Foreign Investments on Chinese Capital Markets

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Schriften zum Unternehmens- und Kapitalmarktrecht
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herausgegeben von

Jörn Axel Kämmerer, Karsten Schmidt und Rüdiger Veil

42

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Enforcement Concepts from a Chinese and German Comparative Perspective

Edited by

Rüdiger Veil and Xujun Gao

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Preface

This book consists of a collection of articles on the development of China's capital market. It is derived from presentations and discussions made by academics and practitioners at the *Foreign Investments on Chinese Capital Markets* conference, held at Tongji University in Shanghai on 23 October 2015. The conference was co-organised and co-sponsored by Tongji University, Bucerius Law School, the Konrad-Adenauer foundation (Shanghai) and the EU Law Institute of Shanghai Law Society. The conference, and therefore this book, would have not been possible without the support of all four co-organisers who had a broad vision for a comparative law conference on the important themes of developments and enforcement-concepts in capital markets law, from both a Chinese and German comparative perspective.

Over the last decade, Chinese stock markets have developed rapidly. The number of stock corporations listed on the Shanghai and Shenzhen stock exchanges alone has exceeded 2,800 with a total market capitalization of RMB 46 trillion. Most importantly, these stock markets are increasingly gaining international influence, as they have recently been opened for foreign investment.

This book discusses developments and enforcement-concepts in capital markets law, from a Chinese and German comparative perspective. All stock markets, regardless of size, country or region, need a regulatory framework ensuring stability and investor confidence alike. This has also been acknowledged by the Chinese legislature and the Chinese supervisory authorities. Nevertheless, China has been confronted with a number of challenges, especially strong price fluctuations. In addition, investors have lost large sums of money thus losing confidence in the functioning of capital markets. As a consequence, further efforts are needed to ensure the integrity of the markets and investor protection, in particular by enforcement mechanisms.

This book is divided in three chapters. The first chapter sets the scene by exploring the possibilities of foreign investment on Chinese capital markets. First, *Xiang Jian* and *Chen Yicong* explain the process of opening up the capital markets in China and highlight important improvements. *Steffen Gehring* analyses the regulatory environment in China for foreign investors and the challenges and risks of Chinese capital markets. Interestingly, he points to some limitations for foreign investors; however, at the same time also acknowledges a satisfactory market access for them. The picture is completed by *Gong Baihua*'s article on the Shanghai Pilot Free Trade Zone, which he sees as an experimental field to understand the impact of the transpacific partnership agreement in China.

The second chapter deals with enforcement concepts in Chinese and German securities regulation. Again, Chinese authors shed light on enforcement powers of Chinese regulators (*Su Huchao*) and point to the need of investor protection (*Xujun Gao*). It might be interesting for Chinse scholars and the regulator how public enforcement works in Germany. Therefore, *Thomas Höppner* from the German supervisory authority BaFin explains the foundations of enforcement by supervisory authorities in Germany and *Alma Pekmezovic* and *Rüdiger Veil* expand on the enforcement concepts at the example of financial reporting in Germany, which is subject to a dual enforcement mechanism. In the US, but also in some European countries, private enforcement plays a prominent role. Therefore, *Anne Gläßner*, *Manuel Gietzelt* and *Matthias Casper* look at different ways of collective action applied in Western countries and compare them with each other. They are in favor of the French *action de groupe*, which would be more efficient than model case proceedings established in Germany, less prone to induce "bounty hunts" by lawyers as in the US and safe-guard investors' procedural rights.

The third chapter refers to corporate law and asks which role the supervisory board plays in terms of enforcement. The relevant background here is that both Chinese and German stock corporations provide a supervisory board (two-tier-system) whose task it is not only to control the management but also to provide advice to it. *Klaus J. Hopt* explains that the German board system is highly path-dependent. Evidence of such path-dependency can be seen in particular in quasi-parity and full parity labor codetermination in the board of corporations, but also in stakeholder orientation and a codified law of groups of companies with corresponding duties of the board of both the parent company and the subsidiaries. *Guo Li* and *Matsuo Takayuki* explain differences between the Chinese, German and Japanese systems of corporate governance. They recommend reforming certain aspects of the Chinese system via the adoption of practices from the Japanese and German systems. In particular, full-time and better educated supervisors would be required. *Guo Li* and *Matsuo Takayuki* argue members of the supervisory board should ideally be more independent

We do very much hope that the insights provided by the authors in this volume are helpful for a better understanding of current developments in China. The comparative analyses shed light on the challenges and experiences in developing China's capital markets and provide food for further thought regarding possible reforms of the Chinese capital markets law.

We would like to especially thank the authors for their valuable contributions. We are also grateful for the support by the Konrad Adenauer foundation. *Tim Wenniges* and his team at the office of Konrad Adenauer foundation in Shanghai stood right behind this project and made the conference at Tongji University Shanghai possible. Thank you very much!

We are greatly indebted to *Alma Pekmezovic* and her team for the translation work. Last, but not least, we acknowledge our gratitude to *Iris Kessler* and *Christian Voigt* for their excellent work on the manuscript.

Shanghai/Hamburg, April 2017 Xujun Gao and Rüdiger Veil

Table of Contents

Chapter 3: Enforcement Concepts in Chinese and German Corporate Law – The Role of the Supervisory Board

Chapter 1

Investments on Chinese Capital Markets

The Process of Opening up the Capital Market in China: Current Practice and Emerging Trends

*Xiang Jian (*项剑*) and Chen Yicong (*陈奕聪*)*[*]

I. The Process of Opening up the Capital Market in China and its Achievements

1. The Rapid Development of the Capital Market During the Reform and Opening-up

China's capital market is a fast-growing emerging market. Since the establishment of the Shanghai Stock Exchange in 1990 China's capital market has had only 25 years of development history, and it is a vibrant and dynamic market. At present, China has formed a multi-layered capital market system, including the Shanghai blue-chip market, the Shenzhen Small and Medium-sized Enterprise Board Market (SME Board), the Shenzhen growth Enterprise Market (GEM), the Beijing National market share transfer system and a number of regional share transfer markets.

To date, the number of companies listed on the Shanghai and Shenzhen stock exchanges has reached about 2800, with a total market capitalization of RMB 46 trillion. In 2015, the total turnover of the Shanghai and Shenzhen stock ex-

[*] Dr. Xiang Jian and Dr. Chen Yicong are members of Shanghai Stock Exchange Law Department.

change amounted to RMB 203.45 trillion, with a funding volume in value of RMB 1 trillion. Although the stock market has experienced abnormal fluctuations in the first half of 2015 until the end of August 2015, the total value of market capitalization, the funding volume and the trading volume of the Shanghai Stock Exchange, remained steadily ranked 4th, 1st and 2nd respectively among global stock exchanges.

2. The Improvement in Level of Openness of the Capital Market

In more than 20 years, China has adhered to its policy of opening up its capital market in a stable and orderly manner. Especially since China's accession to the WTO in 2001, China has actively fulfilled its own commitment to open up the stock market. The degree of openness of the capital market is deepening, while its scope is expanding. Thus, the process of opening-up the capital market is moving forward steadily.

a) Cross-border Financing

aa) Promoting the Listing of Domestic Companies Overseas

Since 1992, qualified domestic enterprises are allowed to issue their shares on foreign stock markets, in order to expand their financing channels and participate in international competition. A large number of domestic enterprises have launched an initial public offering and listing in Hong Kong, the United States, Great Britain, Singapore, etc.

Mainland China has become one of the major suppliers of non-domestic listing resources in global capital markets. To date, there are 215 H-shares and 144 red-chips listed in Hong Kong, with a total market capitalization of USD 27.18 trillion. Meanwhile, the number of US-listed Chinese shares, UK-listed Chinese shares, and in Singapore- listed Chinese shares has reached 185, 36, and 116 respectively.

bb) Foreign Institutions are Permitted to Issue Bonds Within China First as a Test

In 2005, the International Finance Corporation and the Asian Development Bank first issued panda bonds in China; in September 2015, HSBC and BOCHK were first approved to issue RMB bonds in China's capital market.

cc) Domestically-registered Enterprises with Foreign Investments are Allowed to Issue in China

Since November 2001, qualified domestically-registered Co. or Ltd. with foreign investments are allowed to issue shares and list on the domestic market, the amount of which has reached more than 100.

b) Two-way Cross-border Investment

aa) Foreign Investors are Allowed to Invest in Domestic Securities with B Share in a Pilot Phase

At the time of establishment of the capital market, the B Share market was created for foreign investors to trade in US dollars and Hong Kong dollars. Currently, there are 104 B share companies with a funding volume of RMB 33.8 billion, among which 3 companies are listed on the Hong Kong Stock Exchange by way of introduction.

From November 2002, transferring of state-owned shares and legal person shares of listed companies to foreign investors is allowed. As of February 2006, foreign investors are permitted to participate in M&A and long-term strategic investments in domestic listed companies as a long-term strategic investor.

bb) The Qualified Investors System

In 2002, thanks to the establishment of the Qualified Foreign Institutional Investor (QFII) system, foreign institutional investors can directly invest in a share market. In 2007, the Qualified Domestic Institutional Investor (QDII) system was launched to allow Chinese institutional investors to invest in overseas capital markets. In 2011, by the introduction of RMB qualified foreign institutional investors (RQFII) systems, foreign institutional investors can use the RMB to invest directly in the mainland capital market. To date, 277, 132, 141 different institutional investors have been respectively recognized as QFII, QDII, RQFII, with a total value of USD 80 billion, USD 90 billion and RMB 410 billion.

cc) Shanghai-Hong Kong Stock Connect as a Symbol of Interconnection

The launch of the 'Stock Connect' between the Shanghai and Hong Kong stock exchanges on November 17, 2014 established a technical connection between the two exchanges, through which investors in Hong Kong and in Mainland China can trade and settle shares within a predetermined range of listed companies in the respective markets via the exchange and broker in their local market.

The Shanghai-Hong Kong Stock Connect is a significant breakthrough in the opening up of Hong Kong's and Mainland Chinas capital market. As capital projects are not completely convertible in China, the program introduces an innovative cross-border securities investment mode, which has the features of convenient operation and controllable risks. The program follows the existing laws and regulations of settlement; this is the mode of operation in both markets. The main rules govern the following matters:

(1) The Application of Rules Relating to Settlement, Trading and Issuing
The activities of transactions and the settlement are to comply with the provisions of the jurisdiction where the settlement of transactions takes place. Listed companies will continue to be subject to the listing rules and other regulatory rules where they are listed. The trading under the Shanghai-Hong Kong Stock Connect will only be opened when both Shanghai's and Hong Kong's markets are open for trading and the corresponding settlements are open.

(2) The Way of Clearing and Settlement
CSDC and HKSCC conduct cross-border settlement directly, communicate with each other and become each other's clearing participant to provide clearing services for Shanghai-Hong Kong Stock Connect.

(3) Eligible Stocks
At the beginning stage of the testing, Hong Kong and overseas investors are only allowed to trade the shares listed on the SSE including all constituent stocks of the SSE 180 Index and SSE 380 Index, and all SSE-listed A shares that are not included in the above indices but are dual listed in the H share market. Mainland investors will be able to trade the constituent stocks of the Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap Index, and all H shares that are not included in the above indices but are dual listed in the Shanghai A share market. Subject to regulatory approvals, these restrictions are subject to change over time. Both sides can adjust the scope of eligible stocks according to the pilot circumstances.

(4) Quotas
At the initial stage of the testing phase, trading is subject to separate sets of aggregate and daily quotas at launch. The northbound aggregate quota is set at RMB 300 billion, while the daily quota is set at RMB 13 billion. The southbound aggregate is set at RMB 250 billion, while the daily quota is set at RMB 10.5 billion. Subject to regulatory approvals, these restrictions are subject to change over time.

(5) Investors
Initially, only Mainland institutional investors and individual investors who have RMB 500,000 in their investment and cash accounts were allowed by Hong Kong SFC to trade Hong Kong-listed shares.

Shanghai-Hong Kong Stock Connect now operates smoothly: 121 Hong Kong brokers participate in northbound, while 110 domestic brokers participate in southbound transactions. The number of accounts opened by Hong Kong investors is more than 800,000. Meanwhile more than 210,000 households participated in transactions. At the end of October 21, the market capitalization of

northbound is RMB 152.7 billion, accounting for 1.20 % of SSE free-float market capitalization.

c) Two-way Openness in Securities Services

At present, there are altogether 98 fund management companies. Among these, there are 45 Sino-foreign joint fund management companies established in China. There are in total 125 securities companies, among them 11 Sino-foreign joint securities companies. In these companies, the proportion of foreign shareholding has increased from 33 % to 49 %.

There are 19 foreign securities institutions and altogether 38 institutions permitted to engage directly in the trading of B shares in the Shanghai Stock Exchange and Shenzhen Stock Exchange.

More than ten foreign stock exchanges have been allowed to establish representative offices in China, for example the New York Stock Exchange and the London Stock Exchange.

Domestic securities and futures institutions have begun to "go global." Currently, there are 20 securities companies, 15 fund companies and 6 futures companies setting up branches in Hong Kong; 2 securities companies have acquired overseas securities institutions. Besides, since July 2015 the Chinese Mainland and Hong Kong formally have recognized their respective funds (MRF).

d) The Opening of Futures Market

Thus far, 28 domestic enterprises are permitted to engage in overseas futures business for the purpose of hedging. Foreign investors can invest in stock index futures by QFII in China, while domestic investors can invest in overseas futures markets by means of QDII. The international crude oil futures trading platform, which is under construction, is intended to invite foreign investors to participate in these transactions.

3. The Results of Opening up the Chinese Capital Market

a) Support of the Development of the Domestic Economy

By overseas listing, Chinese companies have gained valuable financial support, which in turn has improved their corporate governance and laid the foundation for its development. Meanwhile this has also contributed to the integration of China's economy into the global market.

b) Achievement of a Win-Win Situation and Enhancement of the Competitiveness of Chinese Capital Markets

The opening up of the capital market forces the domestic market players to adopt to international best practices. As a result of competing directly with international companies Chinese institutions have had to improve their management and therefore to enhance their international competitiveness. By participating in international capital markets, foreign investment has shared the results of economic growth, achieved a certain market share and gained a better return of investment in China.

c) Promoting the Progress of the Internationalization of RMB

The opening up of the capital market and internationalization of the RMB are intertwined. For example, the QFII and the QDII systems have promoted two-way cross-border capital flows, while the RQFII system has offered new ways of investing in offshore markets for the RMB and promoted the formation of an offshore RMB center. Meanwhile the Shanghai-Hong Kong Stock Connect facilitates the orderly flow of RMB between Shanghai and Hong Kong.

d) Promoting the Internationalization of the Chinese Market Mechanism

The internationalization of the capital market has not only resulted in an opening up of the market itself, but has also led to the publication of a series of rules and regulations regarding capital-raising behavior, securities trading, and supervision mechanisms. The latter are in conformance with internationally recognized rules. Two-way openness of capital markets, especially the practice of cross-border interconnection, helps to bring the mainland capital market trading rules in line with internationally prevailing rules, and gears the overall market operation mechanisms and regulations towards international standards gradually.

II. Current Trends

1. Improving the Openness of China's Capital Market

a) Enhancing Market Competitiveness

Our market is still in the emerging and transition stage. Thus, certain gaps exist, in comparison to mature markets, such as the volume of direct investment, investors' structure, market stability and the market environment. International competitiveness and the level of recognition require further improvements. For instance, the global index provider MSCI Inc. and FTSE Inc. still exclude A

shares in the emerging markets index in their annual country classification review, which does not relate to the size of the A share market and the overall level of economic development.

b) Tremendous Space for Further Opening up of the Capital Market

According to the current prevailing evaluation system, the level of openness of China's capital market can be analyzed along several dimensions: (1) the degree of free market access for foreign investors and the inflow-outflow of capital; (2) the proportion of international investors and financial institutions in the domestic market; (3) the proportion of international companies or foreign share ownership in all listed companies; (4) the compatibility of the domestic market system, the rules and regulations with international standards; (5) the number of domestic investors or financial institutions participating in the international markets and the number of domestic enterprises listed and initialing in the international markets. Based on these evaluation criteria, the capital market of China has enjoyed the effects of endogenous growth, but offers tremendous space for further opening up.

2. The Strong Impetus for Opening up the Chinese Capital Market

a) Abundant Money Supply

Since the total amount of savings of China is about USD 4 trillion a year, the market's potential money supply is abundant. However, considering the personal financial investment in China, bank deposits account for 64 %, while investments in stocks, bonds, funds, etc. amount to less than 14 %. In contrast, the personal investment in stocks, funds together with pensions, reaches almost 70 % of personal financial investments in the United States.

b) The Number of Enterprises

There are more than 13 million registered enterprises and more than 40 million individual industrial enterprises. There are numerous innovative enterprises seeking support from the capital market. But currently there are only about 2000 listed companies. Hence, a large number of enterprises hope to raise funds through the capital market, but only a minority of them is able to do so. Further, amongst those companies which are listed, most companies are mainly large and medium-sized, i. e. mature enterprises. While a large number of start-ups and emerging businesses in the real economy is in urgently of capital, these companies are yet to receive support from the capital market.

c) Steady Development of China's Economy

According to the Economic and Social Development Plan of 2012, China's GDP growth should be doubled until 2020, namely from RBM 40 trillion in 2010 to RMB 80 trillion in 2020. Because of the international economic situation and the effects of the domestic economic structural adjustment, China's current economic growth has slowed down. In light of this development, the Chinese government has repeatedly stressed its determination to develop the capital market continually, which means that the capital markets need to play a more important role in this process.

d) New Opportunities and Demand for the Opening up of Capital Markets

China's central government has put forward the following goals: to expand financial opening up to the internal and the outside world, to promote two-way opening-up of the capital market, and to speed up the convertibility of RMB capital project. In addition, the Chinese government has also put forward the "One Belt and One Road", "made in China 2025" and other strategic initiatives. All these measures mean that the pace of internationalising and involving Chinese enterprises in global mergers and acquisitions has accelerated year by year. In our view, China's capital markets need to accelerate the process of opening up further in order to meet the needs of the real economy.

3. Gradual Improvement of the Market Environment by Opening up the Capital Market

a) Improving the Convenience of Cross-border Capital Transfers

China is trying to improve the breadth and depth of its capital market step by step, in order to reach the general goal of gradually making the RMB project convertible and also meeting the actual needs of the capital market itself. It is envisaged that a more conditioned and more elastic overall monitoring system over time will replace the existing simple, hard and fast rules. According to the data published by the Bank of China, the process has already been accelerated obviously. This is expected to remove barriers which restrict cross-border capital flow.

b) The Benefits of Gradual Reform

With the further development of the market, regulators prefer the rule of law over administrative methods. This means that the examination and approval of market behavior by the administration will be further reduced, while the capital market will be further deregulated, and the market mechanisms improved.

Since 2001, the CSRC has cancelled 144 items subject to administrative examination and approval in total. Moreover, according to the latest requirements of documents promulgated by the State Council, China will gradually introduce a negative list of market entry system.

c) Strict Investigation and Penalties Against the Behavior of Market Violations

The deregulation of the market is accompanied with a stronger emphasis on the need for supervision. In recent years, the CSRC has carried out a number of investigations awarding severe penalties against market violators. In addition, the CSRC has launched several pilot projects which are aimed at developing mechanisms for the advanced compensation of investors and administrative reconciliation. In 2014, CSRC concluded 163 cases and imposed administrative sanctions against 55 institutions and 416 individuals; with the total disgorgement and fines reaching RMB 704 million. Moreover, 31 people were banned from market entry and 74 cases were transferred to public authorities. It is noteworthy that harsh crackdowns on insider trading have become the focus of legal enforcement. Since the introduction of big data in the second half of 2013, CSRC has detected and received alerts regarding 375 cases of insider trading covering the period to the end of 2014. Of these cases 142 cases were registered.

III. Gradual Improvement of Legislation Regarding the Opening up of the Capital Market

The level of openness of the capital market and the degree of internationalization bears close relation to market legalization. China is promoting the modification of the securities law and other relevant legal systems. One of the important tasks during this process is to reform the corresponding legal systems in order to meet the legislative requirements in the process of internationalization. This also entails reforming border securities issuance and cross-border listing requirements applying to companies, improving capital interconnectivity and enhancing cross-border supervision and cooperation. This also raises issues concerning the conflict of law, the choice of lex causae, the harmonization of regulatory standards, the extraterritorial effect of securities law and the determination of authorities having jurisdiction over a specific case. Solving these legal issues will require positive and long-term cooperation between Chinese experts and scholars, and their foreign counterparts.

The Chinese Capital Markets – from a German Institutional Investor's Perspective

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I. Introduction

Obviously China is one of the fastest growing and dizzying developing countries of the world. From a German point of view it is not only important as an export country, it is also gaining in relevance as a site to invest in the capital market. Of course there are some local Chinese specifics to keep in mind if you want to enter the Chinese capital market as a foreign investor. But there are also particular rules in German law which regulate the access to foreign capital markets, especially depending on what type of investor you are.

In this essay I am going to examine the options for investing in the Chinese Capital Markets as a German institutional investor from both these angles: from the viewpoint of German law as well as from the perspective of the Chinese general regulations and frame conditions.

II. Regulatory Environment in Germany for Different Types of Institutional Investors

There are a lot of different types of institutional investors in Germany. Regarding their behavior as investors, for some there are very specific and strict regulations. Others are completely free in their asset allocation and in their way of investing. The following types of institutional investors are very common in Germany.

1. Social Insurance Agencies, Public Health Funds, Public Pension Funds and Public Injury Insurance Corporations

Social insurance agencies manage large amounts of money. For example most of the German employees pay parts of their wages into a public pension fund system called "Deutsche Rentenversicherung". The same is true for the employees' contribution to one of several public health funds, for example the "Allgemeine Ortskrankenkasse (AOK)".

In case of retirement, illness, injury, unemployment or other situations of need the agencies of the German social insurance system pay money to their contributors. Because they provide elementary services for the public, these agencies are not allowed to take high risks when they invest the contributions of the employees. As a kind of trustee they have to manage their assets in a very sensible way.

According to Section 1 and section 80 (1) of the German Sozialgesetzbuch IV (SGB IV), the assets of the agency have to be invested and managed in a way that eliminates the probability of any losses. In a first step this means, that there is no room for equity investments. In a second step, the potential for a versatile

asset management is further diminished. The agencies have to keep a certain amount of money for reserve funds or savings. Regarding section 83 (1) SGB IV, these savings may only be invested in the following vehicles:

– government and corporate bonds of issuers, who have their registered office in the European Union;
– covered bonds with coverage within the borders of the European Union;
– real estate located in the European Union.[1]

Section 83 (4) SGB IV extends the permitted investment area to countries, which are members of the European Economic Area (EEA), a free trade zone within the borders of Europe. In addition to that, investments in Switzerland are allowed.

But all that goes to show that investments outside of Europe are impossible for German social insurance agencies. So of course, there is also no way for them to invest in China.[2] It seems that the German legislator judges an investment outside of Europe to be generally more risky and dangerous than an investment within the borders of Europe. However, this premise is quite untrue. If we compare a government bond issued by Greece to one issued by China, which one is more risky?

2. Private Insurance Companies, Reinsurance Companies and Pension Funds

In addition to the public social insurance agencies, there is of course a private insurance sector in Germany. For companies belonging to that sector like for example Allianz, Munich Re or private pensions funds there is a law called Versicherungsaufsichtsgesetz (VAG). The VAG, supplemented by a legal ordinance (Verordnung über die Anlage des gebundenen Vermögens von Versicherungsunternehmen, AnlV), imposes the legal framework for investments of these private insurance companies and pension funds. Those parts of their assets, which they hold as a kind of trustee for their clients, are specially protected by law. According to section 54 (1) VAG these assets shall be managed in a way, that guarantees a maximum of safety and profitability, combined with liquidity at any time and a reasonable diversification. The permitted assets are classified in section 2 AnlV and refer almost exclusively to countries which are members of

[1] For details concerning the permitted securities see G.-F. Borrmann, in: K. Hauck and W. Noftz (eds.), *SGB IV* (2015), sec. 83, recital 8 et seq.

[2] A chance for future investments in Chinese securities might arise when a Chinese-German joint-venture will begin to distribute renminbi-based products via the systems of the German Stock Exchange in Frankfurt (cf. Frankfurter Allgemeine Zeitung, 23rd May 2015, www.faz.net/aktuell/finanzen/handel-mit-renminbi-produkten-deutsche-boerse-wird-chinesischer-13608669.html). Then section 80 (1) Nr. 1 sentence 2 SGB IV would probably allow German social insurance agencies to purchase those products.

the EEA or the Organisation for Economic Co-operation and Development (OECD). So again, there is not much room for a China-based investment.

In addition to that, section 3 (1) AnlV rules, that assets issued by issuers outside the EEA should be limited to a cautious measure, if there is no privilege for the creditors of private insurance companies in case of bankruptcy in the given country. The context is, that there is such a privilege in German law in section 77a VAG. So if a country outside the EEA does not offer a similar protection for the clients of private insurance companies, the German legislator does not want Germany based insurance companies to invest their money in those countries. But in fact there are not many countries outside the EEA that provide comparable bankruptcy protection. And even if there is an analogous foreign law, it is hard to decide, if it offers the same kind of protection as its German counterpart. Because they cannot judge foreign bankruptcy laws, most of the German private insurance companies and pension funds limit their investments outside the EEA. As mentioned earlier, section 3 (1) AnlV sets this limit to a "cautious measure". However, no-one exactly knows what the term "cautious measure" means.

Still to come is a fundamental reform of the insurance surveillance in the European Union, which is called Solvency II. It is intended to regulate the capital coverage requirements of insurance companies. According to this, private insurance companies need a certain amount of capital coverage when they invest in equity shares which are listed in EEA- or OECD-countries. The requirements for investments outside of the EEA or OECD are even higher. Again legislative authorities seem to evaluate foreign investments as more risky than domestic ones.

Altogether there are a lot of regulatory reasons, why private insurance companies and pension funds usually keep their assets mainly inside the borders of the EEA or OECD. According to the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the supervising authority for the German financial service sector, German insurance and reinsurance companies only invest about 7,1 % of their assets in Non-Euro-Countries.[3] Within the German and European regulatory environment, there is not much space for investments in China.

3. Non-Profit Organisations (NPOs), Non-Profit-Foundations

Germany has a long tradition of non-profit organisations, especially foundations. These entities support certain purposes that serve the public good. A non-profit-status in that context guarantees tax exemptions. Obviously these organisations manage large amounts of money.

[3] Cf. BaFin, Einzelangaben zu den Kapitalanlagen der Erstversicherungsunternehmen, Bestand in den einzelnen Versicherungssparten, 3. Quartal 2015, www.bafin.de/SharedDocs/Downloads/DE/Statistik/Kapitalanlagen/dl_kapitalanlagen_3q_2015_va.pdf?__blob=publicationFile&v=3.

There is no law which explicitly regulates the asset management of NPOs in Germany. But there is a legal practice, which limits investments. According to that, non-profit status requires investment in assets without particular inherent risks, because non-profit organisations are obliged to permanently conserve their assets.[4] As shown before, German and European authorities tend to emphasize the risk of foreign investment compared to domestic ones. Having that in mind, most of the NPOs avoid foreign investments or limit it to a small degree. There are no comprehensive figures about the asset allocation of German NPOs, but there are mutual funds especially designed for German non-profit foundations:[5]

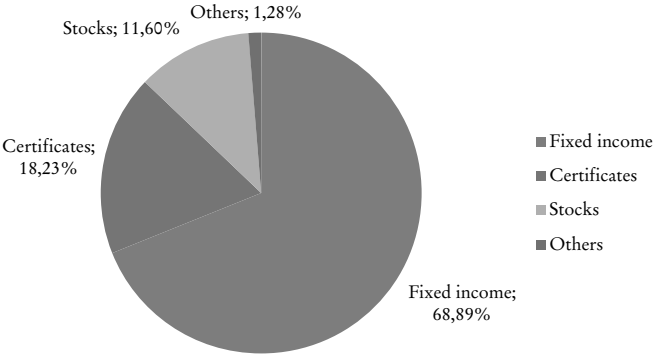

Figure 1: Merck Finck Stiftungsfonds UI, ISIN: DE0008483983 WKN: 848398

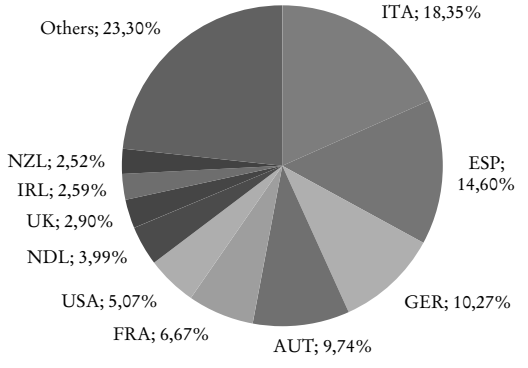

Figure 2: Merck Finck Stiftungsfonds UI, ISIN: DE0008483983 WKN: 848398

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[4] Cf. FG Münster, 11 December 2014 – 3 K 323/12 Erb.

[5] Multi Manager GmbH, with links to pdf-sheets: http://mmd-direct.de/ISIN_DE0008483983_Merck-Finck-Stiftungsfonds-UI/; http://mmd-direct.de/ISIN_DE000A1H44D5_National-Bank-Stiftungsfonds-1/; http://mmd-direct.de/ISIN_DE000A0RE972_BERENBERG-1590-STIFTUNG/.

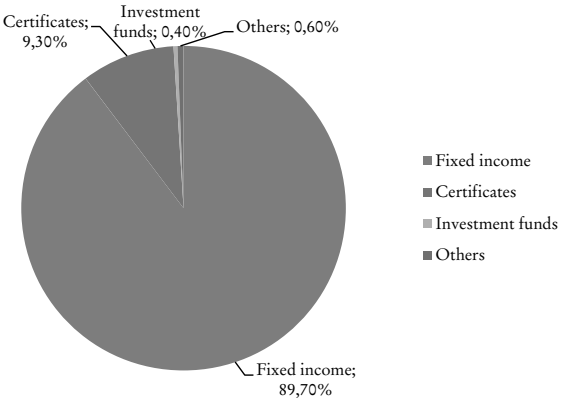

Figure 3: National Bank Stiftungsfonds 1, ISIN: DE000A1H44D5 WKN: A1H44D

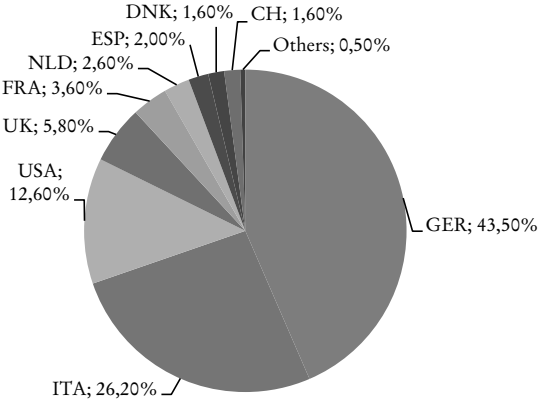

Figure 4: National Bank Stiftungsfonds 1, ISIN: DE000A1H44D5 WKN: A1H44D

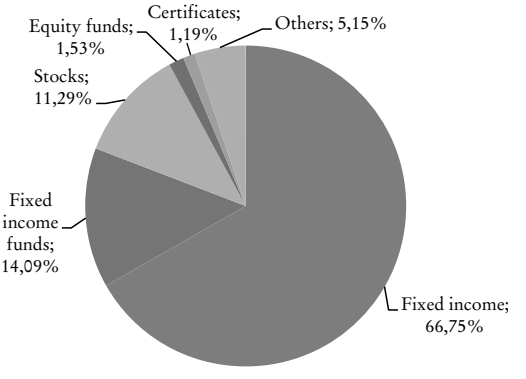

Figure 5: Berenberg 1590 Stiftung, ISIN: DE000A0RE972 WKN: A0RE97

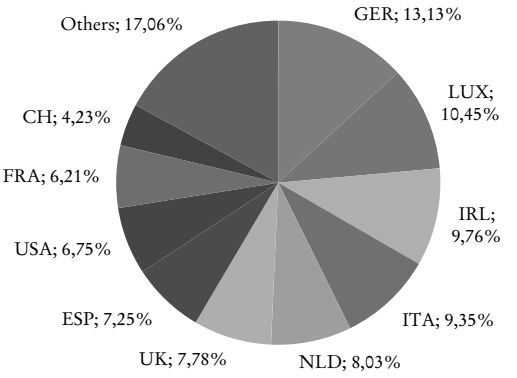

Figure 6: Berenberg 1590 Stiftung, ISIN: DE000A0RE972 WKN: A0RE97

As you can see, typically these mutual funds have only small exposures outside the EEA. It is unlikely that there will be substantial investment in China from German NPOs.

4. Non-regulated Federations, Unions, Family Offices, Religious Groups

There is further a group of typical institutional investors, which is not regulated by law and relating to which there is no limiting case law. Examples for such non-regulated entities are federations, unions, family offices or religious groups such as the Roman Catholic Church or Protestant Church.

These institutional investors are only regulated by internal investment guidelines given by their boards. These guidelines often contain a defined equity rate and rating requirements for the fixed income exposure. Limitations of investments abroad are however not that common. In general, this last group of German institutional investors is basically open for investments in China.

5. Summary

The investment options of many German institutional investors are regulated by law. German and European legislators tend to limit these investment options in matters of investments outside the EEA or OECD. Somehow they seem to believe that investment abroad is generally more risky and dangerous than domestic investment. Perhaps there is also a protectionist thought behind the respective laws. Especially in times of low interest rates it is tempting to force institutional investors to allocate their money mainly within the own borders. However, investments abroad should not be limited merely because they supposedly entail a greater risk. It is obvious, that investments outside of the EEA

or OECD are not more risky in principle. Every investment anywhere in the world has opportunities and risks which have to be evaluated in every particular case. Unfortunately for many institutional investors in Germany the door is not wide open for an investment in the Chinese financial markets.

III. Access to Chinese Financial Markets For Foreign Investors

There are a lot of different asset types for institutional investors. But it is beyond dispute that equity shares and fixed income bonds are the most important ones. In the typical asset allocation of institutional investors these vehicles take most of the space. Because of that the focus will be put on equity shares and bonds when examining the frame conditions of the Chinese financial markets.

1. Equity Shares Traded on Stock Exchanges

a) Direct Investment and Different Types of Shares

For a German investor, a share is simply a share. There are not many types to distinguish. Of course there are ordinary shares and preference shares in Germany, which differ by voting rights. But in practice this does not play a major role. The Chinese equity market is much more confusing. There are a lot of share types to distinguish:

- A-shares: Chinese companies incorporated on the mainland and traded in Shanghai or Shenzhen, quoted in RMB.
- B-shares: Chinese companies incorporated on the mainland and traded in Shanghai and quoted in USD or traded in Shenzhen and quoted in HKD (open to foreign ownership).
- H-shares: Chinese companies incorporated on the mainland and traded in Hong Kong
- Red chips: State-owned Chinese companies incorporated outside the mainland (mostly in Hong Kong) and traded in Hong Kong.
- P-chips: Nonstate-owned Chinese companies incorporated outside the mainland, most often in certain foreign jurisdictions (Cayman Islands, Bermuda, etc.) and traded in Hong Kong.
- N-shares: Chinese companies incorporated outside the mainland, most often in certain foreign jurisdictions, and U.S.-listed on the NYSE or Nasdaq (ADRs of H-shares and red chips are also sometimes referred to as N-shares).[6]

[6] ETF.com, *Complete guide to Chinese Share Classes & China ETF Investing* (February 2013), p. 2 et seq.

The most important thing about the different share-classes is, that a "normal" foreign investor cannot buy the first one. While originally only Chinese citizens were allowed to buy these stocks, since 2002 also so called "Qualified Institutional Investors" (QFIIs) are permitted to buy A-shares. There are not too many licenses for foreigners, at the moment there are exactly 290.[7] In fact, concerning A-shares, the Chinese market is still closed for direct foreign investment. But all the other share-classes are basically open for foreign investors.

b) Availability of Indices

The availability of indices is very important for institutional investors. For example indices show the development of the complete stock market or certain industry sectors. The more indices are available, the better the overview over the market. Fortunately there is a wide variety of indices for the Chinese stock market. Here are some examples, which do not show the entire index world:

– Dow Jones China Offshore 50
– Hang Seng China Enterprises
– MSCI China
– MSCI China H
– CSI 300
– MSCI China A
– FTSE China 50
– FTSE China A 50
– FTSE China A 200
– FTSE China A 600
– FTSE China A
– FTSE Greater China 150
– FTSE China International All Cap
– FTSE China H Share
– FTSE China B All-Share
– FTSE China Red Chip All Cap Capped
– FTSE China P Chip All Cap Capped
– FTSE China S Chip All Cap
– FTSE China N Share All Cap Capped

c) Availability of Exchange Traded Funds (ETF)

Exchange Traded Funds are passively managed mutual funds. The fund manager simply replicates the index without generating any over- or underweight in any position. These funds have recently become very popular, because they usually are not very expensive and they offer an easy access to different market

[7] China XBR, http://china-xbr.com/xbr-quota-data/qfii/, effective as of 29th June 2015.

segments. As shown before, there are many indices covering the Chinese stock market and fortunately, there are also a lot of ETFs:[8]

Table 1: ETFs

Fund Name	Fund Ticker	Underlying Index	Eligible Share Classes
iShares FTSE China 25	FXI	FTSE China 25	H, Red Chips
SPDR S&P China	GXC	S&P China BMI	All Investable Shares
iShares MSCI China	MCHI	MSCI China	H, B, Red Chips, P-Chips
PowerShares Golden Dragon China	PGJ	Nasdaq Golden Dragon China	N
iShares FTSE China (Hong Kong Listed)	FCHI	FTSE (HK Listed) China	H, Red Chips
Guggenheim China All-Cap	YAO	AlphaShares China All-Cap	All Investable Shares
First Trust China AlphaDEX	FCA	Defined China	All Investable Shares
Market Vectors China	PEK	CSI 300	A (Swap)
RBS China Trendpilot ETN	TCHI	RBS China Trendpilot	N
Guggenheim China Small Cap	HAO	AlphaShares China Small Cap	All Investable Shares
iShares MSCI China Small Cap	ECNS	MSCI China Small Cap	H, B, Red Chips, P-Chips
Wisdom Tree China Dividend ex Financials	CHXF	WisdomTree China Dividend ex Financials	H, Red Chips, P-Chips
Global X China Materials	CHIM	Solactive China Materials	All Investable Shares
Global X China Consumer	CHIO	Solactive China Consumer	All Investable Shares
Global X China Energy	CHIE	Solactive China Energy	All Investable Shares
Global X China Financials	CHIX	Solactive China Financials	All Investable Shares
Global X China Industrials	CHII	Solactive China Industrials	All Investable Shares

[8] ETF.com, *Complete guide to Chinese Share Classes & China ETF Investing* (February 2013), p. 7; the list is not complete, these are just examples.

EGShares China Infrastructure	CHXX	INDXX China Infrastructure	All Investable Shares
Guggenheim China Real Estate	TAO	AlphaShares China Real Estate	All Investable Shares
Global X Nasdaq China Technology	QQQX	Nasday OMX China Technology	All Investable Shares
Guggenheim China Technology	CQQQ	AlphaShares China Technology	All Investable Shares

This variety of ETFs makes it easy to begin investments in China, even for institutional investors. Really striking is the availability of an ETF covering the A-shares-market. This synthetic ETF is swap-based and does not replicate the market stock by stock. But nevertheless it offers a good opportunity to invest in the Chinese A-shares-market without taking the detour of becoming or mandate a QFII.

d) Availability of Actively Managed Mutual Funds

For those institutional investors who want to invest in actively managed mutual funds it is important, that there is a great variety of them available. And just as in the case of the ETFs, there is a sufficient universe of actively managed funds:[9]

– Matthews China Investor (MCHFX)
– Fidelity China Region fund (FHKCX)
– Oberweis China Opportunities fund (OBCHX)
– Heptagon Fund Harvest China A Shares Equity Fund (HEPCHNC)
– RS China Fund Class A fund (RSCHX)
– AllianzGI China Equity A Fund (ALQAX)
– EuroPac China Fund (EPHCX)

e) Availability of Derivatives

Institutional investors need a liquid derivative market to have adequate possibilities to establish an overlay management. Normally it is much too expensive to sell all your stocks if you want to tactically leave the market for a shorter period of time. These operations are usually done by the use of future contracts or options. And there is a future contract for the Chinese A-shares-market called CFFEX CSI 300 Future. Meanwhile future contracts for the SSE 50 and the CSI 500 also are available.[10] But newly developed indices usually are not very liquid in the beginning. Furthermore – like the A-shares themselves – the future contracts relat-

[9] The list is not complete, these are just examples.
[10] http://www.cffex.com.cn/en_new/xwzx/myscbg/201505/P020150529401291676885.pdf.

ed to A-shares can also only be purchased by QFIIs.[11] And there is no option market at all for the A-shares, but the China Financial Futures Exchange (CFFEX) has announced to launch index options for CSI 300, the CSI 500 and the SSE50 soon.[12] But there is not only an ETF on the CSI 300 Index, there is also a small option market, that refers to this ETF (for example ASHR US 01/20/17 P26.9 Equity). So overall the derivative market for Chinese equity shares is sufficient.

2. Fixed Income Securities / Bonds

a) Direct Investment and Different Types of Bonds

The Chinese bond market consists mainly of the following securities:

- Government bonds. These are issued by the Ministry of Finance. Local governments also issue bonds, similar to municipal bonds in the US.
- Central Bank notes. These are short-term securities issued by the People's Republic of China as a tool for implementing monetary policy. Central Bank notes are often used in money markets and liquidity management portfolios due to the notes' short maturities.
- Financial bonds. These are the most actively traded bonds in China and are issued by policy banks, commercial banks and other financial institutions. The policy banks are the largest issuers and include the China Development Bank, the Export-Import Bank of China and the Agriculture Development Bank of China. Only Policy Bank Bonds are backed by the central government.
- Non-Financial Corporate Bonds. These include a wide variety of bonds but the largest sectors are known as "enterprise" bonds and "medium-term notes". Enterprise bonds are issued by institutions affiliated to Central Government departments, enterprises solely funded by the State, state-controlled enterprises and other large state-owned entities. Examples of issuers in this market include companies like China National Petroleum, the state-owned fuel production company, China Petrochemical, Asia's largest refining and petrochemical enterprise, and China Telecom, a state-owned telecommunications company. Private companies of any size can also issue corporate bonds. Companies can also issue short-term financial bills and medium-term notes, which are the most liquid non-financial corporate bonds.[13]

The Chinese bond-types described do not differ significantly from the typical bond-types in other countries. But just as with the A-shares equity market, there is a limitation on foreign investors buying these bonds. The Chinese bond

[11] http://www.gtjaqh.com/Channel/63490.

[12] Lu Jianxin and Pete Sweeney, Reuters Markets (24th May 2015), http://www.reuters.com/article/us-china-options-idUSKBN0OA03620150525.

[13] Subash Pillai, Lily Li and Harry Huang, *FAQ: China's bond market*, Goldman Sachs Global Liquidity Management, First Half 2015.

universe is divided into the offshore and the onshore market. Limitations exist for the onshore market:[14]

Table 2: Chinese Bond Market

	Offshore	**Onshore**	
	Hong Kong	Interbank	Stock Exchange
Size (RMB bn)	274	20,483	364
Eligible Investors	All	Central Banks, RMB Clearing & Settlement banks, onshore investors, RQFII	QFII's, onshore investors

b) Availability of Indices

As mentioned before, the availability of indices is important for several reasons. Fortunately, there are a lot of indices covering the fixed income sector:

– FTSE China Onshore Sovereign and Policy Bank Bond 1 – 10 Year Index
– FTSE China Onshore Sovereign Bond 1 – 10 Year Index
– FTSE China Onshore Policy Bank Bond 1 – 10 Year Index
– S&P China Bond Index
– S&P China Agency Bond Index
– S&P China Corporate Bond Index
– S&P China Government Bill Index
– S&P China Industrials Bond Index
– Citi Chinese Government Bond Index (CGBI)
– CSI Aggregate Bond Index
– CSI Aggregate Bond (1–3) Index
– CSI Aggregate Bond (3–7) Index
– CSI Aggregate Bond (7–10) Index
– CSI Aggregate Bond (10+) Index[15]

Comparable to the Chinese stock market, there is a wide variety of indices.

c) Availability of ETFs

There is also good market access concerning the availability of fixed-income-related ETFs:

– Market Vectors Renminbi Bond ETF (CHLC)
– E Fund ETFs Trust – E Fund Citi Chinese Government Bond 5–10 Years Index ETF

[14] Overview by HSBC, A guide to investing in Chinese Fixed Income, London (2012).
[15] The list is not complete, these are just examples.

– Global X GF China Bond ETF
– CBON Market Vectors ChinaAMC China Bond
– China New Balance Opportunity Fund
– RMB High Yield Bond Fund
– Chinese Yuan Dim Sum Bond Portfolio
– E Fund China Commercial Paper ETF
– GF China Bond ETF.[16]

d) Availability of Actively Managed Mutual Funds

There is a sufficient number of actively managed mutual funds for the Chinese market.

– Fidelity Fund – China RMB Bond Fund
– Guiness Atkinson Renminbi Yuan & Bond Fund
– BlackRock BGF Renminbi Bond Fund
– Ping An of China SIF – RMB Bond Fund
– NIKKO AM CHINA ONSHORE BOND FUND RMB
– BARING CHINA BOND FUND
– JPMorgan Funds – China Bond Fund[17]

e) Availability of Derivatives

An adequate market for derivatives on Chinese bonds does not exist. There is a 5-year treasury bond futures contract,[18] but it is only open to QFIIs.[19] Additionally it is planned to allow the trading of a 10-year treasury bond futures contract to finally establish a market-based yield-curve.[20] However, as long as solely QFIIs are allowed to trade future contracts, the market access for foreign institutional investors is very limited. This spoils particularly the possibilities for a professional duration management.

3. Summary

The openings for foreigners to access the Chinese financial markets are growing. There are many equity shares, bonds and related vehicles. On the other hand, regulatory limitations still hinder a completely professional portfolio management. Only with access to the direct purchase of all securities and with

[16] The list is not complete, these are just examples.
[17] The list is not complete, these are just examples.
[18] For specifications see http://www.cffex.com.cn/en_new/sspz/5tf/.
[19] http://www.ft.com/intl/cms/s/0/94600a40-16cf-11e3-9ec2-00144feabdc0.html#axzz3wgya99oK.
[20] http://www.bloomberg.com/news/articles/2015-03-19/china-starts-10-year-bond-futures-trading-as-rate-controls-ease.

an open and liquid derivative market, foreign investors will accept the Chinese financial market as just another financial market.

IV. The Importance of China's National Economy

It is obvious that China's national economy is of extraordinary importance for the whole world. Here are some figures and facts that show the growing importance of China:

1. Population

With approximately 1.364.270.000 people The People's Republic of China has the largest population in the world.[21]

2. Gross Domestic Product (GDP)

In 2012 China's GDP was 8,46 trillion USD.[22] After the USA it is the second largest GDP in the world.[23] The average GDP-growth-rate was more than 8 % in the last ten years:

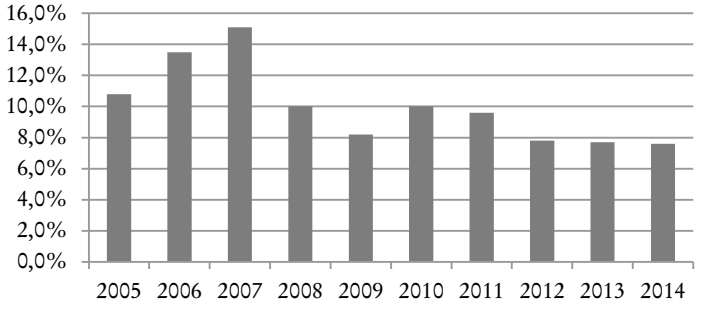

Figure 7: Real GDP growth (%YoY) (Source: National Bureau of Statistics. PNC Financial)

[21] The World Bank, http://databank.worldbank.org/data/reports.aspx?source=2&country=CHN&series=&period=.

[22] The World Bank, http://databank.worldbank.org/data/reports.aspx?Code=NY.GDP.MKTP.CD&id=af3ce82b&report_name=Popular_indicators&populartype=series&ispopular=y.

[23] The World Bank, http://databank.worldbank.org/data/reports.aspx?Code=NY.GDP.MKTP.CD&id=af3ce82b&report_name=Popular_indicators&populartype=series&ispopular=y.

And roughly in 2022 China will overtake the USA and be the largest economy on the planet:[24]

Table 3: China vs. USA

	GDP (US $tn)		Per-capita GDP (US $10,000)		High-income threshold
	China	USA	China	USA	(US $10,000)
2010	5.9	14.5	0.44	4.5	1.23
2020	21.0	23.4	1.50	6.7	1.60
2030	50–65	37.8	3.5–4.5	9.9	2.00
2050	150–250	95.3	11.5–18.3	21.9	3.30

3. Trade Partner of Steadily Growing Importance

The Chinese imports and exports are increasing steadily and rapidly:[25]

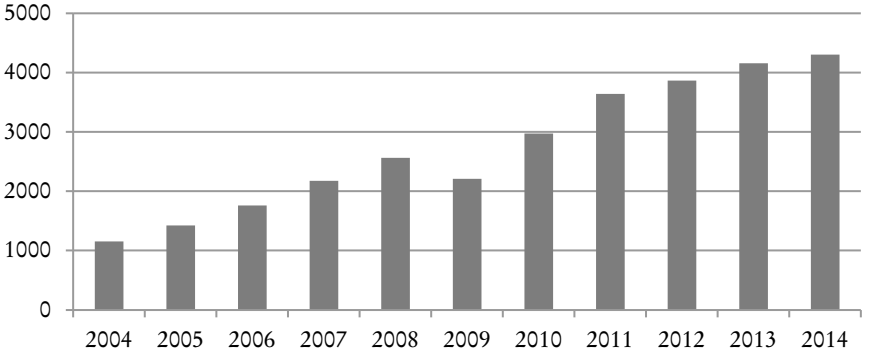

Figure 8: Imports and Exports of goods in US $ billion

[24] Project Team, Development Research Centre of the State Council. GDP and per-capita GDP figures are in current price terms.

[25] http://www.statista.com/statistics/263661/export-of-goods-from-china/; www.statista.com/statistics/263646/import-of-goods-to-china/.

4. Manageable Public Debt

The People's Republic of China has a debt to GDP-ratio of 22,8 % (2013).[26] In comparison to other countries this is quite a manageable figure:

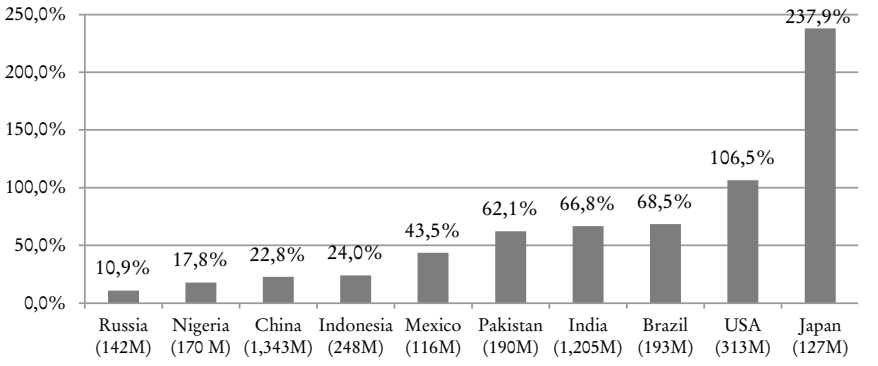

Figure 9: Debt-to-GDP of Most Populous Countries (Source: International Monetary Fund)

5. Growing Infrastructure, Spectacular Development in Mobile Communication and Education

China's infrastructure is growing with tremendous speed. In the last decade China became the country with the largest demand of commodities in the world.[27] Even though China has begun a transforming process into a consumer society, the investments in infrastructure are still enormous.

The same is true for one of the most important future-markets: the mobile communication sector. On the one hand, the number of Chinese citizens using a mobile phone is steadily rising. In 2014, 74 % of the Chinese population used a mobile phone and by 2019 it will be 78,7 %.[28] On the other hand, Chinese home-grown brands have taken advantage of the growing popularity of low-cost smartphones in the domestic market and are on track to become known players also in international markets.[29]

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[26] International Monetary Fund (IMF), http://images.google.de/imgres?imgurl=http%3A%2F%2Fmercatus.org%2Fsites%2Fdefault%2Ffiles%2FCHART-large.jpg&imgrefurl=http%3A%2F%2Fmercatus.org%2Fpublication%2Fhow-does-us-debt-position-compare-other-countries&h=654&w=1000&tbnid=gDUOmeN3b5EDSM%3A&docid=RKCFFqTXkq_2zM&ei=1yeUVuSXBsqvsAGEtZCYAw&tbm=isch&iact=rc&uact=3&dur=412&page=1&start=0&ndsp=15&ved=0ahUKEwik36fn4qLKAhXKFywKHYQaBDMQrQMIPDAK.

[27] Steven S. Roach, *Das neue Asien* (2011), p. 235 et seq.

[28] Statista, The Statistics Portal, www.statista.com/statistics/233295/forecast-of-mobile-phone-user-penetration-in-china/.

[29] Shin-Horng Chen and Pei-Chang Wen, *The evolution of China'a mobile phone industry*

When it comes to international competitiveness, one of the decisive fields is education. Since 1999, China has established various measures to improve its education system. The number of undergraduate and graduate students in China has been growing at approximately 30 % per year since that time.[30] While most of the lower income countries tend to first strengthen basic education to reduce analphabetism and provide other minimum know-how to their population, China's way seems to be different. China used major tertiary (rather than primary or secondary) transformation in educational delivery as a development strategy.[31] Especially in engineering education China has made significant achievements in the last years.[32]

Although it has often been accused of copyright infringement, the country started to develop more and more homemade high-tech. There is now a major focus on patenting, both in China itself and international patenting. There is clear evidence for this increasing tendency of China's patent activity from multiple databases. These include the European (EPO) and US Patent offices (USPTO) database, China's own database and the World Intellectual Property Organization (WIPO) database.[33]

6. Urbanisation and Development of a Consumer Society

China is developing towards a consumer society.[34] First of all, a lot of people are moving from rural areas to the cities. The agricultural sector is shrinking, the service sector is continually growing. In 2030, approximately 60 % of the working people will be employed in the service sector:[35]

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and good-enough innovation, in: You Zhuo, William Lazonick and Yifei Sun (eds.), *China as innovation nation* (2016), p. 261 et seq.

[30] Yao Li, John Whalley, Shunming Zhang and Xiliang Zhao, *The higher educational transformation of China and its global implications*, National Bureau of Economic Research (NBER) (2008), Working Paper 13849, //www.nber.org/papers/w13849.pdf.

[31] Yao Li, John Whalley, Shunming Zhang and Xiliang Zhao, *The higher educational transformation of China and its global implications*, National Bureau of Economic Research (NBER) (2008), Working Paper 13849, //www.nber.org/papers/w13849.pdf.

[32] Zhu Gaofeng, *The Status and Prospects of Engineering Education in China* (2013), http://www.mernokakademia.hu/2013conf/abstrakt/6The%20Status%20and%20Prospects%20of%20Engineering%20Education%20in%20China.pdf; Hong Yan, *Engineering Education in China*, in: Proceedings of 2015 International Conference on Interactive Collaborative Learning (ICL), www.weef2015.eu/Proceedings_WEEF2015/proceedings/papers/Contribution1374.pdf.

[33] Yao Li, John Whalley, Shunming Zhang and Xiliang Zhao, *The higher educational transformation of China and its global implications*, National Bureau of Economic Research (NBER) (2008), Working Paper 13849, //www.nber.org/papers/w13849.pdf.

[34] For thoughts about the challenges this development brings, see Steven S. Roach, *Das neue Asien* (2011), p. 296 et seq.

[35] Project Team, Development Research Centre of the State Council.

Table 4: Urbanisation and Development of a Consumer Society

		2010	2020	2030
Urbanisation (%)		51.3	60.0	67.0
Economic structure (%)	Industrial sector	46.7	42.0	35.0
	Service sector	43.2	52.0	60.0
	Agriculture	10.1	6.0	5.0
	Investment	48.1	43.0	34.0
	Consumption	48.2	55.0	66.0
Main industrial goods output	Steel	6.3	10.5	8.0
(100m tonnes)	Cement	18.6	20.0	15.0

Along with that goes growing wealth and advancement. In 2022 about 56 % will belong to the upper middle class:[36]

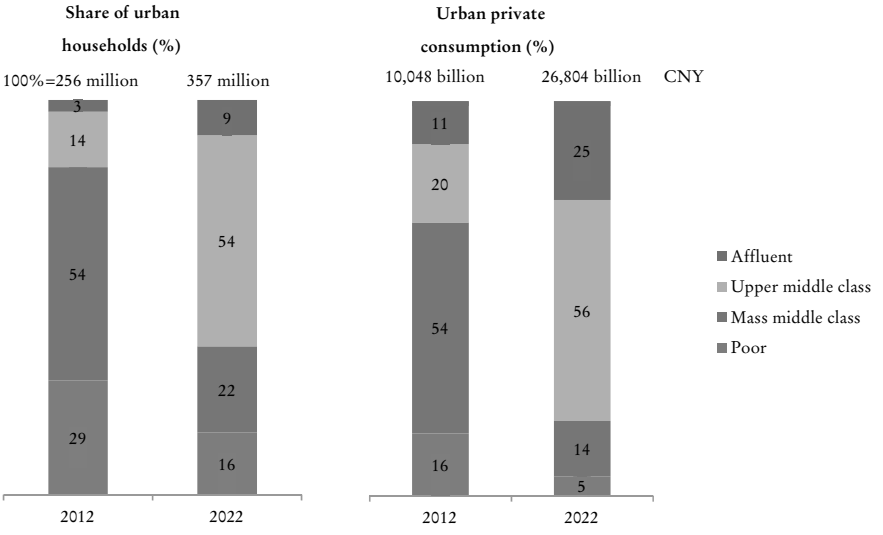

Figure 10: Urban Households and Private Consumption

[36] Dominic Barton, Yougang Chen and Amy Jin, *Mapping China's middle class*, McKinsey Quarterly 2013/03, China's next chapter, p. 54 et seq.; cf. Chen Daofu, *Financial development in the next decade*, The Chinese Dream, CLSA (2014), p. 41, 43.

7. Comprehensive Reform Agenda

Because of its political system, China faces a lot of criticism. On the other hand there are some remarkable efforts to reform the country:[37]

Table 5: Third Plenum Plan's 15 key reform areas

Sector	Key new measures
Basic economic system	– Allow employee share ownership scheme for SOEs – Creation of state-owned asset-management company – SOE to focus on public services, strategic new industries, technology, and national security – 30 % of SOE's profit to be paid to central government – SOEs to continue controlling stake in industries with natural monopoly, and continue reforms
Modern market system	– Implement "blacklist system" for new market players; create a fair, nationwide fair market – Continue pricing reforms in water, oil, gas, electricity, transport and telecom – Unified urban and rural land market; allow rural land to be sold equally – Continue financial reforms; allow privately-owned medium-small banks; make IPOs easier – Improve forex rate mechanism; boost interest-rate liberalization and setup deposit insurance – Push opening of capital markets; allow convertibility of capital flow; capital account opening
Government role	– Corporates are the mail bodies for investment; government no longer approve FAI, except for sectors that related to national security, environmental safety, strategic resources an public interest
Fiscal & Tax	– Transparent budget setting; move from "deficit" budgeting towards "expenditure" budgeting – Raise direct taxes; continue VAT reforms, and expand consumption tax – Accelerate legislation of real-estate tax, and promote resource tax – Central government to play a larger role in certain areas; reform central-local transfer payment

[37] Third Plenum Document Decision on major issues concerning comprehensive deepening reforms (Nov 2013), CLSA.

Urban-rural development	– Improve property rights for rural population; rural residents to gain from land appreciation – Continue urbanization via development of medium-small cities; continues hukou reforms – Allow private capital to participate in city infrastructure construction and operation – Research setup of policy bank specialized on city-infrastructure and residential property
Further opening up	– Relax entry barrier for foreign enterprises; allow "orderly" opening up of financial, education, culture and healthcare sectors; open-up entry barriers on elderly services, architecture, accounting and audit, logistics and e-commerce; further relax manufacturing; create several free trade zones
Political system	– Improve NPC system, CPPCC system, and develop foundation level democracy
Rule of Law	– Uphold the constitution; ensure independence of courts and prosecution
Supervision of power	– Establish means of power restriction; improve mechanism on anti-corruption
Cultural system	– Encourage state-owned cultural institutions to transform into enterprises – Consolidate traditional and new media companies; creation of a unified media/culture regulator
Social services	– Reforms on education, employment, income distribution, welfare, and healthcare sectors – Research progressive delay in retirement age; cut social insurance fees where appropriate – Relax one-child policy to allow second child when either parent does not have siblings
Social governance	– Creation of State Security Committee to ensure national security – Creation of agencies to ensure food and drug safety; reforms on the petition system
Ecological civilization	– Establish systems to define natural resources ownership; implement policies to collect tax/income on consumption of natural resources; resource pricing reforms to ensure prices can reflect market demand-supply, scarcity of resources, and damage to the environment
Defence & army reform	– Modernise army; guide civilian enterprises to provide maintenance services and R&D for the army
Party leadership	– Creation of Central Reform Leading Group

8. Summary

The development of the People's Republic of China in all relevant sectors is so outstanding, that institutional investors cannot ignore the country.

V. Challenges and Risks for China's Capital Markets

As mentioned before, China's capital markets are not entirely open to foreign investors. Of course, the path to an open market is a process of development.

1. Governmental Influence

One of the most characteristic features of the People's Republic of China in the last decades was governmental control. Therefore it seems hard for the Chinese government to surrender the capital markets entirely to the law of demand and supply. After encouraging the citizens to enter the stock market in 2015 – among other things by allowing buying stocks on credit –[38] the market received an incredible boost. The CSI 300 nearly doubled from the beginning of 2015 to the middle of June. After that, a significant crash occurred. The Chinese government began to implement certain measures to prevent the market from being too volatile. Especially a mechanism to automatically stop trading if the market moves more than 7 % in one direction was set up.[39] Perhaps one of the reasons was a fear of social riots, because many Chinese private investors lost their freshly invested money. But suspending stocks from trade is one of the most prohibitive things a government can do to stop foreign investors from entering the market. A liquid market is a basic requirement for foreign investments. The suspending mechanism was introduced in December 2015 and is still in use.[40] By suspending stocks from trade too often, foreign investors' trust in the markets cannot increase. Of course there are other well developed stock markets which are equipped with a suspending mechanism. A so-called circuit-breaker also exists for example for American stock markets like the New York Stock Exchange (NYSE).[41] But these mechanisms are usually implemented either to prevent the market from collapse in case of an accumulation of algorithmic trades triggering stop losses or to limit destabilizing index arbitrage trades. Usually they are triggered very rarely.[42]

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[38] Flossbach von Storch, Half-year report 2015, p. 11.

[39] For an overview of all measures see Roberto Bendini, *Exceptional Measures: The Shanghai stock market crash and the future of the Chinese economy* (2015), p. 5 et seq., http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/549067/EXPO_IDA%282015%29549067_EN.pdf.

[40] Roberto Bendini, *Exceptional Measures: The Shanghai stock market crash and the future of the Chinese economy* (2015), p. 5 et seq., http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/549067/EXPO_IDA%282015%29549067_EN.pdf.

[41] For details see Michael A. Goldstein, Joan E. Evans and James M. Mahoney, *Circuit Breakers, Volatility, and the U.S. Equity Markets: Evidence from NYSE Rule 80A* (2015), http://www.imes.boj.or.jp/cbrc/cbrc-16.pdf.

[42] Michael A. Goldstein, Joan E. Evans and James M. Mahoney, *Circuit Breakers, Volatility, and the U.S. Equity Markets: Evidence from NYSE Rule 80A* (2015), p. 1, http://www.imes.boj.or.jp/cbrc/cbrc-16.pdf.

From the point of view of a foreign investor it would be preferable, if big moves in the Chinese market could primarily be eased by central bank intervention or additional purchases of the Chinese sovereign wealth fund. Having a central bank buying stocks is of course also a highly controversial measure with a lot of disadvantages. But at least it allows investors to enter and leave the market at any time. Fortunately, in 2016 China began to flank their suspending mechanism with central bank interventions.[43]

2. Policy Based Bank Lending, Especially to State Owned Enterprises (SOEs)

While China bears a very moderate government debt, the borrowing of business and corporate entities is much higher. In 2013 it reached 142 % of GDP:

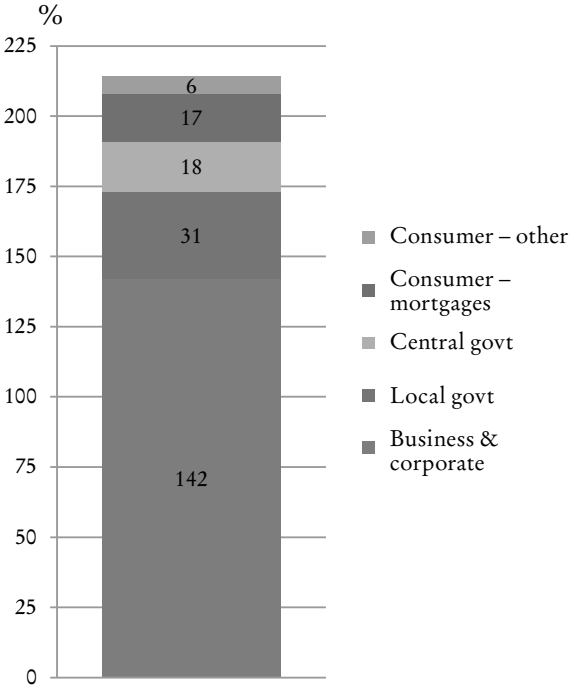
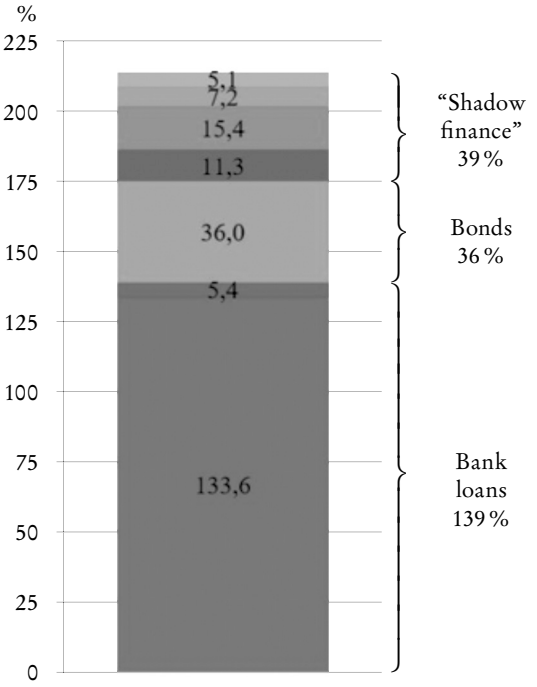


Figure 11: Total credit/GDP by borrower segment (Source: CLSA, PBOC, Chinabond, CEIC, CNAO)

[43] http://www.bloomberg.com/news/articles/2016-01-05/china-said-to-intervene-in-stock-market-after-590-billion-rout.

Distinguishing not by borrower, but by lender shows that so-called "shadow-finance" is rising. "Shadow finance" means credit provided by sources other than traditional bank loans.[44]



*) Excludes PBOC and policy bank bonds.
**) Excludes corporate bonds and non-financial equity.

Figure 12: Total credit in China, as a percentage of nominal GDP (2013) (Source: CLSA, PBOC, Chinabond, CEIC.

Because of that it is not surprising, that credit defaults and non-performing loans are becoming more and more widespread in China. It is uncontested, that lending to SOEs in China is less rigid than lending to other entities without connections to the state. The implicit government guarantee ensures a steady flow of cheap credit to prop up unprofitable and/or failing SOEs through refinancing and evergreening of loans.[45] As long as this does not change, there is no

[44] Derek Ovington and Patricia Cheng, *Too small to bail*, The Chinese Dream, CLSA (2014), p. 29 et seq.
[45] Derek Ovington and Patricia Cheng, *Too small to bail*, The Chinese Dream, CLSA (2014), p. 29 et seq.

urge for SOEs to make their business models more sustainable. Thus it is a big challenge to restructure SOEs. Restructuring is necessary, but it has to be done carefully. Suddenly withdrawing cheap credits would mean forcing a lot of vulnerable SOEs into bankruptcy which comes with massive economic and political costs like unemployment.[46] On the other hand it is most likely no solution to leave things as they are, because alimentation of SOEs has led among other things to severe industrial overcapacities.[47]

3. Relative Sector Attractivity

As mentioned just now, a lot of restructuring work has to be done at the SOEs. For institutional investors, investing means buying index-products or at least taking indices as a benchmark. But indices are usually dominated by SOEs and SOEs most often have their business segment in traditional sectors with a below average growth estimate. For the MSCI China Index this can be shown as follows:[48]

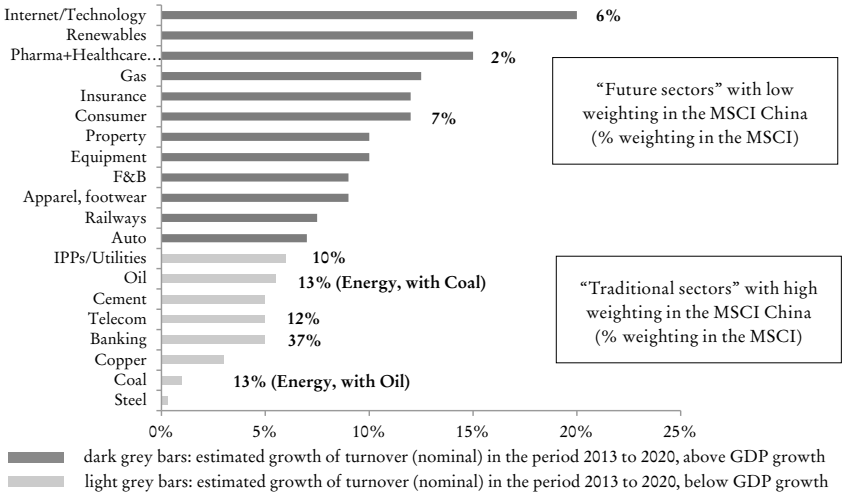


Figure 13: Relative Sector Attractivity

[46] Derek Ovington and Patricia Cheng, *Too small to bail*, The Chinese Dream, CLSA (2014), p. 29 et seq.

[47] Cf. Francis Cheung and Man Ho Lam, Great Transition, Special Report, CLSA (May 2014), p. 37 et seq.; cf. David Cogman, *Due diligence in China: Art, science and self-defence*, McKinsey Quarterly (2013/3), China's next chapter, p. 144, 150.

[48] Figures by ASPOMA Asset Management AG.

SOEs dominate the traditional sectors like energy, banking, telecommunication and construction,[49] while fast growing sectors like internet-related products and services,[50] consumer and healthcare[51] products are mostly driven by private enterprises.

VI. Summary

Unfortunately German law prevents many important institutional investors from investing abroad and therefore from investing in China. Investments outside of Germany, the European Union, the EEA or the OECD are not generally more risky than investments within the mentioned areas. It is comprehensible, that German law intends to protect certain fortunes managed by trustees because the owners of these fortunes deserve special protection. But other solutions should be found to distinguish between risky and conservative assets other than referring to the country, in which a certain security is issued. This is especially true for countries with an advanced financial system.

The Chinese financial system is an advanced one. Of course there are some limitations for foreign investors, but all in all there is satisfactory market access for them. With increasing trust in the products issued in the Chinese financial market liquidity will grow, which is essential for attracting foreign investors.

It is uncontradicted, that the economy of the People's Republic of China is of outstanding importance for institutional investors all over the world. And the economy and with it its importance is still growing.

For institutional investors, China is full of opportunities. However the development towards a completely free financial market is not yet completed. But it is normal for China to evolve step by step. It is very likely that governmental interventions will slowly diminish. In the long run, competitive and sustainable companies will survive and in many industrial sectors they will play a leading role in the world. The impacts of China's movement towards a consumer society are already noticeable. The current collapse of commodity prices all over the world is an effect of that process. Still to come is also maybe an increased free float of the Chinese currency.

So despite some obstacles, there is no alternative for institutional investors to allocate parts of their assets in China.

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[49] Cf. Michael Pettis, *Winners and losers in China's next decade*, McKinsey Quarterly (2013/3), China's next chapter, p. 37 et seq.

[50] Cf. Elinor Leung, *China to beat the West in e-commerce growth*, The Chinese Dream, CLSA (2014), p. 84 et seq.

[51] Cf. Zhang Mingfang, *The new pharmaceutical economy*, The Chinese Dream, CLSA (2014), p. 59 et seq.

The China (Shanghai) Pilot Free Trade Zone – An Experimental Field to Understand the Impact of the Trans-Pacific Partnership Agreement in China

*Gong Baihua (*龚柏华*)*[*]

I. Introduction

The China (Shanghai) Pilot Free Trade Zone (Shanghai Pilot FTZ) is a strategic administrative reform trial project which aims to determine the influence of the Trans- Pacific Partnership (TPP) on China. The TPP contains various rules including new rules for *Competitive Neutrality for State-Owned Enterprises*. Moving forward, the trial will, therefore, seek to develop a legal and business environment which will apply competitive neutrality principles to different types of enterprises with various ownership structures, including Chinese state-owned enterprises (SOEs) and ensure the equal treatment of such enterprises vis-à-vis other enterprises. This note comments on the TPP implementation in China and the operation of the Shanghai Pilot FTZ.

There are various ways in which China could manage the impacts of the Trans Pacific Partnership. First, China could deepen its administrative reform and enlarge its openness to trade to the rest of the world. Second, China could simultaneously narrow the gaps between the Chinese Rules and the TPP Rules. This would allow China to better adjust to the new rules of international trade and investment, regardless of whether China accedes to the TPP Agreement or not.

The TPP Agreement was concluded on 4 October 2015. The Agreement was adopted after protracted negotiations between the U.S. and eleven other states.

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The core objective of the Agreement is to promote a clear set of regional international trade and investment rules (TPP Rules) which will be applied globally (outside the current TPP area). It is envisioned that the TPP Rules will eventually replace the WTO multilateral trade system which is facing various difficulties.

The most important question is what kind of influence will the TPP Agreement have on China and the rest of the world? In my view, it is important to consider such influence carefully and there are a number of views which have been expressed by Chinese academics in this regard. I am of the opinion that while we cannot afford to be complacent about the TPP Agreement, we should not exaggerate its negative impact.

The Chinese government has observed the development of the TPP closely for some time and has undertaken various studies examining the impact of the TPP on China. There is no doubt that the TPP will have a significant impact which will not simply be limited to matters of trade and investment. The content of the TPP not only covers trade in goods, textiles and clothing, rules of origin, customs administration and trade facilitation, but also extends to other specific areas including sanitary and phytosanitary (SPS) measures, technical barriers to trade (TBT), trade remedies, investment, cross-border trade in services and financial services. In addition, the TPP deals with a range of other matters including temporary entry for business persons, telecommunications, electronic commerce, government procurement, competition policy, SOEs and designated monopolies, intellectual property, labour, environment, as well as cooperation and capacity building. Other topics dealt with by the TPP include competitiveness and business facilitation, development, small-and medium-sized enterprises, regulatory coherence, transparency and anti-corruption measures, as well as dispute settlement.

From the broad contents which are covered by the TPP, it is evident that a wide range of domestic measures will fall under its ambit. Traditionally, such measures have been regarded as falling within the exclusive scope and authority of a state. Thus, a state which accedes to the TPP Agreement will have to amend its domestic rules to ensure consistency with the TPP Rules. Because of its wide scope, the Chinese government is hesitant to fully adopt the TPP. Although the requirements of the TPP Rules generally fit into China's broader market economy reformation plan, there are serious questions regarding the feasibility of such significant legislative reform.

China has previously set up Free Trade Zones (FTZ). The rationale for setting up these Free Trade Zones is to conduct a trial in order to establish which pressures China may face if it becomes a TPP signatory. The Shanghai Pilot Free Trade Zone, for example, has experimentally enforced many reform measures similar to the TPP Rules during the two years following its establishment. The trials are described below.

II. The "Pre-etablishment National Treatment Plus Negative List" as a New Model

During the TPP Agreement negotiations, two models were considered. Thus, a "positive list" or "negative list" model was created to determine the degree of market access and openness. Comparatively speaking, a country will undertake more obligations if it adopts the "negative list" model. Here, it is relevant to point out that the "national treatment pre-establishment plus negative list" model is currently the development trend for international investment rules. The TPP has also followed this trend by adopting the "pre-establishment national treatment plus negative list" model rather than the "positive" list model.

The Shanghai Pilot FTZ trial is now regarded as a precursor to further market access and openness which, in turn, requires the government to adopt various reform measures. A starting point for such reforms undertaken as a result of the Shanghai Pilot FTZ trial is the so-called "negative list" which deals with the special administrative measures for the admission of foreign investment.

The Shanghai Pilot FTZ introduced the "negative list" in 2013 and greatly improved on this list in 2014. Since 2015, the "negative list" has been utilised and shared by both foreign and Chinese investors. This not only creates an international, market-oriented, and rule of law business environment for foreign and Chinese investors but also affords governments, at various levels, an opportunity to limit the power of bureaucrats and rein in government spending.

Because the "negative list" adopted by the Shanghai Pilot FTZ is a domestic regulatory document, it cannot be regarded as a binding bilateral agreement between two sovereign states. The contents of the "negative list" can only be adjusted (increased or decreased) by the local government. However, considering the background and purpose of the "negative list", the local government would not alter it arbitrarily. In fact, the Shanghai Pilot FTZ should imitate the mode and idea of the "negative list" in TPP and implement it in Shanghai. It is only in this manner that China will be able to accumulate useful experiences on how to best resist the negative impacts of the TPP. Furthermore, such experiences may also be worth copying and extending to other aspects of China's strategy. The experiences can thus inform various components of China's future implementation strategy.

III. Promoting Further Openness in Trade in Service

One of the key objectives of the TPP is the creation of a high level of market access and openness with regard to trade in services. In addition, part of the purpose of the establishment of Shanghai Pilot FTZ is to conduct a pressure test to examine the openness to trade of the service sector in China. The Shanghai

Pilot FTZ has experimentally opened six service sectors to trade. These sectors include: financial services, shipping services, business and trade services, professional services, cultural services and social services. The opening of the market in these six sectors means that investor qualification criteria, equity ratio limits, scope of business restrictions and other market access limitations are suspended or canceled. These qualification criteria are, however, not applicable to banking institutions and information and communication services sectors.

On 28 June 2015, the State Council approved the Measures on Further Opening of the Shanghai Pilot FTZ (hereinafter referred to as "Measure"). Interestingly, thirty-one articles of the Measure deal specifically with the service sector.

The Shanghai Pilot FTZ was confronted with various institutional limitations in the service sector during its trial phase. The experiences gained during the trial phase, thus, serve as an important step in identifying potential implementation problems. Identifying such problems is crucial for driving reform forward. In fact, it is only through such experiences that the Shanghai Pilot FTZ can assist the Chinese government in dealing with any negative impacts in the event that the service sector is opened up to the high degree as stipulated by the TPP and this causes difficulties.

IV. Performing the Rules for the Free Transfer of Foreign Currency

IV. Performing the Rules for the Free Transfer of Foreign Currency

The TPP Rules have set out requirements for the free transfer of income derived by foreign investment. According to the TPP Rules, all investment income gained by foreign enterprises should be capable of being easily changed into a freely convertible currency, at the market rate of exchange prevailing at the time of transfer, and be able to be transferred to a foreign country without undue delay. The member state may restrict the transfer, if and when necessary, for the protection of public interest.

The free transfer of the foreign investment income is closely related to the administration of foreign exchange as well as the free conversion of capital accounts. The Shanghai Pilot FTZ has carried out a series of reforms with regard to the administration of foreign exchange transactions. This reform process has led to the Shanghai Branch of the State Administration of Foreign Exchange to issue a Notice on *Detailed Rules for the Implementation of Foreign Exchange Administration to Support the Construction of China (Shanghai) Pilot Free Trade Zone. The latter Notice was* published on 28 February 2014 and provides that foreign investment capital is to be changed from a "payment settlement system" to a "willingness to exchange settlement system."

In addition to above trials, the Shanghai Pilot FTZ promotes reform trials in the financial sector. In order to gain enough experiences with dealing with the

TPP, the Shanghai Pilot FTZ should continue to carry out continued reforms regarding the expansion of RMB cross-border business. This should extend to RMB capital account convertibility, the marketisation of financial market interest rate, as well as the administration of foreign exchange.

V. New Modes of Settling Investment Disputes

The TPP Rules provide a comprehensive mechanism of investment dispute settlement. Thus, the Rules state that in the case of an investment dispute, the claimant and the respondent should initially seek to resolve the dispute through consultation and negotiation, which may include the use of non-binding, third party procedures, such as good offices, conciliation or mediation. Investor-State arbitration is therefore the main method of resolving investment disputes between a member state and an investor. The TPP Rules further set out the reasons for the submission of a claim to arbitration, the manner in which each party may express their consent to arbitration and the conditions and limitations for each party to express their consent. Moreover, the Rules deal with the selection of arbitrators, the conduct of the arbitration, transparency of arbitral proceedings, the governing law, as well as consolidation, awards, delivery of notice and other relevant documents.

China is currently considered the second largest recipient of foreign direct investment, and the sixth largest country of outward foreign direct investment (ODI). It is evident that China has a dual characteristic in so far as foreign investment is concerned. This duality means that China has to consider the investment dispute settlement mechanism between investors and recipient states carefully and seek to balance the advantages and disadvantages of this mechanism accordingly.

The Shanghai Pilot FTZ has already made some tentative reforms in the area of dispute settlement. Hence, the Shanghai International Economic and Trade Arbitration Commission (Shanghai International Arbitration Centre) has published the China (Shanghai) Pilot Free Trade Zone Arbitration Rules. The Rules issued on 1 May 2014 regulate international commerce arbitration.

What remains to be seen, however, is whether the Shanghai Pilot FTZ can further extend the regulation of disputes settlement between the government and investors. In this regard, it is interesting to note that the Ministry of Commerce published an "*Opinion on Supporting Innovation and Development of the Pilot Free Trade Zone*"(《关于支持自由贸易试验区创新发展的意见》) on 25 August 2015. Article 22 of the Opinion provides that the Shanghai Pilot FTZ may establish an institution to adopt a new disputes settlement mechanism for investment disputes involving administrative action and improve the level of foreign investor protection in China. It should be understood that such disputes

settlement mechanisms will also deal with investment disputes between investors and the Chinese government.

In future reform trials, it is recommended that the Shanghai Pilot FTZ continuously endeavour to provide business opportunities for investors and to improve the business environment. The Shanghai Pilot FTZ should continue to lead by example while the national strategic reformation trial for coping with the impact of TPP is being carried out. This can be achieved through the creation of an investor-friendly legal environment which provides for equal treatment and meets the new requirements of Competitive Neutrality in the TPP Rules. The Competitive Neutrality requirements are essential rules under which SOEs are allowed to take part in international trade and investment.

VI. Summary

In summary, China should develop various methods of dealing with the impact of the TPP. The most important method, however, is intensifying the reform and extending openness to trade. This means that China should actively narrow institutional gaps in order to achieve alignment with the TPP Rules. If this is achieved, China should be able to appropriately deal with new international trade and investment rules, regardless of whether it accedes to the TPP or not. However, a prerequisite for this would be a strengthening of the ongoing reform processes. Moving forward, it is crucial that the Chinese government approach this task in an adequate manner.

Chapter 2

Enforcement Concepts in Chinese and German Securities Regulation

Enforcement of Regulatory Powers in Capital Markets: China's Practice and Analysis

Su Huchao (苏虎超)[*]

I. Capital Market Regulation Can Produce Value

Although the development of capital markets in different countries and regions is different, so are their history, complexity and level of maturity. Nevertheless, capital markets in different countries have the same characteristics: they are both financial and public markets, and every country has in place some system

[*] Dr. Su Huchao, Director General of Inner Mongolia Regulatory Bureau, CSRC. This article just represents a personal opinion. All materials and statistics in this article are derived from publicly accessible information. This article can't be used to represent the opinion of the author's work unit and the author's public duty and intention.

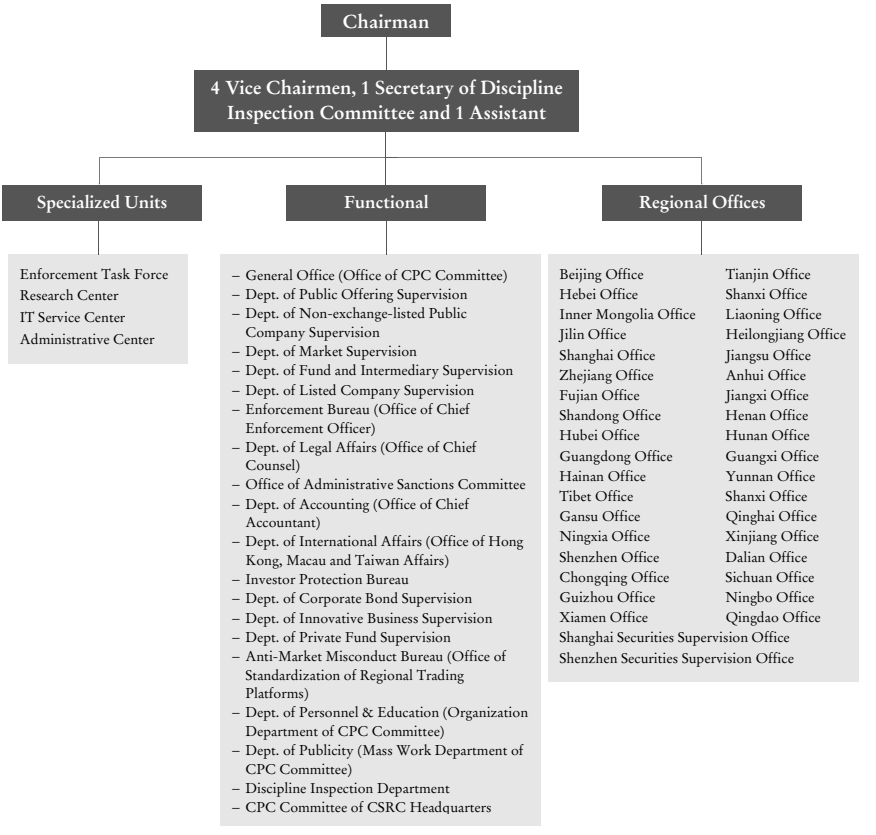
of regulation. In China, public service of government will not be included in the GDP. However, from an economic perspective, such service can produce value – and has proven to do so. The same can be said of capital market regulation.

Even though such value cannot be accurately calculated the autonomy of the market participators, their self-discipline and the civil or mechanisms to pursue criminal trials are important. But they alone cannot ensure the smooth/stable functioning of the market. Here, administrative regulation and supervision have advantages such as professionalism, timeliness/punctuality or/and compulsion. These advantages make administrative regulation and supervision irreplaceable for ensuring law enforcement, maintaining the order of capital markets, promoting market integrity and transparency; they also contribute to administrative regulation and supervision acquiring the lead-position in law enforcement. Administrative regulation and supervision are hence the core factors in the entire capital market regulatory system.

However, administrative regulation and supervision will, of course, produce costs, including both "explicit costs" and "implicit costs". "Explicit costs" are those expenditures produced by direct enforcement of regulatory power, while "implicit costs" refers to those influences on market activities exerted by enforcement of regulatory power. Because of such influences, the government should bear the correspondent responsibility. Inappropriate or "bad" administrative regulation and supervision may suppress the market mechanisms so that the capital market cannot play the important role it should. It can also impede market efficiency. Other negative effects are regulatory failure, regulatory gaps, delays in detecting problems and ineffective problem solving. Of course, the exercise of regulatory power and its mechanisms need to be improved and developed in practice. They do not function properly and are ineffective if they are separated from the actual market operation and development. It is therefore necessary to explore the question of the exercise of regulatory power as it is important for us to know how the power of the administrative regulation and supervision should be set up, defined and exercised.

II. The Regulatory Responsibilities of the China Securities Regulatory Commission

Chinese capital markets are both emerging and transitional. Therefore, the China Securities Regulatory Commission (CSRC), as a regulatory department, operates in a dual role as a market regulator and creator. It has both the task of protecting the legitimate rights and interests of investors, especially small and medium-sized investors, promoting the construction of capital market infrastructure, as well as enriching and improving the functionality of the markets and consistently supporting the real economy.



The aim of the CSRC is to maintain the order of an open, fair and just market, and protect the legal rights and interests of investors, especially small and medium-sized investors, as well as to promote the sound growth of the capital market. This can be summed up as "2 maintenances and 1 promotion".

III. The Regulatory Framework of Chinese Capital Markets

By enacting the "Securities Law" (《证券法》), "Securities Investment Fund Law"《证券投资基金法》) and "Regulations for the Administration of Futures Trading" (《期货交易管理条例》), China established a basic pattern for an administrative regulation and supervision system of capital markets. This system has two core characteristics: "divided operation, divided supervision", and a centralized and unified regulation and supervision.

The CSRC comprises 21 functional departments and 4 specialized units. The CSRC also has 38 regional offices across the country (including provinces, autonomous regions and municipalities) and 19 affiliated institutions under its supervision. The CSRC's headquarters, regional offices and affiliated institutions work together so that a unified national regulatory system of the securities and futures markets in China has already been formed.

In 2014, CSRC restructured its institution and established some new departments. Those are: the Department of Public Offering Supervision, the Department of Listed Company Supervision and the Department of Intermediary and Investment Fund Supervision. The Department of Public Offering Supervision is in charge of regulating all companies newly issuing on the Main Board and the Growth Enterprise, while the Department of Listed Company Supervision is in charge of the supervision of all listed companies. The Department of Intermediary and Investment Fund Supervision is responsible for the supervision of all the securities, funds and futures.

This restructuring provided an organizational guarantee for the improvement of regulatory consistency and the exploration of functional supervision. Moreover, CSRC has established the Department of Corporate Bonds Supervision, the Department of Innovative Business Supervision, the Department of Private Equity Funds Supervision and the Department of Anti-Illegal Securities and Futures Activities Bureau. These authorities strengthen the regulation of new areas in the development of the market.

IV. The Regulatory Framework of CSRC

The CSRC headquarters is in charge of formulating, amending and improving regulations and rules governing the securities and futures markets, developing market development plans, granting approvals of major issues, guiding and coordinating risk mitigation, organizing investigations into and imposing sanctions on major violations as well as guiding, inspecting, overseeing and coordinating supervisory efforts nationwide.

The regional offices of CSRC exercise front-line supervisory duties under the mandate granted by the CSRC, including the supervision of securities and futures-related activities of listed companies, securities and futures institutions, securities and futures intermediary institutions, and also including investigations into and enforcement actions against violations within their respective regions.

As of the end of 2014, the CSRC had 3,167 staff members, 769 or 24.3 % of which worked at the national headquarters and the remaining 2,398 or 75.7 % in regional offices. The staff members have an average age of 36.4. All revenues and expenses of the CSRC are included in the budget of the central government.

V. The Self-Regulatory Supervision of Security Institutions

The affiliated institutions include the following: the securities and futures exchanges, the China Securities Depository and Clearing Corporation Limited (CSDC), the China Securities Investor Protection Fund Corporation Limited (SIPF), the China Securities Finance Corporation Limited (CSF), the China Futures Margin Monitoring Centre Corporation Limited (CFMMC), the China Capital Market Statistics and Monitoring Center Corporation Limited (CMSMC), the National Equity Exchange and Quotations Corporation Limited (NEEQ), the Securities Association of China (SAC), the China Futures Association (CFA), the China Association for Public Companies (CAPCO) and the Asset Management Association of China (AMAC). These institutions conduct frontline and self-regulatory supervision over their members (participants or listed companies) as well as their business activities. This frontline and self-regulatory supervision constitutes an effective supplement to the regulatory and supervision efforts by the CSRC and its regional offices.

Around the cooperative framework of the abovementioned agencies, the CSRC has built up supervisory cooperation mechanisms with relevant economic financial authorities, judicial authorities and so on. So have the regional offices of CSRC. This has resulted in a multi-layered supervisory system.

VI. The Contents and Structure of Regulatory Powers

The basic position of CSRC is a law-enforcing department, which performs duties of administrative approval, routine supervision and law enforcement.

In recent years, in order to allow the market to play a decisive role in allocating resources and allow the government to perform its functions more effectively, the CSRC has worked hard to push forward regulatory transformation, further decreasing administrative approval and strengthening in-process and *ex post* supervision. The so-called in-process supervision mainly refers to the routine supervision of relevant activities of listed companies, securities funds, futures institutions and other market participants, including on-site and off-site supervision, compliance supervision and prudential supervision. *Ex post* supervision means that the CSRC adopts administrative supervision measures to deal with the illegal behavior of the market participants. For allegation of illegal or severe violations, the CSRC will enforce *ex post supervision* by investigating and penalizing the respective offender.

In 2014, the CSRC processed 678 alerts and started investigation in 488 cases. In comparison to 2013, this represents an increase of 11 % and 10.4 % respectively. In 2014, the CSRC closed 163 cases. This represents an increase of 90 % in comparison to 2013. The CSRC has made 158 decisions to impose sanctions

involving fines and disgorgements amounting to RMB 470 million. In total, RMB 704 million of fines and disgorgements were collected, 2.8 times the number in 2013. Finally, the CESRC has made 18 decisions to ban market entry of 31 individuals, including permanent bans of 10 individuals. Most of the cases are related to insider trading, disclosure violations and market manipulation.

At the same time, the CSRC has assisted the police to crack down on illicit stock recommendation software, illegal futures-related activities, etc. In 2014, the CSRC referred 115 cases to the police, and identified 111 cases as illegal activities.

VII. Contents and Enforcement of Regulatory Power

Usually, administrative law enforcement takes place prior to civil and criminal proceedings. Apart from administrative law enforcement, CSRC has other tasks, such as enacting regulations according to the authority of law, cooperating with other legislative agencies, economic and financial regulatory departments and judicial authorities.

The CSRC has also drafted and modified departmental regulations and normative documents and has guided and reviewed relevant business rules. It was actively involved in promoting the legislative work on the amendment of the Securities Law, the enactment of the Futures Law and Regulation of Private Equity Funds Supervision, etc.

Moreover, the CSRC has established a cooperation with the Supreme People's Court and the Ministry of Public Security. It promotes the enactment of judicial interpretation and judicial policy documents about securities and funds, supports investors to protect their legal interests by means of civil actions, improves administrative investigation systems, regulates enforcement, receives administrative judicial review and improves the criminal responsibility system.

The CSRC worked hard to prevent and mitigate system risks. The CSRC performs the duty of compliance supervision and meanwhile strengthens and improves the performance duty of prudential regulation, especially the performance duty of macro-prudential regulation, by means such as investigation and statistical analysis, risk analysis, risk disposition and so on.

Drawing from the Risk Identification Securities Regulators published by the International Organization of Securities Commissions (IOSCO), the CSRC is working to establish a series of indicators that suits China' realities, identifying systemically important financial institutions in China, aiming at providing a starting point for macro-prudential regulation.

Promoting innovation in regulation techniques, the CSRC uses unified monitoring systems to dynamically monitor the risk in futures markets, strengthening information sharing and risk early-warning in financial futures markets,

protecting the markets risks from transmission. Every securities and futures exchange strengthens the monitoring of unusual transactions and market risk and improves the monitoring of new-type transactions, such as program trading.

Under the framework of the Financial Regulatory Coordination Joint Ministerial Conference (JMC), the CSRC continued to strengthen communication and coordination with relevant authorities for rule-setting, implementation and information sharing.

VIII. Undergoing Exploration

1. Administrative Settlement

Administrative settlement is a mechanism aimed at providing better protection of investor rights, where the regulatory authority, following prescribed conditions and procedures, may reach settlement agreements with related parties suspected of law violations, and urge them to disgorge illegal gains or pay even higher fines to cover the investors' losses. Through special administrative enforcement procedures, administrative settlement realizes its core value by providing investors with restitution in a more timely, convenient and direct way. The regulator can also achieve the goal of maintaining the market order through punishing, sanctioning and imposing financial penalties on offenders.

In 2015, the CSRC drafted the Implementing Measures of CSRC on the Pilot of Administrative Settlement under the guidance of the Law Committee of the NPC, the Supreme People's Court and the Legislative Affairs Office of the State Council. The document provides for the applicable scope and conditions of administrative settlement, the negotiation, execution and supervision of settlement agreements, as well as the amount, management and usage of settlement proceedings.

2. Entrust Stock Exchanges with Enforcement

In order to make use of the stock exchanges' front-line advantages in terms of technology and business, in 2014, the CSRC decreed "Provisions on the Pilot Program of Delegating Case Investigation to the Shanghai Stock Exchange and the Shenzhen Stock Exchange". The CSRC authorized the Shanghai Stock Exchange and Shenzhen Stock Exchange to investigate some suspected illegal behavior, such as fraudulent issuance, insider trading, market manipulation, false statement, etc. The CSRC adopted the method of "individual entrustment", authorizing the stock exchange to investigate into certain serious, new and cross-markets illegal behavior.

The stock exchanges should investigate cases within the scope of authority entrusted to them by the CSRC. After they conclude an investigation, they should deliver the evidence or other materials, which are related to the case, to the CSRC's investigation department or other authorized original office for review. The CSRC or other authorized original office will then re-examine and make a final decision according to legal procedure.

3. Strengthening CESR Enforcement Abilities: Information Technology

In 2014, the CSRC released "the Measures for the Administration of the Central Platform of Regulatory Information (Pilot)" and "the Overall Development Plan for the Central Platform of Regulatory Information" to further guide platform development and management. The Central Platform of Regulatory Information is a unified information-sharing platform for the securities and futures regulatory system. It is a fundamental platform built for public interests. The platform supports regulatory needs, collects all data, both preliminary and processed, and information and serves all aspects of the CSRC's work. Units and departments within the CSRC's system all have access to the platform within a prescribed scope of authorization.

In 2014, the CSRC established and formally launched the Integrity Database, and amended the Interim Measures for the Supervision and Administration of Securities and Futures Market Integrity, through which integrity records of market entities are collected and archived in a standardized manner, thereby facilitating inquiry by regulators and market participants and laying a solid foundation for higher integrity standards. In addition, the CSRC launched an Internet-based public inquiry platform for dishonesty records, where the public can access information on records of administrative sanctions, market entry bans and disciplinary measures against market participants. Moreover, the CSRC shares information on actions against dishonest individuals and corresponding records in the Integrity Database with the Supreme People's Court. The CSRC also actively promotes integrity information sharing with judicial organs, other financial departments, State Administration of Taxation, etc.

IX. Gradually Expanding Regulatory Areas

1. Private Funds

According to the Securities Investment Fund Law, The CSRC released "the Interim Measures for the Supervision and Administration of Private Investment Funds", to perform its regulatory duty in relation to private funds. The CSRC and its regional office are authorized to enforce their regulatory duties by mon-

itoring the business situation of private fund managers, private fund trustees, private fund sales institutions and other private fund service institutions.

The Asset Management Association of China (AMAC) is responsible for the registration of private fund management institutions and the filing of private funds under the guidance of the CSRC. By the end of September of 2015, the AMAC had registered 20,383 private fund management institutions. The AMAC had filings of 20,123 private funds. The total size of subscribed capital filed with the AMAC reached RMB 4.51 trillion and paid-in capital amounted to 3.64 trillion. The amount of private funds practitioner reached 317.400.

2. Internet Finance

In July 2015, the People's Bank of China issued the "Guiding Opinions on Promoting the Healthy Development of Internet Finance", which were promulgated jointly with other Chinese authorities. According to the 2015 guideline, the CSRC is responsible for the supervision of equity crowd financing and online fund sales. The equity crowd financing activities are characterized as being "open, small-sum, and public". They concern public interests and the national financial security, and thus must be regulated according to the law. Without the approval of the securities regulatory authority under the State Council, no entity or individual may engage in equity crowd financing. Currently, those activities conducted by some institutional market players named "equity crowd funding" are in fact measures of private equity financing or the offering of private equity investment funds, conducted via the Internet, instead of the "equity crowd financing" as specified in the Guiding Opinions. These activities can easily confuse the markets and the public with regards to the concept of equity crowd financing.

In August 2015, the CSRC released the "Notice of the General Office of the China Securities Regulatory Commission on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet". It decided to conduct special inspections of the platform institutions conducting equity financing intermediary activities via the Internet.

3. Regional Equity Trading Markets

Regional equity trading markets are established with the approval of the local provincial people's government according to the regulations of the State Council. Regional markets are private markets, which provide services regarding issue, transfer and other relevant activities of private securities. The respective provincial people's government at the location of the operation agency shall be responsible for the supervision of the market.

The main duty of the CSRC in this respect is to enact regulatory rules and guide the regulatory work of local governments. The regional offices of CSRC shall establish regulatory cooperation systems with local regulatory departments and provide guidance, coordination and supervision services for the local governments' work on regulating the regional equity trading markets. The CSRC drafted the "Guiding Opinion on the Sound Development of Regional Equity Trading Venues", which was released in June 2015 to seek public opinion.

By the end of April 2015, there were 33 regional equity venues in China. A total of 2,597 limited companies were listed on those markets, and 2,650 companies could be traded. RMB 243.5 billion had been raised.

X. Strengthening International Regulatory and Enforcement Cooperation

Since the CSRC signed the IOSCO MMOU in 2007, it has actively fulfilled the obligations of cross-border enforcement cooperation under the MMOU. In 2014, the CSRC received 97 incoming requests for assistance and concluded 69 of them; 13 requests for assistance were sent out.

By the end of 2014, the Commission had signed the bilateral Memorandum of Understanding (MOU) with 59 overseas regulators from 55 countries and regions.

XI. Supervision of Regulatory Powers

1. Legal Liability

Art. 182 of the Securities Law states that the role of the securities regulatory authority under the State Council shall be duteous, impartial and orderly. Moreover, the authority shall handle matters according to the law, and shall not take advantage of its function to seek any unjust interests or divulge any commercial secrets of the relevant entity or individual it has access to in its capacity as a regulatory authority.

Art. 43 of the Securities Law further provides as follows: The practitioners in stock exchanges, securities companies and securities registration and clearing institutions, the securities regulatory bodies, as well as any other personnel who have been prohibited by any law or administrative regulation from engaging in any stock trading shall not, within their tenures or the relevant statutory term, hold or purchase or sell any stock directly or in any assumed name or in the name of any other person, nor may they accept any stocks from any other person as a present.

2. Discipline Management

The CSRC has a specific Secretary of Discipline Inspection Committee, a Discipline Inspection Department and a patrol office. Moreover, there are Secretary of Discipline Inspection Committees and Discipline Inspection Departments in each regional office.

3. Judicial Review

Any affected party that is dissatisfied with the enforcement of the CSRC, including its administrative approval and administrative penalties, may apply for an administrative review or file a lawsuit with the people's court.

XII. Conclusion

The enforcement of regulatory powers should be continually adapted and improved according to the real development of the financial market. In order to meet the need of the new trends of marketization, levelization, derivatization, informatization, internationalization etc. the CSRC should draw on beneficial experiences from mature markets. In recent years, the CSRC worked hard to push ahead the regulatory transformation, reducing *ex ante* approval requirements and strengthening in-process and *ex post* supervision. According to the concept of "divided supervision combined with unified supervision", the CSRC established and developed a comprehensive regulatory system to allow the market self-discipline organizations to play their role better and accept external regulatory supervision consciously.

Internationalization of the Chinese Capital Market and the Improvement of Investor Protection in China

*Xujun Gao (*高旭军)*

I. Introduction

China began to reform its economic system in 1978. In the thirty-eight years since the reform began, China has gradually expanded the market circulation mechanism from the enterprise system to the financial system. An important reform measure which has been implemented by the Chinese government has been the internationalization of the financial market. The internationalization reform measures are mainly evident in the fields set out below.

First, the Chinese government has taken efforts to promote the internationalization of the Renminbi (RMB). This is not only evident in the fact that as of August 2015, the RMB is the fourth largest payment currency in the world, but also in China's establishment of the Asian Infrastructure Investment Bank (hereinafter referred to as the "Asian Investment Bank"). The RMB is also a major clearing and payment currency for the Asian Investment Bank. The efforts to promote the internationalization of the RMB are also reflected in the fact that the Chinese government is promoting the inclusion of the RMB into the International Monetary Fund's Special Drawing Rights.

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Second, the Chinese government is promoting the internationalization of the capital market. China has realized the transaction interconnection of the Shanghai and Hong Kong stock exchanges (hereinafter referred to as "Shanghai and Hong Kong"). This interconnectedness means that investors in Mainland China can buy shares on the Hong Kong stock exchange and that investors in Hong Kong can also purchase shares on the Shanghai stock exchange. In the future, "Shenzhen-Hong Kong" will also be achieved and foreign investors will be allowed to buy stocks on the Shanghai and Shenzhen exchanges directly.

Third, the Chinese government is vigorously promoting the construction of the Shanghai International Financial Centre. The State Council has clearly expressed the goal that by 2020 Shanghai should become an International Financial Centre, which will further contribute to China's economic strength and enhance the international status of the RMB.

These Chinese government reforms have important practical significance. If China succeeds in achieving the internationalization of its financial and capital markets, not only will there be a significant influx of foreign capital into the Chinese market to promote the Chinese economic development, but China will also become an important member of the international financial system. This means that China will play a greater role in promoting the reform of international financial institutions.

However, the success of the above reform initiatives is subject to multiple factors. One of these is whether China can create the necessary legal environment to ensure the smooth operation of international capital markets and assure a high level of investor protection. This factor will be discussed briefly in this article.

II. High-Quality Legal Protection for Investors – A Prerequisite for the Internationalization of Capital Markets

As stated, one of the aims of the Chinese government is to build a capital market with a high degree of internationalization. Such a highly internationalized capital market would allow foreign investors to list their securities on the Chinese capital market and also trade such securities. In addition, investors would be able to transfer their capital in third countries. By the same token, Chinese companies would have the right to transfer their capital to other countries and list their securities on stock markets in New York, London and Frankfurt. The Chinese government, thus, envisions a highly interconnected market place and the flow of capital to and from China.

A key question which arises in this context, therefore, concerns the prerequisites that must be fulfilled in order to build such an internationalized and interconnected capital market. As we shall see in this chapter, future regulation of stock markets and qualified experts will play a crucial role. No doubt, there are

other enabling factors that will have to be satisfied in order to the create the environment for such a capital market to emerge. In my view, however, one of the most important preconditions will be ensuring that the Chinese legal system provides national and foreign investors fair and efficient legal protection. In this context, I wish to highlight a number of salient points:

First, the most important task of capital markets law is to protect the lawful interests of investors. If investor interests are damaged by illegal acts of listed companies, their directors or any other responsible persons, the legal system of a country must be able to afford investors efficient and justified protection. If a country cannot afford such legal protection to investors, then investors will not be motivated to invest their money.

Second, efficient and fair investor protection is also a criterion which is used not only in market economic countries, but also by the World Bank in order to assess whether the capital market law of a specific country is well-developed.[1] Although the terms "criterion" and "prerequisites" seem to have different meanings, their meanings are essentially the same as both emphasize the importance of "efficient and fair investor protection". The only difference is a matter of perspective. The term "criterion" stresses the perfection degree of the concerned legal system, while "prerequisites" outlines the type of legal system which is required in order to build a capital market with a high degree of internationalization.

Third, experience in countries with a high degree of internationalization of their capital market shows that a high degree of legal protection for investors is a prerequisite for the internationalization of a capital market. The statistics set out in the tables 1 and 2 below demonstrate that there is a close relationship between a country's degree of investor protection and the internationalization of the capital market. Furthermore, the higher the degree of legal protection, the higher the degree of the internationalization of the capital market.

The tables provide a comparison of the status of legal protection in China vis-à-vis the common law countries, on one hand, and countries which apply French or German law, and countries which apply Scandinavian law, on the other.

As can be seen from the tables below, common law countries have the highest level of protection with regard to investor protection followed by Scandinavian law countries, French law countries, German law countries and China respectively. In terms of the quality of law enforcement, however, the highest degree of protection was afforded to Scandinavian Law countries, followed by German law countries, Common Law countries, French Law countries and lastly China. Because high quality law enforcement can, to a great extent, make up for deficiencies the average level of investor protection in common law countries and

[1] Chen Jing (陈静), *Cross-Country Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59.

German law countries is higher than in France. In the five categories of countries mentioned above, in addition to Scandinavian countries, the United States, Britain, Germany, France and China have international stock exchanges and other international financial institutions in place. A comparison of these five categories of countries shows that the degree of internationalization of the capital market in the United States and the U.K. is undoubtedly the highest, followed by Germany, France and China.

The findings set out above indicate that a relationship should exist between the extent of legal protection for investors and the degree of internationalization of the capital market in that jurisdiction. Generally, it can be said that the higher the degree of investor protection in given jurisdiction, the higher the degree of internationalization of that jurisdiction's capital market. In addition, it is an essential prerequisite of realizing internationalization of capital markets that the jurisdiction in question provides investors with adequate legal protection, because to date no country has been able to create a highly internationalized capital market under the premise of inadequate investor legal protection. The reason is obvious – if a country's legal system fails to provide adequate and fair protection for investors, which investor will be willing to place funds into that country's capital market?

III. Chinese Legal Protection of Investors in an International Context

Does the Chinese capital market enjoy an ideal, sound legal environment at present? It is difficult to answer this question comprehensively and objectively. This paper attempts to find an answer to this question through an international comparative analysis of investor protection.

The reason for choosing this approach is that the core task of capital markets law is to protect the legitimate interests of investors. In addition, whether dealing with jurisdictions where capital markets are internationalised, or with the World Bank, providing full legal protection for investors is always a significant criterion. It is necessary to measure if the rule of law of a specific country is adequate or not. The rationale for choosing an international comparative analysis as an analytical method is that only through a comparison of the legal systems of different countries we can assess the extent of the degree of investor protection provided by the Chinese legal system vis-a-vis international competition. Once this is apparent we can find gaps between the capital market laws of China and those of other market economies.

The question which then follows is: what is the status of the legal protection of investors in China relative to international competition? Chinese scholars have carried out specific research dealing with this question. Therefore, this paper will first introduce the conclusions of Chinese scholars, followed by a commentary on such conclusions.

1. Chinese Investor Protection vis-à-vis Investor Protection in Western Countries in 2009

As stated, the following results are extracted from various Chinese studies. A total number of 49 countries, including China, were selected in one such study in order to conduct a comparison of the level of investor protection between different countries. The studydivided the 49 countries into countries applying common law, French law, German law, Scandinavian law and Chinese law. Furthermore, a distinction was made between investor protection provided by these countries in the form of investor protection on the books (or, "written protection") and actual protection provided to investors (or, "real protection"). "Written protection" is defined as the protection afforded in a country's securities law, company law, civil law, civil procedure and other laws, while "real protection" refers to investor protection which is achieved through the application of such law. The main conclusions of the study are presented below.

a) China's International Position in Investor Legal Protection

In order to conduct an objective comparison of the differences in written protection provided by the different states, the scholar uses a Three-Index System which covers: i) the degree of disclosure of information, ii) the extent of director liability and iii) the degree of the convenience of shareholder litigation. The range of the evaluation index is set between 0–10; a 0 represents the worst level investor protection. The higher the value, the higher the degree of protection; therefore, if a value of 10 is awarded, this represents the highest degree of protection available. The scholar created the table below based on statistics published in 2009.

Table 1: International Comparison of Investor Protection in China vis-à-vis Other Major Market Economies

Country	(1) Index of Information Disclosure	(2) Index of Responsibility of Directors	(3) Index of Convenience of Shareholders' Litigation
Average Score of Common Law Countries	7.8	6.5	7.7
Average Score of French Law Countries	6	4.4	5.5
Average Score of German Law Countries	4.4	4.6	5.6
Average Score of Scandinavian Law Countries	7	4.75	7
Average Score of Chinese Law Countries	10	1	4

As shown in Table 1, in comparison to 49 countries, China only achieved the highest value with regard to relevant laws and regulations governing disclosure of information. However, with regard to the relevant provisions dealing with directors' liability, and also with respect to the convenience of shareholder litigation, China received comparatively low rankings and in this respect lies at the bottom of the list. In comparison with other jurisdictions, Chinese law lacked specific provisions which require insiders to bear the liability of compensation or provide the court with a right to cancel a transaction.

With regard to the convenience of litigation, the court does not allow a plaintiff shareholder to acquire any evidence regarding insider trading through their own investigation. Plaintiff shareholders are also unable to approach the defendant and the witnesses for documents during judicial proceedings.[2] In addition, Art. 6 of the "Provisions of Trial of Civil Compensation Cases of the Securities Market due to the False Statement" (SSCTCCFS), promulgated by the Supreme People's Court in 2002, establishes various procedures which make the bringing of legal suits by shareholders much more difficult. This difficulty exists because according to the SSCTCCFS, a Chinese court can only register and hear a claim against a listed company and its directors based on the disclosure of "false information", only when the relevant government authorities have made an administrative penalty decision or when a Chinese court has previously handed down a criminal judgment. This has naturally created a great inconvenience to plaintiff shareholders who sue a listed company and its directors and other persons responsible for civil compensation. Accordingly, though China has made great leaps in the area of information disclosure, wide gaps still exist between China and the main market economies with regard to "law in action."

b) China's International Position in relation to "Real Protection"

In order to objectively analyze the quality of law enforcement in the 49 countries, the study used three indices. These included: the "rule of law", "corruption" and the "enforcement of rules and regulations". The higher a country scores on the index, the better the law enforcement, and vice-versa. The aim of this analysis was to compare the quality of China's law enforcement with that of other jurisdictions.

[2] Chen Jing (陈静), *Cross-Courntry Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59, 61.

Table 2: Comparison of Law Enforcement in China and Other Major Market Economies

Country	(1) Index of Rule of Law	(2) Index of Corruption	(3) Index of Enforcement of Law
Average Score of Common Law Countries	0.534	0.623	0.645
Average Score of French Law Countries	0.290	0.132	0.264
Average Score of German Law Countries	1.499	1.464	1.282
Average Score of Scandinavian Law Countries	1.860	2.202	1.624
Average Score of Chinese Law Countries	-0.35	-0.53	-0.2

The statistical data in Table 2 indicates that, compared with the other 48 market economies, the level and quality of law enforcement in China is amongst the lowest. This is evident from the scores China received on the "index of rule of law", "index of corruption" as well as the "index of enforcement of rules and regulations.". In the "rule of law" dimension, Germany achieved the highest score, being 1.599. Conversely, the law enforcement in France is lower, with France receiving a score of 0.290. However, China scored -0.35. Looking at the the degree of corruption, Scandinavian Law countries performed well receiving a high score of 2.202. French Law countries received a lower score (0.132), while China received the lowest score (-0.53). In terms of the "quality of the implementation of laws", Scandinavian Law countries again received the highest score (1.624). French Law countries were in fourth position with a score of 0.264 and China obtained the lowest score of 0.2.

In summary, there is great room for improvement in China with regard to both the protection of investors through codified regulation as well as the real protection provided by the enforcement of the investor protection laws. Therefore, compared with the other 48 market economy countries China needs to take further reform in this regard.

2. Comments on the Research Findings

Now, the interesting question is whether the above-mentioned findings objectively reflect the reality of legal protection of investor interests. Generally speaking, I think this question can be answered in the affirmative because of the reasons which follow below.

First, the research methods adopted in the study are scientific and rational. On the one hand, the study takes a scientific and reasonable approach by divid-

ing the protection into the "written protection" which exists in the law on the books and "real protection" achieved through the enforcement of the law. Regardless of how perfect and comprehensive codified regulations are, such regulations and their investor protective function will remain simply on paper and "dead" if they are not fully enforced. It is only when the legal liabilities of the infringers are effectively investigated and punished by judicial organs, that the laws become fully "alive" and can fulfill their function protecting investors.

On the other hand, the study takes a reasonable and justifiable approach when dividing the category of "written protection" further into the "information disclosure index", "the extent of director liability index" and the "shareholder suing convenience index." It also makes sense to divide the category of "real protection" into "the rule of law index", "indicators of the degree of corruption" and the "enforcement of law".

Take the three indices of "written protection," for example, they all reflect the different laws put in place by a single country to protect the interests of investors. The "information disclosure index" provisions govern the internal decision-making process regarding transactions and the disclosure of internal information. The "extent of director liability index" mainly covers the provisions: i) regulating the extent, range and type of directors' and other insiders' liability when the act of the company harms the interests of investors, ii) the substantive and procedural law governing the ease with which a shareholder can initiate a legal suit against an insider and the organs proving such acts, iii) those rules dealing with the scope of the rights of the court (including whether it has the right to revoke a transaction) and iv) those provisions governing the right of direct and derivative litigation.

The "shareholder suing convenience index" measures the ease with which external investors can file a complaint against insiders for damages caused by insider trading. For example, the provisions dealing with the rights of shareholders to obtain relevant documents from a defendant and witness during a trial in order "to consult the relevant documents of the accused" are an important measure for determining whether shareholders can bring actions and with what ease or difficulty.[3] Similarly, the three indices of "real protection" also provide specific guidance. The "rule of law index" mainly refers to the status of a country with regard to i) compliance with the law, ii) protection of property rights in society, iii) execution of contracts, iv) judicial justice and v) crime. At the same time, the "corruption index" focuses on public authorities including courts which may misuse the public powers allocated to them. Lastly, the "en-

[3] Chen Jing (陈静), *Cross-Country Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59, 60.

forcement of law index" refers to the actions of the government and the judicial organs in the correct application of the law which is essential for creating a good business environment for companies and investors.[4]

Because the above "indicators" and "indices" deal with different regulations and different levels of implementation of law in a given country as well as relevant regulations and provisions concerning investor protection, the conclusions reached should therefore be able to objectively reflect the actual status of the legal protection afforded to investors' in the relevant country. Therefore, the above findings can be said to be objective and credible. The data in charts 1 and 2 also objectively reflect the position in China with respect to legal protection afforded to investors vis-a-vis international competition.

IV. Proposals for Improving Chinese Legal Protection of Investors

The above research findings not only indicate the gap between China and major western market economies with regard to the legal protection of investors but also demonstrate that China has not yet reached the level of investor legal protection it should reach in internationalized capital markets. Hence, in order to realize the goal of further internationalising capital markets, China should further promote appropriate legislative reform.

In recent years, China has taken various reforms to combat corruption and to promote the independence of its judicial system.[5] These measures provide that "the personnel and funding of local courts should be regulated and provided by the provincial government instead of by local governments" and steps should be taken in "improving the system of accountability for judges."[6] They play an important role to reduce: (i) the administrative intervention in the court system, (ii) the protection of local interests and iii) corruption which has adversely influenced the judicial independence of Chinese court system for a long period. In comparison to the position in 2009, China's legal environment with regard to the protection of investor interests has greatly improved. However, there are various reforms which China is yet to implement. These outstanding reforms are discussed below.

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[4] Chen Jing (陈静), *Cross-Country Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59, 62.

[5] Li Shaoping (李少平), *The judicial Reform in the background of comprehensively implementing governing the country by law* (《全面推进依法治国背景下的司法改革》), 1 Journal of Law Application (《法律适用》) (2015), p. 2, 5.

[6] It refers to the judicial practice, "if the presiding judge, the collegial panel tries a case, the judge and the panel must be responsible for its judgment".

1. Modifying China's Laws to Improve Investor Protection

As stated above, China's company law, security law, and other laws already contain provisions which deal with the disclosure of information. However, with regard to the liability of directors, a number of provisions require further improvement. The most significant areas requiring reform are discussed in this section.

First, the status of insider liability has not been clearly defined by the law. Art. 150–152 of China's "Company Law" currently provide for both the direct action of a shareholder and a shareholder's derivative action. For example, if the directors or supervisors are in violation of laws, administrative regulations, or the articles of association, and such violation causes losses to the company, they are liable for such losses. However, Chinese "Company Law" does not specify the kind of liability relationship which exists between directors, supervisors and senior management personnel. This not only makes it difficult for judicial practice, but also brings uncertainty to investor protection.

It would have been more beneficial if the Chinese Supreme People's Court had clarified such uncertainty through judicial interpretation. This clarification could have been achieved by stating that such liability in this case should be "joint liability" between the concerned parties. Hence, in the event that the conditions for the application of Art. 150 and Art. 152 are fulfilled, the company's directors, supervisors and senior management personnel would be jointly liable for losses suffered by the company or its shareholders.

Second, the cause of action against the company's controlling shareholder, actual controller and so on is not clear. Although, according to Art. 21 of the "Company Law", the controlling shareholder, actual controllers, directors, supervisors and senior management personnel shall not take advantage of the interests of the company, these persons may violate this duty and hence cause losses which harm the interests of the company. In this scenario, they should be liable for damages. If these persons violate this clause and cause loss to the interests of the company, they shall be liable for damages. This is supported by Art. 18, Art. 19, Sec. 20 of the "Supreme People's Court on Several Issues Concerning the Application of Company Law" (promulgated in 2009). However, these articles only apply if the actions of the actual controller cause damage to creditor interests in the process of dissolving and liquidating the company.[7]

This, in effect, deprives shareholders of the right of recourse through the use of the action right granted in Art. 21. It is clear, for example, that illegal related

[7] Provisions of the Supreme People's Court on Several Issues concerning the application of the company law of the People's Republic of China(II) (《最高人民法院关于适用<中华人民共和国公司法>若干问题的规定(二)》), issued im May 2008 by the Supreme People's Court China, Law Explanation (2008) Nr. 6, www. rmfyb.chinacourt.org/paper/html/2014-02/25/content_77257.htm?div=-1, (last visit: 2015.10.14).

party transactions not only harm the interests of company directly, but also harm the interests of shareholders indirectly. Depriving shareholders of a right to sue in this situation amounts to an apparent discrimination against those shareholders who are not involved in these illegal related party transactions. Furthermore, this is not conducive for the protection of the legitimate interests of these shareholders. I therefore propose that shareholders should have the right to sue on the basis of Article 21 of the Company Law. This would effectively allow them to bring actions against controlling shareholders and actual controllers and be compensated for the losses incurred as a result of such related party transactions.

2. Taking Measures for Further Improvement of Law Enforcement in China

In addition to the reforms which would further promote judicial independence, China should gradually take steps in order to reduce barriers that currently exist for securities investors wishing to file civil lawsuits in China. Thus, investors' rights to safeguard their legitimate interests through civil proceedings must be guaranteed. In particular, China should take the reform measures as set out below:

First, the rules limiting Chinese courts form registering securities civil compensation cases should be abolished, so that China's securities investors can bring claims against any wrongful actions by limited companies which cause harm to their investments. According to Art. 63 of China's Securities law, listed companies must disclose information about their financial status. Furthermore, according to Art. 69 they are liable for the publication of false information. In addition to these provisions, Art. 73 of the Securities Law prohibits insider trading, while Art. 77 prohibits market manipulation; and the companies and their directors and officers must also bear the liability of compensating investors for any losses suffered as result of violations of such articles. Despite these provisions, there are only a few cases where investors have successfully brought a complaint. This is mainly because Chinese courts are limited in their powers to register and hear such disputes. Because of these constraints insider trading, fraud, market manipulation and other such illegal actions continue to occur in the Chinese capital market.

These prohibitory actions have seriously damaged the legitimate rights and interests of investors. Unfortunately, China's Supreme People's Court has issued a notice that "clearly states that Chinese courts will not be hearing claims of shareholders because of disclosure of false information, insider trading and market manipulation".[8] Thus China's courts have almost shut their doors to

[8] Notice of the Supreme People's Court on temporarily not accepting the civil compensa-

these kinds of securities claims being brought forward by investors. In 2002, following the passage of the "SSCTCCFS"[9] by the Supreme People's Court, the Chinese Courts finally began to accept and hear such claims. The "SSCTCCFS" authorizes Chinese courts to register and hear shareholder claims brought on the basis of the publication of false information by listed companies. Nevertheless, despite this step forward, Chinese courts tend to take a passive attitude when registering and hearing such cases. They still assume an ambiguous attitude especially towards insider trading and market manipulation.

Second, it is necessary to establish a procedure which would permit investors to file securities civil lawsuits for compensation directly. As stated earlier, Chinese courts began to hear investor claims based on the disclosure of false information only in 2002. In spite of this progress, shareholders cannot bring such legal actions directly before courts since the SSCTCCFS provides that a Chinese court can only be allowed to register and hear a claim against a listed company and its directors, in instances where the relevant government authorities have made an administrative penalty decision or where a court has previously has handed down a criminal judgment in the same case.[10]

The Supreme People's Court has not provided for a similar procedure for civil litigation claims against insider trading and market manipulation, but such a procedure exists in the fact in juridical practice. This is because, regardless of how the courts deal with cases of insider trading and market manipulation, they all have the same characteristics – the prohibited activities are kept secret by insiders. Outsiders are not privy to information regarding what exactly happened within the company. Even if they got such information and access to evidence through personal invesetigation, Chinese courts would not accept such evidence. It is therefore usually the case that only after an administrative penalty has been awarded by the securities supervision institutions or once a criminal judgment has been handed down by a court, that it becomes possible for shareholders to prove the existence of such illegal action and bring lawsuits in court.

This existing procedure has obviously caused significant inconvenience for shareholders who wish to file for civil compensation for damages. Taking the

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tion lawsuits involving securities(《最高人民法院关于涉证券民事赔偿案件暂不予受理的通知》), Law Notice (法明传) (2001) Nr. 406, September 21, 2001. Not valid anymore, homepage: www.law.lawtime.cn/d433590438684.html, (last visit : 2015.10.09); Wei Bing (魏彬), *Research on the civil litigation and compensation of Security insider trading in China* (《我国证券内幕交易民事诉讼与赔偿的研究》), 1 Journal of Nanjing Radio & TV University (《南京广播电视大学学报》) (2010), p. 48, 49.

[9] Notice of the Supreme People's Court on accepting the civil compensation lawsuits involving false statement in security transaction (《最高人民法院关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知》), Law Notice (法明传) (2001), Nr. 43, January 15, 2002, www.chinacourt.org/law/detail/2002/01/id/42068.shtml, (last visit: 2015.10.14).

[10] Certain Regulations of the Supreme People's Court on Acceptance of Civil Tort Dispute Cases Caused by False Statement of Securities Market, F.S No.[2003]2, www.chinaacc.com/new/63/74/2003/1/ad334712401119130021718.htm.

disclosure of false information as an example, in the case where there has not been an administrative or court decision, even if an affected investor can prove that a listed company has published false information (causing damage to the investors), the affected investor will be able to bring an action before the court but the court will still be unable to accept this complaint. This effectively makes the action brought by the affected investor or shareholder meaningless since the court lacks the corresponding power to hear the complaint. Therefore, in order to protect the legal interests of investors, the above-mentioned procedural restriction placed on Chinese courts should be removed.

Third, shareholders should be allowed to investigate and collect their own evidence and the court should admit such evidence. The basic principle in Chinese Civil Procedural Law is that the plaintiff bears the burden of proof. However, in civil lawsuits dealing with security law, it seems that the evidence proving the illegal conduct by the listed company which is collected by shareholders is not admissible in court.[11] The current law of China does not, of course, stipulate such non-recognition explicitly. However, it does so implicitly because of the above-mentioned procedural restrictions contained in the SSCTCCFS, which plays an important role and affects the way shareholders can collect and lead evidence in civil securities lawsuits. This further means that the judicial mechanisms prescribed in China do not support and encourage shareholders to investigate and collect their own evidence. This, in turn, is not conducive for investor protection. Therefore, there is a real need to change current unwritten customary practice and implement further improvements to the law.

Fourth, courts should be authorized to ban actions which amount to illegal trading, including, amongst other things, insider trading. To date, Chinese courts lack authority to decide whether to hear specific insider trading allegations in civil matters relating to security law.[12] It is, however, necessary to grant such powers to courts, in order to protect the interests of the company, its shareholders and its creditors. Courts should have decision-making powers in cases where a shareholder of a listed company has, through his/her own investigations, discovered that the controlling shareholders are or may be willing to engage in insider trading, unless stopped without delay, and it is obvious that this may cause economic loss to the company or to its shareholders and creditors. In such cases, courts should be able to intervene. It is interesting to note that the courts in Germany already possess these kinds of decision-making powers.[13]

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[11] Chen Jing (陈静), *Cross-Country Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59, 61.

[12] Chen Jing (陈静), *Cross-Country Comparison of Investor Legal Protection in China* (《中国投资者法律保护的国际比较》), 5 China Business and Market (《中国流通经济》) (2011), p. 59, 61.

[13] T. Raiser and R. Veil (eds.), *Recht der Kapitalgesellschaften*, 5th edn. (2010), p. 92 et seq.

3. Summary

To date, and especially owing to the economic reform process, China's focus has been on enhancing government supervision of securities markets and this certainly makes sense to a certain extent. However, placing the emphasis on supervision by government authorities does not mean that investors' rights of supervision should be limited. Compared to government supervision, investor supervision offers distinct advantages. It can, for example, conserve public resources and encourage shareholders to pay closer attention to corporate behavior as well as exert pressure on companies to carry out business activities in accordance with law. This, in turn, will enhance investor protection in China and contribute to China's efforts to improve the status of the investor protection.

In addition, investor supervision should ameliorate the gaps with respect to investor protection which presently exist as a result of government inaction. The most effective way to improve investor supervision is to allow shareholders to file a law suit against the company, the directors or its controlling shareholders when any of these parties have engaged in wrongful conduct. Most importantly, Chinese law should not only ensure that every shareholder has substantive investor protection rights, but the laws in place should also make it procedurally convenient for shareholders to exercise these rights.

V. Conclusion

It will be a difficult and arduous task to achieve the internationalization of Chinese capital markets, and make Shanghai an international financial centre. For Shanghai to grow into a leading international financial centre and be capable of attracting foreign capital, foreign investors must be voluntarily willing to invest substantial capital into the Chinese financial market. In order to realize such a goal, the Chinese legal system needs to ensure an adequate level of investor protection. Foreign investors must have sufficient opportunities to realize financial gains while being expected to comply with Chinese law. More importantly, the legal system should ensure that international investors can engage in various financial activities while at the same time being assured that their rights are protected and, in the case of infringement, adequate, effective and impartial legal remedies are available to them. As suggested in this chapter, a number of reforms are required in order to meaningfully enhance the level of protection afforded to investors in China. This, in turn, should make China, and especially Shanghai, an attractive and safe capital investment destination for all kinds of investors, including domestic, international, as well as institutional and individual investors.

Enforcement by Supervisory Authorities: Concepts and Experiences in Germany

Thomas Höppner[*]

I. General Information

The Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) was founded on 1 May 2002. BaFin was created by the merger of the former Federal Banking Supervisory Office (*Bundesaufsichtsamt für das Kreditwesen*), the Federal Insurance Supervisory Office (*Bundesaufsichtsamt für das Versicherungswesen*) and the Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*).

BaFin is an integrated supervisory authority which monitors the entire financial market including the banking sector, the insurance sector and the securities sector. BaFin operates in the public interest. Its primary objective is to ensure proper functioning, stability and integrity of the German financial system. As of 31 December 2016, the number of employees working for BaFin in Bonn and Frankfurt amounted to 2,552.

The monitoring role of BaFin encompasses supervision of credit institutions, financial services institutions, insurance undertakings, pension funds, asset management companies and domestic investment funds. Under its solvency supervision, BaFin inter alia helps to ensure the ability of banks, financial services institutions and insurance undertakings to meet their payment obligations. Through its market supervisory function, BaFin, amongst other things, also enforces standards of professional conduct which help to strengthen investors' confidence in financial markets. In addition, as a part of its investor protection responsibility, BaFin for example seeks to prevent unauthorised financial transactions.

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II. Securities Supervision

The following information refers to the securities supervision function of BaFin. Generally, the tasks assigned to the individual sections are heterogeneous. Capital markets regulations are enforced mainly in order to foster financial market stability, and consequently contribute to investor protection.

Consumer protection has become increasingly important in recent years. There should be a balance between the legitimate interests of consumers and the equally legitimate interests of undertakings. For example, providers should not be hindered by excessive administrative requirements, nor should their innovative spirit be stifled. Furthermore, there should be a balance between government regulation and the consumer's own responsibility. In order to respond to these varied expectations, BaFin has recently incorporated a separate department into the securities supervision dealing with the topic of consumer protection.

BaFin's major responsibilities with regard to securities supervision comprise:

- investigation of market abuse and insider trading;
- supervision of transparency and disclosure (financial reporting, ad hoc disclosure, voting rights);
- monitoring and enforcement of financial reporting;
- supervision of public tender offers and takeovers;
- approval of securities prospectuses;
- supervision of investment services and
- imposition of administrative fines.

1. Enforcement of Regulations

With regard to the enforcement of regulations, a distinction amongst administrative proceedings, administrative fine proceedings and criminal proceedings needs to be made.

a) Administrative Proceedings

These proceedings derive from the preventive and general supervisory function of BaFin. They aim at implementing the legislator's requirements by ensuring compliance with the instructions and prohibitions pertaining to capital markets law. In general, BaFin has the competence to request information and documentation from the issuers.

Administrative proceedings are the responsibility of all specialised sections of BaFin and have a remedial purpose. An example of such an administrative act could be the cancellation of a permission that has already been granted. Such proceedings may also entail coercive measures.

b) Administrative Fine Proceedings

These proceedings may be the result of a repressive supervision in case of a public regulatory law infringement. Not only do administrative fine proceedings aim at admonishing norm addressees to fulfil certain requirements, they also have specific-preventive or general-preventive effects. While the specific-preventive effect refers to an individual norm addressee, the general-preventive effect applies to other addressees who are to be reminded to duly meet their obligations in the future.

Administrative fine proceedings are generally initiated for a number of breaches. Similar to public prosecutors, BaFin has substantial investigation competence. Regular sanctions are administrative fines which are imposed by a special section of BaFin. The proceedings are similar to those under criminal law.

c) Criminal Proceedings

These proceedings are initiated in case of certain serious breaches such as insider trading or market manipulation. Possible sanctions are imprisonment or criminal fines.

Criminal proceedings are conducted by public prosecutors and not by BaFin. However, specialised sections of BaFin work in cooperation with public prosecutors.

2. European Influence on National Securities Supervision

The European Securities and Markets Authority (ESMA) is a part of the European System of Financial Supervision. ESMA aims at coordinating the activities of National Securities Supervisors in various fields. Consequently, the European influence on national securities supervision has been increasing gradually.

Thus, national securities supervision has been progressively determined by European Regulations and Directives. The latter have been transposed into German law. Examples of such Directives include the Transparency Directive, the Market Abuse Directive and the Markets in Financial Instruments Directive (MiFID).

Generally, with regard to the European provisions, a shift can be perceived from minimum harmonisation (as usually stipulated by Directives) to maximum harmonisation (as stipulated by Regulations).

III. Bilateral and Multilateral Cooperation

BaFin has been negotiating Memoranda of Understanding (MoUs) with a number of other supervisory authorities. These memoranda are the formal basis for cooperation among the authorities and for the exchange of information as regards credit institutions, investment services enterprises and other undertakings with cross-border activities.

These types of agreement are mostly entered into because the supervised companies are increasingly extending their international reach. MoUs fall into two categories: abstract, general agreements, which are the norm, and institution-specific agreements. Both types of MoUs can either be sector-specific or cross-sectoral.

IV. Financial Reporting Enforcement

A financial reporting enforcement procedure has been in place in Germany since 2005 to monitor compliance of financial statements and management reports of publicly traded companies with the legal requirements.

A two-tier procedure has been established that splits competence for this enforcement between a private body – the German Financial Reporting Enforcement Panel (FREP) – and BaFin, which has sovereign powers. The enforcement procedure is divided into the error identification procedure and the subsequent error publication procedure.

As a rule, examinations are initiated by FREP in three cases:

- examination with cause (FREP has concrete indications to assume a violation of accounting regulations),
- examination on request of BaFin (BaFin has such indications) and
- examination on random sampling basis (without any particular reason).

Because it lacks sovereign powers, FREP relies on the cooperation of the companies it examines. FREP notifies BaFin of the results of the examination and whether the company has confirmed that it agrees with any errors identified by FREP. This completes the examination procedure for FREP.

BaFin only conducts its own error identification procedure if

- it is notified by FREP that a company refuses to cooperate in an examination or does not agree with any errors identified by FREP or
- there are considerable doubts about the accuracy of the results of FREP's examination or about whether FREP has conducted the examination properly.

If the examination conducted by FREP or by BaFin reveals one or more infringements of accounting standards and if these are material individually or in

the aggregate, the examination concludes that an accounting error has been made.

It is within BaFin's remit to order the company to make public the error(s) established by BaFin or FREP in agreement with the company. The publication must be made immediately in the Official Federal Gazette as well as in either a national official stock exchange gazette or by way of an electronic system for the dissemination of information which is broadly used by such companies.

The two-tier enforcement procedure is funded by a levy payable by the companies subject to financial reporting enforcement. The levy is assessed on the basis of their exchange trading volumes. As at 1 July 2016, 615 companies were subject to this enforcement procedure.

BaFin is a member of numerous European and international organizations. International cooperation regarding financial reporting enforcement is within BaFin's remit and is carried out in consultation with FREP.

Enforcement of Financial Information in Germany

Alma Pekmezovic and Rüdiger Veil[*]

I. Introduction

Germany's financial reporting and disclosure framework has been developed to serve a number of important regulatory ends. The law is not only concerned with requiring the provision of timely and accurate financial information, but also with putting in place supervisory arrangements to ensure the transparency and integrity of that information.

This article comments on the enforcement activities undertaken in Germany to ensure that issuers whose securities are admitted to trading or who have applied for admission to trading of their securities on a regulated market comply with applicable financial reporting and disclosure obligations imposed under both national and EU law. The relevant requirements concerning disclosure of financial information are set out under the Transparency Directive (TD), which applies to issuers already listed on a regulated market, and the IAS/IFRS Reg-

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ulation (which deals with financial information of issuers from third countries who use reporting frameworks which have been declared equivalent to IFRS).[1]

The primary purpose of this article is to provide a background to the present supervisory regime in Germany and outline its key features and characteristics. The chapter comments on the objectives, concept and scope of enforcement of financial information in Germany, and also draws attention to the enforcement strategies adopted in other Member States, with a particular focus on the UK. In doing so, the article provides a roadmap to the European supervisory framework and highlights the powers of the national competent authorities (NCAs) in the Member States[2] and other supervisory bodies responsible for undertaking enforcement responsibilities with respect to financial information (collectively known as "European enforcers").

The concept of "enforcement of financial information" as used in this article is taken to refer to: (1) the compliance of financial information with the relevant reporting framework, and (2) the taking of appropriate measures where infringements are discovered during the enforcement process as well as the taking of other measures relevant for the purpose of enforcement. As we shall see, there is a need for a common European approach to the application of the Transparency Directive and the enforcement of financial information across the individual Member States.

II. European Framework

1. The Objective of Enforcement

Enforcement of financial information is regarded as essential to the proper functioning and development of capital markets. Thus, all investors should have equal and timely access to full and comprehensive information released by disclosing issuers and it is important to ensure the accuracy of such information. Inadequate disclosure, i.e. disclosure which fails to comply with relevant financial reporting standards and transparency requirements, has the potential to discourage confident investor participation in capital markets and undermine investor protection. This, in turn, can reduce the liquidity of capital markets and negatively impact on the price discovery process. The purpose of enforcement of financial information, therefore, is to protect investors and promote market confidence by contributing to the transparency of financial information relevant to the investors' decision-making process.

[1] Cf. H. Brinckmann, *Periodic Disclosure*, in: R. Veil (ed.), *European Capital Markets Law*, 2ed ed. (2017), sec. 18 para. 4–5.

[2] The "national competent authority" in Germany is the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). See T. Höppner, *Enforcement by Supervisory Authorities: Concepts and Experiences in Germany*, p. 77 et seq. in this book.

2. European Law

Over the last years Member States have taken different measures and established new mechanisms to ensure the compliance of financial statements with the relevant legal framework.[3] They enacted these regimes in response to corporate governance and accounting scandals in the U.S. (Enron, WorldCom) and Europe (Parmalat and other similar cases) which highlighted the need to strengthen investor confidence in the correctness of financial statements, and improve and reform financial reporting requirements.

Key requirements concerning enforcement standards and mechanisms are found in the Transparency Directive and the IAS/IFRS Regulation. The latter states in its recitals that "a proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets" and requires Member States "to take appropriate measures to ensure compliance with international accounting standards".[4] The Transparency Directive, on the other hand, provides that Member States shall ensure that competent authorities are empowered (i) to examine that information referred to in the Transparency Directive is drawn up in accordance with the relevant reporting framework, and (ii) to take appropriate measures in case of discovered infringements.[5] While the Directive provides for the designation of a competent authority and refers to a central administrative competent authority, it also provides for the possibility of delegating the enforcement function to another body, with the final responsibility for supervision, however, being maintained at the level of the competent administrative authority.

Under European law, Member States are required to establish an enforcement regime[6] but the European legislator has not set any parameters for the specific organisation of such a regime so that the Member States are free to establish their own enforcement system based on either self-regulation, supervision or a mixture of both. This has not changed in recent years though the European legislature has reformed the national sanctioning regimes in capital market law by introducing a minimum set of harsh sanctioning instruments in 2013.[7]

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[3] For an overview of models in different countries cf. H. Hirte and S. Mock, in: H. Hirte and T. M. J. Möllers (eds.), *Kölner Kommentar zum WpHG*, sec. 37n para. 26 et seq.; H. Brinckmann (fn. 1), sec. 18 para. 55–65.

[4] Recital 16 IAS/IFRS Regulation.

[5] Art. 24(4)(h) TD.

[6] S. Kalss et al. (eds.), *Kapitalmarktrecht I*, 2ed. ed. (2015), sec. 15 para. 47.

[7] The sanctioning regime in European capital markets law has undergone a fundamental change in the last years. This reform goes back to the Report of the High Level Group on Financial Supervision in the EU, chaired by J. de Larosière, 25 February 2009. Cf. on the details of the reform R. Veil, *Sanktionsrisiken für Emittenten und Geschäftsleiter im Kapitalmarktrecht*, ZGR (2016), p. 305–328.

3. European Supervisory Convergence

A European harmonisation of enforcement exists in the form of a coordination of European enforcement institutions.[8] European enforcers coordinate a consistent application of the European IAS/IFRS accounting framework through the European Enforcers Coordination Session (EECS), a network advising ESMA on accounting matters.[9] The main activities of the EECS are the following:

- discussing emerging issues submitted by European enforcers or by ESMA;
- discussing decisions and actions taken by European enforcers submitted to the EECS database;
- when relevant issues have been identified as not being covered by financial reporting standards or as being subject to conflicting interpretations, preparing the issues for referral to standard setting or interpretive bodies such as the IASB and the IFRS IC;
- sharing and comparing practical experiences in the field of enforcement such as selection, risk assessment, review methodology, contacts with issuers and auditors;
- selecting and preparing communication of common European enforcement priorities;
- providing advice on enforcement issues and drafting ESMA statements, opinions or guidelines;
- assisting ESMA in conducting studies or reviews on how IFRS is applied in practice;
- advising ESMA on the publication of selected decisions; and
- organising educational sessions for enforcers. [10]

To achieve a common approach on enforcement and a level playing field, it is important to ensure that NCAs and enforcement bodies follow similar practices. ESMA plays an important role in promoting the convergence of enforcement approaches through co-ordinating decisions (both ex ante and ex post) taken by enforcement bodies at national level. In 2014, ESMA published Guidelines on enforcement to ensure effective and consistent enforcement within the European Union.[11]

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[8] For a list of European enforcers see: ESMA, Report on Enforcement and Regulatory Activities of Accounting Enforcers in 2014, 31 March 2015, ESMA/2015/659, p. 29 (Appendix II).

[9] The European Securities and Markets Authority (ESMA) is a European authority based in Paris. It has the task to coordinate and control the NCAs' cooperation (so-called watch-the-watchers-model). See in more detail F. Walla, *Capital Markets Supervision in Europe*, in: R. Veil (ed.), *European Capital Markets Law*, 2ed ed. (2017), sec. 11 para. 54–119.

[10] EECS, Terms of Reference (revised 2013).

[11] ESMA Guidelines on Enforcement of Financial information, ESMA/2014/1293en. These Guidelines are an important instrument to ensure supervisory convergence across the

The NCAs to whom the guidelines apply are generally required to incorporate these into their supervisory practices.[12] Moreover, where enforcement powers have been delegated to other supervisory bodies, the NCAs remain under an obligation to comply with the guidelines. In this regard, it is important to note that the co-ordination and a high-level of harmonisation of actions among enforcement bodies is considered essential for promoting a similar level of investor protection across all Member States in the EU and ensuring the proper functioning of a European Single Market.

The Guidelines consist of 18 Guidelines in total and require European enforcers, amongst other things, to coordinate the enforcement of financial information with ESMA and other European enforcers.[13] Moreover, enforcers should ensure the effectiveness of the enforcement of financial information. In order to do so, they should have sufficient human and financial resources to carry out their activities in an effective manner.[14] Further guidelines require enforcers to ensure adequate independence from government, issuers, auditors, other market participants and regulated markets operators.[15] Independence from issuers and auditors should, amongst other things, be achieved through codes of ethics and through the composition of the Board of the enforcer. Moreover, European enforcers should discuss and share experiences on the application and enforcement of the relevant financial reporting framework, mainly IFRS, during meetings of the EECS.[16] In addition, European enforcers under ESMA's coordination identify common enforcement priorities on a yearly basis.[17] Also, European enforcers should report periodically on the enforcement activities at national level and provide ESMA with the necessary information for the reporting and coordination of the enforcement activities carried out at European level.[18]

EU. Though they are not legally binding, they can be considered as an important element of soft law requiring NCAs to declare whether they comply or not. See in more detail on the legal nature of Guidelines issued by ESMA F. Walla (fn. 9), sec. 11 para. 98–101.

[12] NCAs may declare not to comply with the Guidelines. However, they have to explain this to ESMA who then will publish the fact and the reasons of non-compliance. Cf. Art. 16 (3) ESMA Regulation.

[13] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Guideline 1.

[14] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Guideline 2.

[15] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Guideline 3.

[16] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Guideline 10.

[17] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Ibid.

[18] ESMA Guidelines on Enforcement of Financial Information, ESMA/2014/1293en, Guideline 18.

4. European Enforcers: Powers and Responsibilities

As stated, under the TD, enforcement responsibilities are either carried out by the competent administrative authority designated in each Member Sate and/or in some cases by other bodies which have been designated or have received a delegation for this purpose. Where responsibility is delegated to a delegated body, the latter must be supervised by the competent administrative authority and be responsible to it. The responsibility for enforcement remains firmly with the competent administrative authority, where a delegation has taken place, and the delegated bodies are also required to carry out enforcement activities in accordance with the guidelines issued by ESMA. According to Article 24(4) of the TD, enforcers in all Member States shall have all necessary powers, which shall at least include:

a) the power to examine compliance of financial information in the harmonised documents with the relevant financial reporting framework,
b) the right to require any information and documentation relevant for enforcement at least from issuers and their auditors,
c) the ability to carry out onsite inspections, and
d) the power to ensure that investors are informed of material infringements discovered and provided with timely corrected information.

Almost all Member States have designated a national competent authority as being responsible for the enforcement of financial information. An exception can be found in Germany and Austria where a procedure of dual enforcement has been established.[19]

By comparison, in the U.K. and Ireland enforcement is split between two authorities; one of which deals with periodic financial reports, while the other is responsible for financial information in prospectuses. In Denmark, there is one authority which deals with financial information in prospectuses as well as periodic financial informational of financial entities, and a separate authority has been set up for dealing with periodic financial reporting by non-financial entities.

[19] In 2013, Austria opted for a system of enforcement based on the German model, setting up the Austrian Financial Reporting Enforcement Panel (AFREP) which carries out a similar role to that FREP. The second layer of review is carried out by the Austrian regulatory agency. See in more detail S. Kalss et al. (fn. 6), sec. 15 para. 65.

III. The German Two-Tier Enforcement Regime

1. Overview

The applicable framework in Germany has been in place since 1 July 2005 and was introduced by the German Financial Reporting Enforcement Act (*Bilanzkontrollgesetz* – BilKoG), which came into force in December 2004. The latter Act forms the basis of the German reporting framework and adopts a dual enforcement system. A key feature of this framework is a two-tiered procedure involving a private and a supervisory enforcement institution:

1) The first tier involves the private enforcement institution, the Financial Reporting Enforcement Panel (FREP) which examines financial statements on either (i) a random sampling basis, or (b) with cause, if there are concrete indications of an infringement of financial reporting requirements, or (c) at the request of BaFin.[20]
2) The second tier involves review by the supervisory authority BaFin. However, BaFin participates in the enforcement proceedings at the second tier level only if an issuer does not participate willingly in the examination conducted by FREP or does not agree with the findings of FREP. Moreover, BaFin would only conduct a review where a company expresses substantial doubts about whether the findings of FREP are correct or whether the examination was conducted properly.[21] In these circumstances, BaFin is entitled to decide on the infringement of financial reporting requirements by order and also to order the publication that the financial statement was incorrect.[22]

The respective statutory provisions of the German Trade Act and German Securities Trading Act do not explicitly regulate the prerequisites for a decision by BaFin. The OLG Frankfurt (Higher regional court), however, ruled that BaFin is only entitled to decide on the infringement by order if accounting law provisions have been *materially* infringed.[23] Relevant for the question whether infringements reach the level of materiality shall be the perspective of an investor on the capital markets.[24]

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[20] Sec. 342b (2) HGB (German Trade Act).
[21] Sec. 37o WpHG (German Securities Trading Act).
[22] Sec. 37p WpHG (German Securities Trading Act).
[23] OLG Frankfurt, 22 January 2009—WpÜG 1/08 and 3/08, ZIP (2009), p. 368, 369.
[24] OLG Frankfurt, 22 January 2009—WpÜG 1/08 and 3/08, ZIP (2009), p. 368, 371.

2. The First Layer of Review: FREP

a) Organisation Structure

In terms of governance structure, the FREP consists of a Governing Board (which comprises five members), the Enforcement Panel, Management and the Nomination Committee. Members of the FREP Enforcement Panel are required to be accounting professionals with sufficient experience in IFRS. A Nomination Committee is responsible for electing the members to the FREP for a period of four years initially, subject to further re-election. The Enforcement Panel consists of 18 members, including the President and Vice-President of the FREP. The President has the responsibility for representing FREP externally and for managing the body.

It is important to note that the FREP is a private sector body lacking formal executive powers. The main task of FREP is to determine whether financial statements provide a true and fair view of the company's financial performance.[25] To this end, FREP is empowered to ask companies to submit information to FREP on a voluntary basis. However, where companies fail to do so, FREP can refer cases to BaFin and thus ensure enforcement.

b) Scope of Review

The FREP only examines financial statements if the company under examination is willing to cooperate with it. Accordingly, the examination procedure of FREP is based on cooperation. If an issuer is not willing to cooperate, FREP will notify BaFin to initiate a formal examination proceeding.[26]

FREP has the power to examine the legality of the most recently adopted annual financial statements or the approved consolidated financial statement and the related interim management report of any company whose securities are admitted to trading on the regulated market of any domestic exchange. In addition, FREP has responsibility for examining half-yearly financial reports. However, this obligation only applies where there are specific grounds for doing so.[27]

The examination conducted by FREP is generally a partial review only, and will not extend to all accounting issues in a financial report, as this is the case in a statutory audit.[28]

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[25] Cf. sec. 342b (2) HGB (German Trading Act).
[26] Cf. sec. 342b (6) HGB (German Trading Act).
[27] Cf. sec. 342b (2) HGB.
[28] Cf. B. P. Paal, in: K. Schmidt and W. F. Ebke (eds.), *Münchener Kommentar zum Handelsgesetzbuch*, 3rd. ed. (2013), sec. 342b HGB para. 19–21.

c) Examination with Cause

An examination with cause is conducted if there are concrete facts to indicate possible violations of financial reporting standards, or following a referral by BaFin. BaFin has the power to instruct the FREP to initiate an investigation and can also define the scope of such an investigation.[29] This is referred to as *reactive* enforcement.

d) Random Sampling

Random sampling carried out by the FREP Enforcement Panel is based on a risk-based approach (*proactive* enforcement). The latter consists of two stages. First, the Panel will consider the information that is publicly available about an issuer and also consider if there are any special risks which would justify further review, for example, extraordinary transactions carried out by the issuer or the issuer being listed for the first time. Based on this review, the FREP randomly selects 30 percent of companies and in the second stage may base its selection on specific focus area. During the second stage, the FREP will distinguish between companies included in the DAX, MDAX, SDAX, or TecDAX index of the Frankfurt Stock Exchange; with the latter typically examined on average every four or five years, whereas smaller listed firms are examined only once every ten years.

The FREP can base its selection on specific focus areas, and will publish its focus areas on a yearly basis.[30] Generally, a decision will be made with respect to relevant focus areas depending on frequently recurring errors as well as anticipated challenges with particular accounting rules or interpretations. In the event of a referral, FREP will focus on particular transactions in questions suspected to be erroneous, whereas the scope of investigations in random selections is likely to involve a broader examination.

The examination process conducted by FREP consists of the following steps:

1. Initiation of examination: This can be either with cause, BaFin request or random sampling.
2. Examination: A first analysis is then undertaken by FREP, and the company in question can provide first answers. This leads to further examination by FREP, and further answers provided by the company. Furthermore, FREP may consult with the company in question.
3. Conclusion of examination: FREP will prepare its conclusions, and provide these to the company for comment.

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[29] Cf. sec. 37p (1) WpHG (German Securities Trading Act).

[30] Cf. FREP, Enforcement Priorities 2017, available at http://www.frep.info/docs/pressemitteilungen/2016/20161103_pm_en.pdf.

4. A subsequent examination by BaFin may be triggered, if the company either does not agree with the results of FREP, or failed to cooperate with FREP. Also, where BaFin has doubts about the examination results or procedure it may take over an investigation from FREP.

3. The Second Layer of Review: BaFin

BaFin is empowered to require firms to disclose error findings in a specified press release via an electronic federal registry (*elektronischer Bundesanzeiger*).[31] Moreover, publication has to occur at least via a multi-regional financial newspaper or an electronic business wire service. Requiring publication of error findings relies on adverse disclosure as a sanctioning mechanism. The intended effect is to "name and shame" companies which fail to comply with relevant standards and financial disclosure obligations. Infringing companies cannot include additional comments or explanations when making an error announcement, but can only include the findings of BaFin or FREP. They must disclose the accounting error in question, as well as the explanatory statement of BaFin. The announcement is intended to provide disclosure as to the nature and gravity of reporting errors, as well as the accounting standards which were breached.

With the exception of adverse disclosure, no other sanctioning mechanisms are utilised. Thus, the German enforcement system entirely depends on the negative effects of disclosure and the reaction of the capital market participants to the news of a company failing to comply with financial reporting requirements.[32] BaFin, however, is empowered to impose a fine of up to €250,000 where a company fails to comply with the disclosure obligation. BaFin can also carry out the publication at the expense of the company. Failure to disclose also constitutes an offence punishable up to €50,000.

In some circumstances BaFin may exempt a company from error publication, such as where this would be against the public interest, or if a company can show that the publication of the error finding is likely to damage its legitimate interests. This may occur where a company has a legitimate interest in keeping the information confidential. However, a legitimate interest would not exist where a company is able to point only to the negative reputational effects of the disclosure, or the loss of investors' trust in the company's financial reporting integrity.

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[31] Cf. sec. 37q (2) WpHG (German Securities Trading Act).

[32] However, different measures of private enforcement apply. In case of a deficient financial report, investors are entitled to sue the issuer and claim damages (cf. H. Brinckmann (fn. 1), sec. 18 para. 69–70). Moreover, shareholders have the right to file a suit against the resolution of the shareholders meeting adopting the financial statement.

4. The Role of AOC and the Chamber of Public Accountants

Where BaFin or FREP uncover material infringements, they will inform the audit oversight bodies AOC (Auditor Oversight Commission) and the Chamber of Public Accountants WPK (Wirtschaftsprüfkammer) of this. WPK is a government agency that is publicly overseen by AOC. Its members comprise public accountants, auditors as well as partners, directors and mangers of audit firms. Membership in the WPK is regulated by the Public Accountant Act. The main task of AOC is to monitor the activities of WPK and its members.
Moreover, a referral to the relevant prosecution authority may be necessary, where the examination results in a suspicion of criminal activity.
In addition, BaFin collaborates with the following bodies: the International Organisation of Securities Commission (IOSCO) which sets international standards for securities supervision and promotes cooperation between national regulatory bodies; the Financial Stability Board; the Basel Committee; the International Organisation of Pension Supervisors and the Financial Action Task Force on Money Laundering.

IV. The Role of the Conduct Committee in the United Kingdom

In the United Kingdom, the Conduct Committee has been set up to enforce financial information. The Committee is part of the Financial Reporting Council (FRC) – UK's regulator for corporate reporting, auditing and corporate governance. As of 2 July 2012, the Conduct Committee has been appointed and authorised by an order of the Secretary of State to exercise the functions of an enforcement body.[33]

The Conduct Committee's scope includes (a) reports required to be issued under the UK Companies Act (2006) and (b) reports that are produced by issuers of listed securities that are required to comply with any accounting requirements imposed by the Financial Conduct Authority's Listing Rules.[34] The Conduct Committee's policy is to select Reports for review by (a) methods which take into account the Conduct Committee's assessment of the risk of non-compliance and the consequence of non-compliance, and (b) as a result of complaints. [35] The Committee relies on a risk-based approach, selecting listed companies for review which operate in "priority sectors" that may be subject to particular risk.

[33] The Supervision of Accounts and Reports (Prescribed Body) and Companies (Defective Accounts and Director's Reports) (Authorised Person) Order 2012, S.I.2012 No. 1439.

[34] As defined in sec. 103(1) of the Financial Services and Markets Act 2000.

[35] The Conduct Committee, Operating procedures for reviewing corporate reporting, October 2014, available at: www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Revised-operating-procedures-for-reviewing-corpora.pdf, para. 3.

The Conduct Committee initiates an examination in case of indications for a potential breach of relevant accounting or reporting requirements.[36] Before a formal enquiry is initiated the Conduct Committee tries to reach an amicable solution in cooperation with the company. If this is not possible, a formal enquiry is opened and a Review Group appointed.[37] After that the Review Group tries to find out in cooperation with the examined company whether relevant accounting or reporting requirements have been breached and if this is the case tries to reach an agreement with the company on the corrective or clarificatory action. If the Review Group cannot reach an agreement with the company the Conduct Committee may resolve on the application to court.[38]

The Conduct Committee is not entitled to impose fines or other sanctions. It is working on a cooperative and voluntary basis with the company although the Conduct Committee enjoys rights on information vis-à-vis the company.[39] Nevertheless, there is a considerable pressure on companies to cooperate with the Conduct Committee during its examination because the Conduct Committee may bring its examination to the attention of the public via a press notice.[40] The possibility of such a notice has a high disciplinary effect on companies.

V. Evaluation

A number of observations can be made when evaluating the German financial reporting enforcement regime. First, the characteristic feature of the German hybrid model of enforcement is that it relies on both public enforcement (the securities regulator, BaFin) as well as a private sector body (the FREP) in the enforcement process. The advantage of such an approach is the ability to utilize the extensive technical expertise of a private sector body, while at the same time delegating primary enforcement responsibility to a government entity.

Second, the most important regulatory role of BaFin in this context is to ensure the disclosure of error findings established by FREP or BaFin. As shown in this article, such an approach is predicated upon adverse disclosure acting as a deterrent. It relies on naming and shaming as a principle means to secure compliance and depends on negative investor reactions to published findings of erroneous accountings to penalize infringing firms. It is important that BaFin explicitly requires infringing firms to refrain from adding any comments or

[36] The Conduct Committee, Operating procedures for reviewing corporate reporting, October 2014, available at: www.frc.org.uk/Our-Work/Publications/Corporate-Reporting-Review/Revised-operating-procedures-for-reviewing-corpora.pdf, para. 16.

[37] The Conduct Committee, Operating procedures (fn. 36), para. 25.

[38] The Conduct Committee, Operating procedures (fn. 36), para. 38. A decision of the court is based on sec. 456(1) Companies Act 2006.

[39] Cf. sec. 459 Companies Act 2006.

[40] The Conduct Committee, Operating procedures (fn. 36), para. 62 et seq.

observations in the error announcements, which are required to provide a detailed insight into the nature and magnitude of the breaches of the respective accounting standards in question.

Third, the German enforcement model has evolved in response to regulatory changes within the EU. Moving forward, it remains to be seen whether the current structure will be redesigned in light of attempts at European level to create common standards on financial enforcement that would apply across the European Single Market. One of ESMA's policy objectives has been to harmonize the legal requirements in the Member States with respect to enforcement of financial information. This would result in issuers and other market participants being subject to an equivalent enforcement system across the EU. However, it is unclear whether any such future regulation or harmonization attempt at European level would necessarily gravitate towards a particular enforcement system currently applied within a Member State. The enforcement systems in place across EU Member States – including both two-tier enforcement structures and one-tier structures – generally result in high levels of enforcement and have evolved in response to differing legal environments and unique national characteristics. Moreover, there is a high level of mutual cooperation and communication amongst national law enforcement agencies and ESMA. As shown in this chapter, ESMA has developed a comprehensive and detailed set of guidelines to coordinate enforcement. This, in turn, assures high levels of harmonization and consistent enforcement within the European Single Market.

In order to ensure maximum harmonization, however, and develop a distinctively common European approach to the enforcement of financial information, further research would be required to gain insights on the comparative advantages of various enforcement regimes laid down in the Member States and the costs and benefits of each.[41] As an alternative to introducing uniform enforcement systems across the EU, the European regulator may therefore opt to maintain the co-existence of different enforcement systems as is presently the case. This would take account of the variations in enforcement structures and allow room for differences in institutional design attributable to national characteristics. Concurrently, this would not detract from ESMA's oversight function and its prime role in supporting the cooperation between European enforcers, co-ordinating their enforcement actions and setting common enforcement priorities as part of the enforcement process.

Finally, it is noteworthy that the two-tier enforcement set-up in place in Germany has received broad support within German academic literature,[42] by pol-

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[41] Cf. H. Brinckmann (fn. 1), sec. 18 para. 80.

[42] Cf. B. Pellens, J. H. Sohlmann and P. Obermüller and S. Riemenschneider, *Evaluation der Arbeit der DPR*, WPg (2012), p. 535, 546; P. Hommelhoff and D. Mattheus, *Ist das deutsche Enforcement-Verfahren europarechtskonform*?, BB (2014), p. 811, 812; H.-J. Böcking,

icy makers[43] and by practitioners.[44] There is a consensus that the prevailing enforcement regime operates well in practice and meets the objectives of enforcement, i. e. it ensures high levels of investor protection and public confidence in the integrity and stability of financial markets.

Redebeitrag anlässlich der Jubiläumsfeier am 3. Juli 2015, in FREP, 10 Jahre Bilanzkontrolle in Deutschland (2005 bis 2015), p. 76, 79.

[43] See Dr. H. Weis and Dr. L. Holle, Letter to the Chair of ESMA (17 October 2013), available at https//www.esma.europe.eu (last accessed 4 January 2017): "Deutschland verfügt über ein anerkanntes und gut funktionierendes zweistufiges Enforcement-System, mit dem eine effektive Bilanzkontrolle sichergestellt wird."; H. Maas, *Redebeitrag anlässlich der Jubiläumsfeier am 3. Juli 2015*, in FREP, 10 Jahre Bilanzkontrolle in Deutschland (2005 bis 2015), p. 59, 61: "Wir wollen das bewährte zweistufige System der Bilanzkontrolle erhalten".

[44] Cf. H. Meyer and K.-P. Naumann, *Enforcement der Rechnungslegung – aktuelle Entwicklungen*, WPg (2009), p. 807, p. 808; M. Hein, *Fünf Jahre Enforcement bei der BaFin – Eine Bestandsaufnahme*, DB (2010), p. 2265, 2270.

Collective Action and Private Enforcement under the German KapMuG – A Comparative Evaluation

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I. Introduction

Legal prosecution of wrongful behaviour is essential for the enforcement of the law. If disregarding legal duties is not properly sanctioned, regulation cannot deter harmful and illegal actions.[1] This means that those who break the law have a significant and unfair advantage over law-abiding competitors.[2] In the case of mass torts and dispersed damages, the injured parties often do not bring action before the court. A recent study in Germany, for example, has shown that most private parties will only sue if the financial damages they have sustained exceed €1.950.[3] As a result, the deterring effect of liability for wrongful behaviour cannot unfold to its full extent. Collective action aims at increasing the amount of wrongful behaviour that is prosecuted.

Effective private enforcement saves public resources as less supervision by official authorities is required. Prosecution is placed in the hands of the market actors thereby strengthening liberalism. The private enforcement of legally mandated behaviour by means of a collective action can take on many different forms. The three most prominent types of collective action are: (1) model case proceedings under the German KapMuG, (2) class actions, and (3) representative actions.[4] This paper will outline their main characteristics. We will focus on the similarities and differences of these types of legal action in order to show that each form of collective action has its merits, but also has striking disadvan-

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[1] If the injured always brought suit for harm, the injurer's expected liability would equal the expected harm. From a law and economics point of view, the injurer would be compelled to choose optimal levels of activity. In other words, liability has a deterrent effect on negligent behaviour; cf. S. Shavell, *Corrective Taxation versus Liability*, in: H. Curti and T. Effertz (eds.), *Die ökonomische Analyse des Rechts, Festschrift für Michael Adams* (2013), p. 23; D. Poelzig, *Normdurchsetzung durch Privatrecht*, p. 250.

[2] A recent prominent example is Volkswagen's emissions scandal caused by a manipulation of equipment via software that reduced emissions while cars were being tested. Automobile producers who illegally manipulated their equipment have an advantage over those producers who did not circumvent emission limits. Investors who hold shares of Volkswagen have now sued the company for damages, as the stock prices have sunk. By April 2016, over 70 individual claims have been filed with the regional court in Braunschweig. Most claimants and the defendant Volkswagen have demanded the establishment of model case proceedings.

[3] Survey conducted by the opinion research institute: Insitut für Demoskopie Allesbach, *Roland Rechtsreport* (2014), p. 35 et seq. can be accessed online: https://www.roland-rechtsschutz.de/media/rechtsschutz/pdf/unternehmen_1/ROLAND_Rechtsreport_2014.pdf.

[4] For other forms of collective redress in Germany cf. the evaluation of the effectiveness of collective redress in Germany by C. Meller-Hannich and A. Höland, *Gutachten Evaluierung der Effektivität kollektiver Rechtsschutzinstrumente* (2010); W.-H. Roth, *Sammelklagen im Bereich des Kartellrechts*, in: M. Casper, A. Janssen et al. (eds.), *Auf dem Weg zu einer europäischen Sammelklage?* (2009), p. 109 et seq.; P. Rott, *Kollektive Klagen von Verbraucherorganisationen in Deutschland*, in: M. Casper, A. Janssen et al. (eds.), *Auf dem Weg zu einer europäischen Sammelklage?* (2009), p. 259 et seq.; C. Alexander, *Kollektiver Rechtsschutz im Zivilrecht und Zivilprozessrecht*, JuS (2009), p. 590 for an overview of collective redress in civil law.

tages. In fact, no existing scheme of collective action is by itself preferable. We will, therefore, discuss whether the planned reform of collective action in Germany is a viable alternative because it aims to combine positive aspects of model case proceedings and representative actions.

II. Model Case Proceedings in Germany

1. Characteristics

a) History of Origin

The general concept of the civil procedure in Germany is that of individual proceedings where one party raises a claim against another party. According to the "principle of party disposition" it is up to the parties and not the court to exercise control over the legal proceedings.

In practice, however, the concept of individual proceedings has its limitations. As previously mentioned, this is in particular the case where it makes no sense, from an economic perspective, for an individual person to initiate litigation. This is especially so in capital markets where the damages incurred by wrongful behaviour are usually spread over many individual investors (mass torts). Also, in these cases the damage each investor has suffered is often so insignificant that the victims lack incentive to sue the tortfeasor (low value damages of less than €1.950). Therefore, each investor has to decide for himself if he wants to take on the risks entailed in every litigation; especially if his damages appear insignificant to him.

However, even if the investors choose to claim redress of their damages there is another challenge legal proceedings have to overcome. One instructive example for this challenge is the *Telekom-Case*. Deutsche Telekom is a German telephone company that was state-owned until the nineties. After the initial public offering (IPO) of its stock and the burst of the dot-com bubble in 2000/2001 more than 17 000 individual suits were filed by investors at the Regional Court in Frankfurt (*Landgericht [LG]* Frankfurt) between 2001 and 2002 because of false or misleading public capital markets information (prospectus liability). Three years after the filing of the suits, the court had not yet scheduled a date for a single court hearing[5] because there was only one judge responsible for all these cases.[6] However, the constitutional right of effective legal protection

[5] F. Braun and K. Rotter, *Der Diskussionsentwurf zum KapMuG*, BKR (2004), p. 296.

[6] In order to prevent arbitrary judgments, German constitutional law provides that "no one may be removed from the jurisdiction of his lawful judge", Art. 101(1) (2) German Basic Law (Grundgesetz). Thus, the courts determine beforehand, which judge is responsible for each case. This is effected by establishing a Geschäftsverteilungsplan, i. e. the President of the Court decides on a general characteristic which will then be used to distribute all incoming

(Art. 19 (4) German Basic Law) calls for a reasonable duration of proceedings. This constitutional right has been extremely strained in these cases, as noted by the *Bundesverfassungsgericht*, our Federal Constitutional Court.[7]

As a result of these experiences and in order to handle this "tsunami" of lawsuits, the German legislator passed the *Kapitalanleger-Musterverfahrensgesetz* (KapMuG) which can be translated as "Act on Model Case Proceedings in Disputes under Capital Markets Law".[8] It could also be called: "The German Class Action Act *light*". As we will see shortly, however, it is not a real class action. The Act came into force in November 2005 and contained a sunset clause, applicable after five years. Yet, after five years, the Telekom-Case was still ongoing and the sunset clause was extended for another two years. After several legislative amendments in 2012, it was again extended until 2020. The Telekom-Case is still ongoing and for the near future, there is no end in sight[9].

The legislator's aim was to change the general civil procedure law only so far as necessary. The general principle therefore remains that each investor has to claim his own damages. However, in addition to the individual proceedings, the *KapMuG* introduced separate model case proceedings. This means that the legal questions of the individual proceedings, which refer to the same subject matter, can be tried separately in model case proceedings.[10]

b) The Complex Procedure of Model Case Proceedings

Compared to individual litigation, model case proceedings based on the KapMuG differ in various aspects, specifically, with regard to the scope of application, the court jurisdiction and its procedure.

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cases between the judges of the court. For example: Judge X will be responsible for all cases in which the defendant's last name starts with an "A".

[7] BVerfG, 27 July 2004 – 1 BvR 1196/04, NJW (2004), p. 3320.

[8] Kapitalanlegermusterverfahrensgesetz, Act on Model Case Proceedings in Disputes under Capital Markets Law. A translation provided by the German Ministry of Justice and Consumer Protection can be accessed online: http://www.gesetze-im-internet.de/englisch_kapmug/index.html.

[9] In the meantime, the Higher Regional Court Frankfurt had given a verdict in the model case proceedings: OLG Frankfurt a.M., 16 May 2012 – 23 Kap 1/06, NZG (2012), p. 747. The court held that the prospectus was not false. Both the model case claimant and the defendant challenged this verdict and appealed to the Federal Court of Justice (BGH). The BGH in turn held that the prospectus was in fact partially false, BGH, 21 October 2014 – XI ZB 12/12, NJW (2015), p. 236. He redirected the model case proceedings to the Higher Regional Court Frankfurt for further fact finding and legal evaluation.

[10] Government's reasoning BT-Drs. 15/5091, p. 1.

2. Scope of Application

The KapMuG's scope of application is very limited. Model case proceedings are restricted to certain claims arising under capital markets law. This includes claims for damages due to false or misleading public capital markets information or failure to offer clarification about the false or misleading nature of public capital markets information (sec. 1 (1) (1) no. 2 KapMuG). This relates especially to false indications in sales prospectuses.

3. Jurisdiction for Model Case Proceedings

The concentration and aggregation of similar cases is achieved mainly by allocating the jurisdiction for model case proceedings at a certain court in Germany. The court of first instance for all claims for damages due to misleading capital markets information is the regional court (*Landgericht*), sec. 71 (2) no. 3 GVG[11]. The specific regional court which is responsible depends on the location of the issuer's seat, sec. 32b (1) (1) ZPO[12].

However, the advantage of this concentration is to some extent diminished by the *Geschäftsverteilungsplan* (organizational rules at each regional court).[13] These rules can potentially allocate the applications for the establishment of a model case to different chambers of the same court.[14] The KapMuG does not include a provision which overrules these organizational rules. This can lead to the situation where two or more chambers of the same Court deal with the same facts[15] and even worse, to them eventually deciding the facts in different ways.

4. Stages of the Procedure

As mentioned above, model case proceedings do not release the individual investor from his obligation to claim his damages in an individual litigation. This has to be distinguished from the model case proceedings in which specific questions that are common to all cases can be resolved by means of the model case procedure.

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[11] German Courts Constitution Act ("Gerichtsverfassungsgesetz"). A translation provided by the German Ministry of Justice and Consumer Protection can be accessed online: https://www.gesetze-im-internet.de/englisch_gvg/index.html.

[12] German Code of Civil Procedure (Zivilprozessordnung). Translation can be accessed online: https://www.gesetze-im-internet.de/englisch_zpo/index.html.

[13] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2710; see also fn 6.

[14] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2706.

[15] N. Stackmann, *Kein Kindergeburtstag -Fünf Jahre Kapitalanleger-Musterverfahrensgesetz*, NJW (2010), p. 3185, 3189.

a) Application for Establishment of a Model Case

An application for the establishment of a model case can be undertaken by the plaintiff and the defendant (sec. 2 (1) KapMuG) by initiating submission proceedings at the regional court. Therefore, model case proceedings cannot be initiated *ex officio*. If the application is admissible (sec. 3 (1) KapMuG), the regional court will publish the application for the establishment of a model case in the so-called Complaint Registry (sec. 3 (2) KapMuG). The main proceedings are therefore interrupted (sec. 5 KapMuG). The model case will be established at the next higher court, the higher regional court (*Oberlandesgericht*), if nine additional, similar applications have been publicly announced (sec. 6 (1) KapMuG).

After the establishment of the model case, all pending individual proceedings or any proceedings initiated from then until the model case ruling is legally binding are formally suspended *ex officio* by the regional courts, if the outcome of these cases depends on the claimed establishment objective (sec. 8 (1) KapMuG). Therefore, the clarification of the relevant legal questions is reserved for the model case proceedings. If the investor does not abandon his individual action (and thus effectively forfeits his claim), the higher regional court's verdict is binding.[16] This seems to be a substantial limitation of the constitutional right of effective legal protection and fair hearing (Art. 19 (4) *Grundgesetz* – German Basic Law). The legislator justifies this constitutional limitation through the streamlining of procedures.[17] However, there is some inconsistency: while the time the regional court may take to decide about the admissibility of an application to establish a model case is limited (6 months, sec. 3 (3) KapMuG), the KapMuG provides no processing period for the reference to the higher court. If it had been a real concern for the legislator to shorten the procedures, he should have set a time limit for the reference to the higher court as well[18] because the regional court has no incentive to speed up this decision on its own volition.

b) Model Case Proceedings

The model case in its proper sense takes place at the higher regional court (*Oberlandesgericht*). First, the court designates by order, as appears equitable, a model case plaintiff from among the plaintiffs whose proceedings have been suspended. The other plaintiffs of the individual cases which are part of the

[16] He could abandon his individual litigation (sec. 8 (2) KapMuG), however, then his claim would be subject to the statute of limitation. By the time the model case proceedings are over, his claim would likely be time-barred, because he cannot register his claim at the higher regional court. This option is reserved for investors who had not sued the defendant prior to the establishment of Model Case Proceedings (sec. 10 (2) (2) KapMuG).

[17] Government's reasoning BT-Drs. 17/8799, p. 15.

[18] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2707.

model case proceedings cannot become a plaintiff in the model case. They only have the status of an intervening party in the model case (sec. 9 (3) KapMuG). Although these plaintiffs do not have the same rights as the model case plaintiff, they can employ all means of contestation or defence and undertake all relevant procedural acts, as long as their statements and actions are not contrary to the statements and actions of the model case plaintiff (sec. 14 KapMuG).

On the other hand, if there are several defendants, the Court will not choose one as a model case defendant. All defendants of the suspended proceedings are defendants in the model case. They form a so-called "joinder of parties" (*Streitgenossenschaft*).[19] Because the joinder of parties can lead to a high number of defendants (especially since the liability for misinformation has been extended to consultants), commentators have proposed that there should be the same selection for one model case defendant as one the plaintiffs' side.[20] However, such a selection would not be feasible because the defendants (issuer and consultant) probably do not share the same interests.

Once the model case proceedings have been publicly announced (sec. 10 (1) KapMuG) other damaged parties can join within six months[21] (registration of a claim) without the obligation to file an individual case beforehand (sec. 10 (2) KapMuG). The effect of this registration is the suspension of the limitation period. Therefore, the registration of a claim is a very investor-friendly option because they can participate in the advantages of a model case without great effort or expense.[22] However, the registration of a claim is not possible if an investor has already filed a suit. In this case, he has already become an intervening party to the model case proceedings. Even if the victim abandons his individual suit and thus leaves the model case he still cannot register his claim. Thus, he cannot circumvent the legal costs an intervening party to the model case has to bear.[23]

The higher regional court decides on the specific legal questions that have been posed. It can review evidence on these questions. The model case proceedings can end with a judgment by the court (sec. 16 KapMuG) against which an appeal on a point of law can be submitted to the Federal Court of Justice (sec. 20 (1) KapMuG). In addition to this judgment, the proceedings can also end with a settlement.

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[19] Government's reasoning BT-Drs. 17/8799, p. 21; sec. 59 et seq. of the German Code of Civil Procedure.

[20] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2709.

[21] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2705, sceptical about the short time period.

[22] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz,* BB (2012), p. 2703, 2705; S. Smid and N. Mohr, *Die Novelle des KapMuG*, DZWIR (2013), p. 343, 348.

[23] Government's reasoning BT-Drs. 17/10160, p. 26.

c) Conclusion of Model Case Proceedings

If the model case results in a verdict, the main proceedings will be continued at the regional courts. The higher regional court's decision is binding to the extent of the establishment objectives of the model case proceedings (sec. 22 (2) KapMuG). It has an effect for and against all parties to the model case irrespective of whether the party itself has expressly complained of all the points of dispute in the model case proceedings. Even plaintiffs who withdrew their complaint in the main proceedings are included (sec. 22 (1) KapMuG). This serves to protect the defendants[24] and ensures the "bundling effect" of model case proceedings.[25]

However, it must be stressed that any binding effect of the model case ruling concerns only proceedings that had been suspended. It does not affect cases brought before a regional court after the model case ruling has been given, even if the same legal questions arise.[26] Likewise, the binding effect of the ruling does not affect the "victims" who only registered their claim without actually suing. The only effect the model case proceedings have for them is the suspension of the limitation period.[27]

A settlement is negotiated solely between the model case plaintiff and the model case defendants (sec. 17 (1) KapMuG) although its binding effect extends to all parties of the model case proceedings in general. Nevertheless, the settlement needs the approval of the court (sec. 17 (1) KapMuG) which is only given if the court deems it to be a suitable amicable settlement of the suspended legal dispute (sec. 18 (1) KapMuG).[28] The other plaintiffs can only give their opinion on the settlement. If they do not want to accept the settlement, they can declare their withdrawal from the settlement within a period of one month after the settlement has been served (sec. 19 (2) KapMuG). Their individual proceedings will then be continued where they had left off before they were suspended. The approved settlement will take effect if less than 30 percent of the investors who individually sued declare their withdrawal from the settlement (sec. 17 (1) (4) KapMuG). The victims who only registered their claims are not affected by the binding effect of the settlement.

Finally, it must be highlighted that the settlement does not only terminate the model case proceedings, but also the individual proceedings of each investor

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[24] Government's reasoning BT-Drs. 15/5091, p. 31.

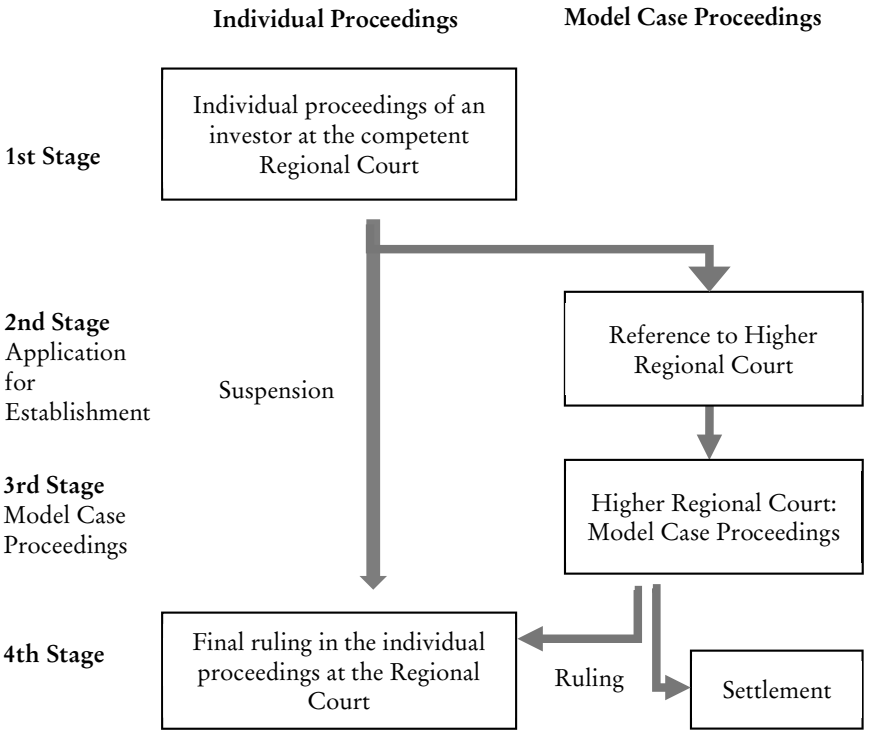
[25] B. Hess, in: B. Hess, F. Reuschle and B. Rimmelspacher (eds.), *KölnerKommKapMuG*, sec. 16 n 23.

[26] C. Wolf, in: V. Vorwerk and C. Wolf (eds.), *KapMuG*, sec. 16 n 4.

[27] Explicitly government's reasoning BT-Drs. 17/10160, p. 25.

[28] Doubtful regarding the courts ability to assess the appropriateness of a settlement because of the divergence of interests: B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2705, 2711; S. Smid and N. Mohr, *Die Novelle des KapMuG*, DZWIR (2013), p. 343, 349.

(sec. 23 (2) & (3) KapMuG). Therefore, the settlement offers an attractive opportunity for the defendants to put an end to all legal disputes at once.



5. Empiric Evidence – or Lack Thereof

At the moment, there are 11 model cases listed as still pending in the complaint registry, including the two spectacular cases of *Telekom* and *Geltl vs. Daimler,* which began in 2005 and 2006 respectively. Besides that, we have 15 new applications for the establishment of a model case. It is not yet clear whether there will be a model case established in these cases. Unfortunately, the complaint registry does not show how many applications have been denied in the past. At the moment, there are only 4 model case proceedings listed as concluded although some older rulings could have been already deleted (see sec. 4 (2) KlagRegV[29]). Due to the courts' duty to delete completed cases from the complaint registry, empirical evidence on the effectiveness of model case proceedings cannot be collected and evaluated.

[29] "The court which is responsible for the registration shall delete the published data in the complaint registry immediately after the model case ruling became legally binding".

One could argue that the success of the KapMuG cannot be measured in the total number of cases in any event but only in the number of individual cases that have been resolved in faster and/or cheaper manner. There are, unfortunately, no studies on this to date. However, considering the *Telekom* and the *DaimlerChrysler* cases,[30] the assumption that the model case proceedings do not offer a substantial gain in time is warranted. To date, six court rulings have been given in the *DaimlerChrysler* case (including one of the CJEU), but neither the model case nor the individual cases have been resolved within the ten years since the individual cases were filed. It is true that the *DaimlerChrysler* case is somewhat extreme in this regard but it provides an impression of how extensive model case proceedings can be in such complex matters.

6. Legal Evaluation

A legal analysis of the German Model Case Proceedings Act shows several advantages and disadvantages. We will demonstrate that the disadvantages outweigh the advantages, which leads to the conclusion that the model case proceedings should be revised.

a) Advantages of Model Case Proceedings

The fact that the legislator did face the demand for collective redress at the capital markets in the first place is a step in the right direction. Empowering the individual investors by placing the enforcement of prudent behaviour in their hands allows for less public enforcement and regulatory interventions which in turn leads to a better allocation of public resources.

The legislator decided to design collective redress in the form of model case proceedings instead of simply adopting the US class action model[31]. There are several advantages of model case proceedings over individual proceedings. Model case proceedings can lower the overall costs of proceedings because expensive types of evidence, e.g. expert witness reports, need only be procured once. Only one court is required to review this evidence which saves time and money. Another advantage of model case proceedings is the *erga omnes* effect. The higher regional court's decision is binding on all suspended individual cases that have been filed before or during the model case proceedings. This means that court rulings become more uniform which increases legal certainty and fairness. This uniformity of law results in an equal treatment of all investors which promotes their right of fair trial.

[30] OLG Stuttgart, 15 February 2007 – 901 Kap 1/06, WM (2007), p. 595; BGH, 25 February 2008 – II ZB 9/07, WM (2008), p. 641; OLG Stuttgart, 22 April 2009 – 20 Kap 1/08, WM (2009), p. 1233; CJEU, 28 June 2012 – C-19/11, NJW (2012), p. 2787; BGH, 23 April 2013 – II ZB 7/09, NJW (2013), p. 2114.

[31] For further detail see chapter III.

b) Disadvantages of Model Case Proceedings

In our opinion, however, the disadvantages prevail. The damaged parties' procedural rights (Art. 101 (1), 103 (1) German Basic Law; Art. 6 (1) European Convention on Human Rights) are incredibly limited. Individual claimants who are not the model case plaintiff only have the status of an intervening party, they cannot act contrary to the plaintiff. They are nevertheless bound by the court's decision in the model case and they cannot effectively opt out of the proceedings. Investors who have already started individual litigation can only evade the binding effect of the model case ruling by abandoning their individual lawsuit; however, they must then wait until the model case ruling is legally binding before initiating a lawsuit again. If they file another lawsuit before the higher regional court's judgment is legally binding, their individual proceedings are suspended again and they once again become an intervening party to the model case proceedings. Yet, if they wait until the model case proceedings are over, their claim will most likely be time-barred due to the statute of limitations. In other words, if the investor seeks compensation for damages sustained, he must be part of the model case proceedings. This contradicts the investors' right to a fair trial.

In addition to this, all investors who have not filed a lawsuit before the model case proceedings were established are effectively forced to at least register their claim. If they sue, they join the model case as an intervening party. If they do nothing, their claim will be time-barred by the time the model case is completed. Only if they register their claim, the statute of limitations will be suspended (see sec. 204 (1) no. 6a BGB). Once a claim has been registered, the investor must bear part of the costs of the model case proceedings.[32]

This lack of an opportunity to effectively opt out of model case proceedings and the fact that investors who have not yet sued are forced to register their claims, is in direct contrast to the European Commission's recommendations concerning collective redress mechanisms. The Commission advises that the composition of the claimant party should be based on an opt-in principle. Ex-

[32] Investors have a strong incentive to register their claim. The court will not examine the merits of the case upon registration. As a result, the number of investors that register a claim will be very great. They have almost nothing to lose by registering their claim and a lot to gain from it. This large number of registered claims (of which some might not have any factual basis) could force the defendant into a disadvantageous settlement, cf. J. v. Hein, in: C. Brömmelmeyer (ed.), *Die EU-Sammelklage*, p. 148; W. v. Bernuth and R. Kremer, *Das neue KapMuG – Wesentliche Änderungen aus der Sicht der Praxis*, NZG (2012), p. 890 et seq.; F. Wardenbach, *KapMuG 2012 versus KapMuG 2005: Die wichtigsten Änderungen aus Sicht der Praxis*, GWR (2013), p. 35, 37. While registered claims will not be time-barred, all connected counterclaims the defendant might have are not included in the suspension of the statute of limitation. If investors litigate after the model case judgment is final, the defendant could be precluded from asserting his counterclaims; J. Wigand, *Die Anmeldung von Ansprüchen zum Musterverfahren*, WM (2013), p. 1884, 1887.

ceptions to this principle (i. e. opt-out models or – as in Germany – not even an effective opt-out but rather a *de facto* binding effect by default) should be duly justified "by reasons of sound administration of justice".[33]

Another aspect that demonstrates how the investors' procedural rights are limited is the fact that the plaintiff representing the group is chosen by the higher regional court (sec. 9 (2) KapMuG). The investor cannot choose his legal representative himself.[34]

This infringement on procedural rights is increased by the unclear wording of sec. 8 (1) (1) KapMuG. All individual proceedings contingent on the questions to be resolved in the model case are suspended. Their claimants become intervening parties to the model case. Depending on how the word "contingent" is interpreted, the group of investors who are forced into the model case proceedings becomes even larger.[35]

Limitations to procedural rights could be justified by the model case proceedings' efficiency and through a significant reduction of the duration of the proceedings. Both of these approaches are "reasons of sound administration of justice". However, the acceleration of proceedings which is effected by the KapMuG is not sufficient compensation for the infringement of the right to a fair trial. Even after the higher regional court has given its model case ruling, the regional court's decision in the individual cases can be challenged by each claimant. The claimants are merely precluded from demanding another model case. However, they can exercise their "normal" procedural rights to appeal the decision. As the prominent cases of *Telekom*[36] and *Daimler*[37] have shown, model case proceedings can be excessively lengthy. Both model case proceedings were established in 2006 and are still ongoing. The duration of the entire proceedings is also increased by the often complex questions regarding causation and scope of damages sustained which must be resolved separately for each individual case.[38]

An actual acceleration of proceedings was not achieved by the KapMuG and, judging by its design, could not even have been expected to be achieved. The legislator's true intention of the model case proceedings act becomes apparent when considering its history of origin: it serves primarily to relieve the courts.[39]

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[33] Commission Recommendation of 11 June 2013, C (2013) 3539/3, para 21, 8, can be accessed online: http://ec.europa.eu/justice/civil/files/c_2013_3539_en.pdf.

[34] B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2710.

[35] C. Wolf and S. Lange, *Wie neu ist das neue Kapitalanleger-Musterverfahrensgesetz?*, NJW (2012), p. 3751, 3753.

[36] 23 Kap 1/06 (plaintiff: Kiefer).

[37] 9 Kap 1/06 (plaintiff: Geltl).

[38] J. v. Hein, in: C. Brömmelmeyer, *Die EU-Sammelklage*, p. 137.

[39] Cf. also B. Schneider and H. Heppner, *KapMuG Reloaded – das neue Kapitalanleger-Musterverfahrensgesetz*, BB (2012), p. 2703, 2710.

The KapMuG is often referred to as the *lex Telekom* because it was enacted in reaction to the overwhelming number of suits filed after the disastrous *Telekom*-IPO in 2000. The economy of procedure and relief of the judicial system is in itself a "reason of sound administration of justice" and can warrant a limitation of individual procedural rights. However, the procedural design of the KapMuG cannot entirely justify the infringement of the individual investors' right to a fair trial because it is not very efficient. The economy of procedure is limited by the fact that the courts' internal organizational rules (*Geschäftsverteilungsplan*) are not overruled by the KapMuG. Even though only one regional court has jurisdiction over the individual cases, different chambers of the court will be responsible. In this respect, the regional courts are not relieved at all.

A greater relief for the courts could have been accomplished by extending the binding effect of the model case ruling to all registered claims (i.e. claims that have not been filed prior to the model case proceedings). At the moment, investors who have only registered their claim will likely call upon the regional courts once the model case proceedings have been resolved in favour of the investors. As the binding effect of the model case proceedings does not extend to these individual litigations, all regional courts have to evaluate the facts of each case again. If the binding effect was extended to all registered claims, the regional courts would only have to resolve those questions that were not subject to the model case proceedings. However, this would limit the investors' procedural rights even further. Because they merely registered their claim, they would have no influence on the model case proceedings and could not even exercise those rights granted to investors whose individual proceedings have been suspended (i.e. the right of an intervening party). The legislator discussed such an extension of the binding effect and dismissed it prior to enacting the KapMuG.[40] At the same time, we realise that this is a rather formal argument as, in reality, there will most likely be a *de facto* binding effect. The regional courts that have to resolve these individual cases will in all probability take the higher regional court's verdict into account.

Another disadvantage that renders model case proceedings inefficient is the duplication of proceedings that is caused by first litigating individual cases on which then the model cases are built. Afterwards, the individual cases must be resolved. This procedure is not only time-consuming and costly, as the investors have to pay the fees for two proceedings,[41] but it also binds public resources.

Thus, the conclusion is warranted that the KapMuG severely limits the individuals' procedural rights. This is justified by the relief the regional courts gain due to an aggregation of common questions that are decided by the higher re-

[40] Government's reasoning BT-Drs. 17/10160, p. 25.

[41] The same applies to the issuer if he loses the proceedings. He then has to pay not only his own legal fees but also the investors' fees and court expenses.

gional court. While the KapMuG is, therefore, constitutional, it must be criticized on a political level as not being as efficient as it could be. The duplication of proceedings and the fact that the courts' internal organizational rules have not been adjusted, render proceedings needlessly inefficient.

In light of these disadvantages, there is an ongoing debate in Germany about redesigning collective actions. This discussion could greatly benefit from taking into account how different countries have regulated collective redress.

III. Class Actions

Considering the substantial disadvantages of the German model case proceedings, we believe that a comparison with legal systems of countries that use other types of collective action is in order. Such a different approach to collective litigation is the class action utilized in the United States, Canada, Australia, Sweden, Finland, and other countries. While model case proceedings merely answer specific questions common to all underlying separate proceedings, the class action is comprehensive. A representative party sues (or is sued) on his own behalf and simultaneously on behalf of others (the class).[42] Once a class has been established, there is only one suit on behalf of the entire class and the court decides on the entire case and not only on common questions. We will briefly highlight the main characteristics of and differences between class actions in the US and in Sweden.[43]

1. Class Actions in the USA

The American class action can be considered as the archetype of modern collective action. Class actions have a long history in the United States. Rule 23 of the Federal Rules of Civil Procedure (FRCP) which now governs class actions, has been in force since 1938.[44]

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[42] R. Mulheron, *The Class Action in Common Law Legal Systems* (2004), p. 3.

[43] For an in-depth discussion of class actions cf. e.g. D. R. Hensler et al., *Class Action Dilemmas* (2000); R. Mulheron, *The Class Action in Common Law Legal Systems* (2004); A. R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem"*, 92 Harvard Law Review (1979), p. 664 et seq.; D. R. Hensler, *Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation*, 11 Duke Journal of Comparative & International Law (2001), p. 179 et seq.; J. C. Coffee Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Columbia Law Review (1995), p. 1343 et seq.; O. M. Fiss, *The Political Theory of the Class Action*, 53 Washington and Lee Law Review (1996), p. 21 et seq.; R. H. Klonoff, *The Decline of Class Actions*, 90 Washington University Law Review (2013), p. 1 et seq.

[44] Regarding the revision process of Rule 23 FRCP, see Mulheron, Ibid, p. 9 et seq; S. B. Burbank, *The Class Action Fairness Act of 2005 in Historical Context*, 156 University of Pennsylvania Law Review (2008), p. 1439, 1453 et seq.; H. H. Lesar, *Class Suits and the Federal Rules*, 22 Minnesota Law Review (1937–1938), p. 34, 36 (Concerning the preceding Federal Equity Rule 48).

a) Characteristics of a Class Action

Unlike the German model case proceedings, class actions under FRCP 23 are not limited to claims arising from wrongful behaviour in securities markets. In fact, the material scope of application is extremely broad, ranging from medical negligence claims, consumer claims, tobacco claims, and environmental problems to claims against the government and/or its agencies.[45]

A class action must satisfy four prerequisites under FRCP 23(a): (1) the class must be so numerous that a joinder of all members would be impracticable (numerosity); (2) there must be common questions of law (commonality); (3) the representative party's claims and defences must by typical of the class (typicality); and (4) an adequate representation of the class by the representative party must be ensured. There are several different types of class actions according to FRCP 23(b).[46] In the context of private enforcement, class actions under FRCP 23(b)(3) are the most relevant as the legislator had the remedy of mass torts in mind.[47] In the case of mass torts, the damages suffered by individuals and also the liability and defences of liability can differ significantly within a class. Thus, an aggregation of claims into one single suit might not be economical. There is a risk that "an action conducted nominally as a class action would degenerate in practice into multiple lawsuits separately tried".[48] Therefore, class actions under FRCP 23(b)(3) must meet further requirements that exceed those laid down in sub-clause (a). These class actions may only be maintained if the common questions have predominance over the individual questions. Also, these class actions are subsidiary and are thus only admissible if no other type of litigation is deemed superior.

If these criteria are met, the court will certify a class and define the class claims, issues, or defences (FRCP 23(c)(1)(B)). In the case of actions under Rule 23(b)(3), the Court will order class members to be notified in a manner that is "practicable under the circumstances". A "reasonable effort" must be made to notify class members individually. The method of notification is important because class action judgments are binding to all members of the class who have

[45] For more detail see R. Mulheron, *The Class Action in Common Law Legal Systems* (2004), p. 13.

[46] FRCP 23(b)(1)(A) class actions are "incompatible standard" class actions that are in order, if separate actions would establish incompatible standards; FRCP 23(b)(1)(B) actions are "limited fund" class actions and FRCP 23(b)(2) class actions have been termed "injunctive" class actions. They serve to settle the legality of a behaviour with respect to the class in its entirety. For further detail see R. P. Phair, *Resolving the Choice-of-Law Problem in Rule 23(b)(3) Nationwide Class Actions*, 67 Chicago Law Review (2000), p. 835, 838 with note 11 and the FRCP Advisory Committee Notes to Rule 23(b)(3) (1996).

[47] Ibid, the FRCP Advisory Committee Notes to Rule 23(b)(3) (1996) pictured: "cases in which a class action would achieve economies of time, effort, and expense [such as] a fraud perpetrated on numerous persons by the use of similar misrepresentations [or] a 'mass accident'"; R. P. Phair, *Resolving the Choice-of-Law Problem in Rule 23(b)(3) Nationwide Class Actions*, 67 Chicago Law Review (2000), p. 835, 838.

[48] FRCP Advisory Committee Notes to Rule 23(b)(3) (1996).

not chosen to opt out of the class action by requesting exclusion from the Court, FRCP 23(c)(2)(B)(v) and (3)(B).

Group litigation by means of class actions has been the subject of a heated political and legal debate.[49] A major point of criticism was the pressure placed on defendants to settle after a class had been certified. The risk of having to pay potentially bankrupting sums of damages in case of a class-wide verdict looms over defendants like the sword of Damocles.[50] Another thorn in the side of corporate defendants was a perceived increase in "forum shopping"; class actions encompassing several states were often litigated in pro-plaintiff state courts.[51] Exorbitant lawyer fees were a further focal point of class action opponents.[52] After intense lobbying from both sides (those in favour and those against class actions), President George W. Bush signed into law the Class Action Fairness Act (2005)[53]. Under this act, the federal courts' jurisdiction has been expanded significantly.[54] Proponents hoped that a transfer from state to federal courts would limit the application of state law because politicians and scholars assumed that federal judges are sceptical towards large-scale, multi-state class actions and would, therefore, reach more moderate certification decisions. Advocates of the Act argued that federal jurisdiction would counter local bias and promote a uniform regulation of interstate commerce because the federal courts' intuition concerning the needs of the national economy are bet-

[49] A. R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem"*, 92 Harvard Law Review (1979), p. 664, 665. An overview of the "holy war" on class actions is there provided.

[50] Ibid, class actions have consequently been dubbed as "Frankenstein's Monster", "legalized blackmail" or a "nuclear bomb"; see dissenting judgment Lumbard, *Eisen v. Carlisle & Jacquelin*, 391, 555, 572 (1968): "[…] put an end to this Frankenstein monster posing as a class action"; M. Handler, *The Shift From Substantive to Procedural Innovations in Antitrust Suits*, 71 Columbia Law Review (1971), p. 1, 8 et seq; G. Vario, *Is the Class Action Really Dead?*, 64 Emory Law Journal (2014), p. 477, 479; For further detail see R. H. Klonoff, *The Decline of Class Actions*, 90 Washington University Law Review (2013), p. 1, 9 et seq.

[51] Klonoff, Ibid, p. 4; J. C. Coffee Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Columbia Law Review (1995), p. 1343, 1405 et seq.; S. B. Burbank, *The Class Action Fairness Act of 2005 in Historical Context*, 156 University of Pennsylvania Law Review (2008), p. 1439, 1442. Pointing out that "forum shopping" in itself is not necessarily negative.

[52] D. R. Hensler, *Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation*, 11 Duke Journal of Comparative & International Law (2001), p. 179, 180; R. H. Klonoff, *The Decline of Class Actions*, 90 Washington University Law Review (2013), p. 1, 4; G. Vario, *Is the Class Action Really Dead?*, 64 Emory Law Journal (2014), p. 477, 494; A study has shown that in 2006 and 2007, district court judges awarded 15 % of the total class action settlement sum (US $ 33 billion) to class action lawyers, see B. T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 Journal of Empirical Legal Studies (2010), p. 811, 830 et seq.

[53] Class Action Fairness Act of 2005, Pub. L. No. 109-2, 119 Stat. 4.

[54] 28 U.S. Code sec. 1332(d) (2): "The district courts shall have original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of USD 5,000,000, […] and is a class action […]".

ter than that of state courts.[55] Whether these assumptions have proven to be true is a matter of great controversy amongst scholars.[56]

b) The Opt-out Model and its Legal Implications

From a German perspective, however, the strongest point of criticism concerning the American model of class actions is the fact that the court's decision is binding for every member of the class. Since the 1966 amendment, members in class actions under FRCP 23(b)(3) do not need to opt in. Instead, the binding effect applies to them by default and they merely have the opportunity to opt-out.[57] Yet, if a class member did not even know that proceedings were ongoing, he cannot opt out. As mentioned above, only a reasonable effort to individually notify class members must be made and the manner of notification needs only to be practicable under the circumstances (FRCP 23(c)(2)(B)). Important cases may receive (nation-wide) media attention, but smaller cases often go by unnoticed. There is a considerable risk of a class member being bound by a verdict or an out-of-Court settlement without ever having the opportunity to opt-out. This infringes on the class members right of a fair trial. Their right of fair hearing[58], especially, could be breached.[59]

2. Class Actions in Sweden

In Sweden, class actions were introduced by the "Group Proceedings Act" in 2002.[60] The prerequisites of Swedish "individual group actions"[61] are very sim-

[55] D. Marcus, *Erie, The Class Action Fairness Act, and Some Federalism Implications of Diversity Jurisdiction*, 48 William & Mary Law Review (2006–2007), p. 1247, 1290 et seq.

[56] P. W. H. Moore, Prepared Statement for the Hearing on "*The State of Class Actions Ten Years after the Class Action Fairness Act"* before the Committee on the Judiciary Subcommittee on the Constitution and Civil Justice United States House of Representatives (February 27, 2015), can be accessed online: http://ssrn.com/abstract=599019.

[57] See T. Eisenberg and G. P. Miller, *The Role of Opt-Outs and Objectors in Class Action Litigation,* 57 Vanderbilt Law Review 2004, p. 1529 for a detailed discussion of the right to opt out; J. C. Coffee Jr., *Class Wars: The Dilemma of the Mass Tort Class Action*, 95 Columbia Law Review (1995), p. 1343, 1446 et seq.

[58] Art. 103 (1) of the German Basic Law; Art. 6 (1) of the European Convention on Human Rights.

[59] With regard to German law: BVerfG (German Federal Constitutional Court), 25 October 1956 – 1 BvR 440/54, NJW 1957, 17; E. Schmidt-Aßmann, in: T. Maunz and G. Dürig (eds.), *Grundgesetz*, Art. 103 GG, para 70 et seq. (2015); dissenting; A. Halfmeier and P. Wimalasena, *Rechtsstaatliche Anforderungen an Opt-out-Sammelverfahren: Anerkennung ausländischer Titel und rechtspolitischer Gestaltungsspielraum*, JZ (2012), p. 649 et seq.

[60] Swedish Group Proceedings Act 2002 (Lag om grupprättegång), official translation can be accessed online: http://www.government.se/government-policy/judicial-system/group-proceedings-act. With regard to the legal situation before enactment of the Group Proceedings Act, see R. Nordh, *Group Actions in Sweden*, 11 Duke Journal of Comparative & International Law (2001), p. 381 et seq.

[61] Other types of group actions are "organisational group actions" and public group ac-

ilar to the requirements for class actions under FRCP 23 (b) (3) in the US. According to Section 8 of the Group Proceedings Act: (1) there must be common questions of law; (2) group litigation must be the best available option; and (3) the plaintiff must be suited for the purpose of representing the group.[62] The plaintiff must also accurately and sufficiently represent the group to which the action relates (Section 9 No. 1 Group Proceedings Act). Contrary to class actions under FRCP 23 (b) (3), however, Sweden has chosen an opt-in model. The class members specified by the plaintiff's description are notified and can choose to join the group litigation. If they do not give notice to the court within a predetermined period, they are deemed to have withdrawn from the group (Section 14 Group Proceedings Act). In 2008, the Swedish Government published an evaluation of the Group Proceedings Act. No changes to the general principle of an opt-in were proposed.[63]

Settlements entered into by the representative and the defendant are only binding for all class members if the settlement is sanctioned by the court.[64] This protects group members from collusive agreements between the representative and the other party. It also guards defendants from unfairly high settlement sums.

Due to the opt-in model, the represented class is in all probability (relatively) smaller than in the US. Thus, the threat faced by defendants is less severe which presumably leads to a lesser deterring effect of class actions. While this might be considered a disadvantage of the opt-in model by some[65], the current Swedish model, at least from a European perspective, appears to be nonetheless preferable. The binding effect of the verdict extends only to those members of the group (i. e. the class) that have been notified of the proceedings. Thus, their right to a fair trial and proper hearing is not negatively affected by a class action.

IV. Representative Actions

While class actions prevail in the Nordic countries, some European countries, such as the Netherlands and France, have chosen a different form of collective redress – the representative action. The plaintiff needs not be affected by the

tions instituted by an authority at the discretion of the government, Sections 4 et seq. Group Proceedings Act.

[62] E. F. Sherman, *Group Litigations under Foreign Legal Systems*, 52 DePaul Law Review (2002), p. 401, 420.

[63] Evaluation of the Group Proceedings Act, 17 May 2015, summary in English can be accessed online: http://www.government.se/information-material/2008/10/evaluation-of-the-group-proceedings-act---summary-in-english/.

[64] S. Grace, *Strengthening Investor Confidence in Europe: U.S. Style-Securities Class Actions and the Acquis Communautaire*, 15 Journal of Transnational Law & Policy (2005–2006), p. 281, 295.

[65] Ibid. "[…] demand for an 'opt-out' provision to provide greater incentive for settlement and finality [increases likelihood] that greater corporate governance will be achieved in Europe".

wrongful behaviour himself, he sues the defendant on behalf of the group members but not for his own sake. The representative's standing results from an express legal act. Common representatives are consumer protection bodies, i. e. foundations or associations.

1. The Netherlands – Opt-out Model

The Netherlands does not have a collective action to compensate damages. Collective redress is solely achieved by means of settlements.[66] The Collective Settlement of Mass Damage Act (WCAM) was enacted in 2005.[67] The WCAM capitalizes on market forces by allowing the parties to reach an amicable settlement which is then approved by the Amsterdam Court of Appeals. The injured group is represented by a foundation/association; individuals are not summoned but are notified by letter or public announcement (newspaper). If the court deems the settlement to be appropriate, it will declare its binding effect on the defendant and all persons to whom damage has been caused.[68]

Once the settlement agreement is binding, all injured persons become party to the contract. If they accept the settlement, they may no longer file individual proceedings. However, they can opt out of the settlement at this point and instigate actions themselves. The opt-out period is determined by the court, it cannot be less than three months. The formal requirements an injured person must meet to step out of the settlement contract are very light, even an e-mail suffices.[69]

The WCAM legislator took the right of access to court and the right to a fair and public hearing very seriously when designing the act.[70] The fact that an opt out is possible *after* the settlement has been finalized in addition to the relatively smaller population of the Netherlands compared to the US warrants the conclusion that the Dutch model does not infringe on the individual's right to a fair

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[66] X. E. Kramer, *Securities Collective Action and Private International Law Issues in Dutch WCAM Settlements*, 27 Pacific McGeorge Global Business & Development Law Journal (2014), p. 236, 239. In summer 2014, however, Dutch legislature declared its intention to extend representative actions to the compensation of damages, see X. E. Kramer, *Dutch draft bill on collective action for compensation – a note on extraterritorial application* (20 November 2014), can be accessed online: http://conflictoflaws.net/2014/dutch-draft-bill-on-collective-action-for-compensation-a-note-on-extraterritorial-application/. So far, no legal act has followed.

[67] *Wet collectieve afwikkeling massaschade*, WCAM, 23 June 2005, i. e. 2005 Collective Settlement of Mass Damage Act, published in Staatsblad 2005, no. 340.

[68] W. H. Van Boom, *Collective Settlement of Mass Claims in The Netherlands*, in: M. Casper and N. Janssen et al. (eds), *Auf dem Weg zu einer europäischen Sammelklage?* (2009), p. 171, 178.

[69] B. Krans, *The Dutch Act on Collective Settlement of Mass Damages*, 27 Pacific McGeorge Global Business & Development Law Journal (2014), p. 281, 298 et seq.

[70] Ibid.

trial to the same extent as class actions under FRCP 23(b)(3). Notification by means of a newspaper is much more feasible in a smaller country than in a country the size of the USA.

2. France – Opt-in Model

France established representative actions (*actions de groupe*) in 2014.[71] The scope of application has been restricted to consumer cases concerning the sale of goods and services as well as competition cases. Similar to the Netherlands, standing has been granted exclusively to national consumer protection associations. They may claim compensation of material damages caused by a professional's violation of legal or contractual duties on behalf of consumers before the civil courts of first instance (*tribunaux de grand instance*).[72]

The court decides on the defendant's liability, the composition of the class, the damages awarded, and the modalities of notifying the consumers.[73] The consumers are notified once the judgment is final.[74] Within a predetermined time-frame (two to six months at the discretion of the court) they now have the option to join the class.[75] After the opt-in period has elapsed, the defendant transfers the entire amount owed as damages to the representative association. The association, in turn, distributes it amongst the consumers.[76]

The procedure is similar to the Dutch model insofar as the injured person can only make a decision after the court's verdict has become legally binding. Another similarity is the fact that the parties are encouraged to undertake a mediation process. Should they reach a settlement, it must be approved by the court.[77] However, French representative actions differ significantly from the Dutch model because France has taken an opt-in approach. This opt-in model ensures that consumers are not forced into a binding judgment without having known about ongoing proceedings. In this regard, their right to a fair trial is respected. Nonetheless, it is an inherent effect of representative actions that the injured persons do not become party to the proceedings. They do not have legal

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[71] Loi n°2014-344 relative à la consommation (loi Hamon), *JORF* n°0065 (18 March, 2014), p. 5400; S. Voet, *European Collective Redress Developments: A Status Quaestionis*, 4 International Journal of Procedural Law (2014), p. 97, 119 et seq.; Concerning the legal situation before the enactment of the loi Hamon, see S. Grace, *Strengthening Investor Confidence in Europe: U.S. Style-Securities Class Actions and the Acquis Communautaire*, 15 Journal of Transnational Law & Policy (2005–2006), p. 281, 297 et seq.

[72] Art. L. 423-1 Code de la consommation (C. comm.).

[73] Art. L. 423-3 C. comm. (Jugement sur la responsabilité).

[74] Art. L. 423-4 C. comm. An appeal to the Court d'appel and the Court de cassation is possible.

[75] Art. L. 423-5 C. comm. (Adhésion au groupe).

[76] Art. L. 423-6 et. seq. C. comm.

[77] S. Voet, *European Collective Redress Developments: A Status Quaestionis*, 4 International Journal of Procedural Law (2014), p. 97, 120.

standing. This means that they cannot influence the course of the proceedings. One is tempted to consider this a severe infringement of their right to fair hearing and access to court but both the Netherlands and France do not prevent injured persons from suing the other party individually. The right to fair hearing in court is, therefore, guaranteed to a sufficient extent.

V. Comparing the Different Types of Collective Action

Private enforcement is carried out by means of collective redress for several reasons. The aggregation of many similar claims arising out of the same or similar wrongful behaviour (e.g. mass torts) can accelerate proceedings and render them easier to handle. Public resources (i.e. the courts) are utilized more efficiently. Another motive for collective action is the fact that low value or dispersed damages are not often litigated individually. From a law and economics point of view, the mere existence of collective actions can serve as a deterrent in these cases because the threat of a lawsuit is increased. The question remains, which type of collective redress best serves these purposes? In other words: how can an efficient and speedy procedure be achieved? What kind of action has the greatest deterring effect in case of behaviour that risks low value damages? Another aspect that must be taken into account when comparing different types of collective action is the individual's right to a fair trial, including access to courts and a fair hearing. In the end, a weighting of the different interests is necessary.

The German KapMuG was created to lighten the load of regional courts in the case of false information of the capital markets. The legislator hoped for an acceleration of proceedings. However, the complexity of the procedure and the fact that only specific questions are decided for all individual cases rendered the model case proceedings to be quite inefficient. Also, the fact that an opt-out is effectively impossible severely limits the individual investors' procedural right to a fair trial.

The strongest deterring effect is achieved in the US. American class actions pose a severe threat because the size of the class can be very large due to the opt-out model. At the same time, the class members' procedural rights are not always guaranteed. The Swedish model does provide for a fair trial because the class members must actively join in in order to be bound by the court's decision. However, class actions in Sweden are notably less threatening and thus less deterring.

Representative actions are more efficient that model case proceedings. Also, representation by an independent association rather than by an injured member of the class is advantageous. The representing associations are not as susceptible to aggressive job creation schemes used by collective redress lawyers. This is a

decisive difference to the reality of class actions in the US. For good reason, American class actions have been disparagingly described as a "bounty hunt" conducted by private attorneys. The promise of generous legal fees induces a very proactive approach by class lawyers,[78] which is strongly criticized by many scholars, and rightly so.

On the other hand, however, there is an actual risk that associations or foundations do not act solely in the interest of injured persons. The decision to litigate could also be fuelled by a further-reaching agenda. Especially if there is more than one nation-wide association that represents consumers, a competition for prestige and influence could emerge.

In summary, every form of collective redress has its advantages – but also has its disadvantages. With regard to the existing models, however, the French *action de groupe* does seem to be the best option. It is more efficient than model case proceedings, less prone to induce "bounty hunts" by lawyers and safeguards the group members' procedural rights. Since the act is relatively young, empirical evidence of its effectiveness has not yet been collected. Hence, a future evaluation will be necessary. If one prefers the class action model due to its stronger deterring effect, the opt-in version should be preferred. The effectiveness of the action in the case of mass torts has to be weighted against the right to a fair hearing during the proceedings. Such a weighting of interests between effectiveness and fair hearing favours the opt-in model in the context of a class action.

VI. The Planned Reform of Collective Action in Germany

In Germany, there is an ongoing debate on a reform of collective redress. The Green Party has entered a notable draft in May 2014 of an opt-in group action with an almost unlimited scope of application to replace the KapMuG. Group actions are planned to be admissible under the same prerequisites as American class actions under FRCP 23(b)(3) (i.e. commonality, numerosity, typicality, adequate representation and common questions that predominate over individual questions).[79] Two different types of actions are proposed, an unlimited and a limited group action. In an unlimited group action the plaintiff can demand performance or declaratory action on behalf of the group. A single case is filed and there are no underlying individual cases. The limited group action is similar

[78] M. H. Redish, *Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals*, 71 The University of Chicago Legal Forum (2003), p. 71, 77.

[79] Green Party ("BÜNDNIS 90/DIE GRÜNEN", currently opposition party) draft published in BT-Drs. 18/1464 (21 May 2014), p. 4 (proposed new sec. 606 Code of Civil Procedure [-E]).

to the KapMuG, it is a single declaratory action followed by several individual cases.[80] For both actions standing has not only been granted to group members (i. e. injured persons) but also to associations.[81] Group actions in Germany would, therefore, be class actions or representative actions. At the same time, limited actions would remain similar to model case proceedings. Defendants would not be able to initiate a group action.

According to the draft, after the regional court[82] has published the establishment of a group action in the official litigation register, the group members can declare their opt-in.[83] During the course of the proceedings, the regional court will inform them about all written submissions and interim decisions by means of a closed electronic information system. The group members who are not the plaintiff will not actively participate in the proceedings.[84] Until the last hearing has been conducted by the court they will be able to choose to leave the group by opting out. The verdict is binding for all injured persons who opted in within the predetermined time frame and who did not opt out again.[85]

The German Federal Ministry for Justice and Consumer Protection also currently plans to draft a new act concerning collective redress. But an official draft has not yet been published. According to State Secretary Billen, the ministry intends to avoid creating a "procedural monster" with many procedural intermediate stages that can be exploited for delaying proceedings.[86] This seems to be a reaction to the extensive duration of model case proceedings under the KapMuG. Also, Billen stated that the Ministry does not want to establish class actions similar to the US because professional class lawyers use these procedural rules as a tool to profit from forcing defendants into inequitable settlements. Apparently, the ministry envisages a type of representative action where associations sue on behalf of consumers. The proceedings will be publicly announced

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[80] Government's reasoning BT-Drs. 18/1464, p. 5 regarding sec. 610-E. At a first glance this seems to imply a duplication of proceedings as it is the case in the KapMuG. However, if the model case ruling in a limited group action is in favour of the defendant, the group members will not sue individually. If the ruling favours the group members, the defendant will try to reach an amicable settlement in order to avoid the high costs of numerous individual litigations. See ibid, page 18 for the convincing argument.

[81] Ibid, p. 5 (sec. 611-E).

[82] Ibid, p. 10 et seq., regional courts are designated as court of first instance in group actions.

[83] Ibid, p. 6 (sec. 614-E et seq.).

[84] Ibid, p. 7 (sec. 620-E). If the plaintiff and the defendant reach an amicable settlement which is approved by the Court, the group members can opt-out within one month, (sec. 623-E (1) (2), 625-E).

[85] Ibid, p. 9 (sec. 627-E).

[86] Speech given by State Secretary G. Billen on 28 September 2015 at the national consumer protection agency (Verbraucherzentrale Bundesverband) can be accessed online: http://www.bmjv.de/SharedDocs/Reden/DE/2015/09282015_StBillen_vzbv.html?nn=6704226; See the Speech given by D. Wiese (Member of Parliament) in the 133rd Session of the "Bundestag", Plenary Protocol 18/133, p. 12955.

and consumers can then register their claims to achieve a suspension of the statute of limitations. A verdict in such a 'model declaratory action' (*Musterfeststellungsklage*) will be binding for every consumer who registered his claim. The ministry hopes to improve the uniformity of the law and the efficient use of public resources by implementing this collective redress mechanism.

Implementing a representative action is a desirable solution, because it increases the probability for efficient and speedy proceedings. However, as it is always the case with reforms and regulation, the devil is in the detail. We agree that an opt-in is preferable to an opt-out model. The Green Party's draft and Billen's statement suggest that consumers must join the group or register their claim *before* the verdict has been given. This is a significant difference to the French opt-in model. In France, consumers can only opt-in once the judgment has been published. One could accuse the French model of encouraging cherry-picking because the injured person will only join the group if he believes the judgment to be his best option. If the consumer thinks that he can gain higher damages by suing individually, he may do so. A possible justification for an opt-in after the final verdict is the fact that the group members are not party to the proceedings and cannot influence its course. Their right to a fair trial, especially to a fair hearing could justify that they are not bound by a verdict without having participated in the proceedings.

However, an opt-in after the verdict is legally binding will open the door for 'free riders' who did not participate in the costs of the proceedings. The French *action de groupe* is only applicable in consumer cases. As already mentioned, consumers statistically only sue for damages exceeding €1,950. In order to increase the numbers of the group in cases of low value, dispersed damages (and thus increase the deterrent effect of group actions), an opt-in after the verdict has become legally binding could be warranted. Yet, the German reform is of a much broader scope. It enables not only consumers but also entrepreneurs and corporations to join group actions. If no consumers are involved, an opt-in up until the last court hearing (as proposed by the Green Party and the Ministry of Justice) might be warranted.

As an official draft by the ministry concerning the "model declaratory proceedings" is still pending, it is not clear, whether this reform can be implemented within the current parliamentary term ending in September 2017. However, its actual design will have to take group members' constitutional rights into account.

VII. Conclusion

Many individuals will only sue for compensation if their financial damage exceeds the transaction costs of proceedings. Thus, the deterring effect of liability provisions cannot fully unfold. Collective action can increase the probability and extent of litigation and thereby promote the enforcement of the law. Also, the aggregation of many similar claims can accelerate proceedings and save public resources.

The German model case proceedings were created to relieve the courts in cases of mass torts occurring in capital markets. The procedure is quite complex and very lengthy. After a model case has been established, all individual proceedings are suspended. The higher regional court will rule on questions of law common to all individual proceedings. The decision has binding effect for all individual proceedings that have been filed up until the ruling. After the model case ruling has become legally binding, the individual proceedings continue.

Compared to individual litigation model case proceedings have the advantage of lower costs for each claimant and a promotion of the uniformity of law which in turn results in an equal treatment of all investors. However, model case proceedings have several striking disadvantages. Most importantly, the claimants' right to a fair trial is limited as they merely have the status of an intervening party even though the binding effect extends to their litigation. This limitation becomes especially apparent as *de facto* there is no possibility to opt-out of the model case proceedings.

On a political level, the limitation of procedural rights would be justified, if the model case proceedings were efficient and speedy enough. This is not the case; the extensive litigation in the *Telekom* and *Daimler* cases has proven that model case proceedings can be extremely lengthy. Furthermore, the duplication of proceedings reduces their efficiency.

If opt-out models are utilized, the number of represented class or group members is larger than in the case of opt-in models. The damages that need to be paid are potentially very high. Hence, opt-out models provide for the strongest deterring effect. From a law and economics perspective they are ideally suited for collective action. Yet, opt-in models remain preferable. The claimants' right to a fair trial outweighs the advantage of a large pool of claimants.

A comparison of class actions, representative actions and model case proceedings has shown that representative actions are advantageous because the representing association is not as susceptible to aggressive job creation schemes by collective redress lawyers as an injured member of the group might be.

Hence, should China look for inspiration when drafting a collective action, an opt-in solution based on the French *action de groupe* (or the expected new German model) is advisable. The current German model case proceedings have proven to be unsuited as a legal transplant.

Chapter 3

Enforcement Concepts in Chinese and German Corporate Law – The Role of the Supervisory Board

The German Law of and Experience with the Supervisory Board

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[*] Klaus J. Hopt, Professor and Director (emeritus) at the Max-Planck-Institute for Comparative and International Private Law, Hamburg. The article benefits from the experience made by having been a member of the European Commission's High Level Group of Company Law Experts and of the Stock Exchange Experts Commission at the Federal Ministry of Finance as well as being a member of the European Company Law Experts (ECLE). The article goes back to a lecture at a conference held at the Tongji University in Shanghai on 23 and 24 October 2015. As to the occasional comparisons with the Chinese two-tier system the presentation by Professor Guo Li and Mr. Matsuo Takayuki from Peking University Law School was helpful.

The article pursues two goals: It informs a non-German audience on the regulation of the supervisory board in Germany, both by binding statutory law and nonbinding corporate governance code rules, highlighting major current problems and controversies, and it undertakes a functional assessment of the functioning of the supervisory board in a comparative perspective. The article uses the English translation of the Stock Corporation Act as of 1 December 2011 by Norton Rose.

Abstract

Together with a number of other countries including China Germany has a two-tier board system, i.e. its stock corporation law provides for the division between the management board and the supervisory board. This is different from most other countries, for example the USA, the United Kingdom, Switzerland and others. Both board systems have their assets, yet in principle both fulfill adequately the task of control over management; there is no clear superiority of one of the two of them. The national board systems are highly path-dependent. Germany has had the supervisory board ever since the late 19th century when the state gave up its concession system, i.e. the approval and supervision of corporations by the state, and introduced a mandatory supervisory board to take over this task from the state. Germany strictly refuses to give shareholders the option to choose between the two systems. Labor codetermination in the supervisory board may be one of the reasons for this refusal. While European legislators have been rather prudent in regulating board matters, there has been a considerable de facto convergence between the two systems. Yet path-dependent divergences remain, as to Germany this is true particularly in respect of quasi-parity and full-parity labor codetermination in the board of corporations, but also as regards stakeholder orientation and a codified law of groups of companies featuring corresponding board duties for both parent and subsidiary companies. The German Stock Corporation Act and the German Corporate Governance Code contain extensive provisions on both the management board and the supervisory board. The provisions on the supervisory board have been considerably reformed since the late 1990s. Today, German corporate governance under the two-tier board system is more or less in line with international good corporate governance. In Germany there are considerable controversies concerning (i) the diversity requirements of 2015, (ii) the definition of independence for supervisory board candidates, (iii) the pros and cons of mandatory quasi-parity and full-parity labor codetermination and (iv) the role of the non-binding German Corporate Governance Code. The article pursues two goals: It informs a non-German audience on the regulation of the supervisory board in Germany, both by law and code, highlighting major current problems and controversies, and it undertakes a functional assessment of the experience with and the functioning of the supervisory board in a comparative perspective.

I. The German Two-tier Board System in a Comparative Perspective

1. One-tier and Two-tier Boards Systems in Comparative Law

a) Two-tier Board Systems and their Assets

Germany has a two-tier board system.[1] This system separates the board into a management board and a supervisory board. The function of the former is as its name says the encompassing management of the company, management of course including delegation to and the help of senior management. The function of the latter is primarily the supervision and control of the management board. The basis for this is the right of the supervisory board to appoint and, under certain conditions, to dismiss the members of the management board as well as to fix their remuneration,[2] a power which does not exist in some other two-tier board countries such as China and makes a fundamental difference.[3] The separation between both boards is mandatory. The major asset of the two-tier board system is this clear separation between the management function and the control function, a separation that in Germany is bolstered by strict incompatibility. This system applies only to corporations; in the limited liability company (GmbH) there is no mandatory supervisory board unless the company is codetermined by law.

Traditionally the supervisory board has not confined itself to its control function but has acted as an advisor of, and sometimes as a co-leader with, the management board. More recently German supervisory boards have tended to

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[1] Cf. (apart from a host of German language contributions) K. J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, LIX The American Journal of Comparative Law (Am. J. Comp. L.) (2011), p. 1, 21 et seq. with references to the board systems of many European and other countries; P. L. Davies and K. J. Hopt, *Corporate Boards in Europe – Accountability and Convergence*, LXI Am. J. Comp. L. (2013), p. 301 and with a more detailed version: idem et al., *Boards in Law and Practice: A Cross-Country Analysis in Europe*, in: P. L. Davies, K. J. Hopt, R. G. J. Nowak and G. van Solinge (eds.), *Corporate Boards in Law and Practice, A Comparative Analysis in Europe*, Oxford (2013), p. 3; M. Roth, *Corporate Boards in Germany*, in: idem, p. 256; H. Merkt, *Germany, Internal and external corporate governance*, in: A. M. Fleckner and K. J. Hopt (eds.), *Comparative Corporate Governance, A Functional and International Analysis*, Cambridge (2013), p. 521; J. J. du Plessis, B. Großfeld, C. Luttermann, I. Saenger, O. Sandrock and M. Casper (eds.), *German Corporate Governance in International and European Context*, Berlin/Heidelberg, 2nd edn. (2012); K. J. Hopt, *The German Two-Tier Board (Aufsichtsrat), A German View on Corporate Governance*, in: K. J. Hopt and E. Wymeersch (eds.), *Comparative Corporate Governance – Essays and Materials*, Berlin/NewYork (1997), p. 3; idem, *The German Two-Tier Board: Experience, Theories, Reforms*, in: K. J. Hopt, H. Kanda, M .J. Roe, E. Wymeersch and S. Prigge (eds.), *Comparative Corporate Governance – The State of the Art and Emerging Research*, Oxford (1998), p. 227; S. Prigge, *A Survey of German Corporate Governance*, in: idem, p. 943.

[2] Sec. 84 of the German Stock Corporation Act ("Aktiengesetz" or "AktG").

[3] Cf. Guo Li and M. Takayuki, *The Chinese Board of Supervisors System: An International Comparison*, p. 151 et seq. in this book.

concentrate more on their control function. The traditional Rhineland capitalism ("Germany Inc.") in which industry and banks closely cooperated in the supervisory boards of major companies by interlocking directorates is quickly fading away.[4] Yet in many corporations the supervisory board is still very powerful,[5] certainly in family-controlled corporations, but sometimes also in other major corporations, in particular if they are in financial difficulties or face an important reorientation, as for example the Deutsche Bank.

b) One-tier Boards Systems and their Assets

Internationally, the one-tier board system prevails, as for example in the United States, the United Kingdom, Switzerland and other countries. The two-tier board system exists in Germany, Poland, France, Italy, the Netherlands[6] as well as other countries such as China.[7] The emergence of either one, the one-tier or the two-tier board system, had historical reasons. In the United Kingdom independent entrepreneurial ownership developed at an early stage without the state or another institution having a function in overseeing management. In Germany the origin of the mandatory supervisory board was in the 1870s when the state gave up supervision of stock corporations and entrusted supervision to a separate supervisory board instead. Later the emergence of labor codetermination in German supervisory boards petrified the two-tier structure while the United Kingdom, never having had such codetermination, stayed with its one-tier board system.

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[4] W.-G. Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of the Deutschland AG*, LXIII Am. J. Comp. L. (2015), p. 493. It is controversial to what degree German banks exercised supervision and control of the stock corporations, however it certainly was the case when the financial difficulties of the corporation were looming.

[5] There were and are, of course cases, in which the supervisory board is rather a „retirement home". Cf. as to China Guo Li and M. Takayuki (fn. 3), p. 164 with reference to: Chang Jian and Rao Changlin, *The Legal Analysis of Perfection of the BoS,* Issue 3 Quarterly Journal of Shanghai Academy of Social Sciences (2001), p. 139, 142 and Liu Miao, *The Reconsideration of the Independent Director System of Our Country*, Issue 4 Law Application (2005), p. 43, 44.

[6] P. L. Davies and K. J. Hopt, *Boards in Law and Practice: A Cross-Country Analysis in Europe* (fn. 1), p. 1, 9 et seq.

[7] Cf. Guo Li and M. Takayuki (fn. 3). For understanding the Chinese legal system three articles were particularly helpful: F. Jiang and K. A. Kim, *Corporate governance in China: A modern perspective*, 32 Journal of Corporate Finance (2015), p. 190; Qingxiu Bu, *Will Chinese Legal Culture Constrain Its Corporate Governance-Related Laws?,* 15 No. 1 Journal of Corporate Law Studies (J. Corp. L. Stud.) (2015), p. 103; C. J. Milhaupt, *Chinese Corporate Capitalism in Comparative Context*, Columbia Law School Working Paper No. 522 (13 October 2015). See also J. Wang, *On Cases Against Corporate Managers for Breaching Their Duty of Loyalty and/or Duty of Diligence in China*, 10 No. 1 Frontiers of Law in China (2015), p. 78–99.

The major asset of the one-tier board is that all members of the board have easy access to information about the company and its management.[8] At the same time, at least more recently, the control function is exercised primarily by independent directors who are full members of the same unitary board. Yet contrary to the widespread opinion under each of the two systems,[9] comparative law and experience does not show a clear superiority of one of the two models.

2. The German Two-tier Board System and its Particularities: A Legal Survey

a) The Regulation of the Supervisory Board in the Stock Corporation Act

The two-tier board system is regulated in some detail in the German Stock Corporation Act of 1965. This Act and also the provisions on the two boards were frequently reformed, in particular by the introduction of (quasi-)parity labor codetermination in the supervisory board in 1976 and after the rise of the corporate governance movement in the nineties of the last century, for example by the Law on Control and Transparency in Enterprises of 1998. The provisions on the supervisory board in sec. 95–116 of the Stock Corporation Act regulate the size and the composition of the board particularly in view of labor codetermination. They contain rules on the personal qualification of supervisory board members, their appointment, term of office and removal. The maximum number of supervisory board mandates which a member may hold is ten (details in sec. 100). Strict incompatibility is prescribed by sec. 105. Several provisions concern the internal organization, the resolutions and the meetings of the supervisory board. Four key provisions set out the duties and rights of the supervisory board members (sec. 107) and lay down restrictive rules on remuneration (sec. 113), contracts between the company and supervisory board members beyond their supervisory position (sec. 114) and the granting of credits of the company to them (sec. 115). At the end there is a provision on the duty of care and responsibility of supervisory boards members (sec. 116). According to the latter provision the same rules apply as for the duty of care and responsibility of management board members, but in 2009 a populist addendum was made: Supervisory board members are in particular personally liable for damages if they set unreasonable remuneration of the management board members. According to

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[8] P. L. Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?*, 2 The International and Comparative Corporate Law Journal (ICCLJ) (2001), p. 435.

[9] The academics and practitioners participating in the 1997 conference on comparative corporate governance at the Hamburg Max-Planck-Institute for Comparative and International Private Law (for the publication see fn. 1), both from Germany and the UK as well as the USA, were convinced that their respective system was the better one.

the Equality Act of 2015,[10] in listed companies with parity or quasi-parity labor codetermination, the supervisory board shall comprise at least 30 per cent women and at least 30 per cent men. In the other companies covered by the Equality Act the supervisory board shall determine targets for the share of women. The enactment of gender equality in its very demanding form, i.e. a 30 per cent threshold to be reached by stock-exchange traded companies with parity or quasi-parity labor codetermination from 1 January 2016 on for any new election, has been highly controversial.[11]

These rules in the Stock Corporation Act contain just the bare skeleton of the law concerning the supervisory board. There is extensive case law and even more extensive legal literature, in particular in the typically German "Kommentare", i.e. many volumes of comments on the law. The Großkommentar zum Aktiengesetz deals with sec. 95–116 in 1,450 pages.[12] German law is known for not just being codified law and case law but for being very much "academic law". The two leading law reviews in the field are the ZGR and the ZHR; specialized law reviews include Die Aktiengesellschaft and NZG.

b) The Regulation of the Supervisory Board in the Corporate Governance Code

The German Corporate Governance Code as of May 2015[13] contains non-binding recommendations for German stock exchange-traded corporations. It aims at making German corporate governance transparent and better understandable and therefore also sets out in a nutshell the law concerning management and control in the corporation. While also containing recommendations regarding shareholders, the general assembly and the reporting and audit of the annual financial statements, the main parts of the Code deal with the two boards. As to the management board the remuneration is regulated in considerable detail. As to the supervisory board the tasks and responsibilities of the board and its chairman, the formation of committees, composition and compensation, and conflicts of interest are regulated. The emphases here are on setting up committees (most importantly the audit committee, but also the nomination committee), independent directors (in the supervisory board only) and conflicts of interest. According to the Code members of the management board of a listed company shall not accept more than a total of three supervisory board man-

[10] Law on Equal Participation of Men and Women in Private-Sector and Public-Sector Management Positions, German Federal Gazette I (2015), p. 642; sec. 25 (1) of the Introductory Law of the German Stock Corporation Act, German Federal Gazette I (2015), p. 656.

[11] C. H. Seibt, *Geschlechterquote im Aufsichtsrat und Zielgrößen für die Frauenbeteiligung*, Zeitschrift für Wirtschaftsrecht (ZIP) (2015), p. 1193.

[12] K. J. Hopt and M. Roth, *Großkommentar Aktiengesetz*, vol. 4, Berlin et al., 4th edn. (2006).

[13] Available on the website of the German Corporate Governance Code Commission.

dates in non-group listed companies. The Code states expressly that the task of the supervisory board is to advise regularly and supervise the management board and that it must be involved in decisions of fundamental importance to the enterprise.

The 2015 amendments adapt the Code to the Equality Act as to gender equality, instruct the supervisory board to make sure that new candidates for the supervisory board can devote the expected amount of time required and recommend transparency where a supervisory board member took part in only half or less of the meetings of the board and of the committees to which he belongs (participation by telephone or video conference counts). All these amendments were very controversial and added to the criticism of the Commission and the Code in general.[14]

3. Giving Shareholders a Choice Between the Two Systems

a) The International Trend

The international trend is clearly towards giving shareholders a choice between the one-tier and the two-tier systems.[15] This is the case for example in France, the Netherlands, Belgium, Luxembourg, Finland and most recently Denmark as well as in some other non-European countries. Some other countries, including Italy and Portugal, even provide for a choice among more than two models. The European Union as well has provided for a choice between the one-tier and the two-tier systems in the European Company (Societas Europaea, SE).

b) German Conservatism

Germany is an outlier in this respect. It has consistently refused to give shareholders a choice between the two systems, even though pleas for such a reform have long since been on the table.[16] Most recently the German Lawyers Association has also recommended such an option to the German legislator by a large majority of the votes.[17] As described before, both systems have developed

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[14] See K. J. Hopt, *Der Deutsche Corporate Governance Kodex: Grundlagen und Praxisfragen,* in: G. Krieger, M. Lutter and K. Schmidt (eds.), *Festschrift für Hoffmann-Becking*, Munich (2013), p. 563.

[15] K. J. Hopt (fn. 1), LIX The Am. J. Comp. L. (2011) p. 1, 22 et seq.

[16] For example K. J. Hopt and P. C. Leyens, *Board Models in Europe, Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, European Company and Financial Law Review (ECFR) (2004), p. 135, 163 et seq. with further references.

[17] German Lawyers Association, 69th Biannual Meeting (Deutscher Juristentag), Munich 2012, *Resolutions of the Commercial Law Division*, Resolution 19: "The legislature should give all stock corporations as in the European Company (SE) the choice between the two-tier and the one-tier board system." The vote was 53 in favor and 26 opposed, with 5 abstentions.

for historical reasons, are path-dependent and have their pros and cons. The shareholders know better than the legislators what suits them, and they also bear the risk in a competitive environment if they make the second-best choice. The restraint of Germany is even less justified since the European companies in Germany do have this choice. The real reason for the restrictive attitude is, besides sheer traditionalism and conservatism, the fact that the trade unions do everything possible to preserve (untouched) labor codetermination in the boardroom at parity or quasi-parity, and they know very well that such codetermination would be much less acceptable in a one-tier board. Thus they shy away from having the flexible negotiation system in force for the European Company under European law extended to German corporations.

4. The European Dimension of Board Regulation

a) Low-key Harmonization by Three EU Recommendations

The European Union has done very little as concerns board regulation. This is understandable, because the far-fetched harmonization plans laid down in the Draft Fifth Company Law Harmonization Directive failed completely. Yet two recommendations of the European Commission were quite influential, also in Germany, not as far as legislation was concerned, but as to recommendations in the German Corporate Governance Code. The Recommendation of 14 December 2004[18] dealt with the remuneration of directors of listed companies and was revised by the Recommendation of 30 April 2009.[19] The Recommendation of 15 February 2005[20] related to the role of non-executive or supervisory directors and the committees of the (one-tier) board or the supervisory board. For both Recommendations there is also an Implementation Report.[21] Furthermore, as already mentioned, the Statute on the European Company of 2001 extends an option right to the founders and shareholders to choose between the one-tier board and the two-tier board and contains some basic provisions on the board. Labor codetermination in the European Company is extensively regulated in a directive that introduces a compromise that is much more flexible and leaves room for negotiation between capital and labor. More generally it has been complained in Germany that the focus of the European Commission when dealing with the board has been on the unitary board, and in so doing extending

[18] Commission Recommendation 2004/913/EC as of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies, OJEU L 385/55 (29 December 2004).

[19] Complementing Commission Recommendation 2009/385/EC as of 30 April 2009, COM(2009) 211 final.

[20] Commission Recommendation 2005/162/EC as of 15 February 2005, OJEU L 52/51 (25 February 2005).

[21] European Commission, Implementation Report as of 2 June 2010, COM(2010) 285 final.

the same rules to the two-tier board without taking into consideration its specificities and possibly different problems and needs. In reaction to this criticism the European Commission has stated several times that it has not taken sides in the discussion on the pros and cons of the two systems.

b) The European Commission's Action Plan and its Failure to Address Board Reform

The European Commission's Action Plan on European Company Law and Corporate Governance of December 2012[22] picked up on the popular topic of remuneration policies and individual remuneration, though not by imposing more rules on the board (viz. the supervisory board) but by proposing a remuneration report and, more far-reaching, shareholder say on pay. As to this a draft directive is pending in the legislative process and may be enacted by winter 2015/16. Yet as to many other reform proposals brought forward in the Member States the Commission has remained silent. The emphasis on independent directors that was still preponderant in the Recommendation of 2005 has given way to a more nuanced view on the composition of the (supervisory) board. In the end the financial crisis has taught the lesson that while independence is good to have, supervision and control by persons who have lengthy experience and are experts in the field is a necessity. An important point for this re-evaluation may also have been the insight gained after the financial crisis that banks are special and so is corporate governance of banks.[23] Empirical evidence has been found that companies and boards of those financial institutions that were more inclined to look after corporate governance and the interests of the shareholders – i. e. that were perfectly complying with good corporate governance standards as developed for companies in general – actually did worse during the financial crisis.[24]

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[22] European Commission, Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies, Brussels, 12 December, COM(2012) 740/2. See K. J. Hopt, *Corporate Governance in Europe, A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance*, 12 No. 1 New York University Journal of Law & Business (2015), p. 139–213.

[23] K. J. Hopt, *Corporate Governance of Banks and Other Financial Institutions After the Financial Crisis*, 13 No. 2 J. Corp. L. Stud. (2013) p. 219. On corporate governance of banks see K. J. Hopt and G. Wohlmannstetter (eds.), *Handbuch Corporate Governance von Banken*, Munich (2011); H.-H. Kotz and R. H. Schmidt, *Corporate Governance of Banks – A German Alternative to the Standard Model*, Zeitschrift für Bankrecht und Bankwirtschaft (ZBB/JBB) (2016), p. 427; K. Johansen, S. Laser, D. Neuberger and E. Andreani, *Inside or outside control of banks? Evidence from the composition of supervisory boards*, 43 European Journal of Law and Economics (2017), p. 31–58.

[24] K. J. Hopt (fn. 23), 13 No. 2 J. Corp. L. Stud. (2013), p. 219, 239 et seq.

5. Convergence and Divergence

a) Signs of Convergence

As to the two board systems, a recent comparative study of boards in Europe[25] found that there is considerable convergence of the two systems and gave four reasons for the phenomenon. First, the one-tier board to a large degree makes use of delegation to the management and considers as its main task monitoring the exercise of the delegated powers. Secondly, both boards depend on the management and the information given to the board by management. Even the decisions the board (viz. the supervisory board) takes must usually be prepared by management. Thirdly, the movement toward independent directors that has started in the USA and the United Kingdom is leading to a sort of de facto separation within the unitary board. Furthermore, the separation between the CEO and the chairman that has started in the United Kingdom has subsequently become a good corporate governance requirement and is accepted, even in stricter regulation, by German legislators. Finally, convergence tendencies exist also in the exercise of certain functions such as strategy, risk management and internal control.

b) Path-dependent Divergence

The American theory that corporate law and more specifically the law on boards will ultimately converge has not been matched by corporate reality,[26] certainly not in its extreme form of "the end of corporate law".[27] This is not the place to go into this extensive international discussion. It suffices here to point to the specific path-dependent characteristics of German corporate law, including the law on the supervisory board.[28] In respect of the board, these path-dependencies include: the two-tier board system, stakeholder orientation, labor codetermination on the supervisory board and the law on groups of companies which comprises specific duties for the boards of both the parent company and the subsidiaries.

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[25] P. L. Davies and K. J. Hopt (fn. 1), LXI Am. J. Comp. L. (2013), p. 301, 310 et seq.

[26] P. L. Davies and K. J. Hopt (fn. 1), LXI Am. J. Comp. L. (2013), p. 301, 356 et seq.

[27] H. Hansmann and R. Kraakman, *The End of History of Corporate Law*, 89 Georgetown Law Journal (2001) p. 439; cf. H. Hansmann, *How Close is the End of Corporate Law,* 31 Journal of Corporate Law (2006), p. 745.

[28] Most recently K. J. Hopt, *Law and Corporate Governance: Germany within Europe,* 27 No. 4 Journal of Applied Corporate Finance (JACF) (2015), p. 8–15.

II. The German Law of the Supervisory Board: Problems and Experiences

1. The Composition of the Board, in Particular Labor Codetermination and the Stakeholder Perspective

a) Quasi-parity Labor Codetermination in German Boards

The primary characteristic of the boards of major German stock corporations is labor codetermination.[29] Labor codetermination in the boardroom is quite common in Europe, but only up to one third of the supervisory board members as in China[30]. According to the Codetermination Act of 1976, corporations with more than 2,000 employees are subject to quasi-parity labor codetermination. Quasi-parity means that both capital and labor have an equal amount of seats in the supervisory board, but in cases of deadlock the chairman of the supervisory board has a double vote. About 280 stock corporations and altogether 700 companies are subject to quasi-parity labor codetermination.[31] Besides quasi-parity labor codetermination, there are still two other forms of codetermination. About 695 stock corporations and altogether 1,500 companies are subject to one-third-parity codetermination, this codetermination with a third of the seats of the supervisory board going to labor is mandatory for companies with more than 500 employees. But there is also full parity labor codetermination. This is mandatory on coal, iron and steel companies and, upon pressure by the trade unions, was kept by the legislature even for those companies that are no longer active in these sectors. In full parity codetermination the law provides for an additional independent member, the 21st, who casts the decisive vote in case of a deadlock. The number of companies under full parity codetermination is small, but altogether around 1,000 stock corporations in Germany are subject to labor codetermination in their boards. Labor codetermination is in principle limited to the supervisory board, but in companies with more then 2,000 employees a "labor director" (Arbeitsdirektor) must be appointed in the management board. Usually he is a member of a trade union which is represented in the company.

b) The Experience with Labor Codetermination

To begin with one should realize that quasi-parity amounts in most cases to full parity since the chairman of the supervisory board will be very reluctant to make use of the second voice in order not to spoil labor relations in the corpora-

[29] See the comprehensive commentary by P. Ulmer, M. Habersack and M. Henssler (eds.), *Mitbestimmungsrecht*, Munich, 3rd edn. (2013). For a comparative evaluation see P. L. Davies and K. J. Hopt (fn. 1), LXI Am. J. Comp. L. (2013), p. 301, 339 et seq.

[30] Guo Li and M. Takayuki (fn. 3).

[31] For these and the following figures see M. Roth (fn. 1), p. 256, 288 et seq. with further references.

tion. In nearly all cases compromises will be found before the double vote comes into the play. Furthermore, under German law the influence of labor interests are further strengthened by the fact that the stakeholder perspective is mandatory for the management board. Under the predecessor of the Stock Corporation Act of 1965 this was stated expressly in the Act. The 1965 Act says only that the management board has direct responsibility for the management of the company.[32] Yet it is generally understood that this does not amount to a change, instead meaning that the management board has to manage the company not just in the interest of the company's shareholders, but also has to take into consideration the interest of labor and the public good and to weigh these interests.[33]

More generally the consequences of labor codetermination on the corporation and on the economy are very much disputed, the debated opinions, arguments and standpoints being very often politically motivated. The empirical studies are for the most part contradictory, and there is a full break between the evaluation by most economists on the one side and the sociologists on the other side.[34] The latter emphasize the contribution of labor codetermination to compromise solutions and the appeasement of capital and labor, and indeed in the reorganization process of Eastern German companies after reunification, labor codetermination definitely helped. This is also true in cases of financial difficulties, when lay-offs and other major cuts in labor conditions are necessary for the survival of the company. On the other side there are considerable disadvantages such as the slowing down of the decision-making process, less readiness to agree to a restructuring of the company having consequences for labor, no openness to (hostile) takeovers, in particular if the bidder comes from abroad, and a strong reluctance to accept new management board members if they have a record of restructuring and of investments abroad and if there are fears that the workforce at home will be diminished. All this carries consequences and costs not only for the single enterprise but also for the economy as a whole, though right now the German economy does not fear this in terms of competitiveness. But on the European level it cannot be disputed that German labor codetermination was one of the major stumbling blocks for the harmonization of company law in the European Union (for which opinions differ as to the pros and cons). The European Company came about only after many decades and under

[32] Sec. 76 (1) of the German Stock Corporation Act.

[33] U. Hüffer and J. Koch, *Aktiengesetz*, Munich, 12th edn. (2016), sec. 76 with many references.

[34] K. Pistor, *Corporate Governance durch Mitbestimmung und Arbeitsmärkte*, in: P. Hommelhoff, K. J. Hopt and A. v. Werder (eds.), *Handbuch Corporate Governance*, Cologne, 2nd edn. (2009), p. 231; idem, *Codetermination: A Sociopolitical Model with Governance Externalities*, in: M. M. Blair and M. J. Roe (eds.), *Employees and Corporate Governance*, Washington D. C. (1999), p. 163; E. McGaughey, *The Codetermination Bargains: The History of German Corporate and Labour Law*, LSE Law, Society and Economy Working Papers (October 2015).

a very difficult, costly and burdensome compromise. The European Private Company had to be abandoned by the European Commission, primarily due to German labor codetermination. Consequently, industry and academia proposals providing solutions more flexible than fully mandatory labor codetermination have been brought forward, but up to now without any prospects of being accepted by legislators. In any case, German (quasi-)parity labor codetermination is not welcome in most of the other Members States of the European Union, a fact that is even conceded by foreign labor lawyers.[35]

2. The Internal Structure of the Supervisory Board and its Relation to the Management Board

a) The Internal Structure and Functioning of the Supervisory Board

Germany has by far the largest boards in Europe.[36] This is mostly due to labor codetermination. For companies subject to quasi-parity codetermination the board must comprise 12, 16 or 20 supervisory directors, depending on the number of employees in Germany (only in Germany and not abroad – this being an issue which is pending before the courts). In companies subject to full parity codetermination the board has 21 members. It is generally understood that a smaller size would be preferable for the work of the board. This is one of the reasons why German companies sometimes choose the legal form of a European Company, under which there is more flexibility.[37]

Traditionally, independent directors are not mandatory under the German Stock Corporation Act, neither in the management board nor in the supervisory board. But since 2005, in the case of companies that are oriented toward the capital market,[38] at least one member of the supervisory board must have expert knowledge in the fields of accounting or annual auditing. In the reform discussion it has been claimed that expert knowledge not only in one, but in both fields should be required. Yet under the German Corporate Governance Code independent directors are deemed appropriate.[39] It is controversial wheth-

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[35] P. Davies, *Efficiency Arguments for the Collective Representation of Workers: A Sketch*, Oxford Legal Studies Research Paper No. 66/2014.

[36] Heidrick and Struggles, *Challenging board performance*, 2011, p. 37; M. Roth (fn. 1), p. 256, 285 et seq.

[37] M. Roth (fn. 1), p. 256, 286.

[38] Sec. 100 (5) of the German Stock Corporation Act. See the definition in sec. 264d of the German Commercial Code: companies that are listed at an organized market in the sense of sec. 2 (5) of the Securities Act (WpHG) or that have applied to be listed. Cf. H. Gesell, *Prüfungsausschuss und Aufsichtsrat nach dem BilMoG,* Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR) (2011), p. 361, 383 et seq.; E. Vetter, *Der Prüfungsausschuss in der AG nach dem BilMoG*, ZGR (2010), p. 751, 780 et seq.; and briefly U. Hüffer and J. Koch (fn. 33), sec. 107 comment 26.

[39] German Corporate Governance Code (fn. 13), no. 5.4.2: "The Supervisory Board shall

er labor representatives in the supervisory board who are employed by the corporation can really be considered as independent as the trade unions and the government maintain.[40] As to union members in the supervisory board the law and experience in the Netherlands is interesting, there only members of unions that are not dealing with the corporation are admitted. But it must be kept in mind that since the financial crisis the pendulum has swung back from too much reliance on independent directors to emphasizing more the competence and experience of supervisory board candidates. According to the Code the supervisory board has to be composed in such a way that its members as a group possess the knowledge, ability and expert experience required to properly complete its tasks.

German law allows only natural persons to be member of the supervisory board. This is in contrast to the law in other countries and has been criticized also in Germany. Several further personal qualifications in the law are of a negative nature.[41] First, as mentioned before, the supervisory board member may not have more than 10 supervisory board mandates in other commercial enterprises which are required by law to form a supervisory board. In the reform discussion, allowing only five has been considered more appropriate and the German Corporate Governance Code recommends only three (with an exception for groups of companies).[42] Then the law provides for incompatibilities between a seat in the supervisory board and being the legal representative of a controlled enterprise of the company, and it prohibits certain interlocking directorships. The most recent provision dating from 2009 provides that a person may not be a member of the supervisory board where he or she was a member of the management board of the same listed company during the past two years, unless he is elected upon nomination by shareholders holding more than 25 per cent of the voting rights of the company. This provision stopped the former widespread practice of changing over from the management board into the chair of the supervisory board, but it is generally criticized for being excessively broad and inflexible.[43]

As to the internal organization of the supervisory board, the law addresses the formation of committees but is very lenient and, without mandating, merely allows the supervisory board to appoint among its members one or more com-

include what it considers an adequate number of independent members.", no. 5.3.2: The chairman of the audit committee shall be independent.

[40] Similarly in China the employee-supervisory system is criticized because employees are under the control of the managers whom the board of supervisors should monitor.

[41] Sec. 100 (2) of the German Stock Corporation Act.

[42] K. J. Hopt and M. Roth (fn. 12), sec. 100, comment 48; German Corporate Governance Code (fn. 13), no. 5.4.5.

[43] Cf. E. Sünner, *Die Wahl von ausscheidenden Vorstandsmitgliedern in den Aufsichtsrat*, Die Aktiengesellschaft (AG) (2010), p. 111; U. Hüffer and J. Koch (fn. 33), sec. 100, comment 16 with further references.

mittees, in particular for purposes of preparing deliberations and resolutions or for supervising the execution of its resolutions. Not even an audit committee is mandatory by law, but if an audit committee is set up in a company which is oriented towards the capital market at least one member of it has to be independent and have the above-mentioned expertise in the fields of accounting or annual auditing.[44] But the German Corporate Governance Code recommends the formation of three committees: for audit, nomination and compensation, the audit committee of course being the most important among them. Nearly all major stock corporations have these three committees, in financial institutions even more, in particular a risk committee. According to the Code the chairman of the supervisory board shall not be chairman of the audit committee.

Further requirements concern the compensation of supervisory board members and contracts with them. The compensation must be determined either in the articles or be set by the shareholders meeting. It shall bear a reasonable relationship to the duties of the members of the supervisory board and the condition of the company.[45] Contracts entered into by a supervisory board member on the provision of professional services in addition to his services as such a member or on undertaking a special assignment require the consent of the supervisory board in order to be valid.[46] This has led to a considerable change of the former board practices under which supervisory board members received additional compensation, which called their independence into question.[47]

b) The Relations Between the Supervisory Board and the Management Board: Control Ex Ante and Co-decision in Fundamental Affairs

The conception of the Stock Corporation Act is that while the two boards have clearly separate functions and the main task of the supervisory board is the control of management, the two boards should cooperate in running the corporation, not only in daily business but also in strategic decision-making. The supervisory board has been characterized as a "co-deciding control organ".[48] It is not questioned that the advice of the supervisory board is considered to be important for the management board, despite the fact that management is legally reserved to the management board. Under the impression of the scandals and failures in the early 1990s, the emphasis as to the function of the supervisory

[44] Sec. 107 (4) of the German Stock Corporation Act. See also *supra* fn. 39.

[45] Sec. 113 (1) of the German Stock Corporation Act. Cf. also German Corporate Governance Code (fn. 13), no. 5.4.6.

[46] Sec. 114 of the German Stock Corporation Act. See also sec. 115 of the German Stock Corporation Act, which regulates the grant of credit to a supervisory board member.

[47] The case law is rather strict and strikes down attempts of corporate practice to evade the requirement of consent. See the recent decision of the Federal Supreme Court (Bundesgerichtshof), BGHZ 194, 14 = Neue Juristische Wochenschrift (NJW) (2012), p. 3235 – Fresenius-case.

[48] K. J. Hopt and M. Roth (fn. 12), sec. 111, comments 52 et seq.

board has moved from mainly ex post control to also control ex ante with a preventive function. This implies that the supervisory board also has, though limited, a right of entrepreneurial initiative.[49] Under certain circumstances the law goes further and empowers the supervisory board with important entrepreneurial tasks, for example as to those management tasks for which the consent of the supervisory board is necessary under the articles of association. Under a reform act of 2002, the articles or the supervisory board is even obliged by law to determine that specific types of transactions may be entered into only with the consent of the supervisory board.[50] According to some voices the consent requirement should apply to all fundamental decisions in the company, yet this would go too far.[51] Among other instances of legally mandated co-decision of the two boards,[52] one should be mentioned specifically. The Takeover Act allows the management board to take frustrating actions against a (hostile) takeover bid if the supervisory board gives its consent.[53] With this provision the German legislature has made use of the right given by the Takeover Directive to opt out of the anti-frustration rule. It is quite obvious that the legislators, under the influence of German industry and not-so-independent academics, expect that a coalition of the two boards and labor will fight off unwelcome takeovers, in particular if they come from abroad.[54]

3. The Tasks, Rights and Duties of the Supervisory Board, in Particular Control Over the Management Board

a) The Tasks, Rights and Duties of the Supervisory Board

The supervisory board has several rights that enable it to control management. The primary right has already been mentioned, namely the right to nominate and possibly to dismiss the members of the management board for cause as well as the right and sometimes the duty to sue members of the management board in the court. This strong position of the German supervisory board is different

[49] K. J. Hopt and M. Roth (fn. 12), sec. 111, comments 84 et seq.

[50] Sec. 111 (4) sentence 2 of the German Stock Corporation Act; K. J. Hopt and M. Roth (fn. 12), sec. 111, comments 595 et seq.

[51] K. J. Hopt and M. Roth (fn. 12), sec. 100, comments 608 et seq.; yet the formula used in the German Corporate Governance Code (see fn. 13), no. 3.3, seems to cover all transactions of fundamental importance.

[52] See the list in K. J. Hopt and M. Roth (fn. 12), sec. 111, comments 67 et seq.

[53] Sec. 33 (1) sentence 2 (at the end) of the German Takeover Act ("Wertpapierübernahmegesetz" or "WpÜG").

[54] As to the decisive influence of German lobby on the watering down of the Takeover Directive under Gerhard Schröder, while he was still sitting in the board of Volkswagen as presiding minister of Lower Saxony, cf. K. J. Hopt, *La treizième directive sur les OPA-OPE et le droit allemand*, in: *Aspects actuels du droit des affaires, Mélanges en l'honneur de Yves Guyon*, Paris (2003), p. 529, 538; R. Skog, *The Takeover Directive. An endless saga?*, 13 European Business Law Review (EBLR) (2002), p. 301.

in some other two-tier systems such as China.[55] The supervisory board has extensive rights of inspection and information in order to fulfill its control function.[56] The information right of the supervisory board is essential and goes very far. Usually the supervisory board gets its information from the management board, but under special circumstances also directly from key function holders in the corporation, for example from the compliance officer or the heads of the corporation's risk management and internal audit. The supervisory board may also commission individual members or, with respect to specific assignments, special experts to carry out the inspection and examination of the books and records of the company as well as the assets of the company. The supervisory board shall instruct the auditor as to the annual financial statements and consolidated financial statements. The supervisory board represents the company both in and out of court as against the management board. This is particularly relevant if one or more members of the management board have violated their duties. In such cases the supervisory board is usually under a legal obligation to enforce the liability claim of the company before the courts.[57] Further rights of the supervisory board against the management board and its members concern, *inter alia*, remuneration, the competition of management board members with the company, the extension of credit to them and in particular the information duties of the management board towards the supervisory board.

b) The Experience with the Control of the Supervisory Board over the Management Board

Overall the prevailing opinion in Germany unlike in China[58] seems to be that the experience made with the control of the supervisory board on the management board, while by no means being perfect, is still more or less satisfactory, though there are of course cases where this control has failed. This has particularly been the case with the German state banks during the financial crisis.[59] Yet the financial crisis and the situation of the German state banks were exceptional, and the experience made there cannot be easily transposed to corporations in general.[60] As a consequence the regulation and supervision of banks after the financial crisis have stiffened dramatically, and rightly so since the corporate governance of banks is very special and cannot be equated with the corporate governance of

[55] Guo Li and M. Takayuki (fn. 3).

[56] See in detail sec. 111 of the Stock Corporation Act.

[57] See *infra* II 4 a.

[58] Guo Li and M. Takayuki (fn. 3): Chinese scholars give very low marks to the Chinese board of supervisors.

[59] H. Hau and M. Thum, *Subprime Crisis and Board (In)Competence: Private v. Public Banks in Germany*, INSEAD Working Paper No. 2010/45/FIN (21 June 2010).

[60] D. Weber-Rey, *Ausstrahlungen des Aufsichtsrechts (insbesondere für Banken und Versicherungen) auf das Aktienrecht – oder die Infiltration von Regelungssätzen?*, ZGR (2010), p. 543.

non-banks.[61] Yet also as to the latter there is a discussion whether the liability provisions need to be improved, as will be discussed in the next section.

4. The Liability of the Supervisory Board

a) The Legal Situation

The members of the supervisory board are liable if they violate their duties of care and of loyalty in the same way as management board members.[62] This means that the extensive, well-established doctrine and case law on such liability[63] are applicable by analogy to supervisory board members too. The members of the supervisory board are liable individually. In case of illegal actions by other members or the board as a whole they must not only abstain from voting, but take the necessary action including informing the chairman of the board or, if need be, the shareholders and in the case of banks in extreme cases even the bank supervisory agency. The analogous application encompasses also the business judgment rule, according to which directors are not deemed to have violated their duties if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting for the benefit of the company on the basis of adequate information.[64] Furthermore, by the same analogy supervisory board members bear the burden of proof in the event of a dispute as to whether or not they have employed the care of a diligent and conscientious director.[65] Yet this rule has become subject to serious criticism, in particular regarding cases in which a director has already left the corporation and has no more access to the corporate files.[66]

b) The Experience: Growing Risk of Liability After the Financial Crisis

The German liability regime for directors, both management and supervisory board members, is rather far-reaching and strict when one looks solely at the Stock Corporation Act. But traditionally there has been little enforcement, though a number of cases have arisen, in particular as to limited liability com-

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[61] S*upra* I 4 b.

[62] Sec. 116 of the German Stock Corporation Act (refers back to sec. 93 on the liability of the members of the management board).

[63] See most recently the extensive comments by K. J. Hopt and M. Roth, *Großkommentar Aktiengesetz*, Berlin, 5th edn. (2015), sec. 93 with many references.

[64] Sec. 93 (1) sentence 2 of the German Stock Corporation Act. As to the business judgment rule see R. Veil, *Business Judgment Rule*, lecture at the conference held at the Tongji University in Shanghai on 23 and 24 October 2015; K. J. Hopt and M. Roth (fn. 12), sec. 93, comments 61–131; K. J. Hopt, *Die business judgment rule, Ein sicherer Hafen für unternehmerische Entscheidungen in Deutschland und in der Schweiz,* in: R. Waldburger et al. (eds.), *Law & Economics, Festschrift für Peter Nobel zum 70. Geburtstag*, Bern (2015), p. 217.

[65] Sec. 93 (2) sentence 2 of the German Stock Corporation Act.

[66] See *infra* fn. 70.

panies (GmbH) and small cooperative banks. This is in line with international findings on the liability or rather non-liability of outside directors and seems also to be the case in China[67]. Yet the ARAG/Garmenbeck decision of the German Federal Court of Appeals (Bundesgerichtshof)[68] and the financial crisis have led to an important change; under the former the supervisory board is required to bring an action against a management board member who has violated his duties, and the financial crisis has evidenced gross management mistakes with enormously high damages. Now many cases are brought, both under civil law and under criminal law.[69] As a consequence there is an ongoing, controversial discussion on the reform of the liability regime for directors, yet most recently the German Lawyers Association has sought only minor reforms (including changing the burden of proof on the side of the director) while leaving the system as such untouched.[70] Up to now there are no signs that German legislators will step in, after having ceded in 2010 to populists claims in favor of prolonging the limitation period for liability claims to 10 years if the corporation is listed at the stock exchange.[71]

5. Concurring Control by Shareholders, Auditors and the Markets

a) Control of the Shareholders over the Board

The control of the supervisory board over the management board works fairly well, but as we have seen is by no means perfect. It is therefore important to consider whether there are other persons, institutions and mechanisms that also exercise control. These are first of all the shareholders, i. e. the principals who have entrusted the supervisory board to exercise for them the control function over the management board. The shareholders control the supervisory board

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[67] F. Xiangxing Hong, *Director Regulation in China: The Sinonization Process*, 19 Michigan State Journal of International Law (2011), p. 501, 532 et seq., 548, 549; Tang Xin, *Directors' liability in Chinese stock corporations – deficiencies and the need for a reform*, lecture at the conference held at the Tongji University in Shanghai on 23 and 24 October 2015. Cf. Also R. Lee, *Fiduciary Duty Without Equity: "Fiduciary Duties" of Directors Under the Revised Company Law of the PRC*, 47 Virginia Journal of International Law (Va. J. Int'l L.) (2007), p. 897, 909 et seq.

[68] This landmark case ARAG/Garmenbeck is a decision by the Supreme Federal Court (Bundesgerichtshof) of 21 April 1997, BGHZ 135, 244 = ZIP (1997), p. 883.

[69] See the references given by K. J. Hopt, *Die Verantwortlichkeit von Vorstand und Aufsichtsrat*, ZIP (2013), p. 1793 et seq.

[70] German Lawyers Association (fn. 17), 70th Biannual Meeting (Deutscher Juristentag), Hannover (2014). Cf. K. J. Hopt, *Die Reform der Organhaftung nach § 93 AktG – Bemerkungen zu den Beschlüssen des 70. Deutschen Juristentages 2014*, in: T. Ackermann and J. Köndgen (eds.), *Privat- und Wirtschaftsrecht in Europa: Festschrift für Wulf-Henning Roth zum 70. Geburtstag*, Munich (2015), p. 225.

[71] Sec. 93 (6) of the German Stock Corporation Act as of 1998. This has been criticized by most commentators and also by the German Lawyers' Association.

directly by electing and, if necessary, revoking its members.[72] Revocation is possible before expiration of the term of office, which is usually up to five years,[73] but only with a qualified majority of three-fourths of the votes cast. The shareholders also have an indirect influence on the revocation of management board members by the supervisory board. Normally the supervisory board members are elected for five years and may not be dismissed earlier unless for cause. Yet such cause is also deemed to be a vote of nonconfidence by the shareholders' meeting, unless such vote of no-confidence was made for manifestly arbitrary reasons.[74] Furthermore the shareholders meeting may adopt a resolution whereby claims of the company for damages against certain management board members shall be asserted and, if the facts are unclear, that special auditors shall be appointed. In both cases the resolution is adopted by a simple majority and, if this majority is not reached, there are special rights for a minority with a share capital of one per cent or shares of at least 100,000 Euros (nominal value).[75] The experience made with these rights shows, however, that they are rarely exercised due to the rational apathy of small shareholders; a controlling shareholder, by contrast, will have his way, at least in the end, through his influence on the supervisory board members. Yet more recently the rise of institutional shareholders may lead to more control, at least indirect control, over the management board.

b) Transparency and the Role of Auditors and Other Gatekeepers

Transparency and disclosure are well-known means of corporate governance and help also to discipline management.[76] Transparency and disclosure requirements, both by corporate law and even more so by capital market law, have become increasingly strict, partly because of the influence of European law. Traditionally the most important part of transparency and disclosure is the annual accounts, but they come only ex post, while capital market law requirements on disclosure usually function ex ante. Control by transparency and disclosure presupposes, of course, reliability, as well as control by independent external agents such as auditors. The law on auditing and auditors has been reformed most recently by the European Union in reaction to the financial crisis

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[72] Sec. 101 and 103 of the German Stock Corporation Act.

[73] See more precisely sec. 102 of the German Stock Corporation Act.

[74] Sec. 84 (3) sentence 2 of the German Stock Corporation Act.

[75] Sec. 147 et seq. of the German Stock Corporation Act on the assertion of damage claims and sec. 142 et seq. on the special audit.

[76] On the role of disclosure there is vast legal and economic literature, see e. g. R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. J. Hopt, H. Kanda, M. Pargendler, W.-G. Ringe and E. Rock (eds.), *The Anatomy of Corporate Law*, 3rd ed., Oxford (2017), p. 245 et seq.; S. Grundmann, W. Kerber, S. Weatherhill (eds.), *Party Autonomy and the Role of Information in the Internal Market*, Berlin/New York (2001).

and is now rather strict.[77] Other gatekeepers like rating agencies, financial analysts and proxy advisers help by evaluating the companies and the performance of the management. They are becoming increasingly regulated, again mostly as a consequence of European law.[78]

c) The Control of the Markets Over the Board, in Particular of the Market for Corporate Control: Limited Experience

Apart from internal corporate governance there is external corporate governance exercised by the markets. Markets that are relevant for disciplining management are the product market, the labor market (market for corporate directors) and the market for corporate control. The product market functions well, though of course varying according to the relevant sector; the market for corporate directors functions well too, albeit more nationally as foreign directors on German boards are still the exception, though recently their number is increasing. While M & A is blossoming also in Germany, the actual market for corporate control, i. e. via public takeover, has traditionally not been very developed, hostile takeovers being very rare.[79] One reason for this is the fact that German shareholdership is for the most part not dispersed, with families and groups of companies most frequently in control. Another reason is the fact that German law did not adopt the anti-frustration rule British style, but rather allows management to take defensive actions without asking the general assembly for its consent. Under the German takeover act it is sufficient if the supervisory board agrees.[80]

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[77] See K. J. Hopt, *Abschlussprüfung in Deutschland und Europa nach der europäischen Reform von 2014*, ZGR (2015), p. 186 and further contributions to issue 2 of this law review, p. 186–324; H. Merkt, *Die Zusammenarbeit von Aufsichtsrat und Abschlussprüfer nach der EU-Reform: Mut zur Erwartungslücke*, 179 Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) (2015), p. 601.

[78] P. C. Leyens, *Informationsintermediäre des Kapitalmarkts – Private Marktzugangskontrolle durch Abschlussprüfer, Bonitätsrating und Finanzanalyse*, Professor thesis at Hamburg University Faculty of Law May 2015, forthcoming.

[79] But cf. the hostile takeover activities of the Chinese Uni Fosum against the BHF-Bank, cf. *Tai-Chi gegen deutsches Investmentbanking*, Frankfurter Allgemeine Zeitung, No. 175 (31 July 2015), p. 22.

[80] For a detailed criticism of German takeover law in this respect cf. K. J. Hopt, *Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis,* 20 Columbia Journal of European Law (CJEL) (2014) p. 249; see also M. Rowoldt and D. Starke, *The role of governments in hostile takeovers – Evidence from regulation, anti-takeover provisions and government interventions*, 47 International Review of Law and Economics (2016), p. 1–15.

III. Summary

1. Together with a number of other countries Germany has a two-tier board system, i. e. its stock corporation law provides for a (mandatory) division between the management board and the supervisory board. This is different from most other countries, for example the USA, the United Kingdom, Switzerland and others that have a one-tier or unitary board. Both board systems have their assets: the two-tier system offering the clear division of management and control function, the one-tier system providing the direct information flow within the board, also to independent directors. Yet in principal both fulfill adequately the task of control over management; comparative law and experience does not show a clear superiority of one of the two systems.

2. The national board systems are highly path-dependent. Germany has had the supervisory board ever since the late 19th century when the state gave up its concession system, i. e. the approval and supervision of corporations by the state, and introduced a mandatory supervisory board to take over this task from the state. More recently, the traditional Rhineland capitalism ("Germany Inc.") in which industry and banks closely cooperated in the supervisory boards of major companies by means of interlocking directorates has been quickly fading away.

3. Germany has stuck to the two-tier system ever since and strictly refuses to give shareholders the option to choose between the two systems. This is so despite the fact that the European Company that exists under German law does have such an option as required by European law. Labor codetermination in the supervisory board may be one of the reasons for this refusal.

4. While European legislators have been rather hesitant in regulating board matters, there has been a considerable de facto convergence between the two systems. Still, path-dependent divergences remain; as to Germany this can be seen in particular in quasi-parity and full parity labor codetermination in the board of corporations, but also in stakeholder orientation and a codified law of groups of companies with corresponding duties of the board of both the parent company and the subsidiaries.

5. The German Stock Corporation Act and the German Corporate Governance Code contain extensive provisions on the management board and the supervisory board. The provisions on the supervisory board in the Act have been considerably reformed since the last quarter of the 1990s, and the provisions in the Code have been continuously reformed, most recently in 2015. Today German corporate governance under the two-tier board system is more or less in line with modern international corporate governance.

6. In Germany there is considerable controversy concerning the diversity requirements of 2015, the definition of independence for supervisory board candidates, the pros and cons of quasi-parity and full-parity labor codetermination in the board, and the role of the German Corporate Governance Code.

The Chinese Board of Supervisors System: An International Comparison

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I. Introduction

There are many countries in the world which have an organ in their corporate governance system called the Board of Supervisors (监事会, "BoS"). In addition to the People's Republic of China[1] ("China"), Germany (Aufsichtsrat)[2] and Japan (监查役会)[3] also have the BoS system.[4] Since there is a separation between the monitor (BoS) and the monitored (directors and officers), the BoS system which does not exist in the USA is sometimes viewed favorably by American scholars.[5] Both systems are different from each other despite the similar name. This paper compares the Chinese, German, and Japanese BoS systems. It analyses the characteristics of the Chinese BoS system and provides legislative proposals for further improving the system primarily by drawing lessons from both Germany as well as Japan. This paper focuses on the BoS of listed companies.[6] It does not address the BoS system of small-sized and closed companies.[7]

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[1] Art. 117 of the Company Law of the People's Republic of China (中华人民共和国公司法, "Chinese Company Law").

[2] Art. 95 of the Law of Stocks (Aktiengesetz, "German Law"): "The BoS shall comprise three members. The articles may provide for a specified higher number. Such number shall be divisible by three. The maximum number of members of the BoS for companies with a share capital of: up to 1,500,000 euros nine, more than 1,500,000 euros fifteen, more than 10,000,000 euros twenty-one. The foregoing shall not affect provisions to the contrary which are contained in the Employees Co-determination Act of May 4, 1976 (Federal Law Gazette I p. 1153), the Coal and Steel Co-determination Act and the Supplemental Act on the Co-determination of Employees in the BoS and Management Boards in the Mining and the Iron and Steel Producing Industries of August 7, 1956 (Federal Law Gazette I p. 707) – (the Supplemental Co-determination Act)".

[3] Art. 390 of the Corporate Law (株式会社法, "Japanese Law"): "The board of supervisors shall be composed of all supervisors"; note that it is a topic of academic discussion whether the Japanese "监查役(监事)" should be translated as a "supervisor" or an (corporate) "auditor". One problem with the latter choice is that the word "auditor" sounds like an accountant conducting accounting audit. Therefore, this paper uses the translation of "supervisor".

[4] Other than the three countries mentioned above, there are many jurisdictions with the BoS system including France, Korea, and Chinese Taiwan. But this paper does not go into the details of the BoS of other jurisdictions.

[5] See C. J. Owen, *Board Games – Germany's Monopoly on the Two-Tier System of Corporate Governance and Why the Post-Enron United States Would Benefit from Its Adoption*, 22 Penn State International Law Review (2003), p. 167, 184: "Adoption of a default corporate governance structure similar to that of the German structure would have the potential to prevent corporate corruption by forcing a separation between those who manage the day-to-day affairs of the corporation and those who appoint and oversee the managers".

[6] Art. 120 of the Chinese Company Law: "For the purposes of this Law, the term 'listed company' means a JSLC whose shares are listed and traded on a stock exchange".

[7] Ibid, such as the Chinese Limited Liability Company (有限责任公司, "LLC").

II. The BoS in Chinese Companies

1. Overview

In China the BoS is a permanent organ in a company stipulated by law and is responsible to the stockholders. It monitors the management of directors/managers and the company's finance. It also seeks to protect the company along with the shareholders' lawful rights and interests.[8]

2. Relevant Provisions of the Chinese Company Law

a) Basic Structure

The most basic structure of the Chinese BoS is characterized by an organ similar to a committee with three or more members (supervisors). According to the Chinese Company Law, a Joint Stock Limited Company ("JSLC") shall have a BoS of not less than three members.[9] BoS meetings shall be held at least once every six months[10] and its resolutions shall require more than half of the supervisors.[11] The supervisory board shall have a chairman who shall be elected by more than half of all the supervisors.[12]

b) Functions and Powers of the BoS

Although there are many functions and powers assigned to the BoS, many of these pertain to the efficient supervision of the company's management by the executives (directors and/or managers). The BoS of the JSLCs shall exercise the same powers as those allotted to the BoS of the LLCs.[13] These include:[14]

i. examining the company's financial affairs;
ii. supervising the directors and senior officers in the performance of their official duties and proposing the dismissal of directors or senior officers who violate laws or administrative regulations or breach the company's articles of association or resolutions of the shareholders' meeting;
iii. rectifying any act of a director or senior officer that could be detrimental to the interests of the company;

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[8] Zhao Zhenhua, *Corporate Law*, 1st edn. (2010), p. 150–153; Li Jianwei, *Corporate Law*, 2nd edn. (2011), p. 329.
[9] Art. 117 (1) of the Chinese Company Law.
[10] Art. 119 (1) of the Chinese Company Law.
[11] Art. 119 (3) of the Chinese Company Law.
[12] Art. 117 (3) of the Chinese Company Law.
[13] Art. 118 (1) of the Chinese Company Law.
[14] Art. 53 of the Chinese Company Law.

iv. proposing to hold interim shareholders' meetings and in the event that the Board of Directors ("BoD") fails to perform its duty of convening and presiding over a shareholders' meeting, to convene and preside over such a meeting;[15]
v. submitting proposals at a shareholders' meeting;
vi. instituting legal proceedings in a people's court against a director or senior officer in accordance with Art. 151; and
vii. exercising other functions and powers specified in the company's articles of association.

In addition to the above, supervisors may also attend meetings of the BoD as non-voting attendees and raise questions or make suggestions in respect of the subject-matter of the BoD's resolutions.[16] If the BoS discovers irregularities in the company's operations it may conduct an investigation and, if necessary, engage an accounting firm or similar at the company's expense to assist in its work.[17]

c) Other Selected Provisions

A number of provisions pertaining to the BOS in the Chinese Company Law include the obligations as well as the qualifications of supervisors. Supervisors shall comply with laws, administrative regulations and the company's articles of association and shall bear an obligation of loyalty and care to the company.[18] If a supervisor violates any of these in the course of performing his or her official duties thereby causing the company to incur a loss, he or she shall be liable for damages.[19]

Further, directors and senior officers may not concurrently serve as supervisors.[20] The term of service of a supervisor shall be three years.[21] There are other provisions as regards the qualification for supervisors.[22]

[15] Art. 100 Item 5 of the Chinese Company Law: "(An interim shareholders' assembly shall be convened when) the BoS proposes that such a meeting be held".

[16] Art. 54 (1) of the Chinese Company Law.

[17] Art. 54 (2) of the Chinese Company Law; Art. 118 (2) of the Chinese Company Law: "The expenses required by the BoS in exercising its functions and powers shall be borne by the company".

[18] Art. 147 (1) of the Chinese Company Law.

[19] Art. 149 of the Chinese Company Law.

[20] Art. 117 (4) of the Chinese Company Law.

[21] Art. 117 (5) of the Chinese Company Law: "The provisions of Art. 53 hereof concerning the term of service of a supervisor of a LLC shall apply to a supervisor of a JSLC."; Art. 52 (1) of the Chinese Company Law: "The term of service of a supervisor shall be three years. At the expiration of his or her term of service, a supervisor may serve consecutive terms if re-elected".

[22] Art. 146 (1) Item 1 to 5 of the Chinese Company Law: "A person may not serve as a director, supervisor or senior officer of a company if: (1) he or she has no or limited capacity for civil acts; (2) he or she has been sentenced to criminal punishment for corruption, bribery, encroaching property, misappropriating property or disrupting the order of the socialist market

It is important to note that China has adopted the employee-supervisor system.[23] The BoS shall be composed of shareholders' representatives and an appropriate proportion of representatives of the company's staff and workers. The latter shall make up not less than one-third proportion of the Board.[24]

3. Relevant Rules of CSRC

Since China does not have a specific law that governs listed companies, the provisions of Chinese Company Law are applicable both to listed as well as non-listed companies. It is evident that the standard of corporate governance in listed companies should be higher than that in non-listed companies. Taking this into account, the Chinese stock market regulator–The China Securities Regulatory Commission ("CSRC", 证监会) enforces rules and guidelines pertaining to the corporate governance of listed companies. The purpose of these rules and guidelines is to aid listed companies in setting up and maintaining higher standards of corporate governance and to promote the credibility of the Chinese stock market. Some of the provisions of these rules and directions are relevant to the BoS and may be summarized as follows:

Sec. 4 of the "Code of Corporate Governance for Listed Companies in China" (enacted in 2002, "CSRC Code") provides for the responsibilities, composition and the rules of meetings pertaining to the BoS. One of the important provisions is Art. 64 which requires supervisors to have sufficient knowledge and experience.[25] In addition, the CSRC Code stipulates the supervisor's right

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economy, where not more than five years have elapsed since the expiration of the execution period; or has been deprived of his or her political rights for committing a crime, where not more than five years have elapsed since the expiration of the execution period; (3) he or she has served as a director, factory manager or manager of a company or enterprise that went bankrupt and was liquidated, where he or she bears personal liability for the bankruptcy of the company or enterprise and not more than three years have elapsed since the date of completion of the bankruptcy liquidation; (4) he or she has served as the legal representative of a company or enterprise that had its business license revoked and was ordered to close down for a violation of the law, where he or she bears personal liability for such violation and not more than three years have elapsed since the date of revocation of the company's or enterprise's business license; or (5) he or she has a comparatively large personal debt that has fallen due but has not been settled".

[23] Li Jianwei, *Corporate Law*, 2nd edn. (2011), p. 332.

[24] Art. 117 (2) of the Chinese Company Law. In addition, this article provides that "the staff and workers' representatives on the BoS shall be democratically elected by the staff and workers of the company through the assembly of the representatives of the staff and workers, the assembly of the staff and workers or otherwise".

[25] Ibid, "Supervisors shall have professional knowledge or work experience in such areas as law and accounting. The members and the structure of the BoS shall ensure its capability to independently and efficiently conduct its supervision of directors, managers, and other senior management personnel, and to supervise and examine the company's financial matters".

to information[26] and the reporting obligation when he/she discovers any illegalities.[27]

Art. 8 to 12 and Art. 27 Paragraph 2 of the "Rules for the Shareholders Meetings of Listed Companies" (last revised in 2016) describe in detail the procedures of the special shareholders' meeting held by the BoS.

Sec. 7 (Art. 135) of the "Guidance of the Listed Company's Articles of Incorporation" (last revised in 2016) stipulates the specific contents of the articles of incorporation regarding the BoS.

Finally, as per the consent of the State Council, the CSRC has issued an opinion regarding "Improvement of the Listed Company's Quality" (enacted in 2005).

4. Relevant Rules of the Stock Exchange

Mainland China has two stock exchanges, namely the Shanghai Stock Exchange (上海证券交易所) and the Shenzhen Stock Exchange (深圳证券交易所).[28] In order to improve the functions of the BoS, stock exchanges have laid down certain rules and guidelines. Selected provisions of the relevant rules by the Shanghai Stock Exchange are discussed in this part of the paper.

Shanghai Stock Exchange published the "Guideline of the Listed Company's Corporate Governance of the Shanghai Stock Exchange" (enacted in 2000). Sec. 4 of the Guideline deals with supervisors. Art. 28 stipulates that a company may appoint an independent supervisor and that a public servant is not eligible to be a supervisor. Art. 32 provides that supervisors shall disclose any conflict of interest with the company. It also limits the number of listed companies in which one person may be appointed as a supervisor or director concurrently.[29]

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[26] See Art. 60 of the CSRC Code: "Supervisors shall have the right to learn about the operating status of the listed company and shall have the corresponding obligation of confidentiality. The BoS may independently hire intermediary institutions to provide professional opinions"; Art. 61 of the CSRC Code: "A listed company shall adopt measures to ensure the supervisors' right to learn about the company's matters and shall provide necessary assistance to supervisors for their normal performance of duties. No one shall interfere with or obstruct the supervisors' work. A supervisor's reasonable expenses necessary to perform their duties shall be borne by the listed company".

[27] Art. 63 of the CSRC Code: "The BoS may have to report directly to the securities regulatory authorities and other related authorities as well as reporting to the BoD and the shareholders' meetings when the BoS learns of any violation of laws, regulations or the company's articles of association by directors, managers or other senior management personnel".

[28] Ibid, in addition, regarding the sales and purchase of the stocks of the non-listed companies, there is a platform called the "New Three Board" (新三板).

[29] Art. 32 of the "Guideline of the Corporate Governance of the Listed Company of the Shanghai Stock Exchange": "In order to guarantee that the supervisor has enough time and energy to put into the company's business, supervisors may not be responsible for the supervision or directors' duties for many other companies. Supervisors need to announce to the BoS and BoD whether they have enough time and energy to perform the duty".

"The Regulating Rules of Listed Companies' Meeting Procedures of the Board of Supervisors of the Shanghai Stock Exchange" (enacted in 2006) lay down specific rules as regards meeting procedures of the BoS.

There are other rules such as the "Guideline of Internal Compliance of the Listed Company of the Shanghai Stock Exchange" (enacted in 2006) which also govern the BoS.

III. The Analysis of the Corporate Governance Framework

In addition to the BoS system, there are several organs of corporate governance in China. The Chinese JSLCs have BoD and shareholders' meetings. China has adopted the one-layer, dual-committee system (单层二元委员会制度). This means that both the BoS and the BoD are elected at the shareholders' meeting.[30] An overview of the BoD, shareholder's meeting, accounting audit, derivative action, and auditing committee system are described in the following paragraphs.

It should be noted that in case of state-owned enterprises the administrator i.e. the State-owned Assets Supervision and Administration Commission (SASAC), plays an important role in governance.[31] However, the paper does not delve into this aspect.

1. BoD

a) BoD

Although some directors (especially "internal" directors) are subject to the BoS's supervision, the directors of Chinese companies establish a BoD. This BoD supervises and monitors the management of the company.

The BoD is a company's permanent body and is composed of the directors elected at the shareholders' meeting. The shareholders' meeting represents the company and exercises the management's authority.[32] The BoD's authority includes deciding on the appointment or dismissal of the managers of the company and matters relating to their remuneration.[33]

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[30] Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 375.

[31] Zhaofeng Wang, *Corporate Governance Under State Control: The Chinese Experience*, 13 No. 2 Theoretical Inquiries in Law (2012), p. 487, 493.

[32] Gan Peizhong, *Corporate and Company Law*, 7th edn. (2014), p. 220.

[33] Art. 108 (4) of the Chinese Company Law: "The provisions of Art. 46 hereof concerning the functions and powers of the BoD of a limited liability company shall apply to the BoD of a JSLC"; Art. 46 of the Chinese Company Law: "The BoD shall be accountable to the shareholders' meeting and shall exercise the following functions and powers: (1) to convene shareholders' meetings and to report on its work to the shareholders' meeting; (2) to implement the resolutions of the shareholders' meeting; (3) to decide on the business plans and investment plans of the company; (4) to work out the proposed annual financial budgets and final ac-

A JSLC shall have a BoD ranging from 5 to 19 members.[34] Some of the directors such as inside directors and executive directors are also responsible for the company's other businesses simultaneously, while other directors are not.[35]

b) Independent Directors

Historically, China has adopted a corporate governance system with a strong civil law influence and BoS is one such mechanism. When the CSRC issued the "Guiding Opinion on Establishing the Independent Director System in Listed Companies" in 2001, the common law i. e. the American system of independent directors was introduced into Chinese corporate governance. However, this did not result in the complete overhaul of the BoS. China still maintains the BoS and incorporates the independent director system at the same time.

Outside directors are not necessarily independent. As a result, those outside directors who are independent are categorically named "independent directors (独立董事)".[36] Chinese Company Law requires listed companies to have independent directors.[37] In prescribing this, Chinese Company Law intends to protect the interests of small and mid-size shareholders.[38]

However, the independent director system in China does not appear to be functioning efficiently.[39] First, there is a question of whether these directors are indeed independent or not.[40] Second, the independent directors do not neces-

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counts of the company; (5) to work out the profit distribution plans and plans for making up losses of the company; (6) to work out plans for the increase or reduction of the registered capital of the company and for issue of corporate bonds; (7) to work out plans for the merger, division, dissolution and restructuring of the company; (8) to decide on the establishment of the company's internal management organization; (9) to decide on the engagement or dismissal of the manager of the company and matters relating to his or her remuneration, and decide on the engagement or dismissal of the deputy manager(s) and the financial officer of the company as proposed by the manager, and matters relating to their remuneration; (10) to work out the basic management system of the company; and (11) other functions and powers specified in the company's articles of association".

[34] Art. 108 (1) of the Chinese Company Law: "A JSLC shall have a BoD of 5 to 19 members".

[35] Gan Peizhong, *Corporate and Company Law*, 7th edn. (2014), p. 223.

[36] Gan Peizhong, *Corporate and Company Law*, 7th edn. (2014), p. 223.

[37] Art. 122 of the Chinese Company Law: "Listed companies shall have independent directors. The specialized measures therefor shall be specified by the State Council"; G. Qiran et al. (eds.), *The Comparative Analysis of the Functions of the BoS and Independent Directors*, Issue 9 Journal of Educational Institute of Jilin Province (2013), p. 136, 137. Note that the State Council has not yet specified the specialized measures and we need to rely on the previous Guiding Opinion regarding Independent Directors.

[38] Zhao Zhenhua, *Corporate Law*, 1st edn. (2010), p. 148.

[39] See D. C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 The Delaware Journal of Corporate Law (2006), p. 125.

[40] See He Xiaoxing, *The Comparison and the Relationship of the Independent Director System and the BoS System*, Issue 8 Economics Information (2001), p. 8, 10.

sarily possess specialized knowledge.[41] Even if they do, they do not often spare sufficient time and effort to discharge their duties effectively.[42]

Third, as outsiders they do not have the opportunity to obtain first-hand information regarding the company. They have to rely on secondary data provided by the internal directors and managers.[43] As a result, it is difficult for independent directors to fully discharge their duties and some scholars even propose that the mandatory independent director system should be abolished.[44]

Another issue at hand is the interplay between independent directors and the BoS. Since the concept of an independent director stems from common law and that of BoS from civil law, there could be certain contradictions between them.[45] It is occasionally contended that independent directors function ex-ante while the BoS functions ex-post and the two can be coordinated.[46] However, both the organs seem to have overlapping functions[47] and this may lead to circumstances where one may "free-ride" (搭便车) on the other's efforts.[48]

c) Auditing Committee

Another "American" aspect of the Chinese corporate governance structure is the auditing committee. The Auditing Committee (审计委员会) is a specialized committee in the BoD composed mainly of independent directors. It monitors disclosure of information, quality of accounting information, internal auditing

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[41] The CSRC's "Guiding Opinion on Establishing the Independent Director System in Listed Companies". It requires the independent director to have the qualification including the experience of 5 or more years on law, economics or other kinds necessary to perform independent director's duties. But there is no higher requirement such as the qualification of being a lawyer, an accountant or a professor. Note that in companies which have an auditing committee at least one independent director should be qualified an accounting professional (Art. 52 CSRC Code).

[42] See Teng Yuge, *The Conflict and Coordination of the Listed Companies' Independent Directors and BoS*, Issue 1 Legality Vision (2014), p. 267.

[43] See Fang Liufang, *The Independent Director in China, The Hypothetical and Reality*, Issue 5 Tribune of Political Science and Law (2008), p. 110, 113.

[44] Zhang Hao, *Legal Aspects Research on the Relationship Between the Board of Supervisors and the Independent Directors*, Issue 3 Journal of Harbin University of Commerce (Social Science Edition) (2010), p. 110, 111.

[45] Wang Xinxin, *Corporate Law*, 2nd edn. (2012), p. 294; Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 399.

[46] See Feng Jiansheng and Xu Huizhi, *On the Co-establishment of Independent Director and BoS in Chinese Listing Companies*, Issue 1 Journal of North China Electric Power University (Social Sciences) (2005), p. 36, 38.

[47] Zhang Peng, *The Problem and the Perfection of the Co-Existence of the Independent Director System and BoS System*, Issue 1 Legal System and Society (2009), p. 273.

[48] Peng Zhenming and Jiang Hua, *The Comparison between the American Independent Director System and German BoS System*, Issue 1 Law Review (2003), p. 36, 41.

and external independent auditing.[49] The CSRC allows a listed company's BoD to set up internal specialized committees including auditing committees.[50]

2. Shareholders' Meetings

As owners of the company, shareholders have a legitimate interest in checking and influencing the company's management by the directors/managers. The shareholder's meeting is the mechanism for ensuring this especially by way of election and dismissal of executives.

The shareholder's meeting is a company's authoritative body and is composed of all shareholders. It decides on important issues with respect to the management of the company and those that are in shareholders' interests.[51]

One of the powers of a shareholders' meeting is the election and replacement of directors and supervisors.[52] The shareholders' meeting also has the authority to dismiss directors who are unfit for their respective positions. In order to re-

[49] Art. 17 of the Guideline of the Listed Company's Corporate Governance of the Shanghai Stock Exchange: "The auditing committee's main areas of authority are as follows: (1) to inspect the accounting policy, the financial situation and the process of financial report; (2) to communicate with the accounting firm through the auditing process, (3) to propose and hire the accounting firm, (4) to inspect the internal control system and auditing function, (5) to inspect the company's situation regarding compliance with the laws and other legal obligations (6) to inspect and monitor all forms of risks, including the financial risks and computer security risks, (7) to inspect and monitor the company's rules for conduct, (8) other authority given by the BoD".

[50] Art. 52 of the CSRC Code: "The BoD of a listed company may establish a corporate strategy committee, an auditing committee, a nomination committee, a remuneration and appraisal committee, and other special committees in accordance with the resolutions of the shareholders' meetings. All committees shall be composed solely of directors. The auditing committee, the nomination committee, and the remuneration and appraisal committee shall be chaired by an independent director, and independent directors shall constitute the majority of the committees. At least one independent director from the auditing committee shall be an accounting professional".

[51] Wang Xinxin, *Corporate Law,* 2nd edn. (2012), p. 104; Art. 99 of the Chinese Company Law: "The provisions of Art. 37 (1) hereof concerning the functions and powers of the shareholders' meeting of limited liability companies shall apply to shareholders' assembly of joint stock limited companies"; Art. 37 (1) of the Chinese Company Law: "The shareholders' meeting shall exercise the following functions and powers: (1) to decide on the business policy and investment plans of the company; (2) to elect and replace directors and supervisors other than those who are representatives of the staff and workers, and decide on matters relating to their remuneration; (3) to consider and approve reports of the BoD; (4) to consider and approve reports of the BoS or supervisors; (5) to consider and approve the company's proposed annual financial budgets and final accounts; (6) to consider and approve the company's profit distribution plans and plans for making up losses; (7) to pass resolutions on the increase or reduction of the company's registered capital; (8) to pass resolutions on the issue of corporate bonds; (9) to pass resolutions on matters such as the merger, division, dissolution, liquidation or restructuring of the company; (10) to amend the articles of association of the company; and (11) other functions and powers specified in the company's articles of association".

[52] Gan Peizhong, *Corporate and Company Law*, 7th edn. (2014), p. 220.

strict large concentration of shareholders' powers in the election of directors, Art. 105 of the Chinese Company Law specifies a cumulative voting system.[53] The CSRC Code also lays down that when the controlling shareholders have 30 % or more of the stocks, the listed company shall adopt the cumulative voting system.[54]

3. The System of Accounting Audit

In addition to the supervision by "insiders", there exists a system of supervision by "outsiders". One of the most effective systems of supervision is that of accounting audit. As per the provisions of the Chinese Company Law,[55] a company's accounting report needs to be audited by a lawfully established accounting firm or auditing firm to ensure truthfulness and legality.[56] A company's accounting audit system enhances the level of its management.[57]

4. The System of Derivative Actions

The decision-making at a shareholder's meeting is done by way of resolutions. This signifies that the number of the shares matter. However, if there is a close connection between the executives and controlling shareholders the mechanism of shareholder's meeting will not function to restrict the executives' management. There should be some mechanism whereby minority shareholders may exercise the right to control and supervise the management of executives. For this purpose, China has adopted a system of derivative actions that also exists in several other countries.

As per the JSLC, (a) shareholder(s) holding at least 1 % of the company's shares for at least 180 days in succession may bring a derivative action against

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[53] Art. 105 (1) of the Chinese Company Law: "When electing directors or supervisors, the shareholders' assembly may implement a cumulative voting system pursuant to the company's articles of association or a resolution of the shareholders' assembly. For the purposes of this Law, the term 'cumulative voting system' means a system wherein each share, when a vote is taken to elect directors or supervisors at a shareholders' assembly, carries a number of voting rights equivalent to the number of directors or supervisors to be elected, and a shareholder may cluster his or her votes".

[54] Art. 31 of the CSRC Code: "The election of directors shall fully reflect the opinions of minority shareholders. A cumulative voting system shall be earnestly advanced in shareholders' meetings for the election of directors. Listed companies that are more than 30 % owned by controlling shareholders shall adopt a cumulative voting system, and the companies that do adopt such as system shall stipulate the implementing rules for such cumulative voting system in their articles of incorporation".

[55] Art. 164 (1) of the Chinese Company Law: "Companies shall prepare financial accounting reports at the end of each accounting year. Such reports shall be audited by an accounting firm according to law".

[56] Gan Peizhong, *Corporate and Company Law*, 7th edn. (2014), p. 302.

[57] Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 437.

the directors or supervisors in the People's Court. Before taking such action, the shareholder(s) shall make a request in writing to the BoS (in case of the directors' violation) or BoD (in case of supervisors' violation).[58]

There have been only around 80 cases in respect of derivative actions until 2013.[59] In reality, most of the derivative actions arise in small or mid-size companies and there are only a handful of cases that arise in listed companies. This indicates that the derivative action has not been utilized effectively in China.

The aforementioned Art. 151 of the Chinese Company Law provides that the BoS has the authority to commence a lawsuit against directors and managers. However, the precondition for such a lawsuit is obtaining a shareholder(s)' request.[60] There is no provision that clearly authorizes the BoS to commence lawsuits for the benefit of the company in other situations. In practice, the BoS rarely commences lawsuits in these other situations.[61] There was a provision that dealt with such powers.[62] However, when the Company Law was enacted this provision was deleted.[63]

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[58] Art. 151 of the Chinese Company Law: "If a director or senior officer has committed a violation as specified in Art. 150 hereof, the shareholders of a limited liability company or (a) shareholder(s) of a JSLC who alone or jointly has/have held at least 1% of the company's shares for at least 180 days in succession may make a request in writing to the BoS, or in the case of a limited liability company that has not established a BoS, the supervisor(s) that he/she/they institute legal proceedings in a people's court in respect thereof. If a supervisor has committed a violation as specified in Art. 150 hereof, the aforementioned shareholders may make a request in writing to the BoD, or in the case of a limited liability company that has not established a BoD, the executive director that he/she institute legal proceedings in a people's court in respect thereof. If the BoS, supervisor(s) of a limited liability company that has not established a BoS, BoD or executive director refuses to institute legal proceedings after receipt of the written request from the shareholders mentioned in the preceding paragraph, fail(s) to institute legal proceedings within 30 days of the date of receipt of the request or, under urgent circumstances where failure to promptly institute legal proceedings could cause possibly irreparable harm to the company's interests, the shareholders mentioned in the preceding paragraph shall have the right, in the interests of the company, to directly institute proceedings in a people's court in their own name. If a third party infringes upon the lawful rights and interests of a company, causing the company to incur a loss, the shareholders mentioned in the first paragraph hereof may institute legal proceedings in a people's court in accordance with the provisions of the two preceding paragraphs".

[59] Zhang Hanwen, *The Empirical Study of the Derivative Action of our Country*, Issue 7 South China Finance (2013), p. 85.

[60] Ibid, Art. 151 provides that when a shareholder "make[s] a request in writing to the BoS" and then the BoS may "institute legal proceedings in a people's court".

[61] Li Xiaomeng, *Research On The Authorities And Guarantees of The Board of Supervisors*, Issue 4 Citizen and Law (2014), p. 41–42.

[62] Ibid, Norm Opinion of JSCL issued by the State Commission for Restructuring the Economics (1992); see Art. 65 (1) Item 6: "Represent the company to negotiate with directors or sue the director at the court".

[63] Guan Jindong and Ji Beihong, *The Problems of Corporate Governance System and the Perfection of BoS*, Issue 11 Law Application (2005), p. 92, 94.

IV. The Practice and the Evaluation

1. General Tendency of Low Evaluation

In general, Chinese scholars do not rank the Chinese BoS system highly. Some critical remarks of the BoS include: "The BoS exists in name only;"[64] The BoS is "the most embarrassing organ;"[65] "Some companies treat the BoS as a retirement home;"[66] and "the BoS is under the control of the BoD."[67]

The Chinese BoS is not only criticized from a theoretical viewpoint, but also for its non-functionality.[68] It is also said that this drawback of the BoS affects the quality of disclosure of a company's information.[69]

2. Scandals and Ineffectiveness of BoS in Chinese Listed Companies

In some Chinese listed companies, managers and directors have harmed the interests of the company and caused serious damage on certain occasions leading to bankruptcy or dissolution. In such cases, the BoS has rarely performed its function of ascertaining possible situations that could result in scandals and preventing them.[70] Some of the recent cases include Nantex (南纺股份),[71] Wanfu Biotechnology (万福生科),[72] Guangdong Xindadi Bio-Tech (广东新大地)[73] and

[64] Li Jianwei, *Corporate Law*, 2nd edn. (2011), p. 331.

[65] Jin Liang, *The Analysis of Our BoS System's Non-function*, Issue 7 Legal System and Society (2010), p. 51.

[66] Chang Jian and Rao Changlin, *The Legal Analysis of Perfection of the BoS,* Issue 3 Quarterly Journal of Shanghai Academy of Social Sciences (2001), p. 139, 142. See also Liu Miao, *The Reconsideration of the Independent Director System of Our Country*, Issue 4 Law Application (2005), p. 43, 44.

[67] Yang Lingshan, *Brief Analysis on the Perfection of the BoS of the Listed Companies of Our Country*, Issue 9 Business Culture (2009), p. 4.

[68] Yuan Ping et al., *The Study of the Effect of the Board of Director and Supervision of Listed Company on the Company's Performance*, Issue 6 Journal of Financial Research (2006), p. 23, 30. For the analysis through the comparison of the provisions of the articles of incorporation, see Zang Zhipo and Wang Guo, *The Practice of the BoS Governance of the Listed Companies of Our Country*, Issue 2 Jin Ling Law Review (2014), p. 112. See also Xu Lifei, *The Empirical Study of the Supervisory Effect of the BoS of Listed Companies of our Country*, Issue 2 China Management Informatization (2013), p. 15–16.

[69] Xue Zuyun and Huang Tong, *Characteristics of BoD and Board of Supervisors, and Quality of Accounting Information*, Issue 4 The Theory and Practice of Finance and Economics (2004), p. 84, 88.

[70] Chen Jianjun, *How to Perfect the Our Country's BoS System*, Issue 6 China Economist (2007), p. 24.

[71] Zhu Chunyu, *Why the State Owned Listed Companies Conducts Window-dressing? – Using the Nantex as an Example*, Issue 9 Finance & Accounting (2014), p. 23.

[72] Kong Ying and Ding Xiaoli, *The Brief Discussion of the Risk and the Countermeasure for the Listed Company's Window-dressing, using the Wanfu Biotechnology as an Example*, Issue 10 New West (2013), p. 60.

[73] Liu Wanjun, *The Method of Window-dressing and the Governance Measures, using the Guangdong Xindadi Bio-Tech as an Example*, Issue 3 Financial & Management (2015), p. 40.

Yunnan Green-Land (云南绿大地)[74] where the BoS did not exercise its preventive functions.[75]

3. Managers/Shareholders Controlling the Supervisors

Some scholars have opined that the Chinese BoS is ineffective because Chinese Company Law does not provide it with sufficient authority such as the power to select or penalize directors and managers or the power to control and supervise executives.[76] According to Art. 53, 99 and 37 of the Chinese Company Law, electing executives is the authority of the shareholders' meeting and not the BoS. Therefore, for those who are well-versed in the German system (explained later) which seems to function well, it may be evident to examine the differences in authority between the Chinese BoS and its German equivalent.

However, it seems that the ineffective functioning of the Chinese BoS is ultimately not caused by the BoS's authority or lack thereof, but by the actual balance of power between the BoS and managers/shareholders.

The fundamental problem of Chinese corporate governance is overly-dominant managers and/or unduly controlling shareholders.[77] Many of the Chinese listed companies have controlling shareholders.[78] In most of the private companies the top manager is also the controlling shareholder and he/she has had a role to play in navigating the company to be listed. Because a majority of the supervisors are representatives of the shareholders,[79] the BoS is under the influ-

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[74] Liu Wanting, *The Reason and the Prevention of the Window-dressing of the Listed Company, Using the Yunnan Green-Land as an Example*, Issue 9 Manager's Journal (2015), p. 35.

[75] See Zhu Chunyu, *Why the State Owned Listed Companies Conducts Window-dressing? – Using the Nantex as an Example*, Finance & Accounting (2014), p. 25.

[76] Jun Zhao, *Comparative Study of US and German Corporate Governance: Suggestions on the Relationship Between Independent Directors and the Supervisory Board of Listed Companies in China*, 18 Michigan State University College Of Law Journal Of International Law (2010), p. 495, 506: "However, in practice the supervisory board has not functioned effectively because it does not have genuine power to select or discipline directors and managers".

[77] Jin Liang, *The Analysis of Our BoS System's Non-function*, Legal System and Society (2010), p. 51; Li Jianwei, *Corporate Law*, 2nd edn. (2011), p. 294; Chien-Chung Lin, *The Chinese Independent Director Mechanism. Under Changing Macro Political-Economic. Settings: Review of Its First Decade and Two Possible Models for the Future*, 1 American University Business Law Review (2012), p. 263, 325: "Analytically, the controlling shareholder/minority-shareholder agency problem and manager/shareholder agency problem are concurrently the two most prominent issues in Chinese corporate governance"; Han Qi and Wang Fang, *Legal Analysis of the Position the Real Control of the BoS*, Issue S1 Journal of Jiangxi Finance College (2008), p. 85.

[78] See Wenge Wang, *Ownership Concentration and Corporate Control of Chinese Listed Companies*, 11 US-China Law Review (2014), p. 57, 80: "Ownership concentration, though it is now not as high as before, is still a distinguished characteristic of corporate China".

[79] Art. 117 (2) of the Chinese Company Law: "The BoS shall be composed of shareholders'

ence of controlling shareholders (many of whom are also the managers at the same time) and cannot fulfill its duty as an organ of corporate governance.

It is evident that in a state-owned company the shareholder(s) i.e. state or government entities and the managers are distinct. However, the controlling shareholder (state) has a strong influence on the company's management and the BoS is under the influence of the controlling shareholder. In such a situation where the manager's illegal or inappropriate decision is based on the undue influence of the controlling shareholder, it would be difficult for the BoS to take a stand and remedy such incorrect decisions. Further, the Chinese Communist Party Committees ("CCPC") set up within Chinese state-owned companies play an important role in the latter's management. In other words, each company has a CCPC with many executives and usually includes the supervisors. In certain occasions, the CCPC is a body or forum of "real" decision-making and the BoD meetings or other meetings stipulated by the law may appear to be mere formalities. Also, since many of the executives including the supervisors are Party members,[80] there could be rankings in the Party which may influence the supervisory role of the BoS. It is said that the top management usually has higher rankings than the supervisors and in such a case it is difficult for the BoS to exercise effective supervisory functions.[81]

An instance of a manager or a controlling shareholder exerting more power than the BoS may be illustrated with an example. In case of a listed company in Shanghai the CEO issues instructions to the BoS to deal with a particular problem. It is plausible that the CEO may have decided to sincerely tackle the problem when it was discovered, but the method that the CEO actually resorts to is to not instruct his subordinates to address the issue but instead to instruct the BoS, or his supervisor, to look into it. This is an action which has been criticized by scholars.[82]

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representatives and an appropriate proportion of representatives of the company's staff and workers, which shall not be less than 1/3".

[80] See Lin Zhang, *Adaptive Efficiency and the Corporate Governance of Chinese State-Controlled Listed Companies – Evidence from the Fundraising of Chinese Domestic Venture Capital*, 10 UC Davis Business Law Journal (2010), p. 151, 162: "Within the [state owned] corporations, the secretaries of the CPC's corporate disciplinary committees and the labor representatives also constitute shareholder supervisors".

[81] Sometimes the position of the supervisors in the CCPC is lower than that of the managers, and so it is very difficult for the supervisors to supervise. See Li Jianwei, *Corporate Law*, 2nd edn. (2011), p. 331.; Li Xun and Wang Yiping, *Brief Analysis of the Status and Function of the CCPC, BoD, BoS and Executives*, Issue 12 Modern Enterprise Education (2014), p. 20.

[82] Wang Xinxin, *Corporate Law,* 2nd edn. (2012), p. 141.

4. Criticism of the Employee Supervisor System

In practice many of the supervisors are insiders of the company and also party members as explained above.[83] This indicates that due to the members' backgrounds the functions of the BoS may be substantially compromised.[84] For example, China has adopted the employee-supervisor system and more than a third of the supervisors are employees. However, the latter are essentially the subordinates of the managers. This may give rise to a situation where "the supervised" becomes the "supervisor". Some scholars criticize the employee-supervisor system claiming that since their promotions are determined by managers, they cannot fulfill their roles efficiently.[85]

Another reason for the inefficient functioning of the BoS from the human resources perspective is that many employee supervisors are not specialists of law and accounting. It is obvious that for the effective control and monitoring of managers as well as supervisors, at least some of the BoS members should have the requisite expertise in law, accounting and other relevant fields. Hence, the general absence of specialized knowledge on the part of the supervisors has also been deprecated.[86]

5. Evaluation and Incentive

Some scholars have further criticized the non-existence of a system to appropriately evaluate, incentivize and restrain supervisors.[87]

It is true that objective evaluation of the supervisors is difficult. For instance, in Company A the BoS pointed out 100 issues in the company in a particular year and instructed the managers to rectify them. In Company B, the BoS could

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[83] Guo Nan et al., *Brief Analysis of the Equity Contents of the BoS*, Issue 13 China Business (2013), p. 94, 95; see also Li Xiuying, *The Perfection of the BoS System of the JSLC*, Issue 6 Academic Forum of Nandu (2009), p. 101. For the secondment system of supervisors in the state-owned enterprises, see also Du Xiqi, *The Case Study of the Supervising of the State-owned Estates by the Seconded Supervisors,* Issue 3 Theoretic Observation (2014), p. 61.

[84] Yuwa Wei, *Volatility of China's Securities Markets and Corporate Governance*, 29 Suffolk Transnational Law Review (2006), p. 207, 230: "Many listed companies in China are state-controlled or state dominant companies in which the State is the dominant shareholder. In such companies, the members of the supervisory board are typically insiders. Where members of supervisory boards and management boards are all insiders, the dedication to supervisory duties is substantially compromised".

[85] J. H. Feinerman, New Hope for Corporate Governance in China?, China Q. (2007), p. 590, 607; see also Ji Xiaowei and Cui Jing, Reconsideration of the Internal Supervisory System of the Listed Companies of our Country, Issue 3 The Modernization of the Market (2015), p. 118.

[86] Wang Xinxin, Corporate Law, 2nd edn. (2012), p. 331; Wu Qizhong, Legal Thinking on the System Reconstruction of BoS of Chinese JSLC, Issue 1 East China Economic Management (2008), p. 137, 139.

[87] Li Jianwei, Corporate Law, 2nd edn. (2011), p. 294.

ascertain only 10 problems. Which company's supervisors performed better? Some may prefer Company A because they could locate a larger number of problems. But others may argue that the supervisors of company B did better because they had successfully established and maintained an efficient system and prevented 90 problems from occurring. It may also be possible that 1000 problems existed in company A and the BoS could identify only 10 % of those (i. e. 100 problems), while in Company B there could only be 10 problems and the BoS could locate all i. e. 100 % of them. This simple example illustrates that it is not easy to evaluate the performance of supervisors.

If there is no system to incentivize supervisors to discharge their duties efficiently, then optimum supervision by the BoS can never be attained. Some scholars argue that providing adequate remuneration to supervisors that is commensurate with their workload could incentivize them. Stock options may also be used as a part of the remuneration.

6. Managers Looking Down on BoS

Reflecting on the non-functioning of the BoS, it may seem that many companies look down on the BoS and treat it as a mere formality. Out of the privately-owned listed companies on the SMEs board (中小板) of Shenzhen Stock Exchange, more than half do not have an office for the BoS and the other half regard the BoS as a temporary organ only.[88]

To monitor managers effectively supervisors should have accurate and full information about the company and one of the best ways to ensure this is from within the company.[89] Part-time supervisors who occasionally visit the company and read materials prepared by managers may only have second hand or even manipulated information especially in the case of accounting scandals mentioned earlier. Many (or at least some) supervisors must be full time in order to exercise their supervisory function effectively.[90] But in reality many of the current BoS members are not full-time employees and do not have offices within the company.[91]

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[88] Chen Xiaogang, *Should the Companies have the BoS and Independent Directors at the Same Time?*, Issue 3 Securities & Futures of China (2013), p. 25.

[89] Yang Dake, *The Analysis and the Lessons from the System of Information Right of German JSLC's BoS*, Issue 1 German Research (2015), p. 70, 71.

[90] Ding Liquan, *The Empirical Study of the Independent Director and BoS of Hunan Province Listed Company*, Issue 4 Consume Guide (2008), p. 121, 122.

[91] Ye Minghai, *The Research of the BoS's Function in the Risk Management of Companies*, Issue 16 Manager's Journal (2014), p. 64.

7. Improvements to the BoS System

Reflecting on the criticism, China has taken several initiatives for reforming the BoS system.[92] There have been arguments in favor of abolishing it. However, many scholars prefer to retain the BoS system and advocate improving it by implementing certain measures.[93]

This demonstrates that China needs new ideas and expertise to improve its BoS system. As discussed earlier, Germany and Japan have efficient BoS systems. The current Chinese scenario makes it crucial to conduct an international comparison of the BoS systems for understanding the scope for improvement.

V. International Comparisons of the BoS

V. International Comparisons of the BoS

To fully understand the Chinese BoS from the viewpoint of a comparative study, this section compares the Chinese BoS system with the German and Japanese BoS systems.

1. German BoS

There are several categories of companies in Germany. The representative category of German listed companies is the Joint Stock Limited Company ("JSLC", Aktiengesellschaft).[94] This paper only deals with the German JSLC and not other categories of German companies.

a) Overview

The corporate governance system in Germany[95] comprises of a two-tier committee system (双层委员会制度) in which the companies set up a BoS as well as a BoD which have the high-low order.[96] The BoD represents the company and the BoS monitors (Überwachung) the BoD.[97] The BoS is the directing organ

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[92] For understanding the variety of ideas proposed by scholars on the reform of BoS system, see Wang Yanshu, *The Research on the Comprehensive Control Model of the BoS of the Listed Companies of Our Country*, 1st edn. (2010), p. 33.

[93] Li Jianwei, *Analysis of the Perfection of the BoS System of the Listed Companies of Our Country*, Issue 2 Law Science (2004), p. 75, 78.

[94] Art. 1 of the German Law: "(1) The company is a stock corporation that constitutes a separate legal entity. Liability to creditors with respect to obligations of the company shall be limited to the company's assets. (2) The company shall have a capital divided into shares".

[95] See J. J. Du Plessis, *Corporate Governance: Reflections on the German Two-tier Board System*, Journal of South African Law (1996), p. 20.

[96] Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 437.

[97] W. Möschel, *German Stock Law*, 1st edn. (2011), p. 31; also see Art. 78 (1) of the German Law: "The management board shall represent the company in and out of court. If the compa-

(Leitungsorgan) of the company.[98] It elects directors,[99] decides their business rules,[100] decides their remuneration[101] and can annul their election.[102] The BoD has an obligation to report to the BoS.[103] At least 4 BoS meetings must be held per year (Art. 110).

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ny does not have a management board (rudderless management), the company shall be represented by the BoS in case declarations of intent are made towards the company or documents are sent to the company".

[98] Art. 76 (1) of the German Law: "The management board shall have direct responsibility for the management of the company"; see also Hu Xiaojing, *Common Function of Aufsichtsrat and BoD in German Listed Companies*, Issue 3 Contemporary Law Review (2008), p. 125.

[99] Art. 84 (1) of the German Law: "The BoS shall appoint the members of the management board for a period not exceeding five years. Such appointment may be renewed or the term of office may be extended, provided that the term of each such renewal or extension shall not exceed five years. Such renewal or extension shall require a new resolution of the BoS, which may be adopted no more than one year prior to the expiration of the current term of office. The term of office may be extended without a new resolution of the BoS only in the case of an appointment for less than five years, provided that the aggregate term of office does not, as a result of such extension, exceed five years. The foregoing shall apply analogously to the contract of employment; such contract may provide, however, that in the event of an extension of the term of office, the contract shall continue in effect until the expiry of such term".

[100] Art. 77 (2) of the German Law: "If the management board comprises more than one person, the members of the management board shall manage the company jointly. The articles or the bylaws for the management board may provide otherwise; however, the articles or bylaws may not provide that one or more members of the management board may resolve differences of opinion within the management board against the majority of its members".

[101] Art. 87 (1) of the German Law: "The BoS shall, in determining the aggregate remuneration of any member of the management board (salary, profit participation, reimbursement of expenses, insurance premiums, commissions, incentive-based compensation promises such as subscription rights and additional benefits of any kind), ensure that such aggregate remuneration bears a reasonable relationship to the duties and performance of such member as well as the condition of the company and that it does not exceed standard remuneration without any particular reasons. The remuneration system of listed companies shall be aimed at the company's sustainable development. The calculation basis of variable remuneration components should therefore be several years long; in case of extraordinary developments, the BoS shall agree on a possibility of remuneration limitation. Sentence 1 shall apply analogously to pensions, payments to surviving dependents and similar payments".

[102] Art. 84 (3) of the German Law: "The BoS may revoke the appointment of a member of the management board or the appointment of a member as chairman of the management board for cause. Such cause shall include in particular a gross breach of duties, inability to manage the company properly, or a vote of no confidence by the shareholders' meeting, unless such vote of no confidence was made for manifestly arbitrary reasons. The foregoing shall also apply to the management board appointed by the first BoS. Such revocation shall be enforceable until rendered unenforceable by a judicial decision that has become final and may not be appealed. Rights arising under the contract of employment shall be governed by general provisions of law".

[103] Art. 90 (1) of the German Law: "The management board shall report to the BoS on: 1. intended business policy and other fundamental matters regarding the future conduct of the company's business (in particular plans regarding financing, investment and personnel) responding to deviations of actual developments from objectives reported in the past and stating the reasons thereof; 2. the profitability of the company, in particular the return on equity; 3. the state of business, in particular revenues, and the condition of the company; 4. transactions

b) Functions of the BoS

In Germany the BoS has control obligations (Kontrollepflicht) as well as advice obligations (Beratungspflicht).[104] Historically, the German BoS only had the function of monitoring but thereafter has been given the additional function of a company's management.[105]

As regards the monitoring obligation, the BoS needs to monitor situations which may have a serious influence on the company's development.[106] In addition, the BoS has both the right[107] and obligation[108] of inspection. Supervision by the BoS will not only cover the legality of directors' management, but also its purposefulness and efficiency.[109]

The BoS does not manage a company's daily business.[110] However, as regards the company's important business, the BoS has the authority to decide or with-

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that may have a material impact upon the profitability or liquidity of the company. If the company is a parent enterprise (sec. 290 (1), (2) of the Commercial Code), then the report shall also deal with the subsidiary enterprise and with joint enterprises (sec. 319 (1) of the Commercial Code). In addition, reports to the chairman of the BoS shall be made on the occurrence of other significant developments, such significant developments shall also include circumstances concerning the business of an affiliated enterprise which become known to the management board and which may have a material impact upon the condition of the company"; see Zhou Mei, *Right to Get Information by the BoS*, Issue 4 Journal of Nanjing University (Philosophy, Humanities and Social Sciences) (2013), p. 27–28; Y. Dake, *The Analysis and the Lessons from the System of Information Right of German JSLC's BoS*, Issue 1 German Research (2015), p. 70, 71.

[104] W. Möschel, *German Stock Law*, 1st edn. (2011), p. 74.

[105] Y. Niiyama, *The Development of the German BoS System and its Meaning*, 1st edn. (1999).

[106] W. Möschel, *German Stock Law*, 1st edn. (2011), p. 74.

[107] Art. 111 (2) of the German Law: "The BoS may inspect and examine the books and records of the company as well as the assets of the company, in particular cash, securities and merchandise. The BoS may also commission individual members or, with respect to specialized assignments, special experts, to carry out such inspection and examination. It shall instruct the auditor as to the annual financial statements and consolidated financial statements according to sec. 290 of the Commercial Code".

[108] Art. 171 (1) of the German Law: "The BoS shall examine the annual financial statements, the annual report and the proposal for appropriation of distributable profits, in the case of parent companies (sec. 290 (1), (2) of the Commercial Code) also the consolidated financial statement and consolidated annual report. If the financial statements are required to be audited by external auditors, the external auditors shall be present at the BoS's or the auditing committee's deliberations regarding such statements and shall report on material results of their audit, in particular on major weaknesses in the internal control and risk management system with regard to the accounting process. The external auditor shall inform on circumstances which might give rise to concerns as to his impartiality and on services he provided in addition to those provided in connection with the audit".

[109] BGHZ 114, 127.

[110] Art. 111 (4) of the German Law: "Management responsibilities may not be conferred on the BoS. However, the articles or the BoS have to determine that specialized types of transactions may be entered into only with the consent of the BoS. If the BoS refuses to grant consent, the management board may request that a shareholders' meeting approve the grant. The

draw consent. According to the articles of incorporation or the decision of the BoS, certain business operations can be only conducted after the consent of the BoS is obtained.[111] In practice the transactions which necessitate the consent of the BoS mainly relate to real estate, building new facilities, obtaining/giving guarantees/loans and setting up and closing branches.[112] According to the Corporate Governance Kodex 5.2, the Chair of the BoS must communicate with directors periodically and give them advisory opinion on the company's strategy, business development and risk management.

c) Participation of Employees

Another characteristic of the German BoS is that it adopts the participation of employees in corporate governance. There are five ways in which employees participate in the BoS system, as outlined below:[113]

aa) A Company where "The Mining and Metallurgy Participation and Decision Law" is Applicable

In companies where the Mining and Metallurgy Participation and Decision Law is applicable, there are 11 BoS members. Four of them are the representatives of shareholders, while four are the representatives of employees, and the remaining three are the representatives of public interest.

bb) A Company where "The Supplementary Law of the Mining and Metallurgy Participation and Decision" is Applicable

In a company which owns the mining and metallurgy industry Konzern (康采恩), the BoS is made up of 15 members – 7 representatives of shareholders, 7 representatives of employees and 1 representative of public interest.[114]

cc) A Company where "The Employee Participation and Decision Law" is Applicable

In companies where the number of employees is 2,000 or more, the Employee Participation and Decision Law is applicable. There is an even number of members of the BoS with an equal number of representatives of employees as well as shareholders. There can be 12 to 20 supervisors depending on the number of employees.

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shareholders meeting by which the shareholders' approves shall require a majority of not less than three- fourths of the votes cast. The articles may neither provide for any other majority nor prescribe any additional requirements".

[111] Ibid.

[112] E. Takahashi, *The Summary of German Corporate Law*, 1st edn. (2012), p. 165.

[113] Ibid, p. 167–170.

[114] At the very large mining and metallurgy concern owning company, the BoS is composed of 21 members.

dd) A Company where "The One Third Participation and Decision Law" is Applicable

Where the number of employees is 500 or more but less than 2000 the One Third Participation and Decision Law is applicable. In this situation the number of supervisors shall be a multiple of three, with two-thirds being the representatives of shareholders and one third being the representatives of employees.

ee) Companies without Employee Representatives

In companies where the number of employees is less than 500, there is no mandatory system of employee participation. Further, when a major part of a company's business directly contributes to politics, party politics, charity, academy and arts, there is no mandatory system of employee participation.

Generally, both employee-elected supervisors and shareholder-elected supervisors vote unanimously but there are certain exceptions.[115] When supervisors representing the employees and those representing shareholders reach an impasse, the shareholder-elected supervisor chairman can cast a second vote to break the deadlock (MitbG 27,28).[116]

According to some scholars, the German BoS system acts effectively especially in displacing inefficient managers.[117] At the very least, it is a mechanism of keeping managers in check and ensuring employee participation.[118]

2. The Japanese BoS

The Japanese corporate governance system is unique in that it allows companies to voluntarily select from amongst three options.[119] Japanese scholars and practitioners believe that the level of compliance of Japanese-listed companies is better than that of Chinese-listed companies. However, in July 2015 Toshiba (东芝), one of the leading companies in Japan, disclosed a report ("Report") by an independent investigation committee which revealed serious defects in its compliance system.[120] After a brief explanation of the Japanese corporate govern-

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[115] D. Sadowski et al., *The German Model of Corporate and Labor Governance*, 22 Comparative Labor Law Journal & Policy Journal (2000), p. 33, 38.

[116] T. J. Andre Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 Tulane Law Review (1995–1996), p. 1826–1827.

[117] S. N. Kaplan, *Top Executives, Turnover and Firm Performance in Germany*, 10 Journal of Law, Economics & Organization (1994), p. 142, 148–155.

[118] D. Charny, *The German Corporate Governance System*, Columbia Business Law Review (1998), p. 145, 159: "[P]erhaps the effect of codetermination as a governance device is to provide a salient means for the expression of worker disapproval, the threat of which helps to keep managers in check. Of greater importance, is the role of board representation in providing information for the functioning of unions and works councils".

[119] Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 375–376.

[120] https://www.toshiba.co.jp/about/ir/jp/policy/message.htm.

ance system focusing on the BoS, this paper will analyze the challenges faced by Japanese-listed companies with reference to the Toshiba case.

a) Three Options of Japanese Corporate Governance

After the revision of the Japanese Law in 2014, Japanese-listed companies can choose among three main options.[121]

aa) One-Layer Dual Committee System (Traditional Model)
This is called the "Japanese Model" or a traditional Japanese corporate governance model.[122] In this model the company has both a BoD (取缔役会) and a BoS (监查役会) and all members are elected at the shareholders' meeting.

bb) American Single-Layer Committee System (American Model)
Under the American Model a company only has a BoD and no BoS. Within the BoD, the company shall set up three specialized committees: the auditing committee (监查委员会), the compensation/salary committee (报酬委员会) and the nominating committee (指名委员会 / 提名委员会). Outside directors shall make up a majority of each committee. The directors including the committee members shall be elected at the shareholders' meeting.

cc) The Hybrid of the Two Models (Hybrid Model)
Under the Hybrid Model, a company has no BoS. The BoD sets up a special committee called the Audit and Supervisory Committee ("ASC") within the BoD. Since the Hybrid Model may be understood thoroughly through a comparison with the Traditional as well as the American Model, a detailed explanation will be provided later in this paper.

b) Historical Developments

Originally, the Japanese BoS system was emulated from the German and French corporate governance systems.[123] Thereafter, until 1950 supervisors had relatively strong monitoring authority. They not only supervised the legality of directors' actions, but also the appropriateness of the directors' management techniques.[124] During the Japanese corporate reforms in 1950 after World War II and under the influence of GHQ and American law it was widely considered

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[121] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 376. Note that there are other options for smaller companies (such as companies only with one or two supervisors and without BoS) but rarely used by listed companies in practice.

[122] Fan Jian and Wang Jianwen, *Corporate Law*, 3rd edn. (2011), p. 375.

[123] C. Yamamura, *The Origin and the Development of the Supervisor System*, 1st edn. (1997), p. 60–61.

[124] Ibid, p. 79–80.

that supervisors were unnecessary.[125] Subsequently, supervisors were deprived of the authority to monitor managers' conduct.[126] The only remaining function of supervisors was the accounting audit function which was to be carried out by professional accountants. It could therefore be said that the system of supervisors during this period was considered temporary and doomed to be abolished in the near future.[127] However, reflecting the window dressing scandals of listed companies which exposed the inefficiency of the BoD's supervision, Japanese legislators changed their minds. Pursuant to the Japanese corporate law reforms in 1979, the supervisors' authority to monitor the management of a company was restored.[128] After the Japanese corporate law reforms in 2002, the American Model was introduced as an option for Japanese companies.[129] Finally, in 2014 the Japanese Law was revised again to introduce a third option i.e. the Hybrid Model. It may be noted that at the same time, the Japanese Law virtually mandated the introduction of outside directors in all three types of companies. However, this topic is not directly relevant to the BoS and the paper will not delve deep into this issue.[130]

c) The Japanese BoS under the Traditional Model

Under the Traditional Model, the Japanese BoS system is similar to that of China. The Japanese supervisor's authority/obligation is mainly to supervise the management of directors.[131] Under the Traditional Model, the directors (especially internal directors) are in charge of the management of daily activities along with some important issues being decided by the BoD. In the case of companies with a BoS, the number of supervisors shall be three or more, and a majority of members comprising the BoS shall be outside supervisors (社外監査役).[132] When the supervisors discover an illegal conduct, they are required to report to the directors.[133] When the directors perform illegal actions likely to cause sub-

[125] M. Hamada, *The Historical Development of Japanese Corporate Law Reforms*, 1st edn. (1992), p. 218: "The fruit of the fight against the GHQ [was to retain the BoS system.]".

[126] C. Yamamura, *The Origin and the Development of the Supervisor System*, 1st edn. (1997), p. 66–68.

[127] M. Matsunaka, *The Identity Crisis of the Supervisors*, 1957 Shoji Homu, (2012), p. 4, 5.

[128] Ibid, p. 9; C. Yamamura, *The Origin and the Development of the Supervisor System*, 1st edn. (1997), p. 80.

[129] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 548.

[130] G. Goto, *The Outline for the Companies Law Reform in Japan and its Implications*, 35 Zeitschrift für Japanisches Recht/Journal of Japanese Law (2013), p. 14, 17.

[131] Art. 381 (1) of Japanese Law: "Supervisors shall audit the execution of duties by directors (or directors and accounting advisors for a Company with Accounting Advisor(s)). In such cases, company auditors shall prepare audit reports pursuant to the provisions of the applicable Ordinance of the Ministry of Justice".

[132] Art. 335 (3) of Japanese Law: "A company with BoS shall have three or more supervisors, and the half or more of them shall be outside supervisors".

[133] Art. 382 of Japanese Law: "If supervisors find that directors engage in misconduct, or

stantial damage to the company, the supervisors may ask courts to restrain the directors from doing so.[134]

Japanese supervisors have the authority to only supervise the conduct of directors in the context of legality.[135] They do not have the authority to ascertain the appropriateness of the directors' conduct. The body that determines whether the management is appropriate is not the BoS, but the BoD. However, when the inappropriateness exceeds a certain degree then such a conduct may violate the directors' duty of care, thereby becoming illegal. In this sense, the supervisors may establish whether the conduct of the directors is excessively inappropriate or not.[136] For example, when a company builds a factory and buys real estate, supervisors usually have no authority to determine the appropriateness of price of the transaction. But if the price is excessively high then it may result in the violation of the directors' duty of care, meaning that the Japanese supervisors would then have the authority to step in at this point. In order to guarantee the effectiveness of the supervisors' actions, they have been given the authority to inspect and can ask the directors and employees to report on the company's asset situation.[137] Also, the supervisors shall attend the BoD meetings and may express their opinion to the directors.[138]

One of the characteristics of the Japanese BoS system is that each supervisor enjoys a full range of authority as stipulated above. This means that the minority BoS members, or even one supervisor, may oversee the managers (whether or not the BoS as a board supports him/her), report to the BoD or even ask the court to control the managers' conduct. Due to this the BoS is merely a platform to share information, specialized knowledge and experience.[139]

Another difference between the two countries, on one hand, and Japan, on the other, is that the Japanese BoS does not have any employee representatives. Japanese Law stipulates that employees cannot become supervisors concurrent-

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are likely to engage in such conduct, or that there are facts in violation of laws and regulations or the articles of incorporation or grossly improper facts, they shall report the same to the directors (or, for a Company with BoD, to the BoD) without delay".

[134] Art. 385 (1) of Japanese Law: "In cases where a director engages, or is likely to engage in an act outside the scope of the purpose of a stock company, or other acts in violation of laws and regulations or the articles of incorporation, if such act is likely to cause substantial detriment to such company with supervisor(s), supervisors may demand that such director cease such act".

[135] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 523.

[136] Ibid, p. 524.

[137] Ibid, p. 525.

[138] Art. 383 (1) of the Japanese Law: "Supervisors shall attend the BoD meeting, and shall state their opinions if they find it necessary; provided, however, that, in cases where there are two or more supervisors, if there is a provision on the vote by Special Directors pursuant to the provisions of Art. 373 (1), the specific supervisor who shall attend the BoD meeting under paragraph (2) of that article shall be appointed by the supervisors from among the supervisors".

[139] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 532.

ly.[140] The BoS is composed of three or more supervisors and more than half of these are external.[141] During the discussion of the Japanese Law reforms in 2014, labor unions and some scholars proposed to introduce the concept of employee-representative supervisors. However, the Japanese legislatures refused its introduction for the following reasons:[142]

- Employees work closely with and under the control of directors and managers as a team whereas the BoS is intended to supervise the directors and managers. Therefore, having an employee representative in the BoS would mean that the supervised participates in the supervision which might make the supervision ineffective (or even meaningless).
- There is usually at least one BoS member who used to be an employee of the company. This means that there is usually at least one supervisor whom employees can trust.[143]
- Shareholders are the owner of a company. Therefore, the bodies of a company (such as directors and supervisors) are elected by the shareholders' meeting and are responsible to the company. If supervisors are elected by the employees, they may not be responsible to the company but to the employees. This would confuse the whole organizational structure of the Japanese corporate system.
- Protection of employees is ensured by labor laws. This responsibility should not be that of corporate/company laws.

As explained above, listed companies' external supervisors have various backgrounds and a relatively large number of them are professionals such as accountants and lawyers.[144] Since there are several matters that supervisors need to monitor, the BoS shall appoint one or more permanent supervisor(s) who shall oversee these on a daily basis.[145]

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[140] Art. 335 (2) of the Japanese Law: "A company auditor of a Stock Company may not concurrently act as a director, employee, including manager, of that Stock Company or its Subsidiary, and may not act as an accounting advisor (if the accounting advisor is a juridical person, the member who is in charge of its affairs) or an executive officer of such Subsidiary".

[141] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 541.

[142] http://www.moj.go.jp/content/000049083.pdf; http://www.moj.go.jp/content/000054772.pdf; http://www.moj.go.jp/content/000072741.pdf; G. Goto, *The Outline for the Companies Law Reform in Japan and its Implications*, 35 Zeitschrift für Japanisches Recht/Journal of Japanese Law (2013), p. 14, 30.

[143] G. Goto, *The Outline for the Companies Law Reform in Japan and its Implications*, 35 Zeitschrift für Japanisches Recht/Journal of Japanese Law (2013), p. 14, 31. This argument is the rebuttal to the pro-employee-representative supervisor argument that "the employees would feel more secure to engage in whistleblowing if they had someone they could trust at the [BoS]".

[144] http://www.kansa.or.jp/support/enquet15_150109-1.pdf. According to the questionnaire of the "Japan Audit & Supervisory Board Members Association" members in 2015, regarding the listed companies, 21.7% of the outside supervisors are lawyers, 20.9% are accountant's/tax specialists, and these two professions are ranked as the number one and two most common backgrounds of outside supervisors. 3.0% are professors.

[145] Keieihoyukaikaishahoukenkyukai, *Supervisor's Guidebook*, 3rd edn. (2015), p. 14.

In large companies assistant staff is necessary for ensuring effective supervision by the BoS. About half of the listed companies have assistant staff for the BoS and these companies have on an average 1.93 assistants.[146] The supervisors' assistants are employed by the company and are on its payroll. They are expected to follow the instructions of the supervisors. In addition, if it is necessary for the supervisors to retain professionals such as accountants or lawyers, such costs shall also be borne by the company.[147]

d) The American Model

The American Model is essentially the same as that which exists in American listed companies. In a company that adopts the American Model there is no BoS and all important decisions are taken by committees within the BoD, a majority of whose members are outside directors. Also, in the American Model the role of the BoD is to supervise and monitor the officers and the day-to-day management roles as entrusted to the officers. As the American Model is similar to the one used in the USA, it is relatively easier for American and other foreign investors to understand. As a result, they tend to rate companies adopting this model higher than those employing the Traditional Model.[148]

In Japan, the American Model has been in use for almost a decade. The original intention behind introducing the American Model[149] was providing options to the Japanese companies to choose the best system fit for their current

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[146] http://www.kansa.or.jp/support/enquet15_150109-1.pdf, "Japan Audit & Supervisory Board Members Association".

[147] Art. 388 of the Japanese Law: "If company auditors make the following requests to a Company with Company Auditor(s) (including a Stock Company the articles of incorporation of which provide that the scope of the audit by its company auditors shall be limited to an audit related to accounting) with respect to the execution of their duties, such Company with Company Auditor(s) may not refuse such request except in cases where it proves that the expense or debt relating to such request is not necessary for the execution of the duties of such company auditors: (i) Requests for advancement of expenses; (ii) Requests for indemnification of the expenses paid and the interests thereon from and including the day of the payment; or (iii) Requests for the payment (or, in cases where such debt is not yet due, provision of reasonable security) to the creditor of a debt incurred"; see also Keieihoyukaikaishahoukenkyukai, *Supervisor's Guidebook*, 3rd edn. (2015), p. 26.

[148] K. A. Alces, *Beyond the BoD*, 46 Wake Forest Law Review (2011), p. 783. Note however that some American scholars are criticizing American corporate governance structure.

[149] See T. Araki, *Changing Employment Practices, Corporate Governance, and the Role of Labor Law in Japan*, 28 Comparative Labor Law Journal & Policy Journal (2007), p. 251, 267 regarding the introduction of the American Model and the comparison between the Traditional Model and the American Model; R. Dore, *Papers on Employees and Corporate Governance*, 22 Comparative Labor Law Journal & Policy Journal (2000–2001), p. 168–169: "Of all the factors making such a change likely, it is not so much the decline in the capacity for company loyalty, changes in values and in the central life interests of younger generations, as the growth of foreign-mostly American-ownership of Japanese industry that is probably the most important".

circumstances.[150] The trend after almost 10 years is that the American Model is on the decline. Out of roughly 4000 Japanese-listed companies, there are only around 100 companies which have adopted the American Model[151] and that number has been decreasing steadily in recent years.[152]

Why did Japanese companies not favor the American Model? In the American Model the nomination of directors and decisions regarding the amount of executives' compensation are both decided by the nominating committee and the salary committee. Also, they need to persuade a majority of the outside directors within these committees. Historically, the source of power of the Presidents and CEOs of Japanese companies stemmed from the authority over the management of human resources as well as salary matters. The introduction of the American Model meant that they were deprived of these powers. Managers do not want to lose nomination and salary powers and for this reason refused the American Model.[153]

One of the notable features about Toshiba is that it has adopted the American Model and its compliance system is considered sophisticated and well-developed.[154]

e) The Hybrid Model

Against the background of Abenomics (the economic reforms of Prime Minister Shinzo Abe), the Japanese government and Japanese companies are earnestly welcoming foreign investors to invest in Japanese listed companies. However, the American and other foreign investors have difficulties in understanding their BoS system. As a result, foreign investors doubt the governance system of Japanese-listed companies.[155]

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[150] H. Kubori et al., *The Everything About the Commercial Law Reform in 2002*, 1st edn. (2002), p. 55.

[151] K. Egashira, *The Laws of Joint Stock Limited Company*, 6th edn. (2015), p. 381.

[152] Y. Abe, The Corporate Law Reform Reading from the Legislative Backgrounds, 1st edn. (2014), p. 46.

[153] K. Egashira, The Laws of Joint Stock Limited Company, 6th edn. (2015), p. 381; Y. Hamabe, The Whereabouts of Governance Reform by the Introduction of the Hybrid Model, 9 Aoyama Law Journal (2014), p. 15, 17; http://www.agulin.aoyama.ac.jp/opac/repository/1000/16996/16996.pdf.

[154] M. Toda and W. McCarty, Corporate Governance Changes in the Two Largest Economies: What's Happening in the U.S. and Japan?, 32 Syracuse Journal of International Law and Commerce (2004-2005), p. 189, 205-206: "Toshiba explained the purpose for its adoption of the new governance system 'as a means to further enhance corporate governance by reinforcing supervisory functions and management transparency and to improve operating agility and flexibility.' Other companies that select this option likely anticipate that as they become more accountable, they will also be more competitive by increasing their corporate value and eliminating corporate corruption through the enhanced corporate governance system."; also see p. 219 where Toshiba is categorized as the company adopting the American Model "that are developing their business operations and raising funds globally".

[155] E. Nagatomo et al., The Future of the Corporate Governance of Our Country in the Global Community, 586 Monthly Supervisors (2011), p. 6.

One of the core suspicions about the Japanese BoS from the foreign investors' perspective is that since supervisors do not have voting rights in the BoD, it is doubtful whether the BoS's supervision is effective.[156] In 2014 the revised Japanese Law allowed Japanese companies to choose the Hybrid Model, which is the hybrid of the Traditional and the American Models. The similarity to the American Model is that under the Hybrid Model companies only have BoDs and no BoS. Further, any important decision by the management can be entrusted to the internal directors (however the Hybrid Model does not have the officers). The similarity to the Traditional Model is that under the Hybrid Model, a committee similar to the BoS is set up within the BoD called the ASC.[157] ASC members are directors but elected at the shareholders' meeting separately from the normal directors (in this sense they are similar to BoS members under the Traditional Model).

The biggest difference between the Hybrid Model and the American Model is that the Hybrid Model has no nominating and salary committee. It allows the current Traditional Model companies to abolish the BoS and transform into having an Americanized BoD-only governance structure while at the same time allowing the President & CEO to maintain his/her power over both human resource management and salaries. Also, since the function of the ASC is similar to BoS, current members of the BoS may be nominated as ASC members. It should be noted that in the Traditional Model Japanese companies already have outside supervisors. By adopting the Hybrid Model and by transforming the BoS into the ASC, the ex-outside supervisors would then become outside directors who are highly valued by American and foreign investors as a key feature of the compliance infrastructure. As of the end of December 2016, more than 700 companies have already announced their intention to adopt the hybrid system.[158]

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[156] B. A. Aronson, The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground between the Board Monitoring Model and Management Model?, 30 UCLA Pacific Basin Law Journal (2012), p. 93, 140 regarding the circumstances that lead to the introduction of the Hybrid Model.

[157] Ibid, the ASC of the Hybrid model and the auditing committee's American Model is very similar. But there are some differences. In addition to the election process as stipulated above, ASC of the Hybrid Model has the authority to give opinions on the nomination and the remuneration of the directors. This means that the ASC under the Hybrid Model is a little bit stronger than the auditing committee of the American Model. Also, whereas the majority of the BoD of the American Model shall be outside directors, the majority of the BoD of the Hybrid Model may be the inside directors. (Note that the majority of the ASC under the Hybrid Model shall be the outside directors).

[158] See http://blog.livedoor.jp/kawailawjapan/archives/8331552.html.

f) Comparison of the Three Models

Currently a vast majority of the Japanese companies adopt the Traditional Model. However, this Model faces a critical problem (especially under the background of promoting foreign investment) in that the foreign investors have difficulties in understanding the compliance level of the company because of the BoS system. It may also be contended that although the Japanese companies need to establish an internal control system, such a system is established by the BoD and the staff engaged in this is under the control and leadership of the President & CEO. Therefore, the BoS cannot fully make use of the internal control system established within the company.[159] One scholar's criticism is that if the legislator wants to strengthen the effectiveness of control by the supervisors, then these supervisors should be changed to directors. This illustrates that Japanese supervisors have been suffering from a serious identity crisis.[160]

The Traditional Model, American Model, and Hybrid Model have their pros and cons. The fact that the auditing committee and ASC members are directors seems to solve some of the problems stated above. The Hybrid Model seems to be more attractive to Japanese companies than the American Model because the former seems to overcome the certain difficulties such as who possesses the power over human resources and salary.

However, it should be noted that both the American as well as the Hybrid Model have one problem in common. The role of the BoS is to supervise and monitor the conduct of officers (in case of the American Model) or internal directors (in case of the Hybrid Model). This means that many important decisions of the management (which are conducted by the BoD in the Traditional Model) are conducted by officers (in the case of the American Model) or internal directors (in the case of the Hybrid Model). Those who are entrusted with such strong powers are usually the President & CEO. This indicates that in both the models, the President & CEO's power can be stronger than in the Traditional Model. In the case of the Hybrid Model, as the President & CEO maintains power over human resources and salary, it may be concluded that his/her powers can be the strongest out of all three models.

g) Brief Analysis of the Toshiba Case

Because of the limited time since the release of the Toshiba Report, it is impracticable to conduct a comprehensive analysis of the case. The Report disclosed that Toshiba's conduct over several years with regard to the implementation of the BoS system continuously and systematically amounted to nothing more than window dressing. The following three points can be enumerated from the case to understand the Japanese corporate governance system:

[159] M. Matsunaka, *The Identity Crisis of the Supervisors*, 1957 Shoji Homu (2012), p. 4, 6.
[160] Ibid, p. 8.

aa) Internal Control System Ineffective in Curbing Managements' Wrongdoing

The Report revealed (or strongly suggested on several occasions) the top management's implicit and sometimes explicit involvement in many of the window dressing endeavors. The internal control system, which is established and led by the BoD, is powerless if the top management gets involved in wrongdoing. Therefore, the blame lies not so much with Toshiba's internal control system but with its top management.

bb) Strong Manager in the American Model

Under the American Model many important decisions are entrusted to the officers (especially the chief executive officer) and in practice the President & CEO can have strong powers. The Report suggests that Toshiba's President & CEO had that kind of undue power. For example, in the monthly meetings with managers, Toshiba's President & CEO directed the managers to attain seemingly impossible targets (sales, profits etc.), making it virtually impossible for other managers to refuse such orders even though these were unrealistic.

cc) Powerless Outside Directors

In 2015 Toshiba had four external directors (who were the members of the auditing committee), two ex-diplomats,[161] one professor and an ex-investment banker. The window dressing cases (or the facts implying window dressing) were not reported to the BoD and hence the outside directors were unable to play effective roles in stopping the scandal. It is unclear from the Report what exactly the outside directors did in their roles as the auditing committee members. But according to it, although some members of the auditing committee were aware of the facts and evidence implying the existence of the window dressing, the issue was not discussed within the committee. In the auditing committee, the majority was outside directors and its president was ex-CFO, which seems to have made it difficult for the outside directors to play their role in monitoring the accounting documents.

3. Comparison and Lessons

What are the characteristics of the Chinese BoS system compared to Germany and Japan? What lessons can China learn from the German and Japanese experiences? The following is a brief summary of the characteristics of the Chinese BoS system and the lessons China can learn from Germany and Japan. It should, however, be noted that while doing so, the cultural characteristics and unique

[161] Ibid, one of the two ambassadors, Mr. Sakutaro Tanino (谷野作太郎), was ex-Ambassador at the Embassy of Japan in China.

national conditions of the countries should be considered in the context of corporate governance.[162]

a) German Law

German law and Chinese Company Law are similar in that both require employee participation as part of the BoS. It is said that in China employee participation is a way to embody "democratic management" by the employees.[163] This means that the German employee-supervisor system could work successfully in China, especially in keeping with the concept of socialism with Chinese characteristics.[164] However, it should be noted that internal supervisors (including employee supervisors) are criticized because they are not independent from the managers. Therefore, China may have to consider ways to preserve the independence of employee-supervisors. One of the possible solutions could be appointing higher level labor union members instead of the company's employees as employee-supervisors.[165] Irrespective of the way in which supervisors are appointed, their performance would still be limited as long as the managers and/or controlling shareholders "control" the BoS.

A major difference between the Chinese and German systems is that the German system has a high-low relationship between the BoS and the BoD while the Chinese system does not. In other words, the Chinese BoS is much weaker than the German BoS system. Some scholars advocate strengthening the Chinese BoS's authority by learning from the Germans. These could include provisions regarding the authority to oppose important decision-making,[166] the right to information,[167] or the authority over the appointment and firing of directors.[168] However, one of the fundamental problems of the Chinese BoS system is that

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[162] See M. H. Lubetsky, *Cultural Difference and Corporate Governance*, 17 Transnational Law & Contemporary Problems (2008), p. 187, 206.

[163] Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 Connecticut Journal of International Law 2006, p. 43.

[164] Li Shengli, *Independent Director or BoS*, Issue 7 Productivity Research (2005), p. 154, 158.

[165] Luo Xiao, *Brief Analysis of the Shortcomings of the BoS of our Company and the Countermeasure*, Issue 12 Legal System and Society (2014), p. 86, 87. Note also that in Germany some supervisors are seconded from banks. It might be better for the Chinese companies to consider enlarging the resources of supervisors learning lessons from Germany.

[166] Cao Jie and Li Ailan, *Analysis on the Conflict and Selection of the Independent Director System and BoS Sytem of our Country*, Issue 10 Legal System and Society (2010), p. 48, 49; see also Zhou Mei, *The New Development of German BoS System and the Lessons for Chinese BoS*, China-German Legal Forum (2009), p. 92, 102.

[167] Ibid, note that as above, CSRC Code already stipulated the supervisors' right to information but it has not been adopted as a part of the Chinese Company Law yet.

[168] Zhou Mei, *The New Development of German BoS System and the Lessons for Chinese BoS*, China-German Legal Forum (2009), p. 92, 101; Ye Chengpeng, *The Perfection of Company's BoS System*, Issue 6 Market Modernization (2011), p. 27, 28.

the controlling shareholders (more often than not they are also the managers/directors) are overly dominant. The BoS would still have difficulties in exercising its new authority since a majority of its members are selected by the shareholders.

One proposal to counter this problem is to restrict the number of companies in which a person may be appointed as a supervisor such as disallowing one person from being appointed as a supervisor for more than 5[169] or 9 companies.[170] This would enable the Chinese supervisors to devote more time and energy towards their duty as supervisors especially in instances where lawyers, accountants or professionals become independent supervisors.

b) Japanese Law

Before making any comparisons the prominent differences between Japan and China may be noted. Many Japanese managers are career managers who typically start their careers in a company just after graduating from university and are finally promoted as managers.[171] This means that in Japan, at least in large listed corporations, the problem of a strong controlling shareholder/manager is not critical.[172] In light of these facts, some of the characteristics of the Japanese BoS may be referred to while considering reforms in China.

First, whereas a Chinese independent supervisor is optional, Japan has mandated the presence of outside supervisors and that they should make up a majority of the BoS. Some scholars argue that the Japanese corporate governance feature should be introduced in China.[173] Also, while more than 40 % of the Japanese outside supervisors are lawyers or accountants, Chinese supervisors are mainly insiders without any specialized knowledge. China may consider including more supervisors who are qualified professionals. Careful selection of

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[169] See Art. 5 (2) of the Guidebook for Listed Companies' Independent Directors in Performing Obligations in 2004 by CAPCO: "The independent directors shall guarantee enough time and energy to effectively perform their obligations. In principle, they can only become independent directors of five listed companies or less".

[170] See Ma Daoyong, *The Analysis of the Perfection of the Law making of the Company's BoS*, Issue 2 Cadres Tribune (2006), p. 41; Liu Miao, *The Reconsideration of the Independent Director System of Our Country*, Issue 4 Law Application (2005), p. 43, 44.

[171] J. O. Haley, *Heisei Renewal or Heisei Transformation: Are Legal Reforms Really Changing Japan?*, 19 Zeitschrift für Japanisches Recht/Journal of Japanese Law (2005), p. 5, 13. Large listed companies are "controlled by career managers who view themselves as the primary stakeholders and actively prevent shareholders from exercising either rights of control or claims to their residual share".

[172] Admittedly, there are some companies in which the founders (and their relatives) are the largest shareholders. However, such companies are usually small- or mid-sized even if they are listed.

[173] Zheng Xiong, *On Improving Supervisors Committee System of National Corporation*, Issue 10 Journal of Huaihua University (2008), p. 44; see also Chen Jianjun, *How to Perfect the Our Country's BoS System*, Issue 6 China Economist (2007), p. 24.

candidates and competitive remuneration should be the prerequisites[174] especially in the context of the time they are expected to devote as supervisors and the motivation to effectively monitor the company. The Japanese Association of Supervisors (監査役協会) provides specialized training to supervisors. China should consider introducing more systematic education to supervisors provided by (semi-)official institutions or experienced supervisors.

Second, the Chinese and Japanese systems are different in that the Chinese listed companies (JSLCs) cannot select the American or the Hybrid Model. Since each company operates under difference circumstances, the corporate governance model which is the best fit for a company may differ. Therefore, China may consider allowing companies to select other options.[175] This must be done cautiously as allowing many models may cause chaos in the market.

Third, whereas a Chinese BoS functions by the resolution of the members, Japanese Law gives individual supervisors the authority to monitor and supervise the managers. This means that when the supervisors disagree on an issue, Japanese supervisors may individually exercise their authority and prevent damage/loss to the company. Some Chinese scholars also advocate giving authority to individual supervisors.[176] Consideration needs to be given in cases where a brave supervisor rightfully divulges certain information despite opposition from a majority of supervisors or a case where an unreasonable supervisor abuses his/her authority and harm the interests of the company.

Fourth, legal systems in Japan and China are similar in that the concepts of independent directors as well as the BoS exist in both countries. The basic idea of the Japanese system is to let independent directors and supervisors coordinate and communicate. This is similar to the proposals laid down by some Chinese scholars.[177]

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[174] Ibid, also, the introduction of the above-mentioned German system of limiting the number of companies a supervisor may serve for is worth considering, especially under this background.

[175] See Long Weiqiu and Li Qingchi, *The Reform of the Internal Governance System of the Company*, Issue 6 Journal of Comparative Law (2005), p. 58, 71.

[176] See Liu Jiasheng, *Board of Supervisors in China's Stock Corporations: Measures to Improve Its Safeguarding Function*, Issue 3 Journal of Huaihai Institute of Technology (Social Science Edition) (2009), p. 43, 45; Ding Liquan, *The Empirical Study of the Independent Director and BoS of Hunan Province Listed Company*, Issue 4 Consume Guide (2008), p. 121, 122.

[177] See Yonghui You, *Coordination and Perfection between Independent Director and Supervisor's Council* 1 Journal of Politics & Law (2008), p. 61, 63: "We should construct sharing system of information and resources between independent director and supervisor". Also see Jiang Ming, *Discussion of The differences between the Independent Directors and the BoS and the Perfection*, Issue 2 Theory Monthly (2006), p. 121, 122; He Jiayou, *On Perfection of and Coordination Between the Independent Director System and the Supervisor Board System in China*, Issue 2 Journal of Southwest Agricultural University (Social Sciences Edition) (2009), p. 37, 40; Wu Xiaoping, *The Re-consideration of the Coordination of the Functions of the Independent Director and the BoS*, Issue 5 Heilongjiang Social Sciences (2010), p. 142, 144; Tian

Fifth, the Japanese BoS has full-time supervisors and approximately two staff members (in companies with BoS staff system). China may consider introducing a full-time supervisor[178] while bolstering the staff supporting the BoS.[179] It should beforehand be considered whether the benefits outweigh the additional costs.

Sixth, Japanese Law[180] stipulates more powers for supervisors over certain areas than their counterparts in China. China may consider requiring BoS's consent in the BoD's nomination of supervisors.[181] It may also consider depriving the BoD/manager of the authority to determine supervisors' salaries and giving the discretion instead to the salary committee or other company bodies.[182] In addition, China may clearly give the supervisors authority to sue directors/managers in court so as to check undesirable conduct and recover the company's damage.[183] Another area over which Japanese supervisors have significant authority is the right to information.[184] Under the Japanese Hybrid Model the ASC has the right to give opinion on nominations which is a kind of middle ground between the Chinese system and the German system.[185]

Finally, as regards the Japanese lawmakers' decision to let companies decide whether to adopt the Japanese, American or Hybrid system, the prime intention is to promote foreign investment. Those companies which focus on receiving substantial foreign investments may choose either the American or the Hybrid system which can be easily understood by foreign investors. If China fully

Wei, *The Analysis of the Coordination and the Development of the BoS and independent Director System in the Listed Companies of our Country*, Issue 4 Legality Vision (2015), p. 60, 61.

[178] Jiang Weijun, *Analysis of the Defect of the Lawmaking of the BoS System of our Country's Companies and its Perfection*, Issue S1 The Journal of Xiangtan University (The Edition of the Philosophy and the Social Science) (2008), p. 37, 38.

[179] See Li Haidong, *How the BoS of State Owned Enterprises Exercise its Functions*, Issue 36 Chinese & Foreign Entrepreneurs (2014), p. 48.

[180] Note that while Chinese guidelines or other documents provide these authorities (such as the right to information in Art.e 60 of the CSRC code), these rights are not stipulated in the Chinese Company Law.

[181] See Fan Yunheng, *Brief Analysis of The Function, Reality and Countermeasure of the BoS of State Owned Enterprises*, Issue 3 Transportation Enterprise Management (2015), p. 48, 50.

[182] Note that some scholars argue that China should let the Remuneration Committee to work out the plan for BoS member remuneration, before such plan is passed by Shareholder's Meeting. See Xu Xiaoyan, *Intensify the Board of Supervisors System and Perfect Corporate Management Structure of Listed Company*, Issue 15 Economic Research Guide (2013), p. 142, 143.

[183] See Chen Jianjun, *How to Perfect the Our Country's BoS System*, Issue 6 China Economist (2007), p. 24.

[184] This means that the BoS's right to information is not necessarily derive from the German-style important decision-making authority. See Li Boqiao and Ling Yonqin, *The Comparative Analysis of the Chinese and Japanese BoS's Information Control System*, Issue 6 Commercial Research (2006), p. 96.

[185] Yang Duifu, *Brief Analysis of the Status and the Function of the BoS in State Owned Enterprises*, Issue 8 China Market (2014), p. 58, 59.

opens its stock market to foreign investors, selecting the American model is also worthy of consideration. In May 2015 Premier Li Keqiang announced that China would steadily continue the process of opening up of the stock market.[186] When the opening up proceeds to the next stage, it would be the right time for China to consider allowing listed companies to choose an American or America-like system to boost foreign investors' confidence. However, it should be noted that if foreign investors believe that the reforms are merely superficial, there is little chance of attracting more investors.[187]

c) Fundamental Problems of the Chinese BoS System

The comparisons with Germany and Japan seem to illustrate the following fundamental problems of the Chinese BoS system:

aa) Lost in Transplantation

China borrowed the concept of the BoS from abroad. Some features of this system might have been lost during the "transplantation" process. For example, China implemented the employee-supervisor system but the original German employee-supervisor system was established and developed in a country which already had strong employees and/or labor unions. In China, considering the relatively weak power of the employees and/or labor unions, the employee-supervisor system seems far from successful.

To improve the Chinese BoS system one needs to analyze what is "lost" during the transplantation process and create a unique BoS system (or any other corporate governance system) which best fits the Chinese market.

bb) Multiple Purpose Syndrome

A fundamental problem may be pointed out in the intentions of the legislator when the BoS system was introduced. The real purpose of the BoS system seems unclear due to the following reasons:

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[186] Li Keqiang, Steadily Proceed the Opening Up of the Stock Market, 2015; http://finance.qq.com/a/20130527/002754.htm.

[187] Note that recent Chinese corporate governance reforms of introducing independent directors have been criticized by an American scholar as simply being formalities. See B. E. Aronson, *Changes in the Role of Lawyers and Corporate Governance in Japan – How do We Measure Whether Legal Reform Leads to Real Change?*, 8 Washington University Global Studies Law Review (2009), p. 223, 238: "Countries like China and Korea are willing to embrace the concept of independent directors for listed corporations precisely because the inclusion of a number of nominally independent directors is unlikely to have a real impact on managerial authority. In addition, corporations in those countries may actually be aiming at an important collateral benefit derived from the introduction of independent directors-a greater willingness of large institutional investors (mostly from the United States and the United Kingdom) to invest in companies that incorporate familiar governance devices such as independent directors while operating in an otherwise weak corporate governance environment".

- Considering that a majority of supervisors are selected by the shareholders, it can be argued that BoS is solely for the benefit of the shareholders (See also "responsible for the whole shareholders" in CSRC code Art. 59).
- On the basis of the minority shareholders' right to elect supervisors (such as in the aforementioned CSRC code requiring the cumulative voting system) it may also be argued that BoS is for the benefit of minority shareholders.
- China adopted the employee-supervisor system and it can be said that the BoS is for the benefit of the employees.
- Considering the stress on CSR in recent years and the protection of multiple stakeholders, it can also be argued that BoS is for the benefit of stakeholders such as creditors and the environment.

To sum up, the BoS system seems to have multiple purposes which often conflict with each other. This could also be an important reason for the malfunctioning of the BoS system.

cc) The Problem of Controlling Shareholders

Finally, any reform of the *legal* system as regards the BoS would make little difference as long as the *practice* is unchanged. The ineffectiveness of the BoS mainly results from strong managers and/or controlling shareholders in Chinese listed companies. Even if the law grants authority and independence to supervisors, they would still be powerless as long as strong managers and/or controlling shareholders control companies. Thus, without changing the shareholding structure of the Chinese-listed companies the BoS will not work.

VI. Conclusion

The characteristics of the BoS system in three countries viz. China, Germany and Japan were discussed in this paper. In spite of the same name, the actual functions of these boards are quite different in these countries. Germany invented the BoS and it appears to fit well into its current corporate framework. The Japanese Corporate Governance, which borrowed heavily from Europe (Germany), has been subject to the increasing influence of the U.S.. The BoS in Japan has had to face challenges from two new options and experiences from cases such as Toshiba.

Many scholars have characterized the Chinese BoS as being ineffective. In order to improve the performance of the BoS China may consider adopting practices from the Japanese and German BoS systems. Full-time and better educated supervisors are required in order to fulfill their duties effectively. They should ideally have more independence and higher leverage. Issues such as division of labor between the BoS and auditing committee, refining the scope of

authority and level of scrutiny for the BoS, collaborating and aligning the work of the BoS and independent directors need to be addressed as well.

Furthermore, it is vital to analyze what aspects are lost during the "transplantation" of BoS system from a foreign country and to reconsider the primary purpose of the BoS. In addition to changing the laws and regulations, a change in the Chinese shareholding system appears to be necessary for improving the function of the BoS.

Last but not least, although this article mainly discusses the internal checks and balances system and its effect on corporate governance, the external checks and balances system is also imperative to get a holistic view of corporate governance.[188] Especially for China, a "market economy with Chinese characteristics" is embodied through extensive state regulation of financial markets and direct ownership of shares in listed companies. As such the importance of the external system cannot be underestimated.[189] Meanwhile, the traditional German (and Japanese) bank-centered external checks and balances systems[190] and the Japanese cross-holding system[191] have helped in shaping up their corporate governance structures respectively. After all, it is infeasible to determine a satisfactory mechanism without giving due consideration to every specific context.

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[188] Zhao Zhenhua, *Corporate Law*, 1st edn. (2010), p. 135–136; Li Jianwei, *Corporate Law*, 2nd edn., (2011), 281–282; D. C. Clarke, *Law Without Order in Chinese Corporate Governance Institutions*, 30 Northwestern Journal of International Law & Business (2010), p. 131.

[189] See I. MacNeil, *Adaptation and Convergence in Corporate Governance: The Case of Chinese Listed Companies,* 2 J. Corp. L. Stud. (2002), p. 289, 339: "The 'socialist market' objective is pursued not through internal governance structures mandated by the law but through extensive state regulation of financial markets and direct ownership of shares in listed companies". See also Hua Cai, *Bonding, Law Enforcement and Corporate Governance in China*, 13 Stanford Journal of Law, Business & Finance (2007), p. 82.

[190] See J. R. Macey and G. P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 Stanford Law Review (1995–1996), p. 73.

[191] Guo Li and Y. Shinsuke, The Cross Holding of Company Shares, 4 Frontiers of Law in China (2010), p. 507; Guo Li, An Analytic and Regulatory Framework on Shares Cross-holding, Issue 4 Journal of Peking University (Philosophy & Social Sciences) (2009), p. 67.