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LEGAL ANALYSIS OF EFFECTIVE PARTICIPATION IN CORPORATE GOVERNANCE BY INSTITUTIONAL INVESTORS IN CHINA: WITH REFERENCE TO JAPAN

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ABSTRACT

China has created a series of new laws and regulations for the corporate governance of listed companies over the past several years, which have improved economic development to some extent. However, the corporate governance of Chinese listed companies still displays significant weaknesses in practice and enforcement. The primary problem currently arises from the abuse and expropriation of controlling shareholders especially for state-controlled companies. Thus, this dissertation explores how to bolster institutional investors' role in promoting better corporate governance in listed companies in China, which can alleviate the expropriation and infringement of controlling shareholders and managers.

In the context of China, the dissertation analyzes the needs for institutional investors and their participating in corporate governance from the following four aspects: (1) the systematic shortfalls in corporate governance; (2) forming an effective monitoring pressure; (3) protecting minority shareholders; and (4) fiduciary duty. On the basis of necessity, the dissertation examines the current legal practices covering legislations and cases of institutional investors' participation in corporate governance in China, and explains the obstacles blocking institutional participation such as (1) the large state-controlled ownership; (2) the misconduct of institutional investors in the emerging stock market; and (3) the shortfalls of legislation on participation in corporate governance by institutional investors.

The dissertation examines the situation covering the historical development and legal practices of institutional investors' participation in corporate governance in Japan, because the corporate governance practices is similar to China and the experience that institutional investors have increased rapidly and gradually influenced the corporate governance in Japan recently can tailor to the context of China to a large extent. This study discusses the similarities and differences of the corporate governance practices between Japan and China

and analyzes the growth basis and different roles of institutional investors in different corporate governance structure in these two countries. By comparison, the dissertation reaches two conclusions: (1) the need for restricting the controlling shareholders; and (2) the need to improve the legal framework on institutional investors' effective participation in corporate governance in China.

Concerning the controlling shareholders, China does not only need for transferring state-owned shares continually, but also needs improving legislations on restricting on the voting rights of controlling shareholders to prevent from abuse. By drawing on Japan, this dissertation mainly proposes that the legal framework in corporate governance should be improved by (1) promoting participation of institutional investors in corporate governance; and (2) strengthening the regulation on institutional investors to promote effective participation in China.

In terms of promoting institutional investors' participation in corporate governance, the study mainly proposes two suggestions, including: a) Establishing guidelines for exerting voting rights of institutional investors; and b) combining the institutional investors with the outside directors to play monitoring function effectively.

Concerning strengthening the regulation on institutional investors, it is of great importance for China to do from two main aspects: a) Disclosing the information of institutional investors, including disclosing voting results and disclosing during soliciting proxy rights of institutional investors; and b) strengthening the regulation on the wrongful share-trading acts of institutional investors.

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LIST OF ABBREVIATIONS

CIRC	China Insurance Regulatory Commission
CSRC	China Securities Regulatory Commission
FSA	Financial Services Agency
ISS	Institutional Shareholder Service
NSSF	National Social Security Fund
OECD	Organization for Economic Co-operation and Development
PFA	Pension Fund Association
QFII	Qualified Foreign Institutional Investor
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission
SESC	Securities and Exchange Surveillance Commission
SHSE	Shanghai Stock Exchange
SOEs	State-Owned Enterprises
SROs	Self-Regulation Organizations
SZSE	Shenzhen Stock Exchange
TSE	Tokyo Stock Exchange

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INTRODUCTION

Background of Research

As China has shifted from a planned economy to a market economy, from establishing Chinese enterprises by government to by legislation, corporate governance has emerged and developed. From the economic reforms in 1978 (Reform and Opening Policy), China began opening its doors and transitioning towards a market-oriented economy. In 1990, China established two stock exchanges (Shanghai and Shenzhen Stock Exchange), which symbolized the establishment of a stock market and was the basis for developing listed companies and a sound corporate governance system.

With the development of legal systems concerning corporate governance, China has made substantial progress in several areas over the last 30 years. Such progress primarily consists of the following aspects: (1) introducing "independent directors" and "shareholder derivative suits" to strengthen duties and liabilities of directors and controlling shareholders; (2) strengthening the information disclosure and transparency of listed companies; and (3) establishing legislation to improve the role of the market on corporate governance.

At present, however, some problems still hinder the development of corporate governance in China. Controlling shareholders and managers in some listed companies abuse their control power and expropriate profits of the company and minority shareholders. At the same time, enforced monitoring mechanisms such as the supervisory board, and the board committees covering independent directors, together with the stock market may not perform their roles effectively. Therefore, China needs using a creative mechanism to resolve the problem of abuse of controlling shareholders and managers.

Significance of Research

The rapid development of institutional participation in corporate governance has occurred in many countries such as the US, UK, Japan and EU since 1980s. Similarly, institutional investors in China have also increased significantly in recent years. With the increase of institutional investors, there is a need to examine how such investors can promote the corporate governance in China as in other countries.

The abuse and appropriation of both controlling shareholders and managers coexist in most Chinese listed companies, which can be mainly attributed to an imbalance of the share ownership structure. On the one hand, the ownership structure is not diversified but concentrated in the controlling shareholders. On the other hand, individual shareholders are relatively scattered, making it difficult to form a monitoring pressure to constrain the conduct of operators. Thus, there is a necessity for institutional investors who hold moderate concentrated shares to constrain the controlling shareholders.

In theory, minority shareholders are usually passive and reluctant to exercise their rights; even if they would like to do so, it is difficult due to the power of the controlling shareholders. Alternatively, relative to minority shareholders, institutional investors usually hold large shares. Furthermore, institutions have professional investing knowledge and skills that lead them to participate in corporate governance and monitor the conduct of operators in the company. Therefore, theoretically, institutional investors should be able to participate in corporate governance.

In practice, a series of official statements recently demonstrates that the central party and government of China attach great importance to the participation of institutional investors in corporate governance. Moreover, the relevant legislation also is issued by China Securities Regulatory Commission (CSRC) to strengthen the influence of institutional investors on

corporate governance.[1]

Institutional investors who pursue their best interests may have both positive and negative sides of influencing the corporate governance. The positive aspects mean that the institutional investors participate in corporate governance actively and effectively on behalf of minority shareholders. On the negative side, these institutions simply support the resolutions of the management even when they infringe upon minority shareholders or involve in wrongful trading acts in seeking short-term interests. In light of this negative side, how to regulate the conduct of institutional investors to promote effective participation in corporate governance is of importance.

Conception of Institutional Investors in China

Before discussing the main body of this dissertation, the conception of institutional investor in China should be explained from both legislation and academia in China. In legislation, the term of "institutional investor" is not defined, while the concept of "Qualified Foreign Institutional Investors (QFIIs)" as an important category of institutional investors in China is stipulated in legislation. According to legislation, QFIIs are categorized as "overseas fund management institutions, insurance companies, securities companies and other assets management institutions which have been approved by China Securities Regulatory Commission to invest in China's stock market and granted investment quota by State Administration of Foreign Exchange."[2]

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[1] China Code of Corporate Governance for Chinese Listed Companies (issued in 2002), Article 11 stipulates that, "Institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes."

[2] China Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFIIs), Article 2, promulgated by China Securities Regulatory Commission, the People's Bank of China and State Administration of Foreign Exchange, enforced on 1st, September of 2006.

In academics, the term of "institutional investors" is usually categorized into general juridical investors and professional institutional investors. The concept of professional institutional investors mainly comprises securities investment funds, insurance companies, securities companies (limited to business which falls under investment management), the enterprise annuity funds, the National Social Security Funds (NSSFs) and QFIIs.[3]

Influences of Institutional Investors on Corporate Governance

This study examines the relation between corporate governance and institutional investors, focusing on the mechanisms of institutional investors on corporate governance. Gillan and Starks claimed that "if shareholders covering institutional investors become dissatisfied with the performance of the company, they have three choices: (1) 'vote with their feet', i.e., sell their shares; (2) hold their shares and voice their dissatisfaction, or (3) hold their shares and do nothing."[4] Kagono contended that "institutional investors may influence corporate governance through two mechanisms including exercising voting rights in general meetings and influencing the stock price in the stock market."[5] According to these two viewpoints, institutional investors may influence corporate governance by two mechanisms. On the one hand, institutional investors may influence corporate governance through participating in corporate governance of their portfolio companies. On the other hand, such investors may influence corporate governance through takeovers in the stock market.

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[3] Zhimin Gen, *Jigou touzizhe yanjiu* [Institutional Investors in China], (China People University, 2002), 13.

[4] Stuart Gillan and Laura T. Starks, "Corporate governance, corporate ownership, and the role of institutional investors: A global perspective," *Journal of Applied Finance* 13 (Fall/Winter 2005): 4.

[5] Tadana Kagono, *Kigyo toji seido no kaikaku no tame ni - kikan toshika to kabunushi sekinin*, [For the Reform of Corporate Governance - the Institutional Investors and the Responsibility of Shareholders], in *Kokumin keizai zashi* [Journal of National Economy] 182, no.6 (2006): 4.

This dissertation focuses on the mechanism of participation in corporate governance by institutional investors. Institutional investors may have two following negative influences on corporate governance. One, institutional investors may be reluctant to participate in corporate governance. Two, due to the purpose of pursuing the profit maximization, investors may conduct some wrongful acts for private interests so that they cannot participate in corporate governance in a lawful and effective way. Accordingly, this study will explore ways to promote the effective participation in corporate governance by institutional investors.

Purpose of Research

In order to alleviate the expropriation of controlling shareholders and managers and improve the corporate governance of Chinese listed companies, this dissertation approaches the core question of how to leverage the effective participation in corporate governance by institutional investors. The study takes two steps to resolve this problem. First, the dissertation aims to examine the need for institutional investors participating in corporate governance in China and the legal practices of institutional participation in corporate governance in China and Japan. Second, by analyzing the experience in Japan with regard to participation in corporate governance by institutional investors, the study expects to improve institutional investors' effective participation in corporate governance in China.

Methodology

Two research methods are applied in this dissertation. First, historical analysis of institutional investors' participation in corporate governance in Japan and China are introduced in order to explain the different background and roles of institutional investors in each country. Secondly, the dissertation compares legal reforms on institutional investors

between Japan and China, because there are similarities between the corporate governance practices in these two countries and the experience that institutional investors have increased rapidly and gradually influenced the corporate governance in Japan recently can tailor to the context of China to a large extent, so China should be possible to learn good experience of Japan.

Outline of the Dissertation

This dissertation is divided into five chapters as follows.

Chapter 1, Chapter 2 and Chapter 3 provide the substantive, analytic body of participation of institutional investors in China. Chapter 1 analyzes current problems of corporate governance in China, the needs for participation of institutional investors in corporate governance, and the source for promoting institutional participation. Chapter 2 provides the historical development and legal practices of institutional participation in China while Chapter 3 further analyzes the obstacles to effective institutional participation in corporate governance in China.

Chapter 4 provides an overview of the participation of institutional investors in corporate governance in Japan where institutional investors are developing rapidly and some special legal framework on promoting institutional participation have been set up. The US is much more developed country where institutional investors influence the corporate governance significantly and the special legal framework on promoting institutional participation and well regulatory structure have been set up. However, the US as a case law country owns large differences with the corporate governance system of China. At the same time, the influence on corporate governance by institutional investors in the US is too far ahead of the actual

situation in current China, so there is no mature condition for institutional investors in China to bring such huge influence on corporate governance as in the US.

However, there are similarities between the corporate governance practices of China and Japan, both of which are civil law countries. Moreover, the experience that institutional investors have increased rapidly and gradually influenced the corporate governance in Japan recently can tailor to the context of China to a large extent, so China should be possible to learn good experience of Japan. The dissertation examines the specific measures for promoting participation in corporate governance by institutional investors in Japan and expects to draw upon good experience to promote institutional investors participating in corporate governance effectively in China.

Chapter 5 draws a general comparison between Japan and China. The chapter further examines the unique opportunity for promoting institutional participation and discusses how to tailor the context to China. By drawing on some of the experiences of Japan, the study includes how to promote effective participation in corporate governance by institutional investors to improve good corporate governance in China.

Lastly, the dissertation provides an overview and reaches a conclusion that China needs learning from the experience of Japan to promote institutional participation in corporate governance on the basis of adapting actual situation of China. The dissertation also discusses the limitation including the difficulty of balancing the share ownership structure and the prospect for future research.

CHAPTER Ⅰ Problems of Corporate Governance in Chinese Listed Companies and the Approach to Institutional Participation

This chapter deals with three points. First, this chapter explains the problems existing in the corporate governance in Chinese listed companies. Second, the chapter analyzes the necessity of participation of institutional investors in corporate governance of China. Third, the chapter analyzes the sources of increasing institutional investors and promoting institutional participation in Chinese corporate governance.

1.1 Problems of Corporate Governance in Chinese Listed Companies

Corporate governance in China is characterized by a relatively concentrated share of ownership by controlling shareholders especially the state. The Company Law 2005 of China provides that "the controlling shareholders refer to those who can control the company depending on the share ownership; that whose shareholding accounts for more than 50% of the total shares of a company, or even his shareholding is lower than 50%, but he has a significant impact on the decision of the general meeting belong to controlling shareholders."[6] In China, most listed companies are carve-outs or spin-offs from large state-owned enterprises (SOEs), in which the original SOEs still own a large percentage of total shares. Thus, the SOEs become controlling shareholders. Shanghai Stock Exchange reported that the listed companies of relative control by the state and absolute control by the state separately accounted for 2/3 and 1/2 of the total number of listed companies in Shanghai Stock

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[6] China Company Law (2005), Article 217(2). The National People's Congress of China revised Company Law 1993 and promulgated new Company Law on October 27, 2005, and brought Company Law 2005 into effect on January 1, 2006.

Exchange in 2009.[7]

According to the analysis of Shleifer and Vishny (1997), in a country with highly concentrated share-ownership and an inefficient legal environment, the controlling shareholder will likely expropriate the assets of companies and infringe on the interests of company and minority shareholders.[8] In China, the share ownership is concentrated and the controlling shareholder can dominate the company according to "majority voting rule."[9] Meanwhile, due to ineffective monitoring mechanisms, controlling shareholders are rarely challenged by minority shareholders in listed companies. Thus, the expropriation and infringement of controlling shareholders exist to a large extent.

A series of scandals occurred in China. For example, the scandals involving the Yin Guangsha Co., Ltd. in 2001, the Sanjiu Group Co., Ltd. in 2005, the Jiangsu SunShine Co., Ltd. in 2007, the Lianhua Gourmet Powder Co., Ltd. in 2008, even the current case of the Wu Liangye Co., Ltd., illustrate the problem that the resources of companies have been expropriated by controlling shareholders through various means; these means include misrepresentation in financial statement, unfair related-transactions and illegal guarantee for parent companies.[10] These scandals infringed upon the interests of the company and minority

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[7] Shanghai Stock Exchange, ed., *Report of China Corporate Governance: Market of Corporate Control and Corporate Governance*, (Shanghai Stock Exchange, 2009), 90.

[8] Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *The Journal of Finance* 52, no.2 (1997): 737-783. They also claim, "Controlling shareholders would bring incentive effect on corporate governance in the countries with effective legal environment, since they have incentive and capability to monitor the managers in the company so as to improve corporate governance and protect shareholders' profits."

[9] Majority voting rule means that those who invest most of amount of the capital in the company decide to pass or not the proposals at the shareholder meetings.

[10] Dan Liu, *Zhengquanfa anli pingxi* [Cases Analysis of Securities Law], (University of International Business and Economics Press, 2010), 382-385. Lei Gao and Gerhard Kling, "Corporate governance and tunneling: Empirical evidence from China," *Pacific-Basin Finance Journal* 16, no.5 (2008): 591–605.

shareholders.

At the same time, the problem of "insider control" also exists in many listed companies in China, but with its own particularity. Corporate insiders usually refer to the directors and executive officers who have actual power of control of the company. "Insider control" means that the corporate insiders abuse their control power to obtain benefits for themselves instead of the company due to dispersed share ownership and "shareholder apathy."[11] Therefore, this problem often exists in some companies with dispersed share ownership. However, the problem of "insider control" also exists in many state-owned listed companies in China.

The state, as the actual owner of the company, delegates the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) to fulfill the duties and responsibilities of the owner of the company and supervise the state-owned assets by law. Therefore, the SASAC is the agent of the state and enjoys the equity right of owners. However, the SASAC cannot intervene in the management of the company directly.[12] Hence, there is absence of the real owner to monitor the behaviors of managers in the state-owned listed companies, and in practice it is likely for managers to control the management of the company.

Due to the concentrated share ownership and absence of the owner, the decision-making power of the major affairs is actually controlled by the managers of the companies. In a

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Chen He, *Zhongguo shangshi gongsi zhili anli* [The Governance Cases of Chinese Listed Companies], (China Development Press, 2009), 68-81; 166-169. Jiangang He, *Dagudong kongzhi, liyi shusong yu touzizhe baohu* [Controlling Shareholder, Tunneling and Investor Protection], (Dongbei University of Finance and Economics Press, 2009), 155-169.

[11] Yousu Zhou, *Shangshi gongsi falv guizhi* [Legal Regulation on Listed Companies], (Commercial Press, 2006), 45.

[12] Provisional Regulations on Supervision and Management of the State-owned Assets, Article 10, promulgated by State Council of China in 2003.

company with larger state-owned shares, the problem of "insider control" may be more serious which might lead to an erosion of profits and the loss of state assets, and further impede the development of the company.[13] Therefore, the problem of "insider control" exists due to the controlling shareholders.

As a result, there are actually two kinds of problems that coexist in the corporate governance of listed companies in China including (1) the agency problem between controlling shareholders and minority shareholders; and (2) the agency problem between the shareholders and managers. Thus, the current aim for corporate governance of China is not only to tackle the classical agency problem between shareholders and managers but primarily to reduce the infringement by the controlling shareholders.

1.2 Necessity of Institutional Participation in Corporate Governance

The abuse and appropriation of controlling shareholders is a primary and serious problem in most Chinese listed companies at current. China is always searching a well mechanism to improve corporate governance. The dissertation analyzes the following four reasons why institutional investors' participation in corporate governance is necessary, including (1) the systematic shortfalls in corporate governance; (2) forming an effective monitoring pressure; (3) protecting the interests of minority shareholders; and (4) fiduciary duty.

1.2.1 Systematic shortfalls in corporate governance

The current corporate governance framework of Chinese listed companies is a two-tier board structure. The general shareholder meeting is the top organ which retains ultimate

[13] Yousu Zhou, 46-47.

power to decide major issues in the company. Under the general meeting, there are two parallel organs which are the board of directors and the supervisory board. Furthermore, listed companies are required to set up independent directors to monitor the management of the company. Independent directors are elected at general meetings. Both the independent directors and the supervisors, who are nominated at general meetings, co-exist in Chinese listed companies. However, in practice, there are four shortfalls in the enforced legal mechanisms of corporate governance of China as follows.

1.2.1.1 Shortfalls in the board of directors

The board of directors in Chinese listed companies mainly provides management of companies. According to the Company Law 2005 of China, the board of directors is given the power to manage the business of the company and make decisions on some management issues. In some Chinese listed companies, by virtue of concentrated share-ownership of controlling shareholders, they actually dominate the general meetings by "majority voting rule" and often bypass the board of directors and supervisory board to involve in the management decision-making in many occasions.[14] Therefore, the board of directors is dependent upon controlling shareholders, represents their desire, and becomes the rubber stamp of controlling shareholders.

1.2.1.2 Shortfalls in the supervisory board

According to the Company Law 2005, the supervisory board oversees the management of the board of directors and inspects the company's finance. However, the effectiveness of the supervisory board in playing its function is subject to much criticism. In practice, some supervisors are employees in the listed companies with concentrated share-ownership, and

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[14] Minghai Wei, Jianhua Liu and Feng Liu, *Zhongguo shangshi gongsi touzizhe baohu yanjiu baogao: 2006-2008*, [Research Report of Protection of Investors in China Listed Companies: from 2006-2008], (Economical Science Press, 2010), 3-5.

they work under the leadership of corporate director who becomes the chairman of the board of directors after the enterprise reformation. In this case, it is difficult for these supervisors to monitor the directors. As a result, "the supervisory board in many Chinese listed companies is incapable of playing an active role in monitoring business due to its less independence, incentives and abilities."[15]

1.2.1.3 Shortfalls in the independent directors

China has introduced the idea of the "independent director," who is expected to monitor the management and controlling shareholders better in order to protect minority shareholders. However, independent directors in China are constrained by the power of controlling shareholders, less information, lack of expertise, and time. Hence, these independent directors are likely to be passive and consent to, instead of actively challenging, management's policies and decisions.[16]

In order to guarantee that independent directors fulfill responsibilities, the board of directors can establish special committees. There is no provision about special committees in the Company Law 2005. However, according to the Code of Corporate Governance of Listed Companies 2002, board of directors of the listed companies may establish special committees covering corporate strategy, auditing, nominations, remuneration and appraisals.[17] According to the Code 2002, "each special committee shall be accountable to the board of directors. All proposals by special committees shall be submitted to the board of directors for review and approval. Independent directors shall constitute the majority of the committees. At least one

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[15] Yousu Zhou, 46-47.

[16] Yongda Wu, *Woguo duli dongshi zhidu cunzai de quexian ji wanshan duice* [Defects of Independent Directors in China and Policy Recommendations], in *Fazhi yu shehui* [Legal System and Society], no.1 (2010): 29-30.

[17] China Code of Corporate Governance of Listed Companies (2002), Article 52.

independent director from the audit committee shall be an accounting professional."[18]

In practice, however, the special committees do not play monitoring function effectively due to the following two main reasons.[19] First, the main duties of the board special committees shall be to conduct research and make recommendations, and the board of directors makes final decisions. Hence, the special committees are not authorized the power to make independent decisions in practice. Second, the shareholder meeting can make a resolution of establishing special committees, while the board of directors is not authorized the power to set up the special committee on their own. In this context, the special committees in Chinese listed companies are actually controlled by the controlling shareholders.

1.2.1.4 Shortfalls in the market mechanism

The corporate governance of listed companies is also dependent upon the outside market mechanism. In China, the market for corporate control is less effective in monitoring and promoting corporate governance for two main reasons.[20] First, due to concentrated share ownership of controlling shareholders, it is hard for other bidders to control the target company through hostile takeovers in China. Even if there are some corporate takeover activities among companies, many of them are led by the government through agreements, showing the relatively strong power of administration.[21] Second, since the Chinese stock market is inefficient and fluctuates frequently, investors are craving for speculation and fraud

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[18] China Code of Corporate Governance of Listed Companies (2002), Article 58.

[19] Zengyi Xie, *Dongshihui weiyuanhui yu gongsi zhili* [Special Committees of Board of Directors and Corporate Governance], in *Faxue yanjiu* [Chinese Journal of Law], no.5 (2005): 60-69.

[20] The market for corporate control describes the role of stock markets in facilitating corporate takeovers and facilitating greater accountability of corporate operators to their investors. See Ajit Singh, "Corporate governance, corporate finance and stock markets in emerging countries," *Journal of Corporate Law Studies* 3 (2003): 63-65.

[21] Shanghai Stock Exchange, ed., *Report of China Corporate Governance: Market of Corporate Control and Corporate Governance*, (Shanghai Stock Exchange, 2009), 34-36.

for short-term interests. In such a case, the stock market is less possible to provide stable and correct price information to reflect the real value of the company, and the takeovers play less effective role in monitoring operators of Chinese listed companies.

Due to the systematic shortfalls above, the interests of the company and minority shareholders are infringed on by the controlling shareholders and managers. In this context, China needs examining a new creative mechanism of institutional investors whether or not it can make up for these shortfalls and plays an effective role in corporate governance in China.

1.2.2 Forming an effective monitoring pressure

The abuse and appropriation of both controlling shareholders and managers coexist in most Chinese listed companies, which can be fundamentally attributed to the imbalance of share ownership structure. On the one hand, the ownership structure is not diversified but concentrated in the controlling shareholders, especially the state. On the other hand, the public individual shareholders are relatively scattered, making it difficult to form a monitoring pressure to constraint the conduct of operators. The individual shareholders voting with their feet in the stock market are prevalent.

As Shleifer and Vishny (1997) claimed, "Large shareholders have incentive and capability to monitor the managers in the company so as to limit agency problems. However, the controlling shareholder can only obtain the interests for himself/herself without monitoring."[22] Accordingly, a reasonable shareholding structure should be neither too concentrated nor too dispersed because they usually lead to the abuse of controlling shareholders and managers. A Chinese scholar Li (2003) asserted, "For the benefits of the company and public small shareholders, it is better form a moderate concentrate share

[22] Shleifer and Vishny, 737-783.

ownership structure on the basis of relative dispersed share ownership."[23] A moderate concentrated share ownership structure requires the existence of shareholders with moderate large equity ownership and moderate control consciousness, and institutional investors meet this requirement.

Compared with other investors, institutional investors own two advantages. Relative to individual shareholders, institutional investors usually hold larger share ownership and voting rights in the company, so they attach more importance to the management of the company in order to protect their shareholdings and profits. As Davis and Steil (2001) contended, "The effectiveness of corporate governance typically also requires the presence of large investors such as institutional investors … They will have the leverage to oblige managers to distribute profits to shareholders; they are needed because individual investors may find it difficult to enforce their rights."[24] Hence, institutional investors typically have an incentive to involve in corporate performance.

On the other hand, relative to individuals and other general juridical investors, institutional investors have more professional knowledge of the investing activities and high level of research on the companies they invest, making them more professional in collecting and analyzing the information of corporate management. Thus, the performance of the company can be evaluated in a professional way and monitored more efficiently.

Therefore, China needs increasing institutional investors with moderate large equity ownership and moderate control consciousness to form an effective monitoring pressure to constraint the conduct of controlling shareholders in Chinese listed companies.

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[23] Shuguang Li, *Zhongguo de gongsi zhili jiqi zhuanxing qi de gaige* [The Corporate Governance of China and the Reform during Transition], in *Zhengfa luntan* [Politics Science and Law] 21, no.3 (2003): 11-12.

[24] E. Philip Davis and Benn Steil, *Institutional Investors* (MIT Press, 2001), 307.

1.2.3 Protecting the interests of minority shareholders

Laporta et al. (2000) concluded, "In the economies where concentrated ownership and poor investor protection exist, the agency problem between controlling shareholders and minority shareholders is more serious than between shareholders and managers."[25] Thus, the primary proposition of corporate governance is to protect minority shareholders under the concentrated ownership structure of China.

Minority shareholders are usually passive and reluctant to attend the general meeting and exercise shareholder rights to protect their benefits. Thus they usually sell their shares in the stock market with enduring the lost of money. Even if such shareholders would like to exercise shareholder rights, it is hard to work effectively due to the power of the controlling shareholder. Moreover, since some legal regulations have higher requirements in proportion to the shareholdings, it is hard for minority shareholders with small share-ownership to meet such requirements. For example, the Company Law 2005 empowers "the shareholders who hold at least 10 percent share ownership of the company with a right to convene general meetings."[26] Therefore, controlling shareholders can make decisions according to majority voting rule without caring about opinions of minority shareholders, which can trigger abuse and misconduct by the controlling shareholders.

In many circumstances, however, institutional investors as important shareholders may participate in corporate governance on behalf of minority shareholders. The interests of institutional investors and public individual investors are often the same in the case of the existence of controlling shareholders. Hence, when institutional shareholders receive benefits by participating in corporate governance, minority shareholders can also enjoy these public

[25] R. Laporta Porta et al., "Investor protection and corporate governance," *Journal of financial economics* 58, no.1 (2000): 13-15.

[26] China Company Law (2005), Article 40.

profits from institutional activism. At the same time, institutional investors need the support of minority shareholders when they take on an active role in corporate governance, such as proxy voting. Consequently, the legislation needs encouraging institutional shareholders to participate in corporate governance and make them voice on behalf of minority shareholders to monitor the conduct of controlling shareholders in Chinese listed companies so that the profits of minority shareholders can be protected effectively.

1.2.4 Fiduciary duty

The legal status of the institutional investor in a portfolio public company is complex. Such investor is not only the shareholder in the listed company, but also regarded as the trustee of other public investors. Since institutions essentially invest “other people’s money,” institutional investors are recognized as trustees who have fiduciary duties.[27]

The doctrine of fiduciary duty originates from the law of trusts in common law countries. The duty of fiduciary covers two aspects including the duty of loyalty and the duty of care. The academia of China explained these two duties, “The duty of loyalty means that institutional investors have to manage the fund assets for maximizing the profits of the beneficiaries; the duty of care refers that the institutional investors as trustees have to exercise care and skill of a man of ordinary prudence.”[28]

The principle of fiduciary duty obligates institutional investors to closely monitor their shareholdings and take action to protect investments against erosion in value. Exercising shareholder rights is one of the most important approaches to fulfill the fiduciary duty, so it is

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[27] Other people mainly concern individuals and juridical persons and other organizations or groups of organizations.

[28] Tiantao Shi, *Xintuo fa chutan* [First Exploration of Trust Law], *Zhongwai faxue* [Peking University Law Journal] 32, no.2 (1994): 50.

necessary for institutional investors to participate in corporate governance actively and monitor the operators in the listed companies.

In practice, some established legislation in China requires institutional investors to manage the investments for the interests of ultimate fund owners. For instance, according to Article 3 (2) of the Law of the People's Republic of China on Securities Investment Fund, it provides that the fund manager as a trustee has the liability to manage the funds for the benefit of ultimate fund owners.[29] Hence, the securities investment funds should intervene in the corporate governance of portfolio companies. Similarly, the legislation provides that "pension fund managers have a duty to maximize the pension funds for retirement benefits."[30]

A difference exists between the trustee and the agent, although both of them behave for the benefits of their principals or clients. The agent behaves in the principal's name, but the trustee behaves for their own interests. Moreover, the trustee has to deal with affairs alone, and cannot delegate to other agents, whereas the agent can delegate the affairs to another agent.

In practice, institutional investors may be involved in investment management directly or delegate the authority to other special management organizations. Most of institutional assets are managed by external "fund management companies" which are hired by traditional institutional investors.[31] Thus, the fund management companies as the trustees fulfill the fiduciary duty and involve in investment activities on behalf of traditional institutional

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[29] China Securities Investment Fund Act (2004) Article 3 (2), promulgated by National People's Congress on October 28, 2003, and came into effect on June 1, 2004.

[30] Provisional Measures for the Administration of the Investments of the National Social Security Fund, Article 8, issued by Ministry of Labor and Ministry of Finance of China and enforced in December 13, 2001.

[31] Jinqian Qiu, *Ownership Structure Corporate Governance and Institutional Shareholder: The Case of Chinese Listed Companie*s, (China Law Press, 2005), 126.

investors. Investment fund managers should engage in monitoring managers' behavior on behalf of their institutional clients. As a consequence, the investment fund managers actually carry out the monitoring function rather than traditional institutional investors. Institutional investors include traditional institutional investors and fund management companies. Fund management companies are also often referred as "institutional investors" since they manage not their own personal property but that of a collection of entities such as pension funds.[32]

By analyzing the four aspects of necessity of institutional participation above, China needs motivating institutional investors to play an effective role in monitoring the corporate governance in China. Basically speaking, relative to other stakeholders in the company, shareholders who can claim the residual interests have the largest and direct endogenous incentives to protect the rights and interests of shareholder group and promote the corporate governance. At the same time, institutional investors with moderate large share ownership are more likely to supervise the operators in the company through combining with other monitoring mechanisms.

1.3 The Sources of Increasing Institutional Investors and Promoting Institutional Participation in China

Before examining current situation of participation in corporate governance by institutional investors in China, this dissertation explains the sources of increasing institutional investors and promoting institutional investors' participation in China. Over the last three decades, China has undergone a period of transition from a planned economy to a market-oriented economy. With the rapid development of the economy and by joining the WTO in 2001, Chinese listed companies are under the external pressure to improve corporate

[32] G.P. Stapledon, *Institutional Shareholders and Corporate Governance*, (London: Oxford Clarendon Press, 1996), 35.

governance to compete with international companies. However, the corporate governance in the current listed companies still displays significant weaknesses in practice. The fundamental problem arises from the unbalanced share ownership structure and the abuse and expropriation of controlling shareholders and managers.

The Communist Party of China and the government have noticed the unbalanced share ownership structure as a serious problem and recognized the important role of institutional investors in alleviating the situation. In this context, the party and the government put forward the following policies to encourage increasing institutional investors in order to seek the balance of share ownership structure of Chinese listed companies including (1) the policy of the party; (2) the policy of the State Council of China; and (3) the statement of China Securities Regulatory Commission.

1.3.1 The policy of the party

In October of 2003, the "Third Plenary Session of the Party's Sixteenth National Central Committee of China" promulgated the *Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Improvement of the Socialist Market Economy* (hereinafter *Decision*) and put forward the policy of promoting reform by opening and developing stable capital markets. Particularly speaking, the *Decision* provides that "China shall develop the capital market, increasing the proportion of direct financing, creating a favorable investment environment, optimizing the allocation of resources and promoting the corporate governance structure."[33] Therefore, the party clearly requires developing direct financing to diversify the investment entities and further optimize the corporate structure.

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[33] Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Improvement of the Socialist Market Economy, promulgated and enforced on October 14, 2003.

1.3.2 The policy of the State Council of China

According to the *Decision* of the party, the State Council of China issued the *Several Opinions of the State Council on Promoting the Reform, Opening-up and Stable Development of the Capital Market* (hereinafter *Opinions*) in 2004, which required "developing the securities investment funds, increasing the direct investment of insurance funds on capital markets and gradually increasing the ratios of social security funds, enterprises supplementary pension funds and commercial insurance funds."[34] The *Opinions* also requires "cultivating a group of professional institutional investors and improves them to become the major forces on Chinese capital markets and corporate structure."[35] Thus, the party and the government of China have realized the importance of developing institutional investors greatly to develop direct finance and improve corporate governance. The *Decision* in 2003 and the *Opinions* in 2004 have become critical sources of increasing institutional investors and their participation in corporate governance and provided for such investors with the feasibility of involving in corporate governance in China.

1.3.3 The statement of China Securities Regulatory Commission

In reality, the State Council authorized the China Securities Regulatory Commission (CSRC) in 2000 to promulgate the strategy to aggressively develop institutional investors, taking it as a key measure for improving the investor structure of the capital markets.[36] Furthermore, in 2002, the CSRC issued the *Code of Corporate Governance for Chinese Listed Companies* 2002 to strengthen the participation of institutional investors in corporate

[34] China State Council Gazette, no.3 (January 31, 2004) http://www.gov.cn/gongbao/content/2004/content_63148.htm (accessed on March 12, 2012).

[35] Ibid.

[36] *Chao changgui peiyu jigou touzizhe* [Aggressively Developing Institutional Investors], in *Zhengquan shibao* [Securities Times], September 2, 2000.

governance of China.

According to the policy of the Communist Party and the government of China, great importance was attached to the increase of institutional investors and encouraging institutional investors' participation in the corporate governance currently. Hence, the institutional investors increase in China corresponding to the needs of policies to some extent, which can be seemed as the government behavior. Under the support and proposal of the party and the government, studying how to promote participation in the corporate governance by institutional investors is necessary and feasible.

CHAPTER Ⅱ Institutional Participation in Corporate Governance in China

This chapter consists of two parts. First, it comprehensively introduces the historical development of institutional investors and their participation in corporate governance in China. Second, this chapter discusses the legal practice of institutional participation in corporate governance in China which covers two aspects including (1) the current legislations on institutional participation; and (2) some cases of institutional investors during participation in China.

2.1 Historical Development

The Chinese stock market was dominated by individual investors over the past decades. Wuhan Branch of the People's Bank of China approved to establish Wuhan securities investment fund as an institutional investor in 1991; in the same year, the government of Nanshan district of Shenzhen province approved to set up Shenzhen Nanshan Risk Investment Fund in 1991. Thus, such securities investment funds became the first two funds in China.[37] Since 1996, securities investment funds have increasingly sprung up in China and there were 72 securities investment funds in total until October of 1997, including state-owned funds and private funds.[38]

Under the support of policies of the Communist Party and government in China,

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[37] The registered capital of Wuhan fund is about 0.1 billion RMB and the registered capital of Shenzhen fund is about 0.8 billion RMB. See Zhimin Dai, *Zhengquan shichang jigou touzizhe guifanhua fazhan yanjiu* [Normal Development of Institutional Investors in China's Securities Market], (ZheJiang University Press, 2008), 16-17.

[38] China Securities Regulatory Commission, *Zhongguo ziben shichang fazhan baogao* [China Capital Markets Development Report], (China Financial Press, 2008), 16.

institutional investors, particularly securities investment funds have boomed and developed rapidly in the past few years. At present, the securities investment funds are the main institutional investors in China. Other institutional investors, such as insurance companies, enterprise annuity funds, the National Social Security Fund (NSSF), and Qualified Foreign Institutional Investors (QFIIs) have gradually entered into the capital market in China. Moreover, the CSRC asserts that "NSSF and insurance companies are the most potential institutional investors that will play significant roles in the capital market of China."[39]

Concerning participation in corporate governance, since there may be some differences in investing scale, styles and purposes among the different categories of institutional investors, such institutions show different levels in concerning corporate governance of the companies they have invested.[40] The study mainly manifests securities investment funds and other forms like the National Social Security Fund (NSSF), insurance funds, securities companies and Qualified Foreign Institutional Investors (QFIIs).

2.1.1 Securities investment funds

In China currently, the securities investment fund is the largest category of institutional investors in the stock market. Securities investment funds in China include close-ended funds and open-ended funds. Closed-end funds emerged first and open-end funds started from 2001 to develop rapidly lately, but they grew at a fast pace.

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[39] China Securities Regulatory Commission, [China Capital Markets Development Report], 100.

[40] Liyan Huo, *Chugoku no kigyo tochi ni okeru kikan toshika no yakuwari to sono kadai* [The Role of Institutional Investors in Corporate Governance in China and Its Challenges], in *Shitenno-ji daigaku kiyo* [The Bulletin of Shitenno-ji University] no.50 (2010): 125-129. Renhua Liu, *Chugoku no corporate governance ni okeru kikan toshika no yakuwari - koka kara kikan toshika e* [A Role of an Institutional Investor in Chinese Corporate Governance - From the State to the Institutional Investor], in *Shogaku kenkyu ronshu* [The Journal of Commerce Research] no.26 (2007): 331.

In order to standardize the operation of fund industry, the State Council promulgated the first Chinese regulations on securities investment fund in 1997, called the *Provisional Measures for Administration of Securities Investment Fund* (abolished on June 29, 2004).[41] In 2003, the Securities Investment Funds Act became the first national legislation on securities investment funds. Such legislation clearly strengthens the fiduciary duty of the fund manager of securities investment funds. According to Article 3 (2) of the China Securities Investment Fund Act, the fund manager (as a trustee) has fiduciary liability to manage the funds for the benefit of actual fund owners.[42] Thus, the fund managers are obligated to closely monitor their shareholdings and take action to protect investments against erosion in value.

In 2004, the *Measures for the Administration of Operation of Securities Investment Fund* (hereinafter *Measures*) was issued by the China Securities Regulatory Commission. According to the *Measures*, securities investment funds are primarily classified into two parts: the stock fund which is required to invest more than 60 percent of its assets equity; and the bond fund which is required to invest more than 80 percent of its assets equity.[43] Moreover, there are some investment restrictions on securities investment funds. For example, the legislation provides that "a securities investment fund is not allowed to hold more than 10 percent of the fund's net assets in any one listed company; neither is it permitted to hold more than 10 percent of a total of one company's in the funds managed by the same fund manager."[44] Securities investment funds may commit the wrongful acts in share trading when

[41] Provisional Measures for Administration of Securities Investment Fund (1997) issued by the State Council on November 14, 1997.

[42] China Securities Investment Fund Act (2004) Article 3 (2), promulgated by National People's Congress on October 28, 2003, and came into effect on June 1, 2004.

[43] Measures for the Administration of Operation of Securities Investment Fund (2004), Article 29, promulgated in June 4, 2004, and came into effect on July 1, 2004.

[44] Ibid., Article 31 (1) and (2).

their shareholdings get to some extent, so the investment restrictions aim to prevent the securities investment funds from involving in insider trading and manipulation of stock price.

All securities investment funds are managed by independent professional fund managers. According to Article 6 of the *Measures for the Administration of Operation of Securities Investment Fund* 2004, the commercial banks as the trustees hold the assets on trust and hire management companies to manage the assets of the fund.

Concerning participation in corporate governance, securities investment funds show two sides of active and negative. On one side, in recent years some cases show that securities investment funds have actively exercised voting rights at shareholders meetings in China, which will be discussed later. On the other side, many of securities investment funds are engaged in speculation in stock market for short-term interests. Therefore, securities investment funds seem instable in participating in corporate governance.

2.1.2 The National Social Security Fund (NSSF)

Pension funds in China primarily consist of three aspects covering the basic pension scheme, voluntary supplemental plans and the National Social Security Funds (NSSF). The basic pension assets which can only be invested in bank deposits and government bonds are publicly managed by the bureaus of Labor and Social Securities. In addition, there are also enterprise funds in China. However, such funds are run on a voluntary basis and are still unpopular in China.

Pension funds run in the safest channels to take safety as their top priority. However, with China entering into an aging society, Social Security benefits are insufficient for a comfortable retirement without outside sources of income. Therefore, pension funds must increase the rate of return on investments to pay the future debt of pensions.

In the context of increasing pensions, the public pension funds NSSF was established in 2000 to serve as a supplement and reserve to support social security expenditures. The State Council of China set up "Social Security Fund Council" to manage the National Social Security Funds. The NSSF usually delegates fund managers to invest the securities investment funds in the stock market.[45]

According to Article 28 and 29 of the *Provisional Measures for the Administration of the Investments of the NSSF* in 2001, not more than 40% of assets of the NSSF can be invested in securities investment funds and equity securities. Investment through one fund manager in the securities or securities investment fund issued by any one company must not exceed 5% of the securities or total fund portion, nor exceed 10% of the total NSSF asset value.[46] Moreover, though the assets up to 40% of the NSSF is allowed to be invested in equities, merely the assets from the state-owned shares are permitted to do so currently.[47]

Due to the advantages of long-term shareholding and relative stability, the NSSF is not the typical fund for committing short-term securities investments. With the increase of equity holdings in the NSSF, such fund may become a very critical institutional investor in the future to bring increasing pressure on those companies they invest to promote better corporate governance practices.

2.1.3 Insurance funds

Insurance funds are managed by internal and external fund managers in China. Traditionally, domestic insurance companies only set up internal investment departments which managed insurance funds and engaged in investments. However, with the rapid

[45] Provisional Measures for the Administration of the Investments of the NSSF, Article 9 (1), Article 25.

[46] Ibid., Article 28 and Article 29.

[47] Ibid., Article 31.

expansion of insurance funds, internal departments may not be sufficient.

China adopted a relatively conservative attitude as to available investment options over the past several years. Until 2004, insurance companies have been allowed to invest shares directly in the stock market, but some legal limitations on the investment of insurance companies exist. According to Article 13 of the *Provisional Measures for the Administration of Stock Investments of Insurance Institutional Investors*, an insurance institutional investor is not allowed to hold more than 30 percent of the ordinary shares of any one listed company.[48] Insurance funds become an increasingly important player in capital markets. In July of 2007, the China Insurance Regulatory Commission (CIRC) allowed insurance companies to invest up to 10 percent of their total assets in stock markets compared with an original 5 percent.[49]

Generally speaking, insurance companies are fundamentally guaranteeing the beneficiary rather than profiting and seeking shareholder wealth maximization, so these companies are more likely to favor their debt over their equity holdings. Moreover, insurance companies as clients of listed companies invest in their own special business connections with the companies they have invested in, so it becomes important to maintain the co-existence.[50] In such a case, insurance companies tend to facilitate the business relations with those companies they invest rather than exerting voting rights against the decisions of management.[51] Therefore, compared to other institutional investors, insurance companies are passive in participating in corporate governance.

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[48] Provisional Measures for the Administration of Stock Investments of Insurance Institutional Investors 1999, Article 13 (1) issued by China Insurance Regulatory Commission (CIRC) on October 24, 2004.

[49] *Institutional investors hold 44% of China's A-share market cap*, August, 27th, 2007. http://news.xinhuanet.com/english/2007-08/27/content_6610808.htm (accessed on November 15, 2011).

[50] Liyan Huo, 127.

[51] Ibid.

2.1.4 Securities companies

The Chinese securities company is a category of institutional investor when it owns substantial equities directly and manages a large amount of stocks for individual investors.[52] Securities companies were not permitted to engage in discretionary management business for their clients and trading stocks in secondary market until 2001. At present, except broking securities companies, other securities companies are permitted to engage in trading securities in secondary market. At the same time, securities companies are permitted to set up their own departments to invest securities. The securities companies are the majority shareholders of many fund management companies in China.

In practice, the securities companies provide various financial services including asset management to corporate clients, so securities companies often compete with each other for financial services.[53] As with insurance companies, there are business connections between a securities company and a listed company. For example, if securities company (X) participates in the corporate governance through voting against a proposal of the listed company (Y), then company Y probably takes the asset management or corporate advisory service from X which has provided for Y. Hence, company X would suffer a loss of business. Therefore, securities companies are passive in participating in corporate governance of the listed companies.

2.1.5 Qualified Foreign Institutional Investors (QFIIs)

As a result of a growing GDP in China, the stock market has attracted foreign as well as domestic institutional investors. The QFII system was started in China in 2002. This system was designed and implemented by the People's Bank of China and the CSRC to allow certain

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[52] China Securities Law (2005), Article 125(5).

[53] Xi Chao, "Institutional shareholder activism in China: Law and practice." *International Company and Commercial Law Review* 17, (2006): 258-259.

types of foreign institutional investors which met the relevant criteria to apply for approval to invest as qualified foreign institutional investors to access in the Chinese stock market. Under legislation, the first QFII Nomura Securities Co. was approved and permitted to invest in Chinese stock market.[54]

Furthermore, the rules regarding the entry of foreign institutional investors in Chinese market were modified in 2006 in order to bring in more foreign investors and to add much more width and depth to the market. Hu (2007) contended that "QFII is considered as a crucial element which might affect the development of Chinese securities market."[55]

Recently, the CSRC and the People's Bank of China and State Administration of Foreign Exchange (SAFE) increased the investment quota of QFII from $30 billion to $80 billion and shortened the deadline of examining and approval of forming QFII. The CSRC reported that 166 foreign institutional investors have become QFIIs in China, in which asset management companies, insurance companies and pension funds together account for 78% of the total assets.[56] Therefore, more and more foreign institutions are expected to apply for a QFII status in order to involve in the stock market in China in the near future.

There are some limitations on the amount investing on QFII as the law states: "shares held by each QFII in one listed company should not exceed 10% of total outstanding shares of the company. Total shares held by all QFIIs in one listed company should not exceed 20% of

[54] Jinqian Qiu, 204-205.

[55] Yonggang Hu, "China's Stock Market under Economic Globalization," <Special Issue> International Symposium on Nations and Companies in the Global Economy, Community and Society, *Journal of region and society* 10, (2007): 39.

[56] China Securities Regulatory Commission, "QFII Investment Quota to be Increased by 50 Billion US Dollars," April 4, 2012, http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201204/t20120404_ 208158.htm (accessed on May 21, 2012).

total outstanding shares of the company."[57] In spite of these restrictions, the CSRC is authorized to adjust the proportion of shareholdings according to the development of stock markets.

The good practice of institutional participation in the corporate governance in companies may be a good lesson for domestic institutional investors in China. With the increase of shareholdings of QFIIs, such investors become important shareholders in the companies they invest and be more concerned about the corporate governance.

In addition, institutional investors in China also can be categorized into two parts covering state-owned institutional investors and private institutional investors. The largest state-owned institutional investor is the China Investment Corporation (CIC), which was established by the Chinese government. The CIC primarily invests in equity securities of enterprises overseas with 60% of its assets in the US.[58] The purpose of the CIC is to maintain and increase state-owned financial assets. With the support of the party's policies, there have been increasing private institutional investors in recent years.

According to the datum of A-share listed companies in SHSE, until December 31, 2011 professional institutional investors held 15.7% of the total market value of tradable shares of listed companies, less than individuals and general juridical investors.[59] Accordingly, the government of China supports to increase the share ownership of professional institutional investors covering both of state-owned investors and private investors.

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[57] Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII), issued by China Securities Regulatory Commission and People's Bank of China, come into effect from 1 December 2002.

[58] Joshua Fellman and Sylvia Wier, "China Sovereign Fund Has About 60% of Assets Invested in U.S., Jin Says," December 10, 2011, http://www.bloomberg.com/news/2011-12-09/china-sovereign-fund-has-about-60-of-assets-invested-in-u-s-jin-says.html (accessed on July 3, 2012).

[59] Shanghai Stock Exchange Statistical Yearbook, 2011.

2.2 Legal Framework for Promoting Effective Institutional Participation in Corporate Governance

The legal framework for effective participation of institutional investors in corporate governance in China may be divided into two including promoting institutional participation in corporate governance and regulating the conduct of institutional investors to promote effective participation.

2.2.1 Legal framework for promoting institutional participation in corporate governance

The current Chinese legislation for promoting institutional participation in corporate governance mainly refers to the Company Law 2005, the Code of Corporate Governance of Listed Companies 2002, and other legal regulations. Those legislations can be categorized into two parts including direct manner and indirect manner. The direct manner of legislation covers the following two parts: (1) the general provisions referring to main methods of institutional investors' participation in corporate governance; and (2) special provisions for promoting institutional participation. The study discusses the indirect manner which provides convenient conditions for attending shareholder meetings and voting.

2.2.1.1 General provisions of participation in corporate governance

According to the main methods of participating in corporate governance by shareholders, the general provisions provide legal environment to facilitate institutional participation in corporate governance including (1) exercise of voting rights; (2) submitting shareholder proposals; (3) litigation; and (4) informal methods.

1. Exercise of voting rights

In the Company Law of China, the voting right refers that the shareholders own the right of voting on a proposal at shareholder meetings, including general meetings and extraordinary meetings. A Chinese scholar contends, "Voting right is the most important right which shareholders are entitled, and this right can ensure the solid position of shareholders in the company effectively."[60] Hence, it is of great importance to discuss the legal regulations on exercising the voting rights by institutional shareholders.

(1) General provisions on shareholder voting

In China, one basic rule of the company law is the "one share, one vote"; that is, when a shareholder attends a general shareholders' meeting, each share he or she holds is entitled to one vote, and every right of voting has the same weight, but shares held by the company itself do not have voting rights.[61] Thus, the shareholders can exercise voting rights at general meetings as they think. In China, there is neither super-voting rights nor double voting rights.

The Company Law 2005 stipulates the points on which shareholders are entitled to vote and legal requirements on proportion of vote. According to the Company Law 2005, there are numerous matters which require shareholder approval including: a) amendments to the articles of association; b) determination of the corporate business policy and investment plans; c) appointment, remuneration, and removal of the directors and supervisors; d) determination of increasing and reducing capital of the company; e) determination of issuing shares or debentures; f) determination of merge, division, dissolution, liquidation or change in corporate form; g) examine and approve the reports of board of directors and the reports of

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[60] Min-an Zhang, *Gongsi gudong de toupiao quan* [The Voting Right of Corporate Shareholders], in *Faxue yanjiu* [Legal Research], no.2 (2004): 84.

[61] China Company Law (2005), Article 104.

board of supervisory or supervisors; and h) declaration of dividend.[62]

The points which require shareholder voting at the general meeting can be divided into two aspects by importance. First, the essential points which can influence the management and decision-making of the company have to be adopted by two-thirds or more of those shareholders who can vote attending the General Shareholders' Meeting. Such votes might include a resolution containing changes to the articles of association or changes to the capital, mergers, divisions, dissolution and corporate form. Second, the usual points require approval of shareholders who hold more than one-second voting rights.[63]

Furthermore, according to Article 105, the points of the transfer or receipt of the company's major assets or providing guarantees should be determined at the general meetings; the board of directors shall convene timely the general meeting and make shareholders vote on these points.[64] The voting is an important and effective manner that institutional investors participate in corporate governance. All of the legal regulations introduced above can actually deal with the exercise of voting rights by institutional investors.

(2) Cumulative voting rights

One of the significant developments in the Company Law 2005 is the provision on cumulative voting. The provision stipulates that "the cumulative voting system may be practiced in accordance with the provisions of the articles of association or the resolution of the shareholders' general meeting when a shareholders' general meeting elects directors."[65] Cumulative voting is opposite to general voting method. In traditional theory of company law, the principle of "one share, one vote" means that controlling shareholders can decide all of the

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[62] China Company Law (2005), Article 38.

[63] Ibid., Article 104.

[64] Ibid., Article 105.

[65] Ibid., Article 106.

directors and supervisors according to the majority voting rule, so minority shareholders have no voice in decision-making at general meetings.

With cumulative voting, each shareholder has a number of votes equal to the number of shares he or she owns multiplied by the number of directorships to be filled but can distribute the votes among candidates as he or she wishes.[66] An example can illustrate cumulative voting: in a company where the board is composed of 20 directors, a shareholder in possession of 5 percent of the capital is entitled to elect one director (100/20=5). Hence, cumulative voting is a mechanism to give the minority a voice and protect the rights and interests of minority shareholders.

According to Article 31 of the *Code* 2002, a cumulative voting system should be advanced in shareholders' meetings for the election of directors. Listed companies with over 30 percent shares owned by controlling shareholders should adopt a cumulative voting system.[67] The CSRC reported that most of listed companies in China have already included the cumulative voting system in their articles of association.[68] However, since this is a selective rather than a compulsory provision in many companies, the company can decide to adopt or not as required. Thus, controlling shareholders may exclude this system in the articles of association in practice.

2. Submitting shareholder proposals

The influence of institutional power is not confined to approval or disapproval of particular corporate activities, and these institutions can also influence the corporate

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[66] Robert Charles Clark, *Corporate Law*, (Little, Brown and Company: Boston and Toronto, 1986), 362.

[67] China Code of Corporate Governance for Chinese Listed Companies (2002), Article 31.

[68] China Securities Regulatory Commission, *China listed company corporate governance report: OECD-China: Corporate Governance Joint Assessment Program Self-Assessment*, (China Financial Press, 2010), 147.

governance through submitting proposals and shaping significant corporate policies. In China, institutional shareholders might submit a proposal on issues of concern at general shareholder meeting, which can put pressure on management. There are some restrictions on the requirement of shareholdings when institutional shareholders submit the proposals.

According to Article 103 of the Company Law 2005, shareholders individually or jointly holding 3 percent of the shares of the company may submit an extraordinary written proposal to the board of directors ten days prior to the general meeting of shareholders. The board of directors should, within two days of receipt of the proposal, inform other shareholders and submit the proposal to the general meeting of shareholders for deliberation.[69] However, the period of holding shares is not regulated in this provision.

3. Rights to compensation: litigation

The system of litigation provides institutional shareholders with another way of redress to protect their interests and that of minority shareholders. The Company Law 2005 established the fiduciary duty of controlling shareholders or actual controllers towards minority shareholders to prevent them from abuse and expropriation. According to Article 20 of the Company Law 2005, "the shareholders of a company shall not abuse their shareholders' rights or go against the interests of the company or other shareholders."[70] Shareholder litigation consists of direct litigation and derivative litigation in China.

(1) Direct litigation

In terms of direct litigation, legislation authorizes a shareholder (an investor) a right to bring litigation before the court in three cases.

First, Article 153 of Company Law 2005 stipulates, "When the shareholders are

[69] China Company Law (2005), Article 103.

[70] Ibid., Article 20.

infringed by operators of the company for breach of the company law, they bring litigation against operators including directors or officers or controlling shareholders for compensating for loss."[71] Pursuant to this provision, shareholders may bring litigation before the court if the operators of the company infringed upon the interests of shareholders. At the same time, due to the fiduciary duty of controlling shareholders under Article 20, shareholders may bring direct litigation against the controlling shareholders for compensation.

Second, the Company Law 2005 also authorizes a shareholder a right to bring litigation before the court to revoke the resolution. According to Article 22 (2), "the shareholders may within 60 days from the day when the resolution is made, request the court to revoke it in two occasions including 1) the procedures or the voting method for calling a general meeting or shareholders' meeting, or meeting of the board of directors, is in violation of any law; and 2) the administrative regulation or the articles of association of the company, or the content of resolution is in violation of the articles of association of the company."[72]

Third, besides the Company Law 2005, the Supreme People's Court of China issued *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market* (hereinafter *Provisions*) in 2002, authorizing an investor a right to bring a civil action for compensation. Under the *Provisions*, an investor is allowed to bring a civil suit before the court for false representation, subject to the condition that the administrative sanction has been imposed on the alleged false representation.[73] The *Provisions* was only limited to the behavior of false representation before 2003, while the Securities Law revised in 2005 has extended to insider trading and

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[71] China Company Law (2005), Article 153.

[72] Ibid., Article 22(2).

[73] Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market (issued on December 26, 2002 and enforced on February 1, 2003), Article 1.

manipulation.

(2) Derivative litigation

Institutional shareholders may use derivative (indirect) litigation to protect the interests of the company. The derivative litigation means that “the shareholders individually or jointly hold 1 percent of the total shares for consecutive 180 days in a joint stock limited company may represent the company to suit against the directors, controlling shareholders for compensating of the company.”[74] This litigation aims to make the interests of the company immune from the infringement by the directors (including senior officers), controlling shareholders or even the third party.

In all methods of participating in corporate governance, the vast majority of institutional shareholders would rarely take, or seriously considered taking, the derivative litigation against company directors or controlling shareholders for breach of their fiduciary duties or duties of care and skill. As a scholar Huang (2005) claimed that three reasons contributed to the disincentive to the derivative litigation: “First, the time would be tied up. Second, the cost was quite high and often more than the benefits that shareholders can obtain through litigation. Third, all other shareholders would be able to free-ride on any benefits obtained in a derivative action.”[75]

Though a shareholder may not bring a derivative suit on behalf of the company, such a person may bring a direct suit to redress harm. In a derivative suit, the company suffers from harm caused by fiduciaries and no individual shareholder is specifically injured. However, in a direct suit, an individual shareholder or an institutional shareholder is injured and this

[74] China Company Law (2005), Article 152.

[75] Hui Huang, *Zhongguo de gudong daibiao susong: lilunfenxi yu shijian jiaodu* [The Shareholder Derivative Litigation in China: Theoretical Analysis and Practical Prospect], in Baoshu Wang (ed.) *Shijian zhong de gonsgi fa* [The Practice of Company Law], (Social Science Academic Press, 2005), 469-475.

constitutes a standing to sue.

4. Informal method: Meetings and dialogues with management

Except for formal approaches such as voting for proposals and litigation, institutional investors can also exert influence on corporate governance through informal meetings and dialogues with managers of companies and they can exchange views and information on strategy, performance, board of directors and supervisory board and quality of management.

Institutional investors are likely to communicate with management of the company. Compared to formal approaches, direct communication with management has several merits. First, the cost of directly communicating with management is limited, since it may avoid complicated procedure of convincing other shareholders to adopt a common strategy for proxy voting. Second, the direct communication can save the time and avoid the variability of price of stocks. Third, the chance of success is large.[76] Due to these merits in communication, both institutional shareholders and the companies are willing to select this approach to promote the corporate governance in practice.

In practice of China, on one side, institutional investors provide recommendations on decisions regarding company management, issue opinions on major corporate decisions, and exercise their influence on the board of directors. “Generally, before further action is taken, the institutional investor tends to convey a message of reform to the management and have effective communication and exchanges with the company management.”[77] On the other side, legislation also encourages listed companies to communicate with institutional investors.

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[76] Michael Useem et al., “US institutional investors look at corporate governance in the 1990s”, *European Management Journal* 11, no.2 (1993): 177–178.

[77] China Securities Regulatory Commission, [China listed company corporate governance report], 27-28.

The CSRC promulgated the *Guidance for the Relationship between Listed Companies and Investors* in 2005, encouraging listed companies to carry out activities to improve the communication between listed companies and investors. The *Guidance* "encourages listed companies to attach great importance to the investor relations and carry out the communicating activities initiatively. And also the means of communication should be effective to facilitate the investors' participation."[78] This provision can be considered as a legal precondition for encouraging negotiation with the managers to promote the involvement of institutional shareholders in corporate governance.

2.2.1.2 Special provision for promoting institutional participation

There is a special provision directly concerning the institutional investor participation in corporate governance in the *Code of Corporate Governance for Chinese Listed Companies* 2002 (hereinafter *Code* 2002). According to Article 11 of the *Code* 2002, "Institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes."[79] This provision actually embodies and implements the party's policy of developing institutional investors and improving institutional participation in the corporate governance of China. The *Code* further clearly strengthens the importance of institutional investors' participation in corporate governance by legislation. This provision for the first time requires the institutional investors participating in corporate governance through three aspects, including the appointment of company directors, the compensation and supervision of management and major decision-making processes.

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[78] China Guidance for the Relationship between Listed Companies and Investors, Article 5 and Article 7, issued by CSRC and enforced on July 11, 2005.

[79] Code of Corporate Governance for Chinese Listed Companies (2002), Article 11.

However, there is just one simple provision in the *Code* 2002 concerning the participation of institutional investors. The provision does not stipulate specific procedure and process in detail how to promote institutional investors to involve in the appointment of company directors, the compensation and supervision of management, and major decision-making processes. Accordingly, the dissertation has to interpret this provision in accord with the Company Law 2005 and other provisions of the *Code* 2002 in China.

1. Appointment of company directors

Institutional investors exert their voting rights at shareholder meetings when they appoint the company directors. According to Article 100 of the Company Law 2005, "the general shareholders' meeting shall exercise the authority to elect and replace members of the board of directors."[80] Accordingly, the shareholders may exercise their voting rights to elect or remove members of the board through participation in general shareholders' meetings. Thus, this provision of the *Code* 2002 requires institutional investors actively exerting voting for or against the nominated directors at shareholder meetings. In the listed companies which adopt cumulative voting system, institutional investors utilize this system to participate in voting to appoint directors.

2. Compensation and supervision of management

Institutional investors play a role in both of the compensation and supervision of management. The decision of the compensation of management is provided in Article 38 (2) of the Company Law 2005: "the shareholders meeting shall exercise the function and power to elect and recall directors and supervisors whose posts are not taken by the representatives of the staff and workers, and to decide on matters concerning the remuneration of directors

[80] China Company Law (2005), Article 100.

and supervisors."[81] Pursuant to this provision, the compensation of management should be decided at shareholder meetings, so institutional investors can actively participate in supervising and making the decision on this matter.

Furthermore, the *Code* 2002 provides the procedure and process for deciding the compensation of management. According to Article 71 (1) of *Code* 2002, "the board of directors shall propose a scheme for the amount and method of compensation for directors to the shareholders' meeting for approval."[82] Thus, institutional investors have the right to actively examine and verify the proposals of the compensation of management.

Moreover, Article 72 stipulates that, "the board of directors and the supervisory board shall report to the shareholder meetings the performance of the directors and the supervisors, the results of the assessment of their work and their compensation shall disclose such information."[83] This provision actually authorizes the shareholder meetings to supervise the compensation of management, so institutional investors actively examine and verify whether those information disclosed are appropriate and reasonable without sacrificing the interests of the company and shareholders.

3. Major decision-making processes

The institutional investors play a role in major decision-making processes. The "major decision-making" refers to those essential matters which can influence the management and decision-making of the company. According to Article 104 of the Company Law 2005, those essential matters such as a resolution containing changes to the articles of association or changes to the capital, mergers, divisions, dissolution and corporate form. Under those circumstances, they have to be adopted by at least a two-thirds majority of the voting rights

[81] China Company Law (2005), Article 38(2).

[82] China Code of Corporate Governance for Chinese Listed Companies (2002), Article 71(1).

[83] Ibid., Article 72.

represented by the shareholders attending the general meeting.[84] Hence, this provision encourages and strengthens the voting rights of institutional investors.

2.2.1.3 Indirect manner: conditions for voting at shareholders meetings

In addition to the general and special provisions of promoting institutional participation in corporate governance, the related company laws in China also indirectly encourage and advocate that listed companies should provide convenient environment for shareholders to actively attend shareholder meeting and vote.

1. Notice of the time and points of the shareholders meeting

Article 103 of the Company Law 2005 provides that in order to hold a general meeting of shareholders, the notice concerning the time, venue and points to be considered at the meeting should be given to each shareholder 20 days in advance. In the event of an interim meeting of shareholders, the notice may be given 15 days in advance.[85] Article 8 of the *Code* 2002 also requires "the time and location of the shareholders' meetings shall be set so as to allow the maximum number of shareholders to participate."[86] Article 55 of the *Guidance for the Articles of Association of Listed Companies* 2006 also provides that the notice shall include the date, location and length of the general shareholders' meeting as well as points and proposals submitted to the meeting for deliberation.[87]

2. Manners of voting

According to Article 8 of the *Code* 2002, a listed company should make every effort, including fully utilizing modern information technology means, to increase the number of

[84] China Company Law (2005), Article 104.

[85] Ibid., Article 103.

[86] Code of Corporate Governance for Chinese Listed Companies (2002), Article 8.

[87] Guidance for the Articles of Association of Listed Companies amended by the CSRC (2006), Article 55.

shareholders attending the meetings.[88] In terms of manner of voting, the CSRC promulgated the *Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders* which requires listed companies providing an online voting platform for its shareholders when the general meeting discusses the required items.[89] The Shanghai Stock Exchange issued the *Detailed Rules on the Implementation of Online Voting at General Shareholder Meetings of Listed Companies* in 2006, providing detailed rules for public shareholders to vote online. The Shenzhen Stock Exchange in China also issued the similar regulation in 2010.[90] These regulations provide facilities for shareholders to attend general meetings via the internet.

3. Providing full information of proposals and items

According to the *Guidance for the Articles of Association of Listed Companies* amended in 2006, the annotation of Article 55 requires that any notice and supplementary notice about a general shareholders' meeting give full and complete information about all detailed contents of all proposals and items.[91] Moreover, concerning the election of directors or supervisors, Article 56 provides that if the election of directors or supervisors is to be discussed at the general meeting, then full and detailed information about the candidates should be disclosed in the notice… the information at minimum includes (1) personal information such as educational background, work experience and concurrent jobs; (2) whether the candidate has any related-party relations with the company, its controlling shareholder or actual controller; and (3) whether the person has been penalized by the CSRC or other competent

[88] Code of Corporate Governance for Chinese Listed Companies (2002), Article 8.

[89] Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders Article 1(2), issued by CSRC on December 7, 2004.

[90] China Securities Regulatory Commission, [China listed company corporate governance report], 35.

[91] China Guidance for the Articles of Association of Listed Companies (2006), Article 55, issued by the CSRC on March 21, 2006.

departments.[92]

2.2.2 Legal framework for regulating institutional investors

As pointed out in the introduction of the dissertation, due to the purpose of pursuing the profit maximization, institutional investors may conduct wrongful acts for private interests so that they cannot participate in corporate governance in a lawful and effective way. The legislation on regulating institutional investors might be classified into two types. The first type requires institutional investors disclosing the information during soliciting proxy voting. The second type regulates wrongful acts in share trading of institutional investors mainly covering insider trading and manipulation in Chinese stock market.

2.2.2.1 Regulation on soliciting proxy voting

In order to have an impact on the results of shareholders' voting, those shareholders who are reluctant to exert voting rights can contact or convince to delegate to some other ones to vote their shares in a specific way. Relative to other shareholders, institutional shareholders might play the role of exercising proxy voting rights. In China, both of the Company Law 2005 and the *Code* 2002 authorize a shareholder the right to collect proxy voting and cast votes at the general meeting.[93]

Both forms of legislation provide regulations on soliciting proxy voting. The Company Law 2005 requires that a proxy holder present the proxy statement issued by the shareholder to the company, and exercise his or her voting rights to the extent authorized by the proxy.[94]

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[92] Ibid., Article 56.

[93] China Company Law (2005), Article 107, and Code of Corporate Governance for Chinese Listed Companies (2002), Article 9.

[94] China Company Law (2005), Article 107.

Accordingly, the proxy holder should exercise voting rights for maximizing the profits of the shareholders.

Meanwhile, the *Code* 2002 provides that the board of directors, independent directors and qualified shareholders of a listed company have the right of soliciting votes in a shareholders' meeting, and information shall be disclosed adequately to persons whose voting rights are being solicited.[95] This provision requires the solicitors disclosing the correct and proper information to the shareholders who are solicited in order to prevent solicitors from abusing proxy rights.

2.2.2.2 Regulation on insider trading

In practice, sometimes some institutional investors may obtain inside information of a company before this inside information is promulgated to the public, so they purchase and sell the shares of the company to seek short-term illegal interests. Such conduct contributes to the insider trading. Recently, the vice-president of the Supreme People's Court of China declared that "the anti-insider trading should focus on the regulation of institutional investors."[96]

According to related statistics, from January to October of 2010, the CSRC received 114 cases of insider trading totally and launched investigation on 42 cases. Finally, the CSRC gave administrative penalties to 16 individuals and 2 institutional investors, and transferred 15 suspected criminal cases of insider trading to the police.[97] The securities investment funds as a very important category of institutional investors in China are mainly engaged in share

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[95] Code of Corporate Governance for Chinese Listed Companies (2002), Article 10.

[96] Feng Guo, *Fan neimu jiaoyi zhongdian zai jigou dahu* [The Anti-insider Trading should Focus on the Regulation of Institutional Investors], *Securities Times*, 6 December 2010, http://www.cnstock.com/index/gdbb/201012/1029080.htm (accessed on April 23, 2011).

[97] Xiaoyong Wu, *Neimu jiaoyi de zhidu anpai yu jianguan jianyi* [System Arrangements and Suggestions on Regulating Insider Trading], in *Zhongguo jinrong* [China Finance], March 2011, 33.

transaction in the stock market, so it is much easier for them to conduct fraud during stock transaction.

1. General legal provisions on insider trading

The regulations of insider trading in China can be divided into four parts, including the behavior of insider trading, the subjects of insiders, the context of inside information and liability of insider trading which are discussed in this section.

(1) What is insider trading?

According to Article 73 of the Securities Law 2005, “anyone is prohibited from taking advantage of the inside information to engage in any securities trading in two occasions: 1) having access to any inside information of securities trading; and 2) having unlawfully collected any inside information.”[98] This provision prescribes three elements of insider trading, including a) the subject of insider trading; b) inside information; and c) making use of inside information to trade securities.

Moreover, according to Article 76 of the Securities Law 2005, “Any insider who has access to insider information or has unlawfully collected any insider information on securities being traded, may not commit three conduct: 1) purchase or sell the securities of the relevant company; 2) divulge such information; and 3) advise any other person to purchase or sell such securities.”[99]

According to the legal regulations on insider trading behaviors above, the insider trading behavior may be categorized into at least four types: 1) anyone who has access to any inside information of securities trading takes advantage of the inside information to purchase or sell related securities; 2) a person who divulges the inside information; 3) a person encouraging

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[98] China Securities Law (2005), Article 73.

[99] Ibid., Article 76.

others to purchase or sell related securities; and 4) a person who collects the inside information illegally involved from the first three behavior.

(2) Who are insiders?

Pursuant to Article 74 of the Securities Law 2005, subjects of insider trading may be classified into three main types.

The first type is the corporate insiders, including: a) directors, supervisors, and executive officers of an issuer; b) shareholders who hold no less than five percent of the shares in a company as well as the directors, supervisors, and executive officers thereof, or the actual controller of a company as well as the directors, supervisors, and executive officers; and c) the holding company of an issuer as well as the directors, supervisors, and executive officers.

The second type is the persons who have statutory authorities or contracts with the company (quasi-insiders), including: d) the personnel who may take advantage of their posts in their company to obtain any insider information of the company concerning the issuance and transaction of its securities; e) the securities regulatory body, and other personnel who administer the issuance and transaction of securities pursuant to their statutory functions and duties; and f) the relevant personnel of recommendation institutions, securities companies engaging in underwriting, stock exchanges, securities registration and clearing institutions and securities trading service organizations.[100]

The third type is the persons who have unlawfully obtained any inside information according to Article 73 of the Securities Law 2005.[101] Since the shareholders who hold no less than five percent of the shares in a company can become the insiders, an institutional investor who holds no less than five percent of the shares in a company would become the subject of insider trading in the stock market.

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[100] China Securities Law (2005), Article 74.

[101] Ibid.

(3)What is “Inside Information”?

Article 75 of the Securities Law 2005 stipulates that "'Inside Information' refers to the information that concerns the business or finance of a company or may have a major effect on the market price of the securities and that has not been disclosed to the public in securities trading."[102] According to this provision, inside information is composed of two critical factors. First, the information has not been disclosed to the public. Second, the information would bring significant effects on the stock price in the stock market. Thus, the stock price would change significantly before and after the announcement of this information and influence the investment judgment and decisions of public investors.

(4)Liabilities of insider trading

The liabilities of insider trading are categorized into three aspects, including civil liability, administrative liability, and criminal liability.

Before 2005, there was no civil liability on violators of insider trading in the stock market. The Securities Law 2005 imposes civil liability on violators of insider trading. According to Article 76, "where any insider trading incurs any loss to investors, the person responsible shall be subject to the liabilities of compensation according to law."[103] Hence, the injured investors may bring a securities civil compensation suit to redress harm done to him or her according to the regulation of this provision. However, in practice it is very difficult for an injured investor to prove there is a casual relationship between the insider trading behavior and the resulting damage.

Concerning administrative liability for insider trading in China, pursuant to the Securities Law 2005, anyone who is engaged into insider trading should be ordered to dispose the securities as illegally held thereby according to law. The illegal proceeds should be

[102] China Securities Law (2005), Article 75.

[103] Ibid., Article 76.

confiscated and a fine of 15 times of the illegal proceeds shall be imposed. Where there are no illegal proceeds or the illegal proceeds are less than 30,000 RMB, the CSRC would impose a fine of 30,000 RMB up to 60,000 RMB. Where an entity is involved in any insider trading, the CSRC would give a warning and imposed a fine of 30,000 RMB up to 300, 000 RMB to the person-in-charge and any other person directly responsible.[104]

For criminal liability, according to Article 180 of Criminal Law of China, any insider should be subject to criminal detention and/or confiscation of any illegal gains when he or she commits insider trading or divulges the information. If the circumstances are serious, then the alleged conduct may be sentenced to fixed-term imprisonment of no more than five years.[105]

2. Short-swing trading

The short-swing trading which is similar to insider trading here, since some institutional investors who hold large shareholdings of a portfolio company might be engaged in short-swing trading in China.

According to Article 47 of the Securities Law 2005, when any officer of a listed company, or any shareholder holding five percent of the shares of a listed company, sells company stock which he holds within six months after purchase, or purchases any stock of the company within six months after selling, then the profits from the sell or purchase will be incorporated into the company. The board of directors of the company should withdraw the profits.[106]

According to the provision, there are a few differences between insider trading and the short-swing trading in China. First, the director, supervisor and senior manager of a listed company or any shareholder who holds more than five percent, while persons who involve in

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[104] China Securities Law (2005), Article 202.

[105] China Criminal Law (1979), Article 180.

[106] China Securities Law (2005), Article 47.

insider trading cover anyone who knows inside information. Second, the insider trading requires knowing and making use of inside information, while the short-swing trading does not consider persons' intent and only requires that one person purchases and sells stocks during prohibitive period.[107] Article 195 of the Securities Law 2005 clarifies that the violation of the short-swing trading would be given a warning and may be imposed a fine of 30,000 RMB up to 100,000 RMB.[108]

2.2.2.3 Regulation on the manipulation of stock prices

The manipulation of stock prices has two negative aspects to the corporate governance. One, the manipulation directly affects the supply-demand relationship in the stock market and causes the stock price to deviate from the real business of the listed company, so that the stock price cannot transfer the real information of the company to the public investors in the stock market. Further, the price mechanism and takeovers of the stock market cannot play its role in promoting corporate governance. Two, institutional investors often involve in manipulation in Chinese stock markets, so they are reluctant to participate in corporate governance.

The Securities Law 2005 provides the definition and methods to explain manipulating stock prices. This legislation provides legal protection for regulating stock market and strengthening the supervision on misconduct in the stock market. This section primarily discusses three aspects of manipulation, including the subjects, manners, and liabilities of manipulation.

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[107] Qijia Ma, *Zhengquan minshi zeren falv tixi bijiao yanjiu* [Comparative Study on Legal System of Securities Civil Liability], (China Legal Publishing House, 2010), 277.

[108] China Securities Law (2005), Article 195.

1. Subjects of stock price manipulation

According to Article 77 of the Securities Law 2005, all persons prohibited from manipulating the securities market by any of the following means: (1) independently or in collusion with others, manipulates the trading price of securities or trading quantity of securities by centralizing the advantage in respect of funds, shareholding advantage or utilizing information advantage to trade jointly or continuously; (2) collaborates with any other person to trade securities pursuant to the time, price and method as agreed upon in advance, thereby affecting the price or quantity of the securities traded; (3) trades securities between the accounts under self-control, thereby affecting the price or quantity of the securities traded; and (4) manipulates the securities market by any other means.[109]

According to Article 77, the subject of manipulation refers to "anyone," which consists of individuals, juridical person and other organizations. In spite of anyone, only those who have the advantages of finance, collecting information and share ownership, or have the expertise are likely to engage in manipulation of the securities in practice. Some scholars mentioned that "from the practice of regulation in China, primarily those institutional investors and some securities service organizations involve in manipulation."[110]

2. Manners of stock price manipulation

According to Article 77 of the Securities Law 2005, there are three main manners of manipulation such as (1) trading jointly or continuously by independently or in collusion with

[109] China Securities Law (2005), Article 77.

[110] An-sheng Dong, Xiaomin Zheng and Miao Liu, *Woguo caozong shichang xingwei de jianguan: xianzhuang, fansi yu jinlu* [Regulation on Market Manipulation in China: Current situation, Rethinking and Approach], in *Faxue Jia* [Jurist], no.1 (2005): 124.

others; (2) collusion made in advance with another party; and (3) conduct fake sales and purchase of securities.[111]

The first manner is about the trading jointly or continuously by independently or in collusion with others. The term "joint trading" means that the violators collude with each other through prior conspiracy to drive or to suppress the stock price, while "continuous trading" refers to the consecutive series of two or more trading behaviors of securities. These series of conducts would mislead other persons into believing that sales and purchase of securities are thriving or would cause fluctuations in prices of the listed companies.

Second, a violator sell (or purchase) securities based on collusion made in advance with another party in which the other party promises to purchase (or sell) the securities at the same price and around the same time the seller sells them. This kind of transaction of securities aims to thrive or cause fluctuations in prices of securities.

Third, the violators conduct fake sales and purchase of securities without purpose of transfer of right, or paying or receiving money, or granting or acquiring of options. Two factors contribute to this behavior including a) the violator actually may control more than two securities accounts; and b) the violator engages in the conduct of securities trading between two or more accounts without purpose of transfer of right, or paying or receiving money. These types of behavior can affect the stock price or the quantity of the stocks traded.

3. Liabilities of stock price manipulation

The legal liabilities of manipulation have three aspects including civil liability, administrative liability and criminal liability.

The law entitled of *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market* in 2002 allows an

[111] China Securities Law (2005), Article 77.

investor to bring an action for false representation, so there is no such similar civil liability provision on manipulation of stock price. However, the new Securities Law 2005 imposes the civil liability on manipulation. According to Article 77 of the Securities Law 2005, "Where anyone incurs any loss to investors by manipulating the securities market, the actor shall be subject to the liabilities of compensation according to law."[112] In this case, the injured investor may bring a securities civil compensation suit to redress harm done to him or her.

Article 203 of the Securities Law 2005 prescribes the administrative liabilities of manipulation of stock price and classifies them into three parts, including (1) imposing a fine of 1-5 times of the illegal proceeds; (2) imposing a fine of 300, 000 RMB up to 3,000, 000 RMB when there is no illegal proceeds or the illegal proceeds; and (3) imposing a fine of 100,000 RMB up to 600, 000 RMB on the person-in-charge and any other person directly responsible."[113]

The definition of criminal liability is provided in Article 182 of Criminal Law which stipulates: "A person who rigs the transaction price of securities risk shift, if the circumstances are serious, he/she shall be sentenced to fixed-term imprisonment of no more than five years or criminal detention and concurrently or independently, to a fine of 1-5 times the illegal proceeds shall be imposed."[114]

2.3 Positive and Negative Cases of Participation in Corporate Governance

In practice of China, some institutional investors have begun to exert shareholder rights in the companies in recent years. In contrast, some cases show that institutional investors are just supportive for the decisions of the management or engaged in wrongful acts for seeking

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[112] China Securities Law (2005), Article 77(3).

[113] Ibid., Article 203.

[114] China Criminal Law (1979), Article 182.

private interests rather than participating in corporate governance. Thus, the cases of institutional participation can be categorized into two parts, positive and negative ones.

2.3.1 Positive cases

2.3.1.1 Excising voting rights

1. Cash offer of new shares of ZTE Co., Ltd.

The case of cash offer of new shares occurred in 2002 and is a good example for institutional investors involved in corporate governance. The ZTE Co., Ltd is China's largest telecoms manufacturer. In July 2002, the board of directors of ZTE Co., Ltd. proposed an H-share offer in the Hong Kong Stock Exchange (HKSE) and set forth the significance of this program for the business of the company. However, the proposal met opposition from securities investment fund management companies as institutional investors. The reason for this opposition was that they as tradable shareholders consider that their interests would be diluted by the dual listing on the HKSE. The institutional investors in ZTE Co., Ltd. jointly held 12.77 percent in tradable share market and took up large percentage of share ownership. Hence, these securities investment funds companies attempted to hold back the proposal by virtue of the regulation issued by China Securities Regulatory Commission (CSRC) in 2002.[115]

According to this regulation, a share offer had to be approved by the majority of the tradable shareholders who voted at the shareholders' meeting when the new shares issued exceeded 20 percent of the company's existing outstanding shares.[116] However, the CSRC

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[115] *2002 nian Guoyou gu zhan ZTE gongsi de 57.05%* [The state-owned share ownership takes up 57.05% in ZTE Co. in 2002], http://www.zte.com.cn/05investor/more2-2.jsp (accessed on October 5, 2011).

[116] Relevant Requirements for Listed Companies' Cash Offer of New Shares, Article 2, issued by the CSRC on March 28, 2001.

denied the applicability of the regulation to the proposal, considering that it applied only to share offers in the domestic A-share market. Despite the CSRC's ruling, 11 fund management companies voted against the H-share offer proposal at the extraordinary shareholders' meeting on August, 20th of 2002. In the end the proposal was passed with the support of a majority of the shareholders. After the failure of institutional shareholders, most of them signed a letter to the CSRC and requesting them to view the ZTE H-share offer carefully and protect the benefits of minority shareholders. However, the institutions sold their shares in the ZTE Co., Ltd. in the secondary market which lead to a drop of 50 percent of share price of ZTE within months. In 2003, ZTE stopped its H-share offer plan.[117]

In the case of ZTE Co., Ltd., the securities investment funds companies expressed their wishes by means of vote in general meeting when the decision of cash offer of board of directors or managers would infringe on the interests of shareholders. Even though such funds companies failed in preventing from the pass of proposal of board of directors, these companies were actively involved in corporate governance and tried to change the decision-making of board of directors and managers.

2. Cash offer of Futon Motor Co., Ltd.

This is a case that institutional shareholders participate in corporate governance and vote successfully on shareholder meeting in China. In September 2004, the institutional investors for the first time voted down a cash offer proposal on shareholder meeting. The listed carmaker Futon Motor performance deteriorated after its previous equity issue in 2003, and they proposed a cash offer when the stock market was in a downturn. Nine out of Futon's top

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[117] Caiping Wang, *Jigou suoyouquan dui shangshi gongsi zhili juece de yingxiang yanjiu* [Institutional Ownership on Corporate Governance Decision Research: ZTE H Shares Issued by an Example], in *Keji guanli yanjiu* [Science and Technology Management Research] no.3 (2007): 68-80.

ten tradable shareholders were institutions (eight funds and one QFII), which held 33.2 percent of Futon's tradable shares and opposed the proposal. In the end, 30 percent voted for the proposal, 10 percent against it and more than 60 percent abstained.[118] Thus, the institutional shareholders covering the securities investment funds and QFII succeeded in voting against the proposal of board of directors.

3. Convertible bond issues of the China Merchant Bank

China Merchant Bank is an outperforming listed bank.[119] In August 2003, the board of directors proposed a convertible bond issue. In response to this proposal, eight funds companies representing about 16 percent of the tradable shares, strongly opposed the proposal and voted against the proposal on general meeting held in October 2003. These funds companies criticized it as an unlawful expropriation of interests of tradable shareholders by non-tradable shareholders. However, the bank still passed the proposal in accordance to the Majority Capital Rule.[120]

According to this case, the investment fund companies indeed participated in corporate governance actively to protect shareholders' rights from expropriation by controlling shareholders, but these companies failed at last. Nevertheless, such a situation trigged the legislation of protecting tradable shareholders covering minority shareholders. Immediately

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[118] *Liutong gudong shuo bu, futian qiche zengfa yi'an weihuo tongguo* [Tradable Shareholders Said 'No", Futon Motor's Cash Offer Proposal Failed to Pass], in *Zhongguo Zhengquan Bao* [China Securities News], September 29, 2004, quoted in Xi Chao, "Institutional shareholder activism in China: Law and practice." *International Company and Commercial Law Review17*, (2006): 254-255.

[119] *2003 nian Guoyou gu zhan zhongguo shangye yinhang de 73.72%* [State-owned share ownership took up 73.72% in China Merchant Bank in 2003], http://www.sse.com.cn (accessed on October 5, 2011).

[120] *Zhaoshang yinghang 100yi zhuanzhai fengbo, jijin lianmeng duikang zhongjin fang'an* [China Merchant Bank Convertible Bond Issue, Funds United Hand in Hand to Counterattack the Merchant Bank's 10 Billion Refinance Proposal, Fund Alliance Confront Zhongjin Proposal], *21Shiji Jingji Baodao* [21st Century Economics Report], September 13, 2003, quoted in Xi Chao, 255.

after this case, legislators found it unreasonable to decide major issues according to the majority voting rule since non-tradable shares take up large percent of the shares of company.[121] Hence, the CSRC promulgated the *Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders* on December 7, 2004, providing that issues such as convertible bond issues of listed companies should be approved by tradable shareholders who hold more than a half percent of voting rights and attend the voting process at the general meeting.[122]

4. Cash offer of new shares of Baoshan Iron and Steel Co., Ltd.[123]

The board of directors of Baoshan Iron and Steel Co., Ltd. (hereinafter Baoshan Co.), on August 12, 2004, proposed applying for an issuing of no more than 50 billion RMB new shares so as to purchase a series of related group companies. However, this proposal would bring negative effects to tradable shareholders covering institutional shareholders. On the one hand, some institutional shareholders such as fund management companies who owned large shareholdings were unwilling to take-over those group companies which were not valuable for them. On the other hand, the fund management companies as tradable shareholders would lose their pre-emptive rights when the company issued new shares according to regulations of CSRC, making it harmful to institutional shareholders if the issuing price of new shares was too low. Therefore, some fund management companies argued against the proposal of issuing.

The largest shareholder of the BaoShan Group Company held 85 percent of share ownership and was not required to vote on the proposal due to the related transaction

[121] Xiuhua Wang, *Jigou touzizhe chigu de gongsi zhili xiaoying yanjiu - jiyu guquan zhiheng shijiao* [A Study on the Effect of Institutional Shareholders on Corporate Governance - The Angle of Balance of Shareholder Ownership Structure], (Enterprise Management Press, 2011), 114.

[122] Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders, issued by China Securities Regulatory Commission on December 7, 2004.

[123] Xiuhua Wang, 114-116.

according to law, so the rest 15 percent of tradable shareholders could vote on this proposal. There were totally 36 securities investment funds that held 25.7 percent of tradable share ownership, so the securities investment funds were the most important deciders on the voting of the proposals.

In this case, some institutional shareholders actively exercised voting rights and some of them even lodged proxy voting. On September 9, the Beijing Shoufang Investment Advisory Co., Ltd. together with dozens of media solicited voting rights of minority shareholders. By virtue of opposition of institutions, Baoshan Co. was forced to lay aside the new-share issuing proposal for a while. However, the Baoshan Co. allowed fund management companies to obtain some benefits, so some fund management companies were supportive for the decisions of the operators in the company and passed this proposal at last. In this case, the institutional investors solicited proxy voting rights to participate in corporate governance and indeed achieved some success, albeit temporarily. Though the result of voting by institutions might not reach the goal in some cases, the voting itself could send a kind of signal to operators in the company, which was important approach influencing the corporate governance.

5. Electing directors of Gree Electric Appliances Inc.

Gree Electric Appliances Inc. (hereinafter Gree Inc.) was a typical company which achieved the success in reducing state-owned shares. The controlling shareholder SASAC of Zhuhai province only held not more than 20% of total shares issued by Gree Inc. at present. The funds including Yale University Fund Association and Penghua Fund held over 30% of tradable shares issued by Gree Inc., so they had strong voice in the company.[124]

In the general shareholder meeting of May 25, 2012, the fund companies consolidated

[124] China Securities Journal, *Gree xuanren dongshi, jigou touzizhe huosheng* [Electing directors of Gree Electric Appliances Inc., Institutional Investors Win], May 29, 2012, http://www.cs.com.cn/gppd/tzpj /201205/t20120529_3350140.html (accessed on June 28, 2012).

together to recommend the director candidate X and expect the director X can participate in the management on behalf of minority shareholders and improve corporate governance. As a result, person X was elected to be the director, while the shareholder meeting did not elect person Y recommended by the majority shareholder.[125]

For the first time institutional investors elected the directors on behalf of minority shareholders, creating the precedent that institutional investors actively participate in corporate governance. Institutional investors came together against the controlling shareholders and achieved success, which was meaningful to protect minority shareholders and prevent from the abuse of the controlling shareholder.

2.3.1.2 Submitting proposals

China Vanke Co. was China's largest listed real estate developer. At the annual general meeting in 2004, the board of directors proposed to alter an article in the company's articles of association. The proposal was to amend the requirement of the shareholder approval of the provision of guarantee, calculating on the basis of the company's total assets. 23 fund management companies, representing 12.83 percent of Vanke's outstanding shares, opposed this proposal of the board of directors. These companies proposed at the shareholder meeting that the thresholds should be calculated according to the companies' net assets, which means constraining controlling shareholders' power by means of supervising the management of the company, and the meeting finally passed the institutions' proposal.[126]

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[125] Ibid.

[126] *Jijin gaodiao banyan jijin touzizhe* [Funds Acted as Active Investors], in *Zhongguo zhengquan bao* [China Securities News], May 9, 2005.

2.3.1.3 Shareholder Litigation

In practice, not many institutional investors bring litigation to the courts in China. One reason that many institutions are reluctant to bring suits might be the passive of institutional investors. Another reason is that the courts have rejected the few cases brought to litigation. For example, the court did not accept the suit against “Yi-an Technology” by institutional investors in 2001 because there was no legislation on securities civil compensation suits before 2002 in China.[127] Recently, a very famous company Wu Liangye Co., Ltd. (hereinafter Wu Liangye) has been involved into the expropriation. The CSRC imposed a very famous company Wu Liangye on administrative penalty in 2011 May. On the basis of such penalty, some institutional investors holding large share ownership of Wu Liangye are very likely to bring litigation.[128]

In one reported case DaCheng securities fund management Co. v. YinGuangSha Co., an institutional shareholder brought litigation against the portfolio company before the court. Some researchers claim that this is the first securities case that the institutional investor brought litigation against the portfolio company and accepted by the court. According to the fund contracts and relevant laws and regulations, DaCheng securities fund management company (company A) was established in 1999 and engaged in investment management activities for the “Fund X” and “Fund Y.” Company A bought a large number of shares of the

[127] Zhiwu Chen, *Sifa duli panli fa yu gudong quanyi baohu* [Independence of the Judiciary, Case Law and the Protection of Shareholders’ Equity], February 28, 2003, http://www.people.com.cn/GB/guandian/29/173/20030228/932865.html (accessed on April 21, 2012).

[128] China Securities Regulatory Commission, *Dui Wu liangye de xinzheng chufa*, [Administrative Penalty Decision on Wu Liangye Co., Ltd.] no. 17, April 29, 2011.

listed company YinGuangSha (B), whose average price of per share was about RMB 31 from August 2000 until December 2000.[129]

On August 9, 2001, company B was suspended for alleged false financial disclosure and other violations, and the stock price of B continued to drop after resumption of trading so that investors suffered heavy losses. “Fund X” and “Fund Y” managed by company A at last sold the shares of company B in September of 2001, and the total loss of these two funds is up to 240 million RMB. In April 2002, the China Securities Regulatory Commission made an administrative penalty on B for false disclosure of financial information and other violations. Subsequently, according to the law of *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market*, many investors filed civil suits against company B for the compensation and obtained compensation in various ways.[130]

In August 2004, company A who represents “Fund X” and “Fund Y” sued and claimed that (a) they confirm that the false statements of B violated the legal right of the funds managed by A; and (b) B is subject to compensate 240 million RMB to “Fund A” and “Fund B.” In January 2007, Yinchuan Intermediate People' Court (trial court) accepted the case but later dismissed the plaintiff's claim. Company A refused to accept the verdict, and made an appeal before Ningxia High People's Court. In March of 2008, the Ningxia High People's Court rejected the appeal of Company A and upheld the original judgment.[131] Though the result of judgment of the court (the investment decisions of Company A was unreasonable significantly) was disappointing to company A, the institutional shareholders have begun to

[129] DaCheng securities fund management Co. v. YinGuangSha Co., Ningxia High People's Court, no. 74, March 22, 2008.

[130] Ibid.

[131] Ibid.

consider protecting their own rights and interests through litigation in China, which is a progress of monitoring the management and improving corporate governance.

2.3.2 Negative cases

In practice, the negative cases have emerged regarding participation in corporate governance by institutional investors. For example, institutional investors only support the resolutions of the management even when such investors found they infringed upon minority shareholders. Furthermore, some institutional investors are involved in selling the shares in the stock market for short-term interests rather than participate in corporate governance. Thus, these institutions do not play an active role in monitoring the operators of the company.

2.3.2.1 Case of Inner Mongolia Yili Industrial Group Co., Ltd.

The Inner Mongolia Yili Industrial Group Co., Ltd (hereinafter Yili Co.) purchased government bonds and lost a lot of money. The independent directors X and Y published a declaration and required to hire an independent audit institution to make investigations and asked Yili Co. to disclose information of purchasing government bonds in detail. This statement showed that the independent directors questioned on the matter of investment in government bonds.[132]

Furthermore, the independent directors X and Y required the supervisory board of Yili Co. to bring an action on behalf of interests of the company due to the fault investment decision of government bonds. At the same time, the CSRC began to launch a criminal investigation when notifying that Yili Co. had been alleged of the violation of securities laws.

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[132] Xingqiang Du and Zejiang Zhou, *Zhidu huanjing, gongsi zhili yu duli dongshi - Yili gufen anli yanjiu* [Institutional Environment, Corporate Governance and Independent Directors - A Case of Yili Co.], in *Shenji yu jingji yanjiu* [Journal of Audit and Economics] 25, no.6 (2010): 75-76.

Following this the independent director Y resigned and Yili convened an extraordinary shareholder meeting and passed a resolution of removing independent director X.[133]

The largest shareholder JinXin Trust Investment Co. held 14.33% of total shares issued by Yili, while the fifth largest shareholder Huashi Trading Co. held about 2.16% of the total shares. However, the executive officers controlled the shareholdings of the largest shareholder and the fifth largest shareholder. Thus, the executive officers held about 16.49% of the proportion of shares and can control the shareholder meetings. During the first top ten tradable shareholders, institutional investors mainly covered the second largest shareholder Qiyuan Investment Co. who held 4.38% of share ownership, the third largest shareholder holding 3.86% and the sixth largest shareholder Construction Bank Trust holding 1.94%. However, the important institutional investors did not oppose the resolution of removing independent director.[134]

If institutional investors noticed that independent directors fought with executive officers of the company on behalf of minority shareholders and the company, they should have participated in shareholder meeting and voted against the resolution of removing independent directors. Those who voted against the resolution were definitely not the top ten shareholders of the institutional investors of Yili.

In this case, institutional investors selected to support the resolution of the removing independent director. If the institutional investors who held large share ownership supported the independent director in shareholder meeting, it was very hard for executive officers to remove the independent director. In that circumstance, the independent director was more likely to play an effective role in monitoring corporate governance.

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[133] Xingqiang Du and Zejiang Zhou, 77-78.

[134] Ibid., 79-81.

2.3.2.2 Cases of wrongful share trading acts for seeking short-term interests

1. Cases of insider trading

In China, some institutional investors obtain the inside information of companies before this inside information is promulgated to the public due to the advantages of shareholdings and information than individual investors. Thus, those institutions will be engaged in insider trading to obtain illegal interests. The dissertation discusses two cases of insider trading as follows.

The NanFang Securities Co. Ltd, (hereinafter NanFang) became the underwriter of BeeDa Technology (Group) Co., Ltd. (BeeDa). The chairman of board of directors of NanFang knew the information about issuing new shares and other significant inside information of BeeDa. On January 11, 1997, the interim shareholder meeting of BeeDa passed a proposal of issuing new shares and NanFang was in charge of the capital increase specifically. NanFang made use of this inside information to trade large volume of stocks of BeeDa from October of 1996 to April of 1997, and took up 16.23% of shares issued by BeeDa, 60.61% of tradable shares. Under the collusion of the two companies, the stock price of BeeDa increased from 8.86 RMB to 16.25 RMB. China Securities Exchange Commission found this insider trading behavior of NanFang and imposed on a fine of 500 million RMB.[135]

Guanghua Fund Co., Ltd. (hereinafter Guang) purchased the equity securities of Zhongyou Jinghong Natural Gas Transportation Co., Ltd. (hereinafter Zhong) and became a shareholder of the portfolio company. In August 2009, company Zhong negotiated with Lingxian Technology Co., Ltd. (hereinafter Ling) to discuss reorganization. In the process of reorganization negotiations, the chairman of board of directors of Guang named as “X” talked with the reorganization with Zhong. Guang and its subsidiary company Guanghua Asset

[135] Zhimin Dai, 71-72.

Management Co., Ltd. (hereinafter Guang-S) made use of this inside information to purchase 42.7 million shares and 16 million shares separately. On December 14, 2009, Guang and Guang-S sold out all of shares and obtained illegal profits of 2.14 million RMB. The CSRC discovered the fact that Guang contributed to insider trading and made a decision to impose a fine of 50,000 RMB, and gave a warning and a fine of 30,000 RMB on the responsible persons of this insider trading.[136]

According to the cases above, the securities company and the fund management company as typical institutional investors in China made use of inside information of portfolio companies and engaged in insider trading, which would bring infringement to the stock market.

2. Case of manipulation of stock price

From December 2000 to January 2004, Nan Fang Securities Co., Ltd. and its subsidiary companies (including Hua De Asset Management Company and Shanghai Tian Fa Investment Company) were involved in manipulation of the share price. These companies violated the regulation that prohibits the legal person from opening an individual account, and opened a 289 account funds in 45 departments of securities companies of 25 cities in the name of juridical person or natural person. Then such companies purchased and sold the Hafei Stock and manipulated the share price. In order to protect the legal rights and benefits of investors and creditors, the CSRC identified this behavior of Nan Fang and confiscated the illegal profits 7455.89 million RMB and imposed a fine of 500 million RMB on Nan Fang.[137]

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[136] China Securities Regulatory Commission, *Zhengjianhui diaocha yu chufa Guanghua zichan guanli gongsi* [CSRC investigated and imposed penalty on insider trading of Guanghua Asset Management Co., Ltd] no.13, January 19, 2012.

[137] Zhimin Dai, 72-73.

2.3.3 Summary and analysis of cases

Table 1 shows the summary of cases of institutional active participation in corporate governance and those negative cases of participation by institutional investors. The section analyzes the conclusions from four aspects including: (1) method of activism; (2) share ownership structure and the manners of voting; (3) results of institutional activism; and (4) negativity of institutional activism.

Table 1: Cases of Institutional Active Participation in Corporate Governance in China

Content / Case	The active institutional investor	The Method of Activism	Ownership Structure	Conflict of Interests	Result of Activism
Cash offer of new shares of ZTE Co.	Securities Investment Fund	Exercise Voting Right	Tradable and non-tradable shares	Not quite clear	Institutional investor failed
Cash offer of Futon Motor Co.	Securities Investment Fund	Exercise Voting Right	Tradable and non-tradable shares	Not quite clear	Institutional investor succeed
Convertible bond issues of China Merchant Bank	Securities Investment Fund	Exercise Voting Right	Tradable and non-tradable shares	Not quite clear	Institutional investor failed
Cash offer of Baoshan Iron and Steel Co.	Securities Investment Fund	Exercise Voting Right	Tradable and non-tradable shares	Serious	Institutional investor failed
Alteration of the articles of China Vanke Co.	Securities Investment Fund	Submit Proposal	Dispersed ownership	Not quite clear	Institutional investor succeed
Misrepresentation financial sheets of YinGuangSha Co.	Securities Investment Fund	Bring Litigation	Tradable and non-tradable shares	Not quite clear	Institutional investor failed
Electing directors of Gree Electric Appliances Inc.	Fund of University and Securities Investment Fund	Exercise Voting Right	Dispersed ownership	Not quite clear	Institutional Investor succeed

Source: summarized by author according to the cases of institutional activism in China above

2.3.3.1 Method of activism

From the cases illustrated in table 1, primarily the securities investment funds participate

in corporate governance in China. Concerning the methods of activism, institutional shareholders mainly exercise voting rights, but they rarely submit the proposals and bring a suit against the portfolio companies. Concerning the context of participation in corporate governance, institutional investors mainly involve in corporate governance on the issues of offering new shares of the listed companies and also the issues of convertible bonds and alteration of the articles of association of the company.

2.3.3.2 Share ownership structure and the manners of voting

In ZTE Co., the largest shareholder holds 52.85 percent of shares, and the non-tradable share ownership takes up 57.05 percent. In Merchant Bank of China, the largest shareholder holds 17.95 percent of share ownership, and non-tradable shares takes up 73.72 percent. In Baoshan Co., the largest shareholder takes up 85 percent. Hence, it is recognized from those cases above that the quite concentrated ownership and non-tradable shares exist in some companies, and controlling shareholders take up large proportion of shares in these companies. As a result, the controlling shareholders could make a decision according to the "majority voting rule" so that institutional shareholders who hold small shareholdings lacked the activism to exercise vote on shareholder meetings.

2.3.3.3 Results of institutional activism

According to the cases illustrated above, there are two results of institutional activism. On one hand, in cases of Futon Motor Co., China Vanke and Gree Electric Appliances Inc., the decisions of institutional shareholders were supported, leading to the success of institutional activism. On the other hand, in the case of ZTE Co., institutional shareholders could not prevent the proposal of issuing H-shares from passing at general meeting. The ZTE Co. then canceled this proposal only because of the market, rather than the institutional

opposing. In other cases such as Merchant Bank of China, Baoshan Co. and YinGuangSha, institutional shareholders failed to prevent the proposals from passing.

2.3.3.4 Negativity of institutional activism

Institutional investors select to vote for the resolutions of shareholders meetings of the companies they invest. Judging from the voting results of the case of Baoshan Co., affirmative votes included 87.66 percent of the tradable share ownership indicating that many investment funds vote for the proposal of board of directors. The reason why such investors vote for the proposal was that Baoshan Co. allowed fund management companies to obtain some benefits for themselves, so some fund management companies were just supportive for the decisions of the operators in the company.

In the case of removing independent director of Yili Co., the Investment Co. and Construction Bank Trust also voted for the resolution of removing independent directors to seek for their own interests, even if they thought this resolution would infringe upon the interests of the company and minority shareholders. Some investment fund management companies and securities companies sometimes are involved in wrongful trading acts for short-term interests including insider trading and manipulation of stock price. Thus, these institutional investors do not play an active role in monitoring the managers of the company.

2.4 Summary

This chapter introduced the history and current legal practice of participation in corporate governance in Chinese listed companies by institutional investors. The legal framework of effective participation by institutional investors in corporate governance may be categorized into two types: promoting institutional participation and regulating institutional conducts to promote effective participation.

First, the legal framework of promoting institutional participation includes: (1) general provisions of participation in corporate governance corresponding to the main methods of participation in corporate governance by shareholders, covering exercising voting rights, submitting proposals, bringing litigation and informal avenues such as meetings and dialogues; (2) the special provision for participating in corporate governance; and (3) providing convenient conditions for participating and voting at shareholders meetings by institutional investors.

Second, this chapter examines the legislation on regulating institutional investors to promote effective participation in corporate governance of China: (1) disclosure during soliciting proxy voting; and (2) regulation on wrongful share trading acts in the stock market including insider trading and manipulation.

In practice, there are some cases that show the different attitudes of institutional investors in participating in corporate governance. Some institutional investors use their "voice" when they are dissatisfied with the performance of the company. Moreover, there are also negative cases showing the passivity of institutional investors: (1) supporting the resolutions for seeking private interests; and (2) involved in wrongful share trading acts for short-term interests.

CHAPTER Ⅲ Obstacles to Effective Institutional Participation in Chinese Corporate Governance

Chapter 2 examined the current situation of the participation of institutional investors in corporate governance in China. This chapter analyzes that some main obstacles have held back effective participation in Chinese corporate governance including (1) imbalance of ownership structure; (2) misconduct in the emerging stock market; and (3) shortfalls in legal framework on promoting effective participation in corporate governance by institutional Investors. The chapter will discuss each of these obstacles below.

3.1 Imbalance of Ownership Structure

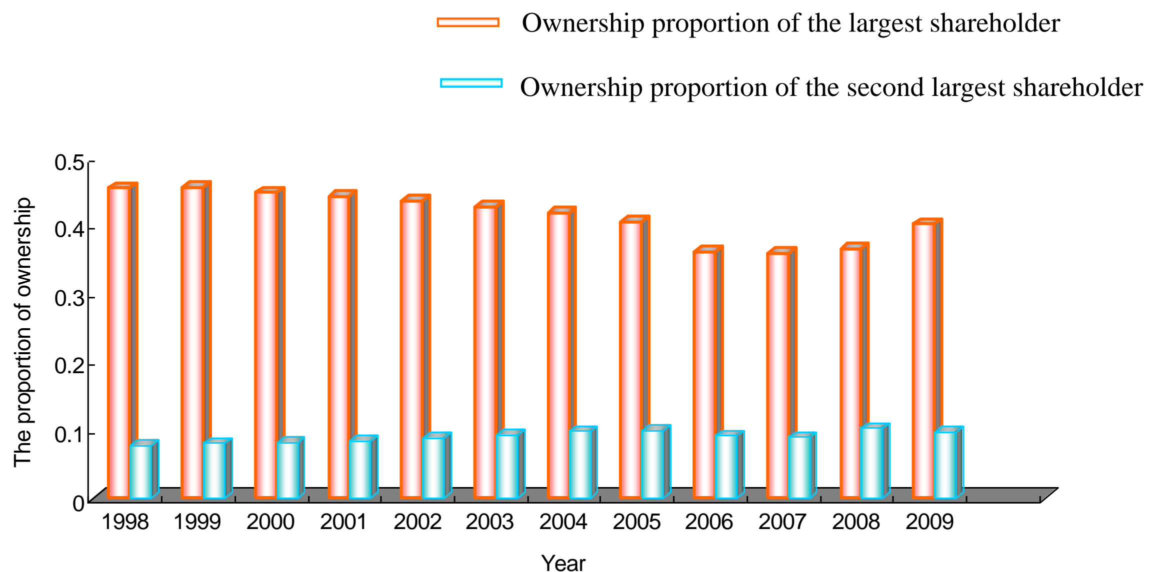
Shares are quite concentrated in many listed companies in China and the cases illustrated in this study show that there was an imbalance in corporate ownership structure. The listed companies controlled (directly and indirectly) by the state account for 2/3 of listed companies in Shanghai Stock Exchange (SHSE) in 2009.[138] Thus, the share of ownership remains concentrated in the hands of the controlling shareholders especially the state.

Furthermore, non-tradable shares including state-owned and juridical shares take quite a large proportion of shares in some listed companies. However, since the "share trading reform" of 2005, an increasing amount of non-tradable shares have become tradable in China stock market. China Securities Regulatory Commission reported that the tradable shares reached almost 80% of the total share ownership in China stock market until 2011, which means that most of state-owned shares can be transferred to non-state owned shares at

[138] Shanghai Stock Exchange, ed., *Report of China Corporate Governance*, 90.

present.[139] In spite of large tradable shares, the shareholdings are still relatively concentrated in controlling shareholders in some Chinese listed companies (See Figure 1 for example).

Figure 1: Ownership Structures of Listed Companies in China: 1998-2009



Source: CCER data base, Corporate Governance of Listed Companies

Note: The numbers of sample of listed companies in China increased from 814 in 1998 to 1621 in 2009.

As pointed out in chapter 1, broadly speaking, institutional investors in China are categorized into professional institutional investors and general juridical investors. According to the statistics of the SHSE, though all of institutional investors accounted for more than 75% of tradable shares of market value in 2010, professional institutional investors only accounted for 15.88% of shareholdings (See Table 2 for the proportion of professional institutional investors). Accordingly, most of institutional investors belong to general juridical investors covering state-owned enterprises in China.

According to the datum of A-share listed companies in SHSE, until December 31, 2011 professional institutional investors held 15.7% of the total market value of tradable shares of

[139] China Securities Regulatory Commission, ed., *China Securities Regulatory Commission Annual Report*, (China Financial and Economics Press, 2011).

listed companies, in which securities investment funds and insurance companies respectively accounted for 6.2% and 5.5%, securities companies were about 1.5%, and social security funds were less than 1%. Furthermore, general juridical investors covering state-owned shareholders accounted for 45.92% of tradable value of the market. Individual investors held 26.5% of the tradable value of the market (See Table 3 for the proportion of professional institutional investors in listed companies).

Table 2: Share Hold of Investors by 2010

Investors (RMB)	Hold Value (100M)	Ratio (%)	Hold Account (10 Thousand)	Ratio (%)
Individual investors	32709.85	23.13	3195.08	99.79
Less than 10 Thousand	6500	4.6	2622.94	81.92
10–30 Thousand	6508.16	406	386.64	12.08
30-100 Thousand	7378.54	5.22	145.16	4.53
100-300 Thousand	5040.46	3.56	31.50	0.98
300-1000 Thousand	3661.44	2.59	7.46	0.23
More than 1000 Thousand	3520.90	2.56	1.38	0.04
General juridical investors	86262.09	60.99	4.54	0.14
Professional institutional investors	22463.31	15.88	2.32	0.07
Investment fund	10157.97	7.19	0.06	0.002

Source: Shanghai Stock Exchange Statistics Annual 2011 (from January 1, 2010 to December 31, 2010)

The statistics illustrate that the percentage stake by professional institutional investors is still small in the tradable market value of listed companies relative to the general juridical investors. Due to small shareholdings, institutional investors are difficult to prevent a proposal

which will infringe on the interests of minority shareholders from being adopted by the "majority-voting rule", just as the cases illustrated earlier. Hence, successful institutional interventions only occur in a small number of companies.

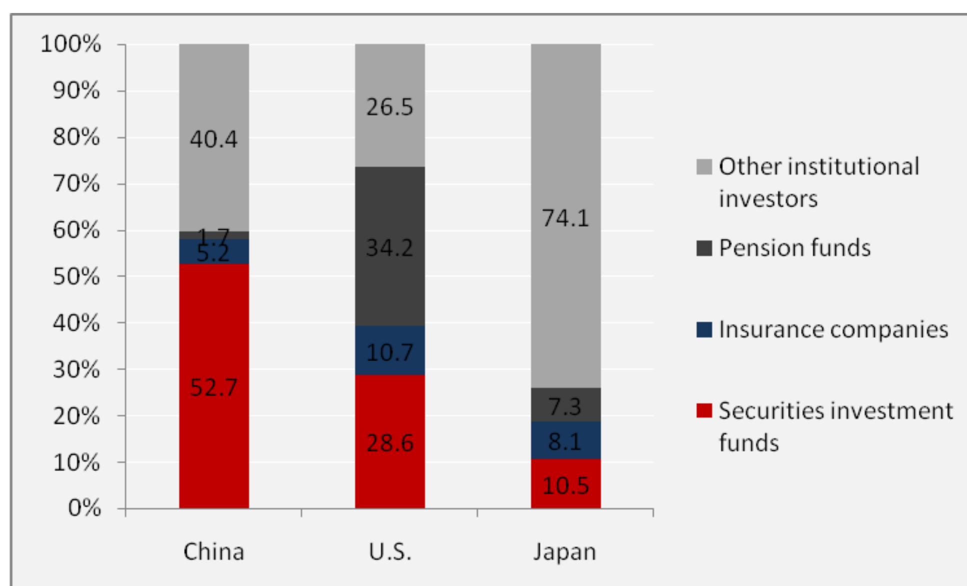
Table 3: Share Hold by Institutional Investors in A-share Listed Companies in China, 2011

Proportion of Shareholdings of general juridical investors	Proportion of Shareholdings of professional institutional investors	Proportion of Shareholdings of all of investment funds	Proportion of Shareholdings of NSSF	Proportion of Shareholdings of insurance companies	Proportion of Shareholdings of individual investors
45.92%	15.7%	6.2%	0.18%	5.5%	26.5%

Source: Shanghai Stock Exchange Statistical Yearbook, 2011.

At the same time, the share ownership structure of professional institutional investors in China remains imbalanced. Relative to other types of professional institutional investors, the pension funds remain a small proportion of market value in the listed companies. (See Figure 2 for the proportion of professional institutional investors in listed companies).

Figure 2: International Comparisons of Main Institutional Investors in the Stock Market



Source: CSRC and World Bank, quoted in China Capital Markets Development Report (2008)

Notes: 1. China's statistics as of the end of 2007.

2. Data for US as of the end of 2006, for Japan as of the end of 2005.

According to Figure 2 illustrated above, compared to the US and Japan, the institutional investors especially pension funds in China take up only a few proportion of market value. In addition, the pension funds in Japan held larger share ownership than in China.[140] Therefore, there is imbalance and irrationality in the structure of ownership in many listed companies and on the whole institutional investors are not active participant in corporate governance in current China.

3.2 Misconduct in the Emerging Stock Market of China

The emerging stock market of China is filled with the misconduct by institutional investors covering speculation and wrongful acts in share trading which leads to the negativity of participating in corporate governance by institutional investors.

3.2.1 Emerging stock market of China

The stock market of China, as one typical emerging market in the world, is far from being an all-round development of emerging market and is filled with speculation and fraud misconducts. Singh (2003) explained that, "An emerging market with non-transparent information and poor legal systems for protecting investors leads to the herding and myopia that can lead the stock market values to diverge significantly from underlying values."[141] Accordingly, in an emerging market, investors are more likely to engage in speculation or fraud during trading stocks in order to obtain short-term interests. Some scholars such as Gen (2002) and Dai (2008) showed that the asymmetrical and incomplete information as typical

[140] Tokyo Stock Exchange et al., *Hesei 22 nendo kabushiki bunpu jokyo chosa keka no gaiyo* [Overview of the Distribution of Shares Survey Results in 2010], http://www.tse.or.jp/market/data/ examination/distribute /b7gje6000000508d-att/report2010.pdf (accessed on May 23, 2012).

[141] Ajit Singh, "Corporate governance, corporate finance and stock markets in emerging countries," *Journal of Corporate Law Studies* 3 (2003): 63-65.

traits in the Chinese stock market contributed to misconduct by institutional investors.[142]

3.2.2 Speculation

At present, in light of the emerging Chinese stock market, many institutional investors have not noticed the importance of long-term investment. These investors often trade stocks in the short term, which manifests in speculation. The institutional investors in China stock markets tend to conduct speculation like individual investors (See Figure 3 for the periods of shareholdings of institutional investors).

According to the statistics of SHSE, in 2011 the average holding period of the investors was 72 days, while the average holding period of institutional investors was about 100 days. The average holding period of QFIIs was 188 days and for insurance companies 121 days, which was longer than other types of institutional investors.[143]

The statistics in Figure 3 indicates that the ratio of turnover of stock transaction of China's investors was quite high with an average of about two months. Even though QFIIs and insurance companies hold shares for longer periods relative to other categories of institutional investors, the average holding period of institutional investors is still short. Therefore, institutional investors trade frequently for short-term investment gain in China stock market and are more likely to conduct speculation in stock market rather than involve in corporate governance.

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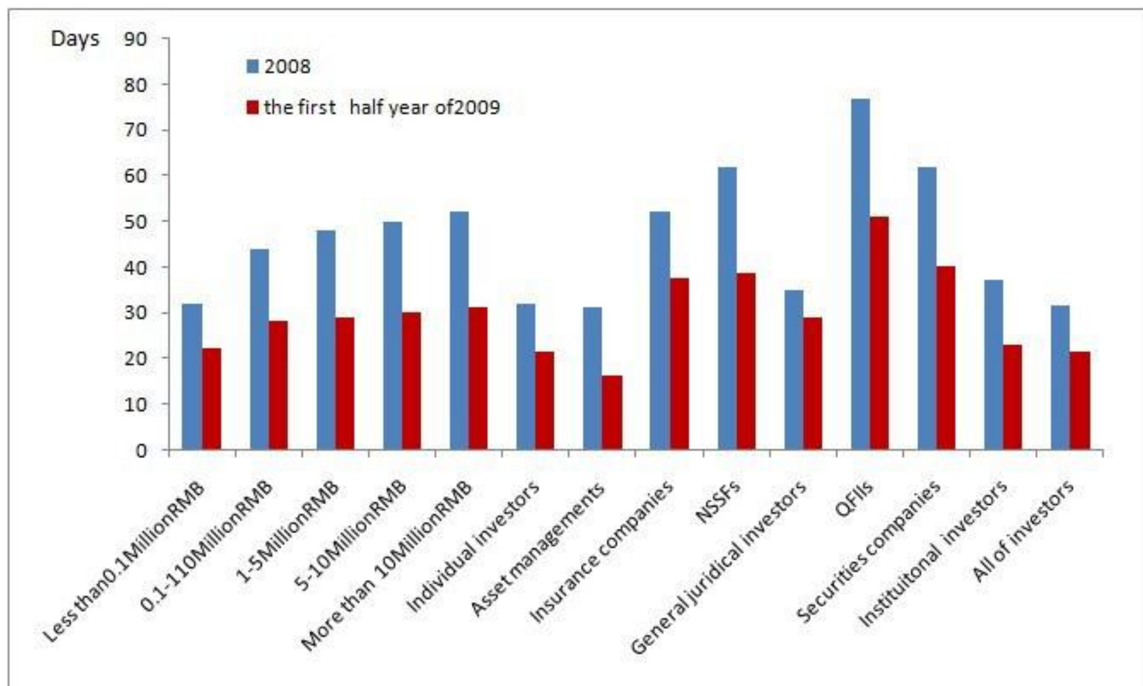
[142] Zhimin Gen, [Institutional Investors in China]. Zhimin Dai, [Normal Development of Institutional Investors in China's Securities Market].

[143] Shanghai Stock Exchange Statistics Yearbook, 2011.

Figure 3: Periods of Shareholdings of Institutional Investors: 2008 to the First Half of 2009



Source: Shanghai Stock Exchange Statistics Report 2009.

3.2.3 Wrongful share trading acts

According to the statistics of the *Analytical Report of Securities Administrative Penalty* by CSRC in 2010, the number of institutional misconduct penalized by the CSRC increased from 2007 to 2010, and seven investment fund management companies were penalized.[144] In 2011, the CSRC initiated 82 cases investigations, 77 percent of which concentrated on three types of misconduct in the securities: insider trading, manipulation and misrepresentation.[145] Furthermore, the vice-president of the Supreme People's Court of China also suggested that

[144] Bin Chen, *Zhongguo zhengjianhui 2010 niandu zhengquan xingzheng chufa fenxi baogao* [Analytical Report of Securities Administrative Penalty by CSRC in 2010], *Securities Market Herald*, September 2011, 60-67.

[145] China Securities Regulatory Commission, *2011 nian qian 11 geyue zhengquan qihuo jicha zhifa qingkuang* [Inspection of the first 11 months of 2011, securities and futures law enforcement situation], November 29, 2011. http://www.csrc.gov.cn/pub/newsite/jcj/gzdt/201111/t20111130_202439.htm (accessed on April 23, 2011).

“the anti-insider trading should focus on the institutional investors.”[146]

According to the analysis above, the regulation on institutional investors in the Chinese stock market becomes necessary, which aims to lead them to behave in a lawful and orderly way. In such a case, institutional investors may attach importance to long-term investments and further involve in corporate governance of the companies they invest.

3.3 Shortfalls in the Legal Framework

The legal framework is the “weapon” of promoting institutional investors participation in corporate governance, but there are shortfalls to hold back institutional participation in Chinese corporate governance lawfully and effectively. The shortfalls are categorized into two parts including: (1) deficiency in the provisions for promoting participation in corporate governance; and (2) shortfalls in regulations.

3.3.1 Deficiency in the provisions for promoting participation in corporate governance

The *Code of Corporate Governance for Chinese Listed Companies* 2002 has been established to promote institutional participation in corporate governance in China, which seems helpful for institutional investors to exert shareholder rights in the companies they have invested. However, the *Code* only has one general provision referring to the participation of institutional investors, but there are no specific provisions or judicial interpretations.[147] The *Code* 2002 does not stipulate specific procedures and process in detailing how to promote institutional investors to become involved in the appointment of company directors, the

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[146] Feng Guo, *Fan neimu jiaoyi zhongdian zai jigou dahu* [The Anti-insider Trading Should Focus on the Regulation of Institutional Investors], *Securities Times*, 6 December 2010, http://www.cnstock.com/index /gdbb/201012 /1029080.htm (accessed on April 23, 2011).

[147] China Code of Corporate Governance for Chinese Listed Companies (2002), Article 11.

compensation and supervision of management, and other major decision-making processes. Thus, this provision is less likely to be exerted widely in current China due to less operability.

3.3.2 Shortfalls in regulations

3.3.2.1 Shortfalls in regulating voting during participation in corporate governance

In both the cases of "Baoshan Co." and "Inner Mongolia Yili Industrial Group Co." introduced earlier, institutional investors selected to support the resolutions of shareholders meetings of the companies they invested, even if they thought these resolutions would infringe upon the interests of the company and minority shareholders. Similarly, many institutional shareholders were reluctant to vote, while they just support the proposals of portfolio companies to seek for private interests in practice. Some fund managers even blackmailed the companies they invested for bribery in return for the institutional investors' support for the companies' share structure reform compensation scheme.[148]

The behavior seeking for private interests during exercising voting rights may bring two negative effects. On the one side, institutional investors as trustees of the ultimate investors do not fulfill the fiduciary duty to protect the value of their shareholdings by participating in corporate governance. On the other side, institutional investors do not prevent those proposals from being adopted even when they find that the interests of minority shareholders are damaged by virtue of those managements.

Therefore, it needs for improving legislations on regulating the conduct of institutional investors during participation in corporate governance, making institutions exercise shareholder rights in a lawful way to protect minority shareholders and improve the corporate

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[148] *Wuliang jijin jingli suohui zao tousu, zhengjianhui yankong gugai heimu* [Villainous Fund Managers Seeking Bribery Subject to Complaints, CSRC Stepped up Scrutiny of Unlawful Activities in the Share Structure Reform], in *Zhengquan shibao* [Securities Times], September 5, 2005.

governance of portfolio companies.

3.3.2.2 Shortfalls in regulating insider trading and manipulation of stock prices

As pointed out earlier, due to the emerging stock market of China, some institutional investors are involved in wrongful acts especially insider trading and manipulation for short-term interests. Meanwhile, the cases introduced in Chapter 2 illustrated some of the wrongful acts committed by institutional investors in China, which have affected participation in the corporate governance. In spite of the legislation on regulating insider trading and manipulation of market, there are two shortfalls: systematic and regulatory authority.

1. Systematic shortfalls

(1) Obscure criteria for identifying insider trading

The standard of insider trading in China seems to be mixed and confused, because there are two standards of identifying insider trading in China including 1) the way to use inside information; and 2) the identity of insiders.[149]

Article 73 of the Securities Law 2005 prevents any insider who has access to any information of securities trading or who has unlawfully obtained any insider information to engage in any securities transaction.[150] Thus, the conduct of insider trading requires "making use of inside information," but it is difficult to prove so in practice.

However, Article 76 of the Securities Law 2005 states that "any insider who has access to insider information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information,

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[149] Lingling Mao, *Zhongmei zhengquan neimu jiaoyi guizhi de bijiao yu jiejian*, [Insider Trading Regulation between the US and China: Comparison and Reference], in *Faxue* [Journal of Law] no.7 (2007): 103-104.

[150] China Securities Law (2005), Article 73.

or advise any other person to purchase or sell such securities."[151] Therefore, this provision judges the insider trading from the identity of insiders rather than the utilization of the insider information.

(2) Civil liability of insider trading and manipulation: heavy burden of proof

Since no legal regulations can cover all behaviors, then a good judicial relief system is need to punish the offenders according to the law and provide the victims with appropriate compensation according to the corresponding damage from violations. Thus, a good judicial relief system comprises of two aspects: punishment and compensation.

Compared to administrative penalty and criminal penalty, the civil liability can directly compensate for the damage suffered by offenders and cannot be substituted by the other two liabilities.[152] At the same time, civil liability can impose on the offenders a much heavier penalty, since the offenders have to pay a mass of money to other public investors for compensation.

Since the deterrence of high civil compensation is much stronger than the liabilities of administration and criminal, it greatly increases the illegal cost of the market fraud behaviors. However, it does not attach importance to the civil liability of insider trading and manipulation. In practice, an injured individual investor is to hold the burden of proof to prove the casual relationship between the damages and the wrongful acts.

2. Shortfalls of regulatory authority

China has a two-tier securities regulatory model in which the special regulation-based CSRC serves as the main body, while the Self-Regulating Organizations as subsidiary body.

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[151] China Securities Law (2005), Article 76.

[152] Qijia Ma, *Zhengquan minshi zeren falv tixi bijiao yanjiu* [Comparative Study on Legal System of Securities Civil Liability], (China Legal Publishing House, 2010), 3.

The CSRC is less independent because it has to accept the guidance of the State Council of China. In practice, the State Council of China primarily authorizes the CSRC to establish related legal regulations on listed companies and supervise the stock market.

According to Article 179 of the Securities Law 2005, the securities regulatory authority under the State Council performs several functions and duties regarding the supervision and administration of the stock market, including: (1) formulating the relevant rules and regulations and exercising the power of examination or verification; (2) carrying out the supervision on the securities behaviors (including issuance, listing, trading and registration) and the securities subjects (such as a securities issuer, a listed company, stock exchange, securities company, securities investment fund management company or securities trading service institutions); (3) supervision and examination of information disclosure regarding the issuance, listing and trading of securities; and (4) investigating into and punishing any violation of Securities Law and other regulations.[153]

The self-regulating organizations that compose of the Stock Exchanges and Securities Industrial Association are required to play a function of supervising securities trading according to the Securities Law 2005.[154] The self-regulating organizations are expected to play a supplemental role in supervising the stock market. The regulatory authority of Chinese stock market also has some defects and failures that include conflicts in the aims developing institutional investors and regulations.

In the emerging stock market of China, there are conflicts between the purpose to develop institutional investors and the purpose to regulate and supervise the conduct of institutional investors in the stock market. The regulatory authority contributes to the development of the stock market by means of increasing the amount of money into the market

[153] China Securities Law (2005), Article 179.

[154] Ibid., Article 7 and 176.

and finance of the listed companies. However, the regulatory authority also regulates the behavior of investors in the stock market. It often occurs that the penalties imposed on the illegal behaviors in the stock market would affect the stock price and decrease the amount of the money into the market.

Sometimes, the regulatory authorities loose the regulation on wrongful acts in trading to develop the stock market. For instance, the CSRC often adopts "selective regulating" on the wrongful acts in trading, which means even for the same type of wrongful acts, the regulation and punishment of CSRC are often of difference. It mainly depends on the situation of the stock market. When the market is in a downturn, the CSRC is cautious in handing out penalties for market manipulation as this might affect the confidence in the market. In contrast, when the market is on an upturn, the CSRC takes appropriate action to strengthen supervision on the investors and periodically investigate a number of misconduct.[155]

Moreover, in practice, the number of cases of manipulation and insider trading by institutional investors has been large, but only a few of these have been reported to the public as shown in notices of the number of penalties by the Regulatory Commission. This situation could be partially attributed to the limitation of capability of the regulatory authority.

Since the misconduct such as insider trading and manipulation are complex and elusive, it usually takes a lot of time and efforts for the regulatory authority to investigate and impose penalties. As a result, the complexity of misconduct leads to the lag of punishment of the regulatory authority and some misconduct may escape from the sanction of the law. For example, "the misrepresentation of Lantian Co., Ltd. was punished by the CSRC after four years", which was too late to cause a legal warning to the violators. Furthermore, "Yi-an Technology Co. involved in the manipulation of stock price, but the misfeasors had escaped

[155] Shunyan Zheng, *Zhengquan shichang weigui xingwei de falv shizheng fenxi* [Legal Empirical Analysis on Securities Market Misconduct], (Chinese Political and Legal University Press, 2000), 147.

and transferred all of illegal profits so that CSRC could not retrieve those profits and impose on a fine."[156] Finally, the regulatory authority cannot play an active role in regulating the illegal behavior for healthy development of the stock markets.

3.4 Summary

This chapter discussed the three main obstacles hindering institutional investors' participation in corporate governance in China. First, controlling shareholders have hindered the participation of professional institutional investors who hold small shares due to the unbalanced share ownership structure of Chinese listed companies. Second, the Chinese stock market is filled with non-transparent information and poor legal systems for protecting investors. Therefore, some institutional investors involve in speculation and wrongful share trading acts, which have affected the effective participation in the corporate governance. Third, there are two shortfalls in legislation including the deficiency of provision for promoting institutional participation in corporate governance and the regulation on institutional investors.

[156] An-sheng Dong, Xiaomin Zheng and Miao Liu, 123-124.

CHAPTER Ⅳ Institutional Participation in Corporate Governance in Japan

This chapter provides a review of the situation of participation in corporate governance by institutional investors in Japan. First, the chapter introduces the historical development of institutional investors and their participation in corporate governance. Second, the chapter analyzes the current legal framework of Japan concerning institutional investors' participation in corporate governance. Third, the chapter discusses several cases on institutional investors' participation in corporate governance.

4.1 Historical Development

This section covers the following two parts: (1) an introduction of the historical development of institutional investors and their participation in corporate governance; and (2) an analysis of the reasons why institutional investors participate in corporate governance in Japan.

4.1.1 Institutional investor participation in corporate governance in Japan

Recently, institutional investors have been expected to participate in corporate governance not only in case law countries, but also in civil law countries like Japan.[157] Compared to case law countries, Japan has a system with relatively concentrated ownership structure in the corporate governance framework. Corporate governance in Japan is characterized by two points: the main bank system and cross-shareholding system. Both of

[157] Yoshihiro Asai, *Waga kuni no kigyo toji ni okeru kikan toshika no yakuwari no bunseki* [Analysis of the Role of Institutional Investors in Corporate Governance in Japan], (Ph.D. diss., Nagoya University, 2005), 14.

these two systems have been in Japan for decades since the end of World War II.

A scholar Lee (2007) described that “After World War II, Japanese financial system mainly depended on indirect financial mechanics; enterprises increased capital and improved business development mainly through bank loans and banks played a pivotal role in monitoring the corporate governance.”[158] Moreover, Lee also explained that “in order to realize the stability of business development and prevent the takeovers, the system of cross-shareholdings (*mochiai*) among banks and companies formed, which was another typical trait in the economical development of Japan.”[159]

Both the active main bank system and the stability formed by cross-shareholdings contribute to the rapid economic development in post-war Japan. Thus, investors were satisfied with the business of the companies so that there was a lack of activism in participating in corporate governance during that period. However, Lee (2007) elaborated that “with the financial liberalization in the late of 1980s, Japanese financial system became shift from indirect financial mechanics to direct financial mechanics; by virtue of the change of financial system, the role of main bank system became weak and many companies in Japan entered into downturn and economy’ recession.”[160] Such changes had two effects. First, Japanese companies began to rely on the stock market to finance. Second, investors became hard to obtain the steady profits due to the downturn of many companies.

After the 1990s, the cross-shareholdings of business of the companies were reduced with the collapse of the bubble economy. Under this circumstance, institutional investors began to grow rapidly and increase their shareholdings, which brought about a large impact on capital

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[158] Bakushu Lee, *Kikan toshika ni yoru governance iyoku no takamari to sono jitsugen mondai*, [The Increase of Motivation and its Realization of Institutional Investors in Corporate Governance], in *Hitotsubashi kenkyu* [Hitotsubashi Journal of Social Sciences] 31, no.4 (2007): 49-51.

[159] Ibid.

[160] Ibid.

market of Japan. A series of statistics showed that the shareholdings of individual shareholders were decreasing, while the shareholdings of financial institutions and institutional investors were increasing. According to a survey of Tokyo Stock Exchange, the shareholdings of private pension funds and investment funds increased from 2.9% of 1986 to 8.7% of 2008; the shareholdings of public pension funds and investment banks increased from 7.3% of 1986 to 19.0% of 2008; and the shareholdings of foreign institutional investors increased from 5.3% of 1986 to 23.1% of 2008.[161] Furthermore, in 2010, the shareholdings of foreign institutional investors increased to 26.7% and the shareholdings of private pension funds and investment banks reached 22.7%.[162]

Two points are implied from these statistics. First, the shareholdings of pension funds increased rapidly due to the aging of Japanese population. As Japan entered the population aging society, Social Security benefits were insufficient for a comfortable retirement without outside sources of income. Therefore, pension funds become more and more important to increase the rate of return on investments to pay the future debts. Second, in light of the opening of the capital market, the shareholdings of foreign institutional investors increased significantly.

With the increase of shareholdings of institutional investors, such investors as another economic mechanics became potential participants and gradually began to exert voting rights at shareholder meetings to bring impact on the management and corporate governance over the past 20 years. Takaya (2005) contended that “Foreign investors are the first to step in as

[161] *Survey of distribution of shares by Tokyo Stock Exchange*. This survey is about the common share distribution of listed companies in five stock exchanges including Tokyo, Osaka, Nagoya and FukuOka from 1986 to 2008, quoted in Linyu Zhai, *Corporate governance ni okeru kikan toshika no yakuwari*, [The Role of Institutional Investors in Corporate Governance], in *Keiei kenkyu* [Management Research] 60, no.3 (2010): 3-5.

[162] Tokyo Stock Exchange et al., [Overview of the Distribution of Shares Survey Results in 2010], 2010.

active players in corporate governance in Japanese companies; many of them are long-term investors in Japanese equities, providing Japanese companies with a solid shareholder base."[163]

By 2000 some institutional shareholders such as "life insurance companies and trust banks began to exercise voting rights and voted against or abstained from voting the proposals of the companies."[164] According to a questionnaire provided by the UFJ bank in Japan, the domestic institutional investors who established and exerted guidelines for exercising voting rights have reached 80.8 percent.[165] In particular, many Japanese companies have received a large number of negative votes for their proposals relating to payment of retiring directors and corporate auditors, as well as the amendment to the articles of incorporation giving powers to directors in handling general meetings.[166] In recent years, Asai (2005) observed that "securities investment funds have become active in participating in merger and acquisition, and played increasing role in corporate governance."[167] At present, institutional investors have become increasingly active in the corporate governance.

4.1.2 Reasons for institutional participation in corporate governance in Japan

According to the historical development of institutional investors and their participation in Japan above, this section will analyze the four main factors contributing to the institutional

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[163] Seki Takaya, "Legal Reform and Shareholder Activism by Institutional Investors in Japan," *Corporate Governance: An International Review* 13, no. 3 (May 19, 2005): 382.

[164] Bakushu Lee, 59.

[165] Akemi Yamazaki, *Kokunai kikan toshika no giketsu ken koshi to kabunushi sokai*, [The Trend of Exercising Voting Rights of Institutional Investors in Domestic and Abroad of Japan], *UFJ Institute Report* 9, no.2 (2004): 44.

[166] Nobuo Sakuma, *Shoho kaisei to corporate governance* [The Amendment of Commercial Law and Corporate Governance], *Nippon Academy of Management* 48 (2003): 15-16.

[167] Yoshihiro Asai, [Analysis of the Role of Institutional Investors in Corporate Governance in Japan], 18.

participation in corporate governance of Japan including: (1) decline of the role of Main Bank System; (2) pressure on managers; (3) increase of institutional investors and fiduciary duty; and (4) development of legal systems.

4.1.2.1 Decline of the role of Main Bank System

Some scholars claimed that "By virtue of the shift of financial system in 1980s and build-up of bad loans after the collapse of the bubble economy in the early 1990s, the monitoring role of main bank system declined and cross-shareholdings of business of the companies reduced; many Japanese companies entered into downturn and economy' recession, so the investors could not expect high capital gains from portfolio companies."[168] Accordingly, such investors began to voice opinions and be involved in corporate governance actively to protect the profits.

4.1.2.2 Pressure on managers

During the period of main bank and cross-shareholdings system, companies looked for friendly and stable shareholders who would hold shares for a long time based on their existing relationships, and formed cross-shareholdings. Also, some large financial institutions (such as the banks) became the major and dominant shareholders in the companies they invested so that these companies could avoid the agency problem between managers and scattered shareholders.[169]

However, banks and business companies reduced their holdings as the role of banks declined and weakened after the 1990s.[170] With the decline of the role of the main bank and

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[168] Hidetaka Kawakita, *Kikan toshika to corporate governance* [Institutional Investors and Corporate Governance], *Financial review*, December 2003, 102.

[169] Seki Takaya, 379.

[170] Bakushu Lee, 50.

cross-shareholdings, the separation of ownership and control occurred in Japan and public small shareholders were hard to monitor the managers effectively because of the scattered share ownership and free-rider problem.[171]

In this context, forming the moderate concentrate share ownership structure is necessary and concentrating share ownership to institutional investors seems possible.[172] Kagono (2006), Kan (2007) and Sakuma (2009) insisted that institutional investors could improve corporate governance through alleviating the agency problems.[173] Therefore, institutional investors, both domestic and foreign, increased so that companies were under increasing pressure.[174]

4.1.2.3 Increase of institutional investors and fiduciary duty

Due to the increase of shareholdings of institutional investors, such investors became larger shareholders relative to other small investors and more concerned with corporate governance for protecting their rights and profits. Moreover, Hashimoto (1998) maintained that "the trustee liability also requires them to monitor the management of portfolio companies."[175] Therefore, it has improved the involvement of institutional investors in

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[171] Linyu Zhai, *Corporate governance ni okeru kikan toshika no yakuwari* [The Role of Institutional Investors in Corporate Governance], in *Keiei kenkyu* [Management Research] 60, no.3 (2010):2-3.

[172] Ibid.

[173] Tadana Kagono, *Kigyo toji seido no kaikaku no tame ni - kikan toshika to kabunushi sekinin* [For the Reform of Corporate Governance - the Institutional Investors and the Responsibility of Shareholders], in *Kokumin keizai zashi* [Journal of National Economy] 182, no.6 (2006): 1-9. Kosai Kan, *Kabunushi sokai ni okeru kikan toshika no yakuwari to ronten* [The Role and Point of Institutional Investors at the Shareholders' Meeting], in *Shoji homu* [Commercial Law], no.1815, (2007):14-24. Nobuo Sakuma, *Kikan toshika to kigyo toji kaikaku* [Institutional Investors and Corporate Governance], in *Soka keiei ronshu* [The Review of Business Administration] 33, no.2 (2009): 71-83.

[174] Seki Takaya, 382.

[175] Motomi Hashimoto, *Kikan toshika to corporate governance* [Institutional Investors and Corporate

corporate governance.

4.1.2.4 Development of legal systems

The legislator in Japan has established some legal systems which aim to protect the rights of shareholders and facilitate participation in recent years, so it becomes helpful for institutional investors to become involved in corporate governance. For example, the chance for institutional investors to involve in corporate governance is increasing in recent years due to the information disclosure requirements of listed companies and legal systems for facilitating shareholders to exercise voting rights such as electronic voting method.[176]

Moreover, in order to alleviate excessive administrative burden and improve investments of institutional investors, the requirement on disclosure of large volume holder of share of institutional investors were relaxed in Japan. Since institutional investors purchase and sell the shares continuously during daily transaction activities, such situation would impose the excessive administrative burden on institutional investors when requiring them to disclose detailed information at every time of the transaction. In light of this situation, the "Special Provisions for Report by Large Volume Holder of Share" is provided in order to relax certain frequency and the deadline for submitting disclosure reports on the basis of not-effecting the transparency and fairness of stock trading.[177] With the growing number of institutional investors, these legal reforms above actually freed up the limitations, helping them to develop, and leading them to become active participants in corporate governance.

Governance], in *Shoken analyst journal* [Securities Analyst Journal] 36, no.8 (August, 1998): 21-23.

[176] Japan Cabinet Office Ordinance on Disclosure of Corporate Affairs (2010), Article 19. Japan Companies Act (2005), Article 312.

[177] Japan Financial Instruments and Exchange Act, Article 27-26 (1), issued in 1948, revised in June 2006 and enforced on September 30, 2007.

4.2 Legal Framework for Promoting Effective Institutional Participation in Corporate Governance

In Japan, the legal framework for institutional investors' participation in corporate governance may also be categorized into two parts including promoting institutional participation and regulating institutional conduct. Before discussing legislation on institutional participation in corporate governance, this section introduces the conception of institutional investors in legislation of Japan at first.

4.2.1 Conception of institutional investors in Japanese legislation

The Securities and Exchange Law 1948 was revised in 2006 and formed new Financial Instruments and Exchange Act, which was enforced in 2007. In the new statute, the investors divided into two parts, professional investors covering institutional investors and individual investors.[178] Thus, the term of "institutional investors" is clearly stipulated in Japanese legislation.

Investors are categorized into professional investors and general investors. Professional investors cover qualified institutional investors according to the legislation.[179] Furthermore, the legislation provides the definition and scope of qualified institutional investors. According to Article 2 (3) (i) of the Financial Instruments and Exchange Act of Japan, the qualified institutional investors is defined as "persons specified by a Cabinet Office Ordinance as those having expert knowledge of and experience with investment in securities."[180] Particularly speaking, legislation also stipulates that "the qualified institutional investors can be

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[178] Japan Financial Instruments and Exchange Act (2006), Article 2 (31).

[179] Ibid., "Professional Investors cover qualified institutional investors, the State, the Bank of Japan, investor protection funds and other juridical persons specified by a Cabinet Office Ordinance."

[180] Ibid., Article 2 (3) (i).

categorized into 26 types such as financial instruments specialist (limited to business which falls under securities services or in investment management), an investment corporation, a foreign investment corporation, a bank, an insurance company, a foreign insurance company, and pension funds and so on."[181]

The term of "institutional investors" is provided in detail and specifically in the legislation of Japan because some provisions which are not to be applied to institutional investors.[182] Some scholars contended that "With the increase of investment activities recently, the unnecessary procedure and cost are expected to decrease to facilitate large investments of institutional investors and increase the efficiency and smooth of the investment, so the legislator establishes different investment legal systems between the professional institutional investors and general investors."[183]

4.2.2 Legal framework for promoting institutional participation in corporate governance

In Japan, some laws are provided to promote institutional investors participation in corporate governance. This section examines these laws from two aspects including direct and indirect manner. A direct manner covers the following two parts: (1) the general provisions under the Companies Act referring to several methods of institutional investors' participation in corporate governance; and (2) special guidelines for institutional investors' participation in corporate governance. An indirect manner includes providing convenient conditions for attending shareholder meetings and voting.

[181] Japan Cabinet Office Ordinance on Definitions under Article 2 of the Financial Instruments and Exchange Act, Article 10 (1). Ordinance of the Ministry of Finance on March 3, 1993.

[182] Japan Financial Instruments and Exchange Act (2006), Article 45.

[183] Ichiro Kawamoto and Yasunami Otake, *Kinyu shohin torihiki ho dokuhon* [Financial Instruments and Exchange Law Primer], (Yuhikaku, 2008), 238-240.

4.2.2.1 General provisions of participation in corporate governance

Institutional investors participate in corporate governance through formal and informal methods. Concerning formal methods, institutional investors primarily participate in corporate governance through exerting voting rights. Moreover, institutions also utilize submitting proposals and litigation in practice. From the aspect of informal methods, communications with portfolio companies such as meetings and dialogues have also been gradually utilized in recent years. These methods will be discussed below.

1. Submitting proposals

The Companies Act 2005 of Japan provides the fundamental requirements of submitting proposals. Pursuant to Article 303(2), shareholders with more than one percent of the total number of shares issued by the company continuously for six months, or 300 votes of shares have the right to present their own proposal at the meetings.[184]

In Japan, institutional shareholders become increasingly important due to the change in the financial system and the weakening of the role of banks in corporate governance. Under such a circumstance, institutional shareholders began to be involved in corporate management, and one of methods was submitting proposals by institutional shareholders. In practice, according to the *White Paper of Shareholder Meeting* published by the Business Law Institute (*Shoji Homu Kenkyukai*) of Japan, "the shareholders of 28 listed companies covering institutional shareholders submitted 31 proposals in 2008, which mainly refer to appeals for amending plans of the distribution of dividends and management of the directors; concerning the appointment of outside directors, institutional investors propose that it should not only focus on the independence of outside directors, but also focus on how the work of outside

[184] Japan Companies Act (2005), Article 303(2), enacted in July 26, 2005 and enforced in May 1, 2006.

directors is going on."[185]

2. Exercising voting rights

In Japan, exercising voting rights at shareholder meetings is one of the important methods of participating in corporate governance by institutional investors. Ema (2010) claimed that "The largest aim for institutional investors exerting voting rights is to improve the performance and increase the value of the company they invest."[186] At the same time, institutional investors as trustees of ultimate investors own fiduciary liability, which requires such institutions monitoring the corporate performance and improving the investment value and profits through exerting voting rights. The exercising of voting rights is actually the embodiment of fulfilling the fiduciary liability of institutional investors.

The Companies Act 2005 of Japan provides the general provisions on exercising voting rights. Pursuant to Article 308(1), shareholders should be entitled to one vote for each one share they hold at the shareholders' meeting. In cases where a "share unit" is provided in the articles of incorporation, they should be entitled to one vote for each one unit of the shares.[187] According to the Companies Act 2005, the resolutions of shareholder's meetings are categorized into three parts: (1) general resolutions; (2) special resolutions; and (3) special resolutions which require more stringent elements.

The first category concerns general resolutions. According to the Companies Act 2005, this kind of resolution of a shareholder's meeting should be made by a majority of the votes of the shareholders present at the meeting where the shareholders holding a majority of the votes

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[185] Business Law Institute, "White Paper of Shareholder Meeting," November 30, 2008, 16-17, quoted in Nobuo Sakuma, [Institutional Investors and Corporate Governance], 79-82.

[186] Naoyoshi Ema, *Kokunai kikan toshika ni yoru giketsuken koshi no jokyo: 2010 nen kabunushi sokai wo furi kae te* [Status of Exercise of Voting Rights by Domestic Institutional Investors: Looking Back on the General Meeting of Shareholders in 2010], in *Shoji homu* [Commercial Law] no.1914 (2010):39.

[187] Japan Companies Act (2005), Article 308(1).

of the shareholders who are entitled to exercise their votes are present, unless otherwise provided for in the articles of incorporation.[188] This provision regulates the basic requirements for resolution of general meetings, but authorizes the articles of incorporation of the company the power to revise them through increasing or reducing the standards of basic legal requirements.

However, there is an exception of revising the standards of basic legal requirements by the articles of incorporation. According to Article 341, in the case of resolutions for the election or dismissal of officers should be made by the majority of the votes of the shareholders present at the meeting where the shareholders holding the majority of the votes (in cases where a proportion of one third or more is provided for in the articles of incorporation, such proportion or more) of the shareholders entitled to exercise their votes are present.[189] Although this provision authorizes the articles of incorporation of the company the power to revise the standards of requirements, the proportion of less than one third of the votes cannot be approved in the case of resolutions for the election or dismissal of officers.

The second category involves special resolutions. Special resolution of shareholder meetings should be made by a majority of two thirds (in cases where a higher proportion is provided for in the articles of incorporation, such proportion) or more of the votes of the shareholders present at the meeting where the shareholders holding a majority (in cases where a proportion of one third or more is provided for in the articles of incorporation, such proportion or more) of the votes of the shareholders entitled to exercise their votes at such shareholders meeting are present.[190]

Special resolutions should make the determination of the matters including: 1) purchase

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[188] Japan Companies Act (2005), Article 309(1).

[189] Ibid., Article 341.

[190] Ibid., Article 309(2).

the shares with restriction on transfer by stock company or designated purchaser; 2) acquisition from specific shareholders; 3) determinations regarding acquisition of class shares subject to wholly call; 4) consolidation of shares; 5) determination of subscription requirements when issuing shares for subscription; 6) determination of subscription requirements when issuing share option; 7) Dismissal of officers and accounting auditors according to cumulative votes; 8) partial exemption from liability of officers; 9) reductions in amount of capital; 10) decisions on matters regarding dividends of surplus; 11) the dividend property consists of property other than monies; 12) changes in articles of incorporation, assignment of business, dissolution and continuation of companies; and 13) approval of the absorption-type merger agreement, approval of share exchange and share transfer, approval of the consolidation-type merger agreement.[191]

Third, there is another category of special resolutions which require more stringent elements than the second category of resolutions. According to the Companies Act 2005, some resolutions of shareholders meetings should be made by at least half of the shareholders entitled to exercise their votes at such shareholders meeting, being a majority of two thirds (in cases where a higher proportion is provided for in the articles of incorporation, such proportion) or more of the votes of such shareholders.[192] These types of resolutions include: 1) Shareholders' meetings where the articles of incorporation are amended creating a provision to the effect that, as the features of all shares issued by a Stock Company, the approval of such Stock Company is required for the acquisition of such shares by transfer; 2) shareholders' meetings where the Stock Company which will be absorbed by merger or Stock Company which effects Share Exchange is a Public Company, and some or all of the Cash to be delivered to the shareholders of such Stock Company consist of shares with restriction on

[191] Japan Companies Act (2005), Article 309(2).

[192] Ibid., Article 309(3).

transfer; and 3) shareholders' meetings where the Stock Company which effects merger or Share Transfer is a Public Company, and some or all of the monies to be distributed to the shareholders of such Stock Company consist of shares with restriction on transfer.[193]

To sum up the point of special resolutions, the Companies Act 2005 of Japan set up three different standards for the votes of shareholders according to the importance of resolutions of shareholder meetings. These provisions show that the legislation attach importance to the protection of shareholder rights.

Cumulative voting rights differ from the traditional voting method. According to Article 342 (1) of the Companies Act 2005, "In cases where the purpose of the shareholders meeting is the election of two or more directors, the shareholders (limited to the shareholders entitled to exercise their votes with respect to the election of the directors. The same shall apply hereinafter in this article) may request the Stock Company that the directors be elected pursuant to the provisions of cumulative voting, except as otherwise provided in the articles of incorporation."[194] As listed companies have the power to select to utilize the cumulative votes or not, many of companies set up the articles of incorporation to exclude the cumulative votes in practice.[195]

3. Shareholder litigation

In Japan, a shareholder (an investor) may bring direct or derivative litigation against the misconduct of officers of the company. The Companies Act 2005 and the Financial Instruments and Exchange Act 2006 authorize a shareholder (or an investor) the right to bring a direct litigation for protecting their own interests.

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[193] Japan Companies Act (2005), Article 309(3) (ⅰ)-(ⅲ).

[194] Ibid., Article 342 (1).

[195] Kenichiro Osumi, Hiroshi Imai and Ryo Kobayashi, *Shin kaisha ho gaisetsu* [Overview of the New Companies Act], (Yuhikaku, 2009), 193.

The Companies Act 2005 authorizes the right to bring litigation seeking revocation of a resolution of a shareholders' meeting. According to Article 831 of the Companies Act 2005, a shareholder may claim revocation of the resolution by filing an action within three months from the day of resolution of the shareholders meetings in three cases: (a) When the calling procedures or the method of resolution of the shareholders meeting violate laws and regulations or the articles of incorporation or are grossly improper; (b) when the contents of the resolution of the shareholders meeting violate the articles of incorporation; or (c) when a grossly improper resolution is made as a result of a person having a special interest in the resolution of the shareholders meeting.[196] A qualified person who becomes a shareholder after the resolution also has a right to sue.[197]

Furthermore, an injured investor may bring civil compensation litigation against the officers of the company which submits securities registration statement containing false statement lack of the required statement. According to Article 21 of the Financial Instruments and Exchange Act 2006, when a securities registration statement contains any false statement on important matters (or is lacking in statement) that should be stated, the violators should be liable to compensate persons who acquire the securities through public offering or secondary distribution for damage arising from them.[198]

In terms of derivative litigation, the Companies Act 2005 also authorizes a shareholder (an investor) a right to bring derivative litigation.[199] According to Article 847 (1), "A shareholder having the shares consecutively for the preceding six months or more may demand the Stock Company, in writing or by any other method prescribed by the applicable

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196 Japan Companies Act (2005), Article 831(1).

197 Kenichiro Osumi, Hiroshi Imai and Ryo Kobayashi, 181.

198 Financial Instruments and Exchange Act (2006), Article 21.

199 Shinichi Asagi et al., ed., *Kensho kaisha ho* [Verification of Companies Act] (Shin san sha, 2007), 182-183.

Ordinance of the Ministry of Justice, to file an action for pursuing the liability of an incorporator, Director at Incorporation, Company Auditor at Incorporation, Officer, or liquidator, an action seeking the return of the benefits or an action seeking payment."[200] When the stock company does not file an action for pursuing liability, within sixty days from the day of the demand under the provision of Article 847 (1), the shareholder who has made such demand may file on behalf of the stock company.[201] Thus, shareholders become the plaintiff for the interests of the company.

Compared to derivative litigation, there are two main characteristics in direct litigation. First, the interests of the investor are infringed in direct litigation while the interests of the company are damaged in derivative litigation. Second, the direct litigation aims to protect the rights of an investor, while indirect derivative litigation aims to protect the rights of the company and the interests by judgment are attributed to the company rather than the investor.

4. Informal method: dialogues with the management of the company

In recent years, institutional shareholders have started to pay more attention in communicating with the management of the companies. The communication with the operators of the companies in Japan includes two aspects. The management of the company should actively explain for the shareholders the management policies, such as the takeover activities. Institutional shareholders can also propose some advices for the management.

The PFA utilizes informal communications with operators of portfolio companies. On most occasions, portfolio companies would actively explain to the PFA the background and reasoning behind company proposals which is helpful for the disclosure of detailed information of companies and the reasons for their actions and proposals to public.[202] The

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[200] Japan Companies Act (2005), Article 847(1).

[201] Ibid., Article 847 (3).

[202] Bruce E. Aronson, "A Japanese CalPERS or A New Model for Institutional Investor Activism? Japan's

TSE published the "Report of Corporate Governance" which recorded the situations of communications between institutional investors and portfolio companies.[203] Moreover, institutional investors established the special organization for promoting dialogues with the portfolio companies and imposed the management pressure to improve the corporate governance. For example, the Japan Investor Relations Association (JIRA) established the *Action Chapter* in December of 2008 to improve the development of communication activities and corporate value and capital market.[204] The JIRA is the only privately-run non-profit organization working for proliferation and improvement of communication activities between institutional shareholders and managers.

4.2.2.2 Special guidelines for institutional participating in corporate governance

Since institutional investors mainly participate in corporate governance through exerting voting rights on proposals submitted at shareholder meetings, these investors need the guidelines covering standards or criteria to check and analyze the corporate governance practices of companies which such investors have invested. According to these guidelines, institutional investors may vote on or against the proposals in order to protect the rights and profits of shareholders and promoting the monitoring role on managers. Besides, Aibara (2002) explained the needs for establishing Principles for Exerting Voting Rights of Institutional Investors since the exerting voting rights actually embodied fiduciary liability.[205] Therefore,

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Pension Fund Association and the Emergence of Shareholder Activism in Japan," *NYU Journal of Law and Business* 7, no.2 (2011): 38-39.

[203] Besatsu shoji homu henshu bu, *Jojo kaisha no atarashi corporate governance* [New Corporate Governance in the Listed Company], in *Besatsu shoji homu* [Separate Volume of Commercial Law], no.344 (2010): 99-100.

[204] *Nippon keizai shinbun* [Japanese Economic News], (December 4, 2008).

[205] Takashi Aibara, *Kikan toshika no kabunushi katsudo*, [The Shareholders' Activity of Institutional Investors], in *Ho to seiji* [Law and Politics] 53, no.4 (2002): 833-845.

establishing guidelines of exercising voting rights for institutional investors is quite critical.

Actually, the establishment of guidelines of exerting voting rights in Japan experienced a continuous process of development. According to the main body of establishing guidelines of voting rights in Japan, the guidelines might be categorized into three parts as follows: (a) established by Pension Fund Association in Japan; (b) established by organization services for institutional investors; and (c) established by institutional investors other than Pension Fund Association.

1. Guidelines of the Pension Fund Association

The Pension Fund Association (PFA, *Kosei Nenkin Kikin Rengokai*), which represents the federation of corporate pension funds, was established in 1967, and became the leading and the most active institutional investor in Japan and the 11th largest pension fund in the world.[206] The responsibilities of the PFA include two points: a) act as the umbrella organization for corporate pension funds in Japan, and b) manage retirement assets for individuals who have left corporate employment in mid-career or whose company pension plans have dissolved.[207] Also, the PFA has to fulfill the fiduciary responsibilities to participate in corporate governance on behalf of its beneficiaries. The Ministry of Health Labor and Welfare regulates the PFA, which is concerned primarily with policy issues such as the appropriate standards and regulation of pension funds.

Initially, the PFA publicized the "Study Group Report of Corporate Governance of Pension Funds" in 1998 and for the first time clearly proposed that pension funds should be involved in corporate governance through exerting voting rights of fund management.[208] In

[206] Bruce E. Aronson, 36.

[207] Pension fund association, "what is the pension fund association?" http://www.pfa.or.jp/english/english01.html (accessed on February 11, 2012).

[208] Research Center of Pension Fund, ed., *Kikan toshika no kabunushi giketsuken koshi to Corporate*

1999, the PFA represented the federation of corporate pension funds and proposed basic principles for fund management. The principles stipulated that "the trustee would exercise the voting right of the shareholder only for the profit increase of the Association as an investor."[209] Thus, the principles clarified the ambiguous of fiduciary obligations through the exercise of voting rights in Japan. In 2000, the PFA publicized the Trustee Liability Handbook (Asset Management Agencies), which proposed that the trustee liability includes the exerting voting rights.[210]

Accordingly, the PFA set up the system of managing funds mainly by asset management agencies.[211] In this context, the Finance Services Agency (FSA) of Japan established a manual for investment advisory companies in April, 2002, covering the exercise of voting rights.[212] On October 5, 2001, the Japan PFA set up *Guideline for Exercising Voting Rights*, which further requires asset management agencies as trustees to attach importance to the interests of shareholders through exerting voting rights.

In addition to delegating investment fund managers the right to manage and operate the investments, the PFA began to be involved in investment management. On February 20, 2003, the PFA established and issued the guideline named as *Criteria for Exercising Voting Rights of Shareholders*. This guideline signaled that the PFA began exercising voting rights with respect to in-house management sections. This guideline consisted of three parts: 1) "basic way of thinking"; 2) "principles of corporate governance"; and 3) "specific criteria for exercising

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Governance [The Exerting Voting Rights of Institutional Investors and Corporate Governance], in *Besatsu shoji homu* [Separate Volume of Commercial Law], no.274 (2004): 97.

[209] Research Center of Pension Fund, ed., [The Exerting Voting Rights of Institutional Investors and Corporate Governance], 98.

[210] Ibid.

[211] Ibid.

[212] Hidetaka Kawakita, 106.

voting rights of shareholders."[213]

With the increase of hostile mergers and acquisition in Japan in recent years, many companies were eager to introduce anti-takeover measures, which triggered opposition of some institutional investors. In this context, the PFA developed its own proxy voting criteria for takeover defenses named as *Guidelines for the Exercise of Shareholder Voting Rights on Anti-takeover Measures* in April 2005, which includes: (a) sufficient explanation of long-term shareholder value; (b) shareholder approval; (c) approval by independent directors or clear provisions which prevent arbitrary decisions by management; and (d) limited duration.[214] This guideline aimed to make shareholders vote against the anti-takeover proposals only for self-protection of managers rather than shareholders' interests.

In February 2007, the PFA revised the *PFA Corporate Governance Principles* (hereinafter *Principles*). These new principles referred to several aspects of corporate governance: (a) proposals concerning corporate organization; (b) proposals concerning director compensation; (c) capital Policy; (d) amendment of Articles of Incorporation; (e) election of directors; and (f) shareholder proposals.[215]

The PFA votes against company proposals according to two original standards under the *Principles*, covering: (a) a company incurred three straight years of losses and no dividend payout or five years of cumulative losses (the 3/5 performance rule); or (b) if during the directors' term there was a violation of law or other matter of corruption which had a large impact on the company (scandal rule).[216] Accordingly, for proposals concerning director compensation, the *Principles* generally favor director compensation proposals, unless the 3/5

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[213] Bakushu Lee, 58-59.

[214] Bruce E. Aronson, 45.

[215] Pension Fund Association Corporate Governance Principles (2007), http://www.pfa.or.jp/jigyo/shisan/gava_giketsuken/files/gensoku_e.pdf (accessed on May 21, 2012).

[216] Bruce E. Aronson, 44.

rule applies; proposals for revision of director compensation unless it is large and there is no persuasive explanation; and favor of retirement bonus for corporate auditor unless scandal rule applies.

Concerning election of directors, the PFA adopts a new proxy voting guideline on return of equity and required that the shareholders could vote against the election of directors at general meetings when the return on equity is less than 8 percent for 3 consecutive years (the "ROE 8% rule").[217] This guideline is the most aggressive guideline in Japan.[218] However, since a substantial number of PFA portfolio companies have failed to meet the ROE rule and PFA often vote against the election of directors, a series of rules covering the "ROE 8% rule" was abolished by the new Criteria in 2011.[219] According to the new Criteria in 2011, more importance is attached to the actual performance of management of the company than formal criteria.

On February 15, 2010, the PFA further strengthened the criteria of the *Principles* and exercise of voting rights by shareholders. Moreover, the PFA revised the criteria of outside auditors, requiring the announcement of results of voting.[220] In 2011, the PFA further simplified the guideline of exercising voting rights.[221] Such changes benefit the PFA to involve in corporate governance and more concern about the actual performance of the portfolio companies. Thus, as Ema indicates, "the PFA is the leading active institutional

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[217] Pension Fund Association, PFA Corporate Governance Principles, (effective February 28, 2007),

[218] Bruce E. Aronson, 46.

[219] Naoyoshi Ema, *Kikan toshika ni yoru giketsuken koshi no jokyo: 2011nen kabunushi sokai no kensho* [Status of the Exercise of Voting Rights by Institutional Investors: Verification of the General Meetings in 2011], in *Shoji homu* [Commercial Law] no.1946 (November 11, 2011): 17-18.

[220] Naoyoshi Ema, [General Meeting in 2010], 40.

[221] Naoyoshi Ema, [Verification in 2011], 17-18.

shareholder for good corporate governance in Japan."[222]

2. Guidelines established by organization service for institutional investors

The Institutional Shareholder Service (ISS) is a famous organization service for institutional investors in the US and provides advice on proxy voting services and research and consulting advice to institutions.[223] Similar to the US, many institutional shareholders in Japan would vote at shareholder meetings on the basis of comments and suggestions by the ISS. The ISS is different from professional analysts of securities companies and investment companies as it does not engage in any securities transactions. Moreover, institutional investors do not have a duty of consulting ISS, and have to hold the liabilities even if such institutions consult ISS.

As an advisory company of institutional shareholder exercising voting rights, the ISS has brought significant influence on institutional voting in Japan.[224] The ISS mainly provides following services for institutional investors in Japan including: (a) the analysis of proposals on the general meeting and service for exercising voting rights; (b) the research on the merger and acquisition of companies; and (c) the research on investment of social responsibility and datum of securities class action.[225]

On the basis of complying with Japanese law, the ISS provides consulting services for institutional investors and plays a critical role in improving corporate governance in Japan. In December 2010, the ISS issued the amendment entitled *Policy on the ISS providing advice for*

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[222] Naoyoshi Ema, [Verification in 2011], 55.

[223] Carolyn Kay Brancato, *Institutional Investors and Corporate Governance*: best practices for increasing corporate value, (IRWIN Professional Publishing, 1997), 83.

[224] Yoshinori Suzuki, *Kikan toshika to kabunushi sokai* [Institutional Investors and Shareholder Meeting], in *Shokei ronso* [Colloquia of Commerce and Economics] 42, no.1 (2006): 57.

[225] Ibid., 50.

the exercise of voting rights of institutional investors in Japan.[226] The ISS revised three points of this policy including: election of directors, director retirement bonus, and stock option plan. The ISS advises to oppose the plan of director retirement bonus without disclosure; and also advises to approve in the case of particular performance.

3. Guidelines by other institutional investors and ultimate investors

In addition of the PFA, other institutional investors may write up their own *Corporate Governance Principles* covering guidelines for exerting voting rights. For example, in practice, some asset management institutions as trustees of institutional investors may establish their own guidelines for exerting voting rights to exercise voting rights. Sometimes the investors who own ultimate profits may provide for the asset management institutions with some instructions concerning guidelines. In such a case, it should take precedence of the specific instructions for institutional investors provided by the ultimate investors, rather than the guidelines developed by institutional investors.[227] In other words, institutional investors should comply with the instructions of the ultimate investors rather than the guidelines of asset management institutions.

Under the guidelines of exercising voting rights, institutional investors have been more concerned with exerting voting rights in recent years. According to an inquiry of 100 companies by the Security Department of Chuo Mitsui Trust and Banking Co., Ltd., the maximum rate of voting by domestic institutional investors reached 100 percent in 2011.[228]

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[226] Masafumi Kawamura, *2011 nen ISS giketsu ken koshi jogen hoshin*, [2011 ISS Providing Advice for the Exercise of Voting Rights of Institutional Investors], (April 28, 2011), http://www.simpral.com/20110428.pdf (accessed on May 3, 2012).

[227] Naoyoshi Ema, [General Meeting in 2010], 40.

[228] Naoyoshi Ema, [Verification in 2011], 19.

Table 4: Japan Securities Investment Advisers Association Questionnaire
Transition of the Ratio of Opposition and Abstention on Proposals of Companies

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Percentage of the Number of Companies	8%	20%	29%	39%	50%	48%	40%	39%	33%
Percentage of the Number of Proposals	3%	6%	11%	15%	15%	10%	11%	10%	11%

Source: Naoyoshi Ema, *Kokunai kikan toshika ni yoru giketsuken koshi no jokyo: 2010 nen kabunushi sokai wo furi kae te* [Status of Exercise of Voting Rights by Domestic Institutional Investors: Looking Back on the General Meeting of Shareholders in 2010], in *Shoji Homu* [Commercial Law] no.1914 (2010): 41.

Shareholders may oppose a company proposal if it has not met the criteria required by guidelines. Application of these proxy guidelines has resulted in increasing institutional investors voting against the proposals of a large number of portfolio companies (See Table 4 for transition of the ratio of opposition and abstention on proposals of companies).

4.2.2.3 Indirect manner

In practice, companies need providing convenient conditions for institutional attending shareholders' meetings. For example, for institutional investors who invest in many companies, the most serious problem is the concentration of companies on the same date for account settlement and general meetings; the period between the mailing date giving notice for the general meeting and the date for the actual general meeting is quite short.[229] The period between the mailing date of proxy and the deadline is also very short. Therefore, listed companies should provide various approaches to facilitate institutional investors to attend general meetings.

The Companies Act 2005 of Japan provides the electromagnetic method. According to Article 312, "if the votes are exercised by an electromagnetic method, it should be exercised

[229] Bakushu Lee, 64-66.

by providing the matters to be entered on the voting form to the stock company, with the approval of such stock company, no later than the time prescribed by the applicable Ordinance of the Ministry of Justice in accordance with the provisions of the applicable Cabinet Order."[230] The stock exchanges make efforts to promote listed companies to utilize this platform of exercising voting rights.[231]

According to Article 446 of *Securities Listing Regulations of Tokyo Stock Exchange*, "the listed companies that issue the shares shall endeavor to facilitate the environment of exercise of voting rights in the shareholders' meetings according to *Securities Listing Implementing Regulations*."[232] According to Article 437 of *Securities Listing Implementing Regulations of Tokyo Stock Exchange*, listed companies should endeavor to facilitate the environment of exercise of voting rights in the shareholders' meetings, covering four aspects including: (1) Avoiding holding the annual general meetings on the same day when other listed companies hold the annual general meetings of shareholders; (2) sending the notice of the convocation of the general meeting two weeks before the general meeting is convened; (3) providing for the investors with electromagnetic means as soon as possible after sending the notice of convocation so that investors may exercise voting rights efficiently; and (4) providing the investors with the notice of convocation of the general meetings translated in English.[233]

Due to the encouragement of legislation, overseas institutional investors utilize the platform of voting rights exercising by electromagnetic avenues broadly in practice. However, there are still few domestic institutional investors utilizing this platform because the costs of

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[230] Japan Companies Act (2005), Article 312.

[231] Besatsu shoji homu henshu bu, [New Corporate Governance in the Listed Company], 100.

[232] Securities Listing Regulations of Tokyo Stock Exchange, Article 446.

[233] Securities Listing Implementing Regulations of Tokyo Stock Exchange, Article 437.

electromagnetic avenues are high.[234] In spite of this problem, some advantages contribute to this platform. First, the platform may save the time for institutional investors to analyze the proposals of the companies they have invested. Second, the platform may save the cost of exercising voting rights, which may facilitate for institutional shareholders to participate in and exert voting rights at shareholder meetings effectively. Third, if institutional investors have the questions about the notice of convocation, then they have the time to confirm to the company.[235]

4.2.3 Legal framework for regulating institutional investors

Recently, with the increase of participation in corporate governance of institutional investors in Japan, the legal framework which strengthens the regulation on the conduct of institutional investors becomes important.[236] The legal framework of regulating institutional investors might be classified into two aspects. First, during the process of participation in corporate governance, the legislation requires institutional investors disclosing the results of exerting voting rights and the information during soliciting proxy voting. Second, this section discusses the regulation of wrongful trading acts of institutional investors to promote effective participation.

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[234] Yuki Kimura, *Corporate governance ni kakaru joho kaiji jujitsu no kensho* [Verification of Full Disclosure of Information of Corporate Governance], in *Shoji homu* [Commercial Law], no.1966 (2012):35-36.

[235] Takeyuki Ishida, *2012 nen ISS Giketsu ken koshi jogen hoshin* [The Policy of Advice of Exercising Voting Rights], in *Shoji homu* [Commercial Law] no.1960 (2012):49.

[236] Tadao Kagono, 2-10. Linyu Zhai, *Corporate governance ni okeru kikan toshika no yakuwari* [The Role of Institutional Investors in Corporate Governance], in *Keei kenkyu* [Management Research] 60, no.3 (2010): 1.

4.2.3.1 Disclosure during participation in corporate governance

1. Disclosing voting results: extraordinary report

The legislation of Japan not only requires institutional investors to actively exert voting rights, but also requires them to disclose the results of exerting voting rights. Lee (2007) insisted that "It was necessary for the legislator to set up related legislation on efficient disclosure to require them to disclose information of meeting with managers and other information to prevent from wrongful behaviors."[237]

On March 31, 2010, the FSA of Japan published and implemented the amendments to *Cabinet Office Ordinance on Disclosure of Corporate Information* (*Cabinet Office Ordinance*) requiring shareholders to submit the Extraordinary Report and disclose their exercise of voting rights. The contents of disclosure of exerting voting rights primarily consist of two parts, including recording content of exercising voting rights and announcing the results of exercising voting rights.

(1) Records of content of exercising voting rights

The *Cabinet Office Ordinance* requires recording the content of exerting voting rights as a legal liability. The Extraordinary Report requires recording the results of the exercising voting rights. The contents of the Extraordinary Report consists of four aspects: a) the time of holding shareholder meeting; b) the content of voting; c) the numbers of voting for or against as well as those that abstain from voting on the proposal, and the satisfied conditions of passing resolutions and the results of voting; and d) the reason why the shareholders who have attended general meetings and exercised voting rights are not counted in the numbers of votes.[238] Particularly speaking, the legislation requires reporting the quorum of attending the

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[237] Bakushu Lee, 49-71.

[238] Department of Strategic Planning of Mizuho Bank, *Giketsu ken koshi keka no kaiji ni kakaru rinji*

general meeting and the elements that approve the proposals.[239]

According to this regulation, the company does not only disclose whether each resolution was accepted or rejected, but also disclose the numbers of votes for support or objection. At the same time, the company should not only record the general scope but also the accurate number of voting for or against the proposal. Thus, the disclosure provides public investors the detailed information of listed companies and the situation of institutional investors' participation in corporate governance, which may bring two effects. On one side, the regulation may promote the institutional investors to be involved in corporate governance of portfolio companies. On the other side, the regulation may also strengthen the liability of on institutional investors as trustees, preventing them from exercising voting rights in a disordered and unlawful way only for their own interests rather than the value of the company and the profits of the ultimate investors. In addition, according to the results of a vote, the Extraordinary Report should be submitted to the Prime Minister without delay.[240]

(2) Announcement the results of the exercising of voting rights

The announcement by a company refers to the statistics that result from the process by which institutional shareholders exercise voting and are reported to the actual fund owners as well as to the public. The specific procedure of announcement consists of collecting, counting and publishing the content and results of exercising voting rights of shareholders.

In June of 2009, the FSA of Japan for the first time discussed the "announcing voting results of institutional shareholders" in the report entitled *International Research Group*

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houkokusho no kisai jirei no bunseki [Analysis of the Cases in Extraordinary Report on the Disclosure of Results of Exercising Voting Rights], in *Besatsu shoji homu* [*Separate Volume of Commercial Law*] no. 348 (2010): 4.

[239] Japan Cabinet Office Ordinance on Disclosure of Corporate Affairs (2010), Article 19-2 (9) (2).

[240] Japan Cabinet Office Ordinance on Disclosure of Corporate Affairs (2010), Article 19-2 (9) (2). Financial Instruments and Exchange Act (2006), Article 24 (5) (d).

Report on Financial and Capital Market of Japan - Strengthen the Corporate Governance of Listed Companies. The problem of investors exercising voting rights dedicates one chapter as being "very important for shareholders to monitor corporate performance and regulate it as the obligation and responsibility of shareholders in order to improve corporate governance."[241] At the same time, this report also provided that "it can not only announce the results of vote for or against the proposals, but also the particular number of voting."[242]

In practice, the Tokyo Stock Exchange (TSE) republished a pronouncement in October 2009 entitled of *Request for Announcement of Voting Result of Proposals on General Meeting*. Though this was not legislation, many companies responded to the call of the Tokyo Stock Exchange and started to publish the voting results.[243] This report in 2009 caused the FSA of Japan to modify the *Cabinet Office Ordinance*.

On March 31, 2010, the FSA published and implemented the *Cabinet Office Ordinance* and required announcing voting results as a legal liability. According to the *Cabinet Office Ordinance*, the results of voting for or against proposals have to be announced to public since the shareholder meetings of 2010 June.[244] As a result, there were two influences. One, the institutional shareholders in listed companies has a liability to exercise voting rights legally and reasonably. Two, this regulation is helpful to improve the transparency of listed

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[241] Yuki Kimura, *Kikan toshika no giketsuken koshi keka kaiji to kongo no kadai* [The Disclosure of Result of Exercising Voting Rights of Institutional Investors and Future Challenge], in *Kigyo kaikei* [Corporate Accounting] 63, no.2 (2011): 113.

[242] Ibid.

[243] Akemi Yamazaki, *Kaisei de henka ga yoso sareru kikan toshika no doko* [The Expected Change of the Trend of Institutional Investors in the Amendment], in *Keri joho* [Accounting Information] no.1246 (2010): 34.

[244] Japan Cabinet Office Ordinance on Disclosure of Information of Enterprises, revised in June 2010 and enforced in October 1, 2010.

companies and protect the rights of minority shareholders.[245]

Under the requirement of the *Cabinet Office Ordinance*, a large amount of institutional shareholders have to fulfill the duty of disclosing voting results in their own rule of exercising voting rights. Thus, such requirement has strengthened the trustee liability of institutional investors and promoted them to involve in corporate governance by exerting voting rights at shareholder meetings.

2. Disclosing duty of soliciting proxy voting

A shareholder may exercise the voting right by proxy in a joint-stock company according to Article 310(1) of the Companies Act 2005 of Japan. The proxy should be submitted in writing to the company from the shareholder or proxies evidencing the authority of proxy. Furthermore, each shareholders meeting should make the grant of the authority of proxy.[246] This stipulation aims to prevent from the managers who may control business of the company abusing the proxy voting rights.[247] The legislation also prohibits from soliciting proxy voting rights in some circumstances. According to Article 194 of the Financial Instruments and Exchange Act of Japan, “No person shall conduct solicitation for having said person or a third party exercise by proxy the voting rights pertaining to the shares of the company which issues the shares listed on a financial instruments exchange, in violation of the provisions of a Cabinet Order.”[248]

The *Cabinet Office Ordinance on Solicitation to Exercise Voting Rights of Listed Shares by Proxy* stipulates that “The solicitors should give the shareholders the document stating

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[245] Naoyoshi Ema, [General Meeting in 2010], 39.

[246] Japan Companies Act (2005), Article 310(1) and (2).

[247] Kenjiro Egashira, *Kabushiki kaisha ho* [Laws of Stock Corporations], (Yuhikaku Press, 2008), 314.

[248] Japan Financial Instruments and Exchange Act (2006), Article 194.

matters of reference for the exercise of proxy votes."[249] This provision actually imposes the duty of disclosing and instructing information on solicitors to shareholders.

Furthermore, the solicitors should state clearly by voting to approve or disapprove on the issues of resolutions in the document evidencing the authority of proxy provided.[250] This stipulation ensures that shareholders have the option to vote to approve or disapprove issues submitted to such shareholders and to vote for or against the proposals. Meanwhile, the stipulation also requires solicitors to disclose the soliciting information in detail to the shareholders.

The prohibition of soliciting proxy voting rights consists of two purposes. First, such prohibition aims to prevent some directors from abusing solicitation of exercising voting rights for their own interests. Second, the prohibition implies that solicitors should disclose enough information in detail to the shareholders and reflect the will of shareholders.[251]

4.2.3.2 Regulation on institutional wrongful trading acts in the stock market

1. General provision on the prohibition of wrongful acts

Article 157 in the Financial Instruments and Exchange Act 2006 is a general provision of prohibiting wrongful acts covering insider trading and manipulation in stock markets, which can be applied to anyone in the stock market. According to this provision, "no person shall conduct the following acts: (1) to use wrongful means, schemes or techniques with regard to sales and purchase or other transactions of securities or derivative transaction; (2) to acquire

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[249] Order for Enforcement of the Financial Instruments and Exchange Act Article 36-2 (1). Cabinet Office Ordinance on Solicitation to Exercise Voting Rights of Listed Shares by Proxy, Article 1.

[250] Cabinet Office Ordinance on Solicitation to Exercise Voting Rights of Listed Shares by Proxy, Article 10.

[251] Masayuki Kawamura, ed., *Kinyu shohin torihiki ho* [Financial Instruments and Exchange Act], (Chuo keizai sha, 2009), 175.

money or other property, using a document or other indication which contains false indication on important matters, or lacks indication about important matters necessary for avoiding misunderstanding, with regard to sales and purchase or other transactions of securities or derivative transactions; (3) to use false quotations in order to induce sales and purchase or other transactions of securities or derivative transaction."[252] The Financial Instruments and Exchange Act 2006 imposes the heaviest criminal penalty on the violators of this provision.[253]

Since the securities trading behaviors in the stock market is complicated, the specific legal regulations are difficult to supervise on every kind of particular misconduct; and the legislation is impossible to enumerate all of misconduct in the financial instruments markets in detail.[254] Article 157 as a general rule aims to compensate for the lack of specific rules and prevent some misconduct from escaping liabilities due to the scarce of legal regulations.[255] Thus, this general rule covers every wrongful conduct covering insider trading and manipulation in the stock market, which means that this general rule overlaps with some specific rules such as insider trading and manipulation.

However, some scholars maintained that "there are few cases which are applied to this general rule in reality since such rule is too abstract to explain."[256] Moreover, "this general rule is less expected to bring the effect since it is difficult to prove the liability in practice and the main purpose of this rule is to play a deterrent function."[257]

2. Regulation on insider trading

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[252] Japan Financial Instruments and Exchange Act (2006), Article 157.

[253] Ibid., Article 197-1(5).

[254] Hideki Kanda, Etsuro Kurunuma and Naohiko Matsuo, *Kinyu shohin torihiki ho commentary* [Financial Instruments and Exchange Act Commentary], vol.4, (Shoji homu, 2011), 12.

[255] Ichiro Kawamoto and Yasunami Otake, *Kinyu shohin torihiki ho gaisetsu* [Financial Instruments and Exchange Act Primer], (Yuhikaku, 2008), 395-396.

[256] Hideki Kanda, Etsuro Kurunuma and Naohiko Matsuo, 6-7.

[257] Ibid.

The legislation on insider trading in Japan derives from the Tateho Chemistry Industry in (1987), which offered an opportunity to establish legal regulations on insider trading when the amending the Securities Exchange Law in 1988.[258] According to the Financial Instruments and Exchange Act 2006, the provisions in Japan are composed mainly of two aspects: insider trading and short-swing trading.[259]

Insider trading means that when persons who has come to know any material fact relating to the business make sales or purchase, other types of transfer for value or acceptance of such transfer for value, before the material facts pertaining to business or other matters are publicized.[260] Institutional investors who purchase the shares of a listed company just for short-term interests are reluctant to hold shareholdings for long term to develop value and improve better corporate governance in order to obtain long-term and large returns. The subjects of insider trading may be categorized into three aspects, including (1) corporate insiders; (2) quasi-insiders; and (3) direct recipients of information from insiders and quasi-insiders. These three aspects will be explained below.

(1) Corporate insiders

According to Article 166(1) of the Financial Instruments and Exchange Act 2006, a corporate insider who has come to know any material fact relating to the business, should not make sales or purchase, other types of transfer for value or acceptance of such transfer for value, before the company publicizes the material facts pertaining to business or other

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[258] Shigeo Itoi, *Nichibei no insider torihiki kisei: kinyu keizai no shinten to shoken shijo kisei no sai kouchiku* [The Regulation of Insider Trading in Japan], in *Matsusho tandai rongyo* [The Journal of Matsusho Gakuen Junior College] no.49 (2000): 17-18.

[259] Tomonobu Yamashita and Hideki Kanda, *Kinyu shohin torihiki ho gaisetsu* [Financial Instruments and Exchange Act] (Yuhikaku Press, 2010), 288-289.

[260] Financial Instruments and Exchange Act (2006), Article 166.

matters.[261] Pursuant to Article 166(1) (ⅱ), corporate insiders not only include an officer, agent, employee or other worker of the listed companies, but also the shareholder who has the right prescribed in Article 433(1) of the Companies Act 2005.[262] These shareholders consist of two kinds of shareholders: (a) the shareholders having not less than three percent of the votes of all shareholders; and (b) the shareholders having not less than three percent of the issued shares.[263]

(2) Quasi-insiders

A quasi-insider is a person who has statutory authority over the listed company, such as auditors or accounting auditors in the company; or a person other than an officer of the company who has concluded or is in negotiation to conclude a contract with the listed company.[264]

(3) Direct recipients of information from insiders and quasi-insiders

According to Article 166 (3), the subject of insider trading also covers a person who has received information on a material fact pertaining to business or other matters on a fact concerning launch of tender offer or a fact concerning suspension of a tender offer from the persons concerned with tender offer referred to the persons concerned with tender offer before the material fact pertaining to business or other matters is publicized.[265]

The material facts are the basis of conducting insider trading. The material facts pertaining to business or other matters mainly covers the points that may have important influence on investors' investment decisions and consist of three aspects below.[266]

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[261] Financial Instruments and Exchange Act (2006), Article 166(1).

[262] Ibid.

[263] Japan Companies Act (2005), Article 433(1).

[264] Financial Instruments and Exchange Act (2006), Article 166 (1) (ⅲ) and (ⅳ).

[265] Ibid., Article 166 (3), Article 167 (3).

[266] Ibid., Article 166 (2).

The first one refers to a) a decision by the organ of the listed company. This type covers some critical facts such as share exchange; share transfer; merger; company split; transfer or acquisition of transfer of whole or part of its business; dissolution and commercialization of new products or new technology.[267] Accordingly, material facts would likely influence the investment decisions of investors.

The second one is b) the occurrence of any of the following facts in the listed company. This type covers two aspects when occurring any of the facts in the listed company, including damage arising from disaster or in the course of performing operations and any change of its major shareholders, and facts that may be a ground for delisting or recession of registration of regulated securities or options.[268]

The third one is c) existence of difference between the latest publicized forecasts of net sales, current profits or net income or of the dividend in the listed company, and new forecasts thereof newly prepared by the listed company or the results in the settlement of account for the business year of the listed company.[269] When the difference between the latest publicized forecasts and new forecasts thereof newly prepared reaches to some standard, it forms the material fact.

Material facts also covers things concerning the operation, business or property of the listed company that may have a significant influence on investors' investment decisions; a decision by the organ of a subsidiary company of the listed company, which is responsible for making decisions on the execution of the operations of the subsidiary company to have the subsidiary company carry out any of the material matters or a decision by said organ not to have the subsidiary company carry out the matter which is decided to be carried out in such a

[267] Financial Instruments and Exchange Act (2006), Article 166 (2) (i).

[268] Ibid., Article 166 (2) (ii).

[269] Ibid., Article 166 (2) (iii).

decision.[270]

Concerning liabilities of insider trading, legislation in Japan gives the conduct of insider trading three liabilities including the civil liability, criminal liability and administrative liability. There are no direct civil remedies or liabilities on insider trading provided in the Financial Instruments and Exchange Act 2006. As a result, a violation may give rise to an action for damages under the general tort liability of Article 709 of the Civil Code of Japan. Thus, a conduct of insider trading in Article 166 constitutes the civil liability in Article 709 of the Civil Code. However, the plaintiff is hard to prove that the causal relationship between damage results and the behavior of insider trading, so that it is less easy for the court to admit the liabilities of the defendant. There is one case judged by Tokyo District Court which denied the casual relationship in the decision.[271]

When insider trading constitutes a criminal offense, the responsibilities will cause the criminal sanction by imprisonment with work for not more than five years or by a fine of not more than five million yen, or both.[272] In the case of a juridical person, such a person shall be punished by the fine of not more than 500 million yen.[273] Actually, the criminal penalties on insider trading in Japan have been strengthened in the past several years. The legislation was revised in 1997 to impose violators on imprisonment with work for not more than three years, while it has increased to five years and strengthened the punishment on insider trading conductors in current legislation.[274]

In recent years, the SESC has strengthened the enforcement of legal regulation on insider trading through the utilization of the administrative monetary penalty which is a relatively

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[270] Financial Instruments and Exchange Act (2006), Article 166 (2) (iv) and (v).

[271] Heisei 3.10.29, Tokyo District Court, in *Kinyu homu jijo* no.1321 (1992): 23.

[272] Financial Instruments and Exchange Act (2006), Article 197-2 (13).

[273] Ibid., Article 207-1 (2).

[274] Shigeo Itoi, 17-18.

important method of regulating insider trading now.[275] To sum up, the legislation on liability of insider trading has been strengthened in the past several years, especially the introduction of the system of administrative monetary penalty. Meanwhile, there is no special provision about civil liability on insider trading in the Financial Instruments and Exchange Act 2006, while the criminal and civil regulations are taken more seriously.

(3) Short-swing trading

Short-swing trading is also the misconduct which institutional investors might become involved within the stock market. Short-swing trading is an important part of insider trading in Japan. However, the difference between the two acts requires insiders to make use of secret information during insider trading.

According to the Financial Instruments and Exchange Act 2006, "in order to prevent wrongful use by officers or major shareholders of a listed company of secret information they have obtained in the course of their duty or by virtue of their position, managers and principal shareholders who hold 10 percent shareholdings of voting rights must return the profits gained from any purchase and sale transaction to the listed companies within a 6-month period."[276] Accordingly, the object of regulation on short-swing trading covers the institutional shareholders who hold 10 percent shares for voting rights.

Moreover, the insiders who obtain the secret information objectively have a duty of reporting the trading information. According to Article 163 (1), the officer or said major shareholder should submit a report on such sales or purchase or other transaction to the Prime Minister on or before the 15th day of the month following the month which includes the day

[275] Financial Instruments and Exchange Act (2006), Article 197-2 (13), Article 175 (1) and (2).

[276] Ibid., Article 164.

of such sales and purchase.[277]

3. Prohibition of market manipulation

Manipulation as a typical fraudulent conduct in the stock market can have a negative effect on the price mechanism and lead the stocks to deviate from real situation of the company. Thus, the stock market will lose its effective role in capital allocation. This study introduces two points of legislation of manipulation of stock price including: (1) manners of manipulation of stock price; and (2) provisions for liabilities.

(1) Manners of manipulation of stock price

According to Article 159 of the Financial Instruments and Exchange Act 2006, the behavior of market manipulation which aims to mislead other persons into believing sales and purchase of securities generally can be classified into five types below.

The first two types includes: a) conduct fake sales and purchase of securities, fake market transactions of derivatives or fake over-the-counter transactions of derivatives without purpose of transfer of right, or paying or receiving money, or granting or acquiring of options; and b) sell (or purchase) financial instruments based on collusion made in advance with another party in which the other party promises to purchase (or buy) the financial instruments at the same price and around the same time the seller sells them.[278] The key point of these two types is to conduct fake transactions without purpose of transfer of right, or paying or receiving money, or granting or acquiring of options. The difference between the two types is that a) is the conduct of individuals, while b) is the conduct of collusion with other party.

The third type refers to c) conduct a series of sales and purchase of securities or make an offer, entrustment or accepting an entrustment that would mislead other persons into believing

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[277] Financial Instruments and Exchange Act (2006), Article 163 (1).

[278] Ibid., Article 159.

that sales and purchase of securities, are thriving or would cause fluctuations in prices of listed financial instruments.[279] Two factors contribute to this type. First, the conduct would mislead other persons into believing that sales and purchase of securities are thriving or would cause fluctuations in prices of listed financial instruments. Second, the purpose of conduct is to induce the stock transaction.

The fourth type is that d) spread a rumor to the effect the prices of securities, or intentionally make a false indication or an indication that would mislead other parties with regard to important matters for the purpose of inducing sales and purchase of securities.[280] There are also two critical factors of this type, which includes that the purpose of inducing trade and make a false indication or an indication that would mislead other parties with regard to important matters for the purpose of inducing sales and purchase of securities.

In addition, the fifth type refers to e) conduct a series of sales and purchase of securities or make an offer, entrustment or accepting an entrustment for the purpose of pegging, fixing or stabilizing prices.[281] The conduct of this type also contributes to the regulation of manipulation. Different from the other types of misconduct, the key point of e) is that fix the stock price from fluctuating, rather than cause to fluctuations in the prices. However, it is the artificial manipulation that stabilizes the stock price from decline, so this conduct like other manipulation behaviors would also impair the function of the market and investors.

(2) Provisions for liabilities

The conduct of manipulation can contribute to three kinds of liabilities, including civil compensation for damages, criminal, and administrative liability. A provision on civil liability of manipulation of stock price is provided in the Financial Instruments and Exchange Act

[279] Financial Instruments and Exchange Act (2006), Article 159.

[280] Ibid.

[281] Ibid.

2006. Pursuant to Article 160(1), "a person who has violated Article 159 is liable for the damages suffered by any person who conducted, or entrusted another person with sales and purchase of the securities."[282]

In terms of burden of proof, according to Article 160 (1), in order to identify the manipulation of the defendant, the plaintiff has to prove the fact that he or she traded the shares according to the manipulated stock price and had a loss which can be difficult to prove by an individual investor. Hence, some scholars insist that "Article 160 is recognized as the special provision of Article 709 of Civil Law of Japan."[283]

Considering the damage to the stock market and the corporate governance, the Financial Instruments and Exchange Act 2006 gives the manipulation the heaviest criminal sanction, aiming to stabilize the stock market and protect the security of transaction.[284] According to Article 197-1(5), any person who commits manipulation should be punished by imprisonment with work for not more than ten years or by a fine of not more than ten million yen, or both. The property gained through manipulation should be confiscated.[285] Furthermore, a person who has, for the purpose of gaining property benefit, committed manipulation should be punished by imprisonment with work for not more than ten years or by a fine of not more than thirty million yen.[286] Besides, the juridical person who commits the manipulation should be punished by the fine of not more than 700 million yen, which is significant heavy.[287] In addition, legislation in Japan also utilized the administrative monetary penalty.[288]

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[282] Financial Instruments and Exchange Act (2006), Article 160(1).

[283] Tomonobu Yamashita and Hideki Kanda, 324.

[284] Financial Instruments and Exchange Act (2006), Article 197-1(5).

[285] Ibid., Article 198-2.

[286] Ibid., Article 197-2.

[287] Ibid., Article 207-1(1).

[288] Ibid., Article 160.

4. Supervising role of Japanese securities regulatory system

In Japan, under the Financial Services Agency (FSA), the Japanese securities regulatory system is a combination of the Securities and Exchange Surveillance Commission (SESC) as the main body and the supplement Self-Regulation Organizations including Financial Instruments Exchanges and Financial Instruments Firms Association. The development of the stock market in Japan depends on the advocate and support of government in a large extent.

(1) The SESC

The SESC is a subsidiary department of the FSA of Japan, which is the only Japanese financial industry regulator. The FSA has been separated from the Ministry of Finance of Japan and was set up in Cabinet Office of Japan in January, 2001. Furthermore, the SESC was established under FSA. Osaki (2001) maintained that "Similar to the Securities Exchanges Commission (SEC) of the US, the SESC in Japan also owned absolute and comprehensive regulatory authority of the stock market, but less independent than the SEC."[289] Moreover, the SESC does not own the authority of legislation and quasi-jurisdiction.

The Prime Minister delegates to the commissioner of the FSA the authorities vested under the Financial Instruments and Exchange Act 2006. Furthermore, the commissioner of the FSA delegates to the Commission the authorities as follows: 1) securing the fairness in sales and purchase of securities by financial instrument firms and financial instrument exchanges; 2) investigation into a criminal case and accusation of a convinced criminal case; 3) on the basis of the results of investigation into criminal cases, proposing to the Prime Minister and Commissioner of FSA imposing administrative penalties (Commissioner of FSA then may make an administrative penalty decision according to the recommendation of

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[289] Sadakazu Osaki, *Shoken shijo kantoku taisei no arubeki sugata* [Ideal Situation of Securities Regulatory System], in *Shihon shijo quarterly* [Capital Market Quarterly] 5, no.2 (2001): 3.

Commission); 4) proposals to the Commissioner of FSA or Finance Minister establishing legal regulations concerning fair trading and protection of investors. In spite of those authorities to the SESC, the Commissioner of the FSA has authority to issue an order of submission of reports or materials in person.[290]

(2) Self-regulation organizations

In practice, fraud in the stock market is regulated by both of administrative and Self-Regulation Organizations (SROs). At present, some Japanese scholars suggest that the SROs covering Financial Instruments Exchanges (FIE), and the Financial Instruments Firms Association in supervising the conduct of investors in the stock market.[291]

A FIE of Japan should properly conduct the Self-Regulation Related Services in accordance with the Financial Instruments and Exchange Act 2006, its articles of incorporation and other rules in order to ensure fair sales and purchase of securities and market transactions of derivatives on the financial instruments exchange market, as well as to protect investors.[292] Pursuant to this provision, the legislation imposes the duty of conducting self-regulation related services on the FIEs.

The FIEs may entrust all or part of the self-regulation related services to a SRO (meaning a juridical person established for the purpose of conducting self-regulation related services). Alternatively, the FIEs may also establish a Self-Regulating Committee to engage in self-regulation related services.[293]

In practice, in order to prevent insider trading, the SROs such as the Financial Instruments Exchange establishes its own rule of regulating insider trading, which strengthens

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[290] Financial Instruments and Exchange Act (2006), Article 194-7 (2).

[291] Ichiro Kawamoto and Yasunami Otake, 418.

[292] Financial Instruments and Exchange Act (2006), Article 84-1.

[293] Ibid., Article 85-1, Article 105-4 (1).

the role of the Stock Exchange in regulating insider trading. For instance, besides the administrative regulating power of the SESC, the Tokyo Stock Exchange (TSE) is also authorized the power to investigate insider trading of securities companies registered with the TSE.[294]

Furthermore, the regulation of market manipulation has become one of the most critical duties of the Commission, which would regulate the behavior of fraud before and after it occurs. At the same time, the TSE can check the accounting books of the securities companies when they found the abnormal changes of the trading price in the stock market.[295]

(3) The relationship between the commission and self-regulation organizations

Compared to the SESC, the Self-Regulation Organizations have several merits. First, a complicated securities market requires the regulatory authorities own professional and special capability of regulation. Relative to the SESC, SROs are more likely to employ some professional persons to response to the change of securities market promptly and effectively. Second, a complicated and fast-changing securities market needs the flexible regulation to correspond to the changes. The SESC engages in direct regulation according to legal due process and sometimes lacks the flexibility of regulation. In contrast, SROs relative to the SESC may change their rules of regulation, explaining and applying the legal regulations more flexible. Third, the SESC may spend more time and money to supervise conduct in the stock market, while SROs are more likely to understand the transactions of investors they can recognize and discipline misconduct in the stock market as soon as possible.[296]

Although SROs have some merits, they are actually under the supervision of the SESC, which has authority to examine and supervise the activities and the rules of SROs so as to

[294] Ichiro Kawamoto and Yasunami Otake, 457.

[295] Ibid., 418.

[296] Tomonobu Yamashita and Hideki Kanda, 420-421.

maintain a national smooth market system. Some scholars also contend, "Both of the supervision of the SESC and SROs are critical in Japan and they shall play a concurrent role in promoting protection of fair transactions in the financial instruments market."[297]

4.3 Positive and Negative Cases of Institutional Participation in Corporate Governance

4.3.1 Positive cases

4.3.1.1 Voting against the proposals

1. Mitsui Trust Bank

As early as 1998, the Mitsui Trust Bank was one category of institutional investors in Japan which managed the pension fund and began to make voice in shareholders meetings. In the general meeting of June 1998, the Nomura Securities Company and Mitsubishi Motors Corporation made a proposal which paid much retirement allowance to the officer who had the liability of wrongful acts. In response to this proposal, Mitsui Trust Bank exercised their voting rights to oppose the proposals since they actually infringed upon the interests of shareholders.[298]

Before this case, Mitsui Trust Bank had always voted for the proposals of portfolio companies.[299] Thus, this case signals that Mitsui began to change from silent partners into active partners, and they started to make "voice" and participate in corporate governance like the institutional investors in the US. As a trustee of public and private pension funds, the Mitsui Trust Bank began to notice the importance of monitoring the management of the portfolio company and protect the interests of shareholders.

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297 Ichiro Kawamoto and Yasunami Otake, 481-482.

298 Shigeki Sakakibara, *Nenkin kikin no kabunushi kodo shugi no keizai koka* [The Benefits of Shareholder Activism by Pension Funds], *Journal of Economics and Business Administration* 180, no.1 (1999): 93.

299 Ibid.

2. Nomura Asset Management

The basic policy of exercising voting rights of Nomura Asset Management (hereinafter Nomura) is that Nomura will respect the management decisions basically and vote against the proposals that infringe upon the interests of shareholders. On the basis of the policy, Nomura sets up guideline to exercise voting rights in order to seek long-term value of shareholders (See Table 5 for voting of Nomura Asset Management).

Table 5: Voting of Nomura Asset Management: General Meetings from July 2008 to June 2009

Number of Companies	2433
Number of Approval	1712
Number of Opposition	721
Ratio of Opposition	（29.6%）

Proposals Submitted by Companies	Number of Proposals	Approval	Opposition	Ratio of Opposition
Dividends of surplus	1584	1548	36	2.3%
Changes in articles of incorporation	2309	2267	42	1.8%
Election or remove of directors	2149	1853	296	13.8%
Election or remove of auditors	1776	1475	301	16.9%
Director retirement allowance	727	711	16	2.2%
Stock Option Plans	223	205	18	8.1%
Director Compensation	147	134	13	8.8%
Introduction of Anti-takeovers	126	7	119	94.4%
Director bonus	278	225	53	19.1%
Other Proposals Submitted by Companies	353	349	4	1.1%
In Total	9672	8774	898	9.3%

Source: Nomura Asset Management. Naoki Iwata, *Kikan toshika no corporate governance katsudo* [Corporate Governance Activities of Institutional Investors], in *Fund Management* (2010): 30.

The tables above illustrate that the opposing voting ratio of anti-takeovers is high. Since the anti-takeover proposals would limit the chances of stock selling of shareholders, Nomura selected to vote against the proposals unless there was a sufficient explanation of protecting long-term shareholder value. The main reasons for opposing were that the proposals did not meet following two criteria: (1) The duration of information provided by a large-scale purchaser was 60 days; or (2) the return on equity was more than 5 percent for 3 consecutive years (the "ROE 5% rule").[300] Therefore, Nomura set up the guideline aiming to vote against the anti-takeover proposals due to the poor performance and the inconsistent compliance.

Moreover, Nomura Asset Management set up another criterion of exercise of voting rights, which means that a company proposal would be opposed if there is a scandal of the company. Nomura voted against the proposals covering Electing Officers, Director Compensation and Officer Retirement Bonus in the occasion of scandals of the companies Nomura has invested, especially when a scandal was too critical to affect the value of the company.[301]

The scandals in the company primarily covered following several parts: (1) the order of stopping work and the order of business suspension; (2) arresting officers, sending the files to the prosecutor, and prosecution with wrongful acts; (3) disposals by Stock Exchanges according to the related scandals (covering fraud, misrepresentation and inappropriate accounting treatments); (4) payment order for surcharge, the order to pay fine, and the instruction of return; (5) business improvement order, correction order and the order of cease and warning; (6) arresting non-officers; and (7) compulsive investigations.[302]

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[300] Naoki Iwata, *Kikan toshika no corporate governance katsudo* [Corporate Governance Activities of Institutional Investors], *Fund Management* (2010): 30.

[301] Ibid., 31.

[302] Ibid.

3. Cases of Pension Fund Association

Some statistics show that the PFA in Japan also participated in corporate governance in recent years. According to the ratio of voting, the PFA primarily votes against several proposals as follows: (a) dividends of surplus; (b) election of directors and auditors; (c) director retirement bonus; (d) takeover defenses; and (e) changes in articles of incorporation (See Table 6 for exercising voting rights at general meetings of PFA).

Table 6: Pension Fund Association: Exercising Voting Rights at General Meetings (June 2010)

Proposals Submitted by Companies	Approve	Opposition	Ratio of Opposition	Subtotal
dividends of surplus	529	66	11.1%	595
changes in articles of incorporation	152	15	9.0%	167
Election of officers	492	242*1	33.0%	734
Election of auditors	354	55*1	13.4%	409
director retirement bonus	115	40	25.8%	155
Director Compensation	79	10	11.2%	89
Stock Option Plans	55	9	14.1%	64
Election of accounting auditors	8	0	0.0%	8
Entity *2	14	0	0.0%	14
Other Proposals Submitted by Companies *3	400	50	11.1%	450
In Total	2198	487	18.1%	2685
Shareholder Proposals	10	72	12.2%*4	82

*1 including some opposition.

*2 merger, transfer of business, acquisition, share exchange, share transfer, and company split.

*3 Acquisition of own shares, reduction of legal reserves, the third-party allocation of shares, reductions in amount of capital, consolidation of shares, approval of financial statements, directors' bonus paid, election of substitute auditors and takeover defenses.

*4 showing the ratio in favor.

Source: Naoyoshi Ema, [General Meeting of Shareholders in 2010], 41.

4.3.1.2 Litigation

1. *The SFP Value Realization Master Fund Co., Ltd. v. Nireko Co.*[303]

The SFP Value Realization Master Fund Co., Ltd. (hereinafter SFP) is an institutional investor and a limited liability company that primarily invests in equity securities of listed companies in Japan. SFP held 2.85% of total shares issued by Nireko. Co. until March 31, 2005. In order to establish the anti-takeover measures, the board of directors of Nireko made a resolution of issuing stock option on March 14, 2005. SFP claimed that this resolution was illegal in two aspects including: (1) Violation of the order of distributing of authority prescribed by commercial law, and the violation of duty of loyalty and duty of care of directors; and (2) the method of resolution was extremely unfair. Accordingly, the plaintiff SFP filed an action and appealed to the court to suspend this resolution.

The court upheld the petition of the plaintiff and decided to suspend temporarily the issuance of stock option of Nireko. However, the court disagreed with the reason that the issuance of stock option violated the law but claimed that the issuance of stock option was extremely unfair and infringed upon the interests of existing shareholders.

The issuance of stock options in this case did not only infringe upon the common interests of shareholders covering institutional investors but also damaged the long-term value of the company. In this context, the investment fund company brought litigation against the management of the portfolio company. This case is a typical one that institutional investors participate in corporate governance actively and protect shareholders' interests.

2. *Royal Bank of Canada and Effissimo Capital v. New Tachikawa Aircraft Co., Ltd.*

In the general meeting of June of 2008, the New Tachikawa Aircraft Co., Ltd elected

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[303] District Court of Tokyo, June 1, 2005, *Nireko shinkabu yoyaku ken hako sashitome moshitate jiken chisai ketei* [Case of Appealing to Suspend the Resolution of Issuing Stock Option], in *Shoji homu* [Commercial Law] no.1734 (2005): 37-46.

eight new directors. According to the Companies Act 2005, "a shareholder may within three months from the day of resolution of the shareholders meeting claim revocation of the resolution by filing an action when the calling procedures or the method of resolution of the shareholders meeting violate laws and regulations or the articles of incorporation or are grossly improper." Accordingly, two of larger institutional shareholders, the Royal Bank of Canada Trust Company Ltd. (Royal Bank) and Effissimo Capital Management Pte Ltd. (Effissimo Management), claimed that the method of resolution of the shareholders meeting violated the laws and regulations and filed an action to appeal to the court.[304]

Similarly, these two shareholders Royal Bank and Effissimo Management also filed an action against Tachihi Enterprise Co., Ltd. (Tachihi) and appealed to the court to revoke the resolution of electing five directors made by the company. The reason why the plaintiffs brought the suit was that they thought the method of resolution violated laws and regulations.

3. *Life insurance Co. and investment bank v. Live-door Co.*

In practice, not so many institutional shareholders bring direct litigation against the portfolio companies in Japan. Institutional investors brought two famous suits. The *Live-door case* (2008) was the first time that institutional investors (including Life Insurance Companies and Investment Banks) filed a securities fraud lawsuit against a portfolio company in Japan, due to the misstatements in securities report of the Live-door Company.[305]

4. *The PFA v. Seibu Railway Co.*

The *PFA v. Seibu Railway Co.* was another famous case of litigation in 2005. The PFA of Japan brought a suit against the Seibu Railway Company by misrepresenting in annual

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[304] District Court of Tokyo, March 10, 2011, quoted in *Kabunushi sokai hakusho* [White Paper of General Meeting], in *Shoji homu* [Commercial Law] no. 1949 (2011): 16-17.

[305] *Live-door ni taisuru kikan toshika niyoru songai baisho seikyu jiken*, [the Case of Claiming Damages by Institutional Investors for Live-door], determined by Tokyo District, June 13, 2008, in *Kinyu shoji hanrei* [Precedent Financial Commerce] no. 1297 (2008).

securities report. Seibu Railway Co. pleaded guilty to criminal charges of falsifying financial statements and insider trading, including a list of shareholders in an effort to conceal concentrated ownership by a controlling group in violation of Tokyo Stock Exchange regulations and avoid a delisting of the company. The PFA filed a suit for civil damages resulting from the subsequent drop in stock price once the scandal become public.[306]

4.3.2 Negative cases

In practice, there are also some negative cases showing the passivity of institutional investors in participating in corporate governance. On the one side, institutional investors only support the decisions of the management or sell out the shares in the stock market when they are dissatisfied with the corporate governance of the company. On the other side, institutional investors sometimes are involved in wrongful share trading for short-term interests. Thus, these investors do not play an active role in monitoring the managers of the company.

4.3.2.1 Case of Olympus

According to the datum before the scandal of Olympus, the share proportion of overseas institutional investors accounted for 20% in 1999 to 37% in 2004.[307] The domestic institutional investors in Japan held about 40% - 45% of total share proportion. Moreover, three outside directors are elected to monitor the management of the company.[308] Hence,

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[306] Tokyo High Court, February 26, 2009, quoted in *Seibu tetsudo kabunushi shudan sosho koso shin hanketsu* [Seibu Railway Shareholders' Class Action], in *Hanrei jiho* [Precedent Times] no.2046 (2009): 40-53.

[307] Hideaki Miyajima, *Olympus, Daio seishi jiken kara nihon no kigyo tochi no shorai o kangaeru* [Think about the Future of Japanese Corporate Governance from the Incident of Olympus and Daio Paper], January 18, 2012, Waseda Institute for Advanced Study, http://www.rieti.go.jp/jp/events/bbl/12011801_miyajima.pdf (accessed on June 30, 2012).

[308] Ibid.

these data indicate that the institutional investors account for large proportion of share ownership of Olympus.

However, neither institutional investors nor the outside directors played a monitoring function in the company. On the one hand, institutional investors did not participate in corporate governance to monitor the managers, and a series of accounting scandals of Olympus were disclosed until November of 2011. After the exposure of the Olympus scandals, some institutional investors such as Yasuda Asset Management chose to sell out the shares in the stock market.[309] Therefore, institutional investors are difficult to exert voting rights effectively. On the other hand, though the outside directors are expected to set up to play a monitoring role in corporate governance, such mechanism did not play this function.

The Olympus scandal reflects the current problems of corporate governance in Japan in several ways follows. First, the mechanisms of board of directors and the auditors can not play an active role in improving corporate governance. Second, there are few numbers of outside directors and the independence, capability and professionalism of outside directors are in question. Third, shareholders can not monitor the management effectively, due to the weak power and the unconcern of the management of the shareholders.[310] Therefore, some managers have abused their power for their private interests and ignored the interests of shareholders.

Just after the Olympus scandal, Japan began to rethink its corporate governance model, discussing how to improve the supervising role of the Companies Act in practice.[311]

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[309] *Olympus ni shijo ga atsuryoku, kikan toshika uri kasoku* [Market Pressure to Olympus, Institutional Investors Accelerated Selling], in *Nipon keizai shinbun* [Japanese Economic News], November 9, 2011.

[310] Shinsaku Iwahara, *Kaisha hosei no yukue - kaisha ho kaisei chukan shian no kosatsu* [The Future of Corporate Law - Consideration of Interim Proposal Concerning Revision of Companies Act], *Jurist* no.1439 (2012): 13-14.

[311] In the “Interim Proposal Concerning Revision of Companies Act,” it suggests that listed companies

Meanwhile, some scholar in Japan also suggests that shareholders covering institutional investors should have more concern about the management of the company they invest.[312] Institutional investors who are the trustees of ultimate investors have the responsibility of monitoring the performance and promoting better corporate governance of the portfolio companies. If institutional investors actively required the board of directors to provide detailed information and explain the resolution, the outside directors would have been forced to supervise the management of the company on behalf of shareholders and further reduce the occurrence of the scandals.

In practice, some institutional investors in Japan have begun to require strengthening the disclosure of information of the listed companies they have invested and the outside directors. Institutional investors may participate actively in electing qualified outside directors and promoting better corporate governance of the portfolio companies. For example, Nomura Asset management Co. set up new stricter criteria of appointing outside directors.[313]

4.3.2.2 Case of "Murakami Fund"

The case of "Murakami Fund" (2007) was famous because it was institutional investors that committed insider trading in Japan. The case shows that sometimes institutional investors purchase and sell stocks of the company for short-term interests. The summary of the facts

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shall establish outside directors and may set up a new form of "Company with Audit and Supervisory Committee" so as to strengthen monitoring the operators. Ministry of Justice, *Kaisha hosei no minaoshi ni kansuru chukan shian* [Interim Proposal Concerning Revision of Companies Act], December, 2011, http://www.moj.go.jp/content/000082647.pdf (accessed on April 23, 2012).

[312] Shigeru Nakajima, *Olympus jiken de manabu kabunushi ga kitai suru torishimariyaku to kansayaku no kino* [Learn the Function of Directors and Auditors Expected by Shareholders from the Case of Olympus], in *Business homu* [Business Law], February 2012, 72-73.

[313] *Ote unyo kaisha ni yoru governance kyokasaku* [Measures to Strengthen Governance by a Leading Management Company], May 29, 2012, http://yamaguchi-law-office.way-nifty.com/weblog/2012/05/ index.html (accessed on July 2, 2012).

were as follows: Mr. Murakami as head of the Murakami Fund was charged with insider trading in connection with Live-door's purchase of a block of Nippon Broadcasting's stock. He had traded in Nippon Broadcasting's shares after being informed that Live-door had decided to acquire a material equity stake in Nippon Broadcasting but before that decision had been publicly disclosed.[314]

On July 20, 2007, the Tokyo District Court handed down a judgment in the Nippon Broadcasting Inc. insider trading case, sentencing the defendant Yoshiaki Murakami to two years imprisonment, a fine of 3 million yen, and a surcharge of almost 1.5 billion yen. Murakami Asset Management Inc. was also fined 3 million yen. The defendants appealed their conviction to a lower appellate court before appealing to the Supreme Court.[315]

The key point of the Murakami case was judging whether or not the management decision influenced investors' investment decisions. The Tokyo High Court contended that it should comprehensively examine the facts at hand and specifically judge whether the decision could significantly influence investors' investment decisions. The Supreme Court, however, disagreed on this point and claimed that insider trading regulations did not require a management decision influence investors' investment decisions.[316]

The Supreme Court ruled that if a company's management decision-making body decides to initiate preparations to acquire a material equity stake in another company as a matter of company business, then it is reasonable to construe such a decision to be sufficient without requiring that the planned acquisition be specifically deemed feasible. In this case, the

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[314] Tokyo District Court, July 19, 2007, quoted in Ichiro Kawamoto and Yasunami Otake, 445.

[315] Ibid.

[316] Sadakazu Osaki, "Problematic Supreme Court Decision in Murakami Fund Case," *Financial Technology and Market Research Department Nomura Research Institute, Ltd.*, 113 (2011): 1-4. http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011113.pdf#search='Murakami fund insider trading' (accessed on March 28, 2012).

Supreme Court ruled that Live-door's plan to acquire shares in Nippon Broadcasting was clearly not completely or practically unfeasible and therefore constituted a "decision."[317]

Therefore, the Supreme Court upheld the Tokyo High Court's conclusion that the "decision" had been made by the management but ruled that the court erred in imposing a requirement that the "decision" be objectively and subjectively feasible. At a result, the Supreme Court imposed a three-year suspended sentence on Mr. Murakami.[318] This case is quite meaningful to judge insider trading, since the judgment of the court gives the guidance to "activist" investment funds.

4.4 Summary

In Japan, institutional investors have developed rapidly and participated in corporate governance. Several factors may have contributed to the institutional activism in Japan, including: (1) the background of downturn of main-bank system and cross-shareholdings; (2) the agency problem due to the separation between ownership and control; (3) the increasing share ownership and fiduciary duty of institutional shareholders; and (4) some legal reforms for protecting investors.

The legal framework for institutional participation in corporate governance may also be categorized into two aspects. First, the legal framework of promoting institutional participation includes: (1) general provisions referring to main methods of participation in corporate governance; (2) the guidelines for participating in corporate governance; and (3) indirect manner providing convenient conditions for participating and voting in shareholders meetings by institutional investors. Second, the chapter examines the legislation on how to regulate institutional investors in Japan: (1) disclosure during participation in corporate

[317] Sadakazu Osaki, "Problematic Supreme Court Decision in Murakami Fund Case," 1-4.

[318] Ibid.

governance covering disclosing duty of voting results and disclosing duty of soliciting proxy voting; and (2) regulation on wrongful share trading acts in stock market covering insider trading and manipulation.

In practice, some past cases showed the different attitudes of institutional investors in participating in corporate governance. Some institutional investors have participated in corporate governance actively. However, some negative cases showed the passivity of institutions: (1) selling shares in the stock market when dissatisfying with the management of the company; and (2) being involved in wrongful share trading for short-term interests.

CHAPTER Ⅴ Improving Effective Institutional Participation in Corporate Governance in China

This chapter primarily discusses the following three aspects of comparison and recommendations. First, this chapter conducts a general comparative study of corporate governance practices and the roles of institutional investors in Japan and China. Second, this chapter analyzes the unique opportunity for China to promote institutional participation. Third, by learning the experience from Japan, this chapter proposes how to improve legal framework of promoting effective participation in corporate governance by institutional investors in China.

5.1 General Comparison between Japan and China

By examining the legal practices of institutional investors' participation in corporate governance in both of China and Japan, a general comparison on the corporate governance practices indicates a different growth basis and roles of institutional investors in different corporate governance structure.

5.1.1 Comparison of corporate governance practices between Japan and China

Chinese corporate governance is characterized by a relatively concentrated share of ownership in some controlling shareholders especially by the state. Without any challenge from the minority shareholders, controlling shareholders likely conduct the expropriation and infringement. As a result, dealing with the fundamental agency problem between the controlling shareholders and minority shareholders is necessary.

On the contrary, Japan experienced a path from the business conglomerates (*zaibatsu*)

and the main bank system of controlling share ownership to dispersed share ownership.[319] A separation of ownership and control occurred with the decline of the role of main bank and cross-shareholdings and the share ownership was dispersed in most listed companies in Japan.[320] Thus, the corporate governance in Japan forms the current primary agency problem between dispersed shareholders and powerful insider managers.[321]

In order to resolve the problems of agency in the companies, both China and Japan adopted the traditional supervising model, which means that the corporate auditors collectively form the board of corporate auditors. However, the board of corporate auditors is independent in neither Chinese listed companies nor Japanese ones. In order to strengthen the independency of the board of corporate auditors, the Commercial Code in Japan made an amendment and requirement in 1993 that large companies appoint at least one "outside" corporate auditor whom the company has not employed.[322]

The similarity of corporate governance between Japan and China is that both countries are based on the traditional system of the board of corporate auditors, which is different from the independent director system under the one-tier board structure as in the UK and the United States. Concerning the issue of strengthening the monitoring function of the corporate governance, the legislator in Japan considered carefully and finally introduced the "outside director" and the new board system until 2002. Accordingly, companies are allowed to establish three committees including nominating, audit and compensation committees. Each

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[319] Seki Takaya, 378-379.

[320] Bakushu Lee, 49-51.

[321] Linyu Zhai, *Corporate governance ni okeru kikan toshika no yakuwari* [The Role of Institutional Investors in Corporate Governance], in *Keiei kenkyu* [Management Research] 60, no.3 (2010):2-3.

[322] Japan Act on Special Provisions on the Commercial Code Concerning Audits of Stock Company, Article 18(1) and (2), revised in 1993.

of the three committees must have a majority of outside directors.[323] Meanwhile, Japan adopted the new board system from the United States and with Japanese characteristics.

First, a company has a mandatory duty to set up all three committees when such company selects the board committees' model.[324] Second, in order to separate the functions of execution and supervision, the board of directors appoints the executive officers to play the operational functions of the board. Those executive officers for divisional operation are given the new title of *shikko-yakuin*.[325] The remaining board directors will concentrate on business strategies and monitoring roles. Third, a company in Japan is authorized the right to select the board committees or the board of corporate auditors. Thus, the company cannot remain the board of auditors when it selects the board committees.

Japan introduced the committee system in order to strengthen the supervision on the operators and expect the outside directors to play an effective role to the maximum. However, currently very few Japanese companies adopt the board committee system, accounting for only 2.6% of all companies who are listed in Tokyo Stock Exchange.[326] Most companies prefer to adopt the traditional board of corporate auditors. There are two main reasons for the reluctance including: (1) Strict rules of establishing all of the three board committees at the same time and non-reversing the decision made by the board committees; and (2) the difficulty of guaranteeing the number of eligible outside directors.[327] Hence, many boards of

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[323] Japan Companies Act (2005), Article 326(2), Article 400(1) and (3).

[324] Ibid., Article 2(12).

[325] Ibid., Article 416(4).

[326] Etsuro Kuronuma et al., *Kigyo tochi ni okeru dokuritsu yakuin shagai yakuin no igi to yakuwari* [The Significance and Role of Independent Directors and Outside Directors], in *Shoji homu* [Commercial Law] no.1965, (2012):11-12.

[327] Hiroshi Ota, *Iinkai sechi kaisha no kikan sekei junanka to kansa kantoku Iinkai sechi kaisha* [Flexibility of the Institutional Design of the Company with Committees and the Company with "Audit and Supervisory Committee"], in *Shoji homu* [Commercial Law] no.1914, (2010):16-17.

directors in the listed companies are not willing to choose this model system. In this context, a new reform under the board of directors of the committee system came into being.

The *Interim Proposal Concerning Revision of Companies Act* in 2011 proposed a new form with a title of "Company with Audit and Supervisory Committee", and this new form was adopted by the *Draft Outline of Amendments to the Companies Act* (hereinafter the draft outline of amendments).[328] In the draft outline of amendments, several traits contribute to this new form of company as follows.

First, a listed company may establish an "audit and supervisory committee" which consists of a majority of outside directors. Second, the directors of the committee should be elected at general meeting. Third, in the case where a listed company adopts the structure of a company with an audit committee and does not have an outside director, it is required to describe "the reason why appointing an outside director is inappropriate" in the business report under the Companies Act.[329]

The shareholders especially institutional shareholders are encouraged to actively utilize these new requirements in their communications with portfolio listed companies and exercise of their voting rights. The new form of a company aims to reduce the cost of establishing three committees and realize the independency of supervisors from the board of directors. Meanwhile, this new form still needs a practical test whether this new system can play a role effectively.

In the recent Legislative Council of the Ministry of Justice on September 7, 2012, the draft outline of amendments was decided to submit to the extraordinary diet session in autumn. Concerning the form of the company, the draft clearly states that "the Audit and Supervisory

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[328] Shoji homu henshu bu, *Kaisha hosei no minaoshi ni kansuru yokoan* [The "Draft Outline of Amendments to the Companies Act"], in *Shoji homu* [Commercial Law] no.1973 (2012): 13-15.

[329] Ibid., 15-16.

Committee can be adopted, and listed companies should disclose the reason why the outside directors are not elected."[330]

Turning to the corporate governance practice of China, legislation permits the companies to establish the board committee system on the basis of remaining the board of corporate auditors. According to the requirement of the Company Law 2005, listed companies are required to establish "outside directors."[331] At the same time, the *Code* 2002 provides that listed companies can set up board committees.[332] Due to the strong push of the CSRC on setting up committees, increasing listed companies set up special committees under the board of directors.

The traits of board committees in China differ from Japan in three ways. First, listed companies have no duty to set up board committees in China, while the decision of establishing committees should be made at shareholder meetings. Second, a company can establish board committees while remaining with a supervisory board. Third, the board committee cannot make independent decisions, and all of the board committees have to be accountable to the board of directors.

In light of the push of the CSRC, there are many listed companies in which more than a half of outside directors constitute the board committees. As a result, there is no deficiency of the number of outside directors in the listed companies. In practice, however, the outside directors and the board committees do not play a monitoring role effectively. The reasons for this inefficiency mainly cover two aspects. First, the special committees cannot make decisions independently without the authority of independent power. The committees only can

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[330] *Nippon Keizai Shinbun* [Japanese Economic News], September 7, 2012.

[331] China Company Law (2005), Article 123. In order to facilitate understanding and comparison, the dissertation maintains the unity with the legislation of Japan and uses the conception of "outside directors" here, although the name of "independent directors" is usually used in legislation of China.

[332] Code of Corporate Governance of Chinese Listed Companies (2002), Article 52.

commit the consultation. Second, outside directors in the board committees are elected at a shareholder meeting, so the controlling shareholders can still manage and oversee the appointment of outside directors. In such case, it is hard for legislation to secure the independency of the board committees.

Accordingly, the key to the effective role of the board committees is to ensure the independency and impartiality of the decision of the committees. By drawing on the experience of Japan, China may resolve this problem through authorizing the board committees with the independent power of decision-making. Nevertheless, the committees still cannot play an effective role in reality. The system of outside directors and board committees aims to monitor the executive directors under the dispersed share ownership structure in Japan, but it cannot be tailored to the context of China.

The essential characteristic of the corporate governance structure cannot be neglected in China. Concentrated share ownership exists in most of listed companies and the controlling shareholder can make important decisions through majority voting rule. With the power of controlling shareholder, the good supervising mechanism is unable to play its role effectively.

Therefore, the corporate governance of China needs the institutional investors. On the one side, before many useful monitoring mechanics are utilized effectively, balancing the share ownership structure and restricting the controlling shareholders through institutional investors are necessary. As pointed in Chapter 1, institutional investors owning relative share ownership can form an effective constraint and prevent from the abuse of controlling shareholders and protect minority shareholders. On the other side, the legislation needs improved so that the supervising mechanisms play monitoring function effectively through the role of institutional investors.

5.1.2 Comparison of growth basis and role of institutional investors in Japan and China

In China, the institutional investors grow and develop corresponding to the needs of the policy of the party and the government to some extent, which is a government behavior. As pointed out in Chapter 1, the Communist Party put forward the policy of "promoting reform and opening capital markets, developing direct financing and optimizing the allocation of resources, and promoting the corporate governance structure."[333] According to this party policy, the State Council of China clearly requires greater development of institutional investors.

On the contrast, institutional investors in Japan developed on the basis of the capital market. Institutional investors in Japan evolved due to the needs of financial innovation and investment as part of the spontaneous behavior in the capital markets. By virtue of the decline of the monitoring role of main bank system and cross-shareholdings of business, public small shareholders cannot monitor managers effectively because of the scattered share ownership and free-rider problem.[334] Therefore, the agency problem between shareholders and managers contribute to the primary problem of corporate governance in Japan. Institutional investors began to grow rapidly and become involved in corporate governance actively to protect the profits.

Accordingly, institutional investors play different roles in corporate governance of Japan and China. Corporate governance in China is unique because it is characterized by a relatively concentrated share ownership in some controlling shareholders especially the state. Hence, the corporate governance in China needs for institutional investors to monitor not only managers but primarily the controlling shareholders. On the contrast, in Japan, institutional

[333] Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Improvement of the Socialist Market Economy, promulgated and enforced on October 14, 2003.

[334] Linyu Zhai, [The Role of Institutional Investors in Corporate Governance], no.3, 2-3.

investors primarily function in monitoring managers in the companies.

No matter what the amount of support of the government or the spontaneous behavior of markets, both China and Japan have realized the role of institutional investors and attach importance to the development of institutional investors. For further steps, both countries emphasize establishing legal frameworks on promoting institutional investors participation in corporate governance.

This study finds two conclusions through comparing different experiences between Japan and China. First, in order to make institutional investors play a role in corporate governance in China effectively, restricting controlling shareholders especially the state-owned shares is necessary. Second, Japan has experienced the process of promoting institutional effective participation in corporate governance. Comparatively, the legal framework of promoting institutional activism in China is still in its infancy. Therefore, China needs learning the advanced experience from Japan and utilizing them to tailor to the context of China.

5.2 Promoting Institutional Participation in Corporate Governance in China

A balanced ownership structure is the basis for promoting corporate governance. The concentrated ownership structure exists in most Chinese listed companies, especially the state controls large proportion of share ownership. Meanwhile, even though professional institutional shareholders take larger proportion of ownership relative to other public investors, they still take a smaller stake in the portfolio companies due to the huge share ownership by the controlling shareholders. Therefore, institutional investors are hard to vote against the decisions of controlling shareholders and prevent from the expropriation of controlling shareholders in listed companies.

Accordingly, the concentrated share-ownership has impeded the institutional participation in the corporate governance. The legislation needs restricting the power of controlling shareholders and enforcing effectively legal systems of promoting institutional participation in the corporate governance.

5.2.1 Theoretical analysis

The concentrated share of ownership is related to the central party's control and form of socialism in China. The party needs to control the assets and resources of the state in order to safeguard its leadership status. The Communist Party not only controls the assets and resources of the state at national level, but also controls the factories and companies. In the case of companies, the party exerts its influence through holding most of share ownership and personnel appointment of listed companies.

In China, most of listed companies are carve-outs or spin-offs from large state-owned enterprises (SOEs) and in which the original SOEs still own a large percentage of total shares. The party can control the larger percentage of state-owned share ownership in the company. Thus, the party accounting for majority shares in most listed companies actually controls the assets and interests of the companies. The party enjoys private interests of control and it is unwilling to give up the interests obtaining from the company. In such a case, Qiu mentions that, "There are two methods for reducing state-owned shareholdings. First is a complete and large scale of privatization strategy, which does not seem to be appropriate in China. Second is the state ownership reform which seeks balance between the state's interest and the non-state's interest."[335]

The first method seems inappropriate for the Chinese situation. Qiu also claims that "The

[335] Jinqian Qiu, 102-104.

way of ownership reform should be politically feasible, which means that the ownership reform should be politically feasible without too much resistance from the government bureaucracy."[336] Some Eastern European countries experienced the path of a complete and large scale of privatization reform and transition, which seems not politically feasible and the result is unsuccessful. Thus, this method is inappropriate in China. At present, China is undergoing a gradual process of economic reform and transition towards market without democratization or liberalization.

Accordingly, it focuses on the second method and examines how it can be successful for state ownership reform which seeks balance between the state's interest and the non-state's interest. In China, it cannot disregard the power and interests of the Party and the government which is a critical political factor when reducing state-owned shareholdings. Therefore, the balance between the state's interest and the non-state's interest should be considered in order to encourage the party to speed up ownership reform. Qiu suggests that "state ownership reform is actually the process of changing the share ownership structure of companies and generally there are two options. One is that diversifying state ownership leads to diffuse ownership. The other is to shift controlling shareholders from the state to institutional shareholders."[337]

Diversifying state ownership to diffuse ownership does not seem to be a workable proposal to China's state ownership reform since the state or the party will completely lose control. Furthermore, this proposal does not consider seeking balance between the state interests and non-state interests and neither politically feasible. Moreover, Gan (2002) insisted that "even if the state ownership was diversified into diffuse ownership, the serious agency problem between the strong managers and minority shareholders would replace the agency

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[336] Jinqian Qiu, 102-104.

[337] Ibid., 104-106.

problem between controlling shareholders and minority shareholders."[338]

Qiu further maintains, "An appropriate state ownership reform seems to be shifting the concentrated state ownership to concentrated institutional ownership."[339] Accordingly, part of the state ownership is transferred to institutional investors under legal regulations and those institutional investors manage and obtain the interests from the state ownership. According to the relevant legal regulations, these institutional investors can gradually trade this part of state ownership in the stock market in the future. As a matter of fact, part of the state ownership is gradually transferred and diversified to public share ownership.

Several advantages contribute to the method of shifting the concentrated state ownership to institutional ownership. First, ownership is not a complexly diffuse but the dominant shareholder still exists, so large shareholders will not lose their control power. Second, "it will tackle the concentrated state ownership and may solve the serious agency problem of the corporate governance in China. Third, it provides a good opportunity to develop institutional shareholders and strengthen institutional shareholders and promote institutional monitoring."[340]

Besides the method of changing the share ownership structure and reducing the state-owned shares, improving the legislation to constrain the voting rights of controlling shareholders is also necessary. Both of reducing state-owned shares and improving legislation are the two main methods of restricting controlling shareholders.

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[338] Peizhong Gan, *Guoyou gu jianchi zhong de zhengfu yu shichang* [The Government and the Market during Reducing State-owned Shares], in *Faxue jia* [Jurist] no.4 (2002): 87-88.

[339] Jinqian Qiu, 105-107.

[340] Ibid.

5.2.2 Legal reforms in practice

Corresponding to the theoretical analysis above, the legal reforms for restricting controlling shareholders in practice cover the reforms of reducing the state share ownership and law-making to restrict the voting rights of controlling shareholders. In particular, the reduction of the share ownership is a constant process of exploration. The party and Chinese government launched this reform in several steps.

Initially, the party promulgated *The Decision of the Central Committee of the Communist Party of China on Major Issues Concerning the Reform and Development of State-owned Enterprises* (the *Decision*) on September 22, 1999 and for the first time proposed to reduce state share ownership.[341] This *Decision* required that, "China should choose a good reputation and large potential for the development of state-controlled listed companies, to reduce the state-owned shares appropriately when it does not affect the state-controlling power, and the proceeds are used to reform and develop the state owned enterprises."[342]

The party lifted the principle of "reducing state share ownership" to allow some state share ownership fade out of competitive industries in the Fourth Plenum of the 15th Communist Party of China Central Committee. However, the party also insists that reducing state share ownership should be conditional upon the control power of the state. Under the policy of the party, there were a series of legal reforms over the past ten years in China.

5.2.2.1 "Selling state-owned shares" in 2001

In practice, China promulgated legislation called "Selling State-Owned Shares" which launched state ownership reform in 2001. In June 2001, a regulation on the reduction of the state-owned share in Chinese listed companies was formally issued by the State Council.

[341] The Fourth Plenum of the 15th Communist Party of China Central Committee on September 22, 1999.

[342] Ibid.

According to this regulation, some companies declared to reduce the state ownership when they issue new shares to existing shareholders or the public.[343] However, this regulation was suspended after six months by the State Council due to depression of the stock prices. Thus, the reform brought negative impact on the stock market of China. Some scholars claim that three reasons can be attributed to the failure of the reform in 2001.

First, the regulation in 2001 required reducing state-owned shares without considering the sector of the company. A line should be drawn between the competitive areas and non-competitive areas in the state-owned companies. In some monopoly enterprises, which are quite important to the economic development of the state (nature resources such as water, electricity and energy etc.), the state still has to control the majority share ownership. These types of companies should keep the control power of the state rather than reduce the state share ownership. However, those enterprises in competitive areas are necessary and feasible to consider selling the state share ownership to diversify the share ownership structure of listed companies. Therefore, it is not appropriate that simply sell the state share ownership in companies as the regulation stipulates without considering what the company belongs to.

Second, Li contends that "this reform did not tackle well the price setting problem. One of critical point of reducing state-owned shares is to handle the problem of setting price properly, in order to balance state interest and non-state interest."[344] Seeking balance between the state interests and non-state interests during this process is necessary. One of the important problems concerns price setting, because it actually decides whether the share ownership reform can be carried out successfully.

Since the state is willing to sell shares at a high price while the public investors hope to purchase at lower price, a lot of work should be done to set the prices reasonably and

[343] China Provisional Measure of Selling State-Owned Shares (2001), Article 4 and Article 6.

[344] Shuguang Li, 14-15.

acceptably to seek the balance between the interests of the state and the public shareholders. According to Article 6 of the regulation, the price should be set on the base of the principle of market price.[345] However, this reform which the state sold shares and the public purchased shares was actually on the basis of administrative order rather than market rule and thus the stock price did not reflect a company value. Therefore, it is not reasonable to sell the state-owned shares at a market price.

Third, Gan claims that "the regulation in 2001 neglects the real significance of the state ownership reform, which is to make some state-owned companies gradually fade out of competitive industries and improve the corporate governance of Chinese companies."[346] However, officials argued that the aim of this regulation was only to raise the social security funds.

5.2.2.2 "Share-trading reform" in 2005

After the failure of the reform in 2001, some scholars argued that "realizing the shares tradable become the most direct and critical method for resolving the state ownership problem."[347] The Communist Party of China also realized that the reducing state ownership should be connected with the tradable shares, since the non-tradable shares hindered the reduction of state-owned shares greatly. Therefore, it is recognized that the "Share-trading Reform" in 2005 continued the reform of reducing state share ownership in 2001, but in different approach.

The two kinds of shares include tradable and non-tradable existing in A-share market of

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[345] China Provisional Measure of Selling State-Owned Shares (2001), Article 6.

[346] Peizhong Gan, 87.

[347] Ibid.

China.[348] Before 2005, almost two-thirds of non-tradable shares, which include state-owned and legal person shares, could not be tradable freely in securities market. According to the policy of promoting the reform and opening and stable development of capital markets of the party, the State Council of China issued the *Several Opinions of the State Council on Promoting the Reform, Opening-up and Stable Development of the Capital Market* in 2004.[349] The *Opinions* proposed that "transfer the untradeable shares of listed companies to tradable shares and the issue of equity separation should be settled in a positive and reliable manner."[350] Accordingly, reducing state shareholding is a gradual process and cannot be done in short time. The "Share-trading Reform" is actually a necessary and transitional phase during the process of reduction of state-owned shares. When most of state-owned shares become tradable in the stock market, the concentrated state ownership reform can become more efficient.

As a result, the "Share-trading Reform" started in China in 2005, and state-owned shares were tradable in the stock market and decreased in proportion to some extent. According to recent statistics recently, almost 80 percent shares became tradable in the Chinese stock market in 2011, indicating that this reform seemed to be successful in the process of the legal

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[348] Category of shares in securities market of China can be divided into three parts: A, B and H shares. A shares: companies incorporated in mainland China and are traded in A-share markets. The prices of A shares are quoted in Renminbi, and currently only mainlanders and selected foreign institutional investors are allowed to trade A shares. B shares: companies incorporated in mainland China and are traded in B-share markets (Shanghai and Shenzhen). B shares are quoted in foreign currencies. In the past, only foreigners were allowed to trade B shares. Starting from March 2001, mainlanders can trade B shares as well. However, they must trade with legal foreign currency accounts. H shares: companies incorporated in mainland China and are listed on the Hong Kong Stock Exchange and other foreign stock exchanges.

[349] The Third Plenary Session of the Party's Sixteenth National Central Committee of China, October of 2003.

[350] China State Council Gazette, no.3 (January 31, 2004) http://www.gov.cn/gongbao/content/2004/content_63148.htm (accessed on March 12, 2012).

reform of state share ownership in China.

One of the most significant factors which contribute to the success of this reform is that it considers both of the state interest and public investors' interests. According to the *Measures for the Administration of the Share-trading Reform of Listed Companies* in 2005, "the motion for the share-trading reform shall be made by all of the holders of non-tradable shares of a company upon consensus, or may be made by the holders that solely or jointly hold 2/3 or more of the non-tradable shares of the company if the consensus cannot be reached."[351] According to Article 16, "when the meeting of relevant shareholders takes a vote on the reform scheme, the reform scheme shall be adopted by shareholders with two-thirds or more of the voting rights participating in the voting and by the holders of tradable shares with two-thirds or more of the voting rights participating in the voting."[352]

Pursuant to these two provisions, the reform scheme is actually concerned with the interests of shareholders, and it has to be approved by shareholders who own tradable shares. Tradable shares are mainly held by public investors covering minority shareholders. Thus, this *Measure* purposes to protect the interests of minority shareholders and thus can be accepted by both of the state and public investors.

The "Share-trading Reform" in 2005 has brought two benefits. First, this reform is helpful to alleviate the conflict of interest between state and private shareholders and improve corporate governance in Chinese listed companies.[353] Second, this reform is helpful to realize the real supply-and-demand pricing mechanism and protect the legal benefits of investors,

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[351] China Measures for the Administration of the Share-trading Reform of Listed Companies (2005), Article 5.

[352] Ibid., Article 16.

[353] Wenxuan Hou and Edward Lee, "Split Share Structure Reform, Corporate Governance, and the Foreign Share Discount Puzzle in China," *European Journal of Finance*, June 29, 2012, 1-25.

promoting the development of Chinese securities market.[354] Therefore, the increase of tradable shares in the stock market contributes to the key step during the process of state share ownership reform. In spite of great progress of the “Share-trading Reform” in 2005, the proportion of state-owned shares remains large and much of shares are still controlled by the state.

5.2.2.3 Transfer of state-owned shares to non-state institutional investors

In the context of increasing tradable shares, the party and Chinese government gradually consider adopting a strategy of transferring state-owned share to non-state institutional investors recently, in order to accomplish the state ownership reform. In November 2006, the *Measures for the Administration of Securities Investment within the Borders of China by Qualified Foreign Institutional Investors* was issued to allow foreign institutional investors to purchase and sell A-shares in Chinese stock market. This regulation encouraged establishing some large institutional investors in China to purchase A-share covering the state-owned shares. Moreover, in order to encourage long-term investment, it gives priority to establish long-term asset management institutions such as pension funds, insurance funds, mutual funds and charitable funds, especially foreign investment fund management companies.[355] According to this regulation, foreign institutional investors who can purchase state-owned shares potentially become active participants in capital market of China.

Since the share ownership structure in China is unbalanced, as the proportion of state-owned shares is too large and public shareholders are scattered, forming a moderate concentrated equity ownership structure in listed companies is necessary in China. In such a

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[354] Jinqian Qiu, 209.

[355] Measures for the Administration of Securities Investment within the Boarders of China by Qualified Foreign Institutional Investors (2006), Article 2 and Article 10.

case, the development of institutional investors with strong equity control consciousness is important. Accordingly, the key to restrict controlling shareholders lays in the reduction of the proportion of state-owned shares at the same time the introduction of strategic institutional investors with strong equity control consciousness.

The "Share-trading Reform" in 2005 actually contributed to the basis of transferring state-owned shares. On the basis of most tradable shares, China began to regulate on the transfer of state-owned shares through legislation. In 2007, the CSRC and the SASAC issued the *Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies* (hereinafter *Measures* 2007). Article 1 of the *Measures* 2007 describes that this regulation "aims to regulate on the state- owned shareholders' transfer of their shares in listed companies, promoting the optimized allocation of state-owned sources, preventing the loss of state-owned assets and maintaining the stability of the securities market."[356]

According to the *Measures* 2007, "In principle, the transfer price is based on the exchange price of stock of listed companies in the stock market; If it transfers the state-owned shares by the way of large transactions of the securities trading system, the transfer price of state-owned shares shall not be less than the weighted average price of the stock of the listed company during the day of transaction."[357]

In this context, the *Measures* 2007 established a market-oriented pricing mechanism which formed on the basis of "Share-trading Reform" in 2005, changing the static pricing mechanism based on net assets. Since the market-oriented pricing mechanism is based on the supply and demand of market, such a mechanism may reflect the real value of state-owned

[356] Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies Article 1, issued on June 30, 2007, and enforced on July 1, 2007.

[357] Ibid., Article 6 and Article 11.

shares than the static pricing mechanism based on net assets.[358]

The regulation 2001 is also based on the stock market and market-oriented pricing mechanism, but such regulation failed in the end. The reason for the failure is that the *Measures* 2007 is on the basis of "Share-trading Reform" in 2005. As pointed out earlier, the reform in 2005 was completed on the basis of the bargain between non-tradable shareholders and tradable shareholders. Wu also maintains that "The reform scheme has to be approved by shareholders who own tradable shares, so it indeed respects the interests of tradable shareholders and takes into account both of the interests of non-tradable shareholders and tradable shareholders. Therefore, the *Measures* 2007 can be implemented successfully in practice."[359]

Moreover, in June 2009, the State Council of China entitled the *Implementation Rules on Transfer of Partial State-Owned Shares on the Domestic Stock Exchange to Enrich National Social Security Fund* in order to increase the shareholdings of National Social Security Fund.[360] According to this new regulation, 10 percent of the total shares in the initial public offering owned by the State must transfer to National Social Security Fund and invested into the capital market. Thus, partial shares owned by the state could become part of the NSSF and increase its shareholdings. The NSSF will begin to play a significant role in Chinese stock market as a potential institutional investor.

Several advantages contribute to the method of shifting the concentrated state ownership

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[358] Xiaohui Wu, *Shangshi gongsi guoyou guquan zhuanrang de falv yuanbian ji qishi* [Legal Change and Revelation of Transfer of State-owned Shares of Listed Companies], in *Tequ jingji* [Special Zone Economy], January 2010, 99-101.

[359] Ibid., 99-100.

[360] Implementation Rules on Transfer of Partial State-Owned Shares on the Domestic Stock Exchange to Enrich National Social Security Fund, issued by Ministry of Finance, State-owned Assets Supervision and Administration Commission (SASAC), CSRC and National Council for Social Security Fund of China and enforced in June 19, 2009.

to institutional ownership. First, there is no complete diffusion of ownership but the dominant shareholder still exists, so large shareholders will not lose their control power. Second, "it will tackle the concentrated state ownership and may solve the serious agency problem of the corporate governance in China. Third, it provides a good opportunity to develop institutional shareholders and strengthen institutional shareholders and promote institutional monitoring."[361]

There are three significant points to this regulation. First, the regulation is significant because it is helpful for China to finance the social security system and the retirement of the aging population by increasing share ownership of NSSF. Second, transferring the state-owned shareholdings to seek balance of share ownership structure of the company to some extent is beneficial. Third, the NSSF with increasing shares becomes realizing its responsibility as trustee and relative large shareholder. Therefore, the NSSF may pay more close attention to the interests obtained from the portfolio companies and actively participate in corporate governance in the future. In addition, the strategy of share repurchase should be also helpful to reduce state share-ownership and provide chances for institutional investors to increase their shareholdings in the company.[362]

5.2.2.4 Restricting the voting rights of controlling shareholders

Reducing state-share ownership is one way of improving share ownership structure and corporate governance, but this way is a constant and lengthy process. Besides, restricting the voting rights of controlling shareholders through legislation to prevent them from abusing rights is also important.

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[361] Jinqian Qiu, 105-107.

[362] China Company Law (2005), Article 143.

According to Article 16 of the Company Law 2005, the security provided by a company to its shareholders or actual controller shall be determined by the shareholders meeting. Such shareholders, or those headed by the actual controller, should not participate in the voting process on the relevant matters. The vote on such matters should be adopted by more than half of all the other shareholders attending the meeting.[363] In addition, the cumulative voting rights and proxy voting rights which have been discussed earlier can also be recognized as the methods of limiting voting rights of controlling shareholders while protecting minority shareholders.

Moreover, the *Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders* is a way of restricting the voting rights of controlling shareholders while protecting minority shareholders.[364] According to this provision, the tradable shareholders who hold more than a half percent of voting rights and attend the process at the general meeting have rights to vote on the proposals including cash offers, right offers, and convertible bond issues, substantial asset reorganization, equity debt swap, and foreign listing of subsidiaries. In addition, all other matters that would have a significant impact on the interests of general public shareholders require the approval of tradable shareholders.

According to this provision, only shareholders who hold tradable shares can vote, so this provision actually excludes the state and legal persons as controlling shareholders holding large untradeable shares. Hence, this provision is a typical example for protecting minority shareholder rights. Since institutional shareholders usually hold relative large percent tradable shares in portfolio companies, these shareholders would be probable to exercise voting rights

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[363] China Company Law (2005), Article 16.

[364] China Several Rules on Strengthening the Protection of the Rights and Interests of Public Shareholders, issued by China Securities Regulatory Commission on December 7, 2004.

against the abuse of controlling shareholders, which has great impact on the results of the effectiveness of the shareholder voting.

However, the legislature sets no standards to judge whether or not a specific issue falls into the category of having a significant impact on the interests of public shareholders. Therefore, institutional investors are hard to decide the issues that have a significant impact on the interests of public shareholders. In fact, those four specific issues can rely on the approval of tradable shareholders. It is also unclear who is entitled to make the judgment: the listed company, the minority shareholders, the CSRC or a court. Moreover, there is no provision whether or not the minority shareholders have a right to sue when they disagree with the listed company's judgment.[365] Therefore, the legislator needs setting specific standards of application for this provision and set redress regulation for minority shareholders.

5.2.3 Summary

As pointed out above, China used two reforms in 2001 and 2005 to try and reduce state-owned share ownership. Though the policy of "reducing state-owned ownership" in 2001 has not been implemented effectively, the "Share-trading Reform" launched in 2005 has made some substantial achievements for the reduction of state-owned share proportion. The reform in 2005 indeed provided an opportunity for the growth and development of institutional investors. Moreover, the Chinese government has issued some policies on transferring state-owned shares to non-state-controlled investors such QFIIs and NSSF. By examining the legal reforms in China over the past several years, several suggestions should be considered below.

[365] Xi Chao, 258.

First, in order to realize this objective of reducing state-share ownership, a line should be drawn between the competitive areas and non-competitive areas in the state-owned companies. On the one side, the state still has to control the majority share ownership in some monopoly enterprises, but these are quite important to the economic development of the state (nature resources such as water, electricity and energy etc.). On the other side, for those enterprises in competitive areas, the Chinese government has made efforts to let some state-owned companies gradually fade out of competitive industries and reduce the majority shareholdings of the state.

Second, the Chinese government has noticed the importance of changing state-owned shareholdings and great achievements towards the diversified share ownership structure orientation have been made. No matter what method is used to resolve this problem, seeking balance between the state and non-state interests during this process is necessary.

One of the important problems to reduce state share ownership is the price setting, because it actually decides whether the share ownership reform can be carried out successfully. The state is willing to sell the shares at high price while the public investors hope to purchase at lower price. The study also should point that China must maintain and increase the assets owned by the state when transferring the state shares. In this aspect, it is necessary for China to set the price reasonably and acceptably to seek the balance between the interest of the state and the public shareholders, which becomes the issue studied constantly in the future.

Third, transferring state share-ownership to some institutional investors such as NSSF seems reasonable and effective because this approach can reduce the state shareholdings and increase the shareholdings of institutional investors. Under this circumstance, such approach actually brings two benefits of reducing state share-ownership and promoting institutional participation in the corporate governance.

Fourth, reducing state share ownership is a long continuing process, which needs constant efforts. Meanwhile, restricting the voting rights of controlling shareholders through legislation to prevent them from abusing rights is necessary and feasible.

5.3 Experience of Japan

5.3.1 Improving the legal framework for promoting institutional participation

5.3.1.1 Establishing guidelines for exerting voting rights

Japan has developed institutional investors with the gradual establishment of related legislation. Compare to Japan, the issue of institutional investor activism in China is still new and just has developed for past several years. There is a deficiency of legislation on promoting institutional investors' participation in corporate governance in China which has hindered institutional activism. Therefore, China needs learning some good experience from Japan and improving the legislation on promoting institutional investors activism.

Exercising voting rights at shareholder meetings is one of the very important methods of participating in corporate governance by institutional investors both in China and Japan. At the same time, institutional investors as trustees own fiduciary liability, which requires them monitoring the performance of the company and improving the value and profits of these institutions through exerting voting rights. The conduct of exercising voting rights actually embodies that institutional investors fulfill the liability of fiduciary.

Since institutional investors mainly participate in corporate governance by exerting voting rights on proposals submitted at shareholder meetings, the legislation needs providing some guidelines covering some standards or criteria for institutional investors to check and analyze the corporate governance practices of companies which these institutions have invested. According to these guidelines, institutional investors may vote on or against the

proposals in order to protect the rights and profits of shareholders and promote the monitoring role of managers. Therefore, establishing guidelines of exercising voting rights for institutional investors is quite critical.

In Japan, the guidelines of voting rights are established according to different subjects, (a) by institutional investors themselves; and (b) by organization services for institutional investors. The PFA as one of the critical institutional investors in Japan developed guidelines for exercising voting rights, which provides for institutional investors with detailed and particular judging standards when exerting votes.

Comparing to Japan, however, China has no similar special guideline for helping institutional investors with voting. Although the *Code of Corporate Governance for Chinese Listed Companies* 2002 stipulates that "Institutional investors shall play a role in the appointment of company directors, the compensation and supervision of management and major decision-making processes."[366] The *Code* does not stipulate specific standards in detail to help investors to judge and consider whether to approve or oppose the proposals. In order to help institutional investors to exercise their voting rights under lawful procedures, establishing related legal guidelines is necessary. The CSRC or other relevant securities regulatory department authorized by the CSRC needs developing particular and detailed guidelines for voting since there is a simple provision about promoting institutional activism.

Drawing on the experience of Japan, developing uniform standards for the institutional voting is difficult because the subjects of establishing guidelines are various. On the one side, the CSRC or other relevant regulatory departments authorized may develop a general guideline for institutional investors to exert voting rights. On the other side, the institutional investors may set up specific guidelines to adapt to their own situations. At the same time,

[366] Code of Corporate Governance for Chinese Listed Companies (2002), Article 11.

these special guidelines have to be supervised by the CSRC and disclosed to the public. The context of guidelines should include the standards and specified procedures of institutional voting, which should be brief and easy to understand in order to facilitate institutional voting in practice.

As pointed out in Chapter 4, some service organizations for institutional investor in Japan established guidelines to help institutions to exercise voting at general meeting and allow them play an active role in corporate governance. For example, the ISS is a very famous association of institutional investor services and provides advices on how to carry out fiduciary responsibility to vote on shares.[367]

In the practice of China, since institutional investors are engaged in stock investment and are passive in participation in corporate governance, establishing similar organizations of services seems not urgent. However, with the increase of shareholdings of institutional investors, increasing institutional investors are willing to involve in corporate governance by voting. In this case, institutional investors are willing to vote, but they actually lack professional experience of participating in corporate management. Therefore, it is necessary that introduce international service organizations such as ISS to China in the future to provide advices for institutional investors to participate in corporate governance of Chinese listed companies.

5.3.1.2 Promoting the role of outside directors through institutional participation

Both Japan and China expect that outside directors promote the supervising mechanism to play function effectively. In China, it is a duty for listed companies to establish the outside directors, which is expected to play a monitoring function effectively. The outside directors

[367] Yoshinori Suzuki, [Institutional Investors and Shareholder Meeting], 57.

can play an effective role when they become main members of the board committees, so how to strengthen the monitoring role of outside director as main members of special committees has become the common problem that both countries need to resolve.

As pointed out earlier, there are some negative cases indicating that some institutional investors still choose to sell out the shares in the stock market or just support the decisions of the management rather than participate actively in corporate governance. In both the cases of Olympus in Japan and Yili in China, institutional investors did not play a function in monitoring the management of the companies in which they had investments. Meanwhile, both companies set up outside directors, but these directors did not play an effective monitoring function.

Generally speaking, institutional investors participate in corporate governance in order to make the management seek profits on behalf of the shareholders. Monitoring the corporate management by institutional shareholders is necessary due to their trustee liability. However, although institutional shareholders have a larger incentive to monitor the management than individual shareholders, institutional shareholders are not familiar with all of particular information about the management and operation in practice. Thus, these institutions are still hard to monitor the management directly through the board of directors. In this context, institutional investors expect that the outside directors whose basic function is to monitor the management can monitor the corporate governance on behalf of the shareholders.

Moreover, outside directors are hard to play a role in monitoring corporate management without the participation of institutional shareholders. Institutional shareholders can appoint the eligible outside directors according to the will of these institutions. Due to the power of controlling shareholders in China, the supervising mechanism does not play an effective role in improving corporate governance. Institutional investors with large shareholdings may

influence on the share ownership structure of the company and restrict the arbitrary decisions of controlling shareholders.

Therefore, combining the role of institutional shareholders with the outside directors is necessary. By examining Japan, institutional investors become active in promoting the outside directors to play a role effectively through the following aspects including: (1) Set up principles and criteria of electing outside directors; (2) attach more importance to the practical performance of outside directors; and (3) require disclosing information of outside directors.

1. Principles and criteria of electing outside directors

Some institutional investors set up their own criteria for assessing the conditions of candidates of outside directors and electing eligible outside directors. After some scandals such as Olympus, some institutional investors strengthened the criteria of electing outside directors. If the candidates of outside directors do not meet the requirements of the criteria for eligible directors, the institutional investors can vote against the proposals for electing directors.[368]

By electing outside directors, institutional investors may reflect their wishes and recommendations to the outside directors. These outside directors can perform on behalf of the institutional investors and prevent the controlling shareholders from abusing power on the board of directors. Accordingly, institutional investors are active to participate in electing eligible outside directors.

2. Attach more importance to the practical performance of outside directors

Outside directors can obtain the approval and support of institutional investors, which promotes monitoring the corporate governance on behalf of the shareholders effectively. After

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[368] *Ote unyo kaisha ni yoru governance kyokasaku* [Measures to Strengthen Governance by a Leading Management Company], May 29, 2012, http://yamaguchi-law-office.way-nifty.com/weblog/2012/05/index.html (accessed on July 2, 2012).

a series of financial scandals in Japan, intuitional investors realize that not only outside directors should meet the formal requirements of independence, but also more importance should be attached to their practical performance.[369] Institutional investors may monitor the performance of outside directors and submit proposals and require removing incompetent outside directors who do not monitor the management effectively.

3. Disclosing information of outside directors

In order to guarantee the independence of outside directors, the shareholders consider it necessary to require disclosing information of their actual performance. In this context, the *Securities Listing Implementing Regulations of Tokyo Stock Exchange* stipulates that "listed companies shall provide the notification about the independent board members covering outside directors and outside auditors in order to ensure the disclosure of information."[370]

Concerning the disclosure of information, institutional investors require recording the information about the independent board members in the Business Reports of list of board members and the candidates of independent board members in the reference documents of general meetings.[371] Although listed companies do not have a duty to record the information about the independent board members in the reference documents of general meetings, it has become a standard.[372] According to statistics from 201 companies, 168 companies recorded the information about the outside directors or outside auditors in their business reports which

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[369] Naoyoshi Ema, [Verification in 2011], 17-18.

[370] Securities Listing Implementing Regulations of Tokyo Stock Exchange, Article 436 (2).

[371] Research Committee of Commercial Law, *Kabunushi sokai hakusho* [White Paper of General Meeting], in *Shoji homu* [Commercial Law] no. 1949 (2011): 51.

[372] Masafumi Nakahigashi, *Ho no sai kochiku to kabunushi sokai – 2011 nen han kabunushi sokai hakusho o yonde* [Rebuilding the Law and General Meetings - Read "The White Paper of General Meetings of the Version of 2011"], in *Shoji homu* [Commercial Law] no. 1953 (2011): 7.

increased to 83.6%.[373] If there is no record, institutional investors are likely to vote against the resolution of electing the independent board member. Thus, coupled with the disclosure of results of voting rights, recording the information about the independent board members is very important.[374]

Institutional investors play a role to some extent in pushing the establishment of the legislation on information disclosure of independency. The *Cabinet Office Ordinance on Disclosure of Corporate Affairs* was revised in Japan in March 30 of 2012, which required recording the information of outside directors and outside auditors from the three aspects. First, this regulation requires recording in securities report that the officer is eligible for outside directors. Second, this regulation requires clarifying the scope and content about the relationship between the outside directors and the company who submits the securities reports. Third, the regulation requires that listed companies should record that there are no criteria or policy on independence of electing outside directors in the company who submits the securities reports.[375] This regulation actually can promote the disclosure of information of outside directors.

On the basis of the legal regulation of disclosure, institutional investors can know about the detailed information of outside directors, which facilitates to elect more eligible outside directors and make them perform monitoring function effectively in practice. These strategies above indicate that institutional investors in Japan have become increasingly active in electing outside directors and monitoring the performance of outside directors to some extent.

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[373] Takaki Teraoka, *Shinsai kanren to kikan toshika he no taio nado shoshu tsuchi no kisai jiko nado no bunseki* [Analysis of the Matters in Notice of Convocation such as Responding to the Earthquake-related and Institutional Investors], in *Junkan keiri joho* [Accounting Information], no.1290 (2011): 70.

[374] Masafumi Nakahigashi, [Rebuilding the Law and General Meetings - Read “The White Paper of General Meetings of the Version of 2011”], 8.

[375] Japan Cabinet Office Ordinance on Disclosure of Corporate Affairs, revised in March 30 of 2012.

In the case of Yili in China, institutional investors voted for the resolution of removing outside directors even when they found that they had performed monitoring function to protect the interests of shareholders. Thus, such case indicates that institutional investors did not attach sufficient importance to the role of outside directors. By drawing on Japan, it is important that institutional investors participate in an election to increase the number of eligible outside directors and supervise their practical performance through requiring a disclosure of information. By doing so, the outside directors can perform on behalf of shareholders and prevent from the abuse of controlling shareholders. To sum up, no one mechanism can play a perfect role in improving corporate governance, and leverage is need to improve the monitoring role of outside directors through institutional investors in China.

5.3.2 Strengthening the regulation on institutional investors to promote effective participation

Legislation in China needs strengthening the regulation on institutional investors when promoting institutional investors to participate in corporate governance. The context of regulations does not only refer to the regulation during institutional investors' participation in corporate governance, but also the conduct of institutional investors in the stock market.

5.3.2.1 Strengthening the disclosing duties during participation in corporate governance

1. Disclosing voting results

In theory, the vote is a kind of right of shareholders, so they have no duty to cast votes at shareholder meetings. The fact that shareholders do not vote is not violating the obligation, but is just recognized as "rational apathy." However, since institutional shareholders as trustees have fiduciary duties, voting is a kind of essential approach that institutions involve in corporate governance and fulfill the obligations of trustees.

Scholars in Japan and China consider that the law should require that institutional investors have a duty of exercising the vote.[376] A neutral point of view is that it is not appropriate that the voting right of institutional shareholders is a general duty, but as an obligation under some specific conditions, which might be feasible to solve the problem of apathy and passive of institutional investors.[377]

Legislation in Japan has established a requirement that shareholders should announce voting results as a legal liability.[378] According to this regulation, listed companies should not only disclose whether each resolution was accepted or rejected but also disclose the number of votes for support or rejection of proposals. The results of institutional shareholders exercising voting rights should not only be disclosed to the actual fund owners but also to the public.

Thus, the legislation in Japan provides public investors the detailed information of listed companies and the situation of participation by institutional investors in corporate governance, which may bring two benefits. The first benefit improves the transparency of listed companies and promotes the institutional shareholders to exercise voting rights properly and reasonably. The second benefit strengthens the disclosure duty of institutional shareholders so that they may exercise voting rights to protect the rights of minority shareholders.[379]

In China, the legislation does not require listed companies to disclose voting results of shareholders meetings. By drawing on Japan, the legal regulations of voting rights should be

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[376] Akira Morita, *Kikan toshi ka* [Institutional investors], in *Junkan shoji homu* [Junkan Commercial Law] no.1466 (1997): 36. Liping Shen, *Jigou touzizhe daili xingshi biaojue quan* [Institutional Investors Exercising Proxy Voting Rights], *Journal of Southwest University of National* no. 216 (2009): 144-145.

[377] Hui Zhang, *Falv xingwei kuangjia zhongde gudong biaojuequan zhidu tanxi* [Shareholders' Voting Rights in Legal Framework], in *Henan shehui kexue* [Henan Social Science] 14, no.4 (2006): 66.

[378] Japan Cabinet Office Ordinance on Disclosure of Information of Enterprises, revised in June 2010 and enforced in October 1, 2010.

[379] Naoyoshi Ema, [General Meeting in 2010], 39.

modified in China in order to require listed companies and their shareholders to disclose their voting results at shareholders meetings. Legislation should require that shareholders disclose not only whether each resolution was accepted or rejected but also the numbers of votes for support or objection of the proposals. Furthermore, the institutional shareholders should announce the statistical results of the voting to the public.

In practice, as pointed out in Chapter 2, some institutional shareholders are passive participants in corporate governance or support the proposals of the portfolio company to obtain their own interests instead of the value of the company and minority shareholders during voting process. Three benefits may contribute to the disclosure of voting results of institutional shareholders. First, the disclosure enforces the institutional shareholders to comply with the liability of disclosing information legally and reasonably to the ultimate fund owners, so that it strengthens the trustee liability of institutional investors. Second, the disclosure may promote the institutional investors to involve in corporate governance of portfolio companies and protect the rights of minority shareholders through exerting voting rights at shareholder meetings. Third, the disclosure also improves the transparency to prevent institutional shareholders from exercising voting rights in a disordered and unlawful way only for their own interests rather than the value of the company and the profits of the ultimate investors. Thus, the disclosure is helpful to alleviate the conflict of interests between institutional investors and portfolio companies.

2. Disclosing duty of soliciting proxy voting

Proxy voting right is an important right of shareholders in company law. Institutional investors may solicit proxy voting rights to other shareholders in some occasions. Both Japan and China provides proxy rights for shareholders. In China, the Company Law 2005 and the *Code* 2002 authorize a shareholder the right to collect proxy voting and cast votes at the

general meeting.[380] The Company Law 2005 further requires that a proxy holder should present the proxy statement issued by the shareholder to the company and should exercise his or her voting rights to the extent authorized by the proxy.[381] The *Code* 2002 provides that the information should be disclosed adequately to persons whose voting rights are being solicited.[382]

In Japan, a shareholder may exercise voting rights by proxy in a joint-stock company according to Article 310(1) of the Companies Act 2005. Article 194 of *Financial Instruments and Exchange Act* of Japan has several prohibitions against soliciting proxy voting rights.[383] The *Cabinet Office Ordinance on Solicitation to Exercise Voting Rights of Listed Shares by Proxy* stipulates, "The solicitors shall give the shareholders the document stating matters of reference for the exercise of proxy votes."[384] Furthermore, the solicitors should state clearly the vote to approve or disapprove issues of resolutions in the document evidencing the authority of proxy.[385]

From the legal regulations of China and Japan, both countries impose the responsibility of disclosing and instructing information on solicitors to shareholders. Legislation requires disclosing information in order to prevent some solicitors from abusing solicitation of exercising voting rights for their own interests. However, Japan in this regard has more specific and stringent requirements. On one side, legislation requires solicitors to disclose the soliciting information in detail to the shareholders so that they may have the option to vote to

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[380] China Company Law (2005), Article 107, and Code of Corporate Governance for Chinese Listed Companies (2002), Article 9.

[381] China Company Law (2005), Article 107.

[382] Code of Corporate Governance for Chinese Listed Companies (2002), Article 10.

[383] Japan Financial Instruments and Exchange Act (2006), Article 194.

[384] Cabinet Office Ordinance on Solicitation to Exercise Voting Rights of Listed Shares by Proxy, Article 1.

[385] Ibid., Article 10.

approve or disapprove issues or to vote for or against proposals. On the other side, the prohibition on soliciting proxy voting rights actually aims to give regulation on solicitors from abusing and seeking their own interests rather than shareholders' profits.

In China, one provision states that solicitors should exercise their voting rights to the extent authorized by the proxy in China, and it implies that solicitors should reflect the will of shareholders and conduct for the benefits of shareholders. Article 10 of the *Code* 2002 stipulates that "The information should be disclosed adequately to persons whose voting rights are being solicited."[386] This provision means that solicitors should disclose enough information in detail to the shareholders. By drawing on Japan, the stipulations should be made clearer to prevent from abusing effectively.

By strengthening the disclosure liability of the institutional investors and the role of supervising authority, institutional investors are required to comply with the compulsive duty of disclosing information to the public investors, which is helpful to prevent unlawful conduct during participation in corporate governance.

5.3.2.2 Strengthening regulations on the wrongful acts of institutional investors

Due to the emerging stock market of China, some institutional investors have been involved in wrongful acts such as insider trading and manipulation for short-term interests. Such acts lead to negative participation in corporate governance by institutional investors. In spite of the legislation on regulating insider trading and manipulation of market, there are shortfalls as pointed out in Chapter 3. Therefore, improving regulating on institutional investor is necessary.

1. Improving systematic regulation on wrongful trading acts of institutional investors

By examining the legislation on regulating on insider trading and manipulation behaviors,

[386] Code of Corporate Governance for Chinese Listed Companies (2002), Article 10.

the system of liability on misconduct of institutional investors between Japan and China includes three aspects: administrative, criminal, and civil liabilities. However, both countries more emphasize the administrative liability and the criminal liability to punish the misconducts in stock markets, while the relevant provisions of civil liability for compensation are weak. One of the important reasons for the deficiency of civil liability is that it is difficult for an individual investor as a plaintiff to prove the casual relationship between the damages and the wrongful acts of institutional investors.

In Japan, the burden of proof of insider trading is unregulated in securities statute, and victims have to bring litigation and hold the burden of proof according to the procedures of the general civil liability on securities misconducts in Japan.[387] Therefore, similar to China, proving the illegal behavior of defendant and the casual relationship in Japan is difficult. Such a situation could be attributed to the dependence on supervision of the administrative agency of the government rather than redress of civil liability.

In 2002, the issue of *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market* indicated the civil compensation action was only limited to the behavior of misrepresentation. During this period, investors brought the civil compensation litigation only due to the behavior of misrepresentation. Moreover, the Securities Law 2005 further expands the civil actions to the insider trading and manipulation of stock price. China has established the legal framework of civil action of securities compensation, but such legislation needs to improve for further step.

An academician suggests that the regulatory authority bears the burden of proof of primary illegal facts and transfer the burden of proof of part of particular facts to the plaintiff

[387] Japan Civil Code, Article 709.

and the third party.[388] Thus, the burden of proof of the plaintiff could be alleviated to some extent, and promote the securities civil action against insider trading and protect the redress rights of public investors.

Moreover, in Japan, according to Article 166(1) of *Financial Instruments and Exchange Act* 2006, "corporate insider who has come to know any material fact relating to the business, shall not make sales or purchase, other types of transfer for value or acceptance of such transfer for value, before the material facts pertaining to business or other matters are publicized."[389] Thus, the legislation identifies the insider trading behavior according to the subjects of insiders. A person cannot purchase or sell out the securities if he/she contributes to the subject of insider trading according to the requirement of law.

In China, however, there are two standards of identifying insider trading. On the one side, the conduct of insider trading requires "making use of inside information," but it is difficult to prove so in practice. On the other side, the legislation judges the insider trading from the identity of insiders rather than the utilization of the insider information.

Accordingly, the standard of identifying insider trading in China is obscure and confusing, and judging whether or not a conduct is insider trading in practice is difficult. It is necessary that simplify and clarify the standard of identifying insider trading. Identifying insider trading on the basis of subjects of insider trading might be appropriate, since proving insiders engage in insider trading is difficult.

2. Improving the role of regulatory authorities in the Chinese stock market

Japan adopted the system of combination of administrative regulation and Self-Regulation Organizations and also relies more on the administrative regulation of the

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[388] Qijia Ma, [Comparative Study on Legal System of Securities Civil Liability], 367-368.

[389] Japan Financial Instruments and Exchange Act (2006), Article 166(1).

government than Self-Regulation Organizations (hereinafter SROs). Similarly, China also owns a two-tier regulatory model, in which the special regulation-based China Securities Regulatory Commission (CSRC) serves as the main body and the SROs as supplement.

As pointed out in Chapter 3, two main defects contribute to the regulatory authority in the Chinese stock market: (1) the selective imposing penalties by the regulatory authority; and (2) the cost in time and efforts to impose penalties. Meanwhile, the SROs, including the Chinese Stock Exchanges and Securities Industrial Association, have not played an effective supervising role.[390] Some scholars contend that the government should give the minimum of hindrance to the market activities and authorize the broad power of supervision to SROs in China.[391] It is inappropriate that the regulatory authority give the minimum of hindrance to supervision, but taking into account the role of the SROs is of importance.

As pointed out in Chapter 4, the SRO consists of several merits. First, the members of SROs are more familiar with the business operations of the stock market and can respond to changes in the complicated stock market promptly and effectively. Second, the SROs are easier to change their rules of regulation flexibility to make up for the loopholes in current regulatory law. Third, the SROs are more likely to understand directly the transactions of investors so that they can recognize and discipline misconduct in the stock market as soon as possible.[392]

In Japan, the SROs are given increasing authority to supervise misconduct in the stock market. For instance, the Tokyo Stock Exchange (TSE) can conduct investigations on the

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[390] Yuqin Bai, *Woguo zhengquan jianguan tizhi de yanjin, pingxi yu wanshan* [The Evolution, Evaluation and Promotion of Chinese Securities Regulatory System], in *Falv shiyong* [Journal of Application of Law] no.7 (2006): 79.

[391] Daisong Chen, *Lun mei ying zhengquan jianguan tizhi zhi xin fazhan* [New Development of Securities Regulatory System of the US and UK], *Hebei Law Science* 24, no.1 (2006): 132.

[392] Tomonobu Yamashita and Hideki Kanda, 420-421.

insider trading behaviors of registered securities companies. Although SROs have some advantages, they are actually under the supervision of the SESC, which has authority to examine and supervise the activities and the rules of SROs.[393] Therefore, in order to strengthen the regulation on insider trading and manipulation of institutional investors in China, strengthening both roles of the CSRC and SROs is necessary so as to maintain a national smooth market system.

5.4 Summary

By comparing and contrasting with Japan, this chapter discusses the similarities and differences of the corporate governance practices between two countries, and further analyzes the growth basis and different roles of institutional investors in different corporate governance structure. In China, the growth of institutional investors is considered as a government behavior. In contrast, the increase of institutional investors in Japan is a spontaneous behavior of the market. By comparison, this chapter reaches two conclusions including (1) the need for restricting the controlling shareholders; and (2) learning experience from Japan to improve legal framework on institutional investors' effective participation in corporate governance in China.

Concerning controlling shareholders, China does not only need for transferring state-owned shares continually, but also needs improving legislation on restricting on the voting rights of controlling shareholders to prevent from abuse. This chapter reaches the following four conclusions: (1) accelerate reducing state-owned shares in competitive areas to let those state-owned companies gradually fade out of competitive industries; (2) seek a balance between the state interests and non-state interests during the process of reducing

[393] Ichiro Kawamoto and Yasunami Otake, 457.

state-owned shares; (3) transfer state share-ownership to some institutional investors such as NSSF in order to reduce the state shareholdings and increase the shareholdings of institutional investors; and (4) improve legislation on restricting on the voting rights of controlling shareholders.

Moreover, China should improve the legal framework of promoting effective participation of institutional investors in corporate governance in the following two aspects: (1) promoting institutional investors' participation in corporate governance; and (2) strengthening the regulation on institutional investors to promote effective participation in China. Concerning promoting institutional participation, this chapter mainly proposes two suggestions including: a) Establishing guidelines for exerting voting rights of institutional investors; and b) combining the institutional investors with the outside directors to play monitoring function effectively.

Strengthening the regulation on the conducts for institutional investors in the following two main aspects: 1) emphasizing the information disclosure of institutional investors, including disclosing voting results and disclosing during soliciting proxy rights of institutional investors; and 2) strengthening the regulation on the wrongful share-trading acts of institutional investors, mainly including improving the civil liability system in the stock market and strengthening both the supervising roles of regulatory authority and self-regulatory organizations in the Chinese stock market.

Conclusion

During the past three decades, China has undergone a period of transition from a planned economy to a market-oriented economy. With the rapid development of the economy and integration into the WTO in 2001, China has created a series of new laws and regulations to improve the corporate governance of listed companies. China's WTO accession in 2001 exerted external pressure upon Chinese legislation so that China had to speed up the legal harmonization of domestic laws in line with international standards. However, the corporate governance of Chinese listed companies still displays significant weaknesses in practice and enforcement. The primary problem currently arises from the abuse and expropriation of controlling shareholders especially state-controlled.

This dissertation studied how to bolster institutional investors' role in promoting better corporate governance in Chinese listed companies which can alleviate the expropriation and infringement of controlling shareholders and managers in China. With the increase of institutional investors in China, using the creative mechanism of institutional investors to improve corporate governance is significant. The unique situation of Chinese corporate governance needs for institutional investor participating in corporate governance in China from the following four aspects: (1) the systematic shortfalls in corporate governance; (2) forming an effective monitoring pressure; (3) protecting minority shareholders; and (4) fiduciary duty. On the basis of necessity, the dissertation examines the current legal practices covering legislations

and cases of institutional investors' participation in corporate governance in China, and explains the obstacles blocking institutional participation such as (1) the large state-controlled ownership; (2) the misconduct of institutional investors in the emerging stock market; and (3) the shortfalls of legislation on participation in corporate governance by institutional investors.

Next, the dissertation examines the situation covering the historical development and legal practices of institutional investors' participation in corporate governance in Japan. By comparison, the dissertation discusses the similarities and differences of the corporate supervising practices between two countries, and further analyzes the growth basis and different roles of institutional investors in different corporate governance structure. In China, the growth of institutional investors is a government behavior. In contrast, the increase of institutional investors in Japan is a spontaneous behavior of the market.

By comparison, this study reaches two conclusions including (1) the need for restricting the controlling shareholders; and (2) the need to improve the legal framework on institutional investors' effective participation in corporate governance in China. Concerning the controlling shareholders, China does not only need for transferring state-owned shares continually, but also needs improving legislations on restricting on the voting rights of controlling shareholders to prevent from abuse.

By drawing on Japan, this dissertation mainly proposes that the legal framework on promoting effective corporate governance should be improved by: (1) promoting participation of institutional investors in corporate governance; and (2) strengthening

the regulation on institutional investors to promote effective participation in China. In terms of promoting institutional investors' participation in corporate governance, the study mainly proposes two suggestions, including: a) Establishing guidelines for exerting voting rights of institutional investors; and b) combining the institutional investors with the outside directors to play monitoring function effectively.

Concerning strengthening the regulation on institutional investors, it is of great importance for China to do from two main aspects including: a) disclosing the information of institutional investors, including disclosing voting results and disclosing during soliciting proxy rights of institutional investors; and b) strengthening the regulation on the wrongful share-trading acts of institutional investors.

This dissertation stresses the role of institutional investors in monitoring controlling shareholders and managers such as directors and executive officers in the listed companies. However, this study had limitations. The largest limitation of this study is the difficulty of balancing the share ownership structure of the listed companies to promote institutional activism. Moreover, the role of institutional investors is just one mechanism that may be used to promote good corporate governance, so strengthening the role of the enforced systematic monitoring mechanisms especially the outside directors is also important. Combining enforced systematic monitoring mechanisms with the leveraging of institutional investor power to improve corporate governance in China is of great importance.

Lastly, turning to topics for further study, there is still a long way to go to further

improve institutional activism in China. China should seize the precious opportunity to continue deepening the reform to transfer state-owned share ownership. In this context, institutional investors can be expected to exert a more significant role in improving corporate governance.

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