The Way Forward for the System of Independent Directors of Chinese Companies from the Perspective of Comparative Law

Yanyi Luo*

School of Economic Law, East China University of Political Science and Law, Shanghai, China

*Corresponding author: 17072701125@ecupl.edu.cn

Abstract: The independent director system is an effective corporate governance system under the unit corporate governance model. This system originated in the United States. Due to the high separation of corporate ownership and control, the problem of "insider control" will harm the interests of shareholders. And this system just enables independent directors to play a role of supervision and checks and balances on the company's board of directors. After China introduced the independent director system at the beginning of the 21st century, due to the different economic and political backgrounds, capital market development, and corporate governance model of the United States, some problems will inevitably arise in the operation of this system in China. The "astronomical price" compensation borne by the company's independent directors in the financial fraud case of Kangmei Pharmaceutical Co., Ltd., and the introduction of a certain degree of independent director resignation after the case, analyze the current status of the independent director system in China. Comparing the system differences between China and the United States points out the problems and reasons for China's independent director system, and puts forward relevant suggestions for improving China's system based on the actual situation.

Keywords: China, United States, Independent Director, Corporate Governance.

1. Introduction

In 2019, Kangmei Pharmaceutical's nearly 30 billion financial fraud cases shocked the entire Chinese capital market. For a long time before, this company had been deeply loved by shareholders in the A-share market and was a representative of China's national medical and health industry. However, in October 2018, some media published articles questioning Kangmei's financial fraud, and then Kangmei Pharmaceutical was investigated by the China Securities Regulatory Commission(CSRC) on suspicion of information disclosure violations. According to the survey results of the CSRC, Kangmei Pharmaceutical's annual reports inflated monetary funds by 22.58 billion yuan, 29.94 billion, yuan and 36.19 billion yuan respectively from 2016 to 2018.

On November 12, 2021, the Guangzhou Intermediate People's Court give a judgment that Kangmei Pharmaceutical should compensate 52,037 investors about 2.459 billion yuan. This sentence has caused heated discussions, especially about the five former and current independent directors of Kangmei Pharmaceutical, who were sentenced to bear joint and several liabilities for the compensation amount of about 369 million yuan. Four of these independent directors who are held liable are university professors, and the joint and several liability compensations totaling more than 300 million yuan can be said to be sky-high compared to their remuneration as independent directors. The independent directors argued in the lawsuit that they did not know and did not profit from it, but the court held that although they did not participate in the day-to-day operation and management of the company, as independent directors, they could not prove that they had performed their duties of diligence.

This case reflects that there are still certain problems in the independent director system under corporate governance. The judgment may impact the willingness and enthusiasm of professionals to serve as independent directors or make them more cautious. However, the most important thing is that this will trigger the thinking and perfection of the independent director system.

Compared with the extreme punishment in the Kangmei Pharmaceutical case, what China's capital market needs more is the reform of the existing independent directors and corporate governance system.

2. Research on the independent director system under the Chinese traditional corporate governance model

2.1 Characteristics of China's Corporate Governance Model

The development of Chinese corporate law took place after the 14th National Congress, and between 1956 and 1979, enterprises were mainly state-owned, which were unified and managed by the state. The Company Law of the People's Republic of China (hereinafter referred to as "the Company Law"), introduced in 1993, focused on the reform of state-owned enterprises, with the goal of establishing a modern enterprise system. Being in a general environment dominated by state control, this version of the Company Law attaches great importance to the protection of shareholders' interests, focuses on the maintenance of state property rights, and grants absolute control to shareholders, while the status of the board of directors is not clearly defined. The Company Law (2005 Revision) clearly stipulates the rights and obligations of the board of directors and provides that "listed companies shall establish independent directors". Although the legislative content and legislative technology have made great progress, it still maintains the legislative concept of being shareholder-based, the Company Law (2018 Amendment) still continues the previous provisions, and the position of the board of directors in the company has not been clarified in all the amendments. Obviously, the shareholders' position in the company is pivotal, and the decision-making power of the company's major affairs is in the hands of the shareholders, and the powers exercised by the board of directors are basically the content of the resolution of the shareholders' meeting. Therefore, the current corporate governance model in China can be basically summarized as a "shareholders' meeting-centric" model [1].

Under this model, Chinese corporate governance adopts a two-tier structure similar to, but different from, that of Germany. First of all, the general meeting of shareholders is relatively complete, however, the high concentration of ownership results in an unreasonable shareholding structure and most of the shares cannot be listed for circulation. Secondly, the board of directors and the supervisory board are elected by the shareholders' meeting, and their status is equal and both are accountable to the board of shareholders. Unlike the German system, the Chinese supervisory board is not given any substantive powers by law. In addition, the Supervisory Board is difficult to act without shareholder ownership, as the members of the Supervisory Board are drawn from the company's shareholders and employee representatives, i.e. reviewing the company's financial position and the conduct of directors and managers. At the same time, the silence in Chinese law, which does not oblige the board of directors to give information to the supervisory board, further increases the difficulty of ensuring effective supervision [2].

This pyramid-shaped governance structure makes the problem of "insider control" more serious. As the market economy develops, the company's management tends to be professional, and the major decisions of the company are almost all decided by the general meeting of shareholders. Actually, most shareholders do not have the capability and experience to manage professionally. This will make the company's operating inefficient and it is difficult for the company to adapt to the needs of rapid changes in the market. Moreover, The interests of each shareholder may not be the same, and there is inevitably a conflict of interest among shareholders, and in this case the majority of the capital of the shareholders to vote will easily infringe on the interests of minority shareholders, thus affecting the overall interests of the company.

Since the supervisory board cannot effectively supervise the management and cannot equally defend the interests of shareholders, the introduction of an independent directorship became a solution to the corporate governance problem. In addition, studies have shown that a higher proportion of

independent directors on a board enables companies to scrutinize management proposals, enhance comprehensive financial disclosure, and improve corporate governance [3-4].

2.2 Introduction of the independent director system

There are two main reasons for the introduction of the sole director system in China: First, a larger part of China's listed companies came from the reform of former state-owned enterprises, and the phenomenon of "one share is too big" and "insider control" is serious. Secondly, the role of the supervisory board is minimal and there are problems with the corporate governance structure.

The promulgation of the Guiding Opinions on Establishing the Independent Director System in Listed Companies (hereinafter referred to as the "Guiding Opinions"), in 2001 was the beginning of the formal implementation of the independent director system for China's listed companies, which provided more specific regulations on issues related to the system of independent directors in China (such as independence, selection mechanism, special rights, etc.). In response to the high concentration of shareholdings in China and the high risk of damage to the benefits of small and medium-sized stockholders, in 2004, the CSRC promulgated "Certain Provisions on Strengthening the Protection of the Rights and Interests of Shareholders of Public Shares", which emphasized that independent directors should pay special attention to the issue of the public shareholder from being compromised. The importance of independent directors to corporate governance was clarified in 2005 by amending the Company Law to raise the status of independent directors to the legislative level. In 2022, the CSRC consolidated and improved the relevant provisions in the Rules for Independent Directors of Listed Companies (hereinafter referred to as the Rules).

2.3 The operation of the independent director system in China

Given that in China the independent directorship was introduced to play a supervisory role that the supervisory board cannot play, with a focus on protecting minority shareholders from controlling shareholders, Clark points out that the establishment of independent directors in China is based on the achievement of four purposes [5]. First, to protect the interests of small shareholders, reduce the negative impact of the State's dominant position in the economic entity, and increase the confidence of small investors. The second is to monitor related party transactions, where the dominant shareholder of the transaction in question will attempt to maximize his or her own interests, often at the cost of minority shareholders. Independent directors, if they are truly independent, should have the ability to block such connected transactions. Third, they provide expert knowledge and advice to the company, which is the most important factor in the popularity of independent directors in listed companies. The fourth is to serve the public interest, which can be summarized as "agents of the state regulator", who should be independent of all those who have an interest in the company.

However, as it can be seen through the cases presented at the beginning of this paper, the current operation of the sole director system in China is faced with several pairs of typical contradictions: lower comprehensive income and higher responsibilities, lower voice and higher social expectations and lower participation and higher professional qualification requirements. The existence of these contradictions makes independent directors often in a state of "silence" when facing listed companies, and it is difficult to effectively perform their duties when the company violates laws and regulations, and sometimes even becomes the person responsible for the violation. These problems are mainly caused by the following reasons:

2.3.1 The independence of independent directors is difficult to guarantee

The original meaning of independence is to stand alone on one's own stand. The independence that independent directors must achieve is not to be attached to or affiliated with the company's major shareholders and executives and to be strictly different from other employees in the company. However, the "Rules" state that candidates for independent directors may be recommended by the board of directors or the board of supervisors of a listed company, or shareholders that individually or jointly hold 1% or more of the issued shares of a listed company may nominate and shall be subject

to election by the general meeting of shareholders. Apparently, this is a one-way selection mechanism. In practice, major shareholders can use their rights to manipulate the appointment of independent directors and find their friends and acquaintances to take up the position. This relationship will inevitably make the independent directors reluctant to "trouble" the company in exercising their rights because they "value the opportunity to work". This potential social relationship will definitely affect the independence of independent directors.

2.3.2 The diligent performance of independent directors is difficult to ensure

The Rules require independent directors to have the duty of honesty and diligence to the company and all shareholders. In their work, independent directors are expected exercise their rights conscientiously and responsibly to protect the interests of the company as a whole. This asks independent directors to devote the necessary time and energy to their work. However, the existing system lacks the necessary measures to ensure the fulfillment of this obligation. At present, most of the independent directors in Chinese listed companies have higher education and hold important positions in their respective fields of work. Some are senior professors in higher education institutions, and some are industry elites in the capital market. They are usually very busy in their respective fields, which affects their duty of diligence as independent directors. Therefore, we cannot only measure the diligent performance by the number of independent directors participating in company meetings and whether they express independent opinions in accordance with regulations. More attention should be paid to the actual quality of work of independent directors.

In addition, the remuneration of independent directors is formulated by the company's board of directors and submitted to the general meeting of shareholders for review and approval. and the annual salary of independent directors of most listed companies is generally determined only by the company's operating conditions in that year and the term of office. Such a standard can undermine independent directors' motivation to work, but if the company pays them enough, their reliance on compensation may also affect their independence in exercising their rights. Under the combined effect of these problems, it becomes difficult to guarantee the diligent performance of independent directors.

2.3.3 Unclear division of rights between independent directors and the supervisory board

There are two main reasons for the emergence of this problem. First, the introduction of the independent director system in the one-dimensional system into the dual-system company system enables the company to have two roles with supervisory functions. Second, there is no clear separation of rights between the two roles in the Chinese legal system. Under the Rules, independent directors shall participate the board meetings on schedule, obtain the information on the production and business operations of a listed company, and submit annual work reports, in which they shall provide a description of their performance of duties, etc. Besides, independent directors also have additional special powers, such as prior approval of independent directors for any major related-party transaction, proposing the holding of meetings of the board of directors, and independently engaging external audit and consulting agencies to provide audit and consulting services in respect of the specific matters of the company, etc. Compared with the functions of the Supervisory Committee stipulated in Company Law, the functions of the two roles overlap in some parts. However, the Company Law is a law formulated by the Standing Committee of the National People's Congress, and the level of effectiveness of the Rules is only a departmental normative document. It can be seen that this system design will inevitably lead to conflicts between supervisors and independent directors in using their rights.

3. Comparison of independent director systems between China and the United States

3.1 The Origin and Development of Independent Directorship in the United States

The rise of independent directors can be traced back to the early 20th century in the U.S., where the capital markets were highly developed and companies were characterized by a decentralized ownership structure, and ownership structure was decentralized. Companies were seen as vehicles for creating shareholder value and increasing shareholder interest, and dispersed investors had little ability to control and discipline the performance of managers. It was not until the early 1970s that there was change. At that time, there was a series of corporate failures that diverted investors' attention away from a more or less exclusive concern with the accumulation of wealth to other aspects of the system, especially the need for monitoring of the management [6].

In the 1980s, the hostile takeover represented by the leveraged buyout (LBO) reached its peak and revealed various shortcomings such as high social costs, and U.S. companies began to improve the "monolithic board of directors" model by introducing outside independent directors to strengthen the board's supervisory power. The corporate governance system of the 1990s relied more on independent boards of directors, a governance model that directly influenced management compensation and tenure primarily through the establishment of stock market-based contracts with management. However, it was clear that the moral hazard of this model was extremely high, and financial reporting fraud eventually became a prominent issue. In the late 20th century, with the popularity of neoliberalism and the Washington Consensus, shareholder supremacy became the core feature of American capitalism. The U.S. legislature and self-regulatory organizations accelerated the promotion of independent directorship, and a global movement for independent directorship ensued. As it entered the 21st century, the Enron and WorldCom scandals vividly illustrated the weaknesses of the corporate governance system. The subsequent Sarbanes-Oxley and Dodd-Frank Acts both strengthened the functions of specialized board committees, such as independent directors and audit committees, to ensure effective oversight of management.

Since the U.S. Securities and Exchange Commission (SEC) approved the new rules of the New York Stock Exchange (NYSE) in 1977, which required that the audit committee members of listed companies should be composed entirely of independent directors [7], independent directors have gradually become the mandatory element of Anglo-American corporate law. It has developed into an extremely well-developed system that has had a profound impact on the corporate governance structure of the United States.

3.2 The similarities and differences between the Chinese and American independent directorships

Based on the origins of the Chinese independent director system described above, it is clear that this system is a transplanted system. Therefore, only by comparing it with the United States, the birthplace of the system, can we better identify the problems in the operation of the system in China, so as to make corresponding improvements and perfections, and give full play to the functions of this system.

3.2.1 Comparison of the background of the independent director system from a macro perspective

First of all, in terms of the corporate governance model, the U.S. adopts a monolithic structure without a supervisory board, so it is impossible to achieve the effect of supervision entirely within the board of directors. In order to increase shareholders' confidence in long-term investment and the credibility of the board of directors' monitoring, it has become a need to set up independent directors. And through controlling the percentage of independent directors to achieve the same redistribution of control and supervision of the internal management of the board of directors. In contrast to the corporate governance structure in China, independent directors in U.S. companies actually play the

role of the supervisory board in Chinese companies, supervising the operating management of the company. When executive and independent directors have their own roles, they can play a supervisory role even without a dedicated supervisory board. The scale of independent directors on the Chinese board of directors is low in comparison, so the role of supervision and checks and balances is also weak, while the overlap between independent directors and the supervisory board may also have an impact on the internal oversight of the company.

Secondly, in terms of the company's internal environment, the ownership structure of the two is very different. Since the independent director system in the United States is based on the equity revolution, the shares of listed companies are extremely scattered, and there is no "one share". the phenomenon, so the will of the company is often the consensus of many shareholders. Moreover, all equity shares are liquid, easily realizable, and in a state of mutual decline, so there are few stable holders who remain unchanged over time. Investors in both the primary and secondary markets adjust their shareholding structure with a profit-oriented approach, thus creating a market-based social evaluation mechanism. In China, however, the capital market is less developed, the shareholding structure of listed companies is overly concentrated, the separation between ownership and control of the company is smaller, and the penetration of the board of directors by major shareholders is stronger. Since a significant portion of China's listed companies is restructured by SOEs, a large part of the controlling shareholders of listed companies is state-owned shareholders, which means that the government and the business sector are highly integrated. In other words, the independent director system is actually an "expedient measure" adopted by the Chinese government to solve the problem of "insider control" of listed companies [8]. Therefore, under such circumstances, it is extremely difficult for independent directors to face such a strong administrative force.

Finally, comparing the external environment in which the independent director system operates, in terms of incentives in the external market, as the capital market in the U.S. is more maturely developed and the independent director system is more well established, those who serve as independent directors are generally industry elites with better material standards. Therefore, they may value the good reputation and networking that their careers bring them more than material compensation incentives. In the case of China, the system is not perfect and no good career market has been formed, so it is difficult for independent directors to bring good evaluation and opportunities for themselves through their diligence and dedication, which often leads them to "seek no-fault" rather than "seek merit" [9]. Obviously, this reputation mechanism is actually a kind of feedback from the capital market for the operation of the independent director system, which is difficult to be accomplished through active construction. There is also a big difference in market recognition and market demand between the two countries. In the mature capital market of the U.S., in the process of investors choosing a target company, the independent directors' independent opinions on major company matters and information disclosure obviously become important considerations.

3.2.2 Comparison of microsystem design

Compared with the NASDAQ Listing Rules of the U.S. and the Rules of CSRC, China and the U.S still have certain differences in the specific system design.

First, with regard to the independence of independent directors, local regulations mainly reflect restrictions on personnel, that is, who cannot serve as independent directors. Regarding the restriction on employment relationship with the company, the main difference is in terms of the time limit. China stipulates that a person serving as an independent director and his or her relatives and major social relations cannot serve in the listed company within one year, while the NASDAQ Listing Rules require: To serve as an independent director, they must not have been employed by the company for the past three years and their family member must not have been an officer of the company during that time. And the restriction on financial transactions with the company means that individuals, their relatives, and their institutions cannot have a certain amount of financial transactions with the listed company, otherwise it will be considered a loss of qualification independence. There is no relevant provision in our country's regulations. However, it is prevalent in the regulations of independent directors of listed companies in the United States. In terms of shareholding, the NASDAQ Listing Rules pointed out that

the NASDAQ market does not believe that the ownership of company stock will hinder the independence of the board of directors. On the contrary, China has made more detailed regulations on shareholding to limit independence. This is actually weakening the relationship between independent directors and the company's major shareholders in order to safeguard the interests of small shareholders.

Second, on the important issue of the election system, the U.S. stipulates that the nomination of independent directors must also be completed by the nomination committee, or the final determination of personnel should be completed by the general meeting of shareholders after voting by a majority of independent directors. In China, although independent directors can be nominated by the board of directors or eligible shareholders, the final decision rests with the controlling shareholders due to the high concentration of shareholdings. And the electoral mechanism still affects independence.

Third, with regard to the exercise of rights, the specialized committees of the American board of directors have a relatively high degree of development. Some important committees are all composed of independent directors and have corresponding specific requirements. However, China only requires the majority, not all, of the seats of independent directors in special committees. At the same time, there is no complete committee charter to refine the regulations in all aspects, which makes China's independent directors more like the company employees serving on the board of directors rather than the actual directors.

4. Suggestions for improving the system of independent directors in China

Through the comparative analysis above, the independent director system transplanted in the U.S. does not work well in China based on the diversity differences between China and the U.S. Therefore, in the design of the system, it is necessary to combine the actual situation of China’s capital market. And the most fundamental reason is that the development of my country's capital market is still relatively backward, and the supporting measures are not perfect, which makes the living environment of independent directors harsh. In this environment, it is essential to further deepen the reform of the capital market. In addition, the following measures are also conducive to improving my country’s independent director system.

4.1 Establishment of a unified association of independent directors

Establish a nationwide independent director association through the CSRC, which manages all independent directors. And all independent directors need to undergo strict selection to obtain professional qualifications. The independent directors of each listed company are uniformly appointed by the association to ensure the independence of independent directors. An external institution independent of the company can effectively improve the problem of insider control, make independent directors really play a role, and facilitate the supervision of the CSRC.

4.2 Optimization of the mechanism for the selection and appointment of independent directors

Based on the above-mentioned independent director associations, a two-way selection mechanism will be established. For example, a company that needs to recruit independent directors sends an application to the association. The association conducts a preliminary screening based on the application and then nominates the company. Finally, the listed company determines the independent directors that can be appointed from the list and reports to the association for the record. Such a two-way selection mechanism may effectively reduce the influence of the shareholders' meeting on the selection and appointment of independent directors, and is also a means to ensure independence.

4.3 Establishing an appropriate compensation evaluation system

The basic responsibilities of independent directors in China are to protect the minority shareholders, supervise the company’s operation and management, express independent opinions and improve the company's decision-making quality. However, there are still big problems between the responsibilities

of independent directors and their remuneration [10]. For this problem, an appropriate salary evaluation system can be established, and an appropriate method can be used to evaluate the diligence of independent directors. For example, by setting up different indicators, conducting a certain quantitative analysis on the on-the-job work of independent directors, rating them according to a 100-point system, and refining the salary levels at all levels. Of course, an absolutely fixed remuneration model will also cause independent directors to fail to perform their duties. In this regard, a corresponding fund can be established, and the fund is managed by the specially established association and used to distribute the remuneration of independent directors.

5. Conclusions

In a word, the implementation of the independent director system is still in an immature development stage in China, there are still many problems to be solved, and the reasons for these problems are complicated. Through the comparison between China and the United States, it is found that the difference in the system is not only the system regulation itself but also closely related to the environment in which the system is located. The degree of matching between the independent director system and the environment in which it is located determines the strength of its role.. It is undeniable that the independent director system is still the common choice of most countries. Therefore, from the current point of view, China should optimize and improve the relevant regulations on independent directors according to its own actual situation, so that independent directors can truly play their supervisory role.

References

[1] Yu Zhichao. The Choice of Corporate Governance Model in China under the View of the Revised Company Law [D]. Lanzhou: Lanzhou University, 2021.

[2] Chao X. In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China [J]. Connecticut Journal of International Law, 2007, 22(1): 3-8.

[3] John A. Pearce II, Shaker A. Zahra. Board Composition from a Strategic Contingency Perspective [J]. Journal of Management Studies,1992,29(4): 411-438.

[4] Chun I. Lee, Stuart Rosenstein, Nanda Rangan, Wallace N. Davidson. Board Composition and Shareholder Wealth: The Case of Management Buyouts [J]. Financial Management, 1992, 21(1):58-72.

[5] Clarke, Donald C.. The Independent Director in Chinese Corporate Governance [J]. Social Science Electronic Publishing, 2006, 31(1): 154-162.

[6] Chao X. Corporate governance and legal reform in China [M]. Wildy, Simmonds & Hill Pub. 2009.

[7] Brown, JR. The Regulation of Corporate Disclosure, Third Edition. 1995.

[8] Sang Yop Kang. The independent director system in China: weaknesses, dilemmas, and potential silver linings [J]. Tsinghua China Law Review, 2017, 9(2):176-180.

[9] Sun Zuheng. The Inspiration of Independent Director System in the U.S. to Listed Companies of China [D]. Jilin: Jilin University, 2016.

[10] Zhou Ling. The independent director system and its legal transplant into China [J]. Journal of Comparative Law,2011, 6(2), 282-283.