake of their private interests, they will violate both relevant law and regulation and their fiduciary duties which should be deemed as insider trading as well. Due to both poor disclosure mechanism and inefficient supervision mechanism of Chinese listed companies, the insiders have much more opportunities to abuse information advantage for the sake of their private interests. The public investors’ interests will be infringed owing to information asymmetry.

Lacking of reasonable and sufficient compensation incentive mechanism of chinese

55 Idem, P319
listed companies, the directors, supervisors and senior officers will face the economic pressure in reality. Some of them attempt to obtain huge profits through insider trading in stead of compensation. Meanwhile, merely few listed companies will implement employee stock ownership plans in China, but those managements hold a relatively low percentage of share. In particular, the majority of the directors, supervisors and senior officers are directly appointed by listed companies’ controlling shareholders. In general, some of those personnel do not receive salaries from their listed companies or do not mainly depend on salaries received from listed companies. Thus, due to the low incentive mechanism, some of them are likely to take advantage of inside information to trade in order to increase their incomes.\textsuperscript{57}

In China, CEO is a relatively new title in the company, for chinese companies ever appointed general manager as the top executive. In accordance with chinese company law 1993, noramlly the chairman of the Board of Directors is the legal representative of a listed company who holds the most powerful position in respect of daily decision-making right. In particular, when the controlling shareholders are SOEs of listed companies, the CEO are likely to satisfy the interests of those controlling shareholders in place of the listed companies or all shareholders including minority shareholders. It is possible that CEO may discolse inside informaiton to the controlling shareholders with breaching of loyalty and fiduciary duty to the listed company and minority shareholders.\textsuperscript{58} In addition, an increasing number of CEO or senior managers who directly appointed by their controlling shareholders SOEs are likely to obtain their private interests through insider trading or corruption when they are close to retire. For instance, there is a common severe situation so called “Age 59 Phenomenon” in China. The retire age in China is 60 for man. Because those CEO or senior managers, most of them are male, will merely obtain relatively low pensions.


\textsuperscript{58} Kato, Takao and Long, Cheryl X., “CEO Turnover, Firm Performance, and Corporate Governance in Chinese Listed Firms” (2005) SSRN, P10-12
after retirement. Some of them attempt to obtain their private interests depending on last limited opportunities when they still hold the powerful position before retirement.\textsuperscript{59}

To some extent, Nowadays, merely administrative and criminal liability regarding insider trading, which can be deemed as public enforcement, are enforced in practice in China. For instance, according to Article 202 of Chinese Security law, any illegal incomes of the inside traders should be confiscated, and a penalty with same amount of the value of the illegal incomes between one and five times should be required simultaneously. Furthermore, according to Article 231 of Chinese Security law, in case the inside traders violate relevant law, they will assume criminal liability. However, according to Article 76 of Chinese Security law, in case inside traders infringe the interests of public investors and cause any losses, they should bear civil compensation liability. In reality, this private enforcement still applied fairly ineffectively. It is quite difficult for public investors to bring civil actions concerning inside trading aspect.\textsuperscript{60} I will explain further in following Part IV.


Part IV The mechanisms on minority shareholder protection

10 The mechanism on minority shareholder protection: Independent Director

From this chapter, I will introduce two mechanisms, which can be used to protect minority shareholder. First of them is the independent director mechanism. China introduces the independent director into the Chinese Company Law, but in practice, the supervision function of independent director has not been exerted sufficiently in China.

10.1 The regulatory regime for Independent Director in China

After the financial crisis, the supervision role of independent directors on blocking the managers’ misconducts and protecting the overall interests of all shareholders has been highlighted. In particularly, in the concentrated ownership structure of listed companies, it is necessary to protect the interests of minority shareholders in the Board of Directors, since the majority shareholders are able to expropriate and infringe both the interests of listed companies and the minority shareholders by abusing the controlling positions.61

First, improvement and operation of independent director mechanism can greatly

mitigate the agency problems, which brought by separation of ownership and management. Furthermore, it can improve phenomenon of adverse selection or moral hazard, which resulted from asymmetric information in corporate governance as well. Meanwhile, it is useful to enhance the supervision to the management for the sake of minority shareholders. Nowadays, it is widely believed that the independent director mechanism has become a significant part of corporate governance all over the world. In recent years, accompanying with rapid development of Chinese listed companies, the corresponding problems concerning the corporate governance have been exposed. To large extent, the supervisory board is remained as the supervision format in the listed companies in place of substantial supervision function.\textsuperscript{62}

On the basis of overseas corporate governance experience and legislation models, mainly from US and UK, the independent director mechanism has been introduced to China. In 2001, CSRC promulgated the Guidelines for the Establishment of Independent Directors System by Listed Companies\textsuperscript{63} that marked the full introduction of the independent director mechanism in Chinese domestic listed companies.\textsuperscript{64} Moreover, CSRC and State Economic and Trade Commission jointly promulgated the Code of Corporate Governance for Listed Companies which explicitly regulated the independent director mechanism in 2002.

\subsection*{10.1.1 Fundamental Principles of Independent Director}

In accordance with the section 1, 2, 5 and 6 of the Guidelines for the Establishment of Independent Directors System by Listed Companies, promulgated by China Securities Regulatory Commission, became effective on 16th August 2001.\textsuperscript{65}

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\textsuperscript{63} The Guidelines for the Establishment of Independent Directors System by Listed Companies, promulgated by China Securities Regulatory Commission, became effective on 16th August 2001
\end{flushleft}
Independent Directors System by Listed Companies, the fundamental principles, including but not limited to duties, procedures of nomination and appointment, significant qualification, special functions and powers and allowance system are regulated as follow.

Due diligence and good faith toward the listed company and all the shareholders are the principal duties of independent directors. They should carry out their duties in terms of relevant law, regulation and Articles of Association of company. Furthermore, they should maintain the overall interests of the company, in particularly, they should pay much attention on protecting the rights and interests of minority shareholders against expropriation and infringement.

As to the nomination and appointment procedures of independent director, according to the Guidelines, the candidates for independent directors can be nominated by Board of Directors, Supervisory Board and the shareholders who individually or unitedly own more than 1% shares of the company. The shareholder’s General Meeting has the right to vote and make decision regarding these nominations. In particularly, it is mandatory that one-third of the Board of Directors shall be independent directors. The independent director has the right to submit his or her demission prior to the end of his or her term.

When the independent directors perform their duties independently, they should not be affected by the majority shareholders, actual controllers or any other people or units, which have relevant relationship with the listed company. In order to maintain sufficient capacity and time to fulfill their responsibilities, they can serve as the independent directors at most in 5 listed companies simultaneously. In addition, there are two more significant qualifications and conditions that the independent directors shall satisfy. Firstly, they should have an essential knowledge concerning the operation and management of listed company, and they should know well relevant law, regulation and rules as well. Secondly, holding more than 5 years’ experience
concerning law, economics or other relevant working experience is another mandatory requirement for the independent director to discharge their duties.

As to the functions and powers the independent directors have, they are entitled to approve the significant related party transactions, and they submit proposals to Board of Directors for consideration and discussion. The total amount of proposed transactions that over than RMB 300 million (approximately € 37.5 million) or over than 5% of the absolute value of latest net assets of listed company reviewed by auditor are reviewed as the significant related party transactions. The independent directors are entitled to make their decisions on the base of the independent financial report provided by intermediary agency. In addition, the independent directors are entitled to make a proposal to the Board of Directors regarding appointing or discharging an accounting firm. Furthermore, the independent directors are entitled to make a proposal to the Board of Directors regarding holding a temporary shareholder’s General Meeting. And, the independent directors are entitled to appoint outside auditing firm and consultant institution. It is mandatory for the independent directors to acquire approval from more than half of all independent directors before they perform above-mentioned special functions. In addition to these, independent directors should give their own opinions to the Board of Directors or shareholder’s General Meeting regarding following matters: (i) Nominating, appointing and dismissing directors; (ii) Employing or dismissing senior management officers (iii) The remuneration regarding directors and senior management officers; (iv) The independent directors recognize the matter that may infringe the interests of minority shareholders. Hence, it is necessary for them to give their independent opinions explicitly, including voting for, against and withheld with reasons respectively.

The proper allowance or salary from listed company is crucial to the independency of the independent directors. The standard of allowance should be proposed by the Board of Directors and submitted to shareholder’s General Meeting for consideration and confirmation. Ultimately, after approval from the shareholder’s General Meeting,
the standard and amount of allowance needs to be disclosed in the annual report. Furthermore, with the exception of above-mentioned allowance, the independent directors shall not accept any additional profits from the majority shareholders, listed company, other institution or person, which has major interests or relationship with the listed company.

10.1.2 Special Committees

In accordance with the Article 52 to 58 of Code of Corporate Governance for Listed Companies, the listed company may set up several special committees in terms of resolutions from shareholder’s General Meeting, including but not limited to the audit committee, the nomination committee and remuneration committee which are comprised of directors exclusively. The independent directors should hold the majority positions and serve as convener in the audit committee, the nomination committee and remuneration committee. Moreover, audit committee should consist of at least one independent director who is a professional accountant.

It is worth to note that the independent directors should be independent from the listed companies and their majority shareholders. With the exception of the title of independent director, they should not serve as extra work in the listed company.
10.2 The enforcement of independent director mechanism in China

10.2.1 The current situation of independent director in Chinese listed companies

According to statistics, by the end of 2012, the total number of independent directors serving at Shanghai Stock Exchange and Shenzhen Stock Exchange is 5972, and on average each independent director held the same position in 1.39 listed companies simultaneously. Moreover, in total, the 2494 listed companies appointed 8225 independent directors with an average of 3.3 independent directors in each listed company. In particularly, 954 listed companies which listed in the Shanghai Stock Exchange appointed totally 3307 independent directors with an average of 3.47 independent directors in each listed company. 1540 listed companies, which listed in Shenzhen Stock Exchange appointed totally 4,918 independent directors with an average of 3.19 independent directors in each listed company. According to mandatory requirement regarding minimum one-third of independent directors in the Board of Directors above-mentioned, the so-called phenomenon of “3 independent directors” is consistent with the phenomenon of “9 directors-scale in the Board of Directors”, and 68.78% of listed companies appointed the independent directors with the proportion between 33% and 40%.65

As I mentioned above, the proper allowance is vital to the independency of the independent directors. In 2012, the average annual allowance of independent directors is RMB 89,000 (approximately € 11,125), and the median annual allowance is RMB 60,000 (approximately € 7,500), which means half of the independent directors

65 China Association For Public Companies, Report on performance of duties by independent director in listed companies
merely obtained less than RMB 60,000 (approximately € 7,500). The highest annual allowance of independent directors ever reached is RMB 1.24 million (approximately € 155,000), but merely 13 independent directors obtained more than RMB 500,000 (approximately € 62,500).  

10.2.2 The problems and reasons of independent director mechanism in China

The supervision function of independent director has not been exerted sufficiently in China. In practice, a huge number of Chinese listed companies appoint the independent directors on the purpose of satisfying the mandatory legal requirements. Those listed companies are not willing to receive any opinion from their independent directors in respect of their business or operation matters. For instance, according to report on the corporate governance of listed companies listed in Shenzhen Stock Exchange in 2012 issued by Shenzhen Stock Exchange, apart from Main Board listed companies, the independent directors have not yet voted against or withheld any matter in both Second Board and SME Board listed companies in 2012. The independent directors merely have voted against the matter regarding revision of Articles of Association in one Main Board listed company. Moreover, the independent directors have withheld the matter regarding two proposals in another Main Board listed company. Thus, the so-called “vase directors” or “signature directors” becomes common in Chinese listed companies.

Furthermore, the unreasonable remuneration system results in insufficient incentive of

66 idem
independent directors. Currently, according to the statistics and report above-mentioned, the remuneration system of independent directors is simply and unreasonable, for the average allowance is relatively lower and lacking of sufficient incentive system. In case the independent directors make their efforts and perform their duties diligently, the listed companies should offer corresponding amount of allowance compared with their achievements as encouragement. Otherwise, it is difficult to active the initiative and motivation of independent directors to participate in corporate governance. In case the allowances are extremely low and unreasonable, independent directors are not willing to spend much time in acquiring the relevant information and making reasonable proposals to the listed companies. Hence, those listed companies may make some wrong decisions due to those careless independent directors. Owing to without dividends, in case they receive lower allowance and still have to assume higher risks, they are extremely likely to prefer conservative projects instead of those projects which are high returns and more risky simultaneously. Thus, the listed companies are possible to miss a plenty of good investment opportunities.69

In addition, both the nomination and appointment procedures and unreasonable remuneration system restrict the independence of independent directors. According to the relevant procedures of nomination and appointment above-mentioned, it is worth to note that the Board of Directors, Supervisory Board and the majority shareholders are entitled to nominate the candidates. Due to the information asymmetry or free-rider phenomenon, the minority shareholders generally may not participate in nomination procedures. In china, it is widely believed that Supervisory Board has not effectively exerted its supervision function. Moreover, the Board of Directors especially the chairman will nominate the candidates who are familiar people or have a friendship with the chairman. The majority shareholders are more likely to nominate the candidates for the sake of their own interests. As I mentioned, the standard of allowance needs to be proposed by the Board of Directors and submitted to

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shareholder’s General Meeting for consideration and confirmation. Under the concentrated ownership structure of listed companies, the majority shareholders have the final decisions rights regarding the standard of allowance, which will have the significant influence on the independence of independent directors. The independent directors may not express their independent and real views or keep silence on illegal and unreasonable resolutions.\textsuperscript{70}

Moreover, lacking professionals and professional training has a negative influence on independent directors’ duty performance. According to the relevant qualification and condition of independent directors above-mentioned, the majority of listed companies prefer to appoint economists, legal advisers and professors of universities as their independent directors. The demand of those professionals has substantially exceeded the supply in the securities market. In terms of relevant provisions and statistics above-mentioned, one person can serve as independent directors at most in 5 listed companies simultaneously. Therefore, it is wide phenomenon that one person holds the same position in different listed companies simultaneously. Sometimes, it is difficult for them to maintain sufficient energy and time to fulfill their responsibilities in different listed companies at the same time. In case those different listed companies make any deal between each other, it is difficult for the independent director to make decisions among those listed companies for the sake of each listed company’s interest. Also, according to relevant surveys from report on the corporate governance of listed companies listed in Shenzhen Stock Exchange in 2012 above-mentioned, the majority of independent directors are not familiar with all the relevant laws and regulations regarding securities and lacking of relevant working experiences in practice. Currently, merely one training per two years is not sufficient to provide professional knowledge to those independent directors on the purpose of performing their duties adequately and professionally.

\textsuperscript{70} idem.
11 The shareholder private securities litigation and the shareholder derivative litigation

Following the last chapter, I will introduce another mechanism on minority shareholder protection: the shareholder litigation. Compared with the independent director mechanism, litigation is an afterward relief mechanism. The shareholder derivative litigation was born in UK and it was introduced into China in 2005 from the legislation perspective. I will elaborate it in the second part of this chapter.

11.1 The development of shareholder civil litigation in listed company in China

Notorious scandals regarding listed companies, Yi’an Technology Co., Ltd. (Stock Code: 000008) and Guangxia Yinchuan Industry Co., Ltd. (Stock Code: 000557), which listed in the Shenzhen Stock Exchange in 1992 and 1994 respectively, have already attracted both an increasing number of scholars and regulators’ intense attentions. Tampering their financial accounts had been disclosed from foregoing listed companies, in particularly, Guangxia Yinchuan Industry Co., Ltd. was deemed as financial fraudulent pronoun in China. Accompanying with the issuance of Chinese Securities Law in 1998, CSRC has strengthened the sanction concerning the illegal conducts of listed companies including financial fraudulent and false disclosure in the securities market. In order to deter fraudulent and other severe misconducts, from 1999 to 2001, 220 listed companies had been inspected and 92 listed companies had been punished with the total amount of penalty RMB 1.42 billion (approximately €177.5 million) due to the fraudulent financial statements. Moreover, accompanying
with the issuance of Chinese Criminal Law in 1997 \textsuperscript{71}, several directors or related persons had been sent to jail due to manipulating the securities market. Nevertheless, public investors were not possible to remedy their losses through above-mentioned administrative punishment and criminal sentence.\textsuperscript{72} Striving for compensations and protecting the interests by virtue of private securities litigations was viewed as the principal and vital goal among a huge number of public minority shareholders.

In 1998, a single investor brought private securities litigation against the directors of Hongguang Industries Co., Ltd. at Shanghai Pudong Xinqu People’s Court owing to false statements, which is regarded as the first civil lawsuit in China. Hongguang Industries Co., Ltd. had already been punished by CSRC with penalty because of exaggerating its proceeds. Hence, this investor claimed for compensation in respect of loss from investing this listed company. As a consequence, the court did not support the claim of plaintiff eventually, for foregoing fraud statement was not direct reason for the loss from investing. Although Hongguang Industries Co., Ltd. case is not a successful beginning, a plenty of public investors still persist in claiming their rights through private securities litigations due to fraudulent financial statements against different listed companies, such as Zhengzhou Baiwen Co., Ltd. (Stock Code: 600898 ) which listed in Shanghai Stock Exchange in 1996 and KMK Co.,Ltd. (Stock Code: 000535 ) which listed in Shenzhen Stock Exchange in 1993.\textsuperscript{73}

On 20\textsuperscript{th} September 2001, with the purpose of claiming a total amount of RMB 24.6 million (approximately € 3.08 million) recovering of loss, 363 deceived public investors in total as the plaintiffs brought private securities litigations at the intermediate People’s court in Beijing and Guangzhou against Yi’an Technology Co., Ltd.(Stock Code: 000008) above-mentioned. The Supreme People’s Court

\textsuperscript{71} The Chinese Criminal Law, issued by Standing Committee of the National People’s Congress, adopted on 1 October 1997 and the latest amendment was effective on 29 June 2006

\textsuperscript{72} Naomi Li, “Civil litigation against China’s listed firms: Much ado about nothing?” (2004) Asia Programme Working Paper No. 13, P3

\textsuperscript{73} Idem, P3-4
promulgated a notice named Notice of the Supreme People’s Court on Refusing to Accept Civil Compensation Cases Involving Securities For the Time Being in the following day. In accordance with foregoing notice, apparently, the Supreme People’s Court had already recognized that the illegal actions including insider trading, fraudulent statement and market manipulation had undermined the fairness of the securities market and infringed legitimate rights and interests of investors and had adversely affected the development of the capital market. However, because of the limitations of the legislative and judicial conditions, the Court had not yet possessed desired qualifications for accepting and hearing foregoing cases. Thus, nationwide courts could not accept foregoing civil compensation lawsuits caused by above-mentioned illegal actions during that period.

On 15th January 2002, the Supreme People’s court promulgated a Notice named Notice of the Supreme People's Court on the Relevant Issues concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market. In accordance with foregoing Notice, after dealing with administrative punishment by CSRC or its agencies, the local intermediate People’s Court could accept and hear those civil lawsuits subsequently. However, this Notice did not yet regulate specific standards and procedures as a fundamental base for the nationwide courts. It is worth to note that there was no specific provision regarding principles of compensation calculation. Apart from the deficiency and uncertainty from legislative and judicial perspectives, it was still viewed as the symbol, for People’s Courts start to accept private securities litigation in China. Till the end of 2002, approximately 10 listed companies had been brought in total 900 private

74 Idem, P4
75 Notice of the Supreme People’s Court on Refusing to Accept Civil Compensation Cases Involving Securities For the Time Being, issued by Supreme People's Court, adopted on 21 September 2001
76 Notice of the Supreme People's Court on the Relevant Issues concerning the Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market, issued by Supreme People's Court, adopted on 15 January 2002
securities litigations, in particularly, cases has been accepted by court nationwide.\textsuperscript{77}

11.2 The regulatory regime and problems for shareholder derivative litigation in China

11.2.1 The regulatory regime of shareholder derivative litigation in China

The shareholder derivative litigation is regarded as one of the most significant legislative innovations under corporate law.\textsuperscript{78} In general, in case the company is not willing or not able to bring action in order to claim the loss and protect its interests, the shareholders are entitled to file civil lawsuit on behalf of their company. To large extent, the shareholders’ rights are strengthened and protected dramatically in the corporate governance. Therefore, it is helpful to deter misconducts of the directors and senior officers, in case they attempt to infringe the interests of companies abusing their powers or positions. On the purpose of maintaining the fairness of the securities market and protecting legitimate rights and interests of investors, China has introduced the shareholder derivative litigation mechanism and enforced it in practice under the Chinese company law (2005 version).

As noted above, before shareholder derivative litigation mechanism applied in China, there were merely several regulations or notices regarding the private securities litigation or civil lawsuit. However, there are a series of uncertain and vague interpretations left in legislative and judicial regime before 2006. Therefore, it is wide
view that the shareholders are entitled to bring derivative litigation under Chinese company law (2005 version), which became effective on 1 January 2006, from legislative and judicial perspectives. In accordance with the Article 152 of Chinese company law, the specific provision such as the claimers and corresponding applicable conditions can be found and interpreted explicitly. As to the qualifications of plaintiffs, each individual shareholder is qualified in the limited liability company, while in the joint stock limited company and listed company, the shareholder who individually or unitedly own at least 1% shares of the company over 180 days is qualified. It is obvious that the qualifications for bringing action are diversified in terms of the types of companies. There is no threshold in limited liability company, but counterpart in both the joint stock limited company and listed company is mandatory for shareholder who individually or unitedly own at least 1% shares of the company over 180 days, which sets the strict limitation for the plaintiffs in foregoing companies. 79

If a director, supervisor or senior officer who violates Article 150 of Chinese Company Law, including with breach of laws, administrative regulations or Articles of Association during fulfilling his or her responsibility for the companies, and foregoing misbehaviors result in any damage to the companies or a third party infringes legitimate rights and interests of company, and foregoing misbehavior results in any damage to the companies, The qualified shareholder is entitled to bring the derivative action. 80

For the limited liability company, in case a director or senior officer violates Article 150 of Chinese Company Law above-mentioned, any shareholder is entitled to require the supervisors or supervisory board by written form to file suit before a People’s court. In case a supervisor violates Article 150 of Chinese Company Law, any shareholder is entitled to require the executive director or board of directors by

79 Idem, P623
80 Idem
written form to file suit before a People’s court.

For the joint stock limited company and listed company, in case a director or senior officer violates Article 150 of Chinese Company Law above-mentioned, the shareholders who individually or united own at least 1% shares of the company over 180 days are entitled to require the supervisory board by written form to file suit before a People’s court. In case a supervisor violates Article 150 of Chinese Company Law, foregoing shareholders are entitled to require the Board of Directors by written form to file suit before a People’s court. In case foregoing supervisor, the supervisory board, executive director or the board of directors refuse to file a lawsuit after receiving the written request, or does not file a lawsuit after receiving the written request within 30 days, or without prompt lawsuit the company may suffer loss, the foregoing shareholders are entitled to file a lawsuit in their own names before a People’s court on the purpose of protecting interests of the company.

It is necessary to note that foregoing preposition procedures mainly involved in two significant rules, so-called exhaustion of intra corporate remedies rule (the demand rule) and request the exemption rule. Under the exhaustion of intra corporate remedies rule, it is mandatory for the plaintiff shareholders to request the corresponding organs of companies, including foregoing supervisor, the Supervisory Board, executive director or the Board of Directors, to take remedial measures first. It refers to filing a lawsuit against perpetrators who infringes the legitimate rights and interests of company resulting in any damage to the companies. In case foregoing organs refuse to file a lawsuit after receiving the written request, or does not file a lawsuit after receiving the written request within 30 days from the shareholders, those shareholders are entitled to bring a derivative litigation subsequently. However, under the request the exemption rule, the shareholder are entitled to bring a derivative litigation directly to the people's court without above-mentioned preposition procedures, in case under the urgency situation without filing a lawsuit timely the companies will suffer
11.2.2 The problems regarding enforcement of shareholder derivative litigation in China

Admittedly, the shareholder derivative litigation mechanism is viewed as a significant measure for improving the corporate governance in the listed companies both in common law countries such as US and civil law countries such as Germany and China nowadays. In theory, on one hand, to large extent, it can deter the misbehaviors and illegal actions of insiders such as director, supervisor or senior officer, so as to provide sufficient protection for the interests of companies and public investors. On the other hand, the shareholders have much more opportunities to recover their losses by virtue of legal remedy. Thus, both scholars and public investors have paid high anticipation and attention on the shareholder derivative litigation mechanism in China. Nevertheless, in reality, it is worth to note that there are a few deficiencies and barriers regarding the enforcement of shareholder derivative litigation mechanism from legislative and judicial perspectives in China.\(^{82}\)

As discussed earlier, there are evidently different qualifications of plaintiffs between the private companies and listed companies. There is no requirement for shareholder in private companies such as Limited Liability Company. On the contrary, it is mandatory for the shareholders to meet the threshold concerning individually or unitedly holding at least 1% shares of the company over 180 days in Chinese listed companies. In practice, the foregoing requirement is too strict to file a lawsuit for a plenty of minority shareholders in Chinese listed companies. Owing to the highly

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\(^{81}\) Zhipeng Wang & QiongFu, “shareholder litigation and abusing controlling power in the listed companies” (2012) Society Scientist No.180 105, P105

concentrated ownership structure in the Chinese listed companies, State-Own shareholders remain the controlling positions, so merely a small portion of tradable shares are held by public dispersed investors as minority shareholders. A good example is the super-large petroleum and petrochemical enterprise group in China, China Petroleum & Chemical Corporation (Stock Code: 600028), so-called Sinopec Group, which listed in Shanghai Stock Exchange in 2001 whose 75.84 % shares are held by State-Own shareholder in terms of 2010 half-yearly report. The second majority shareholder owned merely 0.29% shares, in particularly, the total shares accumulating from the second till the ninth majority shareholders are still under 1% of Sinopec Group. It is obvious to recognize that there is unvanquishable barrier for individual minority shareholder to bring the shareholder derivative litigation under above-mentioned strict conditions.83

In addition, it is inevitable to note that a huge number of minority shareholders are unwilling to bring the shareholder derivative litigation due to the insufficient economic motivations in reality even though certain shareholders have already owned above-mentioned eligible qualifications. In practice, even though the shareholders on behalf of companies win a lawsuit, the recovery or compensation directly belongs to the companies themselves rather than foregoing shareholders. The compensations of shareholders can be realized merely by virtue of their corresponding shares in the listed companies eventually. Moreover, owing to the highly concentrated ownership structure in the Chinese listed companies, the free-rider phenomena lead to lacking of incentives of minority shareholders regarding filing a lawsuit in China.

The relevant complex litigation costs result in another disadvantage for minority shareholders regarding filing a lawsuit in China. In general, the litigation costs consist of the attorney's fees and court fees mainly concerning application or filing fees. When the shareholders file a lawsuit, it is necessary to pay the application or filing

fees by themselves. In case plaintiffs win the lawsuit, the foregoing application or filing fees can be assumed by defendants eventually. Furthermore, each litigation party including plaintiffs and defendants should bear their own attorney’s fees regardless of the final results of lawsuits. To large extent, the complex litigation costs restrict the incentive of the minority shareholders to bring derivative litigation.\(^{84}\)

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Part V Conclusions and Suggestions

12 Conclusions

Experiencing more than 30 years of economic reform accompanying with over two decades fast-growing capital market, China has already acquired a series of prominent achievements such as maintaining high GDP growth rate and emerging a huge number of listed companies and so on. The minority shareholder protection is meaningful both to corporate governance of Chinese listed companies and securities market. Nevertheless, in practice, the legitimate rights and interests of minority shareholders in Chinese listed companies are not sufficiently protected on account of diversified reasons as analyzed in this article.

In conclusion, firstly, owing to China’s economic reform, ultimately, the SOEs became the controlling shareholders in the majority of listed companies. By reason of the highly concentrated ownership structure and inefficient supervision mechanism of corporate governance in Chinese listed companies, it is extremely common that controlling shareholders manipulate unfairly related party transactions and expropriate the interests of listed companies and minority shareholders by means of tunneling, including providing loan guarantee, misappropriation of funds and restructuring assets of listed companies. Secondly, it is worth to note that the Chinese securities market develops rapidly and maintains a bull market within two significant periods when an increasing number of public investors are willing to invest. In the meantime, the insiders, in particularly, traditional corporate insiders including directors, senior officers, have much more opportunities and incentives to abuse their information advantage for the sake of their private interests. However, it is difficult for those regulatory or administrative securities institutions such as CSRC to detect the complex and secret insider trading, partly owing to the unstable and active share prices during above-mentioned two significant periods. Due to the poor transparent
disclosure mechanism and inefficient supervision mechanism of Chinese listed companies, eventually, thousands of minority shareholders’ interests have been infringed severely. Furthermore, both the securities market’s fairness and profitability and its two vital mechanisms, including information mechanism and trust mechanism, have been undermined by masses of illegal actions like insider trading, fraudulent statement and market manipulation.

As a consequence, both policymakers and scholars have paid intense attentions on protection of minority shareholders in Chinese listed companies. The regulatory regimes in respect of constraining and supervising the related party transaction and prohibiting insider trading have gradually been established under Chinese company law and Chinese Securities law. Moreover, with the exception of above-mentioned laws, some vital authorities, in particularly, CSRC, Shanghai Stock Exchange and Shenzhen Stock Exchange, issued and revised relevant administrative regulations and rules, for example, the Rules Governing the listing of Stocks on Shanghai Stock Exchange and Rules Governing the listing of Stocks on Shenzhen Stock Exchange respectively, which provided further guidance for constraining and supervising the related party transaction and prohibiting insider trading in reality ahead of imperfect and uncertain provisions under the above-mentioned laws. CSRC takes charge for prohibiting insider trading on the purpose of maintaining the fairness of securities market and ensuring public investors’ confidences on securities market.

In addition, on the purpose of improving the corporate governance of listed companies and providing sufficient protection for minority shareholders, the independent director mechanism and its fundamental principles have been introduced and established under the Guidelines for the Establishment of Independent Directors System by Listed Companies issued by CSRC in 2001.

Moreover, after experiencing a few notorious scandals concerning illegal conducts of Chinese listed companies such as financial fraudulent and false disclosure in the
securities market, CSRC was empowered to strengthen the administrative sanction to foregoing misconducts under Chinese Securities Law issued in 1998. Several directors or related persons of listed companies had been sent to jail due to manipulating the securities market under Chinese Criminal Law issued in 1997. Nevertheless, public investors were not likely to recover their losses through above-mentioned administrative sanction and criminal sentence. Protecting the interests and recovering the loss by virtue of civil lawsuits was viewed as the principal goal among a huge number of public minority shareholders. It is worth to note that the local intermediate People’s court started to accept and hear civil lawsuits in accordance with a notice Acceptance of Cases of Disputes over Civil Tort Arising from False Statement in the Securities Market issued by Supreme People’s court in 2002. However, there were a series of uncertain and vague interpretations left in legislative and judicial regime before 2005.

Owing to the deficiency and uncertainty from legislative and judicial perspectives, recently, China has formally introduced the independent director mechanism and the shareholder derivative litigation mechanism under the Chinese company law (2005 version) on the basis of overseas corporate governance experience and legislation models. However, in reality, it is worth to note that there are a few deficiencies and barriers in relation to the enforcement of above-mentioned mechanisms from legislative and judicial perspectives in China. There is still a long way to go for China to get the minority shareholders fully protected through different mechanisms.
13 Suggestions

From my perspective, to some extent, the protection for minority shareholders has been improved from the administrative perspective rather than developing legislative system. As a result, it is necessary to formulate the relevant mechanisms and measures definitely into law, such as Chinese company law and Chinese securities law, in order to strengthen the protection on the minority shareholders in Chinese listed companies.

Firstly, in comparison with the relevant rules and regulation applied in Shanghai Stock Exchange, Shenzhen Stock Exchange and Hong Kong Stock Exchange as noted earlier, it is apparent to note that counterpart in Hong Kong Stock Exchange is much more stringent which is beneficial for both relevant authorities and public investors to supervise the behavior of listed companies. In order to constrain and supervise the related party transaction, it is inevitable to emphasize the disclosure of the related party transaction of listed companies timely and fully from the legislation perspective.

Secondly, independent director mechanism is mainly viewed as effective measure regarding supervising related party transaction and insider trading in terms of its legislative purpose. Thus, in order to exert sufficiently the significant supervision function of independent director, it is necessary to formulate several vital provisions in respect of remuneration system, and accountability mechanism. As discussed earlier in Part IV, because of the unreasonable remuneration system, the independent directors are lacking incentive to fulfill their duties diligently. With the exception of fixed and uniform allowance, it is suggested that the listed companies shall offer corresponding additional allowance to each independent director on the basis of his or her attendance and contribution to board and committee meetings. Although there are several provisions concerning including qualification, training and the procedures of nomination and appointment, it is worth to note that accountability mechanism is still vague and uncertain under the relevant law and rules. For instance, to large extent,
lacking of clarified provisions in respect of constraining malpractice and performance appraisal system, numerous independent directors are not willing to act in good faith and perform with due diligence to the listed companies. With the purpose of enhancing the sense of responsibility of independent director, it is suggested that the accountability mechanism and performance appraisal system should be complemented and defined clarified from the legislation perspective.

Lastly, owing to the limitations of the legislative and judicial conditions such as the stringent qualification of plaintiff and complex litigation costs, it is difficult for minority shareholders to file a lawsuit in order to claim the loss and protect their interests nowadays. Thus, it is necessary to relief relevant barriers, which I mentioned in this article, with the purpose of facilitating the civil lawsuits and strengthening private enforcement in reality.
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- Guidelines for the Establishment of Independent Directors System by Listed Companies, promulgated by China Securities Regulatory Commission, became effective on 16th August 2001
- Notice of the Supreme People's Court on the Relevant Issues concerning the

- Rules Governing the listing of Stocks on Shanghai Stock Exchange, issued by Shanghai Stock Exchange, became effective in January 1998, the latest amendment was effective in December 2013.

- Rules Governing the listing of Stocks on Shenzhen Stock Exchange, issued by Shenzhen Stock Exchange, became effective in January 1998, the latest amendment was effective in July 2012.