Institutional Shareholder Activism in China: Law and Practice

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November 23, 2006

Stefano Caselli and Stefano Gatti,
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Dear Professor Stefano Caselli and Stefano Gatti,

I am writing to submit my paper entitled "Institutional Shareholder Activism in China: Law and Practice".

I wish my paper to be considered for publication in the *EFM*, and I am willing to serve as a discussant in the Symposium.

Please let me know if you have any questions about the paper.

Yours sincerely,

Chao Xi

ABSTRACT

The rise of institutional investor activism is changing the corporate governance landscape in China, as it has in the US, UK and a few other economies. The article examines the legal and regulatory environments in which Chinese financial institutions act as shareholders and participate in the governance of their portfolio companies.

The article challenges the conventional wisdom that minority shareholders in Chinese listed companies, in the face of the expropriation by the state-controlled majority shareholders, have been invariably powerless and, in most cases, passive. The article documents the unprecedented level of institutional shareholder activism in China. It shows that institutional activism has brought some corporate governance rules into actual practice in the marketplace, and helped raise corporate governance standards in China.

The article argues that Chinese legal rules designed to protect minority shareholders have the unintended effect of deterring institutional shareholders from owning stakes substantial enough to influence corporate decision-making. The policy implications of the article are significant: there is a tension between the policy goals of encouraging institutional participation in corporate governance and of protecting minority shareholders.

Part I of the article briefly surveys the major types of financial institutions in China. Part II discusses how Chinese institutional investors have exercised the rights attached to the shares of their portfolio companies. Part III examines the factors that have deterred Chinese institutions from exerting a greater voice in corporate governance. Part IV evaluates the implications of some new legal developments to institutional shareholder activism. Part V draws some conclusions.

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Institutional investors have become increasingly important as equity holders in the Chinese financial markets. The equity ownership of securities investment funds, insurance companies, pension funds, securities companies, commercial banks, and qualified foreign institutional investors (QFIIs) has grown dramatically in recent years. As institutional ownership has increased, the institutions' role as shareholders has also evolved. Some institutional investors, particularly securities investment funds, began to abandon their speculative trader role, and become more actively involved in the governance of their portfolio companies. In addition, institutions provided important support for the adoption of some significant legal rules designed to protect the interests of minority shareholders. At one level, these activism efforts have not only brought some corporate governance rules into actual practice in the marketplace, but also helped shape the evolution of Chinese corporate governance standards. However, the general level of institutional shareholder activism in China remains unsatisfactory. Most institutions have been passive. Many factors may have interacted to produce the characteristic passivity of Chinese institutions. These include the ownership structure, self-interest of institutional investors, the conflicts of interest faced by institutions, collective action problems, and legal and regulatory rules that raise the costs of participation in corporate governance, and so on.

Improving the corporate governance of companies is increasingly understood as an important means of enhancing the long-term value of equity investment. There is increasing call in China for the financial institutions that hold large portfolios of shares to participate in corporate governance as shareholders. However, there has been little research investigating the legal and regulatory contexts in which financial institutions participate in corporate governance in China. This article will examine the role that Chinese institutional investors have played in corporate governance, and the factors that have created barriers to active engagement with companies in which the institutions invest. The article is structured as follows. Part I briefly surveys the major types of financial institutions in China. Part II discusses how Chinese institutional investors have exercised the rights attached to the shares of their portfolio companies. Part III examines the factors that have deterred Chinese institutions from exerting a greater voice in corporate governance. Part IV evaluates the implications of some new legal developments to institutional shareholder activism. Part V draws conclusions.

I. A SNAPSHOT OF INSTITUTIONAL INVESTORS IN CHINA

We begin our study of the role of institutional shareholders in Chinese corporate governance with a brief survey of the major players. They are securities investment funds, insurance companies, pension funds, and securities companies, QFIIs, and commercial banks.

Securities Investment Funds. The Chinese securities investment fund industry emerged in 1991. This industry was virtually unregulated until 1997, when the State Council issued the Provisional Measures for the Administration of Securities Investment Funds.[1] By 2000, funds established before 1997 had mostly been restructured into close-ended funds in accordance with the Provisional Measures.[2] 2001 saw the emergence of open-ended funds, which soon overtook close-ended funds to dominate the industry.[3] In 2003, the first national legislation on securities investment funds, the Law on Securities Investment Funds was promulgated.[4] And the industry recorded in 2003 a tremendous annual growth in net asset value, significantly outperforming the stock market indexes. The industry's high profit margin, in tandem with the release of the State Council policy in early 2004 that encouraged the development of institutional investors, prompted an explosive growth of the industry in 2004 and 2005.[5] At the end of 2005 the total assets of funds reached RMB476bn (USD60bn), soaring by 44.5% in one year.[6] Currently, funds in China invest mainly in equities, bonds and monetary products.[7] By the end of March 2006, funds owned an estimated 14.4% of Chinese tradable A-shares,[8] soaring from only 2% in 1998.[9] Securities investment funds are now the largest category of institutional investor in the Chinese stock market.

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[1] *Zhengquan Touzi Jijin Guanli Zanxing Banfa*, issued by the on November 14, 1997. For an account of pre-1999 securities investment fund legal framework, see Tingting Tao, "The Burgeoning Securities Investment Fund Industry in China: Its Development and Regulation," 13 *Columbia Journal of Asian Law* (1999) 203.

[2] China Knowledge Press, *Fund Management in China* (Singapore: China Knowledge Press, 2005), 14-6 [hereinafter, *Fund Management in China*].

[3] Ibid, 18-9.

[4] *Zhengquan Touzi Jijin Fa*, promulgated on October 28, 2003, and came into effect on June 1, 2004.

[5] *Fund Management in China*, 19-23.

[6] "2005 Nian Zhongguo Zhengquan Touzi Jijin Hangye Tongji Baogao" [2005 Statistical Report on China's Securities Investment Fund Industry], *Zhongguo Zhengquan Bao* [China Securities News], January 6, 2006.

[7] *Fund Management in China*, 129-31.

[8] "Zhengjianhui Fuzeren jiu Gugai he IPO deng Wenti Fabiao Tanhua" [CSRC's Responsible Officers Gave Talks on Issues of the Share Structure Reform and IPO], *Shanghai Zhengquan Bao* [Shanghai Securities News], April 28, 2006.

[9] *Fund Management in China*, 17

Insurance Companies. Chinese insurers have been allowed to hold equity positions for their own account since October 2004.[10] Now insurance companies and their asset management arm can invest up to 5% of the total assets into the A-Share market. By October 2005, insurers' direct shareholding has grown to about RMB 13.6bn[11] (USD1.7bn) or 1.3% of tradable A-Shares.[12] In addition to their direct holdings, Chinese insurers have since October 1999 invested indirectly in the stock market through subscribing to securities investment funds, subject to a set of portfolio rules.[13] It is estimated that the indirect investment in stocks by insurance companies has reached RMB106bn (USD13.3bn),[14] or 10.6% of the tradable A-shares. Insurance companies have become the largest single type of investors in securities investment funds.[15]

Pension Funds. Pension funds are a new category of institutional investors. The principal Chinese analogue to American public pension funds is the National Social Security Fund (NSSF) established in 2000. Since June 2003, the NSSF has outsourced funds to selected fund managers, which invest in, among other things, equities.[16] By October 2005, the total investment in the stock market by the NSSF has grown to RMB20.5bn (USD2.6bn), up by 57% compared to the end of 2004.[17] Enterprise annuities, the Chinese supplementary pension analogue to corporate pension plans in the US, have recently entered the scenario,[18] and we lack good data on the burgeoning industry.[19]

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[10] *Baoxian Jigou Touzizhe Gupiao Touzi Guanli Zanxing Banfa* [Provisional Measures for the Administration of Stock Investment by Insurance Institutional Investors], jointly issued by the China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission on October 24, 2004.

[11] See "Dali Fazhan Jigou Touzizhe, Cujin Woguo Jinrong Tixi Xietiao Fazhan" [Vigorously Develop Institutional Investors, Promote the Harmonious Development of the Financial System in China], *Zhengquan Shibao* [Securities Times], December 3, 2005 [Hereinafter, "Institutional Investors Vigorously Develop"].

[12] The calculation is based upon the average market capitalisation of tradable A-shares in 2005, which was about RMB1,000 billion. Source: www.csrc.gov.cn.

[13] China Knowledge Press, *Financial Services in China: The Past, Present and Future of a Changing Industry* (Singapore: China Knowledge Press, 2005), 402-3, [hereinafter, *Financial Services in China*]

[14] "Institutional Investors Vigorously Develop".

[15] *Fund Management in China*, 139-44.

[16] See Stuart Leckie and Yasue Pai, "Fund Management Opportunities in China's Pension Market," 10 *Pensions* (2005) 317, 327-9 [hereinafter, Leckie and Pai, *China's Pension Market*].

[17] "Institutional Investors Vigorously Develop".

[18] Leckie and Pai, *China's Pension Market*, 320-1, 329.

[19] The Ministry of Labour and Social Security (MOLSS) estimated the market potential to be "RMB100bn per year", which was seen by most as overly optimistic even in mid-term. Ibid.

Securities Companies. Chinese securities companies are analogous to the US investment banks. Many securities companies own substantial equities directly and manage a large amount of stocks for retail investors.[20] By the end of 2004, securities companies held about RMB40bn (USD5bn) tradable equities for their own account, and RMB40bn equities as equity asset managers for other holders.[21] Securities companies have a significant bearing on the activism of securities investment funds, since they are the majority shareholders of most fund management companies.[22]

QFIIs. QFIIs are an ad hoc category of institutional investor in the Chinese stock market. Access to the domestic A-Share market was previously reserved only for domestic individuals and institutions. As part of China's commitment to opening up the domestic securities market to foreign investment, QFIIs approved by the CSRC have been allowed to trade A-shares since May 2003,[23] but only within their investment quotas allocated by the State Administration of Foreign Exchange. The size of the total quotas has increased in July 2005 from USD4bn to USD10bn.[24] As of October 2005, QFIIs held tradable A-shares worth RMB17bn (USD2.1bn), and they invested another RMB4.4bn (USD0.55bn) in securities investment funds.[25]

Commercial Banks. Chinese commercial banks were barred from setting up fund management arm before February 2005.[26] By the end of 2005, three fund management companies affiliated to commercial banks had been formed to offer equity funds. In addition to their new role of equity fund managers, commercial banks, especially the "big four" state-owned commercial banks, have long acted as major custodian banks and distributions partners of funds.[27]

One caveat before we examine the degree of involvement by institutional investors in the governance of their portfolio companies. The focus of this Article will be on the securities investment funds, because they have the principal players in the recent movement toward greater institutional activism. Other types of institution are either smaller in size, or

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[20] *Financial Services in China*, 282-3.

[21] *China Securities News* [Zhongguo Zhengquan Bao], December 15, 2005.

[22] *Fund Management in China*, 48-63.

[23] *Financial Services in China*, 308.

[24] See "Why Foreign Investors Are not Saviours", *Financial Times*, July 13, 2005.

[25] "Institutional Investors Vigorously Develop".

[26] *Shangye Yinhang Sheli Jijin Guanli Gongsi Shidian Guanli Banfa* [Administrative Rules for Pilot Incorporation of Fund Management Companies by Commercial Banks], jointly issued by the People's Bank of China, China Banking Regulatory Commission and the CSRC on February 20, 2005 [hereinafter, 2005 Commercial Bank Fund Management Companies Rules].

[27] *Fund Management in China*, 144-54.

they emerged as institutional shareholders only very recently.

II. THE RISE OF INSTITUTIONAL SHAREHOLDER ACTIVISM

Back in 2000, *Caijing*, a leading Chinese financial journal, reported a scholarly study which examined the investment behavior of 22 close-ended funds operated by 10 securities companies. The study showed that Chinese funds had tended to manipulate the stock market and engage in speculative trading in order to gain unlawful short-term profits.[28] The report stirred up a flurry of regulatory and legislative initiatives aimed at curbing the malpractice. Since then, the role of the funds has started to evolve from unscrupulous arbitrageurs to responsible shareholders. What has accelerated the process is the dramatic increase in institutional ownership in recent years, as we have shown in the preceding part. As the shareholdings rise, it has become more difficult for funds to simply sell their holdings in underperforming companies. Often the holdings are so large that the shares cannot be sold without driving the price down and suffering further losses. The corporate governance risks that associate with the low level of disclosure and transparency of Chinese listed companies have thus emerged as a widely shared concern among the funds.[29] Engagement with the portfolio companies would be a useful means to reduce the risk.

Anecdotal evidence suggests that Chinese institutional shareholders have been particularly active on a number of important corporate governance issues. The activism has generally involved two distinct approaches: first, voting, and secondly, presenting a shareholder proposal, on a corporate governance issue at a portfolio company's shareholders' meeting.

A. Exercise of Voting Rights

The most basic statutory rule of voting is "one share, one vote",[30] that is, all shares have one vote, and votes cast at the shareholders' meetings have the same weight. According to Easterbrook and Fischel, this equal voting right attached to shares is a logical consequence of the risk bearing

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[28] Barry Naughton, "The Politics of the Stock Market", *China Leadership Monitor* (2002: 3), 4.

[29] When asked what the most significant advantage of corporate governance is, 80% of Chinese institutions pointed to improved risk management, compared with a global average of 20%. See Institutional Shareholder Services, *2006 Global Institutional Investor Study – Corporate Governance: From Compliance Obligation to Business Imperative*, 40 [hereinafter, *2006 Global Institutional Investor Study*].

[30] 1993 Company Law, Art 106; 2003 Company Law, Art 104.

function of voting.[31] However, votes are proprietary rights, which the holder may exercise in his own selfish interests even if these are opposed to the interests of the company.[32] Therefore, there is a risk that the majority of the shareholders may exercise their voting power in an unfair way.

The risk is particularly acute in most Chinese listed companies, whose shares had been artificially segmented into tradable shares and non-tradable shares.[33] Non-tradable shares account averagely for about two thirds of the listed companies' outstanding shares, and have been concentrated in the hands of a small number of majority shareholders. Also of relevance is a key feature of Chinese company law – shareholder primacy:[34] the shareholder general meeting is the organ which decides on major corporate transactions.[35] These transactions require only the approval of a simple majority of the votes cast at the meeting.[36] The concentrated ownership structure, in tandem with the shareholder primacy norm, enables the non-tradable/majority shareholder to dominate the corporate decision making process. However, legal mechanisms that control the exercise of voting rights by the controlling shareholder have been scant. Thus, institutional shareholders holding a large block of tradable shares have been vulnerable to the expropriation by the majority shareholders.

Facing the expropriation risk, institutions have fought for the adoption of rules that require minority shareholder approval of controlling shareholder transactions. When these rules were put in place, some institutions have wielded their voting power with vigor. And it was mainly on three issues that these institutions have acted in defiance of the majority shareholder's expropriation.

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[31] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Massachusetts: Harvard University Press, 1991), 73.

[32] See, for example, Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* (London: Sweet & Maxwell, 2003), 486 [hereinafter, Davies, *Principles of Modern Company Law*].

[33] A reform has been underway to consolidate the dual structure, see infra note 55.

[34] Cindy A. Schipani and Junhai Liu, "Corporate Governance in China: Then and Now," 2002 *Columbia Business Law Review* (2002) 1, 33-6 (arguing that shareholder primary derives from the political philosophy in the PRC, and presenting a case for a shift to director primacy). *Cf.* the recent shareholder primacy v. director primacy debate. See Lucian A. Bebchuk, "The Case for Increasing Shareholder Power," 118 *Harvard Law Review* (2005) 833, and Stephen M. Bainbridge, "Director Primacy and Shareholder Disempowerment," 119 *Harvard Law Review* (2006) 1735.

[35] 1993 Company Law, Art 103; 2005 Company Law, Art 100.

[36] Only the merger, division, dissolution of the company, and the alternation of the articles of association, require a two-third supermajority approval: 1993 Company Law, Art 106, 107; 2005 Company Law, Art 104.

1. Cash Offer of New Shares

Once a company has made an initial public offering, it has two additional methods whereby it can raise further capital by issuing new shares. These methods are right offer (sold to the company's existing shareholders) and cash offer (sold to all interested investors).[37] The cash offer of new shares had been widely seen as a method by which the non-tradable majority shareholder expropriated tradable shareholder.[38] Consequently, there was a period in 2002 when any announcement of cash offer by a company would prompt a sharp drop in the company's share price and, sometimes, even the stock market index.[39] Facing mounting market pressure to regulate cash offers, the CSRC in July 2002 issued a Regulation on cash offer.[40] The most notable development was the requirement that the a cash offer be approved by the majority of the tradable shareholders who vote at the shareholders' meeting, if the new shares issued exceeds 20% of the company's existing outstanding shares.

The Regulation was tested soon after its issuance. In August 2002, ZTE Co., China's largest listed telecoms manufacturer, proposed a cash offer in the Hong Kong Stock Exchange (HKSE).[41] It was believed that tradable shareholders' interests would be diluted by the dual listing on the HKSE. The proposal met stiff opposition from institutional investors, which attempted to block the proposal by virtue of the Regulation. However, the CSRC denied the applicability of the Regulation to the proposal, ruling that it applies only to cash offers in the domestic A-Share market. Despite of the CSRC's ruling, eleven fund management companies voted against the cash offer proposal at the extraordinary shareholders' meeting. The proposal was passed, nevertheless, with the support of the majority shareholders. Frustrated institutions dumped their holdings, and ZTE's share priced dropped by a half within months, which forced ZTE to eventually abandon

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[37] *Shangshi Gongsi Xingu Faxing Guanli Banfa* [Administrative Measures for Listed Companies' New Equity Issue] (issued by the CSRC on March 28, 2001): Art 2.

[38] A survey, based on the data of 308 listed companies which issued new shares in 2000 and 2001, found that non-tradable shareholders benefited significantly from cash issues at the expense of the existing tradable shareholders. See LI Kang et al, "Peigu he Zengfa de Xiangguanzhe Liyi Fenxi he Zhengce Yanjiu" [Stakeholders of Right Issues and Cash Issues: Interest Analysis and Policy Study], *Jingji Yanjiu* [Economic Studies] (2003:3), 79.

[39] "'Shangshi Gongsi Zengfa Xingu Youguan Tiaojian' Qicao Qingkuang Shuoming" [Some Explanations about the Drafting of the Relevant Requirements for Listed Companies' Cash Offer of New Shares], *Xinhua Wang* [Xinhua News], July 25, 2002.

[40] *Shangshi Gongsi Zengfa Xingu Youguan Tiaojian* [Relevant Requirements for Listed Companies' Cash Offer of New Shares] (issued on July 24, 2002) [hereinafter, 2002 Cash Offer Regulation].

[41] It was the first attempt by an A-Share listed company to seek dual listing on the HKSE.

its dual listing plan.[42]

It was not until September 2004 that the first instance of institutions voting down a cash offer proposal came about. Foton Motor, a listed carmaker, whose performance deteriorated after its previous equity issue in 2003, proposed a cash offer when the stock market was in a downturn. Nine out of Foton's top ten tradable shareholders were institutions (eight funds and one QFII), which held 33.2% of Foton's tradable shares and opposed the proposal. It turned out that 30% voted for the proposal, 10% against it and more than 60% abstained.[43]

2. Convertible Bond Issues

The CSRC relaxed in 2002 its control over the use of convertible bond issues to raise capital, in part due to the dramatic market aversion to equity finance.[44] This deregulation resulted in a surge of convertible bond issues, culminating in China Merchant Bank's proposed convertible bond issue in 2003, valued at RMB10bn (USD1.2bn). China Merchant Bank was an outperforming mega-cap listed bank, and a favorite of institutions – 53 funds were holding more than 25% of the existing tradable shares. In response to the proposal, eight funds representing about 16% of the tradable shares, however, strongly opposed the proposal at the bank's interim performance report meeting held in September 2003. They criticized it as an outright and unlawful expropriation of tradable shareholders by non-tradable shareholders.[45] Private meetings and the public row between the bank and the institutions afterwards failed to compel the bank to withdraw its proposal. At the extraordinary shareholders' meeting in October 2003, forty-eight institutions, representing more than 20% of the tradable shares (or 5% of all outstanding shares), formed an alliance, though knowing that as the minority shareholders there was little chance they would be able to vote down the bank's proposal. They proposed at the meeting, among other issues, the tradable shareholder approval of convertible bond issues. The coalition's proposal was brushed aside as unwarranted, since the Cash Offer

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[42] See, for example, "Zhong Jijin Nanban Zhongxing Tongxun?" [Funds Unable to Bend ZTE?], *Guoji Jinrong Bao* [International Finance News], August 16, 2002.

[43] See, for example, "Liutong Gudong Shuo Bu, Futian Qiche Zengfa Yi'an Weihuo Tongguo" [Tradable Shareholders Said 'No', Foton Motor's Cash Offer Proposal Failed to Pass], *Zhongguo Zhengquan Bao* [China Securities News], September 29, 2004.

[44] ZHU Wuxiang and YAN Chengjiu, "Gupiao Faxing Guanzhi Zhengce Bianhua yu Gupiao Shichang Gaozhang Weisuo de Dongtai Moxing" [The Change in Regulation on Equity Issue and Stock Market Sentiment: A Dynamic Model] (Beijing: National Centre for Economic Research, Working Paper, No. 200405).

[45] "Zhong Jijin Lianshou Fanji Zhaohang Baiyi Zairongzi Fang'an" [Funds United Hand in Hand to Counterattack the Merchant Bank's 10bn Refinance Proposal], *Zhengquan Shichang Zhoukan* [Securities Market Weekly], September 14, 2003.

Regulation apparently does not apply to the convertible bond issue. With 75% of the bank's shares being non-tradable shares, the bank's proposal was passed amid stiff opposition from the institutions. Dramatically, the coalition issued after the meeting a joint statement, which expressed the serious concern about the vulnerability of tradable shareholders to exploitation by overreaching majority non-tradable shareholders. The statement also urged for the CSRC's intervention to overrule the proposal,[46] since the convertible bond issue is subject to the CSRC's approval.

The institutional coalition's unprecedented engagement with the China Merchant Bank sparked a public debate about the crucial governance issue of minority shareholder protection, and, perhaps more fundamentally, about the reform of the share segmentation regime. Clearly the public sentiment was on the side of the institutions and tradable shareholders.[47] The CSRC, which had pledged to act as the guardian of minority shareholders' interests, was placed under the spotlight. Its response was that it would make some "transitional institutional arrangements" to enhance tradable shareholders' role in major corporate decision-making.[48] Tradable shareholder approval of major corporate transactions was said to be one of them.[49]

The arrangements eventually came in 2004, as contained in the landmark Several Provisions on Strengthening the Protection of Social Public Shareholders' Rights and Interests.[50] Four developments are of particular relevance. First, the extension of the tradable shareholder approval requirement from cash offer to all major corporate transactions affecting tradable shareholders. The Provisions list some of these transactions, ranging from cash offer, right offer and convertible bond issue to asset acquisition and overseas listing of subsidiaries.[51] Secondly, the special disclosure requirement that the voting decisions of the top ten social

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[46] See, for example, "Zhaohang yu Jijin: Gudong Dahui shang Doufa" [Merchant Bank and Funds: Contest at the Shareholders' Meeting], *Zhengquan Shibao* [Securities Times], October 16, 2003; "48 Jia Liutong Gudong Fabiao Lianhe Shengming Qianze Zhaohang Weifa Weigui" [48 Tradable Shareholders Issued a Joint Statement, Denouncing the Merchant Bank's Violation of Laws and Regulations], *Zhengquan Ribao* [Securities Daily], October 16, 2003.

[47] See, for example, "Zhengjianhui Chouhua Guoduxing Zhidu Anpai, Baohu Liutong Gudong Liyi" [CSRC Planned for Transitional Institutional Arrangements to Protect Tradable Shareholders' Interests], *21 Shiji Jingji Baodao* [21st Century Economic News], December 31, 2003.

[48] Ibid.

[49] Ibid.

[50] *Guanyu Jiaqiang Shehui Gongzhonggu Gudong Liyi Baohu de Ruogan Guiding*, issued on December 7, 2004 by the CSRC) [hereinafter, 2004 Minority Shareholder Protection Provisions].

[51] Art 1(1).

public shareholders who voted be disclosed.[52] Thirdly, the introduction of the cumulative voting mechanism to empower minority shareholders in the election of board members.[53] Fourthly, the requirement that listed companies strengthen their investor relationship management.[54]

3. Share Structure Reform Compensation Schemes[55]

In the process of the share structure reform, overt activism efforts by the funds were seen from time to time. An immediate reason is that the costs of opposition on the part of institutional shareholders were lower than usual. The compensation scheme is required to be approved by at least two thirds of votes cast by the tradable shareholders. A failure to have the scheme approved may bring about serious consequences for the listed companies. They will have to go through the costly and time-consuming process again. In addition, they run a perhaps more serious risk of being denied further access to the capital market, should the scheme fail eventually to receive the tradable shareholder approval. The negative impacts associated with a failed compensation scheme on the part of the portfolio companies were so significant that it costs little and forces the companies to come to the institutions to negotiate, not the reverse.

In many instances, the funds brought their influence to bear through private meetings with the portfolio company and its controlling shareholder. Most anecdotal evidence points to an increasing responsiveness by the senior managers and the controlling shareholder to the concerns of institutional investors as made known in the meetings. Few cases, however, degenerated into a public battle between the fund manager and the portfolio company. One exception is Shenzhen Yantian Port Co. (Yantian), a company with its top ten tradable shareholders all being institutions. Many of its institutional shareholders overtly threatened to vote down its initial

[52] Ibid.

[53] Art 1(4).

[54] Art 3.

[55] The CSRC launched the so-called "share structure reform" in late April 2005. The reform pushed Chinese listed companies to consolidate their existing dual share structure (namely, tradable shares and non-tradable shares) into a unified structure under which all non-tradable shares are converted into tradable shares. The typical method used in the reform has been the compensation scheme. Under the scheme, non-tradable shareholders offer shares, and sometimes in combination of cash and equity warrants, to tradable shareholders, as compensation for the potential dilution of shareholder value that many of them will suffer.

SHANG Fulin, the CSRC's Chairman, instead, described the method as the "consideration" scheme, namely, a fee for changing the terms of companies' initial public offering prospectuses, which said the non-tradable shares would not be listed. See "China Commits to Market Overhaul Shareholder Reforms", *Financial Times*, August 25, 2005. For the convenience of expression, we use the term "compensation scheme".

compensation scheme.[56] Interestingly, on top of their claim for a more favourable compensation, the fund managers brought to the market's attention a governance issue: Yantian's controlling shareholder competed with the company for business.[57] Yantian later caved in, offering a more favourable compensation and responding to the concerns about its governance practice.[58] Similar market-based pressure appears to have worked in a number of other cases.[59]

In even fewer cases institutional investors went as far as voting against the compensation scheme. A paradigmatic example is the dispute that arose between the Shanghai 3F New Materials Co. (3F) and its institutional shareholders.[60] 3F is a listed company whose tradable shares were highly concentrated in the hands of institutions. Its top ten tradable shareholders were all institutions. The compensation scheme proposed by 3F was rejected by many institutions as providing insufficient compensation to tradable shareholders. 3F refused to compromise and placed the compensation scheme before the voters. The scheme failed to receive sufficient votes to pass, as five out of the ten institutions voted against it. Two other examples of one large institutional shareholder voting against its portfolio company's proposal were the Xishan Coal and Electricity Power Co. (October 2005) and Hailuo Cement Co (February 2006). However, both proposals passed with a tiny margin, despite the opposition.

B. Submitting Shareholder Proposals

The 1993 Company Law contains no provision on how shareholders

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[56] "Yantiangang Gugai Chushi Buli, Jida Zhongcang Jijin Jiti Fandui" [Yantian Port's Structure Reform Proposal Facing Frustration, as Major Block Holding Funds Collectively Opposed It], *Zhongguo Jingji Zhoukan* [China Economic Weekly], January 16, 2006.

[57] Ibid. The competition in the same industry between the listed company and its controlling shareholder, which may undermine the listed company's performance, has been a governance issue that the CSRS attempted to address. For example, *Guanyu Jinyibu Guifan Gupiao Shouci Faxing Shangshi Youguan Gongzuo de Tongzhi* [The Circular Concerning the Further Standardisation of Initial Public Offering of Shares] (issued by the CSRC on September 19, 2003) prohibits such kind of competition: Art 3(1).

[58] "Yantiangang Gugai Guoguan Youjing Wuxian" [Yantian Share Structure Reform Proposal Passed without much Difficulty], *Zhongguo Zhengquan Bao* [China Securities News], March 9, 2006.

[59] For example, Shanghai Airport Co. increased its compensation, facing mounting pressure from institutions.

[60] See, for example, "San'aifu Gugai Liuchan, Farengu Jiezheng Renu Jijin" [3F Share Structure Reform Miscarried, Legal Person Share Problem Annoyed the Funds], *21 Shiji Jingji Baodao* [21st Century Economic News], December 19, 2005; "San'aifu Gugai Yaozhe, Yinhua Jijin Pilu Yuanyin" [Yinhua Fund Explained Why 3F Share Structure Reform Aborted], Shanghai Zhengquan Bao [Shanghai Securities News], December 15, 2005.

make proposals for resolutions which the shareholders' general meeting considers.[61] The Opinions on the Standards for Shareholders' Meetings of Listed Companies [62] fixed the loophole. The Opinions provided that shareholders representing not less than 5 percent of the total voting rights may make proposals for resolutions. If the proposals relate to the issues that have already been contained in the notice of shareholders' meeting, the shareholders may choose to present the proposals at the meeting, dispensing with the need to submit the proposals to the board of directors ahead of the meetings.[63]

There was one reported case in which institutional shareholders successfully availed themselves of the above provisions to address the corporate governance issues of their concern. In this case, the issue in question was the provision of guarantee by listed companies to their related parties, a method by which the majority shareholder deployed to exploit minority shareholders. The malpractice has been rampant in the Chinese stock market, despite the regulatory and judicial efforts to crack it down. At the 2004 annual general meeting of China Vanke, China's largest listed real estate developer, the board proposed to alter an article in the company's articles of association. The proposed amendment set the thresholds that trigger the shareholder approval of the provision of guarantee, calculating on the basis of the company's *total* assets. Twenty-three funds managed by three fund management companies, representing 12.83% of Vanke's outstanding shares, dissented to the board's proposal. They proposed instead at the meeting that the thresholds should be calculated in relation to the company's *net* assets, which means a tighter shareholders' control over the provision of guarantee. The meeting passed the institutions' proposal.[64]

III. THE LIMITS ON INSTITUTIONAL SHAREHOLDER ACTIVISM

As we have seen, the degree of involvement by some Chinese institutional shareholders in the governance of their portfolio companies was stunning. Their overt activism efforts changed company behavior, drew the public attention to governance issues, and provided momentum for the regulatory authorities to raise corporate governance standards. The significance of these efforts, however, needs to be observed with some

[61] LIU Junhai, *Gufen Youxian Gongsi Gudongquan de Baohu* [Protection of Shareholders' Rights in Stock Corporation] (revised edition) (Beijing: China Law Press, 2004), 295 [Liu, *Shareholder Rights Protection*].

[62] *Shangshi Gongsi Gudong Dahui Guifan Yijian*, issued by the CSRC on May 18, 2000.

[63] Art 12.

[64] "Jijin Gaodiao Banyan 'Jiji Touzizhe" [Funds Acted as 'Active Investors'], *Zhongguo Zhengquan Bao* [China Securities News], May 9, 2005.

cautions. These proactive efforts are indeed exceptional. There have been an overwhelming number of instances in which institutional investors were passive and inactive when facing non shareholder value maximization corporate transactions. This Part will examine the factors that may have deterred Chinese institutional investors from exerting a greater voice in corporate governance.

A. Ownership Structure

Part of the explanation for institutional passivity is the highly concentrated ownership structure of Chinese listed companies. The prevailing model is that two third of all outstanding shares are non-tradable and concentrated in the hands of one or two majority shareholders. Tradable shares amount to about one third of all outstanding shares. Of these tradable shares, securities investment funds hold an average of about 15%.[65] In a bunch of listed companies, the funds hold a larger proportion – in a few cases, as much as 50 to 70 percent – of tradable shares.[66] Though significant, institutional shareholding represents, therefore, only a relatively small stake in the portfolio companies. Absent minority protection mechanisms, the majority-voting rule will make it virtually meaningless for institutions to intervene on the issues that the majority shareholder supports. Voting against, for example, a proposal that advances the interests the majority shareholders to the detriment of other investors will not prevent the proposal from being adopted. The return on time and efforts spent for the exercise of voting rights, in turn, would be negligible. Thus, institutional investors lack the incentives to be active; they would be prone to follow the Wall Street Rule of selling their stock when disappointed. Only in exceptional cases where institutional investors were "locked in" and could not sell their shares, would they be willing to intervene.[67]

The tradable shareholder approval rule contained in the 2004 Minority Shareholder Protection Provisions seems to help overcome the concentrated ownership structure barrier to institutional activism. Major corporate transactions such as cash offers, right offers, and convertible bond issues,[68] substantial asset reorganization,[69] equity-debt swap,[70] and

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[65] Supra note 8.

[66] *Fund Management in China*, 127-8.

[67] WEI Lei, "Jigou Touzizhe Canyu Gongsi Zhili Wenti Yanjiu" [A Study on the Institutional Investors' Participation in Corporate Governance], in GU Gongyun (ed.), Gongsi Falǜ Pinglun [Company Law Review] (Shanghai: Shanghai People's Press, 2003), 113, 123-5 [hereinafter, Wei, "Institutional Investor Participation"].

[68] 2004 Minority Shareholder Protection Provisions, Art 1(1).

[69] Ibid, Art 1(2).

[70] Ibid, Art 1(3).

foreign listing of subsidiaries[71] all need to be approved by tradable shareholders. In addition, there is a "catch-all" provision that all relevant issues that have an important bearing on the interests of minority shareholders require tradable shareholder approval. Like many other pieces of Chinese regulations, however, the Provisions set no standards by which to judge whether a specific issue in question falls into the category of "relevant issues". It is also unclear as to which party is entitled to make the judgment: the listed company, the minority shareholders, the CSRC, or a court. Nor is it clear whether the provision creates a private right of action and gives the minority shareholders the right to sue if, for example, they disagree with the judgment that the listed company has made. Thus, a possible practical consequence of the provision's vagueness is that it could hardly be relied upon by institutions to invoke the tradable shareholder approval rule. It may well be that only under the four circumstances the Provisions have specified[72] could the tradable shareholder approval rule be resorted to. A recent case involving the Southern Airline helps to support this proposition. The Airline is one of the three major Chinese airline operators. It proposed at its 2004 annual general meeting to purchase five Airbus A380 planes. Huaxia Fund Management Co., which controlled four funds (all of which were among the top ten tradable shareholders of the Airline) opposed the proposal, on the ground that the purchase would not be cost-efficient in light of the Airline's operation. The proposal was passed despite the opposition, and the invocation of the "catch-all" provision was not intended by the fund manager.[73]

It is notable, however, institutions did not seem to have become more visibly active when the barrier was lowered by the tradable shareholder approval rule. This was the case in the process of share structure reform, when the two-third supermajority tradable shareholder approval requirement presented institutions with the very leverage they need to engage with portfolio companies. Instances of institutional shareholders voting against arguably unfair compensation schemes was so rare, that some commentators suggested that institutions had generally failed to exercise their voting power in the financial interests of those on whose behalf they invest.[74] Institutional passivity must be attributed in a

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[71] Ibid, Art 1(4).

[72] Supra notes 68-71.

[73] "Jijin Fandui Nanhang Mai Kongke A380, Fang'an Yuji Renhui Gaopiao Tongguo" [Sothern Airline's Proposal for Purchasing Airbus A380 Was Passed Despite the Funds' Opposition], *Xinkuai Bao* [Xinkuai News], June 16, 2005.

[74] See SHUI Pi, "Shui Xiachi le Zhongguo Guquan Fenzhi Gaige, Jiekai Toupiao Beihou de Heimu" [Who Coerced China's Share Structure Reform? Exposing the Shady Deals behind the Votes], *Zhongguo Gongshang Shibao* [China Industrial and Commercial Times], October 25, 2005.

large part to other factors.

B. Conflicts of Interest

The main argument which has been put forward to explain the under-use by the institutions of the corporate governance rights is the conflicts of interest that arise at the institutional investor level.[75] The interests of institutional investors and their controllers would often lead them to act in their own best interest and sacrifice shareholder value.[76]

Before we analyse the conflicted interest of fund managers, a brief account of the legal relationships between the parties involved in the fund is necessary. These parties are the fund unit holders, the fund manager, and the fund custodian. Since the fund itself does not have the legal capacity to contract on its own, the management of its portfolio is entrusted to the fund manager (the authorised fund management company).[77] The fund custodian (the qualified custodian commercial bank) is responsible for the oversight of the fund manager's operation as well as for the custody of the fund's assets.[78] The fund manager owes fiduciary duties prescribed by the Law and the fund contract to the fund unit holders.[79] It has a legal duty to act in utmost good faith and due diligence when managing the fund's assets.[80] The Law, however, contains no specific provisions on the allocation between the fund manager and investors of the rights attached to the shares of the company in which the fund invests. Presumably the issue is left for the fund

[75] See Bernard S. Black, "Shareholder Passivity Reexamined," 89 *Michigan Law Review* (1990) 520, 595-608 [hereinafter, Black, *Shareholder Passivity Reexamined*]; Edward B. Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism," 79 *Georgetown Law Journal* (1991) 445, 469-72 [Hereinafter, Rock, *Institutional Shareholder Activism*].

[76] K. A. D. Camara, "Classifying Institutional Investors," 30 *The Journal of Corporation Law* (2005) 219; Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," 93 *Columbia Law Review* (1993) 795.

[77] 2003 Securities Investment Fund Law, Art 12.

[78] Ibid, Art 25.

[79] Three different views were expressed in the legislative process as to fiduciary relationships between the three parties. First, the fund unit holders are the trustor. The fund manager is the management trustee, and the fund custodian is the custodian trustee. They jointly owe fiduciary duties to the fund unit holders. Secondly, the fund manager is the trustee, whereas the fund custodian is the agent of the fund manager. Thirdly, there needs to be a separate trustee, though the fund custodian may act as the trustee. The Law largely adopted the first view. See LI Yinin, "Quanguo Renda Changweihui Fazhi Jiangzuo: Touzi Jijin Falǜ Zhidu" [NPC Standing Committee Legal Lecture: Investment Fund Legal System] (on October 28, 2002), http://www.people.com.cn/GB/14576/28320/28321/28332/1926632.html.

[80] Art 9.

contract to decide.[81] Private contracting between the fund manager and the investors, however, is subject to the CSRC's mandatory provision that the fund manager is entitled to "the rights arising from the investment of the fund's assets into securities".[82] That means that voting and other shareholder rights attached to the shares are all conferred upon the fund manager. The way in which the fund manager exercises the shareholder rights on behalf of the fund investors, however, has not been regulated.

Just as the separation of ownership and control of a company gives rise to divergence between the interests of shareholders and managers, divergence of interests may arise from the separation of "ownership" of the funds from its management. To start with, the fund manager may "have interests that if exercised without restraint would conflict in a material way with the interests of investors".[83] The conflicted interests may lead the fund manager to exercise the shareholders rights for the purpose of obtaining private benefits, instead of maximizing the value of its portfolios' assets. There is anecdotal evidence that some rent-seeking fund managers blackmailed portfolio companies for bribery in return for their support for the companies' share structure reform compensation scheme.[84] Fund managers contemplating to vote against unfair compensation schemes faced considerable conflicts arising from the CSRC's pressure exerted on their voting practices – top managers of the defiant fund management companies ran a risk of being removed from office.[85]

The conflicts of interest may become more acute if the fund manager has certain affiliated relationships with other financial institutions.[86] The affiliates may want the fund manager to operate the fund in their own, rather than the fund investors' interest. The conflict of interest

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[81] Art 3 provides that the rights and interests of the fund manager, the fund custodian, and the fund investors are defined by the fund contract. Therefore, Chinese funds can only assume the contractual form, as opposed to the corporate form and the trust form prevailing in many developed countries. For a comparative study, see, for example, John Thompson and Sang-Mok Choi, "Government Systems for Collective Investment Schemes in OECD Countries," 78 *Financial Market Trends* (2001) 73, 73-4, 90-103.

[82] *Zhengquan Touzi Jijin Xinxi Pilu Neirong yu Geshi Zhunze Di 6 Hao – Jijin Hetong de Neirong he Geshi* [Guideline on the Contents and Format of Information Disclosure by Securities Investment Funds, No. 6 – Contents and Format of the Fund Contract] (issued by the CSRC on September 23, 2004), Art 19(3).

[83] IOSCO, "Principles for Regulation of Collective Investment Schemes", Principle 6.

[84] "Wuliang Jijin Jingli Suohui Zao Tousu, Zhengjianhui Yankong Gugai Heimu" [Villainous Fund Managers Seeking Bribery Subject to Complaints, CSRC Stepped up Scrutiny of Unlawful Activities in the Share Structure Reform], *Zhengquan Shibao* [Securities Times], September 5, 2005.

[85] "Jijin Gongsi: Zapan Haishi 'Du Qianyan'" [Fund Management Companies: Dumping Shares or Self Sacrificing], *Shangwu Zhoukan* [Business Weekly], July 20, 2005, 48, 50.

[86] Davies, *Principles of Modern Company Law*, 339-41.

between the fund manager's majority shareholders and the fund investors has emerged as a major governance issue,[87] and thus needs elaboration. As we have noted, most Chinese fund management companies are affiliated to securities companies, which provide various financial services to corporate clients.[88] Of these services, asset management for listed companies is one for which securities companies fiercely competed. Advising listed companies about the design of the share structure reform compensation scheme is another business from which securities companies generated large profits. A securities company C that has already had business relations with a listed company X would have strong incentives to pressure its affiliated fund management company D to be passive, simply because the price of activism could be high. If D votes against X's proposal, X might take business away from another arm of C that provides the asset management or corporate advisory service. The loss of business could also occur to C, even if it has no relationship (other than the affiliated fund manager's shareholding) with X, but D has developed a reputation of being an "interventionalist". Corporate managers of X may well switch business to more "loyal" securities companies.[89] Absent mechanisms to separate the securities company from the affiliated fund manager, the conflicts can strongly skew the fund manager's decision to become visibly active on corporate governance issues.

It was not until recently that Chinese commercial banks was permitted to set up their fund management arm,[90] and we lack evidence on how the bank affiliated fund managers have acted as a shareholder. However, it is likely that these fund managers may face similar conflicts as those controlled by securities companies. One possible major source of conflicts is the bank's corporate lending business.[91] Commercial lending to listed companies has been the heart of the Chinese bank's business. If the bank's fund management arm uses its corporate governance rights to make life difficult for client companies, the bank's commercial lending business with the companies is likely to be negatively affected. The fund managers

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[87] SUN Jie, director-general of the CSRC's department in charge of securities investment funds supervision, claimed that the major agency problem in the fund management industry was the intervention by the fund manager's majority shareholder in the operation of the fund manager. See "Xu Jinyibu Yueshu Dagudong Ganrao Jijin Gongsi de Xingwei" [Need to Further Constrain the Majority Shareholder's Intervention in the Fund Management Company], *Shanghai Zhengquan Bao* [Shanghai Securities News], September 9, 2005.

[88] Supra note 22.

[89] G. P. Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford: Oxford University Press 1996), 264-5 [hereinafter, Stapledon, *Institutional Shareholders and Corporate Governance*].

[90] Supra note 26.

[91] Black, *Shareholder Passivity Reexamined*, 600-1.

may thus face strong conflicts in voting against the bank's corporate clients. A further potential source of conflicts derives from the bank's fund distribution business.[92] Commercial banks are the major distribution partners of many funds.[93] When the stock market was bearish, banks from time to time called in favour of corporate banking clients to subscribe the funds they distributed. The bank would not want its affiliated fund manager to be active in intervening in its corporate clients, lest it lose their support for its distribution business.

Chinese law has developed a set of structural rules designed to ensure the independence of the fund manager, and thereby, to limit the adverse impact of the affiliated relationships on shareholder activism. Relevant provisions are contained mainly in the 2004 Measures for the Administration of Securities Investment Fund Management Companies.[94] The Measures require the fund management companies to establish a sound system of corporate governance, so as to "maintain the interests of the fund unit holders".[95] More specifically, the fund management company is required to have adequate systems in place to ensure the separation of its own business from that of its shareholders.[96] Shareholders may wield their influence only through the shareholders' meeting, and are refrained from directly intervening in the operation and investment decisions of the fund management company.[97] Nor are they permitted to request the affiliated fund manager to provide assistance to their undertaking, securities investment and other businesses in a way that damages the interests of the fund investors.[98] The staffs of the bank affiliated fund management company are particularly required to cut their economic ties with the bank, and may not work for the bank concurrently.[99] Moreover, a mandatory independent director requirement has been imposed on the fund management company. At least one third of the board should be independent, and certain transactions require the approval of two third of the independent directors.[100]

[92] "China's Slippery Distribution Channels".

[93] Statistics showed that 54% of the funds were distributed by the banks, and 22% by the securities companies. See "Jijin Xiaoshou Qudao Zhankuan [Equity Distribution Channels Widened], *Jingji Guancha Bao* [Economic Observer], September 26, 2005.

[94] *Zhengquan Touzi Jijin Guanli Gongsi Guanli Banfa* (promulgated by the CSRC on September 16, 2004, and became effective on October 1, 2004) [hereinafter, 2004 Fund Management Company Measures]. The Measures repealed the 1997 Provisional Measures.

[95] Art 36.

[96] Art 38.

[97] Ibid.

[98] Ibid.

[99] 2005 Commercial Bank Fund Management Companies Rules, Art 13.

[100] 2004 Fund Management Company Measures, Art 41. A recent survey shows that all fund management companies have complied with the requirement. See WEI Zhongqi,

These rules may, at best, put in place legal hurdles that could prevent the fund manager from being crippled by the conflicted interests of its affiliates. However, they fall short of providing the fund manager with adequate countervailing incentives to become active in exercising the shareholder rights. One possible way of creating the legal incentives is, of course, to impose on the fund manager a duty of active engagement with portfolio companies. Clearly no such duty has been provided for by Chinese laws and regulations, and a possible source of the duty would be the fund contracts. In practice, the fund contracts usually include some terms that spell out the principles by which the fund manager exercises the shareholder rights on behalf of the fund investors. These principles are commonly three folded.[101] First, the fund manager shall exercise the shareholder rights in the interests of the fund investors. Secondly, the rights shall be exercised for the purposes of ensuring the safety, and increasing the value, of the fund assets. Lastly, the fund manager does not seek a controlling stake in the portfolio company, and will not participate in its operation and management. The last principle of "no control or management" may help reduce the risk that a fund exercises undue influence in a particular corporation's affairs.[102] However, it could also be understood as excluding the imposition of a general duty on the fund manager to be involved in the governance of portfolio companies. So, whether in a particular case the exercise of corporate governance rights is required by the fiduciary duties enshrined in the first two principles will be decided by the fund manager on the case-by-case basis. A fund manager may conclude that it will not vote or take other actions, if it believes this decision is made in the best interests of the fund investors.

Of course, the fund manager's decisions will be subject to ex post judicial review, and the fund manager will be liable if it acts in breach of its fiduciary duties and causes some loss to the fund assets or fund investors.[103] The express civil liability provision, however, may provide few legal incentives for the fund manager, for three reasons. First, the application of the business judgment rule will in most cases immunize the fund manager from liability, unless there is a gross breach of duty on the part of the fund

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"Jijin Guanli Gongsi Duli Dongshi Zhidu de Jiegou Fenxi" [Structural Analysis of the Independent Director System in Fund Management Companies], *Zhengquan Shichang Daobao* [Securities Market Herald] (2005:4) 17.

[101] See, for example, the fund contract of E Fund Prudent Growth Fund, Art 4 (9), http://www.efunds.com.cn/view?oid=shownews&newsid=147200.

[102] IOSCO, "Collective Investment Schemes as Shareholders: Responsibilities and Disclosure" (September 2003), para. 14 [hereinafter, IOSCO, *Collective Investment Schemes as Shareholders*].

[103] 2003 Securities Investment Fund Law, Art 83.

manager.[104] Indeed, even there is an alleged gross breach of duty, the evidence will be difficult to obtain.[105] Secondly, it would be extremely difficult to establish the necessary causative link between the failure to exercise shareholder rights and the losses incurred by the fund manager on the shareholding.[106] Thirdly, the provision itself may not necessarily provide a cause of action for the fund investors who have suffered economic losses due to the breach. Consider, for example, Art 69 of the 1998 Securities Law, which contains a very similar liability provision which imposes civil liability on issuers, underwriters, and their directors and other officers for damages arising out of material misrepresentations. Despite the clear language of the Law, Chinese courts had rejected the earlier cases brought by aggrieved investors.[107] It is true that the 2003 Securities Investment Fund Law specifically provides that the fund investors have the right to bring lawsuits against the fund manager in breach of its legal or contractual duties.[108] Nevertheless, the fund investors may well face the legal obstacles that had impeded aggrieved investors from seeking private remedies under Art 69 of the 1998 Securities Law.

Another way of providing incentives to the fund manager is to enable the investors to remove the fund manager if, for example, it breaches its duties or constantly underperforms. Relevant provisions can be found in the 2003 Securities Investment Fund Law. The investors may at the fund unit holder meeting vote to replace the fund manager.[109] Those holding not less than one tenth of the fund units may request the convening of the fund unit holder meeting,[110] and may convene the meeting themselves if their

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[104] E. Norman Veasey, "New Insights into Judicial Deference to Directors' Business Decisions: Should We Trust the Courts?," 39 *Business Lawyer* (1984) 1461, 1474-75. It is true that Chinese company law made no mention about the business judgment rule, see, for example, John D. Osgathorpe, "A Critical Survey of the People's Republic of China's New Company Law," 6 *Indiana International and Comparative Law Review* (1996) 493, 505. However, many Chinese judges have advocated the application of the rule in the adjudication of cases involving director's liability. See, for example, LI Guoguang and WANG Chuang, "Shenli Gongsi Susong Anjian de Ruogan Wenti" [Several Issues Concerning the Trail of Company Cases], *Renmin Fayuan Bao* [People's Court Daily], November 29, 2005.

[105] Deals could be done in a sauna room, with no possibility of being tape recorded or otherwise being kept on record. See, "Jijin Heimu" [Funds: Behind the Dark Curtain], *Caijing* [Caijing] (2000:10), 20, 30.

[106] Stapledon, *Institutional Shareholders and Corporate Governance*, 287.

[107] See Walter Hutchens, "Private Securities Litigation in China: Material Disclosure about China's Legal System?," 24 *University of Pennsylvania Journal of International Economic Law* (2003) 599 [hereinafter, Hutchens, *Private Securities Litigation*].

[108] 2003 Securities Investment Fund Law, Art 71(6).

[109] Ibid, Art 71(5).

[110] 2003 Securities Investment Fund Law, Art 72; *Zhengquan Touzi Jijin Yunzuo Guanli Banfa* [Administrative Measures for the Operation of Securities Investment Funds]

request is refused.[111] Presumably the possibility of displacement acts both as a disciplinary force on the existing fund manager and as a mechanism by which suboptimal management may be corrected. In practice, however, the incentive-creation effect of the above provisions may be very limited. Part of the reason is that it is not at all clear whether the expenses of convening the meeting are to be borned by the fund or by the requisitionists themselves. More importantly, the removal of the fund manager requires the approval of two third of the votes cast at the meeting.[112] This supermajority requirement will make it extremely difficult for investors to remove the fund manager, given the dispersed ownership structure of most funds. In the face of these uncertainties, fund investors dissatisfied with the behavior or performance of the fund manager would presumably prefer the "exit" option – to redeem the fund units in the case of open-ended funds, and sell the units in the case of close-ended funds – to the "voice" option.

What may provide some real momentum for the fund manager to take the shareholder rights seriously is perhaps the device of disclosure. Chinese law seems to have put much emphasis on using disclosure as a weapon to regulate the fund manager. Specific rules have been made on what should be disclosed, how elaborate the disclosures should be, and what procedures should be followed.[113] Under these rules, the fund manager has an affirmative duty to make detailed financial and business related disclosures to the investors. Information about the way in which the shareholder rights are exercised, however, needs not to be disclosed. That means, the fund investors had no ready access to information by which to hold the fund manager who exercises the rights on their behalf accountable.

An initiative introduced by the 2004 Minority Shareholder Protection Provisions marked an important development in this respect. Voting decisions of the top ten tradable shareholders casting votes on certain issues are required to be disclosed by the listed company.[114] It may be disputed that such disclosure is inappropriate, because the fund manager should be accountable to their clients, not to all other shareholders in the company concerned or some wider audience.[115] Note, however, the disclosure is to be made by the listed company, not by fund manager. Thus, it incurs no extra cost on the part of the fund managers that have exercised

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(issued by the CSRC on June 29, 2004, and came into effect on July 1, 2004) [hereinafter, 2004 Fund Operation Measures], Art 39.

[111] 2003 Securities Investment Fund Law, Art 72; 2004 Fund Operation Measures, Art 40.

[112] 2003 Securities Investment Fund Law, Art 75.

[113] *Zhengquan Touzi Jijin Xinxi Pilu Guanli Banfa* [Administrative Measures on Information Disclosure of Securities Investment Funds], issued by the CSRC June 8, 2004.

[114] Supra note 52.

[115] Stapledon, *Institutional Shareholders and Corporate Governance*, 287.

the voting rights. Moreover, by making the voting results public, the exercise of voting rights by the fund manager will be subject to a closer scrutiny by the fund investors and the general public than it had been. Presumably the fund managers will vote the shares with greater care to avoid being accused of misusing the voting rights. Nevertheless, it is possible that a mandatory disclosure of voting decisions may also *discourage* the fund manager to vote. This is because the obtaining by a fund manager of an "activist" reputation carries with it the potential for a loss of business.[116] Ironically, the Provisions gave a leeway for the fund managers who want a quiet life – what was made compulsory by the Provisions was not voting itself; it was the disclosure of the voting decisions of the top ten shareholders who did vote. Thus, unless the stakes are high (like the 3F case), and the investors and the market are watching, the fund manager may choose not to vote.

C. The Collective Action Problem

An alternative solution to the problem of conflicts of interest, as one may suggest, is for the fund managers to act collectively to defend the pressures arising from the conflicted interests.[117] This solution may be, however, made difficult because of the collective action problem. The problem generally arises from two sources.[118] First, the fund manager may have an individual stake which is not large enough to justify the costs of engaging with the portfolio company. Secondly, the gains to the fund manager from active engagement may be less than the gains from alternative courses of action.

We start with looking at the benefits and costs of engaging in actions that increase shareholder wealth of the portfolio companies. A fund manager voting against, for example, the portfolio company's non-shareholder-value-maximization proposal, may improve its own performance. But other fund managers also benefit from the successful intervention. Notably, fund managers are typically evaluated on their performance *relative* to their competitors.[119] So, the active fund manager's relative performance versus his "free riding" rivals may not be improved.[120] In the meantime, costs are incurred to the activist, and will be born by it alone, unless an agreement has been reached to share the costs. Often the direct costs of independently

[116] Supra notes 89-93 and accompanying text.

[117] Black, *Shareholder Passivity Reexamined*, 606.

[118] Rock, *Institutional Shareholder Activism*, 454-8.

[119] Bernard Black and John C. Coffee, "Hail Britannia?: Institutional Investor Behavior under Limited Regulation," 92 *Michigan Law Review* (1994) 1997, 2003, 2064 [Hereinafter, Black and Coffee, *Hail Britannia*].

[120] Ibid, 2057.

assessing the merits of the proposal in question and casting votes are not insignificant. The indirect costs, however, could be even greater. Such costs include, in particular, the loss of access to soft information from the portfolio company.[121] Chinese fund managers have relied heavily on direct communications with the portfolio company to obtain information not disclosed in public statements.[122] An activist posture may greatly reduce or even cut off that access,[123] and consequently harm the fund manager's performance. In short, an active fund manager bears most of the costs of its actions, and receives a fraction of the benefits. Naturally the fund manager would tend to be passive, unless its shareholding in a portfolio company is substantial enough to overcome the free rider problem.[124] Consider the Xishan Coal and Electricity Power Co. (Xishan) case, which was first instance of a fund manager voting against its portfolio company's compensation scheme. The funds managed by the E-Fund Management Company (E-Fund) held a large block (18%) of Xishan's tradable shares.

Interestingly, the fund managers which did intervene in the portfolio company as made necessary by their big stakes always did so in a way not to exasperate the company, so that the potential costs of activism would be minimized. The Xishan case is illustrative of the situation. E-Fund, which disapproved of with Xishan's proposed compensation scheme, valiantly voted against the scheme. However, E-Fund did not solicit proxies in opposition to the scheme from its fellow tradable shareholders; had it done so, the proposed scheme could have been voted down. Commentators suggested that E-Fund refrained itself from leading a coalition fighting against the scheme, in the fear that a proxy solicitation would antagonize Xishan.[125]

Sometimes, even if the net benefit from voting is greater than zero, the fund manager may still be passive, if taking an alternative course of action brings gains greater than the benefits of voting. Again, we consider the situation in the context of share structure reform. When facing a compensation scheme unfair to tradable shareholders, voting against it may

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[121] Other indirect costs include time consumption and distraction of management attention. See Black and Coffee, *Hail Britannia*, 2058-9.

[122] 2006 Global Institutional Investor Study shows that 25% of Chinese institutions have relied on engagement to seek financial information. This compares with the global investor average of just 4%. *2006 Global Institutional Investor Study*, 42 and 81.

[123] Black, *Shareholder Passivity Reexamined*, 602; John C. Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor," 91 *Columbia Law Review* (1991) 1991, 1323-4 [hereinafter, Coffee, *Liquidity Versus Control*].

[124] See "PK Xishan Meidian, Yifangda Shihua Shishuo" [PK Xishan Coal and Electricity Power, E-Fund Told the Truth], *21 Shiji Jingji Baodao* [21st Century Economic News], October 31, 2005.

[125] Ibid.

be a suboptimal course of action for the fund manager. There is a chance that the scheme, despite the disapproval of the fund manager, manages to survive the vote. In this case, the market would expect the dissenting fund manager to sell off its block shareholding. The share price will accordingly fall to reflect the market expectation, and the fund manager's performance will in turn be negatively affected.[126] In other words, institutional activism can carry with it a significant negative stock price side-effect. An alternative course of action for the fund manager is perhaps to vote in favour of the scheme, and sell their shares to others who are unaware of the potential tradable shareholder value dilution that the scheme will bring about. The fund manager may thus be able to sell its block shareholding at a higher price, and avoid damaging its relationship with the portfolio company.[127] In a nutshell, the fund managers may find themselves in a classic collection action dilemma: while it is better for all if each votes against an unfair compensation scheme (which forces the controlling shareholder to offer a better deal for all), it is better for each not to vote against it. This explains in part the pervasive funds' passivity in the share structure reform.

In addition to the collective action problem, there are other factors that create barriers to cooperation among institutions. Natural rivalry among institutions is one of them.[128] Institutions are rivals competing intensely for investor funds, and they tend to do whatever it takes to improve their relative performance. An extreme example we saw in China is the use of sudden massive selling (which can force down the share price sharply) in the last few minutes of the last trading day of the year by some fund managers of the shares that their competitors hold in block.[129] By doing so, these funds may improve their performance relative to the competitors,

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[126] "Gugai Boyi Toupiao Zancheng Haishi Fandui, Jijin xian Liangnian Jingdi" [The Game of Share Structure Reform: Vote for or against the Proposal – Funds Caught in Dilemmas], *Zhengquan Shibao* [Securities Times], November 7, 2005.

[127] Ibid.

[128] Brian Cheffins, *Company Law: Theory, Structure and Operation* (New York: Oxford University Press, 1997), 636.

[129] Consider a simplified hypothetical case. Fund manager A held 500,000 shares in the Company X, and A's major competitor B held 50 million shares in X. A would sell off its 500,000 shares at a price considerably lower than the prevailing market price in the last 5 minutes of December 31, 2005. The sudden strike might lead to a significant drop in the share price, and allowed little time for B to react and pull up the share price. Mathematically A's loss would only be one hundredth of that of B, and thus A's performance in relation to B will be improved. See "2005 Nian 12 Yue 30 Ri Zuihou 5 Fenzhong: Jigou Luanzhan Jijin Hen Shoushang" [The Last 5 Minutes of December 30, 2005: Some Funds Suffered Significant Losses in the Dogfight], *Shanghai Zhengquan Bao* [Shanghai Securities News], December 31, 2005; "2005 Nian Zuihou Yige Jiaoyiri Jijin Zhongcanggu Jiti Zapan Muhou" [Behind the Massive Selling of Shares that Funds Hold in Block in the Last Trading Day of 2005], *Zhengquan Shichang Zhoukan* [Securities Market Weekly], January 16, 2006.

since the annual performance is valuated on the basis of the closing share price of the last trading day. Presumably the hostility developed between institutions as a result of the distasteful practice will make any future coalition formation process a difficult one.

D. Legal Barriers

A direct way to mitigate the collective problems is to own a large stake in the portfolio company. However, there are legal rules that can affect the size of the stakes that the institutions own and what they can do with those stakes. As we will see, these rules place legal limits on the institutional ability to own large stakes, and create obstacles to institutions that are active on corporate governance issues.

1. Portfolio Regulations

Institutional investors are always limited in how much of a company's stock they can own. The equity portfolio of securities investment funds, for example, is regulated by the 2004 Fund Management Company Measures. Two sets of rules are of particular importance. First, the diversification rule: a fund can have no more than 10 percent of its net assets in the shares of any one listed company.[130] This rule helps ensure that the funds maintain a diversified portfolio. Secondly, the fragmentation rule: funds managed by the same fund manager can hold no more than 10 percent of a company's shares.[131] This rule prevents the fund from building a large block in any specific company. Indeed, both rules can be found in, for example, the US Investment Company Act of 1940 and securities legislation in many jurisdictions.

While the diversification rule helps to limit the exposure of funds to the share price fluctuation risk of a single stock, the fragmentation rule seems barely useful in promoting diversification. After all, a fund could have a small portion of its assets in a single company, but if the company were middling-sized, the fund could have an influential block of shares.[132] Roe argued that the fragmentation rule was laid down in the US because Congress believed the control of the industry by the funds would adversely affect the national public interest, and was determined to prevent it from happening.[133] The primary concern of Chinese policymakers, however, might be that fund managers owning a large stake in a company may take

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[130] Art 31(1).

[131] Art 31(2).

[132] Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, New Jersey: Princeton University Press, 1994), 105.

[133] Ibid, 102-5.

advantage of the controlling position to manipulate its share prices.[134] Market manipulation has an acute problem for the Chinese stock market, in large part because of the segmentation between tradable and non-tradable shares.[135] Since averagely only one third of the shares in the Chinese listed companies are tradable, a fund manager holding 10 percent of a company's shares may actually control about one third of its tradable shares. Consequently, the fund manager will be able to manipulate the share price to gain profits from share price movements. Similar quantitative portfolio regulations apply to insurance companies[136] and enterprise annuities[137].

Some commentators have argued for a deregulation of the portfolio rules to allow institutional investors to cross the 10% threshold. Institutional investors with a large shareholding, it is believed, would have real interests in engaging companies in their investment portfolio on corporate governance issues, with a view to ensuring long-term sustainable shareholder value.[138] It is questionable, however, as to whether the proposed deregulation is desirable, since taking a large control position is likely to cause a serious liquidity problem for institutional investors.[139] Chinese investors continually, and with little notice, shift their funds from one fund to another, or withdraw their funds to purchase other non-capital market investments. Open-ended funds must stand ready to redeem on a daily basis the shares of customers who wish to sell. Preservation of maximum liquidity remains a high priority for the rational fund manager.

2. Insider Trading Liability

Institutions holding large, influential stakes (more than 5%) are further limited by insider trading rules in what they can do with those stakes. There are two principal sources of insider trading restrictions.[140] First, the

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[134] Steven Xiong and Stephen Green, "Eggs in A Basket: Evaluating the Performance of China's Investment Funds," (The Royal Institute of International Affairs, Asia Program Working Paper, No. 4: 2003).

[135] Fang Liufang, "China's Corporatization Experiment," 5 *Duke Journal of Comparative and International Law* (1995) 149, 214.

[136] For example, *Guanyu Baoxian Zijin Gupiao Touzi Youguan Wenti de Tongzhi* [The Circular on Relevant Issues of Stock Investment by Insurance Funds] (issued by the China Insurance Regulatory Commission (CIRC) on February 17, 2005). For a brief introduction to the Circular, see Lovells, "China Allows Insurers to Access the Chinese Stock Market" (Client Note, 2005).

[137] For example, *Qiye Nianjin Jijin Guanli Shixing Banfa* [Tentative Measures on the Administration of Enterprise Annuities] (jointly issued by MOLSS, CSRC, CIRC, and China Banking Regulatory Commission on February 23, 2004 and came into force on May 1, 2004): Art 47-9.

[138] For example, Wei, "Institutional Investor Participation", 128.

[139] See, generally, Coffee, *Liquidity Versus Control*, 1318-21.

[140] For a general discussion of the insider dealing provisions in the 1998 Securities

"short-swing" profit forfeiture liability under the securities law.[141] Any profits from selling shares purchased within 6 months, or repurchasing shares sold within 6 months, must be forfeited to the company. The rule has been applicable to the listed company's 5 plus percent shareholders.[142] Therefore, once an institutional investor crosses the 5% threshold, any trading activities within the six month period will produce no profits. Presumably the forfeiture rule would create a strong incentive for institutional shareholders to stay under 5%. Some commentators have argued that an exemption should be made for institutional shareholders on two grounds.[143] First, the forfeiture rule discourages the institutions to hold large stakes, and may thus hinder the development of the securities investment fund industry. Secondly, the 5% threshold is inconsistent with the 10% portfolio rule which we have noted above. Taiwan's experience was refereed to: the 5% threshold has been raised to 10% to ensure the consistency with the fund portfolio regulation.[144] However, the suggested amendment was not adopted by the National People's Congress. Presumably the concern about the major shareholders exploiting information asymmetry to earn short-term trading profits overrode the potential disincentive this provision may create for institutions to own large stakes.[145] One may also suggest that it is simply a myth that the short-swing profit forfeiture provision would be a serious deterrent for institutional shareholders looking to hold large stakes. Although short-swing transactions were allegedly far from uncommon, no case in which the forfeiture provision was enforced has been reported.[146] Commentators have attributed

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Law, see Sharon M. Lee, "The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law," 14 *New York International Law Review* (2001) 1.

[141] 1998 Securities Law, Art 42; 2005 Securities Law, Art 47.

[142] The 2005 Securities Law extends its application to the company's directors, supervisors, officers: Art 47.

[143] For example, ZHU Qian, "Duanxian Jiaoyi de Jige Falǜ Wenti Yanjiu – Jianping Zhonghua Renmin Gongheguo Zhengquanfa Di 42 Tiao" [Studies on Several Legal Issues of Short Swing Trading – Also on Article 42 of the PRC Securities Law], *Fashang Yanjiu* [Studies on Business and Law] (2002:5), 110, 112-3 [hereinafter, Zhu, "Short Swing Trading"].

[144] Ibid.

[145] NPC Law Committee (ed.), *Zhonghua Renmin Gongheguo Zhengquanfa (Xiuding) Shiyi* [Annotations of the (Amended) Securities Law of the People's Republic of China] (Beijing: China Law Press, 2005), 68-9.

[146] For example, FENG Guo, "Neimu Jiaoyi yu Siquan Jiuji" [Insider Dealing and Private Remedies], *Faxue Yanjiu* [Legal Research] (2000:2), 91, 98-101 [hereinafter, Feng, "Insider Dealing and Private Remedies"].

The only known short swing trading case involved Shenzhen Bao'an (Group) Shanghai Company and others, which made short swing profits from trading Yanzhong Industry Co. shares in 1993.

the enforcement problem to a number of legislative loopholes. For example, mechanisms to enforce the provision were impractical, rules to measure the six month period and profits realized were absent,[147] and criminal sanctions were unavailable.[148]

A second potential legal concern is that institutions crossing the 5% threshold face a higher risk of being held liable for insider trading than those who do not. A 5 plus percent institutional investor clearly falls into the definition of "insiders" under the securities law.[149] The institution is prohibited from trading while in possession of inside information that it has a duty not to disclose or trade on.[150] If it violates the trading ban, its profits will be confiscated and administrative and criminal penalties imposed.[151] Of course, the trading ban applies equally to the non-insider institutional investor (i.e., one whose shareholdings do not cross the 5% threshold) that illegally obtains inside information.[152] However, the legal risk of the non-insider being sanctioned may be far remoter than that of the insider, in part because of the different burden of proof. To prove that a non-insider has engaged in insider trading, one needs to show that it obtained the inside information, and the way it obtained the information is illegal.[153] In case of the insider, however, the law presumes that it is in possession of inside information. Presumably the higher vulnerability to the insider-dealing liability associated with the larger stakes could reinforce the reluctance of some institutions to hold a large stake. Again, the enforcement problem may ease the insider dealing concerns of the institutional investors. Many have questioned as to whether China's regulatory authorities have the true will[154]

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[147] See, for example, Zhu, "Short Swing Trading"; ZHONG Yuewei and WANG Feiping, "Neiburen Duanxian Jiaoyi de Faù Zeren" [Legal Liabilities on the Insiders Engaging in Short Swing Trading], *Hebei Faxue* [Hebei Legal Science] (2000:6), 125.

[148] For example, GU Lei, "Jiaru WTO hou Woguo Zhengquan Fanzui Mianlin de Xingfa Tiaozheng he Duiying" [Criminal Law Adaptation and Countermeasures to Securities Crimes after China's Accession to the WTO], *Zhongguo Faxue* [China Legal Science] (2002:1), 16, 22-3; WANG Zuofu and GU Lei, "Zhengquan Neimu Jiaoyi zhong Duanxian Jiaoyi Fanzui de Rending he Chufa Yanjiu" [Definition and Punishment of the Short Swing Trading Crime in Insider Dealings], *Faxue Luntan* [Legal Forum] (2001:2), 78.

[149] 1998 Securities Law, Art 68(2); 2005 Securities Law, Art 74(2).

[150] 1998 Securities Law, Art 70; 2005 Securities Law, Art 76.

[151] 1998 Securities Law, Art 183; 2005 Securities Law, Art 202.

[152] 1998 Securities Law, Art 68, 70; 2005 Securities Law, Art 73, 76.

[153] GU Xiaorong and CHEN Lixing, "Touzizhe Zenyang Caineng Zhengming Neimu Jiaoyi Minshi Zeren de Chengli" [How Do Investors Prove the Civil Liabilities in Insider Trading], *Shanghai Zhengquan Bao* [Shanghai Securities News], May 10, 2005. It is unclear whether a non-insider who legally obtains inside information and trades on the information is liable for insider trading, see Feng, "Insider Dealing and Private Remedies", 94.

[154] Some commentators pointed to nepotism between the regulatory authority and senior managers in financial institutions, which contributes to the serious enforcement

or the organizational capacity[155] to enforce the insider trading provisions. And Chinese courts would not accept civil cases brought by aggrieved investors to enforce insider trading laws.[156]

3. Shareholding Disclosure Rules

Any investor who owns, or jointly owns with others through agreement or other arrangements, more than 5% of a listed company's stock is required to file with the CSRC and the stock exchange, and notify the company and the public.[157] Although the fund managers do not own the shares under their management, they fall, however, into the definition of "share controller" – a company that controls the shares owned by others through agreements or other arrangements – and thus need to comply with relevant disclosure requirements.[158] A fund manager which acquires more than 5 percent of a company's shares is required to disclose, within 3 days of the acquisition, certain information in a "shareholding change report".[159] The fund manager is required to submit the report to the exchange on which the shares are traded, to file the report with the CSRC and the CSRC's local office, and to notify the company and the public.[160] The information needs to be disclosed in the report includes facts about the identities of the fund manager and the portfolio company concerned, the number and percentage of the shares held.[161] Also subject to disclosure is some sensitive information, including monthly trading records and price range of the trading within the six months prior to the disclosure.[162] The same

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problem. See, for example, LUO Peixin, "Jinfang Gugai Chengwei Neimu Jiaoyizhe de Shengyan" [Beware the Share Structure Reform Devolves into a Feast for Insiders], *Zhongguo Jingji Shibao* [China Economic Times], September 21, 2005.

[155] For example, LI Jun and WU Jianbin, "Woguo Zhengquan Neimu Jiaoyi Guize de Lifa Xianzhuang he Qianzhan" [The Status Quo and Prospect of the Legislation for Securities Insider Trading in China], *Guangbo Dianshi Daxue Xuebao* [Journal of Radio and TV University] (2000:1), 75, 77.

[156] SUN Yongxin and XIAO Ying, "Zhengquan Neimu Jiaoyi Xingwei Nengfou Jingxing Minshi Susong" [Whether Civil Litigation Can Be Brought against Securities Insider Dealing Activities], http://bjgy.chinacourt.org/public/detail.php?id=8993.

[157] 1998 Securities Law, Art 79; 2005 Securities Law, Art 86.

[158] *Shangshi Gongsi Gudong Chigu Biandong Xinxi Pilu Guanli Banfa* [Administrative Measures for Information Disclosure of Shareholding Changes of Shareholders in Listed Companies] (issued by the CSRC on September 2002, and became effective on December 1, 2002), Art 8 [hereinafter, 2002 Shareholding Information Disclosure Measures].

[159] Ibid, Art 15.

[160] Ibid, Art 12.

[161] Ibid, Art 14.

[162] *Gongkai Faxing Zhengquan de Gongsi Xinxi Pilu Neirong yu Geshi Zhunze Di 15 Hao – Shangshi Gongsi Gudong Chigu Biandong Baogaoshu* [Guideline on Contents and Format for Information Disclosure of Companies with Publicly Issued Securities No. 15 –

information is required to be disclosed when the fund manager anticipates that its shareholding would pass the 5 percent mark.[163] In addition, the fund manager is required to make a public announcement when its shareholding falls under the 5% threshold.[164] Apart from the direct compliance costs, these disclosure requirements seem to create no particular concern to the fund manager which looks to hold an over 5% stake.

However, institutions that own modest individual stakes and form a consortium to influence company behavior or policy by acting in concert will face more legal obstacles. The shareholder consortium formed through a formal agreement or an informal cooperation would generally fall into the definition of "concerted group".[165] In addition to the above disclosure requirements, some onerous rules apply specifically to the group. First, once the group is formed, the members of the group are required to place their shares in "temporary custody" for at least six months.[166] It remains unclear as to whether shares in custody are prohibited from being traded.[167] If they are, the temporary custody rule will create a potential liquidity problem for those fund managers acting in concert, which may need sufficient liquidity to meet the redemption demand. Secondly, the group is required to disclose its purpose, the time of its formation, its plan with respect to the exercise of voting rights, and various other matters.[168] There will be a legal risk if the disclosure contains false statements, misrepresentations, or material omissions. Though the remedy is often no more than corrective disclosure,[169] a misdisclosure could lead to a CSRC investigation.[170] These rules thus create a double bind for institutional shareholders who intend to form a coalition. If they don't organize, they are unlikely to succeed. Organizing also allow cost-sharing, which can reduce the incentives for passivity created by fractional ownership. However, if institutions do organize, they will face a potential liquidity problem and a more burdensome disclosure requirement.

Report on Shareholding Changes of Shareholders in Listed Companies] (issued by the CSRC on November 28, 2002, and became effective on December 1, 2002), Art 37 [hereinafter, 2002 Shareholding Change Report Guideline].

[163] 2002 Shareholding Information Disclosure Measures, Art 16.

[164] Ibid, Art 19. In an unlikely circumstance, in which the fund manager plans to dispose of over 5% of the shares of a company in its portfolio, it must submit the shareholding change report: Art 18.

[165] Ibid, Art 9.

[166] Ibid, Art 10.

[167] "Qida Mangdian Kunrao Shangshi Gongsi Binggou" [Seven Loopholes Puzzled Mergers and Acquisitions of Listed Companies], *Jingji Ribao* [Economic Daily], August 13, 2003.

[168] 2002 Shareholding Change Report Guideline, Art 18(2).

[169] 2002 Shareholding Information Disclosure Measures, Art 35.

[170] Ibid, Art 36.

IV. Recent Legal Developments

China amended its 1993 Company Law and 1998 Securities Law in October 2005, and both laws came into effect in January 2006. Given that the laws are still quite new, with as yet uncertain effects, we assess in this Part the possible impacts of some legal developments on institutional activism.

A. Cumulative Voting

One of the key developments in the 2005 Company Law is the provision on cumulative voting. Under a straight voting system, the principle of "one share, one vote" means that any shareholder who controls a majority of the votes can elect all the directors and supervisors. This majority rule brought about a widely shared concern about the vulnerability of minorities to exploitation by overreaching majorities, especially in light of the concentrated ownership structure in Chinese listed companies. Cumulative voting has been advocated by many as a handy mechanism to address the problem and to give the minority a voice in the majority-dominated companies.[171] Thus the system of cumulative voting has been seen in some pre-2005 regulations. Under the 2002 Code of Corporate Governance,[172] for example, listed companies that have a majority shareholder holding over 30% of the outstanding shares were required to implement the system of cumulative voting in the election of directors. Other listed companies were encouraged to put in place the cumulative voting system.[173] The 2004 Minority Shareholder Protection Provisions further encouraged the optional use of the cumulative voting system in the election of supervisors.[174] The 2005 Company Law adopts an "opt-in" approach, enabling companies to choose whether to implement the system of cumulative voting in the election of directors and supervisors.[175] The adoption of cumulative voting can give activist institutions the power to put directors and supervisors on the board, and thus an additional leverage in negotiation over the composition of the board.[176] This may help enhance the

[171] See, for example, WANG Jijun, "Gufen Youxian Gongsi Leiji Toupiao Zhidu Yanjiu" [A Study on the Cumulative Voting System in Joint Stock Companies], *Zhongguo Faxue* [China Legal Science], 82.

[172] *Shangshi Gongsi Zhili Zhunze* [Code of Corporate Governance for Listed Companies], jointly issued by the CSRC and SETC on January 9, 2002.

[173] Art 31.

[174] Art 1(4).

[175] Art 106.

[176] Jeffrey N. Gordon, "Institutions as Relational Investors: A New Look at Cumulative Voting," 94 *Columbia Law Review* (1994) 124, 128.

directors' independence from the majority shareholder and the executives and accountability to shareholders.[177]

It was reported that by the end of 2003, over half of the listed companies with a majority shareholder owning more than 30% of the shares had inserted cumulative voting provisions into their articles of association.[178] Anecdotal evidence suggests that cumulative voting has spread among Chinese listed companies. Given that Chinese institutions view board independence, composition and structure as critical to protect their interests,[179] one may expect an active use of the rights by the institutions. However, there has been no reported case of institutional investors electing directors or supervisors by virtue of the cumulative voting provisions. An immediate reason for the under-use of cumulative voting as a governance mechanism is that institutional shareholdings remain relatively small. Cumulative voting assures a board seat not to all institutions, but to those (if any) that have more than a certain percentage of shares. What the critical percentage is depends on, and varies with, the number of directors to be elected at a meeting.[180] By law, the Chinese board of directors shall consist of 5 to 19 members.[181] If there are 19 directors to be elected, a 5.3 percent shareholder is assured of a board seat. However, the average board size of Chinese listed companies is much smaller than 19, and some statistics indicated that it was 10.[182] That means, in average, only a minority shareholder (or a shareholder consortium) with 10 percent or more of the shares can win a seat. Note that the funds' shareholding has recently increased to only an estimated 14.4% of Chinese tradable A-shares[183] or an estimated 4.8% of all Chinese listed equities (since tradable shares amount to one third of all equities). Clearly the level of institutional shareholding has yet to rise to a point where institutions are able to make an effective use of the cumulative voting provisions. Presumably the election of supervisors by the institutions will only be more difficult, mainly because the size of

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[177] Ronald J. Gilson and Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors," 43 *Stanford Law Review* (1991) 863, 881 (arguing it is not enough to make directors independent of executives, it is necessary to make them dependent on shareholders) [hereinafter, Gilson and Kraakman, *Reinventing the Outside Director*].

[178] "Woguo Shangshi Gongsi Leiji Toupiao Zhidu Cunzai Quexian" [Loopholes Exist in the Cumulative Voting System of Chinese Listed Companies], *Shanghai Zhengquan Bao* [Shanghai Securities News], September 16, 2004.

[179] *2006 Global Institutional Investor Study*, 82.

[180] Robert Charles Clark, *Corporate Law* (New York: Aspen Publishers, 1986), 362-5.

[181] 1993 Company Law, Art 112; 2005 Company Law, Art 109.

[182] Stoyan Tenev and Chunlin Zhang, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington, D. C.: World Bank and the International Finance Corporation, 2002), 87-8.

[183] Supra note 8.

Chinese supervisory boards is much smaller than that of the board of directors. What would further reduce the number of supervisors up for election is that normally two thirds of the supervisors are elected by shareholders, and the rest are reserved for workers.[184]

Even if the institutions are able to elect directors or supervisors in a particular company (either because the size of its boards is small, or because the size of institutional shareholdings is large, or a combination of both), there may be other factors that prevent them from using the power to put directors or supervisors on the board. First, many fund managers have pledged in the fund contract not to invest with a view to exercising control or management over a portfolio company.[185] Electing a director to the board is plausibly a breach of this contractual duty, though one may argue that it is in the best interests of the fund investors to do so. Secondly, institutions may not have the expertise of, and sufficient resources to spend on, selecting competent directors. And directors who are selected in the usual way from the usual pool may turn out to be not substantially different from their peers.[186] Perhaps more fundamentally, it remains controversial as to whether the independence of the board has a positive correlation with the performance of the firm.[187] Institutional activism targeted at electing directors independent of the controlling shareholder may well be misdirected, and may therefore, have no positive performance effect.[188] Thirdly, institutions that nominate and elect directors may face insider dealing risk. The directors will sometimes be privy to material nonpublic information, knowledge of which can be inputted to the institutions. The institutions in possession of the information are prohibited from trading the stock until it is disclosed. A violation of the trading ban may lead to private damage actions and administrative penalties.[189] Although this legal risk used to be minimal because of the enforcement problem,[190] some new developments we will examine immediately below seem to make it more likely to be a real one for institutions.

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[184] 1993 Company Law, Art 124; 2005 Company Law, Art 118.

[185] Supra note 101 and accompanying text.

[186] Gilson and Kraakman, *Reinventing the Outside Director*, 873.

[187] See, for example, Sanjai Bhagat and Bernard Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance," 27 *Journal of Corporation Law* (2001) 231; Anup Agrawal and Sahiba Chadha, "Corporate Governance and Accounting Scandals," 48 *Journal of Law and Economics* (2005) 371; Donald Clarke, "The Independent Director in Chinese Corporate Governance," 31 *Delaware Journal of Corporate Law* (2006) 125.

[188] Roberta Romano, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance," 18 *Yale Journal on Regulation* (2001) 174.

[189] Supra note 152 and accompanying text.

[190] Supra notes 155-7 and accompanying text.

B. Private Enforcement of Insider Dealing Law

The 2005 Securities Law takes a significant step forward in policing insider dealing by allowing the private enforcement of insider dealing law. Investors are now empowered to seek damages against the insiders trading on inside information for their economic losses.[191] The rule is still quite new, with as yet uncertain effects. However, recalling the flurry of lawsuits following the SPC's lift of the ban on private enforcement of securities fraud law and the reported cases in which wrongdoers were held liable,[192] it is reasonable to predict that the risks of insiders being sued and held liable for violations of insider dealing law are much higher than in the past. We have noted that the burden of proof for insider dealing is more onerous in the case of non-insider shareholder (holding less than 5% of the shares).[193] Thus there will be a case for institutional investors to stay under the 5% threshold to mitigate the potential insider dealing liability. Institutions that seek to nominate and elect directors will face additional insider trading risk. Of course, the risk may be reduced by building a Chinese wall between the director and the people who make investment decisions. But whether the wall can withstand a lawsuit is uncertain. This potential liability could add a strong impediment to the institutions that seek to nominate and elect directors.

Another development in insider dealing law is the new provision in the 2005 Securities Law which allows shareholders to initiate a derivative action on behalf of the company, if the board of directors fails to forfeit a major (over 5%) shareholder's profits from short swing trading. The Law, however, fails to articulate, for example, the standards used to measure the six month periods and profits realized. Thus, Chinese courts may still hesitate to accept the relevant cases before specific implementing rules are issued, despite the clear language.[194] Nevertheless, the possibility of being subject to a derivate action and the adverse publicity associated with the action will reinforce the reluctance of some institutions to hold large (over 5%) stakes. In addition to the forfeiture liability, administrative penalties will be imposed on the institutions that violate the six-month short swing trading restriction.[195]

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[191] 2005 Securities Law, Art 76.

[192] See, Chao Xi, "Private Enforcement of Securities Law in China: *Daqing Lianyi Co v ZHONG Weida and Others* (2004) Heilongjiang High Court", *Journal of Comparative Law* (forthcoming, 2006).

[193] Supra note 154 and accompanying text.

[194] Supra note 107 and accompanying text.

[195] Art 195. Though the potential penalties for violations are mild, include disciplinary warnings, and a fine between RMB30,000 to 100,000 (US$3,750-12,500).

V. CONCLUSIONS

Over the last five years or so, some Chinese institutional investors have been involved in the governance of their portfolio companies. These activism efforts have brought some corporate governance rules into actual practice in the marketplace. As a result, interests of minority/tradable shareholders were better safeguarded, and shareholder value increased. Moreover, institutional activism has played an important role in improving Chinese corporate governance standards.

However, shareholder activism remains at a preliminary stage in China. Despite the recent increase in institutional activism, the degree of institutional engagement with listed companies remains low. The reluctance of institutions to intervene may be partly attributed to the regulatory prohibition on institutions from holding a large, influential stake (over 10%), especially in light of the concentrated ownership structure of Chinese listed companies. Ironically, legal rules designed to protect minority shareholders – insider trading rules, shareholding disclosure rules, cumulating voting rules – may operate to further deter Chinese institutions from owning large stakes (over 5%). While smaller institutions may form coalitions to engage with the companies, the activity is constrained by the potential collective action problems. Moreover, the misaligned incentives of fund managers, and the conflicts of interest faced by fund managers who want to retain corporate business are both overwhelming barriers to institutional activism. In the meantime, the existing legal incentives are too weak to motivate active institutional engagement with portfolio companies. In conclusion, many obstacles to institutional activism still remain, and much has yet to be achieved.