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# Towards a Market-oriented Business Organization Law System in China

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## **Abstract**

*Strong state control over the market economy is the fundamental feature of the Chinese economy. However, a series of significant legal reforms of enterprises during the recent years make the Chinese commercial law much more market-oriented than ever before. This essay briefly reviews the ongoing institutional development of enterprise laws in China and points out the comprehensive impact on Chinese economy in a foreseeable future.*

## **1. Introduction**

The institutional transplantation in transitional economies is experiencing a new age. The forty-year market-oriented legal reform with strong state control in China has reshaped the relationship between government and market participants. The strong state intervention in market economy in China makes it not surprising that the nature of the Chinese enterprise is not as ‘contractual’ as that in western countries, especially the commercial law in the common-law jurisdiction. In other words, to how large extent the law of enterprises in transitional China is market-oriented is still debatable. However, the ongoing legislative reforms in the area of business organization law in China have stepped towards a market-oriented business organization law system, which may provide law scholars and business lawyers with new expectation and understanding of the institutional features of the enterprises and financial investment in China. In this brief note, I will systematically review the recent developing trends in the law of business organizations in China, namely the mixed ownership reform of state-owned corporations, liberalistic reform of company law and a market-friendly securities investment fund law during the recent years, and then point it out its potential development path in short future and its limitation as well.

## **2. The On-going Mixed Ownership Reform of the SOEs in China**

Since the promulgation of the Decision on Major Issues Concerning Comprehensively Deepening Reforms (hereinafter ‘the Decision’)<sup>1</sup> by the Central Committee of the China Communist Party (the Central Committee) in November 2013, a new wave of marketization reform of China’s SOEs have been launched, in which the political foundation and legitimacy for specific the mixed ownership

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<sup>1</sup> The Decision on Major Issues Concerning Comprehensively Deepening Reforms (12<sup>th</sup> November 2013).

reforms of the SOEs was established. As a fundamental guidance for the reform, it is clearly stated that ‘Diversified ownership integrated by State capital, collective capital and private capital is the prime method for materializing the basic economic system’<sup>2</sup>, the ‘Non-State shares will be allowed in State capital investment projects’<sup>3</sup> and the ‘Mixed-ownership enterprises will be allowed to utilize employee stock ownership to form a vested community of capital owners and workers’<sup>4</sup>, which implicates that the private capital can invest in public-owned enterprises as the shareholders. Moreover, the Decision also points out that abolishing of unreasonable regulations on the non-public economy, eliminating hidden barriers and encouraging non-state enterprises to invest in or play a controlling role in mixed ownership enterprises<sup>5</sup>. From a perspective of legal reform, above policy has released a signal that the specific institutional transformations will be carried out in two dimensions, the one is enhancing the legal protection for private business and the other is legitimizing the marketization of the SOEs, both of which are expected to deeply influence the development of corporate governance of Chinese companies.

In August 2015, Guidance Opinions on the Deepening of Reform of State-Owned Enterprises (‘the Guidance Opinion’)<sup>6</sup> was passed the Central Committee and the State Council, which provides thirty specific guiding points for mixed ownership reform of China’s SOEs. According to this Guidance Opinion, the SOEs in China are classified into ‘commercial’ and ‘public interest’ SOEs with different economic and social functions respectively<sup>7</sup>. In the context of commercial SOEs that operate on a market basis, the private investors are allowed to invest in or even control the SOEs<sup>8</sup>, by which the economic efficiency of SOEs’ corporate governance can be improved. As for the ‘public interest’ SOEs providing that provide public services and goods for general populations, the ownership of such SOEs may still remain state-controlled, while in which the minority investors are allowed to invest<sup>9</sup>. Additionally, to mitigate the risks in social stability and people’s livelihood, the non-profitable institutions affiliated with SOEs such as public schools and hospitals are proposed to spin off, restructure or transfer their non-core sectors to private investors<sup>10</sup>.

In regard of the capital structure reform of China’s SOEs, the Guidance opinion encourages private capital holders to apply equity subscription, convertible bonds and equity swaps to invest in SOEs for purpose of diversifying the ownership structure of the SOEs<sup>11</sup>. Moreover, the preferred share as another legal instrument for diversifying the ownership structure of SOEs has also been accepted by

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<sup>2</sup> *ibid*, s6.

<sup>3</sup> *ibid*.

<sup>4</sup> *ibid*.

<sup>5</sup> *ibid*, s8.

<sup>6</sup> Guidance Opinions on the Deepening of Reform of State-Owned Enterprises (24<sup>th</sup> August 2015) .

<sup>7</sup> *ibid*, s4.

<sup>8</sup> *ibid*, s5.

<sup>9</sup> *ibid*, s6.

<sup>10</sup> *ibid*, s28.

<sup>11</sup> *ibid*, s17.

China's top decision makers<sup>12</sup> and securities regulators<sup>13</sup>, by which the state can still remain the control over the SOEs in some special fields such as financial and media industries and at the mean time the private investors can guarantee their financial interests by exercising their preference rights in profit distribution and liquidation.

### **3 The Company Law and Securities Law Reforms for Deregulating Private Economy**

Just as mentioned above, the development of the private economy is another dimension of social reform in contemporary China. The latest revision of the company law was completed in December 2013 by the Standing Committee of the National People's Congress (SCNPC) and came into force since March 2014. Compared with the previous version of the Company Law (2005 Revision), the most remarkable highlight of the revised company law is the liberalization and deregulation of registering companies in China. For instance, the Company Law (2013 Revision) abolishes the paid-in capital registration system which required companies to file not only the registered capital but also paid-in capital with the State Administration for Industry and Commerce. The new Company Law only requires the registration of the 'subscribed capital'<sup>14</sup> and correspondingly the requirement to file a certified accountant's verification of the capital is also removed<sup>15</sup>. Moreover, in consideration of the convenience for the establishers of small enterprises, especially those technical innovation start-ups, the new Company Law cancels minimum capital threshold for establishing a company with limited liability (including the one-member limited liability company)<sup>16</sup>. In addition to the relaxation of capital registration, the requirement that no less than 30% of the registered capital of a company with limited liability must be in the form of cash has no longer applied, the shareholders currently are entitled more freedom of choosing different types of assets including cash, physical objects, intellectual property and land use rights as their contribution<sup>17</sup> and in terms of the timeframe for completing the capital contribution, the previous two-year deadline within which the complete contribution must be made, is also removed<sup>18</sup>. Overall, the new Company Law of PRC provides more opportunities for entrepreneurs which will make the market mechanism more important in China's economy. As a result, at least for non-state companies, the market of managers may play a more significant role in rebuilding the corporate governance structure in Chinese companies.

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<sup>12</sup> According to s7 of the Guidance Opinion, the state-owned capital are allowed to be transferred into preferred shares in the SOEs in some particular industries, by which the state can remain the managerial power over such SOEs.

<sup>13</sup> As early as March 2014, the CSRC has issued The Measures for the Pilot Administration of Preferred Stock, in which the detailed rules pertaining to the rights of preferred shareholders, the procedure of issuing preferred shares and special restrictions of listed companies are provided.

<sup>14</sup> s7 of the Company Law (2013 Revision) of the PRC.

<sup>15</sup> *ibid*, s29.

<sup>16</sup> *ibid*, s23, 58.

<sup>17</sup> *ibid*, s27.

<sup>18</sup> *ibid*, s26.

In respect of the China's capital markets, for meeting private-owned companies' financing demand, liberalization of listing system in the PRC securities market is also proposed and carried out in process. According to the current Securities Law (2014 Revision), any IPO application on China's domestic stock exchanges will not be allowed, unless it is approved by China Securities Regulatory Commission (CSRC)<sup>19</sup>. With the development of non-state economy during recent years, currently the innovative business and e-commerce have become the new pushers of China's economy, however, due to the inadequate cash flow and high risk of business failure, only very few small enterprises can successfully apply the loans from commercial banks or meet the strict fiscal requirement of listing on China's main board of stock exchanges<sup>20</sup>, which has seriously impeded the development of China's economy especially the cutting edge technical industry. It can be imagined that the deregulation of listing requirement to the private companies would play a positive role in encouraging the developing non-state companies and improving the equality in China's capital market.

As a response to such plight, the reform of China's listing rules from 'approval system' to 'registration system' is being carried out by the legislator. In 2015 the amendment of the Securities Law has been proposed and launched by the SCNPC, in which the two following deregulating approaches are to be highlighted and expected to come into force in latest legal reform<sup>21</sup>. Firstly, it is proposed to entitle the compliance approval power to the stock exchanges, the CSRC's approval power should be removed; what's more, the requirement of the applicant's profitability record during the latest three fiscal years is recommended to be cancelled, as the law should leave more freedom for market participants to independently judge the risks, prospect and profitability of a given company, by which the competition mechanism can be fully promoted<sup>22</sup>. Secondly, the significance of a candidate's 'continuous profitability' should be diluted in examining a candidate's listing qualification. In contrast, the quality of information disclosure and honesty and integrity of not only the candidate company but also its management layer should be investigated more strictly by the stock exchanges<sup>23</sup>. The CSRC will then play a pivotal role in regulating, supervising and sanctioning the listed companies of PRC stock markets after their IPOs, through which public investors' interests will

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<sup>19</sup> s10 of Securities Law (2014 Revision) of the PRC.

<sup>20</sup> For example, Measures for the Administration of Initial Public Offering and Listing of Stocks (2015 Revision) which was firstly created and issued by the CSRC in May 2006 stipulates that any applicant for listing on the main board of PRC stock markets must accumulatively create net profit more than 50 million RMB in latest three fiscal years and the general capital shall be no less than 30 million RMB before the listing (s33).

<sup>21</sup> The SCNPC has officially decided to authorise both the Shanghai and Shenzhen Stock Exchanges to carry out pilot practice of registration system of issuing securities in March 2016. Unknown Author, 'IPO Registration System Pilot Reform is Planned to be Carried Out Next Month' *Securities Daily* (Beijing, 16<sup>th</sup> February 2016).

<sup>22</sup> Dongfang Li, 'The Registration System Reform of Issuing Securities: a review of the equity registration regime in the Revised Draft of the Securities Law of PRC' (2015) 3 *Journal of China National School of Administration* <[http://kyhz.nsa.gov.cn/xzxy\\_kygl/pf/xzxywz/yksInfoDetail.htm?inford=2566](http://kyhz.nsa.gov.cn/xzxy_kygl/pf/xzxywz/yksInfoDetail.htm?inford=2566)> accessed 15 February 2018.

<sup>23</sup> *ibid.*

be continuously guaranteed and protected, but at the meantime, the market selection mechanism will keep the primary position in China's securities regulation<sup>24</sup>.

#### **4 The Investment Fund Law Reforms for Developing Institutional Investors**

As the theme which has been widely accepted that the primary problem in China's corporate governance is the over-concentrated ownership structure in both the SOEs<sup>25</sup> and the non-state enterprises<sup>26</sup>. In terms of diluting the state control in SOE's corporate governance, the development of institutional investors in China also must be strikingly important. Since the Law of Securities Investment Funds<sup>27</sup> was revised in December 2012, the privately-held investment funds have been officially regulated by the CSRC, which means that the investors of hedge funds are better protected by Chinese law. Later on, since the promulgation of the Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds (the Interim Measures 2014) in August 2014, according to which private equity and venture capital investment funds have also been uniformly regulated by the CSRC<sup>28</sup>. Last but not the least, the Asset Management Association of China (AMAC) founded in June 2012 is also accepted by CSRC as the self-regulatory institution for investment funds on a national level<sup>29</sup> and all the fund managers are required to comply with the self-disciplinary rules issued by the AMAC, otherwise the AMAC has the power to impose reputational sanction on the managers of private investment funds<sup>30</sup>.

Against such a background, institutional investors especially the PE/VC and hedge funds are encouraged to widely invest in the restructuring projects of SOEs. In such a way, the state's dominating status in SOE's shareholdings can be substantively diluted, through which the state shareholders' monopolistic power of nominating directors of senior managers of SOEs can be reduced<sup>31</sup>. As a result, the interest pattern in corporate governance structure of China's SOEs will be more balanced and the protection for non-state shareholders will be enhanced.

#### **5. Concluding Remarks**

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<sup>24</sup> *ibid.*

<sup>25</sup> Jean Jacques du Plessis et al, *Principles of Contemporary Corporate Governance* (2nd edn, Cambridge University Press 2011) 396.

<sup>26</sup> Qilin Su, Family Control, *PE Investment and Corporate Governance of Private Listed Firm* (Economic Science Press 2013) 76.

<sup>27</sup> The Law of Securities Investment Funds of PRC (2012 Revision) <[http://www.pkulaw.cn/fulltext\\_form.aspx?Gid=191978](http://www.pkulaw.cn/fulltext_form.aspx?Gid=191978)> accessed 17 February 2018.

<sup>28</sup> CSRC, Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds (2014).

<<http://www.amac.org.cn/cms/article/preview?ID=386993>> accessed 17 February 2018.

<sup>29</sup> According to s7 of the Interim Measures (2014), all the private investment funds raised in PRC must be registered with the AMAC.

<sup>30</sup> *ibid.*, s29(2).

<sup>31</sup> Hongliang Zheng, 'Corporate Governance Theories and the Reform of China's SOEs' (1998) 10 *Economic Research Journal* 20, 25-26.

Since the first company law was promulgated in 1993, a series of market-oriented reforms of commercial organization laws in China have been carried out continuously. Even though the effectiveness of the present-day reform of Chinese SOEs or capital markets is still not clear and of course, the political nepotism may still impede the marketization of Chinese economy, the unbalanced economic structure and serious corruption in the SOEs has pushed the authority to restrict the monopolistic status of state-owned enterprises and state control over private economy substantively. Against such a complex social background, China may provide comparative law scholars with a valuable opportunity to observe how the state control over the transitional economy may essentially change the economic function of business organizations.