Growth Without Institutions? The Case of China

_Horace Yeung_¹ & _Flora Xiao Huang_²

‘Crossing the river by feeling each stone’ refers to the pragmatic policy of Deng Xiaoping,³ to move ahead with economic reforms slowly and pragmatically. It appears that in the financial crisis, such a pragmatic approach, which reflects the conventional wisdom of a common Chinese; that is, conservatism, has saved China from crashing into a wall like its Western counterparts. The economic reform in China has been clearly one with

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² Lecturer, School of Law, University of Hull; E-mail: x.huang@hull.ac.uk. An earlier draft of this article has been presented in the Second Annual Conference of the Younger Comparativists Committee of the American Society of Comparative Law. The authors would like to express their gratitude for the comments received. Also, the financial assistance from the British Academy/Leverhulme Trust towards this project is gratefully acknowledged. The usual disclaimer applies.
³ Deng, the reformist leader of the Community Party of China, was in office between 1982 and 1987.

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‘Chinese characteristics’. In contrast to those in Russia and Eastern Europe, there has not been any transfer of control from the state to the private hands.\footnote{See for example, B Black et al, ‘Russian Privatisation and Corporate Governance: What Went Wrong?’ (2000) 52 Stanford Law Review 1731 and L Cao, ‘The Cat that Catches Mice: China's Challenge to the Dominant Privatisation Model’ (1995) 21 Brooklyn Journal of International Law 97.} Whilst the separation of ownership and control have been viewed by commentary as the necessary feature of many Anglo-American corporations which dominate the world, the difficulty for China to make a clear break with its socialist past and leap into capitalism largely comes from the Chinese leadership’s rejection of privatisation. It appears the growth of China has followed a unique path of development. One notable example is that, although the economic reform started in 1978, a formal framework of company, financial and labour laws did not come until around mid-1990s. Moreover, only until mid-2000s were these laws then revised and polished to international standards. However, the growth of China
remained strong amid a fairly long period of ‘institutional void’.

This article first offers a brief explanation to the importance of re-considering institutions, especially after the financial crisis. Then, it discusses the role of these institutions in the context of China. One focus will be on the legal institutions in China. This article will consider different areas of law, for example, company, securities and labour laws, as well as their enforcement. Afterwards it goes on to discuss the role of other institutions such as politics, culture, as well as certain professionals. The final part concludes. This article seeks to present a comprehensive and contextual analysis of a spectrum of factors relevant to the growth of China, with the support of existing empirical evidence.

Reconsidering institutions after the financial crisis
There has been a very common assumption that financial markets are the cutting edge of institutional innovation and that countries without a highly developed system of financial markets are somehow backward or underdeveloped.\textsuperscript{5} From the experience of Japan and Germany, it appears that the two features of Anglo-American capitalism, namely dispersed ownership of companies and sophisticated financial markets are not necessarily the pre-requisites of prosperity.\textsuperscript{6} In fact, advocates of the continental system claim that this structure fosters long term planning, while a market-based system is said to encourage short term expectations of investors and responsive short term strategies by managers.\textsuperscript{7} Regrettably, the crash of the


\textsuperscript{6} According to the findings from Levine, the US, the UK, Germany and Japan have very similar long-run growth rates, see R Levine, ‘Bank-Based or Market-Based Financial Systems: Which is Better?’ (2002) 11 Journal of Financial Intermediation 398.

global financial markets in 2007-08 has given the world economy a painful lesson.

The scene of the credit crunch was set up by the subprime mortgage crisis. The fall in expectations of property prices led to the rising defaults in subprime loans in 2006. In the next year, the US government assisted the rescue of Bear Stearns, one of the largest global investment banks. This rang the bell of the liquidity strains of major financial institutions. During 2008, housing market problems were recognised as widespread in the US, UK and other countries. House prices fell and supply of credit dried up. The funding problem of major mortgage providers, for instance, Fannie Mae, Freddie Mac and Northern Rock intensified. From September onwards, massive loss of

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confidence materialised. The Bankruptcy of Lehman Brothers broke the traditional belief that some large institutions would be too big to fail. A mix of credit problems caused a chain reaction of collapse such as Washington Mutual, Bradford & Bingley and Icelandic banks. Exceptional government measures have then been deployed to prevent the problem from worsening. The Western world has ironically gone back to socialism whilst China is marching towards a market economy.

The original sin of Western capitalism revealed by the credit crunch is greed. Awards have not only been given to winners, but also to losers. For example, Fred Goodwin, the former chief executive of the Royal Bank of Scotland (RBS), who was stripped of his knighthood in 2012, was heavily criticised for taking a pension amounting to £700,000 per year.\(^9\) There is nothing

\(^9\) BBC, ‘Former RBS Boss Fred Goodwin Stripped of Knighthood’ (31 January 2012), available at <http://www.bbc.co.uk/news/uk-politics-16821650>. Although the recent outcry for better corporate governance should not be taken lightly, the very basic objective of executive remuneration to attract, retain and motivate the executives
wrong in an employee receiving a pension proportionate to his position, but the problem is that under Goodwin’s leadership, RBS suffered an annual loss of £24.1 billion, the largest annual loss in the UK corporate history. RBS had to be bailed out and nationalised by the government. Therefore, his pension would effectively be paid out of the pockets of all taxpayers.

While the Chinese still well remember the calamity that followed from the Maoist centrally planned economy, the desire for an orderly society is deeply ingrained in the mentality of all Asians. Indeed, according to some commentators, many of Asia’s most successful entrepreneurs are keen to retain family control of the business, which enables them to take a long-term

view. But of course, the story of China is different. There is more than one Asian approach.

It all started in 1978, when *gaige kaifang* - the twin strategies of reform and opening-up the economy - was initiated. Reform first started from some rural areas, then to some small to medium enterprises in urban areas, and then to some larger state-owned enterprises (SOEs). The increasing economic prominence of China is clearly reshaping the international financial system. It has grown strongly over the last decade with averaged GDP growth at 9.1 per cent and almost unaffected by the financial crisis. Towards the new millennium, China’s state-owned sector looked like an economic disaster. In the aftermath of the Asian financial crisis, average profit margins in Chinese SOEs fell to close to zero. After ten years, in 2007, the combined profit of the 150 or so companies controlled by the state reached US$140

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billion. At the end of that year, out of the five largest companies in the world, three were SOEs including PetroChina, China Mobile and the Industrial and Commercial Bank of China (ICBC). As for the financial institutions, in 1999, Citigroup was the newly formed colossus. Ten years after in 2009, the top of the league table is dominated by China’s three largest banks: the ICBC, China Construction Bank and Bank of China (see Table 1 below). As for the stock market, the Shanghai Stock Exchange was at the time the fifth largest in the world, even above the London Stock Exchange. The development of China's stock market from 1991 to 2012 is given in Table 2 below. The demise of a dynasty brings about the rise of a new one. The surplus of state funds accumulates in the form of central bank reserves. China’s went up from nearly US$145 billion in 1998, to

almost US$3,300 billion in 2012. These are typically invested almost exclusively in apparently risk-free government bonds or government guaranteed bonds. From a political economy perspective, holding an abundant amount of US debts has given China the competitive edge over the power struggle with the US on various policy issues. China has become both an economic and political superpower.

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Table 1: Largest Financial Institutions in the World (Market Capitalisation: US$ Billions)

<table>
<thead>
<tr>
<th></th>
<th>Origin</th>
<th>Company</th>
<th>Market Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>US</td>
<td>Citigroup</td>
<td>150.9</td>
</tr>
<tr>
<td>2</td>
<td>US</td>
<td>Bank of America</td>
<td>112.9</td>
</tr>
<tr>
<td>3</td>
<td>UK</td>
<td>HSBC</td>
<td>93.7</td>
</tr>
<tr>
<td>4</td>
<td>UK</td>
<td>Lloyds TSB</td>
<td>72.0</td>
</tr>
<tr>
<td>5</td>
<td>US</td>
<td>Fannie Mae</td>
<td>69.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Origin</th>
<th>Company</th>
<th>Market Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>China</td>
<td>ICBC</td>
<td>175.3</td>
</tr>
<tr>
<td>2</td>
<td>China</td>
<td>China Construction Bank</td>
<td>128.7</td>
</tr>
<tr>
<td>3</td>
<td>China</td>
<td>Bank of China</td>
<td>112.8</td>
</tr>
<tr>
<td>4</td>
<td>US</td>
<td>JP Morgan Chase</td>
<td>94.5</td>
</tr>
<tr>
<td>5</td>
<td>UK</td>
<td>HSBC</td>
<td>78.3</td>
</tr>
</tbody>
</table>

Source: PT Larsen and S Briscoe, ‘The Fearsome Become the Fallen’  
Financial Times (London, 23 March 2009).
Table 2: Development of China's Stock Market 1991-2012 (RMB in Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Listed Companies</th>
<th>Capitalisation</th>
<th>Annual Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>52</td>
<td>105,000</td>
<td>92,177</td>
</tr>
<tr>
<td>1994</td>
<td>291</td>
<td>367,585</td>
<td>840,775</td>
</tr>
<tr>
<td>1996</td>
<td>540</td>
<td>943,981</td>
<td>2,128,478</td>
</tr>
<tr>
<td>1998</td>
<td>851</td>
<td>1,950,565</td>
<td>2,354,400</td>
</tr>
<tr>
<td>2000</td>
<td>1,088</td>
<td>4,809,100</td>
<td>6,082,700</td>
</tr>
<tr>
<td>2002</td>
<td>1,224</td>
<td>3,832,900</td>
<td>2,799,000</td>
</tr>
<tr>
<td>2004</td>
<td>1,377</td>
<td>3,705,600</td>
<td>4,233,400</td>
</tr>
<tr>
<td>2006</td>
<td>1,434</td>
<td>8,940,390</td>
<td>9,046,889</td>
</tr>
<tr>
<td>2008</td>
<td>1,625</td>
<td>12,136,644</td>
<td>26,711,264</td>
</tr>
<tr>
<td>2010</td>
<td>2,063</td>
<td>26,542,259</td>
<td>54,563,354</td>
</tr>
<tr>
<td>2012</td>
<td>2,494</td>
<td>23,035,762</td>
<td>31,466,741</td>
</tr>
</tbody>
</table>

A distinctive feature of China is its bank-centred system. Banks intermediate nearly 75 per cent of the capital in China, a significantly higher proportion than in other Asian countries (43 per cent in India, 35 per cent in Japan and 33 per cent in South Korea) and the United States (only 19 per cent).\textsuperscript{15} This is understandable since an efficient banking system is usually a greater priority to a developing economy. A stock market relies on an elaborate array of institutions that are difficult to establish at an early stage of economic development.\textsuperscript{16} However, the non-performing loans in China’s banking system have driven Chinese leaders to consider a shift away from the heavy reliance on the state-controlled banking system.

\textsuperscript{16} See for example, Allen and Gale (n 5).
The problem of the Chinese bank-centred system can be explained by several factors. First, state-controlled banks have continued to account for 83 per cent of bank assets in China since the new millennium. The state ownership of banks has reduced competition and lessened the pressure on banks to operate on a commercial, profit-oriented basis. Second, there is a lack of good internal credit assessment capabilities in many banks. The reason behind most of the non-performing loans in the past was the directed lending policies of the government to fund SOEs (state-owned enterprises) regardless of their profitability. Third, these state-owned banks have a decentralised structure. Lending decisions are made at the local branch level, which is susceptible to influence from local government and favouritism towards local SOEs. This diffuse structure of banks and many SOEs makes it difficult for banks to collect and

share useful information to make an informed lending decision.

Other than the predominantly state-owned banking system, the SOE system is another product of the Communist regime in China. In 2003, the State Council approved to found the State-owned Assets Supervision and Administration Commission (SASAC) with a view to separating the government’s social and public management functions from the role as the investor of the state-owned assets.\(^1^8\) It is intended to push the reform and restructuring of the SOEs. Meanwhile, it also performs some substantive duties in relation to the operation of SOEs such as appointing, removing and evaluating the executives of the enterprises. In 2010, the SASAC oversaw over 120 large SOEs. The formation of the SASAC was regarded by the

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state as a centralised effort to improve the socialist market economy.\textsuperscript{19} Before that, its duties were carried out by different organisations such as the State Economic and Trade Commission, Work Committee of Enterprises of the Communist Party of China Central Committee, the Ministry of Finance as well as the Ministry of Labour and Social Security. For SOEs that are not managed by the SASAC, the local government established the Bureau of State Asset Management (BSAM) to manage the state assets. Although the SASAC and BSAM are tasked to separate government functions from enterprise management and relieve themselves from social and public duty burdens, government and political interferences continue to take place through them as they are still staffed with bureaucrats and Party Committee members.\textsuperscript{20}

\textsuperscript{19} ibid.
Alternatively, it has been suggested that shifting the ownership of state shares from government agencies such as the SASAC and BSAM to the corporate form of SOEs may result in better monitoring of top executives.\textsuperscript{21}

It may not be easy to define the word ‘institution’.\textsuperscript{22} This article attempts to adopt a wide meaning of the word. A legal system is widely regarded

\begin{flushright}
\textsuperscript{21} ibid. 176.
\textsuperscript{22} According to Acemoglu and colleagues, economists and historians have long emphasised the importance of institutions. The institutions hypothesis alleges that societies with a social organisation that provides encourage for investment will prosper. See D Acemoglu et al, ‘Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution’ (2002) 117 Quarterly Journal of Economics 1231, 1262. As put by North, ‘Institutions are the rules of the game in a society or, more formally, are the humanly devised constrains that shape human interaction.’ See D North, Institutions, Institutional Change and Economic Performance (CUP 1990) 3. Whilst saying that ‘there is no unanimity in the definition of this concept [of institution]’, Hodgson tries to define institutions as ‘systems of established and prevalent social rules that structure social interactions’ and thus ‘language, money, law, systems of weights and measures, table manners, and firms (and other organisations)’ are all institutions. See G Hodgson, ‘What Are Institutions?’ (2006) 40 Journal of Economic Issues 1, 2.
\end{flushright}
as one of the foundations of economic growth. The Doing Business project of the World Bank provides objective measures of business regulations in 185 economies.\textsuperscript{23} According to the World Bank, governments around the world have reported more than 300 regulatory reforms that have been informed by Doing Business since 2003. Empirically, the importance of the legal institutions is supported by the ‘legal origins’ hypothesis that legal systems have a long-run impact on patterns of economic growth.\textsuperscript{24} It is claimed that

\textsuperscript{23} Doing business captures several important dimensions of the regulatory environment as they apply to local businesses. It provides quantitative measures of regulations for starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency. Doing Business also looks at regulations on employing workers. For more information, Visit the website of the Doing Business project at <http://www.doingbusiness.org>.

countries whose legal systems have a common law origin are more capable of fostering financial markets and hence economic growth than those with civil law roots.

However, Roe has indicated that a political economy based explanation seem stronger than the legal origins hypothesis.\textsuperscript{25} He argues that continental social democracies did not provide institutions that markets need, such that the markets in continental Europe have flourished to a lesser degree than their Anglo-American counterparts. While the work of the World Bank from a legal perspective and that of Roe from a political perspective have produced a great deal of discussions, the effect of culture appears to be relevant too.\textsuperscript{26} From a


\textsuperscript{25} M Roe, \textit{Political Determinant of Corporate Governance} (OUP 2003).

\textsuperscript{26} See for example, A Licht et al, ‘Culture Rules: The Foundations of the Rule of Law and Other Norms of Governance’ (2007) 35
cultural perspective, laws and rules are used to prevent uncertainties in the behaviour of other people. Therefore, people will look for ‘a structure in their organisations, institutions, and relationships which makes events clearly interpretable and predictable’. Within a company, there are laws and rules, which can be either formal or informal, controlling the rights and duties of employers and employees.

Without doubt, the emergence of some private institutions, which often takes place in line with economic growth, is an essential part of a business environment. Reputational intermediaries, for instance, accounting firms, investment banking firms, law firms, and financial press have both the economies of scale and

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scope to make them the suitable institutions to perform their roles.\textsuperscript{28} All the factors above can be considered as instrumental to growth. This article will examine each of these factors in the context of China one by one.

**Legal dimension**

The commencement of company law in China on 1 July 1994 was a milestone in developing a formal framework regulating corporate activities.\textsuperscript{29} Indeed, prior to that, many companies had already been established. This is a distinctive feature of Chinese law in which the formal legal framework is usually put in place at a relatively late stage. Likewise, even though both stock exchanges in Shanghai and Shenzhen were established in the early


\textsuperscript{29} The Chinese Company Law (‘the Company Law’ hereinafter) was adopted by the Standing Committee of the National People’s Congress on 29 December 1993, effective as of 1 July 1994, revised on 25 December 1999 and 27 October 2005, effective as of 1 January 2006.
1990s, the first set of securities laws did not come into effect until 1999.\textsuperscript{30} This pattern of development can be associated with the Chinese tendency to subordinate law to government authority and exercise detailed administrative control over economic activities rather than permitting activities within a range defined by law.\textsuperscript{31} Positive changes in the regulatory framework have recently been made through revisions to the Company Law and Securities Law, both effective on 1 January 2006. Investor’s rights have been further strengthened.\textsuperscript{32}

\textsuperscript{30} The Chinese Securities Law (‘the Securities Law’ hereinafter) was adopted by the Standing Committee of the National People’s Congress on 29 December 1998, effective as of 1 July 1999, revised on 28 August 2004 and 27 October 2005, effective as of 1 January 2006.


\textsuperscript{32} Investor’s rights are strengthened in the following ways: (1) allowing companies to use cumulative voting, if desired, thereby empowering minority shareholders to appoint directors and/or supervisors; (2) imposing a stricter duty of care on directors, supervisors and senior management; (3) granting shareholders the right to bring a derivative suit or direct suit against directors, supervisors and senior management; (4) granting an exit right to the
Another area of law that is relevant to entrepreneurship is labour protection. The Labour Law of China was adopted on 5 July 1994 and came into effect on 1 January 1995. In a decade since then, not much has been done to protect labour rights. A breakthrough came when the Labour Contract Law (LCL) was adopted on 29 June 2007 and came into force on 1 January 2008. To clarify uncertainties contained in the LCL, the State Council passed the Implementing Regulations for the LCL on 18 September 2008. This move has arguably been


These two pieces of legislation together form a comprehensive framework about a number of employment issues. There are quite a number of key areas of concern, but to name a few: signing a labour contract; remuneration; termination of labour contract and compensation; and labour disputes. To further strengthen worker protection, on 28 December 2012, the Standing Committee of the
consistent with the worldwide trend of recognising corporate social responsibility. Not only must companies take good care of their investors, but also respond to demands from their employees and their customers, as well as broader environmental and social concerns. Following the legal moves to enhance labour rights, the rising cost of China’s famously cheap labour, the very thing the country’s economic boom was built on, appears to be irreversible. A change, which should be welcome by workers, means soaring business costs.

Accompanying the laws is the regulators. The China Securities Regulatory Commission (CSRC) is the competent authority supervising the listed companies and securities markets in China. It formulates the relevant rules and regulations on the supervision and

National People’s Congress issued a decision to amend the LCL. The new LCL will come into effect on 1 July 2013. This is the first amendment to the LCL since it was issued in 2008.

34 Art 178 of the Securities Law.
administration of the securities market. It also carries out supervision on the issuance, listing and trading of securities. Issuers, listed companies, stock exchanges, organisations in the securities industry such as securities companies, clearing houses and stockbrokers as well as professionals such as auditors and lawyers are all under the supervision of the CSRC. It is empowered by law to investigate and deal with violations of the laws and regulations. The CSRC’s supervision over listed companies covers information disclosure, corporate governance, related parties transactions and mergers and acquisitions. For labour law, the Ministry of Human Resources and Social Security is the responsible government department.

Conceptually, the business laws should start from the mitigation of the agency problem and attainment of

35 Art 179(1) of the Securities Law.
36 Art 179(2) of the Securities Law.
37 Arts 179(3) and 179(4) of the Securities Law.
38 Art 179(7) of the Securities Law.
efficient markets.\textsuperscript{39} For the former, the focus is placed on how shareholders and various stakeholders can be protected from opportunistic managers or some predatory controlling shareholders, whereas the success of the latter hinges on the disclosure duties of companies and their managers. On the face of it, today’s general regulatory framework of markets and companies in China seems no different from that of developed markets. For example, regarding information disclosure, under Article 164 of the Company Law, listed companies are required to establish a financial and accounting system that must comply with relevant laws and regulations. They are also required to prepare

\textsuperscript{39} In economic terms, the agency problem essentially involves the conflict between the company’s owners and its managers. The owners are the principals and the managers are the agents. Other two conflicts can also arise in business enterprises, such as the conflict between the majority and minority shareholders (majority-minority conflicts) and the conflicts between the company itself and stakeholders such as creditors, employees, and customers (insider-outsider conflicts). See R Kraakman et al, \textit{The Anatomy of Corporate Law: A Comparative and Functional Approach} (2nd edn, OUP 2009) 36.
financial statements at the end of each financial year. The information disclosed by issuers and listed companies must be authentic, accurate and complete and must contain no false or misleading statements or major omissions, as required by Article 63 of the Securities Law. Labour protection is also embodied in the Company Law. Article 17 requires a company to ‘protect the lawful rights and interests of its employees, conclude employment contracts with the employees, buy social insurances, and strengthen labour protection so as to realise safe production’, as well as ‘reinforce the vocational education and in-service training of its employees so as to improve their personal quality’.

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40 Art 165 of the Company Law. Financial accounting reports must be prepared in accordance with laws and regulations, for example, the Accounting Law of China and the Enterprise Financial and Accounting Reports Regulations issued by the State Council. Such reports shall be audited by an accounting firm. According to Art 66 of the Securities Law, an annual report must include the following: (1) company profile; (2) financial accounting report and business report of the company; (3) profile of the directors, supervisors and senior management personnel and their shareholdings; (4) the actual controlling party of the company and others.
In relation to corporate governance, the Code of Corporate Governance for Listed Companies, which was issued in 2002, sets forth the basic principles for the corporate governance of listed companies.\textsuperscript{41} A listed company must introduce independent directors to its board of directors, and they should account for at least one-third of the board. Directors’ duties are also covered by law. For related-party transactions, timely information disclosure is required by the CSRC. Also, the director representing a related party is required to withdraw from voting when the board or the shareholders’ meeting is deliberating and voting on the related party transaction.\textsuperscript{42} With respect to market regulations, insider dealing, market manipulation and other securities frauds are banned. Any individuals or

\textsuperscript{41} The Code is applicable to all listed companies within the boundary of China. The requirements of the Code must be followed when listed companies formulate or amend their articles of association or rules of governance.

\textsuperscript{42} Art 125 of the Company Law.
institutions involved bears the civil and/or criminal liability depending on the severity of the crime.\textsuperscript{43}

Although the above has mentioned several shareholder and worker protection mechanisms in China’s legal framework, a feasible way to compare China with the rest of the world is to turn the law into numerical indexes.\textsuperscript{44} Using a panel data set covering a range of developed and developing countries, Armour and colleagues have discovered that significant upward movement in the level of shareholder protection was made by China between 1995 and 2005.\textsuperscript{45} It experienced a jump in its shareholder protection score from 5 to 6.5.

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\textsuperscript{43} Prohibited trading behaviour is stipulated in Section IV of the Securities Law.
\textsuperscript{44} One argument against the use of numerical comparative law is that ‘law is special, complex and cannot be reduced to numbers’, despite its now popular use across various areas of law, see M Siems, ‘Numerical Comparative Law - Do We Need Statistical Evidence in Law in Order to Reduce Complexity?’ (2005) 13 Cardozo Journal of International & Comparative Law 521.
\textsuperscript{45} Armour et al (n 24). But the indexes constructed in the study refer only to the ‘law-on-the-books’ only. Separation investigations may be required to ascertain the quality of legal institutions.
\end{flushright}
According to their shareholder protection index of 2005, although the UK and US were the top performers (scores of slightly more than 7), China was more protective of shareholder interests than some developed countries such as Germany and Switzerland (see Figure 1 below). Likewise, according to the OECD Indicators of Employment Protection, China’s employment protection is the best among various countries (see Figure 2 below).
Figure 1: Shareholder Protection Index of 20 Selected Countries in 2005

Note: AR (Argentina), BR (Brazil), CA (Canada), CH (Switzerland), CL (Chile), CN (China), CZ (Czech Republic), DE (Germany), ES (Spain), FR (France), GB (United Kingdom), IN (India), IT (Italy), JP (Japan), LV (Latvia), MX (Mexico), MY (Malaysia), PK (Pakistan), US (USA), ZA (South Africa).

Figure 2: Employment Protection in 2008 in Selected Countries

Scale from 0 (least stringent) to 6 (most restrictive)

Source: OECD Indicators of Employment Protection
Although China seems to have improved its legal system, three points are worth noting. First, this ‘protection-on-the-books’ does not necessarily mean that shareholders and workers in China are in fact more protected in China, since the efficiency of courts also has to be taken into account. Thus, it is useful to consider a ‘rule of law’ ranking, which is based on the World Bank Governance Indicators (see Figure 3 below). In this context, developed countries remained performing better than developing countries. One explanation for this is that copying legal rules is easier than addressing more deep-rooted features of the court system.\footnote{M Siems, \textit{Convergence in Shareholder Law} (CUP 2008).} The substantive issues of enforcement, both public and private respectively, are to be further examined later.
Figure 3: ‘Rule of Law’ of 20 Selected Countries in 2005

Note: AR (Argentina), BR (Brazil), CA (Canada), CH (Switzerland), CL (Chile), CN (China), CZ (Czech Republic), DE (Germany), ES (Spain), FR (France), GB (United Kingdom), IN (India), IT (Italy), JP (Japan), LV (Latvia), MX (Mexico), MY (Malaysia), PK (Pakistan), US (USA), ZA (South Africa).

Second, the legal ideology between the East and the West might not necessarily be the same. ‘Rule by law’ refers to the instrumental use of law by the state to govern, whereas the ‘rule of law’ refers to a normative and political theory of the relationship of legal institutions and the political state focusing on a theory of limited government through the separation of powers among executive, legislative and judicial organisations. The current situation in China seems to be the former. Indeed, Tomasic has alleged that the privileges of incorporation and limited liability under the Company Law in China were ‘jealously guarded by the state’ and the state would closely monitor the actions of incorporated companies. Milhaupt and Pistor have further alleged that China’s commitment to the rule of

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48 R Tomasic, ‘Company Law and the Limits of the Rule of Law in China’ (1995) 4 Australian Journal of Corporate Law 470, 473. According to Art 19 of the Company Law, a company must provide the necessary conditions for the establishment of the organisation of the Communist Party of China and the carrying out of party activities within a company.
law has been weakened by other governance mechanisms.\textsuperscript{49} For instance, while the Company Law 1993 stipulated the conditions under which a company could issue shares to the public, they were complemented shortly afterwards by a set of regulations promulgated by the State Council and the CSRC. MacNeil has confirmed this by indicating that there has been an extensive state regulation of company formation in the sense that approval must be obtained from the relevant government departments in addition to satisfying the requirements of the Company Law.\textsuperscript{50}

Third, there is a tension between the economic benefits of law and compliance costs. The manufacturing sector officially makes up about 50 per cent of gross domestic product in China and China’s coastal manufacturing belt has been better known as the workshop of the world. The additional costs involved

\textsuperscript{50} MacNeil (n 31) 302.
may not be a problem to large state-owned enterprise because of their capability to absorb the costs. However, smaller scale manufacturing is clearly struggling, especially amid a global recession.\textsuperscript{51} Millions of factories are being squeezed from all sides by rising costs, labour shortages, shrinking margins and a collapse in new orders from overseas. Many small manufacturers face the prospect of going out of business owing to government policies and immutable demographic and economic forces that make low-end production in China increasingly untenable. Pressures from the labour law may encourage factories to close rather than pay what they owe to workers under the law. Companies avoid paying claims by liquidating or by just disappearing without properly settling their business. In 2008, more than 15,000 enterprises in Guangdong, the manufacturing-heavy southern province, shut their

doors.\textsuperscript{52} For example, after their factory closed, workers from the Shatangbu Yifa Rubber & Hardware Factory in Shenzhen filed for the back pay and severance promised under a contract required by the law. The Hong Kong-based owner disappeared. That left many migrant workers stranded without enough money to return to their hometowns hundreds of miles away. Enforcement of the laws remains an imminent issue.

Laws in China are rapidly changing. For example, the Company Law, which came into effect in 1994, was revised in 1999, 2004 and 2005. Although undeniably the laws have been revised and improved, whether those enforcing the laws can keep up with the changes is questionable. To investigate the legal and

institutional conditions of China, one must look into the laws-in-action as well as the laws-on-the-books.\textsuperscript{53}

According to Tomasic and Fu, both the early Company Law and Securities Law were in many aspects almost immediately out of date after their passage, and it was left to the Supreme People’s Court to issue interpretations of these statutes and to regulatory bodies such as the CSRC to promulgate regulations, guidelines and interpretation to fill in the holes and gaps.\textsuperscript{54} The traditional emphasis of Chinese legal culture has been on administrative and criminal sanctions, but not on civil liability and procedural law.\textsuperscript{55} In terms of public enforcement, it is possible for the CSRC to bring

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\textsuperscript{54} R Tomasic and J Fu, ‘Regulation and Corporate Governance of China’s Top 100 Listed Companies: Whither the Rule of Law’ (2005) Research Committee on the Sociology of Law Conference Paper, 15.
\end{flushleft}
criminal or administrative actions against companies and their officers who have been engaged in market misconduct.\(^{56}\) In terms of private enforcement, investors have had much less success in seeking compensation through the courts by way of civil actions, despite the existence of legal provisions that seem to allow for such actions.\(^{57}\) In practice, Pistor and Xu have stated that the private enforcement of investor rights has been virtually absent in China, not because of a lack of demand for them, but because courts have restricted investor lawsuits.\(^{58}\) The sections below will examine the public and private enforcement of the laws in China.

\(^{56}\) See Chapter XI of the Securities Law.
\(^{57}\) See for example, Arts 20 (for abuse of shareholder’s rights) and 152 (derivative suit) of the Company Law and Art 69 of the Securities Law (for civil liability of false recording, misleading statement and material omission made by issuers and securities companies).
Public enforcement

The enforcement of labour law is mainly in the form of private enforcement. So, the focus here will be corporate and financial law. The Chinese regulator has been inclined to seek mainly administrative penalties rather than criminal penalties via the court system.\(^{59}\) The CSRC uses three primary tools to sanction listed companies: correction orders, formal warnings or fines, and a bar from participation in the securities markets (although in theory directors, managers and even controlling shareholders can be subjected to criminal liability).\(^{60}\) The first administrative case of insider trading was announced in 1994, in which the violator, the Shanghai securities brokerage division of the XiangFan Trust and Investment Company, was fined by the CSRC.\(^{61}\) This

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\(^{60}\) For a list of possible legal liabilities arising from securities market crimes and the resulting penalties, see Chapter XI of the Securities Law.

\(^{61}\) Chen (n55) 461.
was the first attempt to enforce securities market rules. Later, in 1996, the first administrative case against false disclosure and misleading statements in connection with securities trading was decided. However, there were concerns that the administrative penalties imposed were not effective. Managers and intermediaries responsible for misleading or cheating investors were not actually fined personally. It was usually the listed companies that were fined, so that ultimately the shareholders (state entities especially) bore the cost. In the case of state-owned companies, punitive fines might not provide the desired deterrent effect. This is because the payment would follow an essentially circular path: from the state to the state.

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62 In this case, the DaMing Group (a listed company of ShengLi YouTian), and the underwriter firm, accounting and auditing firm, and law firm that each provided service to facilitate the IPO of the DaMing Group were prosecuted by the CSRC for misrepresentation of the listed company’s outstanding share structure, omitting material facts, and false statements in its IPO Prospectus.
A quantifiable approach to measuring enforcement is to focus on inputs and outputs. Generally, for inputs, the funding available to the regulator will be one of the focuses.63 Unfortunately, this information is not publicly available in China. For human resources inputs, according to the investigation by Huang, the number of staff in the CSRC was 2,512 and that of the comparable regulation in the US, i.e. the Securities and Exchange Commission (SEC), was 3,511 in 2008.64 Whilst the US looks stronger from the figures, the conclusion will be different if those figures are scaled with respect to the relevant stock market capitalisation. Quite surprisingly the ratio of staff to market capitalisation in China was more than four times that in

the US. The CSRC has a number of seasoned and highly experienced staff from other jurisdictions, for example, Laura Cha and Anthony Neoh from Hong Kong, and it has actively sought co-operation from regulators in the US and other parts of the world. Its close connection with Hong Kong has particularly facilitated the learning process. However the middle

65 ibid. The market capitalisation of the US at that time was about US$11,737 billion whilst that of China was US$1,778 billion. Also, it is worth noting that the CSRC had triple the number of regional offices than the SEC, despite having a substantially smaller market.

66 By the end of 2011, the CSRC signed 51 Memoranda of Understanding (MOU) with securities regulators from 47 jurisdictions. The MOUs facilitate information exchange, cross-border assistance and dialogue on policies and regulation. See CSRC, ‘Annual Report 2011’ (2012) 49. Also, in May 2002, IOSCO adopted the Multilateral Memorandum of Understanding Concerning Consultation and Co-operation and the Exchange of Information (MMoU), the first multilateral international arrangement of its type among financial market regulators. The SFC (including other major markets such as the US, UK, Germany, France and Canada) was among the first signatories to have signed the MMoU in February 2003. The CSRC also became a party in April 2007. As of 20 February 2013, there were 92 signatories of the MMoU, and the instrument becomes the major basis of cooperation for the CSRC to work closely with fellow regulators.

67 According to the Securities and Futures Commission (SFC) of Hong Kong, over the years, the relationship between the SFC and the CSRC has been strengthened through consultation, co-operation
and lower executive levels often lack both expertise and experience. In general, it is argued that the CSRC is not very effective at identifying and prosecuting frauds.\textsuperscript{68} Other criticisms include its susceptibility to political pressure. The CSRC is a ministry-level commission. It is financed by and answerable to the State Council. Therefore, it is common that a company chairman has a higher rank than a CSRC official and, as a result, it can be difficult for the CSRC to deal with the company effectively.\textsuperscript{69} This largely reflects that the state may be committed to developing a financial market following

\footnotesize{and exchange of personnel. The SFC and the CSRC conduct regular staff exchanges, which helps to foster better understanding of one another’s securities markets and regulatory approach and to strengthen regulatory co-operation. See E Fong, Chairman of the SFC, ‘Financial Regulation in Hong Kong: A Securities Regulation Perspective’ (26 May 2012) Speech at the Centre for Financial Regulation and Economic Development, Faculty of Law, CUHK and Duisenberg School of Finance, The Netherlands. See also FX Huang and H Yeung, ‘Regulatory Co-operation between Securities Commissions: A Reflection from Hong Kong’ (2013) 1 Chinese Journal of Comparative Law 112.\textsuperscript{68} G Chen et al, ‘Is China’s Securities Regulatory Agency a Toothless Tiger? Evidence from Enforcement Actions’ (2005) 24 Journal of Accounting and Public Policy 451.\textsuperscript{69} Tomasic and Fu (n 54) 24.}
from Deng’s economic reforms, but the development of an investor-friendly regulatory framework has been paid less attention. The government has imposed politically motivated regulation to ensure state control of the market. It has neglected to establish the market-based regulation needed to ensure market efficiency.\(^{70}\) A strong market and high quality shareholder protection should co-exist.\(^{71}\) If the correlation is true, the state’s recent plan to develop Shanghai into an international centre of finance and commerce might not work.\(^{72}\)

For outputs, the CSRC initiates investigations based on a number of leads. These leads include complaints from investors and information from insiders or former employees of companies. The CSRC also

\(^{71}\) See the literatures in n 24.  
conducts the on-going surveillance of listed companies and has a practice of regular reviews and random investigations. The results of these investigations are made public if wrong-doing is found. Between 1997 and 2001, the CSRC published 205 formal rulings in total, including 15 for market manipulation, two for the dissemination of wrongful information, nine for insider trading and 39 for violation of disclosure rules.\textsuperscript{73} This number is far lower than that of the US and UK, which often had more than 500 and 100 enforcement cases brought by the national regulator per year respectively.\textsuperscript{74} This can be partly explained by the size of markets. The size of China’s market and the number of listed companies were then still small. Yet, considering that the private enforcement of securities law in China remained uncommon, such a number of public enforcement alone might not be a strong deterrent to market misconduct.

\textsuperscript{74} Coffee (n 53) 269.
The number of enforcement actions in 2002 and 2003 were about double those of 1999 and 2000.\textsuperscript{75} The main violations were major failures to disclose information, false statements, a delay in disclosing information and inflated profits. According to a report compiled by the Shenzhen Stock Exchange (SZSE), in 2007 around 80 per cent of the enforcement actions were also related to information disclosure offences, whereas there were only nine cases related to insider trading and market manipulation.\textsuperscript{76} There can be two explanations for this. The investigation of insider trading and market manipulation cases is often complicated. Therefore, more time is required and a lot of cases were not published. Secondly, some cases were re-classified as

\textsuperscript{75} Chen et al (n 68) 466.

\textsuperscript{76} Shenzhen Stock Exchange, ‘Research Report: 2007 Securities Market Rules Violations’ (2008) <http://www.szse.cn>. This report appeared briefly on 16 July on the official website of the SZSE before being removed. An anonymous source at the SZSE told Caijing that exchange officials had asked the web manager to remove the report that night because ‘further review is needed about the content, and it will be published in the future when the timing is right’. See Caijing Magazine, ‘Shenzhen Bourse Report Blasts Regulators’ (in Chinese)(18 July 2008).
information disclosure offenses for the ease of prosecution. Although these explanations make perfect sense, it is doubtful whether the CSRC has the determination and resources to prosecute complicated but serious offences. According to the SZSE report, the CSRC’s administrative commands often hindered market mechanisms, and the poor implementation of regulations, including some laws flawed from the start, left the market open to exploitation.\textsuperscript{77}

A genuine threat of sanctions is required to deter market misconduct. It is still hard to say if the CSRC, which is empowered by the Securities Law to produce a single strong regulator, is experienced enough or whether its enforcement intensity (both \textit{ex ante} and \textit{ex

\textsuperscript{77} ibid. The report said the CSRC had expanded its jurisdiction with little oversight, and oversaw a wide range of issues including professional standards, business approvals, IPO regulation, and investor education. Meanwhile, CSRC gave itself the right to make rules and supervise the nation’s bourses, and assumed a bailout role during market troubles.
post) is sufficiently strong. However, as Pistor and Xu have rightly pointed out, it is difficult to interpret enforcement activities in the absence of comparative data. For instance, in 2003, when total enforcement procedures reached 51, there were 1,278 listed companies in China, implying that at most one in 25 companies was the subject of any kind of enforcement activities. To compare, in the same year, there were 175 enforcement cases brought by the Financial Services Authority (FSA) when there were 2,692 listed companies on the London Stock Exchange, implying a ratio of

78 There has been a debate on the relationship between enforcement intensity and market competitiveness. The Securities Exchange Commission of the US and the Financial Services Authority of the UK have different regulatory philosophy, but both markets are successful. The former has taken a more proactive approach while the latter has had a more laid-back approach. Ferran has tried to explain the difference by suggesting that a successful principle-based regulatory strategy that relies heavily on ex ante compliance may be capable of producing the desired deterrent effect. See E Ferran, ‘Capital Market Competitiveness and Enforcement’ (2008) <http://ssrn.com/abstract=1127245>.
79 Pistor and Xu (n 73) 195.
80 ibid.
around 1:15. In the US, the ratio was around 1:10. Unfortunately, the data is simply not comparable, because the FSA’s numbers for enforcement actions cover all aspects of the financial services industry, including banking, pensions and insurance. In 2008, the number of enforcement actions in China was apparently catching up with the US market. In that year, the SEC brought 671 actions, six times more than the CSRC (which took 107 actions), but with an understanding that the size of the US market was likewise around six times larger than that of China. But a comparison between that of the US and China is not conclusive either, because low public enforcement intensity can be complemented by other mechanisms. Enforcement actions done in an informal manner are not included. The raw data might not tell the whole story. This is particularly important in the context of China. The role

81 ibid. There were 6,159 listed companies and the number of enforcement actions was 679.
82 Huang (n 64) 334.
of reputation has a more plausible effect to deterring wrongdoing. It has been suggested that the public criticisms issued by the exchanges largely complement regulatory efforts by the CSRC.\textsuperscript{83} Besides, domestic media coverage of the sanctions of affected companies and individuals serves as an important mechanism of discipline. Reputational effects raise the cost of doing business and can damage careers. Both companies and individuals fear any exposure of wrongdoing and as a result this may deter them effectively from committing any offences in the first place. Also, there might be other functional substitutes such as private enforcement or the existence of professional institutional investors. In the UK, where both private and public enforcement is weaker than in the US, the role of institutional investors is large.\textsuperscript{84} Unfortunately, in China, institutional investors

\textsuperscript{83} Liebman and Milhaupt (n 59) 954.

\textsuperscript{84} Myners recognised the highly-developed equity culture and the professionalisation of investment in the UK as ‘key national assets’, see P Myners, ‘Institutional Investment in the United Kingdom: A Review’ (2001)
governed by the Qualified Foreign Institutional Investor (QFII) or Qualified Domestic Institutional Investor (QDII) schemes did not actually emerge until the new millennium. Therefore, there is a need to investigate the private enforcement situation.

Private enforcement

In addition to the functions fulfilled by public enforcement (i.e. justice and deterrence), civil remedies have the advantage of compensating the wronged. Unfortunately, the private enforcement of investor rights has been almost non-existent in China.\(^85\) For example,
the World Bank’s Doing Business studies once awarded China 2 out of 10 for a shareholder’s ability to sue officers and directors for misconduct.86

The first civil compensation attempt on account of false statements occurred in 1998.87 The case was dismissed by the court because of a lack of direct causal link between the false disclosure and the loss. However, it was suggested that the actual reason for this decision was because the court believed that the case should be standing to bring derivative actions. Also, shareholders’ right to take on private securities action was substantially restricted by the court system. Pistor and Xu shared similar opinion that private enforcement of securities cases have virtually been absent in China. See Pistor and Xu (n 58) 191.

86 Dam (n 24) 236.
87 N Li, ‘Civil Litigation Against China’s Listed Firms: Much Ado About Nothing?’ (2004) The Royal Institute of International Affairs: Asia Programme Working Paper No.13, 3. According to Art 77 of the Provisional Regulations on the Administration of Issuing and Trading of Stocks, the responsible directors, supervisors and/or mangers of the issuer or distributing securities company would be jointly and severally liable for any damages arising from false representation in the course of securities trading (Art 63 of the Securities Law 1998 and Art 69 of the Securities Law 2005).
referred to the CSRC to determine.\textsuperscript{88} This indicates the reliance on administrative measures, rather than formal legal mechanisms, in China. Private litigation began to take off only in 2001 in response to fraud at Guangxia Company. The Guangxia case is a benchmark case for private securities litigation in China, and is often referred to as ‘China’s Enron’.\textsuperscript{89} In total, 1,000 cases were filed in Wuxi, Jiangsu province, against Guangxia alone.\textsuperscript{90} This shocked the key government officials because they had always thought in terms of administrative sanctions instead of judicial remedies. These events evidenced the need for a drastic legal overhaul. Disappointed investors

\textsuperscript{88} ibid.

\textsuperscript{89} Located in Ningxia province, Guangxia was listed on the SZSE in 1994 as a manufacturer of floppy disks and related products. After experiencing poor and deteriorating performance for the first five years, the company reported unprecedented high earnings per share. Consequently, the company’s share price shot up from RMB14 to RMB76 in one year. Later, Caijing Magazine played the role as a whistle blower and the CSRS launched an investigation. It turned out that the reported earnings as well as many sales records and contracts were fabricated. See F Allen et al, ‘China’s Financial System: Past, Present, and Future’ in T Rawski and L Brandt (eds), \textit{China's Great Economic Transformation} (CUP 2007).

\textsuperscript{90} Pistor and Xu (n 58) 192.
started to demonstrate in front of the CSRC building. Key officials from the CSRC initiated meetings with the Supreme People’s Court, urging the court to assume a more significant role in regulating the securities market through adjudicating cases.\(^91\) In September 2001, the Supreme People’s Court issued a notice directing all lower courts not to accept private securities lawsuits temporarily, until the further clarification of the appropriate judiciary procedures.\(^92\) In January 2003, a circular was issued setting out more detailed procedural rules for dealing with securities cases.\(^93\) From 1 February 2003, Chinese courts have been able to adjudicate private securities litigation on the basis of rules issued by the Supreme People’s Court in the circular. In the opinion of Zhu, these procedural rules, in conjunction

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\(^91\) Chen (n 55) 464.
\(^92\) Notice Concerning Temporarily Not Accepting Civil Compensation Cases Related to Securities (issued by the Supreme People’s Court on 21 September 2001).
\(^93\) Several Regulations Concerning the Adjudication of Civil Compensation Securities Cases Based upon Misrepresentation (issued by the Supreme’s People’s Court on 9 January 2003).

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with other relevant provisions of law, such as the Company Law, the Securities Law and the Civil Procedure Rule, have finally provided courts with the guidelines necessary to address claims from investors.\footnote{S Zhu, ‘Civil Litigation Arising from False Statements on China’s Securities Market’ (2005) 31 North Carolina Journal of International Law and Commercial Regulation 377, 381-382. For example, Art 63 of the Securities Law 1998 expressly mentioned civil liability and compensation of losses caused by false statement and Art 17 of the 2003 circular specifies that a false statement on the securities market is defined as a false recording, misleading statement, material omission or improper disclosure.}

China’s court system was undoubtedly slow to react to the demand for the private enforcement of securities cases, considering that both domestic stock exchanges commenced their operation in the early 1990s. There were two reasons for this, according to an insider of the CSRC.\footnote{Li (n 87) 4.} First, despite the general provisions set out in the Securities Law 1998, there were no specific rules and guidelines as to the implementation of private securities litigation. Second, given the huge
disparity in the quality of judges among courts nationwide and the lack of precedent, there would have been many inconsistent judgments, which might have made the situation more chaotic.

The effect of the circular was immediate; more than 900 private securities suits were brought by investors.\textsuperscript{96} This illustrated the demand for private securities litigation. In practice, the courts appeared to be uncertain about how to apply the rules.\textsuperscript{97} Even though actions could be initiated, courts tended to refuse to make a judgment, and none was settled by a court judgment in favour of the investors.\textsuperscript{98} The ban on all private securities cases in 2001 to 2003 showed that both the \textit{ex ante} and \textit{ex post} threat of private enforcement was weak. Furthermore, according to the 2003 circular, claimants can only sue in the court where the

\begin{flushleft}
\textsuperscript{97} Li (n 87) 10.  \\
\textsuperscript{98} ibid.  
\end{flushleft}
headquarters of the listed company is located. Previously, according to the Civil Procedure Rule of China, investors had enjoyed the right to sue either in their own domicile or at the location of the company’s operation. The new restriction raised the concern of local protectionism. Judges and courts in China, especially at the lower level, often lack independence because governments at the same level control them through appointment and budgetary powers. The integrity of the legal structure can easily be undermined by political influence. In fact, this influence is very strong in China.

After the 2003 circular, the level of private enforcement in China might have been greater than ever before. Cheng has examined 26 cases and found that the new Company Law might have removed certain drawbacks in the first Company Law but the new law can protect interests of minority shareholders only to a

99 Hutchens (n 96) 621.
certain extent. Therefore, further amendments may still be needed. However, it is hard to say whether this trend will continue and even whether China will follow in the footsteps of the US. Indeed, the intention of the circular was not to encourage shareholder actions, but rather to limit the scope of cases that will be accepted by the courts and the eligibility of investors to receive compensation. Apparently, the state is still in the process of striking a balance between social stability, economic development and shareholder protection.

Private enforcement of labour law is particularly crucial for labour protection. When a contract of

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101 During their investigations of the regimes of the UK and US, Armour and colleagues discovered that the shareholders in the US are far more litigious than the UK. The general reason may be, unlike the US where class actions and the use of contingency fees are permitted, the UK’s ‘loser pays’ fees rule has discouraged representative litigation. See J Armour et al, ‘Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US’ (2009) 6 Journal of Empirical Legal Studies 687.
102 Zhu (n 94) 427.
employment can be considered as the cornerstone of employment law, then employment tribunals and/or other advisory, conciliation and arbitration services can be considered as its foundations. The idea is that employment disputes should be heard in an atmosphere far removed from the courtrooms, accessibly, informally, speedily and cheaply. One feature is that the importance of labour union is rising. According to the Chinese Company Law, employee representatives are required to be included on the board of supervisors in companies. Furthermore, companies are required to consult with trade unions and employees when deciding about significant operational issues. According to Article 18 of the Company Law, employees should organise a trade union to carry out trade union activities and safeguard the lawful rights and interests of the employees. The company is required to provide necessary conditions for its labour union to carry out these activities. However,

103 Art. 118 of the Company Law requires that labour representation must not be less than one-third of the board.
labour unions have traditionally been controlled by management and local government. Foxconn, the contract manufacturer whose biggest customer is Apple, is preparing genuinely representative labour union elections in its factories in China for the first time. According to the press, this would be the first such exercise at a large company in China and is consistent with Beijing’s move to encourage collective bargaining as a way to help contain the growing worker protests.¹⁰⁴ In the past, Foxconn’s labour union representatives were chosen under democratic processes, because there was no open and transparent nomination of candidates, and in the committees that run the union, more than half of the committee members were from management.

The new labour law in China has resulted in a big jump in labour disputes. In the city of Guangzhou, the local arbitration office received more than 60,000 cases

in 2008, about as many as it handled over the previous two years combined.\textsuperscript{105} The fast-rising caseload has overwhelmed the system and the number of labour arbitrators is simply not sufficient. Before the labour contract law, most companies saw very little legal risks associated with employees. Now, they are beginning to see the risks as employees are increasingly likely to sue. Chinese employees have become keen litigants and it is expected that some companies may face exposure of up to US$20 million.\textsuperscript{106} Indeed, according to the figures from Ministry of Human Resources and Social Security, there has been a sharp rise in labour law cases since the Labour Contract Law came into effect in 2008 (see Table 3 below).

\textsuperscript{105} Canaves (n 52).
The characteristic of the Chinese legal system is that it emphasises administrative system prevailing over vertical authoritative control, than horizontal checks and balances.\textsuperscript{107} The authorities retain substantial administrative discretion with very weak judicial control over the exercise of discretion. Litigation is not encouraged for civil disputes. The court is mainly to deal with offenders who violate state law and policy. The

\begin{table}
\centering
\caption{Labour Disputes Cases in China from 1996 – 2009}
\begin{tabular}{|c|c|c|c|c|c|c|c|}
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1996 & 48,121 & 71,524 & 93,649 & 120,191 & 135,206 & 154,621 & 184,116 \\
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\end{tabular}
\end{table}

Source: Ministry of Human Resources and Social Security of China

\textsuperscript{107} S Lubman, \textit{Bird in a Cage: Legal Reform in China after Mao} (Stanford University Press 2000).
access to justice is very limited to individuals and there is a lack of protection for individual legal rights. Courts have been used to discharge all government functions including administration. Therefore, it comes as no surprise that as the global financial crisis hits the heart of the world's factory floor, labour activists say officials are turning a blind eye to the new labour requirements.\textsuperscript{108} Meanwhile local governments deny they are becoming lax, yet complaints against employers languish in huge backlogs as many are simply shuttering their factories. This means that the workers get no recourse even if they succeed in their claims. ‘The enforcement of the Labour Contract Law is facing new problems,’ said Hua Jianmin, chairman of the National People's Congress Standing Committee, China's top legislative body.\textsuperscript{109}

\textsuperscript{108} Canaves (n 52).
\textsuperscript{109} ibid.
Final remarks

Both the company law regime and the stock markets in China were established from scratch in the early 1990s. Apart from the fact that market operation had already begun, a formal set of securities laws only came into effect in 1999. Undoubtedly, the laws-on-the-books have improved over the years, as evidenced in Armour and colleagues’ study. However, China’s commitment to building a market economy that respects private economic interests has been unconvincing. A conflict of interests persists between the state ownership of many listed companies and enforcement by the CSRC. As for private enforcement, shareholders’ rights to bring actions were banned in 2001-2003, despite the law clearly conferring such rights on shareholders. This clearly illustrates that the market, and indeed various economic activities in China, is not only governed by legal

110 See Armour et al (n 45).
institutions. Political considerations must also be taken into account.

As for labour protection, with reports emerging of layoffs preceding its implementation, and company closures or relocations to cheaper jurisdictions afterwards, it has been widely believed that the new law would add considerable burden to employers. There are undoubtedly comprehensive improvements to worker rights. However, all these represent costs to a company. The impact can particularly be devastating considering that labour intensive productions have been the major economic driver in China. After the new law coming into effect and the financial crisis, there have been epidemic closures of factories across the Pearl River and Yangtze River Deltas. The affected workers have limited recourse in reality and indeed been worse off, despite the improvements in law.
Political and cultural dimensions

The adverse effect of politics in China lies in the fact that the market has been dominated by state-owned listed companies. This has led to suboptimal enforcement and greater majority-minority conflicts. The reason why state-owned companies have paramount importance in China is because the state has been reluctant to let go of its control in these companies, as well as the economy. The compatibility of private economic activities and socialism has always been an ideological dilemma to Chinese leaders. Deng Xiaoping asked the following:

Are such things as securities and stock markets good or bad? Can they only exist under capitalism? Cannot they also be adapted to socialism?\(^{111}\)

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\(^{111}\) Speech made by Deng Xiaoping during his Southern Excursion in 1992.
There have been numerous concerns over reinterpreting Marxism and leaping into a ‘socialist market economy with Chinese characteristics’. Would the introduction of a capital market be consistent with socialist economic division and production? For Chinese leaders, the use of non-socialist development and the taste of capitalism are only the tools to get China into the ‘socialist utopia’. In this sense, capitalist means can be borrowed and utilised for the building of socialism. Would the state-owned nature of Chinese enterprises be changed? Would workers be exploited by profit-oriented companies? Responding to economic reforms, substantive changes were made to the structure of the legal system by learning from other developed countries. But socialism is still the basic system. Law has essentially been a tool for

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112 Based on this theory, the socialist system will evolve into four phases: from capitalism to the primary stage of socialism, then to the advanced stage of socialism and finally to communism. Y Hu, China’s Capital Market (The Chinese University Press 1993) 67.
the maintenance of state domination.\textsuperscript{113} As discussed before, according to Roe, labour orientation in social democracies might not be compatible with the shareholder wealth maximisation norms, which are important to entrepreneurship.\textsuperscript{114} Indeed, the new Company Law of China still has the feature of social democracies by requiring the presence of the representatives of workers on both the board of directors and the supervisory board.\textsuperscript{115} Zhu has noted that since 1987 two main themes have been running throughout the development of securities regulation in China: one is to ensure the primacy of socialist ownership and the other is to restrict foreign ownership in SOEs.\textsuperscript{116}

\textsuperscript{114} Roe (n 25).
\textsuperscript{115} See Arts 45 and 51 of China’s Company Law 2005.
Heavy governmental intervention might not be desirable to the development of a strong market. The Chinese state has a high degree of control over market regulation. In addition, it can exert influence through its company ownership. A distinctive feature that separates China’s stock market from those in other countries is the phenomenon that two-thirds of the outstanding shares in China are not tradable. Any SOEs converting into a shareholding company has to divide up its share into three roughly equal parts. About one-third of shares can be publicly issued, owned by individuals and legal persons, and freely traded. The remaining two-thirds are

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118 H Yeung, ‘Non-tradable Share Reform in China: A Review of Progress’ (2009) 30 The Company Lawyer 340. About a third of equity will be transferred to state organs. These shares are either managed and represented by the Bureau of National Assets Management or held by other state-owned companies. The ultimate owner of state shares is the State Council. Another one third of every listed company’s equity will be sold to domestic institutions (securities companies and SOEs with at least one non-state owner). These shares which amount to two-thirds of the total shares issued are non-tradable. The remaining will be offered to the public.
allocated to state shares and legal person shares which cannot be traded on the stock market.\textsuperscript{119} Such shares have been issued to the founders of a corporation, business partners or employees and have served two main purposes: to keep the control of SOEs that were floated on the market, and to maximise IPO proceeds.\textsuperscript{120} All these arrangements have flowed from the rejection of privatisation by the Chinese state. Instead, corporatisation was adopted in which SOEs were converted to joint stock companies, featuring both state and non-state ownership. The goal was to improve managerial incentives by installing shareholders with incentives and the ability to monitor the managers.

As Clarke has rightly pointed out, these diagnoses and the implementation of corporatisation as a

\textsuperscript{119} Art 36 of the Provisional Regulations on the Administration of Issuing and Trading of Stocks.

solution are flawed. The chief purpose of corporatisation is to promote higher efficiency through better management. The goal of the state owner in the new system is assumed to be profits according to the traditional shareholder’s value maximisation norm. Indeed, the state owner is still the direct owner of companies in a number of sectors. It is simply too difficult for the state as the majority shareholder to exercise effectively its monitoring role.

The separation of ownership and management of control, as claimed by Berle and Means in 1932, has been viewed by Chinese commentators as ‘a positive good to be pursued for its own sake’, because it seems to be the necessary feature of a modern enterprise, as well as the feature of many Anglo-American corporations that now dominate the world. This requires a widely

dispersed shareholder base. In practice, a large number of corporatised SOEs remain dominated by a single state shareholder that exercises its control either through formal channels such as shareholder voting, or through traditional channels such as the appointment of key personnel.\textsuperscript{123} Ironically, the state as the majority shareholder plays an ineffective role in monitoring the behaviour of managers, because it is a collective body. There is no body within it with the sufficient and appropriate incentives to perform the monitoring function. Meanwhile, the holders of tradable shares are typically minority shareholders with limited power to affect management decisions. The problem is twofold. First, there is a majority-minority conflict. The interests of the state as the majority shareholder might not necessarily intersect with those of the minority shareholders, whose interests are purely profit-seeking. Second, there is a principal-agent conflict. With inadequate shareholder pressure, it is questionable\textsuperscript{123} Clarke (n 121) 499.
whether trust can be placed in managers. In fact, many Chinese companies are characterised by excessive CEO power, insider control, collusion and weak transparency.\textsuperscript{124}

On the other hand, culture is important in market development. For example, Black has suggested that a culture of honesty is one of the essential ingredients of a strong market.\textsuperscript{125} Legal culture might also be relevant. However, in the context of China, political factors are apparently more influential than legal factors. Moreover, what China lacks is a well-developed investment culture. One of the major aims of corporate and financial law is to protect investors, but at the same time these investors are not completely innocent if they buy stock in


organisations of doubtful validity and practices.\textsuperscript{126} Although they do not have any obligations to conduct any research or investigation, such as reading the financial statements of a company, before putting any money into a company, the press describes the behaviour of Chinese investors as ‘betting’ or putting stock in ‘Lady Luck’.\textsuperscript{127} Other than the obvious explanation that people have limited alternative investment channels, share trading offers ordinary Chinese the chance to gamble. In fact, the stock market in China is like a casino. Xie has revealed that the chance for ordinary investors to profit from the Chinese stock market has

\textsuperscript{126} US Supreme Court Justice Louis Brandeis indicated that ‘there is no such thing as an innocent purchaser of stocks’, quoted in R Monks and N Minow, \textit{Corporate Governance} (Blackwell 2004) 127.

only been 40 per cent, even lower than the odds to win in a casino (48 per cent). 128 ‘Seven lose, two even, one wins’ has been a favourite saying among China’s share investors. 129 Standard legal protections are essential in a scenario where investors are too naïve to protect themselves. 130 There can be both governance and regulatory strategies. However, both are problematic in the context of China, largely because of the dominance of state-owned companies. First, absolute control in these companies is still retained by the state. Second, enforcement, both public and private, against these companies has not been common as discussed.

In addition, the corporate culture of China is not compatible with the best corporate governance practices. The Western concept of separate legal personality can

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play a role in safeguarding investors’ interests, because there is a real separation between family/state and company.\textsuperscript{131} There is an impersonal pattern of possession in the UK, the US, Australia, Canada and New Zealand. However, the culture of a place can entail correspondingly different expectations of a company. Chinese companies, for example, show different characteristics. As opposed to the separation of ownership and control, professionalisation, bureaucratisation and neutralisation, they retain characteristics of small scale family businesses such as paternalism, personalism, opportunism and flexibility, even when conducting a very large scale of operations. There is not a culture of honesty. Corruption is widespread in China with excessive entertainment, embezzlement, bribery and moonlighting.\textsuperscript{132} Personal

\textsuperscript{132} According to the 2012 Corruption Index released by the Transparency International <http://www.transparency.org>, China
connections or *guanxi* have remained a key element of Chinese organisations. China’s traditional business culture is characterised by discretionary power, secrecy, a substantial government role in large-scale production and personal connections. Conversely, it is commonly asserted that securities markets depend on the rule of law, transparency and the interactions of private parties who are often strangers. Therefore, Hutchens has referred to the development of securities markets in China as a ‘cultural revolution’, where there has even been stimulating growth of professions and institutions previously unknown in China, such as accounting, legal professions and investment banks.¹³³

Hofstede conducted one of the most comprehensive studies of how values in the workplace are influenced by culture.¹³⁴ His dimension framework was ranked 80 out of 176 countries. The perceived level of corruption in China remained high.

¹³³ Hutchens (n 96) 622.
characterising culture is still the most influential and the most used in international management studies. In the 2010 edition of his book, scores on the dimensions are listed for 76 countries, partly based on replications and extensions of the 1991 study on different international populations. Whilst China is a highly long-term oriented society in which persistence and perseverance are normal, a low score on uncertainty avoidance may be a hindrance to development. The latter means that in China adherence to laws and rules may be flexible to suit the actual situation and pragmatism is a fact of life. This can explain the existence of corruption and backdoor guanxi.

In summary, from a political perspective, law has been used as a tool by the government to achieve its own agenda, instead of a tool to restrict the conduct of government. Within a company, the state as the controlling shareholder, has failed to perform an effective monitoring role. As a result, both majority-
minority conflicts and principal-agent conflicts are imminent. From a cultural perspective, laws and rules are intended to prevent uncertainties in the behaviour of other people. *Guanxi* and the advocacy of harmony in the Chinese society add a degree of uncertainty to the market. In China, people still tend to solve a problem through ‘informal channels’. Corruption remains widespread in China. Solving all these problems may not be easy and will involve a lot of efforts.

**Supporting professions and infrastructures**

The emergence of private institutions such as accountants, which often takes place in line with economic growth, is an essential part of market development. Ironically, China is actually one of the oldest countries using an accounting system. Well over 2,000 years ago, China was already applying a highly developed accounting and auditing system for financial
and economic activities. Under the rule of the communist party, the accounting system was a modified Soviet system called ‘state accounting’. This was used as a tool for the implementation of the state’s production quota and government budgets. Managers personally selected an accounting approach and decided on the content of accounting statements and even on the amounts of profits. Considering the absence of a sound accounting framework for a long period of time, an official with the Chinese Institute of Certified Public Accounting stated that Chinese accounting firms were lagging behind international standards regarding qualifications, services and management, even in this market economy era.

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Intermediaries in the Chinese financial markets have predominantly been state-owned. Securities and investment fund management firms were established by state-controlled companies or directly by government agencies in the 1980s. Most restructured in the 1990s into shareholding companies with a state organisation as the majority shareholder. Since government agencies remain in control of these firms, they have been vulnerable to administrative interference. Dozens of underwriters have been implicated in disguising the accounts of restructured SOEs with the assistance of local officials to allow it to list.\textsuperscript{137} Even though some of them are not state-owned entities, they are controlled by the CSRC in respect of licensing, capital adequacy and the conduct of business. The presence of intermediaries, in theory, should facilitate the operation of the market. For instance, the certification services performed by

accountants and lawyers can alleviate the information asymmetry by saving investors’ time and costs in verifying the information. Furthermore, the financial press allows the dissemination of information, both favourable and unfavourable, from companies to a large group of people in a short period of time. For this to occur, intermediaries must be independent of issuers and investors. In China, this might not be possible because intermediaries are often owned or controlled by the state, which is the most regular issuer of securities and is also generally the controlling shareholder in companies.\textsuperscript{138} Hence, the intermediaries are in an awkward position when performing their roles as ‘gatekeepers’.

Indeed, China has done particularly well in policy level reforms to foster development. One example is the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone. Following the State Council’s decision to develop Qianhai into an

\textsuperscript{138} MacNeil (n 31) 321.
international commercial centre, it has been widely tipped to become the next ‘mini Hong Kong’.\textsuperscript{139} The government grants pilot preferential development policies in the financial, legal services, human resources, education, medical and telecommunication sectors to facilitate its development.\textsuperscript{140} For example, the joint operation of law firms in Mainland China and Hong Kong will be permitted in Qianhai. Similarly, the new policy allows Hong Kong professionals with Chinese Institute of Certified Public Accountants (CICPA) qualifications to become partners of accounting firms in the Mainland China, using Qianhai as a pilot district. Apparently, it is an attempt to piggyback the institutions

\textsuperscript{139} J Harper, ‘Chinese City of Qianhai could be “the Next Hong Kong”’ \textit{The Telegraph} (London, 31 July 2012).

\textsuperscript{140} Following the State Council’s agreement in principle on ‘The Overall Development Plan for the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone’ in 2010, it officially approved preferential policies to facilitate the development of the zone on 27 June 2012. See the ‘Announcement on the Preferential Policies for Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone’ (2012) issued by the State Council (‘Guohan No. 58’).
in Hong Kong, which is widely considered as one of the most developed markets in the region.\textsuperscript{141}

In summary, there has been a continued need in China to strengthen the system of reputational intermediaries, including professionals such as accountants and lawyers as well as other financial services firms such as investment banks and securities analysts. Before the economic reform, there was little or no demand for them. However, considering the current market size, ensuring an adequate supply of high quality personnel is crucial to the future development of the Chinese market.

\textsuperscript{141} Indeed, the Chinese state’s decision to list many of its SOEs in Hong Kong has been an attempt to piggyback the legal system as well. As of the end of February 2013, there were 179 companies listed abroad, predominantly in Hong Kong. See Huang and Yeung (n 26); Huang and Yeung (n 67); and FX Huang and H Yeung, \textit{Chinese Companies and the Hong Kong Stock Market} (Routledge 2013) (forthcoming).
Conclusion

The Chinese path of development and its associated rapid growth is puzzling to the West, because it seems to defy some conventional wisdom.\textsuperscript{142} Although China has adopted many of the policies advocated by economists, such as being open to trade and foreign investment and sensitive to macroeconomic stability, China’s reform succeeds without complete liberalisation, without privatisation and without full democratisation. These conditions are thought to be necessary for growth.

China, on its course to a more capitalist state, offers a promising investment opportunity to investors. At the same time, investors must be very cautious if they want to take advantage of this opportunity. In the early years of China’s open-door policy, foreign investors were put off by the lack of a functioning legal system. With eyes dazed by the promise of a market of over a

\textsuperscript{142} G Meier and J Rauch, \textit{Leading Issues in Economic Development} (OUP 2005) 46.
billion captive customers and a production base of cheap labour input, many multinational companies still eagerly invested in China even though they lost money. Capitalism is based on rational economic calculability, and capitalist development requires a legal framework of sufficient predictability to allow such calculability.

A reliable legal framework has been the assets of the Anglo-American system, but at the same time a moral hazard problem might have contributed to the backlash of Anglo-American capitalism, as seen in the financial crisis. Investors feel more comfortable in a protective jurisdiction and they are willing to surrender funds in exchange for securities, because they believe there is proper oversight on corporate and market governance. Nonetheless, this by no means implies that China should not develop a better institutional and regulatory framework. An effective economic system should involve the regulation of both companies and markets. To put it simply, in the company dimension, a
shareholder should have the right to receive information about the company, and to expect that there are adequate laws and other pressures to discourage expropriation by insiders. In the market dimension, there must be mechanisms to ensure an orderly operation of the markets, fair dealing and integrity. Also, there is a need to ensure that outsiders are adequately protected such that creditors will not be expropriated, workers not exploited and consumers not misled. By learning from the experience of the Western markets, revisions to the Company Law and the Securities Law of China in 2005 and the introduction of the Labour Contract Law in 2008 have reflected a convergence to the Western model. Institutions are constantly being built and fine-tuned. Undoubtedly, this will be an on-going process.