SHAREHOLDER PROPOSAL RIGHT IN PUBLIC CORPORATIONS IN CHINA'S TRANSITIONAL ECONOMY:

FROM THE PERSPECTIVE OF SHAREHOLDER ACTIVISM

Qing Cao

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Abstract

This paper is dedicated to find the appropriate approach to adopt a new "shareholder proposal rule" for the improvement of the corporate governance of Chinese public companies. This paper argues that the current Chinese shareholder proposal rule is primitive and not practical and it does not provide a mechanism for the shareholders to seek remedies after their proposals are illegally excluded by the board of directors. In this paper, the author spends substantial effort on examining the Chinese shareholder proposal rule which is in its infancy stage. Based upon the examination of shareholder rules in nine representative jurisdictions, the author stresses that the proposal right should be treated and protected as one of shareholder's fundamental rights. Unfortunately, the existing Chinese law does a poor job on securing this right. After demonstrating how the current corporate law and policies in China's transitional economy indirectly eviscerate and limit the shareholder proposal right, this paper proposes that the Chinese legislators and the government agencies, especially the China Securities Regulatory Commission (CSRC), should notice this regulatory disadvantage and promulgate a practical and integrated shareholder proposal rule in order to encourage shareholder's participation in corporate governance.

I. INTRODUCTION

Since this paper is an exploration of the shareholder proposal rule, it will begin with an introduction of the shareholder proposal and the shareholder proposal rule. The second section of this chapter will focus on the comparative study of the shareholder proposal rules in nine representative jurisdictions, which provides a

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basis for the analysis of the Chinese shareholder proposal rule. An introduction of the shareholder activism in which shareholder proposals are used as a main legal device is provided in the third section, and the fourth section focuses on the theoretical discussion of why shareholders should be granted the right to submit proposals to corporations. In the fifth section, the author will give a detailed analysis of the shareholder proposal rule. The last section draws the conclusion.

A. An introduction to shareholder proposal

In this section the author will make a comprehensive introduction of shareholder proposal and the "shareholder proposal rule". The objective is to enable the reader to fully understand the background of this article. It will begin with an explanation of the shareholder proposal and the utilization of shareholder proposal in the context of shareholders' meeting, which is the main platform for the shareholders to participate in corporate governance. After that, the author will make a general explanation of "shareholder proposal rule" and its emergence in the United States.

1. Shareholders and meeting of shareholders

Modern public corporations[1] are generally structured with several tiers of organs charged with different powers and functions. Theoretically, the shareholders are collectively on the top of the organizational structure, since they are regarded as the ultimate owners of the corporation.[2] However, due to the large number of shareholders in a corporation, it is impossible to allow every shareholder to participate in the daily management of the corporation. Therefore, the corporation law gives the power of supervising and monitoring the operations of the corporation to the board of directors who are elected by the shareholders, and then the board will appoint senior management to operate the daily business of the corporation. Thus, the shareholder's financial interest[3] in the corporation is guaranteed only when the directors and senior

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[1] Here public corporations mean publicly held corporations whose shares are listed in the stock exchanges and can be freely transferred, see generally ROBERT W. HAMILTON, THE LAW OF CORPORATIONS: IN A NUTSHELL (W. Pub. Group 1996).

[2] There are many theories on the nature of the corporation. Some of the theories suggest that the shareholders are just the supplier of the capital such as the nexus of contract theory, see id. at 6-12. But in practice, the shareholders are collectively regarded as the owner of the corporation, while the corporation itself enjoys its own legal personality.

[3] Basically, the shareholder's financial interest in the corporation comes from the dividend distributed by the corporation and selling the shares in a higher price which depend upon the well financial performance of the corporation, see generally Julian Velasco, *The Fundamental Rights of The Shareholder*, 40 U.C. DAVIS L. REV. 407 (2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=761904.

management can skillfully fulfill their fiduciary duties to the corporation.[4] This kind of separation of ownership and control is a common feature of modern public corporation.[5] Noticing this feature as the economic background, legislators around the world had modified corporation laws to be in accordance with the transitioned ownership structure and provided mechanisms to protect the interest of shareholders.[6]

Therefore, the regulations on public corporations should try to minimize the negative effect of this agency problem.[7] They should provide mechanisms for the shareholders to monitor the activities of the directors and corporate officers, and empower them with the right to make decisions on the fundamental matters of the corporation in certain circumstances. One of these mechanisms is the shareholders' meeting.[8]

As prescribed by the corporation laws[9] and the charters or bylaws of the corporations, the corporations are required to convene all the shareholders to have an annual meeting to vote on fundamental matters of the corporation.[10] Besides the annual general meeting, an extraordinary general meeting can also be called by the board of directors or the shareholders who own certain percentages of the outstanding shares independently or jointly, or by the corporate officers[11] under certain circumstances.

A shareholders' meeting essentially consists of three steps: (1) the preparation of the meeting; (2) the meeting/voting itself; and (3) the judicial review of whether the directors, the controlling shareholders,

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[4] The directors are considered as the trustees of the corporation. And they bear a fiduciary duty to the shareholders. Generally speaking, the fiduciary duty comprises two duties: duties of loyalty and duty of care, see HAMILTON, *supra* note 1, at 378.

[5] This feature was first identified by the U.S scholars Berle and Means, see ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119-20 (1991).

[6] Christine L. Ayotte, *Reevaluating the Shareholder Proposal Rule in the Wake of Cracker Barrel and the Era of Institutional Investors*, 48 CATH. U. L. REV. 511, 512 (1999) ("For example, in the United States, the Securities Act of 1933 was promulgated to address matters such as the disclosure of corporate information to shareholders since they were in a disadvantageous position. It was considered as the first step in ensuring corporate accountability to the shareholders through shareholder knowledge and participation.").

[7] Agency problem is a trust problem between the principal and the agent when the agent does not perform his duty well. The agency problem in the public corporations will be discussed in the third chapter as the reason for supporting the incorporation of shareholder proposal rule in the corporation law framework, see *infra* Part 3.2.

[8] The rule on the shareholder's meeting is an indispensable part of the corporation law, see, e.g., Canadian Business Corporation Act §§ 132-154; Code de Commerce § 3 (art. L. 225-96- L 225-126) (Fr.); Germany Federal Stock Corporation Act §§ 118, 241; Del. Gen'l Co. Law §§ 211-233.

[9] *See*, *e.g*., MODEL BUS. CORP.ACT § 7.01(a) (1984). (A shareholders' meeting shall be held annually at a time stated in or fixed in accordance with the bylaws.).

[10] Due to the time limit, some institutional investor can not attend the shareholder's meetings of all its portfolio companies, they may grant its voting right through proxy and other voting agreement.

[11] *See* HAMILTON, *supra* note 1, at 204.

or the shareholders' meeting itself violate statutes, charters, bylaws, or other corporate rules.[12] Unless the shareholders themselves invoke the meeting, the agenda and the proxy materials of the meeting will be prepared by the board of directors and the corporate officers.[13] Generally speaking, the following matters will be discussed and voted in the general shareholder meeting: (i) the election of the directors; (ii) the issuance of new shares; (iii) the matter of merger and acquisition or the sale of substantial assets.

2. Shareholder proposal[14]

As discussed above, the shareholders are granted the power to vote on certain fundamental matters of the corporation in the shareholders' meeting. Furthermore, corporation law in all jurisdictions also empowers shareholders to submit their own proposals to the shareholders' meeting and requires the board of directors to circulate these proposals to all the shareholders.[15] These proposals are called "shareholder proposals" or "member's resolutions".

The shareholder proposals are presented in written form and submitted to the board of directors before the shareholder general meeting. The proposals usually suggest the corporations to make certain actions with a brief explanation or statement. The proposals are under a limitation of length, which means they cannot exceed a certain number of words. The shareholder proposals can be mainly divided into two categories according to the addressed matters: "corporate governance proposals"[16] and "corporate social responsibility proposals".

The corporate governance proposals are proposals which directly address corporate governance issues.[17] They involve many issues

[12] *See* Dirk Zetzsche, *Shareholder Interaction Preceding Shareholder meetings of Public Corporations- A Six Country Comparison*, EUR. CORP. & FIN L. REV., Feb. 6, 2005, at 8, *available at* http://ssrn.com/abstract=624241.

[13] *See id*. at 8 (This procedure has actually confined shareholder's rights to a very little amount.).

[14] Shareholder proposal is a term mainly used in the American legal tradition. Under the British legal tradition, the same things are called member's resolution. This terminology has been used in the Australian law, Hong Kong law, see *infra* Part 2.

[15] *See* Zetzsche*, supra* note 12, at 13.

[16] Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. The principal stakeholders are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large.

[17] For example, in the United States, "out of the 668 shareholder proposals submitted during 2003 proxy season, 423 were corporate governance proposals", see Diane K. Schooley, Celia Renner & Mary Allen, *Corporate Governance Reform: Electing Directors Through Shareholder Proposals*, CPA J., Oct. 2005, *available at* http://www.nysscpa.org/cpajournal/2005/1005/essentials/p62.htm.

such as the excessive executive compensation[18] and the rescission of use of poison pills[19] for anti-takeover defense. Other issues addressed by those shareholder proposals include the declassification of the staggered board of directors[20] and the separation of the CEO and board chairman positions. Some corporate governance proposals also call for the adoption of cumulative voting for the election of directors.[21]

Another category of proposals which can be classified as corporate social responsibility proposals addresses to the social responsibilities of the corporations.[22] The issues which have been expressed in this kind of proposals range from employment

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[18] *See Fat Cats Feeding*, ECONOMIST, Oct. 11, 2003, at 84; *see* Diane, *supra* note 17 ("For example, in the 2003 proxy season nearly 40% of the 423 corporate governance proposals were related to executive compensation. Issues included whether to award stock options and, if so, when to expense them. Stock options are often issued with the aim of aligning executives' interests with those of the shareholders. The recent use of stock options, however, has taken executive compensation to such absurdly high levels in the minds of some that they think that the executives are overpaid, a situation that is not in the shareholders' best interests."). Excessive executive compensation has become the top concern of corporate governance.

[19] Poison pill is a strategy used by the target company in the occasion of hostile takeover. With this strategy, the target company aims at making its own stock less attractive to the acquirer. There are two types of poison pills. The 'flip-in' poison pill allows existing shareholders (except the bidding company) to buy more shares at a discount. This type of poison pill is usually written into the company's shareholder-rights plan. The goal of the flip-in poison pill is to dilute the shares held by the bidder and make the takeover bid more difficult and expensive. The 'flip-over' poison pill allows stockholders to buy the acquirer's shares at a discounted price in the event of a merger. If investors fail to take part in the poison pill by purchasing stock at the discounted price, the outstanding shares will not be diluted enough to ward off a takeover. An extreme version of the poison pill is the "suicide pill" whereby the takeover-target company may take action that may lead to its ultimate destruction.

[20] *See* HAMILTON, *supra* note 1, at 219 ("A staggered board of directors occurs when a corporation elects its directors a few at a time, with different groups of directors having overlapping multi-year terms, instead of *en masse*, with all directors having one-year terms. Each group of directors is put in a specified "class", e.g., Class I, Class II, etc., hence staggered boards are also known as "classified boards""); Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) ("In publicly held companies, staggered boards have the effect of making hostile takeover attempts more difficult. When a board is staggered, hostile bidders must win more than one proxy fight at successive shareholders' meetings in order to exercise control of the target firm. Particularly in combination with a poison pill, a staggered board that cannot be dismantled or evaded is one of the most potent takeover defenses available to U.S. companies.")

[21] *See* HAMILTION, *supra* note 1, at 566 ("Cumulative voting is a method of voting that allows substantial minority shareholders to obtain representation in the board of directors. When voting cumulatively, a shareholder may cast all of his or her available vote in the election in favor of a single candidate.").

[22] Corporate social responsibility (CSR, also called corporate responsibility, corporate citizenship, and responsible business) is a concept whereby organizations consider the interests of society by taking responsibility for the impact of their activities on customers, suppliers, employees, shareholders, communities and other stakeholders, as well as the environment.

discrimination[23] to the sweatshops in the Asian countries. Some other issues include the calling for the companies to retreat investment from countries where human right is abused or poorly protected.

B. The shareholder proposal rule

1. The elements of the shareholder proposal rule

Corporation laws in all jurisdictions have set up the rules and procedures for shareholders to submit the shareholder proposals and on how the board of director can deal with them.[24] The shareholder proposal rule is mainly about (1) eligibility: the requirement of eligibility from the shareholders is measured by the relative or absolute holding of the shares of the corporation and the holding period; (2) timeliness: the proposal should be submitted in advance for a certain period; (3) length limit: the proposal cannot exceed a certain number of words; (4) scrutinizing mechanism: in order to avoid the abuse of the shareholder proposal right, the management is given the discretion to deny the circulation of some proposals under prescribed criteria; (5) redress system: here it means the remedies from administrative agencies or judicial organs that can be sought after by shareholders when their proposals are improperly denied by the board of directors.

2. The emergence of the shareholder proposal rule in the United States

Since the separation of ownership and control in modern public corporations was identified by US scholars,[25] the legislators and regulators in the United States including the Securities and Exchange Commission (hereinafter "SEC") correspondingly enacted a number of legislations[26] and regulations to protect the shareholders who are in a disadvantageous position in terms of their powers to control the operation of the corporation and to access to the internal information of the corporation.[27]

[23] *See*, *e.g*., Anne Moore Odell , *Proxy Votes on Sexual Orientation Nondiscrimination Draw Strong Support*, SOC. FUNDS, Feb.5, 2007, *available at* http://www.socialfunds.com/news/article.cgi/2221.html.

[24] The author has conducted a legal survey on the shareholder proposal rules in several jurisdictions, *see infra* Part 2.

[25] *See supra* note 5.

[26] *See* Ayotte, *supra* note 6. The U.S. Congress also enacted the Securities Exchange Act of 1934 to provide protection to investor to ensure fair and orderly securities market.

[27] *See generally* Ayotte*, supra* note 6, 511-556.

Embedded with the authority to promulgate rules and regulations for the protection of the investors,[28] the SEC enacted the SEC Rule 14a-8.[29] Section 14a of the Securities and Exchange Act of 1934[30] grants the SEC the right to prescribe detailed rules for the proxy process.[31] This has the effect of giving shareholders the right to submit their proposals to the shareholders' meeting and specifying the conditions "when a company must include a shareholder's proposal in its proxy statement and identify the proposal in its form of proxy when the company holds an annual or special meeting of shareholders".[32]

A more detailed introduction of the rules and an assessment of the impact and practice of this rule will be discussed in the following section.[33]

II. A GLOBAL SURVEY OF SHAREHOLDER PROPOSAL RULE

Since the shareholder proposal rule was first promulgated by the SEC in the United States in 1942, similar rules that grant shareholders the right to submit proposals to the shareholders' meeting have been incorporated in corporation laws or commercial laws in many jurisdictions around the world.

In order to obtain a comprehensive understanding of the importance and the mechanism of the shareholder proposal rule, the author has done a preliminary comparative legal survey[34] of the rule

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[28] Securities Exchange Act of 1934, §14 (a), 15 U.S.C. 78n (a) (1994) ("a. Solicitation of proxies in violation of rules and regulations: It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12."). This rule gives the SEC the authority to prescribe rules to further the proxy rules.

[29] *See* Shareholder Proposal Rule, 17 C.F.R. § 14(a)-8 (1998).

[30] *Id.*

[31] *See* Hamilton, *supra* note 1, at 221-222 ("Proxy is a confusing term. A proxy can be referred to a person who is authorized by a record shareholder to vote his or her shares. The relationship is one of principal and agent. Proxy can also be used to designate the document that creates the authority, the grant of authority itself. The Model Business Corporation Act (1984) limits the use of the word proxy to the person with the power to vote, it refers to the grant of authority as the appointment of a proxy, and the document creating the appointment as an appointment form."), According to this rule, the SEC has promulgated 19 SEC rules from SEC rule 14a-1 -14a-17, and SEC rule 14a-103, 14a-104, and one schedule 14A on the information required in proxy statement. The list and text of all these rules is available at http://www.law.uc.edu/CCL/34ActRls/reg14A.html.

[32] *See supra* note 29.

[33] *See infra* Part 2.1.

[34] Comparative studies is one of the most important ways of studying law. Through comparative studies, we can acquire a comprehensive knowledge of the common and different feature of the legal rules in different jurisdictions, and observe the interaction between the legal rules and its social and economic background, and finally we can achieve a better result in finding a solution for our own

under the corporation laws[35] of several jurisdictions.[36] A basic assessment as to the efficiency of the rules in some jurisdictions will be conducted.

A. United States[37]

As introduced in the aforesaid paragraphs, the shareholder proposal rule was firstly promulgated in the United States by the SEC in 1942. The SEC intended this rule to ensure an avenue for shareholders' active participation in corporate governance. The promulgation of this rule was appreciated by the legal academia who argued that the shareholder proposal rule gives shareholders an opportunity to influence the decisions of the management.[38]

The rule grants certain categories of shareholders the right to require the board of directors to put their proposals in the annual proxy materials.[39] The rule defines the shareholder proposal as "a recommendation or requirement that the company and/or its board of directors take action".[40] To be eligible to submit the shareholder proposal, a shareholder must have continuously held at least $2,000 in market value, or 1% of the company's securities. He is then entitled to vote on the proposal at the meeting for at least one year by the date he submits the proposal.[41] The directors are given the discretion to exclude some proposals under the criteria[42] prescribed in the rule by submitting a reason to the SEC. The SEC can take actions to enforce the directors to include certain proposals under the requirement of the shareholders if they deem proper to do so.

Since its promulgation in 1942, the SEC rule 14a-8 has been revised repeatedly to mitigate the confusion in practice. One of the notable modifications is the explanation of "proper subject". The SEC issued the policy statement that the purview of what constitutes

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respective jurisdiction. To know more about the comparative law, see generally MARY ANN GLENDON ET AL., COMPARATIVE LEGAL TRADITION IN A NUTSHELL (1999).

35 "Corporation law" here is used in a broad sense, which includes all the relevant legislations and regulations related to the corporations.

36 Jurisdictions to be discussed in this section are representatives of the two main legal traditions: Civil law and Common Law.

37 United States is a federal nation whose constitution did not grant the Congress the power to make legislation on corporations; instead, it is the authority of state legislatures to do so. However, the Congress has made two laws on securities regulations which have effect on the shareholder's right. Here the author is going to study the SEC rule 14a-8, which was promulgated by the SEC under the authority from Securities and Exchange Act of 1934.

38 *See* Milton V. Freeman, *An Estimate of The Practical Consequence of The Stockholder's Proposal Rule*, 34 U. Det. L. J. 549, at 555 (1957).

39 *See* SEC. EXCH. ACT §14a-8 (1934).

40 Question 1, *Securities Lawyer's Deskbook,* U. CINC. College of Law, http://taft.law.uc.edu/CCL/34ActRls/rule14a-8.html (last visited Dec. 26, 2010).

41 *Id*. question 2.

42 *Id*. question 9.

a proper subject was more appropriately left to the discretion of the individual states in accordance with state law.[43] But this attempt failed due to the vagueness of the statement and it resulted in continuing problems.[44] Another important revision of this rule centered on the "ordinary business exception".[45] This revision permits the management to exclude shareholder proposals that deal with public policy issue such as economic, racial, and religious issues. It was regarded as the beginning of a restrictive trend of decreasing corporate accountability to shareholders.[46]

The shareholder proposal rule has been playing an important role in the shareholder activism movement from the 1980s, in which some aggressive institutional shareholders pressed for the directors and the management to make changes in order to render better corporate governance as well as to ultimately improve financial performance.[47] However many recent empirical researches suggested that the rule is an inefficient mechanism to protect the shareholders' interest.[48] They attribute this inefficiency to the board's great discretion in excluding the proposals and the non-binding force of the proposals even though they have been passed by the majority vote. Nevertheless other researches suggested that even if the proposals are not binding, some change has taken place in the corporation after the passing of shareholder proposal. To some extent, this implicated that the shareholder proposal is influential on corporate governance.[49]

B. Germany

Under Germany's Federal Stock Corporation Act of 1965, shareholders have two kinds of right to make their proposals in the shareholders' meeting.

The first right is that shareholders can put an item in the shareholders' meeting agenda, which is generally prepared by the managers and the board of directors. Shareholders who own shares of a minimum of 5% or of a nominal value of 500,000 Euros may add items to the agenda.[50] This right is subject to the same terms as the right of the minority to convene the general meeting.

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43 *See* Ayotte, *supra* note 6, at 523.
44 *Id.* at 4.
45 Securities Lawyer's Deskbook, *supra* note 40, question 9.
46 *See* Ayotte, *supra* note 6, at 524.
47 A more detailed introduction about the shareholder activism movement, *see infra* Part 3.
48 *See* Bernard S. Black, *Shareholder Activism and Corporate Governance in United State, in 3*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 459-65 (1998).
49 *See* HAMILTON, *supra* note 1, at 360.
50 *See* Germany Federal Stock Corporation Act §§122, para. 2 (1965).

The second right lies in Article 126 of the Federal Stock Corporation Act of 1965. It provides that the shareholders can make counter-proposals to be put in the agenda of the shareholders' meeting.[51] However, this article did not set up any threshold to define the eligibility of shareholders who want to submit their counter-proposals. Under The counter-proposals rule, the shareholders are granted the right to give opposite opinions to the items in the shareholders' meeting agenda, but they have to do so with a supporting statement in their counter-proposals.[52]

C. Canada[53]

In Canada, Article 137 of the Canadian Business Corporation Act (1985)[54] provides that shareholders who hold the prescribed amount of shares can submit their proposals with a supporting statement to the shareholder's meeting. The rule also set up exceptions for the corporations to exclude certain categories of proposals in order to avoid the abuse of the requisition right.

The Canadian Business Corporation Act Regulation of 2001 provides a supplementary regulation to clarify the eligibility. Part 6 of this regulation is devoted to the interpretation of the shareholder proposal rule. It stipulates that the shareholders who hold 1% of the outstanding shares or at least 2,000 Canadian dollars for at least six month[55] are eligible to submit proposal to the shareholders' meeting.

D. United Kingdom

In the United Kingdom, the latest legislation on corporations is the Companies Act of 2006. Part 13 of this legislation prescribes detailed rules on the member's resolution and statement.[56] Section 281 provides that a resolution of the members of a public company must be passed at a meeting of members.[57] Sections 288-295 involve the general rules of written resolutions. Under these rules, the members are eligible to require the corporation to circulate to the

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51 Germany Federal Stock Corporation Act §§126 (1965).

52 *See, e.g.*, *The Shareholder Proposal Submitted to the General Shareholders' Meeting of 2006*, Siemens AG, http://w1.siemens.com/pool/en/investor_relations/events/annual_shareholders_meeting/archive/Gegenantraege_D_1331552.pdf (last updated Jan.12, 2006).

53 Canada is a federal country, where both the federal government and provincial government have the right to make legislation on the corporations. Here the author only discusses the legislation in the federal level.

54 Canadian Business Corporation Act, R.S.C. 1985, c. C-137.

55 Canadian Business Corporations Regulations**,** SOR/2001-512, par. 6, http://laws.justice.gc.ca/en/showdoc/cr/SOR-2001-512/bo-ga:l_6//en (last visited Dec. 8, 2010).

56 Companies Act, 2006, c. 46 (U.K.) (The title of part 13 is "resolutions and meetings". It has seven chapters.).

57 Companies Act, 2006, § 281(2) (U.K.).

other members their resolution with a statement not exceeding 1000 words[58] but they have to cover the expenses of circulation by themselves unless the company resolves otherwise.[59] In the context of public companies, members who represent more than 5% of the total voting rights or a group of members who hold shares of more than 10,000 Euros are eligible to require the company to circulate their resolution proposal,[60] and the company will cover the expenses incurred. The companies may reject the circulation of the resolution if it is defamatory, frivolous or vexatious.[61]

E. Australia[62]

In Australia, the newly enacted Corporation Act of 2001 provides that members of the corporation (shareholders) have the right to submit their resolution and attached statement to the meeting of members of the corporation.[63] Members holding shares of more than 5% of the vote or alternatively 100 members who are entitled to vote[64] can cast the resolution. The proposed resolution must not be more than 1,000 words in length or defamatory.[65] The corporation will cover the expenses of the circulation if the resolution and statement are submitted within the specified period.

This rule is often used by the Australian activist shareholders such as the labor unions. Regarding its effectiveness, one research indicates that even though "no resolution put forward by a union has been passed at a company's annual general meeting (AGM) and 'vote no' campaigns against board resolutions have failed to garner significant support of other shareholders", this kind of action still "has the potential to facilitate action on the part of the board to resolve issues raised by unions, particularly where some support of institutional investors is attained. It may also have the effect of influencing the future conduct of the board of directors, in their relationship with unions."[66]

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58 Companies Act, 2006, c. 46 (U.K.) (Title of section 293 is "circulation of written resolution proposed by the members" while title of section 314 is "members' power to require circulation of statement".).

59 *See* Companies Act, 2006, c. 2 § 294(1) (U.K.).

60 *See* Companies Act, 2006, c. 4§338 (U.K.).

61 *Id.*

62 *Id.*

63 *See Corporations Act 2001* (Cth) ss 249N-249P (Austl.).

64 *See Corporations Act* 2001 (Cth) s 249N(1), (Austl.). This rule is also called "The '100 member rule' ", see KIRSTEN ANDERSON & IAN RAMSAY, FROM THE PICKETLINE TO THE BOARDROOM: UNION SHAREHOLDER ACTIVISM IN AUSTRALIA 50 (Ctr. for Corporate Law and Sec. Regulation & Ctr. for Emp't and Labor Relations Law 2005)(2005).

65 *Corporations Act* 2001 (Cth) s 249O 5(a) (Austl.).

66 ANDERSON & RAMSAY, *supra* note 64, at 6.

F. Japan

Among the jurisdictions in the Asian countries, Japan was the first to adopt the shareholder proposal rule into its Commercial Code.[67] The legislative modification which grants more right to the shareholders to participate in the shareholders' meeting was strongly influenced by the SEC shareholder proposal rule from the United States. The legislative intention was to revitalize the shareholders' meeting and enable minority shareholders to express their concerns and opinions as well as to exert their shareholder right collectively.

The Commercial Code of Japan was renamed to Company Law after a systematic revision in 2005, of which the shareholder proposal rule was incorporated in Articles 303, 304, 305.[68]

In brief, the rule sets up a relatively low eligibility requirement. Shareholders holding either shares of more than 1% of the voting right or more than 300 shares are eligible to submit proposals. Corporations can prescribe lower requirement in their charters. The minimum of the holding period is six months.[69]

G. Republic of Korea

In the Republic of Korea, the Commercial Act is the main legislation that regulates the corporation activities. The latest modification of this act was in 2001.

Articles 363 Paragraph 2 provides for the shareholder proposal rule, which was added into the Commercial Act in 1998. The rule gives the shareholders who hold more than 3% of voting shares to submit a proposal to make a matter a subject of the shareholders' meeting. The proposal must be submitted in written form to the directors at least six weeks before the day set for such meeting.[70] The board has to accept the proposal unless it violates the relevant legislations or charters of the corporation. The shareholders are granted the right to explain their proposal in person at the shareholders' meeting.[71]

H. Taiwan[72]

In 2005, Taiwan revised its Company Law in light of the global tendency that emphasizes on the importance of corporate

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[67] *See* SHŌHŌ [SHŌHŌ] [COMM. C.] 1950, art. 237 (Japan), *available at* http://www.japanlaw.info/japancommercialcode/Japan%20Commercial%20Code%20Table%20of%20Contents.html#Chapter 7. Commercial Agents.

[68] Kaisha Kosei Ho [Japan Corporations Law] 2005, art. 303-305.

[69] *Id.*

[70] Sangbeob [Commercial Act], Act. No. 1000, Jan. 20 1962, art. 363-2 (1) (S. Kor.).

[71] *Id*. art. 363-2(3).

[72] *Id*. art. 363-2(3).

governance. The revision granted more right to shareholders to monitor the activities of the board of directors and the management.

Article 172 sets up the rules for the shareholders to submit their proposals to the shareholders' meeting. The shareholders who hold more than 1% of the issued shares are eligible to submit their proposals to the corporation in written form. One shareholder can only submit one proposal to the corporation in order to avoid the abuse of this right and to limit the workload of the corporation. In addition, the length of the proposal is restricted to 300 Chinese characters.[73]

The rule also grants the board of directors the power to exclude certain proposals under the following criteria, namely: (1) when the proposal is beyond the authority of the shareholders' meeting; (2) when the shareholders who submit the proposal do not reach the requirement of minimum holding; and (3) when the proposal is submitted out of the period that is set forth in the notice of the shareholders' meeting.[74]

I. Hong Kong[75]

In Hong Kong, the shareholder proposal rule is provided in its corporation legislation. Under Article 115A of the Companies Ordinance of Hong Kong, members of the company are eligible to require the company to circulate their resolution to other members.[76] Only a member or members representing not less than one-fortieth of the total voting rights of all members are entitled to have such a requisition right. In occasions where more than 50 members holding shares in the company on which there has been paid up an average sum, per member, of not less than $2000,[77] members can ask for the circulation of the resolution. However, the expenses of the circulation have to be covered by the members.[78]

J. Summary

After the examination of the shareholder proposal rules in these nine jurisdictions, we can find a certain degree of similarity among those rules. This phenomenon can be viewed as an example of

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[73] *See* Zhonghua Minguo Gongsi Fa (Company Act of Taiwan) art. 172 (2005) (Taiwan, China).

[74] *Id.*

[75] Hong Kong had been a colony of United Kingdom since the the middle of the 19th century and its legal tradition is based on the United Kingdom legal system. From July 1 1997, the People's Republic of China began to exert sovereignty in Hong Kong, while keeping the basic legal system intact including the corporation legal framework. We can see a lot of similarity between UK corporation law and Hong Kong Company Ordinance.

[76] Hong Kong Companies Ordinance, (2010) Cap. 32, 102, § 115A1(a).

[77] Hong Kong Companies Ordinance, (2010) Cap. 32, 102, § 115A1(b).

[78] *Id.*

"legal transplant".[79] In the context of shareholder proposal rule, we can see that the US rule, i.e. the SEC Rule 14a-8, does influence the adoption of the shareholder proposal rule in Canada. Later Japan transplanted the US rule into its Commercial Code,[80] which was subsequently modeled by the Republic of Korea.

From another perspective, this similarity can be viewed as an example of the global trend of convergence in corporation legislation.[81] A principal reason for this convergence is a widespread normative consensus that corporate managers should act exclusively in the economic interests of shareholders, including the non-controlling shareholders.[82] Other reasons for the new consensus include the competitive success of contemporary British and American firms, the growing worldwide influence of the academic discipline in economics and finance, the dispersiveness of share ownership in developed countries, and the emergence of active shareholder representatives and interest groups in major jurisdictions.[83]

III. WHY IS THE SHAREHOLDER PROPOSAL RULE IMPORTANT FOR SHAREHOLDERS?

In this section, the author will conduct a theoretical discussion on the importance of shareholder participation in corporate governance through the submission of shareholder proposal. The author will argue in the following two approaches: firstly, a shareholder's right to submit shareholder proposals to the shareholders' meeting should be part of his fundamental right; secondly, a shareholder should be encouraged to participate in corporate governance in order to reduce the agency cost.

A. Shareholder's fundamental rights[84]

Shareholders are the owners of the corporation. This has been explicitly stated in the corporation law in many jurisdictions. A set of rights is granted to the shareholders, and these fundamental rights constitute the basis for shareholders to participate in corporate

[79] *See* ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW (2d ed. 1993) (Legal transplant can be defined as a body of law or individual legal rule that was copied from a law or rule already in force in another country.).

[80] *See infra* Part 2.6.

[81] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* (Harvard Law Sch., Discussion Paper No. 280, 2000).

[82] *Id.*

[83] *Id.*

[84] *See generally* Julian Velasco, *The Fundamental Rights of the Shareholders*, 40 U.C. DAVIS L. REV. 407 (2006).

governance. In this part, the author will first give a summary of the shareholder's rights, followed by a discussion on the different roles of directors and shareholders. Secondly, the author will argue that shareholders should be granted the right to submit shareholder proposals for the purpose of ensuring the enforcement of their basic rights and the protection of their interests.

1. The four basic rights

According to Velasco's research,[85] shareholders' rights can be classified into four categories: (1) economic rights; (2) control rights; (3) information rights; and (4) litigation rights.

a. Economic rights

Shareholders invest in a corporation primarily for economic gain through receiving the distribution of the company's profit or from selling the shares at a higher price. Correspondingly, the economic rights of shareholders should include the right to the declared dividends[86] and the right to sell shares.[87]

b. Control rights

As the owners of the corporation, shareholders should be given certain control of the company in order to secure their investment interest. Since there are too many shareholders in a modern public listed company, it is therefore impossible for all the shareholders to control the company directly. Instead, they are given the right to elect a board of directors to supervise and manage the business operations of the corporation. Those directors owe a fiduciary duty to the shareholders. By electing the directors, shareholders are supposed to have the ultimate control of the business. In addition, they are given the right to vote on the fundamental matters of the company. These fundamental matters vary in different jurisdictions, but some matters are common in all jurisdictions such as the approval of a merger and the amendment of charters and bylaws of the corporation.[88]

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[85] *See* Julian Velasco, *The Fundamental Rights of the Shareholders*, 40 U.C. DAVIS L. REV., 407, 439 (2006).

[86] *Id*. at 414 ("The right to receive dividend is a limited one, both in law and in fact. Legally, shareholders only have the right to receive such dividends as are declared by the corporation's board of directors. Directors have no obligation to declare dividends and may reinvest the corporation's profit rather than distribute them to shareholders.").

[87] The shares are considered as a form of personal property, *id*. at 414-15. However the freedom of transferring the stocks by shareholders is limited under several conditions especially under the situation of hostile takeover.

[88] *See id*. at 419 (The right to vote on fundamental matters gives shareholders a voice in corporate affairs, but this voice is limited. First, shareholder generally can vote only on matters submitted by the directors. Moreover, directors often can find ways around the shareholder approval requirement.).

c. Information rights

Shareholders need to be informed in the company's operation and its corporate governance so that they can evaluate the company's performance and reconsider their investment decision: whether to hold the shares for a longer time or sell them. Thus shareholders need timely and genuine information on all the fundamental matters and material events of the corporation. Shareholders of publicly listed corporation can easily get this information since the public corporations are under the mandatory disclosure requirement by the securities law.[89] Shareholders can also obtain other information from the directors and corporate officers by demonstrating a proper purpose.[90]

d. Litigation rights

Litigation is the last resort used by shareholders to protect their financial interests. There are two kinds of litigation the shareholders can launch: "direct litigation" and "derivative litigation". Direct litigation refers to the situation where shareholders can sue the corporation under their own name. For example, they are allowed to sue the corporation for non-payment of dividends, or to present a petition to the court for the dissolution of the corporation or to file a class action with other shareholders under certain circumstances.[91] Derivate action means that the shareholders can sue the directors and management who have performed poorly or breached their fiduciary duty. Since the shareholders act on behalf of the corporation, this kind of action is called derivative action.[92]

e. Prioritizing the rights

Shareholders possess the four categories of rights above. However, they are not of equal significance. Two of them are more important than the others: "economic right" and "control right". With respect to the economic rights, the right to receive dividend is not much expected by shareholders since it is within the discretion of the board of directors. In contrast, the right to sell the shares is relatively more important both because it is a mean of obtaining economic benefit from their investment and because it is their means

[89] Mandatory disclosure of business information of public corporations is very common in securities laws over all jurisdictions, see*,* e.g., SEC. EXCH. ACT, § 13(a)-(b), 15 U.S.C. 78m (a)-(b), 17 C.F.R. 240.13a-1,-11,-13(2006), (annual report, current reports, and quarterly reports, respectively).

[90] *See supra* note 84, at 408.

[91] *Id*. at 423. However as stated by the author, shareholders' right to bring direct action toward the corporation is limited.

[92] *See id*. at 422 (The shareholders' right to launch derivative suit is also limited under many complicated procedures and chances of wining this kind of derivative suit are also small).

to exit if they become dissatisfied with the management.[93] As for the control right, i.e. the right to elect the directors, the reason for its significance is because the shareholders can make the directors accountable by removing those whom they are discontent with while the voting rights only have a limited influence on the board.[94]

2. Director's role and shareholder's role in corporate governance

Under the corporation law framework, the directors have a different role from the shareholders. They are regarded as the ultimate managers of the business, but their discretion is not unlimited. Directors' authority is only within the management of the affairs of the business but not the affairs of the shareholders. Similarly, they have the power to control the assets of the corporation, but not the personal assets of the shareholders.[95]

If we examine the ownership structure of a modern public corporation, we can find two tiers of ownership structure: the shareholders own the companies by holding the stocks of the company, while the company itself owns the corporate assets.[96] In a way, we can say that the shares owned by the shareholders are their personal assets. When the directors make some decisions that will influence the shareholders' interest in their shares, these decisions should be approved by the shareholders. The election of directors is also exclusively the affairs of shareholders. If directors use some mechanism to intervene the election, it would contravene the regulations.

3. Shareholder proposal right as a monitoring mechanism

We have known that directors should not intervene in shareholders' own affairs and basic rights, but the reality is that shareholders' rights and interests are often infringed or ignored. For example, in the context of shareholders' meetings, nearly all the matters are prepared and arranged by the directors, including the nomination of new directors. Therefore, in order to protect their own interests, the shareholders should be eligible to work together to subject to the accountable directors and remove the policies which hurt the interest of the shareholders. The shareholders' meeting is the main forum for shareholders to discuss their affairs and exert their voting rights. In these occasions, shareholders should be

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[93] *Id*. at 425.
[94] *Id,* at 426.
[95] *Id*. at 431.
[96] *See* Iwai, Katsuhito, *The Nature of the Business Corporation: Its Legal Structure and Economic Functions,* 53 JAPANESE ECON. REV., 243 (2002).

granted the right to submit their own proposals for discussion and voting in order to counter the directors' control of the meeting agenda.

B. The agency problem in a public corporation

1. The agency theory

One of the features in a modern public corporation is the separation of ownership and control, which means that shareholders as owners of the public corporations do not have much control in the management of the corporation. The power of managing the daily operations in the corporation is held by the directors and the corporate managers.

We can find the agency problem from this separation of ownership and management. An agency relationship involves a principal (the owner or shareholder) and an agent (a manager or director or employee).[97] The principal hires or retains the agent because of the agent's specific talents, knowledge and capabilities to increase the value of an asset. In order to increase the value of that asset, all or some of the principal's decision rights over that asset must be transferred to the agent for a finite period of time. The agency theory assumes that the interests of owners and managers or board members (principals and agents, respectively) are not, *ex ante*, aligned.[98] For instance, managers or directors want to maximize their own wealth, power and prestige while safeguarding their reputation, whereas shareholders want to maximize the value of their assets. These interests often collide, as managers and directors can take actions that increase their power, influence or prestige without increasing the value of the shareholders' equity.[99]

Usually there are two kinds of managerial failures which increase of the costs of the corporation, deviating them from acting as perfect agents of the shareholders:

(1) Failures of managerial competence (genuine mistakes and miscalculations) relating to unwitting mistakes in the discharge of managerial control; (2) Failures of managerial integrity (lies, fabrications, embezzlement and self-dealing) referring to the willful behaviors on the part of managers that negatively impact the value of the company's assets.[100]

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[97] *See generally* Michael C. Jensen and William H.Meckling, *Theory of the Firm: Managerial Behavior, Agency Cost, and Ownership Structure*, 3, J. FINANCIAL ECON., 305 (1976).

[98] *Id.*

[99] *Id.*

[100] Mihnea Moldoveanu and Roger Martin, *Agency Theory and the Design of Efficient Governance Mechanisms,* U. TORONTO, (Feb. 2, 2001), http://www.rotman.utoronto.ca/rogermartin/Agencytheory.pdf.

There are three basic elements in the agency model: (1) decision right; (2) knowledge; and (3) incentive. The decision right can be divided into two categories: decision management right and decision control right. Knowledge can be classified into two kinds, one is general knowledge and the other is special knowledge. The incentive is about reward and punishment. Correspondingly, there are two kinds of incentive: pecuniary and non-pecuniary incentives. The agency failure occurs whenever the decision right, the necessary specific and general knowledge and the incentives are not co-located in the same person. Therefore, to design an efficient corporate governance framework is also to co-locate these three elements into one person. There are three possible ways to avoid the agency failure:

a. Align decision rights with specific knowledge. This principle suggests that decision rights should be pushed downward in the organizational hierarchy to the levels at which they reside in the same people (managers or employees), who have the specific knowledge to competently use those rights.[101]

b. Align incentives with decision rights. This principle suggests that the incentive package given to board members, managers and employees match the decision rights given to these people.[102]

c. Design efficient monitoring mechanisms based on observable performance measures.[103]

2. Encouragement of shareholders' monitoring to cut the agency cost

An efficient monitoring system depends on the diligent performance of the monitors. In the context of public corporations, the role of the board of directors is monitoring rather than managing the corporation. They are supposed to monitor the performance of the managers who are appointed by them. However, sometimes there are internal problems, which will impair the efficiency of the monitoring and supervision of the management performance.

First is the overlapping of the board and the senior management. In modern public corporations, some senior corporate officers also sit in the board of the directors. It is common that the chairman of the board is also the chief executive officer of the same corporation. This phenomenon causes people doubt on how efficient is the board's monitoring of the performance of the managers. A possible solution to solve this agency problem is to allow shareholders to directly monitor the performance of the managers through the

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[101] *Id.*
[102] *Id.*
[103] *Id.*

submission of shareholder proposals under this circumstance. They should be entitled to vote on the proposals such as the separation of the chairman and the directors, or a reduction in the excessive compensation of the executives.

The second is that no one monitors the directors: the directors are supposed to be the monitors of the corporation. However, there is no one who actually monitors those directors, and we can not be absolutely sure that the directors always perform their duties well. Given the fact that shareholders are the owners of the corporation and the directors should work for their interests, the corporation law should allow them to participate more in the monitoring of the directors. They can monitor the directors through the voting and election of directors, and the cumulative voting system should be adopted to make the minority shareholders being represented by the directors who care for their interests.

IV. FEATURES AND PROBLEMS OF CORPORATE GOVERNANCE IN CHINESE PUBLIC COMPANIES

This paper attempts to find a solution for the problems in the corporate governance among Chinese public companies from the perspective of shareholder participation. The previous chapters can be viewed as a preparation for this mission. They constitute as a reference and theoretical basis for my research in the examination of Chinese shareholder proposal rule which will be the main task of the following two sections.

A. Ownership structure and protection of the minority shareholders

The ownership structure of Chinese public companies is highly concentrated. Most of the listed companies are restructured from state-owned enterprises (SOE). Upon their listings in the stock exchanges, they are still controlled by state-owned companies who act as a separate legal entity. The State-owned companies are usually the largest shareholders, and hold more than 80% of the shares which cannot be traded in the market.[104] Due to the high concentration of ownership, shareholders' meetings become a form where the will of the largest shareholders—the state-owned companies, will definitely be accorded and the interest of the minority shareholders is almost always neglected and expropriated.

[104] On September 5th, 2005, CSRC issued the "*Measures on administration of split share structure reform of listed companies*". By this regulation, CSRC intended to solve the non-tradable shares problems which constitute a hurdle for the development of Chinese stock market. At the end of March of 2006, 769 listed companies had either completed or initiated their NTS reform process. *See* Andrea Beltratti and Bernardo Bortolotti, *the Nontradable Share Reform in the Chinese Stock Market*, September 2006, *available at* http://web.econ.unito.it/bortolotti/bb/chinaNTS.pdf .

B. The management structure- three committee system

According to the Chinese Company Law enacted in 1993, the listed companies are required to have three governing bodies: the shareholders' meeting, the board of directors and the board of supervisors.[105] These three governing bodies hold different functions as prescribed in the Company Law.

1. Shareholders' meeting

The most important function of the shareholders' meeting is to elect the board of directors and to approve the budget of the corporation.[106] Due to the concentrated ownership, the shareholders' meeting does not function sufficiently as a platform for the minority shareholders to express their opinions.

2. The board of supervisors

According to the Chinese Company Law, the board of supervisors should be composed of representatives from both shareholders and employees. Among them, the number of employee representatives should not be less than one third of the all the representatives. The board of supervisors monitors the activities of directors and senior managers, ensuring that they act in the interest of the company. However, the boards of supervisors in listed companies do not perform as well as expected.

There are several causes for this problem. First, many of these supervisors are state representatives, party officers or labor union leaders, and they are actually in a lower position than the board of directors. They lack information and the professional knowledge to monitor the performance of directors and senior officers. Another cause is that some external supervisors are not stationed at the company's offices. As a result, they can not adequately monitor the directors and senior officers.

3. The board of directors

The board of directors should consist of 5 to 19 members under the current law.[107] The members of this board should be elected in the shareholders' meeting, and the representatives of the employees can sit in this board.[108] Before 2001, there were no independent directors or outside directors sitting in the board. In 2001, CSRC

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[105] Simon S.M. Ho, *Corporate Governance in China: Key Problems and Prospects,* 33 Research on Applied Ethics 62, 62 (2005) (Taiwan, China).

[106] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People' Cong., Dec.29, 1993, revised Oct. 27, 2005, effective Jan. 1, 2006) (Chinalawinfo) art.38 (Chinalawinfo).

[107] *Id.* art. 109.

[108] *Id.* Note that an employee representative is not allowed to sit in board of directors and board of supervisors at the same time.

issued a regulation,[109] which requires the listed companies to have one third of their directors composed of independent directors. A research in 2005 found that the proportion of outside directors on the board is surprisingly high, with a mean of 70.6% and a standard deviation of 18.3%.[110] However, the research also indicates that although the proportion of outsider directors on the board is high, the level of the board's independence and professionalism does not necessarily correlate. For example, in the board of many listed companies, politicians and state-controlling owners occupy most board seats. They report that almost 50% of the directors are appointed by state-controlling owners, and another 30% are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants, finance experts) on Chinese boards and almost no representative of minority shareholders.[111]

Another problem in the board is that more than one third of the CEOs are also the chairmen of the board of directors. This has the effect of hindering the board from playing an elective monitoring role.

C. *The state of information disclosure*

According to the Chinese rules on information disclosure,[112] a public company has to notify its shareholders of its periodical and annual financial statements, as well as the information relating to the material events such as the sale of assets or a merger and acquisition. The CSRC is the monitor of these disclosure activities by the public companies. One major problem related to the disclosure of the financial information is the fraud and misrepresentation of financial statements. Several scandals have happened in the recent years. Some researches argue that the cause of such fraud is that the cost of committing dishonesty is too low while the potential return is very high.[113]

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[109] See Guanyu ZaiShangshi Gonggsi jianli Duli Dongshi Zhidu de Zhidao Yijian (关于在上市公司建立独立董事制度的指导意见) [Establishment of Independent Director Systems by Listed Companies Guiding Opinion] (promulgated by the China Securities Regulatory Commission., Aug 16, 2001, effective Aug 16, 2001) (Chinalawinfo) art.1 (Chinalawinfo).

[110] Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants, 52* CESifo ECON. STU'S 415, 423 (2006), *available at* http://www.hiebs.hku.hk/working_papers.asp?ID=152.

[111] *Id*.

[112] *See* Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. Nat'l People' Cong., Dec.29, 1998, revised Oct 27, 2005, effective Jan 1, 2006) (Chinalawinfo) art.63, 64, 65, 66, 67 (Chinalawinfo).

[113] *See* Ho, *supra* note105, at 66.

D. The role of the governmental agency: CSRC

Since its establishment in 1992, the Chinese Securities Regulation Committee (CSRC) has issued many regulations concerning corporate governance. In particular, on the basis of the OECD principles, the CSRC and the State Economic and Trade Committee jointly issued the "*Code of Corporate Governance for Listed Companies in China*" in January 2001. Another important function of CSRC is to enforce the legislations and regulations related to the securities of public companies. Some researches indicate that the CSRC's reluctance to impose tough sanctions on the companies that violate the rules results in more misconduct of public companies.[114]

E. Shareholders' participation in corporate governance

Chinese individual investors are generally passive investors.[115] They take a speculative strategy on stocks and frequently follow others' investment activities, and seldom apply the basic analysis to choose stocks. Since individual investors usually hold only a very small amount of shares, they are not so willing to attend the shareholders' meetings and to take part in corporate governance.

On the other hand, Chinese institutional investors participate more actively in corporate governance. As institutional ownership increases, institutional investors begin to actively involve in the governance of their portfolio companies. But the general level of institutional shareholder activism remains unsatisfactory.[116] The factors which lead to the passivity of Chinese institutional investors include the ownership structure, the self-interest of institutional investors, and some other regulatory rules that raise the costs of participation in corporate governance.[117]

V. AN ANATOMY OF THE SHAREHOLDER PROPOSAL RULE OF CHINA

In this section, the author will begin with an introduction to the Chinese shareholder proposal rule. Generally speaking, the shareholder proposal rule of China is made up of provisions from the Company Law and the regulations promulgated by the CSRC, therefore the introduction of this rule will be divided into two parts based on its composition. The author will analyze the rules by comparing the Chinese rule with the rules in other jurisdictions.

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[114] *See* Ho, *supra* note 105, at 4.1 Legal Enforcement.

[115] *See generally* ZHENGQUAN SHICHANG DE GUOJI BIJIAO (证券市场的国际比较) [INTERNATIONAL COMPARISON OF SECURITIES MARKETS] (XIE BAISAN ED., 2003).

[116] *See generally* Chao Xi, *Institutional Shareholder Activism in China: Law and Practice*. 17 INT' COMP. & COMM. L. REV., 251 (2006).

[117] *Id.* at 251.

The author will then point out the impracticality and shortcomings of the Chinese rule. Lastly, the author will make a legal recommendation based on the comparative study.

A. Shareholder proposal rule in the Company Law

The Company Law of China was enacted in 1993. At that time, the shareholder's right to submit proposals to the shareholders' meeting was not provided for. The Company Law was revised in 1999 and 2004 respectively, but these two revisions did not mention anything about the shareholder proposal rule. In 2005 the Company Law was revised for the third time, and the shareholder proposal rule was finally incorporated into the text of the Company Law.

The shareholder's right to submit proposals to the shareholder's meeting is provided in the paragraph 2, article 103:

> the shareholders who hold solely or jointly more than 3 percent of the shares of the company, can move proposals and submit it to the board of directors in written form ten days before the date set for the shareholder's meeting; the board of directors should notify other shareholders in two days after the reception of the proposals, and bring these proposals to the shareholder's meeting for deliberation. The content of the proposal should be within the authority of the shareholder's meeting and with a clear issue and concrete items for resolution.[118]

We can see that the rule is quite simple. It sets up a relatively high standard on the eligibility of the shareholders who want to submit the proposals and gives a general requirement on the content of the proposals. However, it did not specify the length of the holding period and the numbers of proposals a shareholder can submit. The author will make a detailed analysis and comments on this rule in the following paragraphs.

B. CSRC rule

After the Company Law was modified in 2005, CSRC also modified the *Rules on the Shareholder's Meeting of Listed Corporations*.[119] Articles 13 and 14 of this regulation are about the shareholder proposal. First let us have a look at the text of these two provisions.

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[118] Gongsi Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat'l People' Cong., Dec.29, 1993, revised Oct. 27, 2005, effective Jan. 1, 2006) (Chinalawinfo) art.103(2) (Chinalawinfo).

[119] The rule was initially issued in 2000, and was modified in order to be in accordance with the revised Company Law in 2005.

Article 13

The content of the proposal should fall in the scope of the authority of the shareholder's meeting. It should have a clear subject matter and concrete item for voting of resolution. It also should be in consistent with relevant provisions of the legislation, administrative regulation and the charter of the corporation.

Article 14

The shareholders who hold solely or jointly more than 3 percent of the issued shares of the corporation are entitled to submit interim proposals in written form to the convener 10 days before the shareholder meeting. The convener of the meeting should issue a supplementary announce notifying the content of the interim proposals two days after the reception of the proposals.

Except the rules provided for in the above provision, the convener can not alter the prescribed resolution or add new resolution after the announcement of the shareholder's meeting has been notified. The proposals which are not included in the notification materials of the shareholder's meeting or are not in consistent with the article 13 of this rule, should not be voted and made into resolution in the shareholder's meeting.

We can find that the CSRC rule did not add any substantial point to the provisions in the Company Law (2005).

In summary, the Chinese shareholder proposal rule is very primitive and not practical. This will cause confusion and problems when the shareholders apply this rule to submit proposals. Furthermore, it does not prescribe detailed instructions for the directors on how to deal with the shareholder proposals. At last, there is no redress system where the shareholder can seek remedies if their proposals are improperly excluded. The author will give an analysis point by point in the following paragraphs.

C. Eligibility

1. The amount of the shares

Eligibility is the first issue of the shareholder proposal rule. It is about who are eligible to submit shareholder proposals to shareholders' meetings. The eligibility is determined by the amount of the shares held by the shareholders. Generally speaking, there are two standards adopted by the legislators of those jurisdictions examined in the comparative study: "absolute amount" or "relative amount".

Absolute amount means that the rule clearly specifies the number of shares that the shareholder has to hold to be qualified. As for relative amount, the rule simply provides a ratio of required holding of shares such as 1% or 2.5%. In some jurisdictions both standards are provided for, while in every jurisdiction they adopt the relative amount standard.

We can see how the eligibility is prescribed from the table below.

Table 1: Eligibility[120]

Jurisdiction	Absolute amount	Relative amount
United states	$2000	1%
Germany		5%
Canada	2000 Canadian dollar	1%
United kingdom	10,000 Euros	5%
Taiwan		1%
Hong Kong	100,000 HKD	2.5%
Australia		5%
Japan	300 shares	1%
Republic of Korea		1%
People's Republic of China		3%

The legislative concern in setting up a threshold for those shareholders, who want to submit the proposals, is to avoid the abuse of this requisition right.

We can find that in nearly all the jurisdiction, the requirement on the amount of holdings is lower than the standard adopted by Chinese shareholder proposal rule. Under the current Chinese rule, only the shareholders who hold solely or jointly more than 3% of the shares of the corporation with other shareholder are eligible to submit proposals.

The requirement on the amount of shares is too high under the current situation of Chinese stock market. It discourages the shareholder's incentive to submit proposals to the shareholders' meeting. As mentioned earlier, the ownership of Chinese public companies is concentrated in the hands of state-owned companies or the controlling families. Individual investors and institutional investors only hold a small portion of the issued shares and their holdings are dispersed, so only a few investors are eligible to submit proposals. Furthermore, there are some state-owned companies whose market capital is more than 100 billion RMB, such as the financial institutions[121] and utility companies. It is unlikely that an

[120] Blank means there is no such standard adopted in that jurisdiction or the relevant information is not available.

[121] For example, the largest bank in China is the Industrial and Commerce Bank of China (ICBC), its market capitalization is more than 2000 billion RMB in April 2008, and the largest institutional investor only holds 0.1% of the issued shares of ICBC, see the financial data of ICBC, *available at* http://money.finance.sina.com.cn/corp/go.php/vCI_CirculateStockHolder/stockid/601398/displaytype/30.phtml. If those institutional investors want to submit proposals to the shareholders' meeting of

investor can hold more than 1% of the issued shares. Based on this analysis, it is necessary for the Chinese regulator to lower the requirement of the amount, from 3% to 1%, which goes more in line with global practice. It will also be a good approach if the regulator adopts the absolute standard for the shareholder proposal rule, since more shareholders would be encouraged to take part in the shareholders' meeting and monitor the behavior of the management. A proper standard would be the shareholders holding more than 1000 shares of the company are eligible to submit their proposals to the shareholder's meeting.

2. The requirement of holding period

Besides the restrictions on the amount of holdings, the rule also defines the eligibility by requiring that the shareholders must have held the shares for a certain period before they submit the proposals.

Table 2 The requirement of holding period

Jurisdictions	United states	Canada	Japan
Length of holding period	One year	Six month	Six month

Among all the ten jurisdictions examined, only three jurisdictions made such requirement on the holding periods. Canadian and Japanese shareholder proposal rules are influenced by US SEC rules.

The absence of the requirement on a holding period in the Chinese shareholder proposal rule is a defect which will bring negative effect to the company and the stock market. Since the Chinese stock market is not as mature as its counterpart in the United States, there are still a lot of speculation activities in the market. In order to discourage this kind of speculative activities and maintain a healthy environment for the stock market and the public companies, the regulator needs to fill in this loophole. The author's recommendation is to set the requirement of holding period to 6 months.

ICBC, they need to find at least thirty other institutional investors to act together to meet the requirement of 3%, and it will cause a lot of communication cost for those investors, and this will apparently discourage them to adopt the activism strategy even there are serious corporate governance problem exist in the company.

D. The procedure of the proposal

1. When to submit: the timeliness of the submission of proposals

The timeliness of the submission of the shareholder proposal is an important issue. The timeliness refers to the time when the shareholders shall submit their proposals to the board of directors before the opening of shareholders' meeting.

We can see the difference from this table

Table 3: The timeliness of the submission

Jurisdiction	**Time**
United states	At least 120 days before the release of the proxy statement
Germany	Reasonable time before the notice
United kingdom	6 weeks before the meeting
Canada	90 days before the shareholders' meeting
Japan	8 weeks before the meeting
Australia	n/a
Taiwan	n/a
Republic of Korea	Six weeks before the shareholders' meeting
Hong Kong	n/a

The legal concern in requiring shareholders to submit their proposals in advance of the shareholders' meeting is to give time to the board for dealing with these proposals. Practically speaking, the more time the board has, the lower are the chances of the shareholders to prevail in pursuing their issue,[122] since many of the proposals are not are not aligned with the interest of the board.[123]

The Chinese rules only mention that the shareholders have to submit the proposals 10 days before the shareholders' meeting. This time is comparatively shorter than other jurisdictions. As a result, little time is left for the board of directors to prepare its defense against the proposals. In order to make a balance between the shareholders and the board, and to be in accordance with other legal recommendations, the author proposes the shareholders shall send in their proposals one month before the date set for the shareholders' meeting.

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[122] *See* Zetzsche, *supra* note 12, at 17.

[123] For example, many proposals call for the decrease of the excessive executive compensation and adoption of cumulative voting system in the election of the directors. If these proposals passed, it will restrain the board of directors from doing activities to increase their personal interest. So the board of directors always tries to defend against these proposals and solicit more shareholders to vote against these proposals by proxy solicitation.

2. How many proposals can be submitted?

The Chinese rule does not explicitly mention about the number of proposals a shareholder or a group of shareholders can submit. On the other hand, this issue has been explicitly mentioned in the shareholder proposal rules of the US, Japan and Taiwan, where the number of proposals is limited to one. The legislative concern for this restriction is to save the resources of the corporation since the expense in circulating the shareholder proposals is usually borne by the corporation.[124]

Considering the current situation of corporate governance in Chinese public companies, the author thinks it is better to give the shareholders more chance to express their concerns in the shareholders' meeting. The author proposes that the number of the proposals one shareholder can submit cannot be more than three. The author believes that this proposed regulatory change will encourage the passive Chinese shareholders to participate in corporate governance more actively.

3. The length of the proposal

In order to save the time of the board of director in dealing with the proposals, the rules require the proposals to be concise, which means that it cannot exceed a certain number of words.

The below table gives a comparison between jurisdictions in the length of the proposal.

Table 4: the length of the proposal

Jurisdiction	**Limit of length**
United states	500 words
Canada	500 words
Australia	1000 words
Taiwan	300 characters

The length of the proposals is a technical issue. The only legal concern in setting up such a limit on the length is to make communications faster and easier between shareholders and the board. The primitive Chinese rule does not consider about this issue. The author considers it necessary for the Chinese rule to have such a limitation and a proper limit is 500 characters, a length that allow the shareholders to make a concise proposal with a brief explanation.

[124] But there are also exceptions where the cost of circulation of the proposals will be covered by the shareholders who submit the proposals such as the U.K. rule and Hong Kong rule.

E. Scrutinizing of the proposal

The shareholder proposals mainly address issues related to corporate governance and corporate social responsibility. If the board accepts all the proposals submitted by the shareholders, it will be a big burden for the board of directors. In addition, it is not easy for the shareholders to discuss and vote on these proposals. Therefore, a scrutinizing system is necessary to lighten the burden of the board and avoid the abusive submission of shareholder proposals. The common practice for this matter is that the shareholder proposal rule prescribes criteria under which the board can exclude certain proposals. The following paragraphs will talk about the standards for exclusion of certain proposals and the procedures.

1. The criteria for exclusion of certain proposals

Among the ten jurisdictions examined in this article, the SEC rule 14a-8 of the United States prescribes the most detailed criteria.[125] Under that rule, a proposal will be excluded if it falls under one of the thirteen circumstances.[126] The Canadian rules also set up criteria for the board of directors to exclude certain proposals[127]. Among the civil law jurisdictions, all the rules are common in one standard: the proposal should not fall outside the authority of shareholders' meeting which has been prescribed by the company law and the charters of the company.

After a comparative study, the author summarizes the common exclusion elements depicted in the rules among all the jurisdictions.

The proposal is in violation of laws, regulations, charters and bylaws of corporations.[128]

The content of the proposal is beyond the authority of the shareholders' meeting.[129]

The submission is out of the prescribed period.[130]

Resubmission of proposal which was excluded before or not supported by a prescribed minimum amount of shareholders.[131]

Nomination of directors.[132]

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[125] *See* Securities Lawyer's Deskbook, *supra* note 40, Question 9.

[126] *Id*.

[127] *See* supra note 54.

[128] This circumstance is commonly prescribed in the civil law countries, such as Japan, *see*, *e.g*., Kaisha Kosei Ho [Japan Corporations Law] 2005, art. 305(4). *See* Sangbeob [Commercial Act], Act. No. 1000, Jan. 20, 1962, art. 363-2 (3) (S. Kor.). *See also supra* note 125.

[129] *See supra* note 73, art.172 (4).

[130] *See supr*a note 54, c. C-137 5(a). *See also id*. art.172.

[131] *See supr*a note 54, c. C-137 5(d). *See also supra* note 68, art. 305 (4).

[132] A common practice for the nomination of directors by shareholder is to require the shareholder to hold a relatively big amount of shares, usually more than 5 percent of the issued shares, see *supra* note 54, c. C-137 4. *See also* SEC. EXCH. ACT, 17 C.F.R. § 240.14a-8.

The Chinese rule does not prescribe detailed criteria under which the board can exclude shareholder proposals. It simply states that the proposal should be in accordance with the relevant legislations, regulations and charters of the company. It should have a clear subject and concrete item for resolution. After comparing with the rules in other jurisdictions, the author is of the opinion that the best way for a modification is to model the U.S SEC rule 14a-8 and incorporate the above exclusion elements into it.

2. The procedure of exclusion

The rules in some jurisdictions provide for the procedure when the board excludes the proposals under the prescribed criteria. Usually, the board is required to give notice to the shareholders whose proposal is excluded,[133] and submit the reason for the exclusion to the administrative agency[134] that regulates the securities activities.

The Chinese rule requires the board of directors to give an explanation for the exclusion of the shareholder proposal during the shareholders' meeting. The board also has to include the excluded proposals in the public announcement at the shareholders' meeting. Under this rule, the shareholders have no time to prepare arguments in support of their proposals and debate with the board.

F. Redress system

It is easy to imagine that the board sometimes excludes proposals due to negligence or a lack of personal interests. Obviously shareholders' interest will be affected under these kinds of circumstances. In order to protect the shareholders' interest, we need a redress system, which can provide remedies to the shareholders when their proposals are excluded improperly by the board of directors.

Usually there are three ways that the shareholders can seek remedies from. First, they can convoke a new shareholders' meeting to discuss about the excluded proposals;[135] second, they can seek remedies from the government agencies that regulate the activities of public corporations and securities investment such as the SEC of the United States.[136] Finally, they can submit their dispute

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[133] *See supra* note 54, art.137 (7).

[134] *See*, *e.g.*, SEC. EXCH. ACT § 14a-8 j(1) (1934).

[135] This method is too costly for the corporations and the shareholders.

[136] *See*, *e.g.*, SEC. EXCH. ACT § 14 (This subsection allows the shareholders who believe that the company's opposition to his or her proposal contains materially false or misleading statement to submit a letter explaining his or her view to SEC staff and the company. And if SEC holds that there is no wrongdoing of the company, they will issue a no-action letter and require the shareholder to revise the proposal.).

with the board to the judicial court and ask the court to judge whether the exclusion of the proposals is just under the law.[137]

The Chinese rule does not mention any of these three systems. If shareholder proposals are improperly rejected by the board, the shareholders have no way to redress the wrongful act of the board. The best choice for the regulator is to model the U.S rule, and the author proposes the following recommendation.

If the company wants to exclude the proposals, it should send a copy of the resolution and an explanation for its exclusion to the CSRC. If shareholders do not oppose this exclusion, they may ask the CSRC to provide a judgment. The CSRC can issue a non-action letter or require the board of directors to include the proposals if it concludes that the exclusion is without justifiable cause. Alternatively, the shareholders can also appeal to the court if they think that CSRC's issuance of non-action letter is groundless.

G. Summary

After analyzing the Chinese rule carefully, the author has found that the Chinese shareholder proposal rule is in its primitive stage. If the Chinese government intends to encourage shareholders' participation in corporate governance, it is necessary to make a modification on the current shareholder proposal rule.

Since the Chinese Company Law has not made a very detailed prescription of the requirements and procedures for shareholder proposal[138], the best approach for modification is to issue an interpretative regulation by the CSRC, which is in charge of supervision of public companies in China.

VI. CONCLUSION

As a tool utilized by the shareholders to take part in the corporate governance, the shareholder proposal has become more and more important, especially when the norm of shareholder primacy and the importance of corporate governance are gradually acknowledged in most of the jurisdictions in the world. As an example, we have seen the shareholder proposal rules has been adopted in many jurisdictions of the world.

The Chinese shareholder proposal rule is in its crawling stage. The current law with respect to shareholder proposal right is

[137] The court can restrain the holding of a meeting to which the proposal is sought to be presented on the application of a person who claims to be aggrieved by the corporation's refusal of his or her proposal, see Canadian Business Corporation Act, R.S.C. 1985, c. C-137 7 Para. 8.

[138] The Company Law of China serves as a general principle on the legislation of corporation. It will be supported by the administrative regulation issued by the State Council and other specialized governmental agencies such as CRSC.

impractical and lacking . While the corporate law explicitly grants shareholders the rights to submit proposal on certain matters, these provisions need more detailed interpretations in support. Therefore, problems come up when these existing provisions are being applied by the shareholders and the board of directors. In this regard, the author hopes the Chinese legislators and the government agencies, especially the CSRC, will notice this regulatory disadvantage and promulgate a practical and integrated shareholder proposal rule as to encourage shareholders' participation in corporate governance. This may be helpful for the improvement of corporate governance in Chinese public companies.

In sum, in order to make the shareholder proposal right fully protected, the Chinese legislators should pay special attention on improving the limits of the shareholder proposal eligibility. If measures of ameliorating the shareholder proposal scrutiny system and developing a remedy system are not implemented as soon as possible, the progress of economic transition would be negatively influenced. The author would like to conclude this article by hoping that China will find more stones beneath the water and keep on treading on them in the course of crossing the river.