University of Reading

# *Enhancing director's integrity in People's Republic of China*

Article

Accepted Version

Lin, W., Ye, Z., Xing, L. and Safari, N. (2019) Enhancing director's integrity in People's Republic of China. Company Lawyer, 40 (12). pp. 395-402. ISSN 0144-1027 Available at https://centaur.reading.ac.uk/110611/

It is advisable to refer to the publisher's version if you intend to cite from the work. See Guidance on citing.

Publisher: Sweet and Maxwell

All outputs in CentAUR are protected by Intellectual Property Rights law, including copyright law. Copyright and IPR is retained by the creators or other copyright holders. Terms and conditions for use of this material are defined in the End User Agreement.

www.reading.ac.uk/centaur

**CentAUR**

Central Archive at the University of Reading

Reading's research outputs online

# Enhancing Director's Integrity in People's Republic of China

Wangwei Lin[1]

Zhen Ye[2]

Lihong Xing[3]

## Introduction

The effectiveness of the legal system has a crucial impact on a country's business prospects and has a direct impact on international society's confidence in that country.[4] Thus, it is of great benefit to China, which is rapidly becoming one of the world's largest economy,[5] to establish and maintain an effective legal system to assist in the sustainable growth of its economy. Due to the poor practice and apparent lack of integrity in China's listed companies, establishing a streamlined legal framework capable of deterring directors from abusing their power and promoting directors' stewardship[6] towards the company has become a pressing issue in China. Nevertheless, a double agency costs problem and the unique Guanxi tradition in China have made the regulation of director behaviour a particularly onerous task for China's regulators.

## The necessity to improve integrity in the marketplace

---

1 Senior lecturer in law, School of Law, Coventry University.

2 Jesus College, University of Cambridge

3 Principle lecturer in law, BPP University

4 See, for example, Burns and Riechmann (2004) and Saleh (2004). Phil Burns and Christoph Riechmann, *Regulatory Instruments and their Effects on Investment Behavior* (World Bank Research Working Paper 3292, 2004); Jahangir Saleh, *Property Rights Institutions and Investment* (World Bank Research Working Paper no. 3311, 2004)

5 China overtook the US in purchasing power parity in October 2014 according to data released by the International Monetary Fund; see Keith Fray, 'China's Leap forward: Overtaking the US as World's Biggest Economy' *Financial Times* (London, 8 Oct 2014)

6 Stewardship theory argues that directors are stewards whose needs are compatible with those of the company. Directors, therefore, are internally driven to act in the best interests of the company and shareholders. See L. Donaldson and J.H. Davis, 'Stewardship theory or agency theory: CEO governance and shareholder returns' [1991] 16 Australian Journal of Management 49

It is argued that in China, multiple market participants (such as listed companies, financial intermediaries, relevant professionals including accountants and law firms, institutional investors and even individual investors) collude in making excessive profits. As one of the main participants in financial markets, listed companies have dented the confidence of investors in China. Li provides a survey on listed companies' creditability. Of over 100 randomly selected individual investors he interviewed at one local branch of a securities company, only 26 expressed confidence in listed companies, especially their accounting statements and other relevant disclosed information, while 33 demurred and 44 investors were sceptical. This seems to lead to the obvious conclusion that the overwhelming majority of investors in China's financial markets regard listed companies or at least some of them, as untrustworthy.[7] One of the reasons that investors distrust listed companies is their poor practice and apparent lack of integrity. There is a perception that many listed companies in China actively engaged in activities which may not always be lawful or proper. They may for example engage in so-called 'technical treatment' of disclosure by taking advantage of loopholes in accounting regulations that deliberately delay the disclosure of information. One of the most recent examples will be the April 2019 Kangmei Xinkaihe Pharmaceutical accounting scandal where Kangmei Xinkaihe Pharmaceutical announced an 'accounting mistake' of historical amount of 30 billion RMB (equivalent to 3.43 billion GBP). [8] In other cases listed company simply misrepresents or falsifies information which would significantly affect the market prices of their securities, for example, announcing anticipated gains in the reports of the first quarter, while the annual reports reveals massive losses.

Stability and integrity of financial markets are interconnected. In order to achieve financial stability that enables efficient resource allocation and proper risk transference, it is vital to ensure that no financial institution is able to affect the market price dishonestly. Nor should any speculator be able to exert influence on the price that makes it move away from the values supported by rational economic fundamentals.[9] All of the above can, to some degree, be achieved by imposing integrity obligations

---

[7] Baozhi Li, 'A Study About Listed Company's Accounting Credibility'(2008) Market Modernisation 15.

[8] See <http://www.sohu.com/a/311374630_391478> accessed on 23 May 2019.

[9] The Reserve Bank, The Impance of Hedge Funds on Financial Markets (Paper submitted to House of Representatives

on market participants, more specifically, the directors of the market participants. The imposing of integrity obligations on directors are of particular difficulty because of the existence of the double agency costs problem and the Guanxi tradition in China.

**Double agency costs in China**

In 1932, Berle and Means in *Modern Corporation and Private Property* documented a phenomenon of separate ownership and control of public corporations. They argued that in modern corporations, the two attributes of ownership (control and economic rights) are no longer attached to the same individual or group: 'The stockholder has surrendered control over his wealth'.[10] Because ownership of the company is widely dispersed among the shareholders, the problem of collective action and the issue of rational apathy make it difficult for the dispersed shareholders to coordinate their activities. Management has a strong incentive to increase the number of shares, not only because to do so increases the available capital and helps transferability by keeping the prices of individual shares comparatively low, but also because increasing the number of shares reduces the incentive and ability of each shareholder to gather information and monitor the performance of the firm effectively.[11] Every step that weakens the monitoring power of shareholders potentially enhances the authority of the board of directors. However, Berle and Means suggested that the board of directors should be regarded merely as agents.[12]

The theory regarding the separation of ownership and control is on the threshold of the principal-agent model of the firm.[13] Agency theory argues that when the directors have a conflict of interests with the corporation and the shareholders, the directors tend to sacrifice the interests of the corporation and

---

Standing Committee on Economics, Finance and Public Administration's Inquiry into the International Financial Markets Effects on Government Policy, 1999) <http://www.rba.gov.au/publications/submissions/impact-hdge-fnds.pdf> accessed 10 May 2019.

[10] Adolph Berle and Gardiner Means, *The Modern and Private Property* (Transaction Publishers 1991) 297

[11] Robert A.G. Monks and Nell Minow, *Corporate Governance* (Black Well Publishing 2001), 95

[12] *supra* n.10, at 217

[13] Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' [1976] 3 Journal of Financial 303-60

shareholders in favour of their own interests. The argument echoes Adam Smith's suspicious opinion of top managers.[14] The information asymmetry existing between the management as 'insiders' and the everyday shareholders, in particular minority shareholders, and stakeholders as 'outsiders' makes it easier for the management to generate benefits against the shareholders' interests from the agent-principal relationship.[15] The costs resulting from the agent-principal relationship and the information asymmetry are called agency costs. The agency problem exists in three ways: between the shareholders as principals and managers as agents, between the majority shareholder and minority shareholders, and between the firm itself and other stake holders.[16]

If there are multiple principals, and these principals belong to different interest groups, extra effort has to be made in order for the principals to act collectively. These are called coordination costs.[17] The agency problem will be amplified in situations where coordination costs are heavy.[18]

It is more important for countries with concentrated share structures, such as China, to enhance directors' fiduciary duties and discipline directors' conduct because the agency problem in these countries tends to be more severe than in countries with dispersed share structures. This is because those countries with a concentrated share ownership structure are more likely to have to deal with the 'double agency costs' that exist between shareholders and managers and between the majority shareholders and the minority shareholders. In addition, the minority shareholders may suffer from collusion between the directors

---

[14] Adam Smith gave a similar opinion in his masterpiece *The Wealth of Nations* in 1776, 'The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. … Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.' See Adam Smith, *The Wealth of Nations* (Modern Library 1776) 229

[15] Hideki Kanda, 'Debtholders and Equityholders' [1992] 21 Journal of Legal Studies (1992) 431, 440-1, 444-5, and Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 2000) 39-44

[16] John Armour and Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies' in Reinier Kraakman and others (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009) 36-7

[17] James M Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (The University of Michigan Press 1962) 63-116

[18] *supra* n.16, at 36. This is because the difficulties of generating collective actions may result in the principals delegating more decision-making rights to the agents, and because the principals' failure to agree on one set of goals may leave a space the agents can exploit.

and the majority shareholders. Coordination costs are high, and the double agency problem creates additional challenges for the legislators and policy makers when producing regulations on directors' integrities and fiduciary duties in China.

**The tradition of Guanxi**

Another significant factor challenging the integrity of company directors in China is the traditional culture of Guanxi. In the 2013 Transparency International Corruption Perception Index, China ranked 80 out of 180 countries, thus showing that China is perceived as highly corrupt.[19] China has a well-known business culture that favours cooperation with family members and close friends (Guanxi).[20] Company directors are pressurised into finding ways to use Guanxi to establish, develop, and expand their business in China. This promotes the use of bribery. Gradually, bribery evolves into 'trade usage' in certain industries in China whereby it becomes impossible to operate without giving money or gifts. It is especially harmful for those multinational companies that have strong business ethics in their home countries. It is either too remote for the headquarters to control the subsidiaries in China, or the headquarters must choose to ignore the problems in the subsidiary. Further, the strong governmental bureaucratic control over directors in public-listed companies[21] exacerbates the situation. The Glaxo Smith Kline (GSK) case in September 2014 is a classic case of corruption in the Chinese operations of a multinational company. The British pharmaceuticals company GSK systematically bribed doctors in China. As a result, the company was fined £297m for bribery by the Chinese authorities, and Mark Reilly, the CEO for GSK's China operations, was given a three-year suspended prison sentence.[22] Thus, it is the legislators' task to examine how the law should empower company directors to maintain business integrity and how the law could protect the directors' right to conduct business in an ethical manner.

---

[19] See <http://cpi.transparency.org/cpi2013/results/> accessed on 15 August 2014

[20] S. Lubman, *Bird I a Cage: Legal Reform in China after Mao* (*Stanford University Press* 1999) 303-4

[21] Charles KN Lam, S.H.Goo, 'Confucianism: A Fundamental Cure to the Corporate Governance Problems in China' [2014] 35(2) Company Lawyer 52-6

[22] <http://www.telegraph.co.uk/finance/newsbysector/pharmaceuticalsandchemicals/11108376/China-fines-Glaxo-297m-for-bribery-Mark-Reilly-sentenced.html > accessed on 22 May 2019

**The emerging legal framework**

Following a civil law tradition, director's integrity and business ethic requirements are state in the Company Law of the People's Republic of China 2014 (CCL 2014) and the Guidelines for Articles of Association of Listed Companies 2006 (amended in 2014). Article 5 of the CCL 2014 is the main provision regulating directors' integrity in China. Article 5 imposes ethical requirements on companies by requiring a company to abide by the laws and administrative regulations, observe social morals and business ethics, act with integrity and in good faith, accept the regulation of the government and the public, and undertake social responsibilities when engaging in business activities.[23] Thus, as the agent of a company, the board of directors is responsible for observing social, moral, and business ethics; acting with integrity and in good faith; and undertaking social responsibilities.

However, the enforcement of Article 5 has not been an easy task. It is argued that the two-tier board system adopted in China, that is, the independent director system and employee participation system, will dilute the managerial power of directors[24] and consequently, reduce directors' authority and capability to enforce Article 5. Also, unlike in common law countries, the fiduciary duties of directors in China are specified in codified black letter law leaving no scope for any flexible interpretation in terms of the content of directors' integrity. Indeed, it has long been argued that the slight respect and ineffective enforcement of the law are the main reasons for China falling behind in the legal system with respect to environmental problems, labour protection, and other social issues.[25]

As to director's fiduciary duties, the regulation on directors' fiduciary duties dates back to as early as 1994 when the first Chinese Company Law 1994 (CCL1994) was enacted. The legislation was prepared and produced in the wider context of the Chinese Communist Party's (CCP) political will to establish a modern corporate system. The Third Plenary Session of the Fourteenth Chinese Communist Party National Congress was held in Beijing in November 1993, and it passed a Central Committee

[23] Article 5 of the CCL 2006

[24] Jingchen Zhao, *Corporate Social Responsibility in Contemporary China* (Edward Elgar 2014) 142

[25] K. Buhmann, 'Corporate Social Responsibility in China: Current Issues and Their Relevance for 'Implementation of Law' [2006] 22 Copenhagen Journal of Asian Studies 64

Resolution on Several Issues Regarding Building a Socialist Market Economy. The aim of the Congress was to establish a socialist market economy through reforming the management mechanism of state owned enterprises (SOEs) and establishing a modern enterprise system that is adaptive to market needs, clear in property rights, clear in the separation between government and enterprises, and scientific in management.[26] To achieve this goal, many corporate laws, including the CCL1994, were produced. These laws focused on various aspects of the corporate governance mechanism, including directors' integrity and fiduciary duties.[27] Directors' integrity was vaguely stated in Article 14 of the CCL 1994: 'Companies must comply with the law, conform to business ethics, strengthen the construction of the socialist civilization and subject themselves to the Government and public supervisions in the course of their business.'[28] Further amendments to corporate and securities regulations took place in 2006. Provisions on directors' integrity and fiduciary duties were greatly refined and enhanced in aspects such as the balance between directors' responsibility and the reasonable protection of directors.[29] The Chinese Company Law was further amended in 2014 (CCL 2014), but no amendments were made to directors' duties. The changes mainly concerned a looser supervisory regime on registered capital and the changing role of the government in the supervision of corporations.[30]

Chapter 6 of CCL2014 focused on the qualifications and obligations of the directors, supervisors, and senior managers of a company. Key provisions regarding directors' fiduciary duties are found in Article 148, where directors are required to assume the duty of loyalty and duty of care to the company. Articles 149 to 150 impose a series of specific duties on directors, including a duty of good faith, a duty of care, a duty not to misappropriate company assets, a duty to disclose, a duty to maintain secrecy, a duty to compensate the company for any breach of duty, a duty not to be involved in a competing business, and a duty not to deal fraudulently with the assets of the company.[31] All earnings obtained by the directors

---

26 See <http://cpc.people.com.cn/GB/64162/134580/137920/> assessed on 1 August 2014

27 Article 1 of the CCL 1994

28 Article 14 of the CCL 1994

29 J. V. Feinerman, 'New Hope for Corporate Governance in China?' [2007] 191 China Quarterly 590

30 Anjie Jiang, 'Understanding and Considering the Reform on Corporate Capital System in Company Law – Interview with Professor Xudong Zhao, China University of Political Sciences' [2014] 3 Legal Daily. See <http://www.legaldaily.com.cn/zbzk/content/2014-03/26/content_5399256.htm?node=25498> accessed on 21 February 2015

31 Article 1 of the CCL 2014

or senior managers in violation of the provisions in the preceding paragraph must be returned to the company.[32]

Shortcomings in the provisions relating to directors' fiduciary duties in CCL2006 were soon identified and were addressed in CCL 2014. The first was the existence of conflicting provisions.[33] For instance, Article 1 of the CCL 2006 stressed the importance of promoting a 'socialist market economy', which suggested that for the directors, the political agenda eclipses economic aspirations, whilst Article 5 of the CCL 2006 stipulates that the directors owe fiduciary duties to the stakeholders and must act in line with both social morality and business morality.[34] These provisions add to the legal uncertainty in the ultimate question of to whom directors should be accountable.[35]

Secondly, many provisions were lacking in detail. For instance, according to CCL 2006, the directors owed a duty to not be involved in a competing business. However, the provision did not address the duration of such a duty. Accordingly, confusion arose on issues such as whether a director would owe this duty after his or her resignation. Another good example would be the provision in relation to directors' duty to compensate the company when the company has suffered a loss due to directors' breach of laws and regulations. There were no follow-up provisions addressing technical issues, such as the calculation of the loss caused and the compensation methods and compensation time frame of the loss.[36]

Thirdly, it had been widely acknowledged that in China, the laws were drafted in broad terms intentionally by the government so that they could be implemented flexibly according to diverse local conditions in a fast changing era.[37] This was echoed in the CCL 2006 provisions on directors' duties.

---

[32] Article 149 of the CCL 2014

[33] K.L. Alex Lau, 'The Chinese Limited Liability Company under the New Company Law' [2006] 36(3) Hong Kong Law Journal 633

[34] See Article 97 and Article 98 of the Guidelines for Articles of Association of Listed Companies 2006

[35] Angus Young, 'Conceptualizing a Chinese Corporate Governance Framework: Tensions between Tradition, Ideologies and Modernity' [2009] 20(7) International Company and Commercial Law Review 235 -244

[36] Guangdong Xu, Tianshu Zhou, Bin Zeng and Jin Shi 'Directors Duties in China' [2013] 14 European Business Organisation Law Review 61

[37] S. Lubman, 'Birds in a Cage: Chinese Law Reform after Twenty Years' [2000] 20 Northwest Journal of International Law

Those provisions, however, were criticised as being too abstract, as this created difficulties in legal practice. [38] For instance, the provisions imposed the duty of diligence on directors, supervisors, and senior managers without specifying how the duty should be applied to each category of leadership.[39] Indeed, there have been intense discussions on the difficulty regarding the codification of directors' fiduciary duties in a civil law environment.[40] The difficulty in implementing directors' duties, a concept that originated in a common law background, commonly exists in a civil law country in emerging markets with transplanted hybrid legal systems.[41]

Stricter rules apply to directors in public listed companies due the profound economic and social impact of public companies in the financial and securities market and beyond. Further liabilities were not imposed on directors by the Security Law of PRC but rather were stipulated in the department regulations of China Securities Regulatory Commission (CSRC), the watchdog for China's securities market, notably, the Guidelines for Articles of Association of Listed Companies 2006 (amended in 2014). This reflects the strong pro-administration characteristic in China's legal framework.[42] The Guidelines echo CCL 2006 and stipulate directors' duty of loyalty in Article 97 and duty of care to the company in Article 98. In particular, the Guidelines further introduced directors' duty on equal treatment of all shareholders and reinforced directors' duty on the genuine disclosure of company information. Directors' fiduciary duties are also mentioned in the Code of Corporate Governance for Listed Companies 2002. According to Article 33 of the Code, directors shall 'faithfully, honestly, and diligently perform their duties in the best interests of the company and all the shareholders'. [43] However, because of the self-regulatory nature of the Code, there is a prepositional procedure for imposing any sanctions

---

and Business 251

[38] P. Luo, J. Li and Y. Zhao, 'An Empirical Analysis of Judicial Discretion on Duty of Diligence of Senior Managers in China' [2010] 3 Securities Law Review 372

[39] Guangdong Xu, Tianshu Zhou, Bin Zeng and Jin Shi, 'Directors' Duties in China' [2013] 14 European Business Organisation Law Review 61

[40] R. Clark, *Corporate Law* (Little, Brown & Company 1986) 141; K. Pistor and C. Xu 'Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law' in C.J. Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deal* (Columbia University Press 2003) 77

L.A. Hamermesh, 'The Policy Foundations of Delaware Corporate Law' [2006] 106 Columbia Law Review 1777

[41] Jingchen zhao

[43] Article 33 of the Code of Corporate Governance for Listed Companies 2002

on the directors according to the Code. The listed company will be obliged to comply with the Code only if it has previously been given an administrative sanction by the CSRC. The legal deterrence of the Code is substantially reduced due to the prepositional procedure.

According to CCL 2014, directors must act in accordance with their fiduciary duties in the ordinary course of business and when passing company resolutions. First of all, directors are answerable for their own conduct. Where a director breaches any laws or administrative regulations or the company's articles of association when performing his or her duties for the company, and causes losses to the company, the director will be obliged to compensate the company.[44] Secondly, directors are responsible for the resolutions passed by the board of directors. In the event of directors' duty of loyalty and duty of care being breached by the board passing a resolution which is in breach of the laws, administrative regulations, the company's articles of association, or the resolutions of the shareholders' general meeting, and the company suffers serious losses as a consequence, the directors participating in the adoption of such a resolution shall be liable for paying compensation to the company. [45]

Directors in China may be prosecuted for criminal offences if they commit financial crimes, such as insider dealing[46], the crime of appropriation[47], money laundering[48], market abuse[49], bribery[50], etc. However, under those circumstances, directors are subject to criminal sanctions because they are in breach of criminal law but not because they are in breach of company law.

Directors' compliance with the above laws and regulations are subject to internal and external

---

[44] Article 150 of the CCL 2014

[45] Article 113(3) of the CCL2014

[46] Insider dealings may also trigger a criminal offence. The Criminal Law 1999 was amended in 2009. Article 180(1) of the Criminal Law 2009 stipulates (as amended) that 'for insider trading that has a material effect on the transaction price of securities or futures. If the circumstances are serious, be sentenced to fixed-term imprisonment not more than five years or criminal detention, and/or be fined 1 to 5 times the illegal gains; or if the circumstances are extremely serious, shall be sentenced to fixed-term imprisonment not less than five years but not more than ten years, and be fined 1 to 5 times the illegal gains'.

[47] Article 271 of the Criminal Law 2009

[48] Article 191 of the Criminal Law 2009 stipulates sanctions on criminal offence on money laundry.

[49] Article 182 of the Criminal Law 2009 deals with manipulation of securities and future trading.

[50] Article 390 of the Criminal Law 2009 deals with criminal offence in relation to bribery.

supervision. Internally, the legality of the conduct of directors and the resolutions passed by directors are subject to the supervision of the board of supervisors[51] and the independent directors[52]. Externally, directors' conduct is monitored by various governmental agencies[53], the general public (whistle blower), the media etc.

Board of directors are under the watch of the board of supervisors by law in China. Directors must provide truthful information on any data the board of supervisors might request. Directors are prohibited from impeding the board of supervisors in the exercise of their legitimate power to supervise the operation of the company.[54] In public listed companies in China, directors' compliance with their fiduciary duties is further subject to monitoring by independent directors. A system of independent directors was introduced in 2001 by the CSRC through the Guidance on the Establishment of a System of Independent Directors in Public Listed Companies. The system of independent directors was stipulated in Article 123 CCL2006.[55] Further guidance on the Indecent Directors' Performance of Duties was produced for independent directors on how to exercise their power in 2012 by the China Association for Public Companies, in the hope of promoting better corporate governance in listed companies in China. Nevertheless, the mechanisms of independent directors in China is not without flaws. Due to the ambiguity in the nature of independent directors,[56] independent directors in China act more like management consultants than independent monitors. The independence of such directors is often questioned because the majority shareholders constantly nominate their 'insiders' as independent directors. Further, current regulations on independent directors are found to be only loosely set out in

---

[51] Article 151 of the CCL 2014 stipulates directors' duties to the board of supervisors. 'Directors must provide truthful information and data requested by the board of supervisors should they request it. Directors are prohibited from impeding the board of supervisors from exercising their legitimate power to supervisor the operation of the company'.

[52] According to CCL2014 Article 123, a listed company shall appoint independent directors. The specific measures in this regard shall be formulated by the State Council.

[53] E.g. The CSRC, for instance. Directors compliance on environmental regulations are supervised by Ministry of Environmental Protection

[54] Article 150 of the CCL 2014

[55] Article 123 of the CCL2014

[56] Niu Yuan ,'A brief analysis of the defects and countermeasures of the independent director system in China' [2009] 51(4) International Journal of Law and Management 261

the CSRC administrative rules and the self-regulatory rules of the two stock exchanges. There is a lack of systematic and streamlined rules on the system of independent directors, in particular, rules on the accountability and disqualification of independent directors.[57] At an institutional level, the co-existence of a two-tier-board system and independent director system increases transaction costs and may cause confusion in any attempt at legal enforcement.[58]

**Enforcement mechanism**

In China, the enforcement of regulations regarding directors' fiduciary duties is achieved mainly by private enforcement. Where a director's breach of their fiduciary duties results in a loss for the company, the shareholders can either request that the board of supervisors take the director in question to court or they can take a derivative action against the director in question if the board of directors refuses to take legal action on behalf of the shareholders. The shareholders are also eligible to bring a derivative action in the event of emergency where irreparable loss might occur.[59] Where the director in breach of fiduciary duties causes a loss to the shareholders, the shareholders are entitled to take direct legal action against the director in question in his or her own name after going through a prepositional procedure.[60] Although there had been reported cases on derivative actions prior to CCL 2006, derivative action was not codified until CCL 2006.[61] Since 2006, there has been a growing will from shareholders to utilise derivative actions as a private enforcement mechanism. There has been a noticeable increase in the number of attempts to take directors to court with derivative actions for breaching their fiduciary duties. Research has shown that among the 79 derivative actions that took place between 2000 and 2010, 19 of those occurred prior to 2006 while 60 took place after 2006. [62]

---

[57] Gang Xiao: Strengthen Independent Directors' Role in Corporate Governance in Public listed Companies available at <http://news.xinhuanet.com/finance/2014-09/15/c_126985571.htm > accessed 15 September 2014

[58] Yuwa Wei, Directors' Duties under Chinese Law: A Comparative Review / Wei, Yuwa, Directors' Duties Under Chinese Law: A Comparative Review (November 9, 2008). (2006)3 UNELJ pp.36-7.

[59] Art152 of CCL 2006

[60] Art 153 of CCL 2006

[61] Dan Wang, *Corporate derivative actions – theoretical basis and institutional structure*' (China Legal Publishing House 2012) 8

[62] *ibid* 317

The prepositional procedure nevertheless, becomes a blockage which may reduce shareholders' incentives to bring derivative actions. Under the current regime, a shareholder needs to meet the criteria regarding the percentage of shares he or she holds and the duration of his or her shareholding. Thus, there is a strict limitation on which shareholders can bring derivative actions. Such strict criteria greatly limit minority shareholders' ability to bring derivative actions in China. The law also does not specify the eligibility of special categories of shareholders, such as shadow shareholders, shareholders with no voting rights, or holders of preferred shares, in bringing derivative actions. [63] Another blockage for shareholders in bringing derivative actions is the lack of compensation of legal fees in derivative action legal proceedings. Shareholders cannot be compensated for the legal costs of bringing a derivative law suit whilst the beneficiaries in these proceeds are the company but not the shareholders.[64] In practice, due to the lack of detailed rules regarding derivative actions, the judges face several dilemmas when applying the law. Strict compliance with the black letter law may result in a rigid and over-conservative application. However, a flexible and creative application of the law brings the danger of the 'judge making the law', which is forbidden in a civil law country like China.[65]

Shareholders in the public listed companies, may experience further difficulties in bringing derivative actions due to the hierarchy in the force of law. According to the Law of the People's Republic of China on Legislation (hereafter Law on Legislation), in China's legal system, various laws and regulations have various degrees of force under the law. The Constitution has the supreme force of the law.66 This is superior to that of administrative regulations, local regulations and the rules of local governments. The force of administrative regulations is superior to that of local regulations and the rules of local governments.67 Finally, the rules of departments and local governments have equal force.68 Hence, the force of administrative regulations is superior to that of the rules of departments. The Code of Corporate Governance for Listed Companies as a regulation of the CSRC is categorised as one of the rules of departments. Its force is accordingly weaker than that of administrative regulations. Consequently, it does not fall in the aforesaid class of regulations which could lead to derivative actions if breached. Therefore, if a director is in breach of the Measure, the shareholders will not be able to bring a derivative action. Derivative actions can only be brought when a director's breach is in breach

---

[63] *ibid* 164, 165

[64] Zhengfeng Lu, *A Study on Shareholder Legal Action* (People's Court Press 2013) 172

[65] *supra* n.61, at 8-9

[66] Article 78 of the Law of the People's Republic of China on Legislation 2000

[67] Article 79 of the Law of the People's Republic of China on Legislation 2000

[68] Article 82 of the Law of the People's Republic of China on Legislation 2000

of the laws, administrative regulations or the articles of association according to CCL 2006. In other words only when the director is in breaches the laws, administrative regulations or the articles of association of the listed companies, may the shareholders be eligible to bring a derivative action.

As a complementary enforcement mechanism, public enforcement is also crucial in ensuring directors' fulfilment of their duties under relevant legislation in China. Where public listed companies are involved, the CSRC, as the supervisory body for the securities market in China, will take steps to intervene. Examination of the enforcement output and enforcement input is often adopted as one of the key methods to measure the effectiveness of legal enforcement.[69] This, however, is based on the presumption that the regulator is independent and accountable to the investors.[70] The independence and accountability of the regulators in China's securities market have been put into question due to recent insider dealing and corruption scandals of the CSRC officials.

The regulation of directors' duties in listed companies reflects the strong pro-administration characteristic of Chinese legislation. The implementation of the provisions largely depends on the discretion of bureaucrats. Broad bureaucratic discretion does not mean it is inefficient, but bureaucratic discretion needs to be exercised according to the legal principles set out in the legislation and within the scope of the authority delegated to the CSRC. It is essential to ensure that the CSRC as a whole exercises administrative discretion within the authority delegated to it by the State Council according to the legal principles set out in the laws and administrative regulations. The CSRC must be careful in exercising its discretion and not crowd out investors' incentive for seeking compensation through private litigation. Legal deterrence of market offenders does not compensate the investors.

In terms of the efficacy of public enforcement in the securities market , the CSRC has been reluctant to admit that its efficiency in enforcement, both in respect of investigation and decision-making process, can be improved. It has identified the lack of resources, both in respect of experienced staffing and adequate funding, as fundamental reason for this unsatisfactory level of enforcement. By mid-2012 they

---

[69] John C. Coffee Jr, 'Law and the market: the impact of enforcement' [2007] 156 The University of Pennsylvania Law Review 229, 258, 263.

[70] Hui Huang, 'Insider Trading and the Regulation on China's Securities Market: Where Are We Now and Where Do We Go from Here?' [2012] 5 Journal of Business Law 398

had a staff of only about 20 and 140, respectively, which were clearly inadequate in view of the population of investors in China's securities and futures markets which exceeded 1 billion in 2012.

The CSRC, as the primary regulator of China's securities industry, has undertaken a series of reforms in recent years in order to perform its regulatory and supervisory obligations. However, it is not with no deficiencies. One fundamental problem that needs to be addressed is that of clarifying the authority of the CSRC within the Chinese legal system. Despite acting as such regulator, the authority of the CSRC has never been clearly defined in the basic securities laws. It is of greatest importance to amend the establishing law, that is the Securities Law 2005(SL 2005 thereafter) explicitly to authorise the CSRC to be the securities regulator. Without this there will always be issues of legitimacy and constitutionality that may open the door to political issues. Another problem requiring amendment is the ambiguous status of the CSRC. The CSRC has been set up as a ministerial-level public institution that is not an administrative organ according to the State Council (SC thereafter), which renders its authority for issuing relevant regulations and rules. Thus, the SC should elevate the status of the CSRC to a ministry as soon as feasible.

The Shanghai Stock Exchange and the Shenzhen Stock Exchange (the SSE and the SZSE) and the Securities Association of China (SAC) have been seen as the self-regulatory organisations which monitor the securities markets and their members and thereby assist the CSRC to address market misconducts. Despite the legitimate authorisations given to the stock exchanges and the SAC as a self-regulatory organisation, there has been increasing criticism concerning the limited roles they have played in ensuring fair, orderly and efficient markets. The securities markets, traditionally, have been subject to excessive governmental regulation not allowing them to build a tradition of self-discipline. Although the stock exchanges rarely take disciplinary actions against members and member companies according to the rules or listing requirements. Rather, they make referrals to the CSRC for further action. Both the SSE and SZSE, moreover, are administratively subordinate to the CSRC, and their presidents are directly appointed by the CSRC. The SAC and its local branches are registered as public institutions with limited self-disciplinary powers. As a result, the roles of both the stock exchanges and the SAC are too narrow for them to act as effectively as they should.

Like many developing countries[71] China has encountered a major systematic problem, corruption, which is generally condemned as one of the most notorious obstacles to China's development. CSRC as the watchdog of the securities market have had many corruption related scandals. Gang Yao, a former vice chairman of the CSRC was sentenced for 18 years for corruption in 2015.[72] More recently, in May 2019, former chairman of the CSRC, Shiyu Liu was reported to have turned himself in with the Central Commission for Discipline Inspection.[73] Corruption and lack of integrity are not only found in isolated cases: they are known to be prevalent in all societies. Due to their detrimental effect upon democracy, equality, the rule of law and economic efficiency, they particularly jeopardise those developing countries like China which have been through a transitional period.[74]

**Concluding remarks**

The paper examined the laws and regulations governing the integrity and duty of company directors in contemporary China. It considered general issues, such as the need to regulate directors in China due to China's problem of double agency costs as well as the traditional Chinese culture of Guanxi, the establishment and recent development of relevant laws and regulations in China, the flaws inherent in the legislation, and how the supervisory and enforcement mechanism directly and indirectly leads to non-compliance. Notable achievements have been made in regulating directors' integrity in China. A comprehensive and complete legislative framework covering directors' ethical standards and a wide range of directors' fiduciary duties in private and public companies has been established. Ancillary governmental regulations have also been produced to facilitate regulating more specialised areas not covered by CCL2014, such as directors' duties in public listed companies. A supervisory mechanism monitoring the compliance of directors of relevant laws and regulations enabling the wide participation and deep engagement of internal and external monitors has been established. Private and public enforcement procedures have also been developed to provide means of sanctioning non-compliance and

---

[71] See generally Barry Rider, *Combating Economic Crime* (Commo Wealth Secretariate, London 1979) and Barry Rider, *Corruption: the Enemy Within* (Kluwer Law International 1997).

[72] See <http://www.xinhuanet.com/fortune/2018-09/29/c_1123500081.htm> accessed on 23 May 2019.

[73] See <http://www.ccdi.gov.cn/toutiao/201905/t20190519_194192.html> accessed on 23 May 2019.

[74] Peter Nolan, 'China at the Crossroads'3 Journal of Chinese Economic and Business Studies 1, 2-9; Susan Rose-Ackerman, 'Political Corruption and Democracy'(1999) 14 Conn J Int'l L 363, 365.

claiming for damages and compensation resulting from non-compliance. Given that the first Company Law in PRC had not been enacted until 1994, regulating directors' behaviour in China is still at the early stage of development. Therefore, legislators and implementers still face various difficulties, for instance, the problem inherent in transplanting abstractly worded Anglo Saxon common law corporate governance legislation into a German French civil law system where there are no precedents to provide guidance on the identification and treatment of violation. Establishing a sound court system for private enforcement and enhancing the integrity of the supervisory governmental agency are also vital issues to be considered in the compliance side of the law. To conclude, the laws regulating directors' integrity and duty in China are a work in progress and are far from mature. There is a series of theoretical and practical problems to be studied and steps to be taken to improve and perfect the law.