



Independent Director System in Chinese Corporate Governance:

Formal convergence, substantial divergence?

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Debates on convergence or divergence

■ Formal convergence: Hansmann & Kraakman

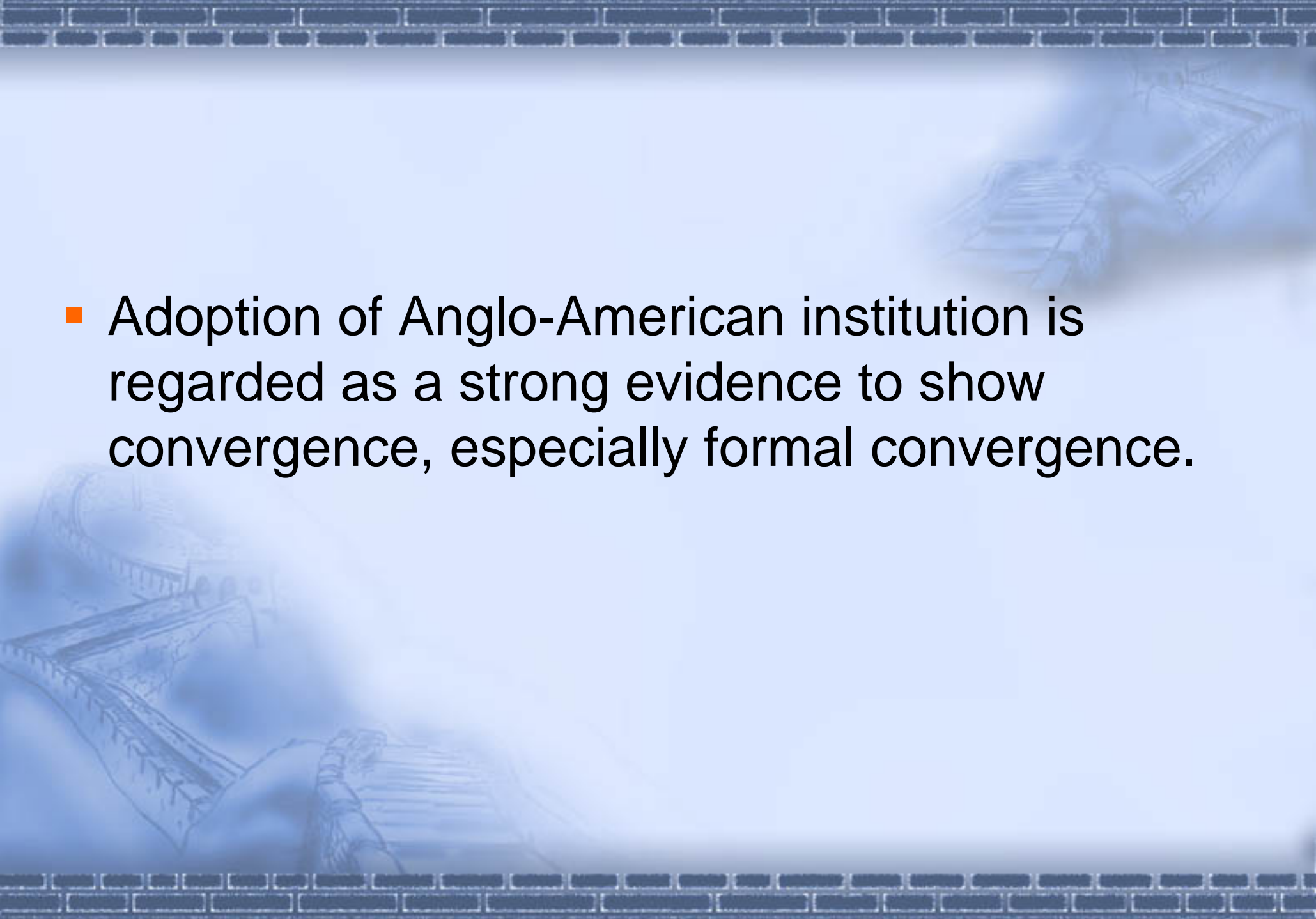
- Formal convergence of “most of corporate law” has already occurred towards American Model, shareholder-oriented model.
- Convergence of corporate law proceeds more slowly than convergence in governance practices.
- But, there are already important indications of evolutionary convergence, such as the adoption of American institutions in the realms of board structure, securities regulation and accounting methodologies, and even the regulation of takeovers.


■ Functional convergence rather than formal convergence: Ronald Gilson; John C. Coffee

- Functional convergence is likely the first response to competitive pressure because changing the form of existing institutions is costly.
- Little formal convergence has occurred because each system’s governance institutions have sufficient flexibility to find a solution within their path dependent limits.

■ Divergence: Lucian Bebchuk & Mark Roe; Curtis Milhaupt

- Path dependence makes structural convergence unlikely.

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- The background of the slide features a faint, blue-toned illustration of a person sitting and reading a large book. The person is positioned in the upper right quadrant, and the book is open, with pages visible. The overall style is that of a classic woodcut or engraving, rendered in a light, semi-transparent blue color against a white background. The top and bottom edges of the slide are framed by a decorative border consisting of a repeating pattern of small, rectangular blocks, resembling a brick or stone wall.
- Adoption of Anglo-American institution is regarded as a strong evidence to show convergence, especially formal convergence.

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- The independent director system is one of the most important Anglo-American institutions in corporate governance.
 - In 2001, China formally adopted independent director system from the US.

Differences in rules regarding independent director system between China and US

- **Different expected roles**

- US: To solve agency cost problem

- China: To solve the abuse by controlling shareholders at the expense of small shareholders, preventing recurrence of corporate scandals.

Differences in rules regarding independent director system between China and US (Con'd)

- **Difference in delimitation of independence**
 - US: Focusing on the independence from management
 - China: Emphasizing on the independence not only from management, but also from controlling shareholders.

Differences in rules regarding independent director system between China and US (Con'd)

- **Difference in proportion requirement**

- US: Composed of a majority of independent directors. In addition, nominating committee, compensation committee, and audit committee must be composed entirely of independent directors
- China: At least one-third independent directors in the Board

Differences in rules regarding independent director system between China and US (Con'd)

- **Difference in requirement on committee structure**
 - US: Listed company in NYSE must have audit committee, nominating committee, and compensation committee, composed entirely of independent directors.
 - China: Listed companies are free to establish committees.

Differences in rules regarding independent director system between China and US (Con'd)

- **Different requirement on nomination**

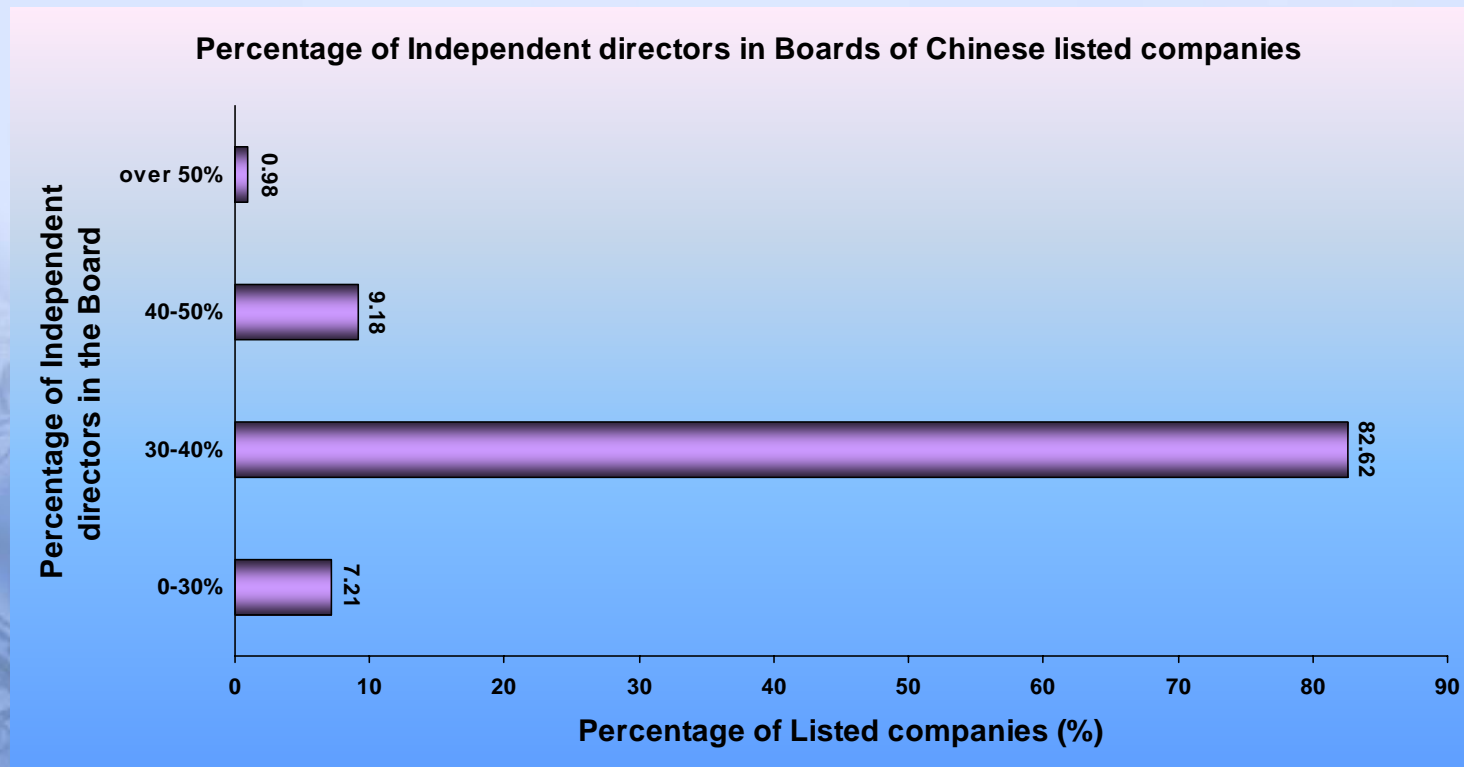
- US: Nomination of directors should be controlled by entire independent directors.
- China: Board of directors, supervisory board and shareholders who independently or jointly hold more than 1% of the shares issued by the listed company may nominate independent directors.

Differences in rules regarding independent director system between China and US (Con'd)

- **Difference in necessity to reconcile independent director and Supervisory Board**
 - US: No such concern.
 - China: How to allocate the powers and how to reconcile the relationship between independent directors and Supervisory Board are quite tough problems for China to solve.

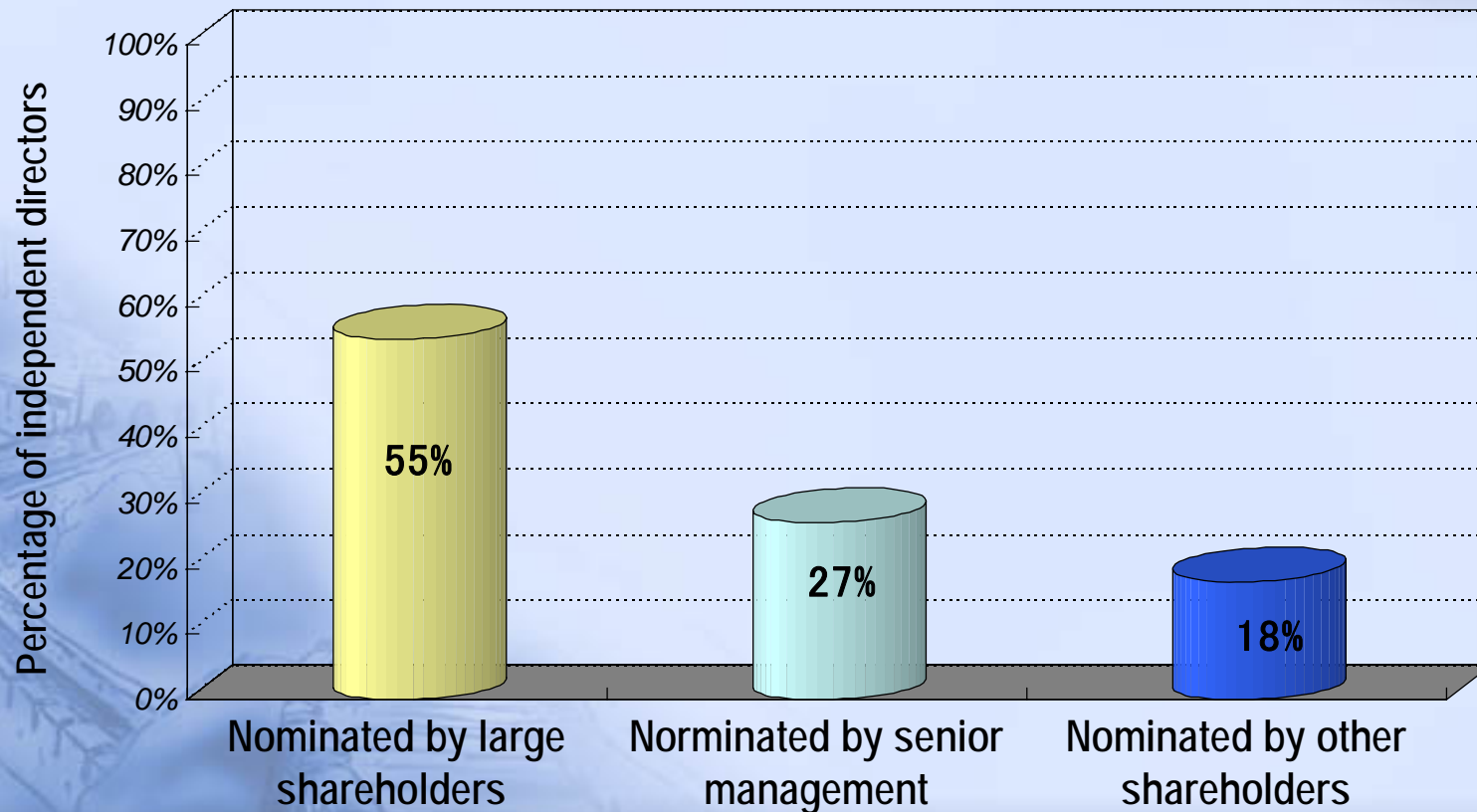
Empirical study on functional effect of independent director system in China

- Status of independent directors in china



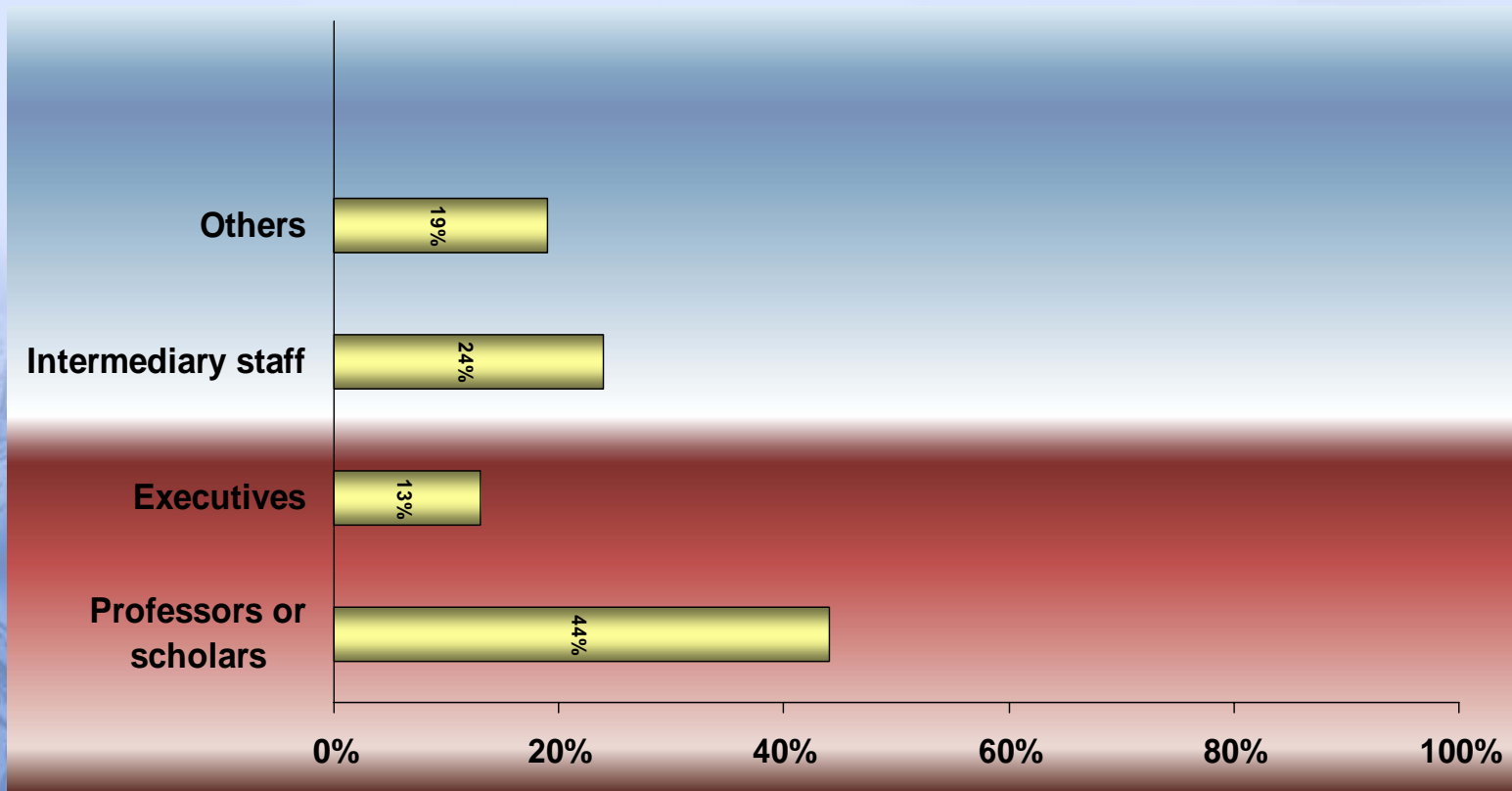
Empirical study on functional effect of independent director system in China (Con'd)

- **Nomination of independent directors in China**



Empirical study on functional effect of independent director system in China (Con'd)

- **Composition of independent director in China**

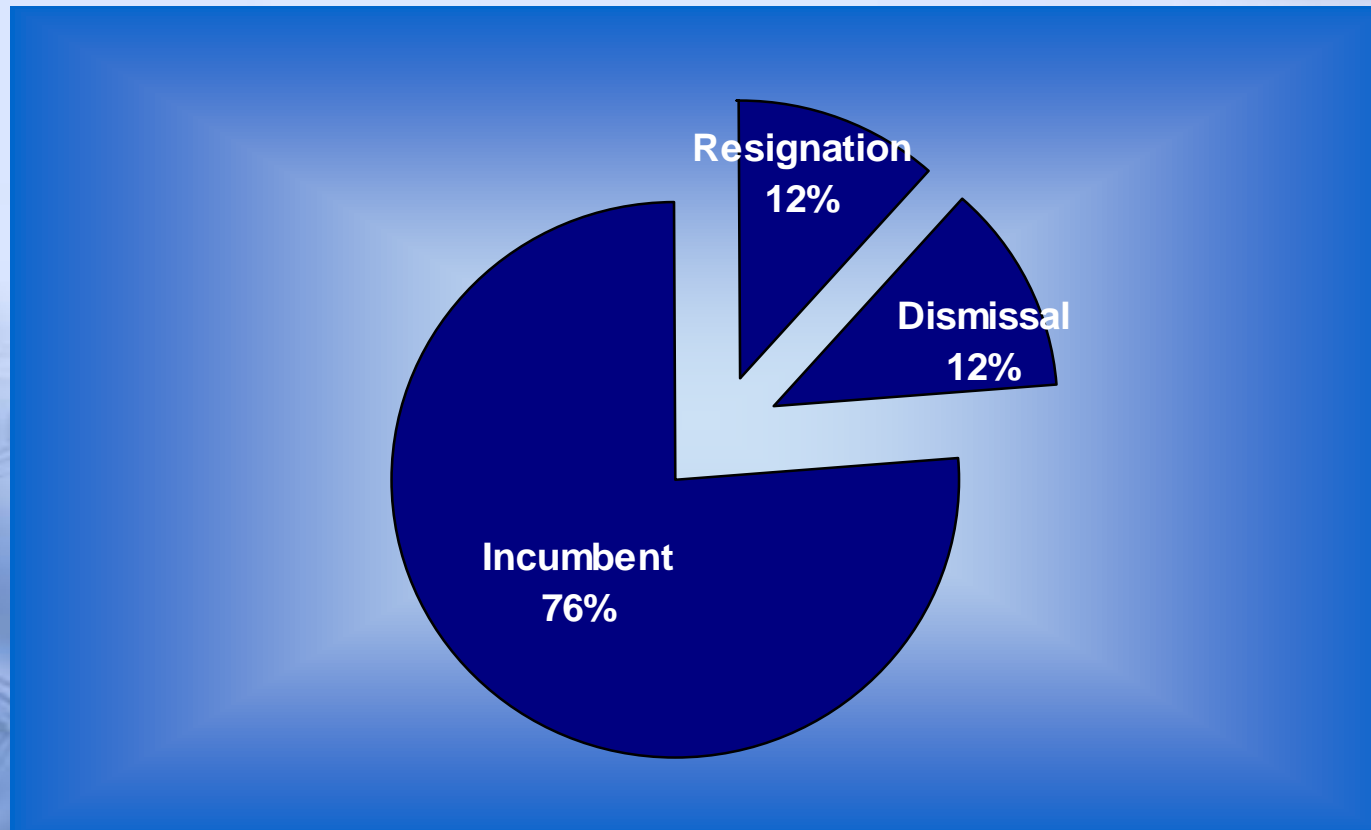


Empirical study on functional effect of independent director system in China (Con'd)

- **Participation of independent directors in China**
 - 35% of independent directors didn't express independent opinions divergent from the opinions of the big shareholder or senior executives; over 70% of independent directors didn't use or intend to use the special powers authorized by CSRC.
 - 2% independent directors admit that they are “vase directors”; 39% independent directors implicitly identify their role as counselor; and only 37% independent directors regard themselves as monitor.

Empirical study on functional effect of independent director system in China (Con'd)

- Replacement of independent directors in China



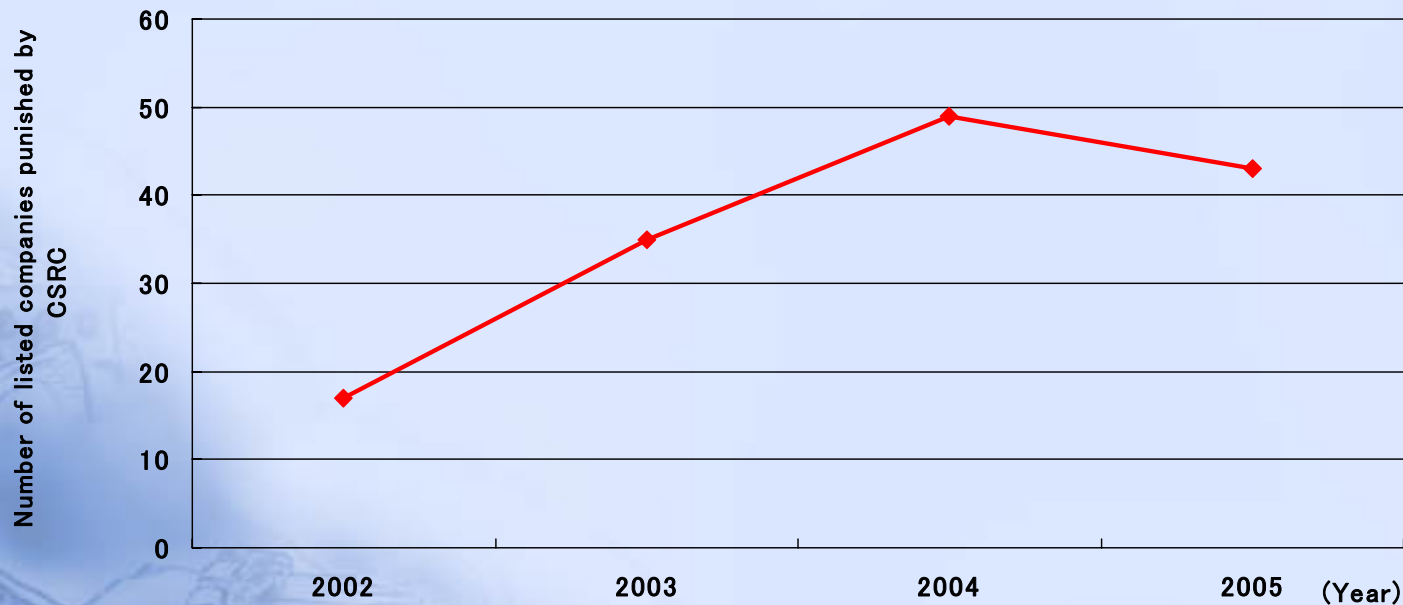
Empirical study on functional effect of independent director system in China (Con'd)

Link between independent directors and corporate performance in China



Empirical study on functional effect of independent director system in China (Con'd)

- Amount of listed companies punished by CSRC



Empirical study on functional effect of independent director system in China (Con'd)

■ Four cases about independent directors in China

➤ Lu Jiahao Case

- Firstly, "I always regard the independent director as an honorary title."
- Secondly, "I didn't take part in the decision-making. Neither did I directly compile the false accounting documents, nor did I attend the meetings that approved such documents."
- Thirdly, "I am a teacher, teaching foreign language, knew nothing about the operation of the company. I didn't have the ability to understand the accounting sheets."

➤ Leshan Electric Power Case

- Leshan case is the first case that independent directors started to use the right of inviting outside audit firm to investigate the company, with the end that independent directors failed and resigned.

➤ Xinjiang Tunhe Case

- Wei Jie, a well-known economist at Tsinghua University
- Even though Wei Jie vetoed the issues discussed in the Board, those issues still got approval as scheduled. In addition, Wei Jie couldn't resign as he expected.

➤ Inner Mongolia Yili Case

- The first case in China that Board of Supervision made the proposal to dismiss independent directors.

**Role to solve
big shareholder's abuse**



**Special delimitation
of independence**

Low proportion



**Free to establish
committee structure**

Nomination rules

**Coexistence of independent
director and supervisory board**

**Few company with majority
of independent director**

**Nomination controlled
by big shareholders**

**Mainly composed
by academics**



Inactive participation

**Frequent dismissal
and resignation**

**Little link with
corporate performance**

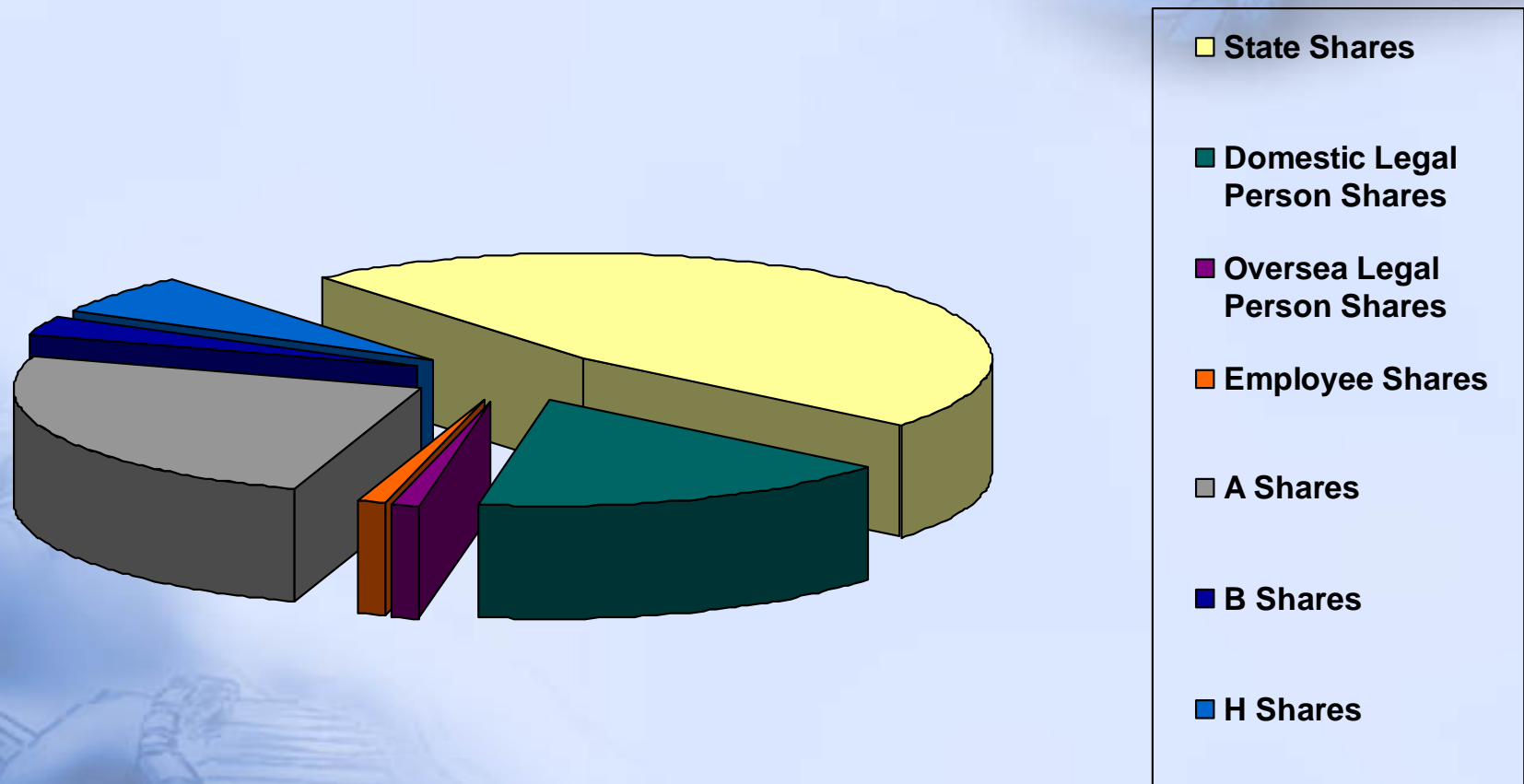


Restrictions from local forces

- **Restriction from concentrated shareholding structure**
- **Lack of candidates for independent directors**
- **Restriction from Two-tier Board structure**

Restriction from concentrated shareholding structure

Shareholding structure in Chinese listed companies



Restrictions from local forces (Con'd)

■ **Restriction from concentrated shareholding structure**

- The origin of the serious problems, exploitation of small shareholders by controlling shareholders.
- Such problems resulted in special role of independent directors. Special role caused special requirements for independence.
- Special role also caused tremendous resistance to requiring a majority of independent directors and a committee structure.

■ **Lack of candidates for independent directors**

- Due to the lack of qualified candidates, it is difficult to require listed companies to have majority of independent directors in the Board.

■ **Restriction from Two-tier Board structure**

- In terms of oversight, the role of Supervisory Board and independent directors are highly overlapped. The existence of Supervisory Board makes it hard to put all emphases on independent directors.

■ **Other restrictions from local forces**

No sign to change

- **Concentrated shareholding structure**
- Even though China is undergoing share-trading reform of listed companies, it is clearly stated by the government that “the share-trading reform that is now under way is to realize trading of non-tradable shares rather than to sell State shares through the capital market, and the State does not consider selling the State shares to raise funds through the domestic capital market”.

No sign to change (Con'd)

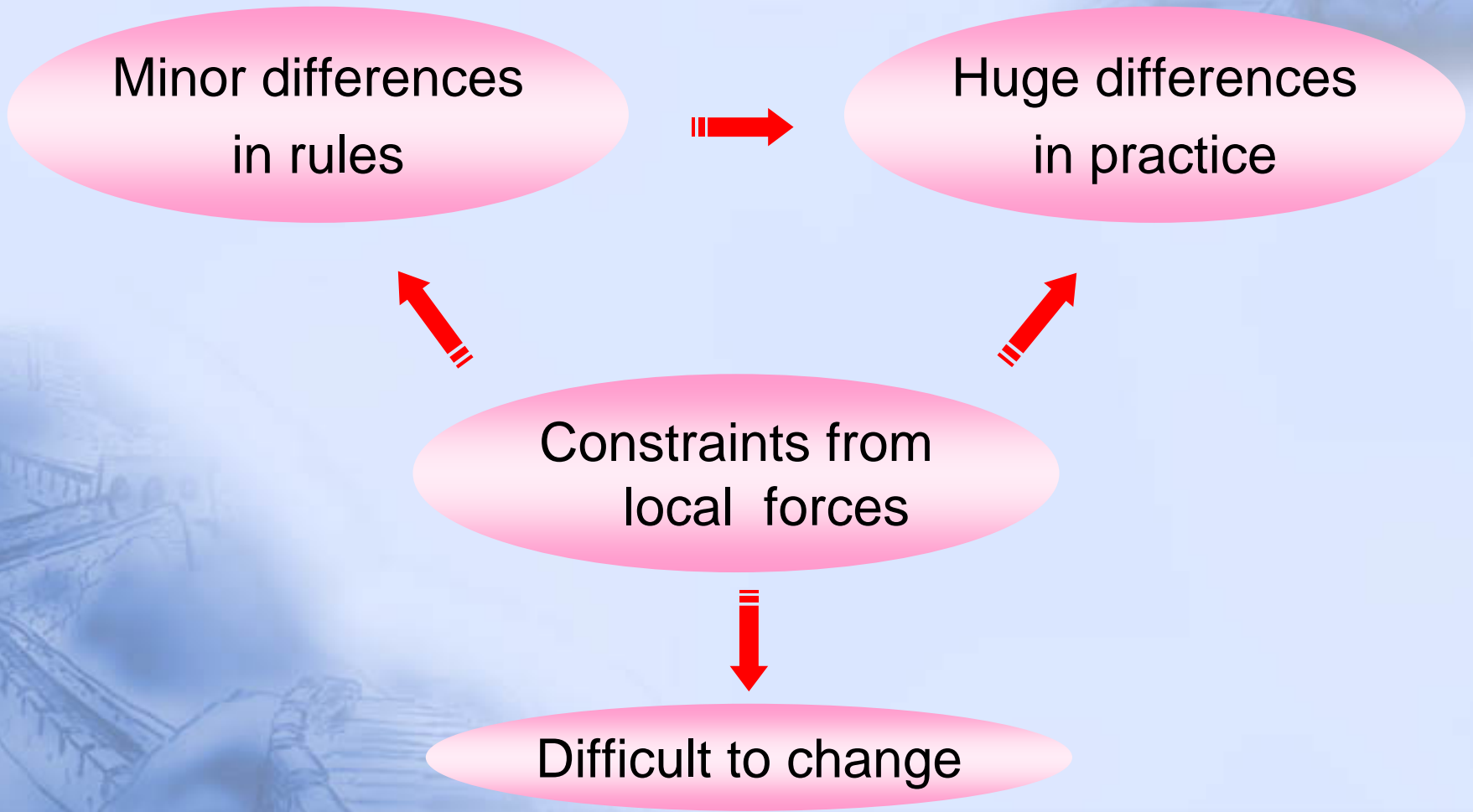
- **Two-tier Board structure**

- Prediction by Hansmann & Kraakman

“With respect to board structure, convergence has been in the direction of a legal regime that strongly favors a single-tier board with a substantial complement of outside directors. Two-tier board structures seem a thing of the past.”


- Reality in China:

Significant revision of Chinese Company Law in 2005, instead of weakening Supervisory Board, in an opposite direction, emphasizes on strengthening the powers of supervisory board, and vesting supervisory board with broad new authorities. There is no sign for China to give up supervisory board and change to be one-tier board structure.



Conclusion

- On one hand, adopting the Anglo-American norm and institution of the independent director in China evidences some limited level of convergence in form.
- On the other hand, there exists many 'minor differences' in the detailed rules and the shareholding structure and board structure that still remain different from the US, which at the same time show many indications of divergence.
- Adoption of Anglo-American institution can't be simply used as an evidence to prove convergence.

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- To which level Corporate Law and Corporate governance will converge worldwide ?
 - Chinese experience indicates that limited formal convergence may occur, but substantial statutory convergence is unlikely.

Thank you!

