REFORMING CORPORATE COMPLIANCE SYSTEMS IN CHINA UNDER THE NEW COMPANY LAW: LESSONS FROM THE UNITED STATES AND JAPAN

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Abstract: This article investigates the construction of an ideal compliance system under China's new Company Law through a comparative legal analysis. It begins by identifying the existing challenges in China's compliance framework, particularly the historical dominance of shareholder primacy and the uneven distribution of responsibilities under the previous Company Law. These issues have hindered the development of an effective compliance system, necessitating a reevaluation of corporate governance principles in China. The comparative analysis examines the compliance systems in the United States and Japan, focusing on the frameworks and key elements such as fiduciary duties and the application of the business judgment rule. The study highlights significant differences in how these jurisdictions handle compliance, providing insights into potential improvements for China's system. This section underscores the importance of adapting international best practices to local contexts to enhance the effectiveness of corporate compliance in China. Finally, the article proposes a dual-level compliance concept tailored to China's unique legal and corporate environment, integrating both private and public interests. It outlines specific compliance duties for directors, supervisors, and other compliance personnel, emphasizing the need for robust information transmission, whistleblower protections, and temporary management systems. The conclusion calls for a comprehensive and flexible compliance framework that not only ensures corporate profitability but also promotes broader societal welfare, aligning with the evolving goals of corporate governance in China.

Keywords: Compliance System, Corporate Governance, Fiduciary Duties, Business Judgment Rule, New Company Law

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INTRODUCTION

Non-compliance with laws and regulations can lead to significant reputational harm for organizations, investments in compliance have kept up with the evolving regulations and enforcement measures.[1] Hence, the enactment of the new Company Law in China marks a significant shift in the nation's corporate governance landscape, emphasizing the importance of robust compliance systems. [2] Historically, China's corporate governance has been dominated by the principle of shareholder primacy, which prioritizes shareholder interests often at the expense of broader stakeholder considerations.[3] This focus has led to challenges in enforcing compliance, with a lack of clear frameworks and responsibilities resulting in inconsistencies and inefficiencies. The new Company Law aims to address these issues by introducing comprehensive reforms designed to balance shareholder interests with broader corporate responsibilities.[4]

In China, the concept of compliance has traditionally been fragmented and inconsistently applied.[5] The previous Company Law provided limited guidance on the distribution of compliance responsibilities, leading to ambiguities and varied interpretations across different regions and industries.[6] This inconsistency has been compounded by the lack of a standardized judicial approach to adjudicating cases of director diligence and fiduciary duty, making it difficult to enforce compliance uniformly.[7] The new Company Law seeks to rectify these shortcomings by establishing clear guidelines and responsibilities for corporate directors, supervisors, and other key personnel.

To contextualize these reforms, it is essential to examine the compliance frameworks of other jurisdictions, particularly the United States and Japan. The United States offers a well-established model of corporate compliance, with fiduciary duties

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[1] Harald Haelterman, Breaking Silos of Legal and Regulatory Risks to Outperform Traditional Compliance Approaches, 28 Eur. J. Crim. Pol'y & Res. 19, 20 (2022).
[2] Arendse Huld, China's Revised Company Law in Effect from July 1, 2024: Key Details Here, China Briefing (June 8, 2024), https://www.china-briefing.com/news/china-company-law-amendment-july-1-2024/.
[3] Robert J. Rhee, A Legal Theory of Shareholder Primacy, 102 Minn. L. Rev. 1951, 1951 (2017).
[4] Hawksford, Explaining the recent amendments to China's Company Law, Hawksford (March 12, 2024), https://www.hawksford.com/insights-and-guides/explain-amendments-to-china-company-law (Fiduciary and diligence obligations for senior executives).
[5] There is no clear and uniform definition of compliance within China's academic circle; different scholars have different opinions, resulting in various interpretations of the concept and respective approaches. The lack of a unified opinion has made it hard to have a standardized compliance framework for theoretical research and its practice in different business sectors. See, e.g., Zhao Wanyi (赵万一), Hegui Zhidu de Gongsi Fa Sheji Jiqi Shixian Lujing (合规制度的公司法设计及其实现路径) [The Design and Implementation Path of Corporate Compliance Systems in Company Law], 2 Zhongguo Faxue (中国法学) [China L.] 69, 71 (2020) (China).
[6] Deng Feng (邓峰), Gongsi Hegui de Yuanliu Ji Zhongguo de Zhidu Juxian (公司合规的源流及中国的制度局限) [The Origins of Corporate Compliance and Institutional Limitations in China], 1 Bijiao Fa Yanjiu (比较法研究) [Comp. L. Res.] 34, 42 (2020) (China).
[7] One of the most important things will be a unified legal concept in use and interpretation across several sectors in China. It is an increment to coherence and clarity on the application and interpretation of the said laws. A cohesive legal framework could achieve better legal predictability, stable business conditions, and greater potential for fair and equal treatment before the law. Id.

and the business judgment rule playing crucial roles in ensuring accountability.[8] This model encourages directors to make bold and innovative decisions while being protected from legal repercussions, provided they act in good faith and with due diligence. Japan, on the other hand, integrates compliance within its broader internal control systems, focusing on the duty of care and loyalty of directors and emphasizing a holistic approach that includes stakeholder interests and robust internal controls.[9]

Drawing insights from these international experiences, this article proposes a dual-level compliance concept tailored to China's unique legal and corporate environment.[10] This concept integrates both private and public interests, ensuring that compliance duties are clearly defined and enforced across all levels of corporate governance.[11] The proposed model emphasizes the importance of robust information transmission systems, whistleblower system, monitoring system and business screening system to enhance the effectiveness and resilience of the compliance framework.[12]

The new Company Law seeks to redefine the roles and responsibilities of corporate directors, supervisors, and other key personnel, ensuring that compliance obligations are clearly delineated and systematically enforced.[13] This redefinition is essential for addressing the historical dominance of shareholder primacy and fostering a more balanced and effective compliance system. By incorporating international best practices and adapting them to the local context, China can establish a compliance system that not only meets legal standards but also promotes sustainable and ethical corporate governance.

In conclusion, the construction of an ideal compliance system under China's new Company Law requires a comprehensive and flexible framework that balances corporate profitability with societal welfare. This article aims to contribute to the ongoing discourse on corporate compliance in China, providing a roadmap for future reforms and advancements in corporate governance.

I. OVERVIEW OF CORPORATE COMPLIANCE SYSTEMS IN CHINA

The concept of a compliance system and its practical application have garnered significant attention in Chinese academic circles.[14] However, given China's previous legislative environment, effectively integrating a compliance system has proven challenging. This section will discuss China's understanding of the compliance concept and the reasons behind the difficulties in building a compliance framework in China.

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[8] Id. at 35-38.
[9] See infra section II.B.3, pp. 28-29.
[10] See infra section III.A, pp. 33-36.
[11] Id.
[12] See infra section III.C.1, pp. 45-46.
[13] Jonathan Bench, Understanding the China Company Law Amendments that Matter to Foreign Businesses, Harris Sliwoski (May 15, 2024), https://harris-sliwoski.com/chinalawblog/understanding-the-china-company-law-amendments-that-matter-to-foreign-businesses/.
[14] See Zhao Wanyi supra note, at 69.

A. Definition of the Compliance Concept in China

Currently, the interpretation of "compliance" is difficult to unify in Chinese, primarily due to the diverse forms and varying applications of the legal departments it involves. [15]In an English context, "compliance" means "to comply with or are asked to do," initially referring to adherence to effective regulations or performing required actions. [16] In China, however, the academic community has many definitions of compliance, with a more authoritative explanation found in Article 2 of the "Compliance Management Measures for Central Enterprises." This defines compliance as the behavior of enterprise operations and management, as well as the performance of duties by employees, in accordance with national laws and regulations, regulatory requirements, industry standards, international treaties, rules, and company charters and related regulations.[17]

Regardless of the definition adopted, it is impossible to encapsulate the rich connotations of the concept of a compliance system. I think, understanding the concept of compliance in China should be approached from two dimensions. First, as an external control role, it requires that both internal and external behaviors of a company comply with laws, regulations, and mandatory norms while simultaneously meeting commercial practices, internal company behavior consistency, and company bylaws. This represents the external requirements and expectations for company operations. Second, as an internal operational self-restraint, it aims for the company to adapt to changes in the internal and external environment to achieve stable self-control and sound management.[18]

In summary, the concept of compliance in China is neither solely the control by external legislation nor merely confined to the internal autonomy of the enterprise.[19] Instead, it should be an organic combination of both, aimed at the effective management of the company and the efficient governance of society.[20] This point reveals that in China, the concept of corporate compliance also has obvious ESG characteristics.

B. China's Compliance Challenges

China's compliance system has faced many difficulties in its construction. The main reasons are the prevalence of shareholder primacy in China and the unequal distribution of responsibilities under the old Company Law.[21]

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[15] See Id. at 71.
[16] Id.
[17] Zhongyang Qiye Hegui Guanli Banfa (中央企业合规管理办法) [Compliance Management Measures for Central Enterprises] (promulgated by the State-owned Assets Supervision and Administration Commission, Aug. 23, 2022, effective Oct. 1, 2022), State-owned Assets Supervision and Administration Commission Order No. 42, available at https://www.gov.cn/zhengce/zhengceku/2022-09/19/content_5710633.htm (China).
[18] See Zhao Wanyi supra note 7.
[19] Compliance, in a sense, also aligns with the requirements of ESG principles. Id.
[20] Id.
[21] Deng Feng supra note 6, at 43.

1. The Dominance of Shareholder Primacy in China

Shareholder primacy, also known as shareholder-centric, posits that shareholders occupy the most central position in the entire corporate organizational structure.[22] They are considered the owners of the company and can employ professional managers to operate the company for the benefit of the shareholders.[23] In a company, shareholders entrust professional managers to manage the company on their behalf, with the implicit default rule being that professional managers should utilize their management skills to help shareholders achieve their profits.[24] Consequently, in the course of management, professional managers have no reason to constrain themselves for any purposes other than those of the shareholders. Furthermore, the ultimate power of the company is exercised by the shareholders. Even though, in most cases, shareholders may not bypass the governance expertise provided by professional managers, they still retain the final decision-making authority.

In China, most companies strictly adhere to the principle of shareholder primacy.[25] In routine governance, the voting rights represented by shareholders and the management rights represented by the board of directors often appear inseparable, a classic phenomenon.[26] The organizational level of companies is relatively low, with almost all company powers concentrated in the general meeting of shareholders.[27] The board of directors is practically regarded as an extension of the shareholders' meeting, lacking compliance management. The development of China's corporate system is relatively recent, evolving from Sino-foreign joint ventures.[28] In such joint ventures, to ensure the stability of company development and with the frequent inclusion of state-owned capital, the equity structure is highly concentrated.[29] This equity-centric ideology has continued to this day, whether in limited liability companies with a prominent "personality" attribute or joint-stock companies with a significant "capital" attribute. The power of the general meeting of shareholders (and major shareholders) has always been central, directly overlooking the representative system characteristics that should be met in corporate governance.[30]

The excessive concentration of power in the general meeting of shareholders or a particular shareholder has blurred the essential feature of the company as an independent entity.[31] Some Chinese perspectives have even seriously deviated from the essence of the company, viewing the company as the property of the shareholders,

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22 D. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277, 282 (1997).
23 Id.
24 Id.
25 Liu Kaixiang (刘凯湘) & Liu Jing (刘晶), Woguo Gudonghui Zhongxin Zhuyi de Lishi Chengyin (我国股东会中心主义的历史成因) [The Historical Causes of Shareholder Centralism in China], 6 Faxue Luntan (法学论坛) 51, 52 (2021) (China).
26 Id.
27 Deng Feng supra note 13.
28 Id.
29 Id.
30 Id.
31 Excessive concentration of power within the shareholders' meeting, whether directly or indirectly, results in the loss of independence of a company. All such imbalances innovate against the basic principles of good corporate governance—checks and balances—which could consequently result in decisions favoring just a few at the expense of other broader stakeholder interests. Id.

who can freely dispose of the company's assets and personnel. This leads to the disregard of existing election procedures. Shareholders, relying on the "principal-agent" system, can effectively replace directors and senior management at any time.[32] In state-owned enterprises, the majority implement a party committee system, where the appointment and removal of senior management are often overridden by party regulations.[33] Government agencies, as shareholders, seem to be exempt from or find it challenging to comply with the basic limitations of internal company charters and procedures.[34] This situation actually contradicts the provisions of company law, which stipulate that the powers of the board of directors are derived from the general meeting of shareholders through elections.[35]

Although under the principle of shareholder primacy, as discussed above, the positions of board members, supervisors, and senior management within a company are not stable, in the process of accountability, these agents in the principal-agent relationship often passively bear the responsibility for executing the will of the principals. In fact, from my perspective, the external form of responsibility is generally borne by the company making the external declarations, while internal responsibility should be allocated according to different divisions of labor. However, under this theoretical model, the internal declarations of the company are predominantly influenced by the shareholders' will. It is challenging to separate the will of senior management from that of the shareholders. In some instances, management personnel may have no involvement of their own will in certain decisions. According to general principles of responsibility allocation, the shareholders behind these decisions should logically be held accountable. However, in practice, it is very rare for such accountability to be pursued in China.[36]

2. Lack of Obligations for Key Roles in the Old Company Law

In the corporate governance process in China, the primary duty of directors is fiduciary duty, which comprises two categories.[37] The first is the duty of loyalty, meaning that in the course of corporate governance, directors must prioritize the interests of the company and must not place personal interests above those of the company.[38] The second is the duty of care or duty of diligence, which requires directors to act prudently in the course of corporate governance to prevent actions that may lead to losses for the company.[39] These two duties form the basis of directors' responsibility

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[32] Id.
[33] Liu Kaixiang & Liu Jing supra note 17, at 54.
[34] Id.
[35] Liu Kaixiang & Liu Jing supra note 17, at 52.
[36] In China, companies controlled by shareholders effectively do not have independent status, making actual claims against the shareholders hard to pursue. This scenario engenders a shock to principles of corporate autonomy and accountability, giving rise to possible cases of conflicts of interest and corporate governance. Deng Feng supra note 13, at 44.
[37] Fu Qiong (傅穹), Gongsi Liyi Fanshi Xia de Dongshi Yiyi Gaige (公司利益范式下的董事义务改革) [Reforming Directors' Duties Under the Paradigm of Corporate Interests], 6 Zhongguo Faxue (中国法学) [China L.] 197, 204 (2022) (China).
[38] Id.
[39] These two duties regulate the behavior pattern of directors from two dimensions. They set clear guidelines to ensure the best conduct of the company's interest with a touches of ethical standards. Id.

to the company in their management roles.[40]

However, despite this seemingly comprehensive duty system, there are significant issues. The construction of China's Company Law differs from that of common law countries such as the UK and the US, adopting legislative principles more aligned with French law. French law, in its requirements for company directors, places greater emphasis on the fulfillment of the duty of loyalty during corporate governance, while the demands for the duty of diligence are relatively lower. Consequently, although the 2005 Company Law of China stipulates the duties of directors, it does not provide detailed explanations on how directors should fulfill their appropriate duties or what constitutes the fulfillment of such duties.

China previously lacked the foundational basis for establishing a compliance system. This article argues that the construction of a compliance system may include not only the establishment of specialized compliance organizations and the clarification of compliance norms but, regardless of how the final system is constructed, the most critical aspect is rationally establishing a complete set of obligations. I believe that the clarification of these obligations is the cornerstone for constructing the entire compliance system, with two main adjustment directions:

First, the system should include how the compliance department ultimately transmits or executes the necessary compliance information. During the operation of the compliance department, any information potentially harmful to the company's interests must be promptly communicated to the company's directors, supervisors, and other senior management personnel.

Second, the construction of the compliance obligations also plays a crucial role in the allocation of internal responsibilities within the company and the assumption of external responsibilities. Clear obligations are essential for the substantive allocation of responsibilities. The aforementioned obligation system had significant loopholes before the introduction of the new Company Law, preventing China from constructing an effective compliance system.

Simultaneously, the lack of uniformity in judicial decisions across different regions in China also complicates the construction of a compliance system.[41] The current judicial approach in China regarding whether directors have violated the duty of diligence generally follows these steps: first, establishing a causal relationship between the objective losses specified by the company and the directors' actions, excluding situations arising from normal business risks or force majeure; second, determining whether the directors' actions violated internal company bylaws or laws and regulations; and finally, examining whether the directors' actions were prudent and reasonable.

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[40] Id.

[41] For example, the consequence of local protectionism can be different court rulings on the very same case. Such inconsistency undermines equal justice under law and may eventually destroy public confidence in the rule of law. Yuan Meng, The Limits of Judicial Reforms: How and Why China Failed to Centralize Its Court System, 255 China Q. 753, 763 (2023).

Although this "three-step" judgment approach appears to be progressive, there are two main issues faced by judges in the adjudication process:

First, regional differences. For corporate disputes in different regions, particularly in economically more developed and mature market areas,[42] the business models are more complex, and naturally, the requirements for directors' duty of diligence are higher. Consequently, the standards for adjudicating cases vary according to the level of economic development and market environment of different regions. This results in differing standards for examining directors' duties and the duty of diligence, leading to regionally stable but inconsistent judicial outcomes.

Second, there are few cases where courts adjudicate based on the legal principle of the duty of diligence. This lack of a unified rule for determining whether the duty of diligence has been violated leads to inconsistencies, with some judges even conflating the duty of loyalty with the duty of diligence. This severely impacts the stability of judicial decisions.

II. INNOVATION IN CORPORATE COMPLIANCE SYSTEMS UNDER CHINA'S NEW COMPANY LAW

China currently lacks requirements for establishing compliance systems, and, as previously discussed, this presents significant deficiencies. In the context of the new Company Law, China aims to lay the groundwork for a more comprehensive compliance system and further pursue ESG goals by making improvements related to employee rights and the duties and responsibilities of directors.[43]

A. Establishment of Employee Representatives

The new Company Law in China has removed the upper limit on the number of directors and has further improved the system for establishing employee representatives. Previously, only certain wholly state-owned enterprises and some limited liability companies were required to have employee representatives. Under the new Company Law, this requirement has been expanded to include all limited liability companies with more than 300 employees. Moreover, it emphasizes the allowance for the inclusion of

[42] Wenyan Zhu (朱文雁), Cong Sifa Xianzhuang Kan Panli Zai Woguo Sifa Guocheng Zhong de Jiazhi (从司法现状看判例在我国司法过程中的价值) [The Value of Case Law in China's Judicial Process from the Perspective of Current Judicial Status], 21 Faxue Luntan (法学论坛) 120, 123 (2006) (China).

[43] Lei Zhao (赵磊), Gongsi Fa Shang Xinyi Yiwu de Tixi Goucheng——Jian Ping Xin "Gongsi Fa" Xiangguan Guiding (公司法上信义义务的体系构成——兼评新《公司法》相关规定) [The Structure of Fiduciary Duties in Company Law—Comments on the Relevant Provisions of the New Company Law], 3 Caijing Faxue (财经法学) 67, 67 (2024) (China).

employee representatives in boards of directors consisting of three or more members.[44] This enhancement strengthens the interests of employees and other stakeholders, significantly improving the compliance foundation at the employee level.

B. Innovation in the Duties and Responsibilities System for Directors

As previously described, the main obstacle to building a compliance system in China has been the unclear duties and responsibilities of directors and other personnel. Therefore, in the new Company Law, China addresses this by establishing effective duties to compensate for these shortcomings.[45]

1. Strict Liability of Directors to Third Parties

China's new Company Law legislatively imposes strict duties and responsibilities on directors and other senior management personnel for harm caused to third parties.[46] Previously, the Company Law only stipulated compensation rules for damages caused to the company by directors and senior management personnel in the execution of their duties, without clearly defining their liability to third parties. The new Company Law explicitly outlines the directors' responsibility to third parties, thereby strengthening the duties and responsibilities of directors, which are critical to the integrity of the compliance system.[47]

However, I hold the view that this new regulation may be somewhat unreasonable as it could excessively expand the directors' liabilities. In the business world, no decision can satisfy everyone, implying the existence of both beneficiaries and those adversely affected. Therefore, directors should not be held liable for every third party's losses resulting from their business decisions. Even if subjective elements are limited, this remains ineffective because the underlying logic of any business decision involves intentional or gross negligence, which falls outside the reasonable scope of liability. Thus, while this regulation appears to strictly protect third-party

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[44] By having employee directors, companies can definitely ensure the safeguarding of the rights of workers to some extent. In other words, through this, workers obtain representation in decision-making, and the company's governing structure becomes fairly comprehensive and whole. This method reduces the possibility of concerns arising from the employee end and increases job satisfaction by developing a sense of ownership and dedication among the workers, thereby contributing immensely to overall company stability and success. Zhao Xudong (赵旭东), Zhou Linbin (周林彬), Liu Kaixiang (刘凯湘), Zhao Wanyi (赵万一), Zhou Yousu (周友苏) & Li Jianwei (李建伟), Xin "Gongsi Fa" Ruogan Zhongyao Wenti Jiedu (Bitan) (新《公司法》若干重要问题解读（笔谈）) [Interpretation of Several Important Issues in the New Company Law (Symposium)], 2 Shanghai Zhengfa Xueyuan Xuebao (Fazhi Luncong) (上海政法学院学报(法治论丛)) 1, 25 (2024) (China).

[45] Zhao Lei supra note 35, at 71.

[46] The responsibility of directors towards third parties has been reconstructed from the perspective of tort theory. This approach redefines the scope and nature of directors' duties, emphasizing their accountability for actions that cause harm to external parties. Tang Xin (汤欣) & Li Zhuozhuo (李卓卓), Dongshi Dui Disanren Zeren de Lilun Jichu Yu Guifan Gouzao (董事对第三人责任的理论基础与规范构造) [Theoretical Basis and Normative Structure of Directors' Liability to Third Parties], 3 Falü Shiyong (法律适用) 75, 76 (2024) (China).

[47] Id.

interests, it may, in practice, lead to an unreasonable expansion of directors' liabilities.

2. China's Version of the Shadow Director System

The new Company Law in China clarifies the duties and responsibilities of controlling shareholders and actual controllers, emphasizing their obligations towards the company's social responsibilities. In common law systems, the shadow director doctrine is used to regulate the unlawful behaviors of controlling shareholders and actual controllers by subjecting them to directors' duties and responsibilities.[48] China's new Company Law adopts a similar theory but extends the civil law concept of joint tort liability, which holds those who instigate or assist in unlawful acts jointly liable.[49] This extension aims to hold controlling persons jointly liable with directors and senior management for unlawful acts.[50] This regulation helps prevent the abuse of control rights by protecting the interests of the company and its minority shareholders from improper conduct by controlling persons.[51]

III. COMPARATIVE ANALYSIS OF CORPORATE COMPLIANCE SYSTEMS

This section provides a detailed comparative analysis of corporate compliance systems in the United States and Japan. It highlights the key components and structures of these systems, focusing on fiduciary duties, business judgment rules, and internal control mechanisms. The U.S. compliance framework emphasizes fiduciary duties and the business judgment rule, encouraging bold decision-making while ensuring accountability. Japan's approach integrates compliance within broader internal control systems, emphasizing the duty of care and loyalty of directors and considering stakeholder interests. By examining these international models, the section draws insights to propose a dual-level compliance concept tailored to China's unique legal and corporate environment, ensuring effective governance and balancing private and public interests.

A. The Compliance System Framework Under U.S. Law

The U.S. compliance system involves professionals such as corporate lawyers and auditors to oversee corporate operations, emphasizing self-regulation to prevent violations and unethical practices.[52] Developed over forty years, this system addresses

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[48] Wei Zhang (张巍), Dongshi Dui Gudong You Wu Xinyi Yiwu——Xin Gongsi Fa Di 191 Tiao, Di 192 Tiao Zhi Fali Yu Xianshi (董事对股东有无信义义务——新公司法第一百九十一条、第一百九十二条之法理与现实) [Do Directors Have Fiduciary Duties to Shareholders? The Theory and Reality of Articles 191 and 192 of the Ne-w Company Law], 4 Renmin Sifa (Yingyong) (人民司法（应用）) 106, 109 (2024) (China).

[49] Tang Xin & Li Zhuozhuo supra note, at 38.

[50] Zheng Yu (郑彧), Shizhi Dongshi de Falü Guizhi: Yin He, Wei He Yu Ru He (实质董事的法律规制：因何、为何与如何) [Legal Regulation of De Facto Directors: Reasons, Purposes, and Methods], 3 Caijing Faxue (财经法学) 81, 95 (2024) (China).

[51] Id.

[52] Arthur Andersen LLP v. United States, No. 04-368, 2005 U.S. LEXIS 4348, at *1008-1019 (U.S. May 31, 2005).

the inadequacies of corporate self-regulation highlighted by historical financial crises. Key components include connecting structures, top-level awareness, and a compliance culture, supported by specialized employees. These elements ensure robust compliance through mandatory disclosures and fostering a compliance-oriented corporate environment, crucial for effective governance.

1. Overview and Evolution of Compliance Systems

In the United States, the compliance system generally involves professional personnel such as corporate lawyers, auditors, and ethics officers to help supervise the basic operations of companies. In capitalist countries, financial crises are sometimes seen as inevitable cycles brought about by their economic systems. For the U.S. federal government, the numerous corporate illegal activities and crimes during these cyclical crises are closely related to inadequate self-regulation by companies. [53]Since the 1970s, scholars have suggested constructing internal management structures or decision-analysis institutions to help companies avoid violations, unethical business practices, and illegal actions. [54]Subsequently, scholars began advocating for the establishment of compliance management systems to achieve corporate self-regulation, including enforced self-regulation and management-based regulation.[55]

However, research in the early 21st century indicated that due to the inherent biases in the implementation of corporate management measures, companies were often unable to make necessary changes to achieve external policy goals,[56] resulting in compliance systems failing to reach their ideal state.[57] In some cases, corporate managers might spend a lot in forming a compliance system with high cost, still resulting in hard to deter wrongdoing,[58] who are more inclined to accept the high risks of non-compliance to achieve higher expected benefits, rather than adopting compliance management as intended by regulatory bodies. Even if the goal of corporate management is to avoid non-compliance, it is challenging for most professional managers to establish an effective compliance system in such an environment.[59]

In an environment where most companies either have no compliance requirements or engage in formal compliance, managers are expected to prioritize

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[53] Many enterprises expand in times of boom without proper awareness of compliance. This lack of compliance consciousness may lead into regulatory breaches and governance issues, thereby exposing the companies to legal risks. Miriam H. Baer, Governing Corporate Compliance, 50 B.C. L. Rev. 949 (2009).

[54] John Braithwaite, Corporate Crime Research: Why Two Interviewers Are Needed, 19 Sociology 136, 136-138 (1985).

[55] Cary Coglianese & David Lazer, Management-Based Regulation: Prescribing Private Management to Achieve Public Goals, 37 Law & Society Rev. 691, 691-730 (2003).

[56] Ulrike Malmendier & Geoffrey Tate, Does Overconfidence Affect Corporate Investment? CEO Overconfidence Measures Revisited, 11 Eur. Fin. Mgmt. 649, 655 (2005).

[57] Id.

[58] Todd Haugh, Nudging Corporate Compliance, 54 Am. Bus. L.J. 683, 685 (2017).

[59] Some managers are myopic, considering only performance during their working life. This type of thinking can result in strategies aimed to achieve gains in the short term at the expense of long-term sustainability and that might ultimately compromise the future growth and stability of the company. Christine Parker & Sharon Gilad, Internal Corporate Compliance Management Systems: Structure, Culture and Agency, in Explaining Compliance: Business Responses to Regulation 170-197 (2011).

company interests. In a worse circumstance, managers are forced to transfer interests from stakeholders to shareholders.[60] In such cases, non-compliance becomes a more cost-effective decision. Nevertheless, the improvement of compliance systems is a dynamic process that has been evolving for over forty years. With the close relationship between internal control mechanisms and economic development, the U.S. Department of Justice has expanded and strengthened the implementation of criminal law content to include corporate compliance within its jurisdiction. Additionally, research indicates that well-operating companies are more cooperative with mandatory disclosure obligations and other compliance matters, making the construction of an effective compliance system essential for companies.[61]

2. Key Milestones in the Evolution of Compliance Systems

Professors Christine Parker and Sharon Gilad believe that in the daily operation of corporate compliance systems, there are three key points that frequently participate in the construction of substantive corporate activities.[62] These points are not the only paths for interpreting corporate compliance systems, but they are one of the models that can effectively categorize and summarize current corporate compliance experiences. The three key points are: connecting structures, individuals, and compliance culture. The following sections will detail their roles in the operation of compliance activities:

For the development of professional compliance management, the connecting structures are composed of densely distributed knowledge and professional skills.[63] In an effective compliance system, these nodes consist of numerous specialized employees such as compliance professionals, environmental managers, and in-house lawyers. Companies delegate authority to these professionals, who use their expertise to categorize and solve issues, ultimately ensuring that each problem is addressed most professionally, leading to effective compliance management. In practice, for a company, these individuals who integrate knowledge and professional skills serve as the connecting nodes between the company and business opportunities. They use their abilities to ensure the effective operation of compliance activities. However, it is inevitable that despite their efforts to balance obtaining business opportunities with legal control, thesse professionals will often have to make decisions that either achieve the company's commercial objectives or ensure the effective implementation of legal norms. For instance, they may need to present compliance conflicts inherent in decisions directly to top management for resolution or involve external regulatory bodies in the compliance system's management to prevent top management from pushing through certain actions while ignoring compliance. Therefore, to clearly understand a compliance system model, it is essential to clarify the management attitudes held by its internal professionals, whether they are more politically inclined or conciliatory. This will directly influence the relationship between the compliance system and external controls, as well as the internal operations of the compliance system. Ultimately, it will have a significant impact on the company's long-term

[60] Mark R. DesJardine, Muhan Zhang & Wei Shi, How Shareholders Impact Stakeholder Interests: A Review and Map for Future Research, 49 J. Mgmt. 400, 407 (2023).
[61] Stephen Owusu-Ansah, Factors Influencing Corporate Compliance with Financial Reporting Requirements in New Zealand, 15 Int'l J. Com. & Mgmt. 141, 141-157 (2005).
[62] See Parker & Gilad supra note 9, at 170-197.
[63] Id. at 167-168.

commercial decision-making habits and objectives.

In U.S. compliance, whether agency of individuals within the company incorporates their personal philosophies into the establishment of compliance standards will significantly affect the operation of the compliance management system within the company.[64] Particularly, the agency of management commitment demonstrated by top individuals in daily affairs greatly influences the successful implementation of compliance management.[65] For example, a classic compliance incentive measure is determining the level of compliance behavior norms that company personnel must achieve to avoid internal accountability. Employees, in most cases, will choose to maintain the company's compliance system to avoid potential substantial financial penalties, thereby promoting effective compliance within the company. Additionally, during the recruitment of senior personnel, instilling the understanding of the high market operating costs associated with non-compliance before they join the company can lead them to effectively fulfill their fiduciary duties to the company and maximize corporate interests through effective compliance. Although building a compliance culture is not instantaneous, sustained policy pressure and continuous management can ultimately influence executives' and employees' understanding of the relationship between compliance concepts and business objectives, leading to the establishment of an effective compliance culture.[66] Furthermore, the influence of compliance culture extends beyond top management awareness. The feedback structure from the numerous employees within the company can also inversely affect the development and final implementation of the compliance system,[67] even adjusting top management's awareness. Moreover, the occurrence of sudden financial events can also highlight the need to improve the compliance system. In reality, companies without compliance often recognize the risks of non-compliance only after experiencing a crisis. This realization prompts top management and other personnel to advocate for the construction of a compliance system to mitigate future risks in different parts, including the decisions, internalization and implementation.[68]

In a compliance system, the timeliness and accuracy of information transmission significantly impact the system's operational efficiency. Additionally, how internal employees understand the compliance system contributes to the company's compliance culture.[69] Culture mediates between formal compliance systems and individual actions by influencing perceptions and shaping responses.[70] Particularly in terms of the distribution of compliance obligations, distributing them across every entity within the process is a more rational approach. Compliance is not solely based

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64 See Parker & Gilad supra note 9, at 178.

65 The ideas and views of the top management will dominate the company's operating environment. From a strategic point of view, their vision and styles of decision-making not only set up the corporate culture and organizational priorities but also the overall direction of the business. See Id. at 179.

66 Sharon Gilad, Accountability or Expectations Management? The Role of the Ombudsman in Financial Regulation, 30 Law & Policy 227, 227-253 (2008).

67 See Parker & Gilad supra note 9, at 179.

68 Id.

69 Id.

70 The environment in which the company operates will profoundly impact the governance of the company. The external and internal factors include the regulatory framework, market conditions, organizational culture, and stakeholder expectations that mold the governance practices and policies. Id.

on top-level management or the combination of professional personnel; it is actually the responsibility of everyone in the company. This means that constructing a compliance system must consider the functioning of lower-level employees and management models. Designing the compliance system according to the value orientation of these employees will make the process smoother. For example, establishing promotion-based incentives in the compliance system is one approach.[71] Offering cash rewards or promotions to lower-level employees who provide important compliance-related information that prevents significant company losses is another. In this model, information transmission within the company system becomes smoother and more effective, and employees will concentrate on collecting and analyzing effective information, which can be crucial when the company needs to comply. It is also essential to reasonably divide the responsibilities of employees. It should not be determined by the employee's level but rather guided by their obligations. This prevents the creation of ambiguity regarding duties and rights within the company culture, which could otherwise lead to distrust in the company's operations and hinder the normal functioning of the compliance system.

3. Compliance Obligations of Directors

According to Delaware law, directors will not choose to engage in unlawful actions that are profitable for the company.[72] New York law stipulates that directors are liable for illegal actions, even if those actions benefit the company.[73] In corporate governance, a significant proportion of companies attempt to comply with the law or intend to comply with the law. However, when faced with complex and potentially ambiguous legal interpretations, they may choose to circumvent the law to maximize their profitability. [74]Therefore, it is crucial to clearly define the compliance obligations of directors and the standards by which these obligations are judged.

Regarding compliance obligations, the primary duty model actually stems from fiduciary duty. The fiduciary duty, etymologically, is based on the trust a principal places in an agent to handle their affairs.[75] It is commonly applied in many areas involving agency relationships, from basic agency to partnerships and corporate governance.[76] Generally, fiduciary duty requires the agent to act in the best interest of the principal, especially when their own interests conflict with those of the principal.[77] In terms of compliance matters, the relationship between directors and the company is essentially a fiduciary one. This means that directors, based on their fiduciary duty,

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[71] Ivo Hristov, Riccardo Camilli & Alessandro Mechelli, Cognitive Biases in Implementing a Performance Management System: Behavioral Strategy for Supporting Managers' Decision-Making Processes, 45 Mgmt. Res. Rev. 1110, 1111 (2022).

[72] See Marc S. Gerber, Edward B. Micheletti Peter & A. Atkins, Directors' Fiduciary Duties: Back to Delaware Law Basics, Skadden (February 19, 2020), https://www.skadden.com/insights/publications/2020/02/directors-fiduciary-duties.

[73] NY Bus Corp L § 719.

[74] The balance between compliance costs and non-compliance benefits has been struck. Firms do take the cost of compliance into consideration against their probable short-term gains for bypassing these rules. David B. Spence, The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Environmental Law, 89 Calif. L. Rev. 917, 974-75 (2001).

[75] See Marc S. Gerber, Edward B. Micheletti Peter & A. Atkins supra note 33.

[76] Id.

[77] Id.

must endeavor to avoid commercial risks that could potentially harm the company, thereby protecting the company's interests.

In the United States, there is a classic explanation of fiduciary duty, which states that directors are responsible to the shareholders or the company.[78] These fiduciary duties include four main components: the duty of loyalty and the duty of care. Professor Black believes that two additional duties should be included: the duty of disclosure and the duty of extra care when the company becomes a takeover target. [79]This article will also incorporate these two duties into the comparative legal discussion and will discuss them one by one:

The fiduciary duty of loyalty is paramount, requiring decision-makers to prioritize the company's interests over their own, avoiding self-dealing or dual agency.[80] For many companies, especially smaller ones, completely prohibiting self-dealing is impractical due to limited transaction channels.[81] If a director can bring profitable opportunities to the company, such actions may not need to be prohibited.[82] In the U.S., a conflict of interest transaction will be recognized by the court if it was conducted under fair negotiation, with disinterested directors' approval, unless shareholders can prove the transaction was unfair to the company.[83] Independent directors typically assess such transactions, and even if the company might bear the damages, they often restrict interested directors' voting to protect their and the company's credibility from public criticism, which is the outcome of a cost-benefit calculation.[84]

The duty of care, as the second type of fiduciary duty, typically applies in situations where there is no conflict of interest.[85] This duty requires directors to maintain a prudent attitude and make well-considered decisions.[86] The duty of care does not require directors to make perfect decisions; rather, it demands that directors be present, act prudently, and make business decisions that are not completely irrational.[87] In essence, directors must remain diligent and relatively reasonable in their actions towards the company.[88]

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[78] Id.
[79] Bernard Black, The Principal Fiduciary Duties of Boards of Directors, OECD (April 4, 2001), https://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf.
[80] Id.
[81] Id.
[82] In actual operations, it is not uncommon for company directors to leverage their personal connections to benefit the company. This practice can provide strategic advantages, such as gaining access to new markets, securing favorable contracts, or fostering beneficial partnerships. While this can be advantageous for the company, it also requires careful governance to ensure that such practices align with ethical standards and do not lead to conflicts of interest or undermine corporate integrity. Id.
[83] Id.
[84] Wei Jiang, Hui Wan & Shan Zhao, Reputation Concerns of Independent Directors: Evidence from Individual Director Voting, 29 Rev. Fin. Stud. 655, 670 (2016).
[85] Bernard Black supra note 40.
[86] Id.
[87] Id.
[88] Julian Velasco, The Diminishing Duty of Loyalty, 75 Wash. & Lee L. Rev. 1035 (2018).

The duty of disclosure will be fiduciary in nature is doubtable,[89] but it is already mandated by securities law for publicly traded companies, and it is also a crucial compliance obligation.[90] Directors must firmly fulfill their disclosure obligations to shareholders in the following two situations: when shareholders are required to vote and when the company has just completed a conflict-of-interest transaction. Regarding shareholder voting, shareholders need to analyze and vote based on the actual situations they are aware of; thus, they have the right to know all information that might affect the voting results. As managers of the company's daily affairs, directors naturally become the subject of this disclosure. Regarding conflict-of-interest transactions, two main dimensions need consideration. First, after disclosing all details of the transaction to shareholders, as previously mentioned, shareholders can block the completion of the transaction if they can prove it is not entirely fair to the company. Second, the information might reveal that directors have violated their duty of loyalty, providing grounds for shareholders to sue the directors.

Directors also have a special additional duty of care.[91] When a company becomes a takeover target, the board of directors may face a situation where their interests are significantly affected.[92] After the company is acquired, all members of the board may lose their management positions, even if they assume certain management roles in the new company, these roles will differ from their previous powers as directors.[93] Therefore, in this situation, all directors become interested parties, and whether to approve the acquisition becomes a conflict-of-interest transaction.[94]

At this time, directors must fully disclose this information to the shareholders of the company, and the decision on whether to accept the acquisition should ideally be made by the shareholders themselves. This prevents directors from making decisions that violate their duty of loyalty due to their conflicting interests.

4. Application of the Business Judgment Rule

In the United States, the business judgment rule effectively protects directors and senior executives from excessive scrutiny regarding their compliance obligations.[95] This protection is based on several key points: First, courts should not second-guess business decisions after the fact because unfavorable outcomes in business investments can result from various factors, and poor management decisions might be just one of

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[89] Bronwen Nosworthy, A Directors' Fiduciary Duty of Disclosure: The Case(s) Against, 39 Univ. N.S.W. L.J. 1389, 1408 (2016).

[90] Matthew C. Turk and Karen E. Woody, The Leidos Mixup and the Misunderstood Duty to Disclose in Securities Law, Harvard Law School Forum on Corporate Governance (July 21, 2017), https://corpgov.law.harvard.edu/2017/07/21/the-leidos-mixup-and-the-misunderstood-duty-to-disclose-in-securities-law/.

[91] When a company becomes a target for acquisition, directors, due to their unique positions, will bear additional responsibilities. Bernard Black supra note 40.

[92] Id.

[93] Id.

[94] Id.

[95] Ivan R. Gutierrez, The Business Judgment Rule: A Shield and Sword, ABA (July 22, 2019), https://www.americanbar.org/groups/litigation/resources/newsletters/business-torts-unfair-competition/business-judgment-rule-shield-and-sword/.

them.

Second, unfavorable outcomes are among the business risks that shareholders should have anticipated from the outset. Third, many business decisions involve risks that can yield significant benefits for the company, although some might result in losses. If directors were held liable for every adverse outcome of risky business decisions, they would be less inclined to take such risks, which could reduce the number of potentially beneficial decisions made. Removing directors' discretionary power could result in overly cautious decisions that appear to meet compliance goals but ultimately hinder the company's long-term development, which compliance itself aims to support. So crucially, the court's inquiry does not focus on the substance, not even to a minimal rationality standard, but rather on whether the decision ultimately made was a 'rational result of' the decision-making process that was actually carried out.[96]

In essence, the business judgment rule provides directors with a certain level of immunity when making risky decisions, ensuring they can act in the company's best interest without the constant threat of personal liability for adverse outcomes.

B. The Compliance System Framework Under Japanese Law

In Japan, compliance systems are integrated into broader internal control systems. Although the Japanese Companies Act does not mandate internal control systems, directors are expected to adhere to relevant laws and company regulations. The duty of care and loyalty form the legal basis for these systems. Key elements of Japan's internal control system include a control environment, risk assessment, control activities, information and communication, and monitoring activities. These components ensure that corporate operations are conducted ethically and legally, with directors playing a crucial role in maintaining compliance and addressing risks through a structured and proactive approach.

1. Legal Basis

In Japan, compliance systems are actually included in internal control systems, also known as risk management systems. In fact, the Japanese Companies Act does not mandate the establishment of internal control systems. It only requires directors to adhere to relevant laws, [97]regulations, and the company's articles of incorporation when performing their duties, [98] without a system mandating the board to fulfill corresponding internal control responsibilities. [99] However, if a company has established an Audit Committee, then it must construct an internal control system.

According to previous Japanese case law, the board of directors, as the executors

[96] Lyman Johnson, The Modest Business Judgment Rule, 55 Bus. Law. 625, 650 (2000).
[97] In Japan, setting up internal control systems is a judgment call of companies. This kind of independence enables every company to design the proper internal controls over their operational needs and business environments. Kaisha-hō [Companies Act], Law No. 86 of 2005, art. 416, para. 1 (Japan).
[98] Id.
[99] Id.

of company affairs, has the obligation to establish an internal control system. The legal foundation for constructing this internal control system lies in the duty of care of a good manager. [100]The legal basis for the internal control system can include the duty of prudence, the duty of care, the duty of supervision, or the duty of monitoring.

2. Basic Elements of the Internal Control System

The basic elements of internal control are the necessary components for achieving internal control objectives. Referring to the "Standards for Evaluation and Audit of Internal Control over Financial Reporting" issued by the Financial Services Agency of Japan (hereinafter referred to as the "Internal Control Standards"), the basic elements of internal control mainly include six key components:[101]

The first key component is control environment that refers to the values held by an organization and its basic personnel and work structure systems.[102] It is the key component of the internal control system, determining the attitudes towards control among various parts of the organization and within the internal control system of each individual. It forms the foundation for the other elements.[103] The organizational culture often reflects the intentions and attitudes of the Chief Executive Officer towards the internal control system and other company systems. Additionally, the value standards held by the organization and the basic systems of the internal control system will similarly influence the attitudes of personnel within the organization towards the internal control system. Generally, the usual aspects of the control environment include but are not limited to: a. Organizational integrity and ethics. b. Management's intentions and attitudes. c. Management policies and strategies. d. Division of functions between the board of directors and auditors. e. Organizational structure. f. Allocation of rights and responsibilities. g. Human resources policies and procedures.[104]

The second key component is risk assessment that refers to the process of identifying, analyzing, and evaluating events that could potentially or have already impacted the achievement of organizational objectives.[105] Specifically, risks can be analyzed from two levels: external factors and internal factors. External factors include natural disasters, external illegal acts, market competition changes, foreign exchange impacts, etc. Internal factors include information system failures, top management decision failures, etc.[106] Due to the specific business characteristics and other factors, the approach to risk assessment will vary. The general process is as follows: First is risk identification. The first step in the risk assessment and response process is to establish

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[100] 東京高等裁判所 [Tokyo High Ct.] May 21, 2008, 1281 判例タイムズ [Hanrei T.] 274 (Yakult Case) (Japan.).

[101] Financial Services Agency (金融庁), Standards for Evaluation and Auditing of Internal Control over Financial Reporting (財務報告に係る内部統制の評価及び監査の基準), Financial Services Agency (金融庁) (December 6, 2019), https://www.fsa.go.jp/singi/singi_kigyou/kijun/20191206_naibutousei_kansa.pdf (Japan).

[102] Id.

[103] Id.

[104] Id.

[105] Within an internal control system, identifying risks is of paramount importance. Effective risk identification forms the foundation for developing appropriate mitigation strategies and safeguards. Id.

[106] Id.

how to correctly identify risks.[107] Since risks exist in various business processes within the company, risk identification should be a continuous and phased process to more effectively discover events that may impact the achievement of organizational objectives. The second step is risk classification. Risks can be categorized as historical risks and future risks, as well as company-wide risks and business process risks. The third step is risk analysis. Each risk has a different impact on the company. Generally, companies take corresponding actions against significant risks. This step involves identifying the potential impact of each risk on the company. The fourth step is risk response.[108] I hold the standpoint that here are four main response measures: a. Risk avoidance: This is chosen for situations where the risk impact is very high or difficult to control. b. Risk mitigation: This involves taking corresponding actions to establish internal controls that reduce the impact of the risk. c. Risk transfer: This involves transferring all or part of the risk outside the company to reduce its adverse impact, such as purchasing relevant insurance or conducting direct risk hedging transactions. d. Risk acceptance: This means taking no action against the risk. This measure is a result of balancing the benefits and costs behind it. If the cost of addressing the risk exceeds the benefits, the risk should be accepted to gain more benefits, and vice versa.

The third key component is Control activities that refer to a broad range of policies and procedures implemented to ensure that management's directives are properly executed.[109] For example, the separation of authority and responsibilities: management will clearly define the boundaries of power and responsibility for each process owner, and establish a system based on this to ensure that the responsible person performs their duties within appropriate limits, thereby minimizing the risk of fraud and errors.[110] Additionally, these responsibilities should be distinctly separated. This separation not only facilitates accountability but also ensures mutual checks and balances among responsible parties, thereby improving the overall operational efficiency of the system. Furthermore, as mentioned in the risk assessment above, control activities are closely related to it. A company must ensure the completeness of control activities to implement correct measures to address risks. In practice, the emergence of risks can indeed stem from the inadequacies within the control activities themselves. Regarding the monitoring activities to be discussed below, the completeness of control activities can also establish a more efficient monitoring system. Therefore, ensuring appropriate control activities within the internal control system is crucial.

The fourth key component is information and communication systems that refer to the processes that ensure necessary information is identified, analyzed, processed, and effectively communicated within and outside the company.[111] These systems

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[107] This process involves systematically analyzing all potential threats to the organization's operations, financial integrity, and compliance obligations. Id.

[108] Id.

[109] Id.

[110] In a company, defining the scope of duties and powers of management personnel is extremely important. Clearly delineating these responsibilities ensures that managers understand their roles and the extent of their authority, which is crucial for effective governance and decision-making. Id.

[111] Information can be said to be the engine that drives corporate governance. Perfect information flow within a company ensures that there is an availability of relevant, correct, and timely information to all levels of the organization, enhancing transparency, accountability, and the ability to make informed decisions. Id.

enable timely and appropriate capture, identification, and transmission of information required by all relevant internal and external parties to perform their duties. Whether manual or automated, these systems handle the processing and transmission of information.[112] More importantly, the information needs to be not only transmitted but also understood correctly by the recipient and shared with the necessary individuals within the company. The primary process of this system allows the company to identify genuine and valid information. If the information is deemed necessary for the company, it is incorporated into the information system.[113] Additionally, this system typically includes a whistleblowing mechanism to enhance the collection of external information. Although this is not a conventional communication channel, it serves as a mechanism for information transmission and supervision, allowing all members of the company to convey information to the board of directors, auditors, or in some cases, to external contacts like lawyers.[114] When introducing a whistleblowing system, the board should take measures to ensure its effective operation. A key aspect of this is establishing an effective whistleblower protection mechanism to prevent retaliation against whistleblowers, thereby maintaining the overall operation of control activities. This information management system is closely linked to other elements. For example, when a new policy is established in the control environment, this information is communicated to the appropriate personnel within the organization and understood accurately to facilitate subsequent risk assessment and control activities. If significant deficiencies are identified in control activities or monitoring processes during operation, this information will also be promptly and accurately communicated to the board of directors to innovate the control environment and implement appropriate control activities. Therefore, it is crucial to ensure that the company's organizational structure related to information is rational and to guarantee a high-quality information communication system.

The fifth key component is Monitoring, which is the continuous process of assessing whether the internal control system is functioning effectively.[115] This includes routine monitoring integrated into business operations and independent evaluations separate from business activities. Both types can be conducted independently or in combination.[116] Routine monitoring involves the continuous review and assessment of the internal control system's effectiveness through procedures integrated into regular business operations.[117] For instance, in financial reporting, this might involve periodic or ad-hoc supervision of accounts receivable balances by management. Any discrepancies identified are promptly analyzed and corrected, making this process effective in verifying related financial information. Independent evaluation, on the other hand, can be conducted by three main entities: a. The Board of Directors: Given that the board determines the basic control environment and oversees the execution of company affairs in daily operations, it is effective for the board to conduct independent evaluations. b. The Supervisory Board: The supervisory board,

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[112] Id.
[113] Id.
[114] Id.
[115] Monitoring of commercial decisions and member behavior within the company is also very important within an internal control system. It ensures that the decisions made are in line with the corporate policies and strategic objectives of the organization and directs proper ethical conduct that answers to regulatory standards. Id.
[116] Id.
[117] Id.

established within the company, is responsible for overseeing daily business operations. Its role in independent evaluation helps to effectively improve the internal control system. c. Auditors: Auditors can audit the performance of the board of directors and the supervisory board and conduct investigations using relevant personnel.[118] This ensures the timely detection of internal control deficiencies. d. Following these monitoring activities, a report on the internal control system's monitoring results should be promptly generated and communicated through a comprehensive information transmission mechanism within the internal control system.[119] Effective adjustments should be made in a timely manner based on this report.

The sixth key component is information technology readiness that refers to the level of information technology required to achieve the appropriate functioning of the first five factors in business operations, based on the company's pre-established policies and procedures.[120] Most effective information management systems today utilize information technology, and there is a significant difference in information processing capabilities among various technologies. For example, the latest product from OpenAI, ChatGPT, possesses an extremely high level of information processing technology due to its advanced artificial intelligence module. Integrating such advanced information processing technology into a company's internal control system can have a substantial positive impact, significantly reducing the costs associated with the relevant system. Although AI processing cannot replace humans as the ultimate source of information generation, it can process and learn from the continuously generated information within the company. This makes the information system more aligned with the needs of the inquirers, enhancing the control environment of the information system.[121]

3. The Duties of Directors

In Japanese law, the duties of directors are closely related to their supervisory obligations. Regardless of whether a board of directors is established within the company, directors responsible for business execution naturally bear the duty of supervising their respective areas. With the increasing emphasis on corporate compliance, Japanese scholars believe that the supervision by directors should not be limited to direct supervision by superiors but should also encompass the supervision of company employees and overall business operations.[122] The board of directors is the core of the company's daily operations, directly influencing changes in the control environment of the internal control system and shaping the company's future direction.[123] Whether they are employees, middle management, or senior executives

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[118] Id.
[119] Id.
[120] Modern models of corporate governance can leverage technology for governance to significantly enhance effectiveness. Advanced technological devices permit more accurate analyses of the data, smoother processes, and better decision-making. Id.
[121] Holden Thorp, ChatGPT Is Fun, but Not an Author, 379 Science 313, 313 (2023).
[122] Liang Shuang (梁爽), Mei, Ri Gongsi Fa Shang de Dongshi Hegui, Neikong Yiwu Ji Qi Dui Woguo de Qishi (美、日公司法上的董事合规、内控义务及其对我国的启示) [Directors' Compliance and Internal Control Obligations in U.S. and Japanese Corporate Law and Their Implications for China], 2 Zhongwai Faxue (中外法学) [Peking University L.J.], 530 (2022).
[123] The board of directors may go on to have a great influence on the long-term business decisions of a company. Their strategic guidance and oversight set the vision, mission, and total direction for a company. Kaisha-hō [Companies Act], Law No. 86 of 2005, art. 348, para. 1 (Japan).

such as directors, all are bound by the control environment. Therefore, directors inherently have corresponding supervisory obligations and other organizational duties over all entities affected by the control environment.

In Japanese law, the legal duties of directors are divided into the duty of care and the duty of loyalty. The duty of care requires directors to act with caution while supervising and organizing company management activities. For instance, the duty to report, as stipulated in Article 357 of the Japanese Companies Act, mandates that if a director discovers a fact that may significantly impact the company, [124] they must promptly report this fact to the shareholders and the board of auditors. The duty of loyalty obliges directors to act in the best interests of the company and its shareholders when supervising and organizing company management activities. [125] This duty requires directors to prioritize the company's and shareholders' interests over their personal interests.[126]

4. Application of the Business Judgment Rule

In Japan, the business judgment rule serves as a decision-making framework. It generally allows directors and executive officers the discretion to make business-related decisions, provided that the content and process of these decisions are not unreasonable. Under this rule, such decisions would not be considered as violations of the duty of care. Typically, the business judgment rule is also applicable to the obligations related to the construction of internal control systems.[127] Directors within the company structure are regarded as management experts. Shareholders entrust the directors with management authority, allowing them to utilize their management skills and fulfill their responsibilities to ultimately maximize the company's interests. Throughout this process, directors are afforded the utmost respect, and retrospective evaluations of their decisions for potential violations of the duty of care are not permitted.

Directors should take bold risks to maximize company profits, but excessive liability for damages in case of failure can lead to bankruptcy, causing directors to avoid necessary risks, thus impacting company benefits. [128] Legal policy should remove factors causing directors to hesitate by pre-limiting compensation amounts to a lower amount or zero, ensuring directors can take necessary risks without fear of personal financial ruin.[129] While profits from successful risk-taking benefit the company, losses should not be solely imposed on directors; the company should share both benefits and

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[124] Hisahisa Uedaya (恒久 上田谷), Limitation of Directors' Liability to the Company [取締役の対会社責任の制限], 39 Tsukuba L.J. [筑波法政] 145, 149 (2005) (Japan).
[125] Id.
[126] Id.
[127] It simply means that even within the operation model of an internal control system, the division of duties among the internal structures can also be based on the business judgment rule. In this principle, the internal control system simply makes sure that the decision-making process is made in good faith, with due care, and in a manner believed to be in the best interest of the corporation. TOSHIO SAKAMAKI (酒巻俊雄) & SETSU TATSUTA (龍田節), ARTICLE-BY-ARTICLE COMMENTARY ON THE COMPANIES ACT, VOLUME 5 (逐条解説 会社法 第 5 巻) 362 (2011).
[128] Hisahisa Uedaya Supra note 63, at 150.
[129] Id.

risks.[130] Legal accountability for directors' negligence should only be pursued when there is clear evidence. Fairly limiting liability encourages directors to perform effectively, preventing the loss of valuable director talent. [131] A balance is needed between safeguarding company interests and motivating directors to take necessary risks.[132]

C. Horizontal Comparison

This chapter focuses on the organizational frameworks and the duties of directors and in the compliance systems of the United States and Japan. Common elements in the overall framework of compliance organizations can be summarized as follows: having an upper organizational intent, compliance organization members, information exchange mechanisms, supervision mechanisms, remedial mechanisms, and the policies corresponding to these mechanisms: First, having an upper organizational intent determines the compliance environment of the company. The form of compliance and its direction must be established through the expression of the upper organizational intent. Establishing a good upper organizational intent is crucial to the effectiveness of company compliance, akin to the "constitution" within a company's compliance system. All major compliance activities of the company will be based on this intent. Second, compliance organization members are the specific implementers of the compliance system. This includes the board of directors, the supervisory board, independent auditors, external directors, and internal employees. The specific roles they undertake in the compliance process need to be clearly defined by the company. Third, the information exchange mechanism is one of the most critical components of the system. In the compliance system, the transmission of information is responsible for conveying risk information promptly to the management and executive levels. Effective and efficient information transmission is the foundation of an effective compliance system. If information transmission is hindered, the compliance system will ultimately fail to resist risks, regardless of how well other parts of the system operate. Fourth, the supervision mechanism is closely related to the information exchange mechanism. While the information exchange mechanism collects and classifies risk information, the supervision mechanism analyzes and reviews all information and personnel, promptly reporting factors that might affect the effective operation of the compliance system to the relevant compliance officers through the information exchange system. This mechanism typically needs to be established as an independent system to prevent undue influence from interested parties. Fifth, the remedial mechanism is a dynamic system that addresses risk issues identified by the supervision system, preventing the escalation of harm. It involves preemptive remedies before risk occurrence, corrective measures during risk occurrence, and solutions after risk occurrence. The effectiveness of the compliance mechanism is judged by whether risks have impacted the company or have

[130] Id.
[131] It would provide greater opportunities for the company's directors to perform effectively if they were given greater autonomy. Greater autonomy will permit directors to exploit their expertise, make rapid strategic decisions, and innovate without obtrusive controls. Id.
[132] Excessive autonomy given to directors can go against the interests of the company; therefore, it is important that regulatory design provides an effective balance. That means the liberty for making strategic decisions has to be available to the directors, but it needs to go with checks and balances that obviate its abuse. Id.

been promptly mitigated by the company.

Regarding the duties of directors, senior management within the company should owe fiduciary duties to the company, including the core duties of loyalty and diligence. These duties require directors to prioritize the company's interests and handle company affairs with a cautious attitude.

Concerning compliance responsibilities, both countries have introduced the business judgment rule as a core standard for determining whether directors and other management personnel have breached their duties. Under this standard, directors have the discretion to make business decisions, ensuring an effective balance between benefits and risks, rather than avoiding all risks in their decision-making.

The understanding of the business judgment rule in the United States and Japan is not entirely the same. In the United States, the principle of the business judgment rule is that the content of business decisions is not subject to post hoc review by the courts. The perspective is that if the presumed actions of directors are made in the best interest of the company, the courts will not scrutinize the management decisions after the fact.[133]

In contrast, Japanese courts, when applying the business judgment rule, analyze and review both the process of forming the business judgment and the content of the judgment. The Supreme Court of Japan, in its 2010 case No. 2091, ruled that in the process of considering acquisitions, directors should take into account the valuation of shares and the appropriateness of the acquisition when making decisions. As long as the process and content of their decision are not grossly unreasonable, it will be interpreted as not violating the duty of care expected of directors. This indicates that the Japanese Supreme Court's interpretation of the business judgment rule involves examining whether directors' business decisions meet the standard of care expected of a prudent manager. In the United States, the application of the business judgment rule is understood as requiring verification of relevant facts before making a business judgment. As long as directors make decisions that are suitable for the company based on these facts,[134] they are not considered to have violated their duty of care, even it cannot be suitable in the perspective of Delaware's court.[135]

IV. ESTABLISHING AN IDEAL COMPLIANCE SYSTEM MODEL

This section proposes a dual-level compliance concept tailored to China's unique legal environment, integrating both private and public interests. At the private level, companies focus on profitability and efficient operations, balancing shareholder value and compliance costs. At the public level, compliance aims to meet societal

[133] Hindsight judgment is impermissible under the business judgment rule in US. The rule protects the directors from unfair criticism by demonstrating that decisions, upon hindsight, appeared at that time to be reasonable and informed, even though the outcome may not turn out favorable. MITSUO KONDO (近藤光男), KEIEI HANDAN GENRI (判例法理 経営判断原則) 12 (2012).

[134] Bernard S. Sharfman, The Importance of the Business Judgment Rule, 14 NYU J.L. & Bus. 27, 49 (2017).

[135] Id.

expectations, ensuring market stability and enhancing social welfare. The proposed model emphasizes robust information transmission, whistleblower protections, and temporary management systems to enhance effectiveness. By clearly defining compliance duties for directors, supervisors, and employees, the model aims to create a comprehensive and adaptable compliance framework that supports sustainable and ethical corporate governance.

A. Duality of Compliance Concepts

An effective local compliance concept for China should encompass two levels: the private level and the public level. At the private level, companies need to consider their primary goal of profitability, which requires balancing the value of private interests. This involves ensuring that the company operates efficiently and profitably while adhering to compliance standards that protect its interests. At the public level, the focus is on the societal expectations of companies.[136] A well-functioning company should not only ensure the realization of its own interests but also contribute to the overall social value.[137] From the perspective of compliance concepts, this might sometimes involve sacrificing certain company interests to ensure the stability of the overall market transactions and enhance societal welfare. This dual approach ensures that companies not only thrive economically but also uphold their responsibilities towards broader societal goals.

1. Consideration of Private Interests

The consideration of private interests encompasses two dimensions. First, it involves the long-term development needs of the company's value. Second, it addresses the needs of the company's shareholders. Particularly under the theory of shareholder primacy, a company should adopt effective compliance plans to prevent behaviors that could harm its value, thereby ensuring capital stability and protecting the stability of shareholder interests, which have been converted into equity.

Furthermore, from a long-term perspective, the establishment of a compliance system can positively enhance the social reputation of the company and its shareholders. This improved reputation can, in turn, positively influence the company's competitiveness in various business opportunities, reduce transaction costs, and increase transaction efficiency. Therefore, when designing specific compliance concepts, it is essential to ensure the rationalization of transaction costs, the rationalization of compliance costs, and the maintenance of transaction opportunities as part of the compliance concept for private interests:

a. Rationalization of Transaction Costs

In the course of daily transactions, companies should avoid engaging in transactions where the estimated transaction costs significantly exceed the estimated

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[136] David S. Ruder, Public Obligations of Private Corporations, 114 U. Pa. L. Rev. 209, 211 (1965).
[137] Id.

transaction benefits.[138] In practice, companies face limitations in judging the opportunities of transactions and cannot always directly determine the exact benefits and costs. Transactions are often evaluated before they are concluded. Transactions with relatively high costs are not necessarily excluded by the compliance concept but are assessed based on the potential estimated benefits. If the estimated benefits exceed the estimated costs, the transaction can proceed. However, this does not guarantee absolute profitability. If directors approve such a decision and the company incurs a loss from the transaction, the company cannot demand compensation from the directors solely based on this loss.[139]

b. Rationalization of Compliance Costs

Ensuring the rationalization of compliance costs is crucial for maintaining the financial health and operational efficiency of a company. Effective compliance programs should be designed to minimize unnecessary expenses while maximizing the benefits of compliance. This involves implementing streamlined processes, leveraging technology, and training employees efficiently to reduce the costs associated with compliance. By doing so, companies can avoid excessive spending on compliance measures that do not proportionately contribute to risk mitigation or operational efficiency. Rationalized compliance costs ensure that the company maintains its competitive edge without sacrificing legal and regulatory adherence. Furthermore, a cost-effective compliance strategy enhances the company's ability to invest in growth opportunities and innovation, ultimately contributing to its long-term success and stability.

c. Maintenance of Transaction Opportunities

Maintaining transaction opportunities is vital for a company's growth and competitive positioning, which can be a risk and needed be safeguarded.[140] So a robust compliance framework should not hinder the ability to engage in beneficial transactions but rather support it by creating a reliable and trustworthy business environment. This involves ensuring that compliance measures are flexible and adaptable to changing market conditions and opportunities. By fostering a culture of compliance that emphasizes the importance of ethical behavior and transparency, companies can build strong relationships with partners and stakeholders, thus preserving and enhancing transaction opportunities. Effective compliance systems help in identifying and managing risks proactively, allowing the company to seize profitable opportunities while mitigating potential downsides.[141] This balanced approach ensures that

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[138] In the course of business decision-making, among the expected factors to be dealt with seriously are risks, costs, and benefits. The decision-maker has to analyze carefully the possible hazards, financial implications, and expected returns. Oliver E. Williamson, Transaction Cost Economics, 1 Handbook of Industrial Organization 41, 42-44 (1989).

[139] L. McMillan, The Business Judgment Rule as an Immunity Doctrine, 4 Wm. & Mary Bus. L. Rev. 521, 569 (2013).

[140] Jeffrey H. Dyer, Effective Interim Collaboration: How Firms Minimize Transaction Costs and Maximize Transaction Value, 18 Strategic Mgmt. J. 535, 537 (1997).

[141] This points to developing an effective compliance system that mitigates risks but maximizes benefits. The law and other regulatory standards help business organizations avoid penalties and reputational damage if complied with, thus safeguarding operations. Id.

compliance supports rather than stifles the company's strategic initiatives and market responsiveness.

2. Public Interest

The purpose of corporate compliance extends beyond considering the interests of a specific company and its shareholders. As an organization, a company is also a part of the nation and should recognize its role as a "citizen." As a citizen, a company must ensure that its operations, especially compliance processes, do not harm other companies or stakeholders while safeguarding its own risk avoidance.

According to classical Western political thought, particularly the individualism-based liberal tradition, a company as a citizen has a passive citizen image. Although its core purpose is to protect its own rights, the criteria for judging whether a company is a good citizen include paying taxes, adhering to laws, and not violating regulations. On the other hand, the republican tradition views citizenship as the qualification to participate in public discourse. The ideal good citizen prioritizes public affairs over private matters and actively contributes to the construction of public affairs to demonstrate its value. Thus, under this tradition, corporate compliance inherently involves greater public interest.[142]

Therefore, in designing specific compliance concepts, ensuring overall market safety and stability, protecting creditor interests, and safeguarding employee interests should be embedded within the compliance system.

B. Typification of Corporate Compliance Rules

Typification of Corporate Compliance Rules is needed in China,[143] thus this section categorizes rules on directors' compliance duties into three main areas: decision-making, supervision, and remediation. Directors must gather and utilize relevant information to make informed decisions that benefit the company while minimizing societal harm. They are responsible for overseeing compliance-related activities within the company, ensuring adherence to regulations, and monitoring other directors and employees. When compliance issues arise, directors must take corrective actions, establish temporary management systems, and design effective remediation standards. Additionally, the section outlines the compliance obligations of supervisors

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[142] It is intrinsically conceived that a compliance system shall serve not only the interest of shareholders in a company but also protect interests of society. While guiding itself with the tenets of the rule of law and ethical guidelines, it makes sure that business activities will have a positive social impact, be environmentally friendly, and respectful toward human rights. Wan Jianlin (万健琳) & Yang Songlei (杨松雷), Gongmin yu Guojia Hexie Guanxi de Goujian—Gonghezhuyi Lilun Yiyun Zai Wajue (公民与国家和谐关系的构建—共和主义理论意蕴再挖掘) [Constructing Harmonious Relationships between Citizens and the State—Further Excavation of Republican Theory], 4 Shandong Shehui Kexue (山东社会科学) [Shandong Soc. Sci.] 122, 126 (2015) (China).

[143] Dong Zhang (张栋) & Ke Li (李轲), Zhuti Lun Shiyu Xia She'an Qiye Hegui Youxiaoxing Shencha de San Zhong Moshi (主体论视域下涉案企业合规有效性审查的三种模式) [Three Models of Reviewing the Effectiveness of Corporate Compliance Involved in Cases from the Perspective of Subject Theory], 3 Jiaoda Faxue (交大法学), 129, 136 (2024) (China).

and other key personnel, such as compliance officers and information system members, emphasizing the importance of information accuracy, timely reporting, and whistleblower protections. This comprehensive approach ensures effective compliance management, balancing internal governance with external legal requirements.

1. Directors' Compliance Duties

Directors' compliance duties can be divided into the duty of loyalty and the duty of diligence within the realm of compliance.[144] In the context of compliance affairs, there are three main categories: decision-making, supervision, and remediation. This method allows for a typology of directors' compliance duties, as detailed below:

a. Decision-Making Duty

The compliance decision-making duty refers to the compliance obligations that directors must fulfill when making compliance decisions. These obligations generally involve two levels: the collection and utilization of decision-making information and the decision-making process itself.

Regarding the former, directors are obliged to be informed of information related to the decision-making content, and for important information, they should undertake a more rigorous duty of examination. For instance, when a company provides external guarantees, directors must ensure that the transaction has been approved by the shareholders' meeting. If such a decision has not been made, the directors can refuse to proceed with the transaction during the information collection stage.

As for the latter, the duty of decision-making does not strictly prohibit directors from making any decisions that might expose the company to risk. Rather, it requires them to make reasonable judgments based on the current operating conditions of both the company and the transaction partner, balancing the benefits and risks associated with the transaction. As long as directors effectively understand the information at this stage and make rational judgments in the best interest of the company based on that information. According to business judgement rule, which is simply a policy of judicial non-review.[145] In this case, they are deemed to have fulfilled their decision-making duties, court won't do the second guess.[146] Moreover, the decisions made by directors in the process of establishing or revising compliance systems are equally subject to the compliance decision-making obligations.

The determination of reasonable judgment requires consideration of two aspects: benefit to the company and minimal harm to society:

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[144] In China, the new Company Law adopts a classic bifurcation strategy in designing the duties of directors. Jianwei Li (李建伟) & Kexin Ma (马可欣), Xinyi Yiwu Tixihua Sheji de Gongsi Fa Fang'an (信义义务体系化设计的公司法方案) [A Corporate Law Proposal for the Systematic Design of Fiduciary Duties], 5 Henan Shehui Kexue (河南社会科学), 36, 40 (2024) (China).

[145] Lyman Johnson supra note 96, at 632.

[146] Id.

Firstly, the benefit to the company means that the director's ultimate goal in making a decision is to help the company gain profits.[147] These profits need further definition and should be analyzed in conjunction with the company's long-term business plans. For example, if a company's long-term operational goal is to gather funds to expand production, and a current transaction can bring profits but requires a substantial one-time investment that affects the company's capital accumulation, the director should decide against the transaction to align with the company's long-term operational plan.

Secondly, minimal harm to society means that the director's decision should not seriously harm societal interests. In reality, it is impossible to ensure that every transaction completely aligns with societal interests, especially in situations where a company's actions might result from a balance of interests, ultimately sacrificing some societal interests for the company's benefit. According to the business judgment rule, this can also be a reason for a director's exemption from liability.

For decision-making, the ultimate aim is to apply these decisions in social practice. When there is a significant conflict between legislative regulations and social practices, directors may indeed have to make decisions that sacrifice the societal interests underlying those regulations in favor of aligning with the current social environment.

b. Compliance Supervision Obligation

The compliance supervision obligation requires directors to oversee compliance-related matters during the company's operations. This means that directors are not only responsible for ensuring their own decisions comply with regulatory requirements but also have a supervisory duty over the decisions of other directors and other compliance-related entities within the company.

To effectively fulfill the compliance supervision obligation, it should be constructed on two levels: establishing an effective information transmission and reporting system, and designing effective compliance supervision standards.

Establishing an effective information transmission and reporting system should be the core duty within this obligation. The effectiveness of compliance supervision directly depends on how information is obtained. In companies lacking a robust compliance system, there typically exists an unstable or non-existent information reporting system. A mature system should be independent and possess high-level access to company information. Independence ensures that information acquisition during supervision is not restricted by interested senior executives. High access permissions help the system obtain comprehensive information. If the system lacks such permissions, information can be bypassed through high-level communication, thereby

[147] This means that, in the case of a conflict of interest, directors are bound to give priority to the concerns of the company. They must step back from personal gains or pressures from elsewhere and make a decision that will benefit the company and the stakeholders. Lyman Johnson, Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose, 38 Del. J. Corp. L. 405, 411 (2013).

restricting the full functionality of the reporting system.

Directors, supervisors, and employees' execution of compliance supervision duties require the company's standardized guidelines. As the core of company affairs management, directors have the obligation to design regulations on how supervision should be conducted. The standards should clarify the supervision obligations for each department, identify the responsible individuals within various departments (such as finance, design, logistics) and clarify the primary entities responsible for supervision within the board of directors and the board of supervisors.

Moreover, protection and incentive mechanisms for whistleblowers need to be established. These mechanisms should protect whistleblowers from retaliation or dismissal risks posed by company management and stakeholders after disclosing information. Additionally, encouraging whistleblowing by offering promotions or financial rewards can foster more effective compliance reporting and support the company's compliance supervision system.

By ensuring that these two levels of the compliance supervision obligation are effectively constructed and implemented, companies can achieve robust oversight and adherence to regulatory requirements, thus safeguarding both the company's interests and societal welfare.

c. Compliance Remediation Obligation

The compliance remediation obligation requires directors to promptly take remedial actions when they discover potential or existing damage to the company through compliance supervision. There are two primary duties that need to be clarified in this domain: the duty to establish a temporary management system and the duty to design effective compliance remediation standards.

Regarding the temporary management system, this involves the formation of a temporary group specifically tasked with addressing the identified issue once potential or actual damage is discovered. Directors should mobilize other directors, supervisors, internal employees, and even external lawyers, as well as gather a portion of temporary funds to resolve the issue. For example, if a transaction failure occurs, it not only directly harms the company's interests but also affects the interests of consumers. If timely remediation is not undertaken, the company's reputation could suffer significantly. Therefore, according to their compliance remediation obligation, directors should establish a temporary management system, promptly allocate funds to compensate consumers, and address potential legal actions, ultimately minimizing the harmful outcomes.

As for the duty to design effective compliance remediation standards, this duty is similar to the aforementioned duty of establishing compliance supervision standards. As core managers, directors should clearly define the subjects responsible for remediation measures and the reward and punishment mechanisms for such measures. The responsible subjects refer to who should undertake specific remediation roles under

particular circumstances. For example, in the event of a public opinion crisis, the head of the publicity department should be responsible for promptly controlling the spread of information to prevent further deterioration and subsequent secondary harm. The reward and punishment mechanism should establish incentives, such as promotions or bonuses, for departments or individuals who promptly complete compliance remediation. Conversely, there should be penalties for those who fail to do so in a timely manner, thereby promoting the effective operation of the compliance remediation mechanism.

2. Supervisors' Compliance Obligations

Based on the previously described compliance obligations of directors, it can be understood that supervisors' compliance obligations are fundamentally the same as their fiduciary compliance obligations, namely the duty of diligence and the duty of loyalty under the context of their fiduciary duty to the company. The content of these obligations can be divided into two parts based on the objects of the supervisory board's oversight:

a. Supervision of the Board of Directors and Its Members

The supervision of the board of directors and its members is the core content of the supervisory board's oversight. Since directors are at the heart of decision-making and execution of company affairs, their responsibilities also encompass compliance matters. Therefore, to oversee whether directors can effectively govern the company, supervisors need to strictly control the effective execution of compliance and other affairs. Their supervision methods include, but are not limited to, substantial review of the content of directors' resolutions and examination of the appointment of directors to help the board of directors fulfill its corresponding obligations.

b. Supervision of Other Compliance Personnel

While decision-making and execution of company affairs are primarily handled by the company's directors, the operation of the company's compliance system also involves members of the information system and other employees, including temporary staff. These compliance personnel participate in the collection, integration, and processing of information related to compliance matters, and may even engage in preliminary decision-making on specific matters. This means that although directors are responsible for the final decisions and their execution, the completeness of information, the methods and results of its processing, and the preliminary decisions all impact the directors' final judgment. Therefore, it is necessary to conduct compliance supervision over these personnel.

3. Obligations of Other Compliance Personnel

During the company's operations, particularly within the compliance system, setting obligations solely for directors and supervisors is insufficient to ensure the effective operation of the system, every compliance professionals and other staffs are

also important in this system.[148] The compliance obligations of other important entities within the compliance system should also be clearly defined. This section analyzes the obligations of some representative personnel, such as independent compliance officers, information system members, and temporary staff:

a. Compliance Officer

A compliance officer is a specialized member responsible for compliance matters during the company's operations, not subject to restrictions from other management personnel. We can also define a compliance officer as the person who specifically implements the company's compliance management affairs, serving as the decision-maker and supervisor of the compliance plan. Known as the Chief Compliance Officer (CCO), many companies not only have a chief compliance officer but also have junior, mid-level, and senior compliance officers. Regardless of the level, the obligation of a compliance officer is to ensure the proper operation of the company's compliance affairs and to be responsible for the development of the company's compliance matters.

b. Comprehensive Obligations of Information System Members

Based on the aforementioned comparative experiences, establishing an effective compliance system necessitates the comprehensive construction of the information system.[149] Therefore, the obligations of the members within this system need to be clearly defined and improved. Generally speaking, the obligations of these information system members should be closely related to the collection, transmission, storage, and analysis of information.[150]

Firstly, regarding information collection, information system members are obliged to ensure the completeness and accuracy of the information. This means that when collecting information, they should conduct a formal review and handle any obviously incomplete or inaccurate information before deciding whether to collect it.

Secondly, concerning information transmission, information system members are obliged to ensure the timeliness and accuracy of information transmission.[151] Information should be delivered to the necessary directors, supervisors, compliance officers, auditors, etc., within the specified time frame, and special information should be accurately conveyed to non-stakeholder entities.

Thirdly, regarding information storage, information system members are obliged to ensure the timeliness of information storage. This means that any needed information should be retrievable from the storage system at any time, and outdated

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[148] While no doubt directors are important in the compliance system, so are compliance officers, employees, and other members. All of these participants aid in keeping the integrity and effectiveness of the system intact. See Cristie Ford & David Hess, Can Corporate Monitorships Improve Corporate Compliance, 34 J. Corp. L. 679, 693 (2008).
[149] Financial Services Agency supra note 101.
[150] Id.
[151] Id.

information should be regularly cleaned out.

Fourthly, within the aforementioned monitoring system, information must go through an initial screening before being passed on to subsequent compliance personnel. Information system members are obliged to ensure that no obviously unreasonable information is transmitted during the first screening, and the analysis standards should be stable and appropriate.[152]

c. Temporary Employees

Temporary employees in companies often find themselves in situations where their rights and obligations are unclear. For the company, especially in compliance matters, it is important to promptly determine whether temporary employees have compliance obligations. Specifically, in the area of whistleblower mechanisms, temporary employees should be required to report to the company immediately if they discover any significant risk of damage to the company. This obligation represents the minimum requirement for temporary employees. The company can further specify the compliance obligations of temporary employees in various situations through its bylaws and other means.

C. Composition of the Compliance System

Based on the aforementioned comparative law experiences, this article posits that an effective compliance system should consist of two main parts.

First, the compliance system's connective elements, which do not directly make the final compliance decisions or execute actions, but serve as connectors to assist in compliance-related judgments. These elements include the information transmission system, the whistleblower system, and the monitoring system.

Second, the compliance system's functional elements, which directly address risks or dangers in compliance matters. These elements encompass the board of directors and its members, independent directors, the supervisory board and its members, the compliance officer system, the business screening system, and the temporary management system. The following sections will analyze each of these components in detail.

1. Connective Elements of the Compliance System

[152] The information transmission system within the compliance framework assumes the role of a first filter for identifying and highlighting transactions that are explicitly and unreasonably posing risks. It is a system for the red flagging of questionable activities, and if need be, freezing transactions that raise serious compliance concerns. This way, it allows risky or unethical transactions to be put under scrutiny and probably prevented from going through, thus shielding the company from possible legal and financial repercussions. Id.

a. Information Transmission System

The role of this system is to ensure the effective flow of compliance information during the company's daily operations, allowing relevant compliance personnel within the company to receive timely information and make informed judgments based on it.[153] It is particularly important to regularly inspect this information transmission system to ensure the proper preservation of information, that the information processing and analysis methods align with the company's current business paths, and to keep the system technologically updated to maintain efficient operations.

b. Whistleblower System

The whistleblower system serves as a special source of information within the company's compliance system.[154] It allows anyone within the company to report potential risks or existing harms. Theoretically, this system operates independently of other management departments and reports directly to the highest-level board of directors. Whistleblowers should be protected by the system, including job security and information security after making a report. Additionally, if their report is verified and helps the company mitigate losses, they should be rewarded.

c. Monitoring System

The monitoring system is designed to oversee whether the company's daily operations are conducted within the required compliance standards.[155] The system's main functions are twofold. First, the regular monitoring system continuously analyzes and evaluates the effectiveness of the compliance system's operations, particularly in departments where financial or other risks are common, ensuring high-frequency information monitoring to safeguard the company's operations. Second, the special monitoring system addresses suspicious information obtained from the whistleblower system or the information transmission system. It involves special monitoring of the departments in question and may incorporate external assistants, such as external accountants or lawyers, to enhance the monitoring effectiveness.

d. Business Screening System

The business screening system filters the numerous transaction opportunities

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[153] As such, the timeliness of information transmission will indirectly determine the efficiency of the business decisions. Quick and accurate dissemination of information puts decision-makers in a good position to make timely responses to emerging opportunities and risks, ensuring strategic decisions are made based on the most up-to-date data. Id.

[154] A whistleblower system can compensate for some of the potential risks in corporate governance. Having put in place a reporting mechanism for unethical and illegal activities, it increases the possibilities of identification with a view to correction of the hidden problems before they explode into big ones. B. C. Meitasir, A. Komalasari & R. Septiyanti, Whistleblowing System and Fraud Prevention: A Literature Review, 22 Asian J. Econ. Bus. & Acct. 23, 26 (2022).

[155] Renzo Conforti, Marcello La Rosa, Giancarlo Fortino, Arthur H. M. ter Hofstede, Jan Recker & Michael Adams, Real-Time Risk Monitoring in Business Processes: A Sensor-Based Approach, 86 J. Sys. & Software 2939, 2941 (2013).

the company encounters during its daily operations. This system evaluates whether a transaction should be considered further based on the current commercial transaction standards set by the company. The decision does not solely depend on whether the transaction can bring profit to the company. The two main criteria are: first, the potential benefits of the transaction must outweigh the potential risks; second, the transaction must conform to the company's current commercial transaction standards and operational practices. When both criteria are met, the transaction can be forwarded to other departments for substantive discussion.

If there are issues with the transaction, it is not immediately rejected; instead, the problems are flagged and presented to management for a decision on whether to proceed. This flagging will also impact the board of directors' future commercial judgment rules. If a flagged transaction results in significant harm to the company, the board's defense under the business judgment rule will be weakened due to the prior warning, and they will bear a greater burden of proof to demonstrate the reasonableness of the transaction.

2. Functional Elements of the Compliance System

a. The Board of Directors and Its Members, and Independent Directors

The board of directors and its members are at the core of decision-making and execution in both compliance matters and the company's other daily operations. This means that the board naturally leads the compliance system, overseeing decision-making at all levels and determining the implementation of specific regulations and measures within the compliance system.

Independent directors, due to their external and often part-time status, generally do not have a significant impact on improving company performance in the context of corporate governance in China, according to empirical research. Particularly, they often do not publicly challenge the decisions made by the board.[156] Therefore, independent directors mainly serve as a check on the board's actions in terms of compliance. When the board engages in clearly non-compliant behavior, independent directors are obligated to fulfill their compliance duties by pointing out and stopping such actions promptly.

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[156] In China, the independent director system itself has been ineffective in performing its job. Theoretically, it is there, although most of the time, the independent director has not much influence and far from sufficient authority to effect any changes or able to exercise oversight of any kind. That seriously delimits their contribution to the enhancement of corporate governance, which in turn lowers the potential of the system in safeguarding shareholder interests and promoting transparency. Gao Minghua (高明华) & Ma Shouli (马守莉), Duli Dongshi Zhidu yu Gongsi Jixiao Guanxi de Shizheng Fenxi—Jian Lun Zhongguo Duli Dongshi Youxiao Xingquan de Zhidu Huanjing (独立董事制度与公司绩效关系的实证分析——兼论中国独立董事有效行权的制度环境) [Empirical Analysis of the Relationship Between the Independent Director System and Corporate Performance—Also Discussing the Institutional Environment for Effective Exercise of Independent Directors' Rights in China], 2 Nankai Jingji Yanjiu (南开经济研究) [Nankai Economic Studies], 2002, 64-68 (China).

In the future, when constructing a more rational corporate governance system, independent directors should take on a more important role in supervision and governance than they do in the current environment.

b. Supervisory Board and Its Members

The supervisory board and its members play a supervisory role within the compliance system, effectively overseeing the directors, compliance officers, and other compliance personnel, and ensuring the effective operation of other departments within the compliance system. The duties of the supervisory board within the compliance system are not explicitly defined. In China, the supervisory board functions as a specialized supervisory department overseeing the company's management activities. However, the supervisory board should not only have a post-facto correction function for narrow issues but also possess the authority to conduct preemptive reviews and supervise the decisions of the board of directors.

Limiting the supervisory powers of the supervisory board within the compliance system would significantly reduce the system's operational efficiency and could potentially render the compliance system ineffective by being circumvented by the board of directors. [157]Therefore, to ensure the smooth localization of the compliance system, it is necessary to enhance the supervisory powers of the supervisory board and expand its scope of oversight. This approach will maximize the effective operation of the compliance system.

c. Compliance Officer System

The compliance officer system is a newly introduced element within the compliance system. The effective establishment of this system does not merely involve appointing a Chief Compliance Officer (CCO) but also requires the formal creation of a compliance organization led by the CCO. This organization should ensure effective connections between its policies and measures, with compliance officers corresponding to each department level to carry out compliance activities.

In most company operations, compliance officers do not serve as the final decision-makers. Instead, they act as evaluators of compliance for decisions made by various departmental decision-makers and the board of directors. However, if a business decision clearly violates the compliance requirements of the company's bylaws, or even reaches the level of illegality or criminality, the compliance officer has the obligation to prevent the decision from being made. Therefore, relevant legislation should empower compliance officers with the authority to effectively intervene in company decisions under special circumstances, rather than merely offering

[157] Yang Dake (杨大可), Shenji Weiyuanhui Neng Tida Jian Shi Hui Ma?—Jian Lun Gongsi Neibu Jian Du Jigou de Yingran Zhize (审计委员会能替代监事会吗?——兼论公司内部监督机构的应然职责) [Can the Audit Committee Replace the Board of Supervisors?—Discussion on the Proper Duties of Internal Supervisory Bodies], 5 Zhongguo Zhengfa Daxue Xuebao (中国政法大学学报) [J. China Univ. Pol. Sci. & L.] 146, 157 (2022) (China).

recommendations.

d. Temporary Management System

The temporary management system is established by the board of directors and the compliance officer system when the monitoring system or other elements identify existing or potential dangers in company transactions. This system is designed to promptly address and resolve specific compliance issues facing the company.

The temporary management system includes its own decision-making and execution layers and is composed to tackle particular compliance problems. It should include professionals who can help resolve these issues, such as external accountants and lawyers, as well as internal employees who have previously participated in similar transactions, mid-level managers, directors, and relevant compliance officers.

The composition of this system is not fixed like that of the board of directors. It adapts to the specific issues at hand, changing its makeup accordingly. This flexibility makes the temporary management system a crucial tool in the remediation stage of the company's compliance system. By varying the compliance personnel based on different compliance matters, the company can reduce the costs associated with selecting personnel and mobilizing capital, thereby enhancing operational efficiency. Furthermore, by standardizing the composition of compliance personnel for recurring compliance issues, the company can further streamline its compliance operations.

CONCLUSION

The enactment of China's new Company Law signifies a transformative moment in the nation's corporate governance landscape, aiming to address long-standing challenges and enhance the effectiveness of compliance systems.[158] Historically, the principle of shareholder primacy has dominated Chinese corporate governance, leading to an uneven distribution of responsibilities and significant compliance challenges. The new Company Law introduces comprehensive reforms to establish clear guidelines and responsibilities for corporate directors, supervisors, and other key personnel, promoting a more balanced and effective compliance framework.[159]

The comparative analysis of compliance systems in the United States and Japan provides valuable insights into potential improvements for China's compliance

[158] The new Company Law will enshrine in legislation the elevation of overall corporate governance standards in China to near international norms. This effort is legislative to guarantee transparency, accountability, and efficiency within companies. This bill is therefore expected to enhance a better business and investment environment following global best practices, hence increasing the level of investor confidence required in order to boost sustainable economic growth. Qingsong Wang (汪青松), Zhongguo Tese Xiandai Qiye Zhidu de Gongsi Fa Jinlu (中国特色社会主义现代企业制度的公司法进路) [The Company Law Approach to the Modern Enterprise System with Chinese Characteristics], 3 Shanghai Zhengfa Xueyuan Xuebao (Fazhi Luncong) (上海政法学院学报(法治论丛)) 14, 25 (2024) (China).

[159] Id.

framework. The U.S. model, with its emphasis on fiduciary duties and the business judgment rule, encourages bold and innovative decision-making while ensuring accountability and transparency. Japan's holistic approach integrates compliance within broader internal control systems, emphasizing the duty of care and loyalty of directors and including stakeholder interests.

Drawing from these international best practices, this article proposes a dual-level compliance concept tailored to China's unique legal and corporate environment. By incorporating both private and public interests, the proposed model ensures that compliance duties are clearly defined and enforced, enhancing the resilience and effectiveness of the compliance system. Key elements such as robust information transmission systems, whistleblower protections, and temporary management systems are crucial for managing risks and promoting ethical business practices.

The construction of an ideal compliance system under China's new Company Law requires a comprehensive and flexible framework that balances corporate profitability with societal welfare. By learning from international experiences and adapting them to the local context, China can establish a compliance system that not only meets legal standards but also fosters sustainable and ethical corporate governance. This article aims to contribute to the ongoing discourse on corporate compliance in China, providing a roadmap for future reforms and advancements in corporate governance.