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**Testimony before the U.S.-China Economic and Security Review Commission  
Hearing on “U.S. Investment in China’s Capital Markets and Military-Industrial Complex”**

**Panel I: The Role of the State in China’s Stock, Debt, and Venture Capital and Private  
Equity Markets**

**March 19, 2021**

Hearing Co-Chairs Borochoff and Fiedler, distinguished Commissioners and staff, thank you for inviting me to submit a testimony concerning the PRC’s party-state ownership, control, and corporate governance landscape. My testimony is based on past research<sup>1</sup> as well as on a book manuscript that I expect to complete in the coming months.<sup>2</sup>

*Q1: How does China’s government use its shareholding capacity to advance policy goals, and how does this differ from other means the state may use to direct the economy, such as controlling capital allocation via the financial system?*

The shareholding capacity of the Chinese government is an important tool among many others in the party-state’s toolbox for streamlining and consolidating control over the development of the market. At the market level, state holdings facilitate coordination, reducing information asymmetries between various state capacities and institutions. At the firm-level, the various interests of multiple state bodies can be consolidated and expressed in unison through the shareholders’ vote mechanism. These are a few of the basic theoretical assumptions that guided China’s experimentation with share ownership in the mid-1980 and which motivated the corporatization reform that later ensued.

Today, various forms of state ownership enable the party-state to have a continuously adaptable approach towards liberalization through experimentation, adjustments and stabilizing restraints—a significant advantage in a rapidly developing economy. Of course, the shareholding capacity of the state also bestows the party-state with potential economic as well as domestic-political gains that are still tied to its legitimacy narrative as the People’s Party.<sup>3</sup>

The advantages of state ownership, however, are not without costs to the party-state. As I elaborate below, in trying to mitigate such costs through a series of reforms, consequent legal and political-economic conditions developed and hinder the ability of the state to exercise unbridled control even in enterprises with majority state holdings.

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<sup>1</sup> Mainly: Tamar Groswald Ozery, *The Politicization of Corporate Governance—A Viable Alternative?*, AM. J. COMP. LAW, (forthcoming, 2021); Tamar Groswald Ozery, *Illiberal Governance and The Rise of China’s Public Firms: an Oxymoron or China’s Greatest Triumph?*, U. Pa. J. Int’l L., Vol 42(4) (forthcoming, 2021)

<sup>2</sup> Tamar Groswald Ozery, LAW AND POLITICAL ECONOMY IN CORPORATE CHINA: EVOLUTION, REVOLUTION AND MARKET DEVELOPMENT (under review).

<sup>3</sup> Yet, the economic gains from state ownership that end up in the central state’s coffers are substantially lower than set targets: see, Tianlei Huang, *Chinese SOEs should Help Fund China’s Response to Pandemic*, PIIIE, Apr. 2, 2020, <https://www.piiie.com/blogs/china-economic-watch/chinese-soes-should-help-fund-chinas-response-pandemic>

The historical context of the Chinese state's capacity as a shareholder is interlinked with its effort to establish a “modern enterprise system”. Such effort, taken formally in the early 1990s, had two primary goals: 1) financing and rebuilding a troubled state sector, and; 2) reversing some of the political effects of economic decentralization of the earlier decade.

The shift to a modern, share-based, enterprise system was carried through China's “corporatization” scheme—an industrial reorganization plan set to reorganize State-Owned Enterprises (SOEs) as one of the 3 corporate forms recognized under China's then newly enacted Company Law.<sup>4</sup> The new corporations embraced attributes of a “modern enterprise system”, including corporate legal personhood, limited liability, and transferability of rights. Social welfare functions, remnants of the planned economy, were removed and shares were issued to signify the ownership interest of the state. Separation between ownership and management was also formally adopted to gradually shift the management of state assets from bureaucrats to professional managers.

Almost simultaneously, these now-corporatized SOEs turned to China's newly established stock exchanges to raise capital. They issued their shares to domestic and foreign investors, while strategically refraining from privatization and maintaining control with the state. China's nascent capital markets were then, and to a large degree still today, a financing platform for state enterprises that enables the state to preserve its voting control disproportionately to its cash flow contributions.

Increasing the gap between the state's voting control and its cash flow rights was actively pursued in China throughout its market transition. From the inception of China's corporatization process with SOEs that raised passive equity capital while keeping state shares non-tradable; through the reorganization of these firms into larger pyramid holding groups in the 90s and early 2000s; waves of M&A activity that reduced the number of state-owned enterprises but enhanced their scope;<sup>5</sup> and finally via the mixed-ownership scheme that is pursued in full gusto in the past several years.<sup>6</sup> Like public listings, mix-ownership was commonly branded as a plan to “privatize” Chinese SOEs, but in fact, entrenched the state as a controlling shareholder in many ostensibly “privatized” firms. Indeed, the said aim of these schemes is to make firms more efficient by diversifying their shareholder-base, making their managers more accountable to market forces and more focused on generating returns, while still retaining state control.

One of the main mechanisms to carry forward the mixed-ownership reform is public financing (capital market issuance and listing of shares). According to an Asia Society and Rhodium Group study, the state holds more than 20 percent ownership in only 14 percent of China's publicly listed firms (506

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<sup>4</sup> See *Zhonghua Renmin Gongheguo Gongsifa* [中华人民共和国公司法] (The Company Law of the People's Republic of China) (promulgated by the Standing Comm. of the Eighth Nat'l People's Cong., Dec. 29, 1993, rev'd Oct. 27, 2005, last amended and effected Oct. 26, 2018) [hereinafter “the Company Law” or “2005 Company Law”].

<sup>5</sup> CHINA AND THE GLOBAL FINANCIAL CRISIS: A COMPARISON WITH EUROPE 5-6 (Jean-Pierre Cabestan et al. eds., 2012) (pointing out that between 2003 and 2010, the total number of SOEs dropped from 159,000 to 114,500, but the total assets of 121 large national SOEs managed by SASAC increased from 3 trillion to 20 trillion yuan).

<sup>6</sup> The term was coined at the 17th National Congress of the CCP in 2007, and later pushed forward in the 3<sup>rd</sup> Plenum of the 18<sup>th</sup> Central Committee, defined by subsequent policies and regulations as: “cross-shareholdings by, and mutual blends of, state-owned capital, collective capital, and non-public capital.” *Zhongguo gongchandang di shiba jie zhongyang weiyuanhui di san ci quanti huiyi gongbao* (中国共产党第十八届中央委员会第三次全体会议公报) (adopted and promulgated by the Third Plenary Session of the 18th Central Comm. of the Communist Party of China, Nov. 12, 2013); *Zhonggong Zhongyang Guanyu Quanmian Shenhua Gaige Ruogan Zhongda Wenti de Jueding* (中共中央关于全面深化改革若干重大问题的决定) [Decision on Certain Major Issues Concerning the Comprehensive Deepening of Reform] (promulgated by the Central Comm. Communist Party China, Nov. 15, 2013).

firms in 2018) but is the *ultimate controller* in 31 percent (1,101 companies, of which 395 ultimately controlled by the central government and 706 by local governments).<sup>7</sup>

It is important to note that the mixed-ownership reform is advanced in a segmented manner. It aims to increase equity diversification and sometimes majority sales to private shareholders in some competitive commercial industries while allowing more limited private capital investments and maintaining state-control (absolute or actual) in strategic segments and key areas.<sup>8</sup>

As China became more economically advanced and its financial market more sophisticated, the tools utilized to facilitate state ownership and control have evolved and become more complex. Mixed ownership is pursued also through various forms of restructuring such as mergers & acquisitions and convertible bond issuances. In recent years, there is a push to promote mixed ownership in the opposite direction — forming state capital investment vehicles to invest in private companies, particularly in key areas and projects.<sup>9</sup>

It is mostly in this manner that the state utilizes its shareholding capacity to advance policy goals, maintaining various degrees of ownership and control ratios in corporatized SOEs in priority sectors and expanding its reach into private firms in other key areas through finance (including into private listed firms but mainly non-listed companies and start-ups).

To the extent that the party-state is able to mobilize its agents—both the professional managers appointed to operate state-invested firms and the officials assigned to monitor them—to pursue its policy goals through the firm, such goals naturally do not always align with the most efficient and productive way of operation. For example, when China adopted a split-share structure reform in the mid-2000s, the state’s shareholding capacity and its impact on management helped ensure that the reform is being implemented rapidly, issuing generous compensation plans to public shareholders, even at the expense of firm-level economic interest.<sup>10</sup> Similarly, perhaps the most commonly mentioned example in Western media is the mobilization of state-controlled companies in pursuit of Belt and Road projects, many of which criticized for serving mainly geopolitical aspirations, presenting potentially exacerbated investment risks, and lacking in economic fundamentals. State-controlled firms are also mobilized to carry domestic welfare schemes, such as in the poverty alleviation campaign; or to assist the government in a broad array of ad-hoc social and national tasks, from the Beijing Olympic Games and the Shanghai World Expo to providing relief following natural disasters.<sup>11</sup>

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<sup>7</sup> Daniel Rosen, Wendy Leutert, and Shan Guo, *Missing Link: Corporate Governance in China’s State Sector*, ASIA SOCIETY & RHODIUM GROUP, Nov. 2018, p.12.

The PRC Company Law, *supra* note 4, art. 216(2) defines a “controlling shareholder” as: a shareholder whose capital contribution accounts for more than 50% of the total equity stocks, or a shareholder whose capital contribution or proportion of stock is less than 50% but who enjoys a voting right large enough to have a significant impact upon the resolution of the shareholders’ meeting or the shareholders’ assembly.

Art. 216(3) further defines an “actual controller” as: “anyone who is not a shareholder but is able to hold actual control of the acts of the company by means of investment relations, agreements or any other arrangements.”

<sup>8</sup> Guowuyuan Guanyu Guoyouqiye Fazhan Hunhe Suoyouzhi Jingji de Yijian (国务院关于国有企业发展混合所有制经济的意见) [Opinions of the State Council on State-owned Enterprises Development of a Mixed-Ownership Economy] (promulgated by the State Council, Mar. 23, 2015, release No. 54 [2015]), art. 2. See also my answer to Q3 below.

<sup>9</sup> Hao Chen, Meg Rithmire, *The Rise of the Investor State: State Capital in the Chinese Economy*, 55(3) STUDIES IN COMPARATIVE INTERNATIONAL DEVELOPMENT 257(2020).

<sup>10</sup> Michael Firth et al., *Friend or Foe? The Role of State and Mutual Fund Ownership in the Split Share Structure Reform in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 685, 692, 699–704 (2010).

<sup>11</sup> Jiangyu Wang, *The Political Logic of Corporate Governance in China’s State-owned Enterprises*, 47 CORNELL INT’L L.J. 631, 663 (2014).

Prioritizing state interests is easier when the state's holding ratio in the firm is higher. Yet firms can be enlisted or at least pressured to contribute to national goals even with minority or no state ownership.<sup>12</sup> A survey of China's top 500 private enterprises (biggest enterprises by annual operating income) shows that 94.2 percent of such enterprises participated in various national development schemes during 2019.<sup>13</sup>

A legal obligation to bear social responsibilities applies to all companies and can be imbued by the shifting goals of the party-state. The SOE Assets law prescribes national and social-responsibility obligations for any state-invested enterprise<sup>14</sup>, applicable to any enterprise with state investment regardless of the state's ownership ratio.<sup>14</sup> The same law also determines that any investment made by a "state-invested enterprise" shall comply with national industrial policies, transactions shall be fair and paid for and consideration should be *reasonable*.<sup>15</sup> Similarly, the PRC Company Law mandates social responsibility obligation on all companies,<sup>16</sup> and the 2018 amendment of the Code of Corporate Governance for Listed Companies incorporated a complete chapter on ESG responsibilities.<sup>17</sup>

Notwithstanding the discussion above, I would like to illuminate an important aspect of state ownership and control that is not often discussed in the current climate — the political-economic and legal reins over the shareholding capacity of the state.

While state-ownership is commonly portrayed as an easy control mechanism and was indeed embraced with the intent to project state interests more uniformly through the shareholders' vote, the reality is far from simple. The Chinese economy and party-state bureaucracy developed in ways that produced complex linkages of economic interests and institutional authorities. These realities hamper the party-state's ability to push forward policies uniformly even through its shareholding capacity. Indeed, even after the establishment of SASAC—which was designed to function as a unified national, ministry-level agency, to shoulder the State Council's role as a controlling corporate shareholder—the party-state's ability to advance a particular directive through its shareholding capacity (as through its other means) remained extremely challenged at the institutional and firm levels.<sup>18</sup>

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<sup>12</sup> For example in the recent Covid-19 context, firms were mobilized to shift production lines to combat the spread of COVID-19, Finbarr Bermingham, Su-Lin Tan, *Coronavirus: China Ramps up Mask Production, and Reminds World it is Manufacturing King*, INKSTONE NEWS, March 12, 2020, <https://www.inkstonenews.com/business/coronavirus-china-ramps-mask-production-and-reminds-world-it-manufacturing-king/article/3074900>. Private firms are similarly mobilized in pursuit of Xi's poverty alleviation campaign, Yang Xuemin, *How Companies Help Alleviate Poverty in China?*, CGTN, Sep. 13, 2020, <https://news.cgtn.com/news/2020-09-13/How-do-companies-help-alleviate-poverty-in-China--TKAtKzLUJ2/index.html>

<sup>13</sup> *2020 Zhongguo Mingying Qiye 500 qiang Fabu Baogao* [2020 中国民营企业 500 强发布报告] (China Top 500 Enterprises 2020 Survey and Analysis Report), released by the Ministry of Econ. Affairs, Sep. 10, 2020, [http://www.acfic.org.cn/zzjg\\_327/nsjg/jjb/jjbgzhdzt/2020my5bq/2020my5bq\\_bgbd/202009/t20200904\\_244200.html](http://www.acfic.org.cn/zzjg_327/nsjg/jjb/jjbgzhdzt/2020my5bq/2020my5bq_bgbd/202009/t20200904_244200.html)

<sup>14</sup> *Zhonghua Renming Gonghe Guo Qiye Gouyou Zichan Fa* (中华人民共和国企业国有资产法) [Law of the People's Republic of China on the State-Owned Assets of Enterprises] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 28, 2008, effective May 1, 2009) [hereinafter SOE Assets Law], art. 17: "A state-invested enterprise engaged in business activities shall... accept the supervision of the general public, assume social responsibilities, and be responsible to the contributor [i.e. the state shareholder]"

<sup>15</sup> *Ibid*, art. 36.

<sup>16</sup> 2005 Company Law, *supra* note 4, art. 5: "When conducting business operations, a company shall comply with ... social morality... accept the supervision of the government and general public and bear social responsibilities."

<sup>17</sup> *Shangshi Gongsi Zhili Zhunze* [上市公司治理准则] (Code of Corporate Governance for Listed Companies) (first promulgated by the China Sec. Regulatory Comm'n and the State Economic and Trade Comm'n, Jan. 7, 2001, Rev'd Sep. 30, 2018), Chapter IX.

<sup>18</sup> Since its establishment, SASAC faced strong resistance from various interested parties within China's political economy. Other national-level ministries that compete with SASAC on regulatory powers, as well as powerful industry behemoths

At the firm level, the state naturally operates through human appointees both as corporate insiders in SOEs (managers) and their supervising agents (officials). This situation introduces monitoring challenges and abundant opportunities for self-enrichment. This structural predicament became known in China as the “absentee principal” or the “absent owner” (*suoyouzhè quēwēi*). Consequently, firms in China became de facto controlled by largely unmonitored powerful insiders (*neibùrén kòngzhì*), leading to the relative apathy of government officials towards corporate misconduct.<sup>19</sup> My academic work elaborates on the corporate governance consequences of this reality which includes widespread self-dealing and corruption. The same political-economic reality also captures the state and hinders its ability to advance reforms and implement policies at the firm level.<sup>20</sup>

This is not to say that the state is unable to mobilize firms in pursuit of state goals, but rather that such process is not without challenges and not without spending substantial political capital and economic cost. Understanding this explains the array of regulations and policy measures that were put in place to minimize the government’s routine involvement in firms on the one hand, while expanding the pathways for state and party monitoring, on the other.

The party-state is certainly aware of the tradeoffs and the costs as it tries to walk a fine line between mobilizing insiders and firms according to its priorities while allowing them sufficient decision-making plasticity, and at the same time curbing down against the economic and political consequences such plasticity brings.

*Q2: How do corporate governance rights afforded to the state versus public shareholders in China differ from those typical in a developed democracy such as the United States, in law and in practice?*

I believe that rather than establishing my analysis on regime type, comparing the rights afforded to public shareholders in China with the rights afforded to public shareholders in systems where corporate ownership is similarly concentrated is a more suitable approach.<sup>21</sup>

Indeed, many of the mechanisms the Chinese state use to entrench its control in its capacity as a shareholder are commonly employed by controlling shareholders in other systems.<sup>22</sup> Corporate pyramids, cross-ownership, preferential shares, and various contract-based structures are used extensively around the world, enabling controlling shareholders to raise capital while keeping control over governance. These control-entrenching structures separate decision-making powers from cash flow rights and distort the incentives of corporate controllers, enabling the extraction of private benefits of control.<sup>23</sup>

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under its supervision and apparent control that share similar hierarchical administrative levels, challenge its institutional capacities. Li-Wen Lin & Curtis Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 726-738 (2013).

<sup>19</sup> Donald Clarke, *Corporate Governance in China: An Overview*, 4 CHINA ECON. REV. 494 (2003).

<sup>20</sup> Tamar Groswald Ozery, UNRAVELING CHINA’S CAPITAL MARKET GROWTH: A POLITICAL ECONOMY ACCOUNT, The University of Michigan Law School, 2019, dissertation manuscript, available at <https://repository.law.umich.edu/sjd/>.

<sup>21</sup> For the implementation of such comparative approach see, Groswald Ozery, *Minority Public Shareholders in China’s Concentrated Capital Markets—A New Paradigm*, 30 COLUM. J. ASIAN L. 1 (2016).

<sup>22</sup> To note, my answer here is focused on the shareholding capacity of the state. Of course, China is unique in the impact and roles of the CCP in corporate governance. I address this in my answers to Q3 and Q4 below.

<sup>23</sup> See generally, Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295, 295 (Randall K. Morck

Where ownership is concentrated at the hands of controlling shareholders and their insiders—be they state organs, family groups, financial conglomerates—public shareholders’ participation in governance is generally limited. External investors in these markets also hold very limited bargaining power (at both the firm and market levels) to change this reality. In that respect, China is not an exception regardless of its state-ownership. Investors in Chinese public firms know to expect this.

The situation in China is, however, somewhat different in the intensity of its corporate power structures and thus the intensity of the problems such structures bring: 1) the well-known corporate monitoring predicament—“who monitors the monitor?”—is exacerbated in China as it extends to multiple layers of agents inside and outside state-invested firms. Such structures limit the accountability of corporate controllers and insiders and amplify the potential for shareholder abuse.<sup>24</sup>

2) the prospect for shareholder rights reform is even more limited in China due to the state’s “self-capture”. The regulatory capacity of the state to bring about shareholders’ rights reform is captured by its own shareholding capacity (the interests of institutions representatives of the state as a shareholder and their appointees) as well as by co-opted private individuals as powerful controlling shareholders.

When assessing shareholder rights and protections in China an important distinction should be made between economic rights and participation rights in governance. The first problem above impacts mainly the economic rights of shareholders, while the second hinders mainly shareholder governance-rights reform. The PRC has made important strides to overcome concerns for economic rights. It borrowed as well as innovated ways to strengthen investor protection in order to secure investors from economic abuse by insiders [such as derivative lawsuits,<sup>25</sup> enhanced pathways for monitoring and enforcement against self-dealing and corruption,<sup>26</sup> a push to crack-down insider trading,<sup>27</sup> and a recent potential path for a shareholder representative action (resembling “class action”) against securities fraud].<sup>28</sup>

Concerning governance rights, however, public investors are designed to remain passive. This is notwithstanding a shareholder-empowering corporate governance orientation. Indeed, judged solely based on China’s black-letter law, shareholders in China enjoy one of the most robust shareholder-empowering governance frameworks in the world.<sup>29</sup> Their powers go far beyond those granted to shareholders even in Anglo-American systems, the foothold of shareholder-primacy. As I discuss

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ed., 2000). For an alternative view see, Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

<sup>24</sup> Groswald Ozery, *supra* note 21, p. 11.

<sup>25</sup> Hui (Robin) Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27(4) *Banking and Finance Law Review* 619, 2012 (assessing that derivative lawsuits are making a “noticeable impact”); but see Nicholas C. Howson & Donald Clarke, *Pathway to Minority Shareholder Protection: Derivative Actions in the People’s Republic of China*, in THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 243 (Dan W. Puchniak et al. eds., 2012) (criticizing the ability to exercise such right in potentially sensitive cases).

<sup>26</sup> Groswald Ozery, *Illiberal Governance and The Rise of China’s Public Firms*, *supra* note 1.

<sup>27</sup> Huang (Robin) Hui, *Enforcement of Chinese Insider Trading Law: An Empirical and Comparative Perspective* (January 30, 2019). Forthcoming, Am. J. Comp. L. (2020).

<sup>28</sup> Zhonghua Renmin Gongheguo Zhengchuan Fa [中华人民共和国证券法] (Securities Law of the People’s Republic of China) (promulgated by the 6th Meeting of the Standing Comm. of the 9th Nat’l People’s Cong., Dec. 29, 1998, rev’d Oct. 27, 2005, amended Dec. 28, 2019 (effective, March 1, 2020)), art. 95; Provisions of the Supreme People’s Court on Several Issues Concerning Representative Actions Arising from Securities Disputes [最高人民法院关于证券纠纷代表人诉讼若干问题的规定](*Zuigao Renmin Fayuan guanyu Zhengquan Jufen Daibiaoren Susong Ruogan Wenti de guiding*), issued by the Supreme People’s Court, July 30, 2020.

<sup>29</sup> See, 2005 Company Law, *supra* note 4, arts. 37, 98, 99, 104, 124, 150.

elsewhere, however, this facially shareholder-empowering regulatory framework does little to empower *public* investors.<sup>30</sup>

Unlike certain other concentrated markets, the Company law does not *mandate* mechanisms that could have provided public shareholders with a meaningful impact on decision making [e.g., negative minority veto rights over certain decisions, supermajority requirements (majority-of-minority support)<sup>31</sup>, mandatory participation of institutional investors in certain decisions, minimum board representation, cumulative voting]. Furthermore, since public shareholders are generally a passive and dispersed minority group with limited coalition-building options in China, a shareholder empowering approach ends up furthering the interests of controlling shareholders, including but not limited to the party-state. Challenges remain also with respect to public shareholders' ability to enforce their rights in court and have recourse for their damages, due to economic and/or political reasons.<sup>32</sup>

### **Boosted State Rights as a Shareholder**

In addition to public shareholders' lesser ability to implement the governance rights afforded to all shareholders, the state is granted corporate governance rights outside the company and securities laws. This means that the state may be afforded rights that are beyond the reach of other shareholders.

The SOE Assets Law regulates the rights and interests of the state in its capacity as an investor. The law gives the state *quo* investor (SASAC, its local branches, other bodies performing the state's capital contributor capacity) the power to *propose* to the shareholders' meeting, candidates to be appointed as directors and supervisors in any "state invested enterprise" as well as to *propose* their removal.<sup>33</sup> These "boosted" governance rights are afforded to the state whether it has a controlling or non-controlling stake in the enterprise. In contrast, according to the Company law, shareholders with 10 percent or more voting rights can request the company to convene a special shareholders' meeting in which shareholders holding 3 percent or more (separately or aggregately) can submit written proposals including on personnel-related issues.<sup>34</sup>

Additionally, the state has the authority to establish an assessment system for managerial performance in state-invested enterprises, and to determine standards for remuneration, authorities that otherwise lie with the board.<sup>35</sup> With respect to managers appointed by the state, the state shall be the one to determine remuneration standards, conduct their assessment, and decide on rewards and punishments according to such assessment results.<sup>36</sup>

In addition to these rights on personnel-related matters, the state *quo* investor has the power to decide on the transfer of state-owned assets (i.e., the rights and interests of the state) in any state-invested enterprise. This can be interpreted to give the state a de-facto veto right in certain transactions that otherwise would have been at the purview of the board, such as a merger of a subsidiary.<sup>37</sup>

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<sup>30</sup> Groswald Ozery, *supra* note 20.

<sup>31</sup> With exception in providing guarantees to shareholders and actual controllers, 2005 Company Law, *supra* note 4, art. 16.

<sup>32</sup> See sources in note 25 *supra*.

<sup>33</sup> SOE Assets Law, *supra* note 14, arts. 22(3) & 23.

<sup>34</sup> See 2005 Company Law, *supra* note 4, arts. 37(2), 39, 101, 102.

<sup>35</sup> Compare SOE Assets Law, *supra* note 14, art 27 with Company law, *supra* note 4, art. 46(9).

<sup>36</sup> SOE Assets Law, *ibid*, *ibid*.

<sup>37</sup> See SOE Assets Law, *supra* note 14, Sec. 5 (Transfer of State-owned Assets) (particularly art. 51, 53). Li-Wen Lin & Milhaupt, *supra* note 18, at 743 n.135, n.136 (noting relevant court cases that invalidated contracts for the transfer of shares without prior SASAC approval).

In “important” companies where the state holds a controlling stake, certain matters—such as mergers, split-up, dissolution, bankruptcy petition, any restructuring that will result in the loss of state control “or any other meaningful matter...as prescribed by law and regulations”—should be first approved by the corresponding level of the people’s government before the state representative casts a vote in the company’s shareholders meeting.<sup>38</sup>

Finally, beyond conventional company law fiduciary obligations that are owed to the company as a whole, the SOE Assets Law includes a form of fiduciary duty of directors, supervisors, and senior managers not only to the invested enterprise but also specifically to the interests of the state investor (regardless of its holding ratio)<sup>39</sup>, as well as fiduciary responsibility of the invested enterprise itself to the state investor.<sup>40</sup> The law also determines liability for actions that caused losses of state-owned assets, specifically.<sup>41</sup>

Notwithstanding these “boosted” rights and as pointed earlier, the state’s capacity as an investor is not without reins. Its shareholding capacity is exercised formally through the shareholders’ assembly following defined corporate procedures and is therefore subject to potential scrutiny and corporate governance limitations. The SOE Assets Law makes clear that the state as an investor shall follow the Company law procedures for shareholder deliberation and voting even concerning major corporate decisions. The law also asserts to guarantee operating autonomy and limits intervention in day-to-day decision-making.<sup>42</sup>

*Q3: How has corporate governance evolved as a result of changes to management and structure of state-owned enterprises and firms in which the state is a minority shareholder under General Secretary Xi Jinping? What political and policy objectives are driving these changes, and what changes do you expect in the future?*

Just as industrial policy was a substantial part of China’s economic approach even while engaging in various economic liberalization schemes, so were state and Party capacities a part of China’s corporate governance landscape throughout its market development. Such space has been reserved all along with explicit affirmations from the Chinese party-state that it is there to stay. Still, notwithstanding both the state and the Party being constant features of China’s corporate governance landscape, there is certainly a noticeable shift in both respects.

Concerning the state, as I indicated in my answers above, the main change is in the forms of the state’s shareholding capacity which have become more advanced and more complex. To clarify, this does not necessarily mean that the state is now exercising its shareholder rights more extensively. Future empirical research would need to assess the level of the state’s shareholder activism. In the absence of such empirical studies, limited information can be drawn based on law and policy indications.

Both the SOE Assets law and the SOE Reform Guiding Opinions, as well as various regulations concerning mixed enterprises, reflect that while the routes and forms of state investments have grown, the party-state still adheres to its former reform approach in which government involvement in firms

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<sup>38</sup> See SOE Assets Law, *supra* note 14, arts. 31-35, 39(3), 40, 53.

<sup>39</sup> See SOE Assets Law, *supra* note 14, art. 17.

<sup>40</sup> See SOE Assets Law, *supra* note 14, art. 26.

<sup>41</sup> See SOE Assets Law, *supra* note 14, art. 71.

<sup>42</sup> See e.g., SOE Assets Law, *supra* note 14, arts. 13, 16, 30, 33, 35, 40, 46. But see matters for which prior government approval is needed in state-controlled companies, *supra* note 38 and related text.

For political-economic reins on the state’s capacity as a shareholder see answer to Q1 above.

through its shareholding capacity is mainly channeled to designated “categories”. In general, “commercial SOEs whose core business is in sufficiently competitive industries and fields” are directed to have greater equity diversification. The state may hold “absolute or relative control” in these firms or be “merely a shareholder”. Firms in this category are subject to market forces and given managerial autonomy to a greater degree. The criteria for managerial appointments and assessments in these firms are based more profoundly on business performance indicators. Conversely, “commercial SOEs in major industries or key fields concerning national security or national economic lifeline, or that are mainly responsible for major special project tasks” are designed to maintain state control even while encouraging contributions by external investors. Managerial appointments and assessments involve market indicators but are expressly focused on assessing their efforts “to serve national strategies, safeguard national security and the operation of the national economy, develop cutting-edge strategic industries and complete special tasks.” Public welfare SOEs is yet another category, with firms designed to remain wholly owned by the state, and operational assessments being focused on their public utility functions.<sup>43</sup>

Notwithstanding what I believe to be a limited change in the role of the state in corporate governance in its shareholding capacity, there has been a more noticeable development in the regulatory capacity of state institutions. This has taken form in both ad-hoc interventions such as trade suspensions to control supply and demand and stabilize the market (more substantially since the 2015-16 market turmoil), as well as in an ongoing process to increase the effectiveness of the regulatory regime concerning corporate malfeasance.

China’s Securities Regulatory Commission (CSRC) has been particularly active in recent years in its preventative measures, by developing innovative market monitoring mechanisms to detect suspicious trading activity in real-time and prevent securities market fraud. These efforts are said to create a “giant network of (market) surveillance” facilitated to protect investors.<sup>44</sup> The CSRC has also been increasingly active in taking public enforcement actions against securities law violations. Experts assessed the CSRC’s public enforcement of insider trading rules to have reached a level of insider trading enforcement that is comparable to other countries (incl’ the U.S., U.K., Australia, Singapore) and in some measures much higher.<sup>45</sup>

This trend is expected to continue following the March 2020 amendment of the PRC Securities law, which added clarity and force to the CSRC’s scope of administrative sanctions and remedies. The law also broadened the path for private enforcement (misrepresentation claims) through enabling group lawsuits by approved “investor protection institutions”.<sup>46</sup> These developments could contribute to the effectiveness of the regulatory regime around corporate misconduct.

Finally, a perhaps more substantial corporate governance change has taken form in the corporate governance capacity of the Chinese Communist Party (“CCP”, or the “Party”). In recent years, the Party has stepped into corporate governance, bolstering and at times substituting many traditional corporate governance institutions both inside and outside firms.<sup>47</sup>

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<sup>43</sup> SOE Reform Guiding Opinions, *infra* note 50, art. 2(4), 2(5), 2(6).

<sup>44</sup> Shen Hong, Stella Yifan Xie, *That Calm Chinese Stock Market? It’s Engineered by the State*, THE WALL STREET JOURNAL, May 31, 2018.

<sup>45</sup> Huang, *supra* note 27.

<sup>46</sup> See, *supra* note 28 and related text.

<sup>47</sup> Discussed extensively in Groswald Ozery, *The Politicization of Corporate Governance*, *supra* note 1.

Externally: there has been a more open involvement by the CCP in the law-making process in recent years.<sup>48</sup> This has manifested in the context of corporate governance by an increasing number of opinions (*yijian*) and guiding opinions (*zhidao yijian*) issued by the CCP, alongside the State Council, to regulate economic activity. While opinions and guiding opinions are not a source of authoritative formal law under the PRC Legislation Law, they are normative documents with a binding effect in practice.<sup>49</sup> Based on such opinions, the CCP is expanding its direct regulatory capacity over public and private market participants.<sup>50</sup>

Additionally, the recent reorganization of China's supervision apparatus contributed to the external monitoring capacity of the CCP over corporate conduct. The reorganization, among its other aspects, incorporated the CCDI (Central Commission for Disciplinary Inspection) into a newly created National Supervision Commission and granted it wide authority to monitor, investigate and sanction misconducts by Party and state agents. Corporatized SOEs and their state-appointed functionaries are formally included, with spill-over implications on affiliated network firms.

Internally: the Party was given a greater role in corporate governance with respect to internal monitoring as well as decision making. The latter has been taken form particularly concerning SOEs. I elaborate on these aspects in response to the next question.

These changes in corporate governance take part in a broader political economy shift where regulatory and economic decision-making powers are relocating from central government institutions to the CCP (alone or in hybrid). In my forthcoming book, I refer to this as a shift towards “a legalized politicization era”, where the Party is increasingly encroaching on the authorities of state institutions blurring further the (perhaps only apparent) lines of Party/government separation.<sup>51</sup>

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<sup>48</sup> *Decisions Concerning Some Major Issues in Comprehensively Moving Forward Ruling the Country According to Law* (中共中央关于全面推进依法治国若干重大问题的决定)[*Zhonggong Zhongyang Guanyu Quanmian Tuijin Yifa Zhiguo Ruogan Zhongda Wenti de Jueding*], adopted at the 4<sup>th</sup> Plenary Session of the 18<sup>th</sup> Central Committee of the CCP, Oct. 29, 2014. The broader trend was observed in Jianfu Chen, *Out of the Shadows and Back to the Future: CPC and Law in China*, *ASIA PACIFIC LAW REVIEW* 24(2), 176 (2016).

<sup>49</sup> Particularly since issued alongside the State Council. Jurisprudence discussions in China generally treat decisions and opinions by the State Council to have the same binding effect as administrative regulations. See, Jinrong Huang, *The Legal Definition and Effect of “Normative Documents”* [“规范性文件”的法律界定及其效力] (“Guifanxing Wenjian” de Falü Jieding jiqi Xiaoli), *LEGAL REVIEW* (Jul. 2014), Research Center for Constitutional and Administrative Law of Renmin University of China, available here: <http://www.calaw.cn/article/default.asp?id=10042>

<sup>50</sup> E.g., *CPC Central Committee and State Council Opinions on Deepening the Guidance of State-Owned Enterprise Reform* (中共中央、国务院关于深化国有企业改革的指导意见)[*Zhonggong Zhongyang, Guowuyuan guanyu Shenhua Guoyou Qiye Gaige de Zhidao Yijian*] (Aug. 24, 2015) [hereinafter “SOE Reform Guiding Opinions”]; *Opinions of the CPC Central Committee and the State Council on Creating a Sound Entrepreneur Growth Environment, Advocating Excellent Entrepreneurship and Better Using Entrepreneurs' Role* [中共中央、国务院关于营造企业家健康成长环境弘扬优秀企业家精神更好发挥企业家作用的意见] (*Zhonggong Zhongyang, Guowuyuan guanyu Yingzao Qiyejia Jiankang Chengzhang Huanjing Hongyang Youxiu Qiyejia Jingshen geng hao Fahui Qiyejia Zuoyong de Yijian*), issued by the Central Committee of the CCP and the State Council, Sep. 8, 2017; *Opinions of the CCP Central Committee and the State Council on Creating a Better Development Environment and Supporting the Reform and Development of Private Enterprises* [中共中央、国务院关于营造更好发展环境支持民营企业改革发展的意见] (*Zhonggong Zhongyang Guowuyuan guanyu yingzao geng hao Fazhan Huanjing Zhichi Mingying Qiye Gaige Fazhan de Yijian*), issued by the CCP Central Committee and the State Council, Dec. 4, 2019; *The CCP Opinions on Strengthening the United Front Work of the Private Economy in a New Era*, [中共中央办公厅印发、关于加强新时代民营经济统战工作的意见] (*Zhonggong Zhongyang Bangongting Yinfa, guanyu Jiaqiang Xin Shidai Mingying Jingji Tongzhan Gongzuo de Yijian*), issued by the General Office of the Central Committee of the CCP, Sep. 15, 2020.

<sup>51</sup> *Supra* note 2.

*Q4: What is the role of CCP committees in corporate governance? How are they evolving, and how might they be used in the future?*

The Charter of the CCP, as well as the PRC Company Law, prescribes a role for a Party organization (for simplicity, “Party committee”) in any company established and registered in the PRC territory with at least three party members.<sup>52</sup> The CCP is thus recognized as a distinct corporate stakeholder with a reserved capacity within Chinese firms, whether private or state-controlled, with or without foreign investment.

The CCP itself, beyond any traditional shareholder role the state may have, thus became a legal corporate constituent with unique interests and a distinct capacity to convey, direct, and monitor the ways these interests will be pursued. Unlike the state’s shareholding capacity, the internal operations of this CCP capacity in firms is not regulated and is not subject to any transparent corporate procedures (or other) checks and balances established in law.

The Party’s presence in firms is not a new feature, it has been assigned in law at least since the first modern company law was enacted. Yet, its roles within firms and its relationship with other corporate governance bodies were opaque. Moreover, it was not deployed systematically outside several meaningful state-controlled firms. There has been a change in both respects:

### **More Systematic Deployment of Party Committees in Firms**

In 2015, a joint CCP Central Committee and State Council document, “SOE Reform Guiding Opinions”, adopted various provisions for “Party building” work within SOEs and emphasized the obligation to formally establish a Party committee.<sup>53</sup>

The obligation to establish a Party committee apply to all SOEs, extending to firms with mixed ownership and thus potentially also to enterprises with minority state shares. Similarly, all SOEs are required to incorporate Party committees and clarify their roles in their governing documents (articles of association).

Following such developments, in 2018, the Code of Corporate Governance of Listed Companies was amended to acknowledge the presence of a Party committee in *any listed company* (based on the provision of the PRC Company Law). Here too, only *state-controlled publicly listed firms* were required to include provisions about Party building work in their governing documents.<sup>54</sup>

While private firms are currently not required to show the same level of commitment to Party building as SOEs, there is certainly a noticeable push by the CCP to strengthen Party building work and

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<sup>52</sup> Zhongguo Gongchandang Zhangcheng (中国共产党章程) [The Charter of The Communist Party of China] (as amended and promulgated by the Nat’l Cong. of the Communist Party of China, Oct. 24, 2017); 2005 Company Law, *supra* note 4, art. 19 (“The Chinese Communist Party may, according to the Constitution of the Chinese Communist Party, establish its organizations in companies to carry out activities of the Chinese Communist Party. The company shall provide necessary conditions to facilitate the activities of the Party.”).

<sup>53</sup> SOE Reform Guiding Opinions, *supra* note 50, arts. 1(3) & 7. Art. 1(3) states: “The Party building of enterprises shall be comprehensively strengthened ... the Party organizations of SOEs shall enjoy a more solid statutory position in corporate governance, and fully display their core political role...”.

<sup>54</sup> Code of Corporate Governance of Listed Firms, *supra* note 17, art. 5. To note, the Code is considered to be a standard setting document for “best practices”.

establish Party committees within completely private firms as well. This push dovetails a broader effort to strengthen the interlinkages between the Party and the private sector, reflected in both rhetoric and party-state policies in recent years.<sup>55</sup>

Studies show that the number of firms with a Party organization incorporated in their charters has risen in recent years, including among firms that are listed outside mainland China.<sup>56</sup>

In mainland China, by 2019, of all non-financial *publicly listed* firms, approximately 30.3 percent amended their charters to reflect Party building provisions.<sup>57</sup> Of all non-financial listed SOEs (~1,008-1,078 firms), close to 90 percent amended their governing documents to reflect Party building provisions.<sup>58</sup> Variations were found across studies based on factors such as industry, ownership concentration of state as well as non-state shareholders, political connectedness, and whether the firm is cross-listed or not. Profs. Lauren Lin and Milhaupt found that close to 6 percent of privately owned listed enterprises (143 firms) voluntarily amended their governing documents to reflect the presence of a Party committee.

The number of private firms with a Party committee outside the listed-companies population is only partially available and is based mostly on party-state survey reporting. Surveys by the All-China Federation of Industry and Commerce (commissioned by organs of the Party-state) reflect a substantial increase in the ratio of private enterprises with Party organizations. By 2018, 48.3 percent of the surveyed private enterprises (3,973 surveyed firms) reported having established a Party organization, up from 35.6 percent in 2012. The survey notes significant variations based on geographic location and industry. These results, of course, do not say much on the absolute number of private enterprises with Party organizations.<sup>59</sup> Another official survey shows that over 92 percent of China's top 500 private enterprises have a Party organization.<sup>60</sup>

With respect to foreign-invested private firms, limited regional surveys suggest a lower presence of Party organizations in foreign-invested enterprises. For example, 12 percent of foreign-invested enterprises in Hangzhou reported in official data to have a Party organization out of a total of 3,248 enterprises surveyed.<sup>61</sup> 19 percent of Shanghai AmCham member organizations reported having a Party organization, out of a total 434 Shanghai AmCham survey respondent companies.<sup>62</sup>

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<sup>55</sup> While analysts tend to focus on the recent CCP opinions on strengthening the United Front Work, efforts to enhance the Party's influence on the private sector are long standing. For notable recent policies concerning the private sector see, *supra* note 50. For recent attention in rhetoric see, *Xi Jinping: Speech at the Symposium of Private Enterprises*, PEOPLE'S DAILY, Nov. 1, 2018. For a general discussion see Dickson, *WEALTH INTO POWER: THE COMMUNIST PARTY'S EMBRACE OF CHINA'S PRIVATE SECTOR*, Cambridge: Cambridge University Press (2008).

<sup>56</sup> Sun Leqi, *yu 120 Zhongzhiu sheli Dangwei quanli kong lingjia Dongshihui [More than 120 Chinese Stocks Set Up Party Committee Power to Overthrow the Board of Directors]*, APPLE DAILY (Sept. 26, 2018), <https://hk.finance.appledaily.com/finance/realtime/article/20180926/58722466>.

<sup>57</sup> Lauren Yu-Hsin Lin & Curtis Milhaupt, *Part Building or Noisy Signaling? The Contours of Political Conformity in Chinese Corporate Governance*, EUR. CORP. GOVERNANCE INST. (law working paper No. 493/2020, Jul. 14, 2020).

<sup>58</sup> John Zhuang Liu and Angela Huyue Zhang, *Ownership and Political Control: Evidence from Charter Amendments*, 60 INT. REV. L. ECON. 1 (2019) (finding 84 percent of publicly listed SOEs amended their charter to incorporate Party building provisions by September 2018); Lin and Milhaupt, *ibid* (throughout 2015-2018, 12.79 percent of central SOEs and 9.19 percent of local SOEs were yet to adopt party building provisions).

<sup>59</sup> China 2019 Statistical Yearbook point to a total of over 16.2 million private companies by the end of 2017.

<sup>60</sup> Reports on the ACFIC surveys' results are available here: [https://www.acfic.org.cn/fgdt1/zjgd/201905/t20190523\\_125262.html](https://www.acfic.org.cn/fgdt1/zjgd/201905/t20190523_125262.html), [http://www.acfic.org.cn/zjig\\_327/nsig/jjb/jjbgzhdzt/2020my5bq/2020my5bq\\_bgbd/202009/t20200904\\_244200.html](http://www.acfic.org.cn/zjig_327/nsig/jjb/jjbgzhdzt/2020my5bq/2020my5bq_bgbd/202009/t20200904_244200.html).

<sup>61</sup> Neil Thomas, *Party Committees in the Private Sector: Rising Presence, Moderate Prevalence*, MACRO POLO, Dec. 16, 2020

<sup>62</sup> American Chamber of Commerce in Shanghai, 2018 China Business Report, p.19.

## Additional Clarity on Party Committee Roles within Enterprises

Traditionally, the Party committee roles in enterprises were to disseminate Party line, policies, and principles, and to function as the body that organizes and unites Party members inside the organization. Party committees perform recruitment and training for new CCP members, hold study groups concerning Party ideology and policies, and organize other social activities. Party committees are also assigned a leadership supportive role for different mass organizations within enterprises (such as the Communist Youth League, trade unions).

In addition to these social and ideological functions, Party committees were given authorities concerning monitoring and participation in decision making. These two main functions of corporate governance have been more clearly delineated in recent years.<sup>63</sup>

### *Monitoring—oversight and disciplinary functions*

In its monitoring capacity, the Party organization within firms is assigned to oversee not only internal observance of Party policy and discipline, but also compliance with state laws and regulations by Party members, state personnel, and “the people” (presumably those involved with the enterprise).<sup>64</sup> Its roles in this capacity are typically carried through another sub-level Party organization designated for discipline inspection work and led by the deputy of the Party committee secretary.

With respect to SOEs, broadly defined, the oversight and disciplinary capacities of party committees within firms have been given greater emphasis following the recent SOE Reform Guiding Opinions. The following excerpt from art. 7(26) is representative:

“The Party organizations of SOEs shall... [it is required to] establish a practical *accountability system* which shall be *linked to enterprise appraisal*, and *investigate both the liabilities of the parties concerned to a case and the liabilities of relevant leaders*; develop more details, procedures, and systems for the dual leadership regime of SOE disciplinary inspection commission over subordinate ones; *strengthen and improve tour inspection of SOEs*, and *reinforce the supervision and restraint over the operation of power*; and, keep using the thinking and methods of the rule of law to *fight corruption, fine-tune anti-corruption institutions and systems, strictly enforce the provisions against formalism, bureaucracy, hedonism and extravagance*, and strive to build effective mechanisms where enterprise leaders dare not to, are not able to, and do not want to, engage in corrupt practices.”

Beyond SOEs, based on relevant CCP and State Council Opinions, the Party is trying to assert itself a greater role in monitoring private firms as well, to enhance legal and political compliance. Private firms and entrepreneurs are also expected to assist in anti-corruption efforts.<sup>65</sup>

The CCP’s internal monitoring capacity within firms supports the operations of the PRC’s external oversight institutions—the National Supervision Commission through CCDI. A shift that has blurred the lines between enforcement against disciplinary violations, corruption, and corporate wrongdoing.

The corporate governance implications of enhanced CCP monitoring capacity within firms include the spread of fear governance, risk aversion, and potential managerial paralysis. As I noted earlier,

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<sup>63</sup> Groswald Ozery, *The Politicization of Corporate Governance*, supra note 1.

<sup>64</sup> The CCP Charter, as amended, supra note 52, Chapter 5, Arts. 32 (7),(8) & 33.

<sup>65</sup> For a list of relevant policy in the private sector and the specific provisions see, Groswald Ozery, *Illiberal Governance and The Rise of China’s Public Firms*, supra note 1, p.48-49 fn 218 and 223.

there is an effort to offset some of these implications through incentive mechanisms, particularly by incorporating elements such as high-quality development factors and production efficiency levels into the assessment and promotion processes of political cadres, state officials, SOE managers, and private market participants (i.e., political career prospects).

Existing and potential positive contributions are present as well. Positive capital market reaction to enhanced CCP oversight in firms, increase in accountability of corporate insiders for wrongdoing, deterrence against corruption and corporate malfeasance, improvements in overall market regularity, and potential contributions to investors' confidence, have been noted in recent studies.<sup>66</sup>

### *Party role in decision making*

There is an increasing concern both in and outside China that the roles of Party committees within firms extend, or will extend in the future, beyond their traditional ideological and social functions and even beyond monitoring into corporate decision making.

Indeed, at least concerning SOEs, Party committees now hold a direct and explicit role in internal governance. Such role has been formally established in the 2017 amendment to the CCP Charter, art 33: "The leading Party members groups or Party committees of state-owned enterprises shall play *a leadership role, set the right direction*, keep in mind the big picture, ensure the implementation of Party policies and principles, and *discuss and decide on major issues of their enterprise* in accordance with regulations."

The 2015 SOE Reform Guiding Opinions similarly calls to uphold the Party's leadership over SOEs, and together with subsequent regulations details 3 primary paths through which the Party committee is set to have a greater influence on internal governance<sup>67</sup>:

- 1) the Party committee is granted authority with respect to the management of personnel, including recommending, assessing, and nominating candidates for leading corporate positions;
- 2) encouraging cross-representation of board members, supervisory committee members, and members of the management with members of the Party committee, and merging the position of the chairman of the board with that of the Party secretary as the default;
- 3) setting the authority of the Party committee to oversee, audit, and assess major corporate decisions. This alone would push directors and managers to consult with the Party committee before making major decisions.

The term "SOEs" in the Guiding Opinions seem to be broadly interpreted, thus including potentially enterprises in which the state holds even a minority position. At the same time, however, the document emphasizes enhancing the role of market mechanisms, especially concerning mix-ownership enterprises. Managerial autonomy, market-oriented governance, and performance-based evaluation are repeatedly noted. The SOE Reform Guiding Opinions thus seem full of contradictory provisions.

A careful observer, however, would notice that the reform is designed to be pursued in a classified manner and distinguishes between various types of SOEs, such as commercial and public welfare SOEs, as well as between competitive industries and key fields such as national security and national

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<sup>66</sup> See discussion in related studies in, *ibid*.

<sup>67</sup> These authorities are scattered along the provisions of the SOE Reform Guiding Opinions. For details and discussions on specific articles see, Groswald Ozery, *The Politicization of Corporate Governance*, supra note 1, pp. 25-33.

economic lifeline. The categorization affects the intended level of state involvement versus a greater degree of market forces and managerial autonomy.<sup>68</sup>

The same categorized approach is reflected concerning Party intervention as well. The Guiding Opinions note the need to refrain from a uniform approach:<sup>69</sup>

“...the methods to set up Party organizations, and the responsibilities and management models thereof shall be scientifically determined according to the characteristics of different types of mixed ownership enterprises.”

Accordingly, a circulated template text for revisions in the articles of associations of SOEs was devoted to wholly-owned state enterprises and state-controlled holding companies.<sup>70</sup> Subsequent CCP rules also affirm the need for a categorized approach with laxer applicability for enterprises with relative state shares.<sup>71</sup> Indeed, empirical studies have found that not all publicly-listed SOEs closely followed the distributed template for the articles of association revisions. Wide variations were found particularly around decision-making and personnel-related provisions.<sup>72</sup>

Clearly, the party-state walks a fine line trying to project a balanced approach towards SOEs by recognizing that “It is essential to correctly handle [...] the relationship between reform, development and stability, and the relationship between making proper top-level designs and respecting grass-roots initiative...”<sup>73</sup>

With respect to the private sector, while there has been a rather successful push by the Party to set Party committees in the private sector as well,<sup>74</sup> the space intended for their active participation in internal governance is still largely vague. The various policies concerning the private sector mainly use non-obligatory rhetoric, such as private enterprises shall be guided to/encouraged/taught and directed/supported to take/explore ways to, etc.

There are also initial market indications that Party committees’ involvement in the governance of private listed firms, particularly in day-to-day decision making, is more limited. For example, private-owned listed firms that amended their articles of associations following the recent Party-building pressures mainly adopted symbolic provisions (91.95 percent adopters on average), while avoiding provisions that allow greater control over personnel (15.72 percent adopters on average) or involvement in decision-making through prior consultation mandates (25.17 percent adopters on average).<sup>75</sup>

It is still too early to ascertain how the various corporate governance roles of the CCP will develop in the future nor how will they be implemented in practice across different firms and sectors. The long-

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<sup>68</sup> SOE Reform Guiding Opinions, *supra* note 50, art. 2(4), 2(5), 2(6).

<sup>69</sup> E.g., SOE Reform Guiding Opinions, *supra* note 50, art. 7(24); art. 3(9) similarly advocates to avoid a one size fits all approach in applying methods for personnel selection and appointment.

<sup>70</sup> *Guanyu Zhashi Tuidong Guoyou Qiyue Dangjian Gongzuo Yaoqiu Xieru Gongsi Zhangcheng de Tongzhi* [关于扎实推动国有企业党建工作要求写入公司章程的通知](Notice Regarding the Promotion of the Requirements of Incorporation of Party Building Work into the Articles of Associations of State-owned Enterprises), promulgated by Org. Dep’t CCP & Party Comm. SASAC, Mar. 15, 2017.

<sup>71</sup> The Communist Party of China Rules on the Work of Primary Organizations of State Owned Enterprises (trial) [中国共产党国有企业基层组织工作条例(试行)](*Zhongguo Gongchandang Guoyouziye Jiceng Zuzhi Gongzuo Tiaoli (shixing)*), issued by the Central Committee of the Chinese Communist Party, Dec. 30, 2019, art. 39.

<sup>72</sup> Liu & Zhang, *supra* note 58, p.4 and Table 3; Yu-Hsin Lin & Milhaupt, *supra* note 57, Table 4.

<sup>73</sup> SOE Reform Guiding Opinions, *supra* note 50, art. 1(2).

<sup>74</sup> See discussion above on rate of adoption.

<sup>75</sup> Liu & Zhang, *supra* note 58, p.4 and Table 3; Yu-Hsin Lin & Milhaupt, *supra* note 57, Table 4.

term social, political, and market effects are similarly uncertain at this point. Currently, at least, it seems that at the firm level, the Party is mainly intent on utilizing its corporate committees to ease up access to information and enhance monitoring and accountability (adherence to Party line, discipline, and laws). At the market level, Party committees as well as other Party building efforts, function as an additional communication channel between the Party and the market. Such channels can be used to encourage private firms to participate in major national strategic development plans, reducing coordination challenges and streamlining the party-state's overarching control over the broad course of China's market development.

Laws and policy rhetoric, as well as political-economic realities, suggest that the party-state's desire and ability to direct corporate decision-making at the firm-level, however, and particularly on a routine basis, is more limited than commonly assumed. Empirical work, such as interviews, surveys, and continuous observance of disclosures by listed companies should be done to affirm the long-term workings of the system.

*Q5: How do you assess the impact of current U.S. restrictions on investment in Chinese companies listed on the Mainland? Is there anything the United States could do differently to target investment that could potentially benefit Chinese defense firms or otherwise fund companies acting contrary to U.S. national security interests?*

To assess the impact of the current investment restrictions in Chinese Communist Military Companies (CCMC), one needs to work with data on the current and prospective scopes of U.S. investments in these firms. It is my general impression that there was not much groundwork on this prior to the issuance of the relevant Executive Order (13959). Considering the general scope of foreign investments in Chinese companies listed in the mainland (estimated at 3-6 percent of total equity and debt), it seems that foreign finance, and all the more so U.S public finance, is not a significant source of financing in Chinese listed companies, and by extension in CCMCs specifically. Draining such money will not pose a capital challenge to CCMCs expansion.

Similarly, from the perspective of China's prospect for greater global financial integration, such restrictions are likely to have a marginal impact.

Since I am not privy to the considerations made by the Department of Defense and the Treasury before each specific company was put on the list, I cannot make judgment as to whether portfolio investing restrictions are good from a national security perspective.

Yet, I believe that an ever-expanding approach to the current restrictions will mostly come at a cost for U.S. investors and the financial industry. Ultimately, sources of money are interchangeable and corporate nationality is fluid. Broader restrictions on portfolio investing, especially taken without similar restrictions by other global financial markets, will impose a burden on U.S. asset managers and investors. The industry might be pushed to find creative, costly ways to circumvent the restrictions through 3<sup>rd</sup> party countries and entities. Using U.S. global capital flows for geopolitical gains could also come at a cost for the credibility and reputation of the U.S. market as a hub for global financial participants.

Considering the relatively small share of U.S.-public investments in China and alternative global sources of capital, restrictions on portfolio investing would have little effect. Perhaps more effective would be to consider due-diligence obligations on asset managers and institutional investors for investments beyond certain scopes as well as a risk disclosure regime. Investment restrictions and pre-

ruling methods could be more productive in scrutinizing how capital is used in the FDI space (inbound as well as outbound), but in the public finance space they seem counterproductive.

*Q6: The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. Do you have any other recommendations for legislative action based on the topic of your testimony?*

My first suggestion would be to invest in getting more and better data on China's financial integration, preferably from one or few designated sources (a designated research unit or 3<sup>rd</sup> party analyst), creating unified standards and data sets from which all agencies can draw.

There should be more research and more unity around the data. Take data on cross-border portfolio investments, for example; different government agencies rely on different 3<sup>rd</sup> party sources to collect fractions of information on aspects most concerting to them. This results in meaningful gaps and a lack of unity around the numbers. Clarity on fundamental concepts is also sorely lacking (e.g., is the data looking at companies? other forms of enterprise organization? what is "control", what is a "Chinese company", an "SOE", etc.)

Also on data, a proactive diagnostic approach should be taken to track and analyze the expansion of CCP presence in U.S.-invested Chinese firms. This can include initiating systematic surveys and informative sessions (e.g., through AmCham bodies, U.S. consulates and/or their U.S. investor).

Finally, there is clearly a gap between the interests and considerations of the U.S. security apparatus and those of the business community on various China policies. While this gap is natural, I believe it can and should be narrowed down. This can be achieved by shifting the mindset of the business community (corporate management and the investment industry) to consider long-term sustainable growth and the interests of all stakeholders. This shift might already be underway, and still, under the existing U.S. corporate governance framework, companies and investors have neither incentives nor fiduciary responsibility to consider anything but shareholder value (case law looks at "the best interests of the company" but this has de-facto been implemented as to maximize shareholder stock value as an easily measurable target) and many consider it for the short term.

This should be considered as part and parcel of any approach that strives to advance the interests of the United States by strengthening its core. Of course, we can never expect, nor should we, that businesses would replace their economic interests with national security. But if the core approach to economic growth will better protect the interests of all stakeholders, many potential threats from China would become less ominous (e.g., for inbound and outbound investments).