

The Independent Director Requirement and Its Effects on the Foreign Investment Climate in China:

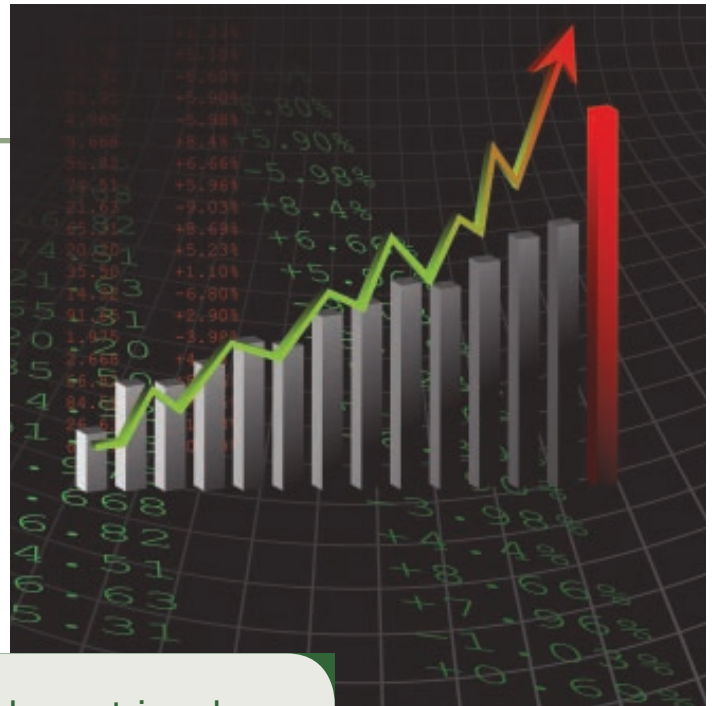
PROGRESS OR REGRESS?

By Matthew Weinstein*

Introduction

Centrally owned businesses are the backbone of China's economy. Since enacting the Company Law in late 1993,¹ the State has converted many of its traditionally structured enterprises to corporate entities and issued publicly traded shares to raise funds.² By 2004, listed companies under the control of State-owned holding enterprises represented more than 71 percent of the listed companies on the Chinese securities market.³ In 2006, China disclosed that the top twenty-one listed centrally owned enterprises by market value (including Sinopec, Bao Steel, Huaneng, Sinoair and COSCO) "accounted for 68 percent of the total profits of the top 100 listed companies."⁴ In addition, those same twenty-one listed companies accounted for almost one-fifth of the total market value of all listed companies in China.⁵ Indeed, the Chinese government truly is an '800 pound gorilla in the room' in the Chinese securities market.

The number of listed companies continues to multiply and foreign investment continues to flood into China. Yet, China is one of the only countries where one can find both a booming securities market *and* State control of the vast majority of companies. Contrary to common Western practice, the State (as controlling shareholder) often pursues different objectives compared to traditional, profit-seeking investors.⁶ Thus, foreign investors must be vigilant of significant risks involved in such an investment climate and it is more important than ever to understand the fundamental differences between Western corporate governance systems and those in place in China. To that end, this article examines China's realization of a fundamental element of Western corporate governance — independent directors — and examines both the positive and negative effects this implementation has had on the investment climate in China.



China is one of the only countries where one can find both a booming securities market and State control of the vast majority of companies.

I. COMPARING CHINESE CORPORATE GOVERNANCE TO THE WEST

Even though China has a surprisingly long corporate tradition, corporate governance in China has developed slowly and the State has been careful not to dive headfirst into adopting Western practices. In fact, as one scholar has noted, "China had a world leading economy for a considerable time prior to modern history."⁷ By the dawn of the Western industrial age, however, China had fallen behind Western economic powers, which in turn "caused China's recent history to be subject to commercial and political turmoil."⁸ Though the Chinese introduced modern corporate concepts as early as the late 19th century, the adoption of communism led to the near elimination of private ownership.⁹ As it has been said that "the corporate structures that an economy has at any point in time depend in part on those that it had at earlier times," China's political tradition helps provide an explanation for the evolution of Chinese corporate doctrine and the integration of practices from Western developed economies.¹⁰ Only after a short but sustained period of economic,

legal, and political debate did China begin to take slow but steady steps to promote privatization.¹¹ After setting up the Shanghai and Shenzhen stock exchanges in the early 1990s and enacting the Company Law in 1993, it was not until 1997 that China announced it planned to convert most state-owned enterprises to corporations.¹²

Donald Clarke, Professor of Law at George Washington University, defines corporate governance in China as:

[T]he set of rules and practices regulating relationships among participants in a post-traditional Chinese business enterprise and governing decision making within that enterprise. By 'post-traditional' enterprise I mean any enterprise that is no longer bound tightly within the traditional State planning system and operated by its administrative superior agency essentially as a division within a larger enterprise. It is an enterprise in which voluntary, contractual relationships are important and top-down commands from government are less important.¹³

As corporate governance reform progressed, some scholars argued an independent director institution would solve numerous corporate governance problems entangling Chinese listed corporations.¹⁴ Though Sibao Shen, Dean of the Law School of China's University of International Business and Economics notes that the concept of independent directors appeared in China as early as December 1997,¹⁵ it was not until 2003 that the 'minimum one-third' independent director system now in place was mandated.¹⁶ By June of 2003, "1244 of 1250 corporations listed in China's two stock exchanges had independent directors on their boards."¹⁷ Though companies integrated the system quickly, there was natural resistance to introducing a customarily Western corporate institution.¹⁸ The independent director in China as it has developed, however, is distinct from and exists for different motivations than an independent director in the West.



A. Independent Directors in the West: Protectors of Shareholder Interests?

"Corporations have been the common business structure in the Western world since at least the beginning of the 19th century."¹⁹ The corporate structure thrives because of limited liability, encouraging funds to flow freely to businesses from the global investor pool.²⁰ The modern corporate structure also gives businesses functional independence from their investors.²¹ Dean Shen offers that "independent directors first appeared in the United States to cure the corporate governance problems of public corporations, which have widely dispersed shareholders."²² Independent directors were created for two major reasons: First, to act as securities law monitors in the aftermath of the massive securities frauds of the 1920s and 1930s; and second, to provide profit-seeking shareholders with more adequate controls over the performance and reliability of management.²³

In a Western system, tensions within corporate governance structures require compromises between authority and responsibility.²⁴ Western independent directors are leaders in their fields and trusted business advisors who are expected to provide guidance with respect to corporate strategy.²⁵ The purpose of having directors independent of management is so that the many (often conflicting) interests of employees, shareholders, and business partners can be adequately recognized.²⁶ Thus, independent directors can act as a powerful social responsibility instrument for the public, serving to calm investors and reassure them that management is ultimately accountable for their actions.²⁷

With regard to public companies in the United States, directors are expected to be — as Professor Clarke puts it — "systematically independent of management."²⁸ As this is the primary concern and requirement for independence, stock ownership is allowed.²⁹ Both major U.S. stock exchanges, however, require listed companies to have at least half of its board of directors be independent.³⁰ Requiring that the board be comprised of a majority of independent directors empowers such directors to more effectively carry out the responsibility of maximizing shareholder value in the companies they oversee and guarding against conflicts of interest.³¹ This is because the United States' system takes a view of independent director representation one level deeper than simple 'on-its-face' independence — independent directors who are also disinterested provide fair, impartial evaluations of transactions and management decisions, in turn allowing independent directors with occasional conflicts to serve effectively.³²

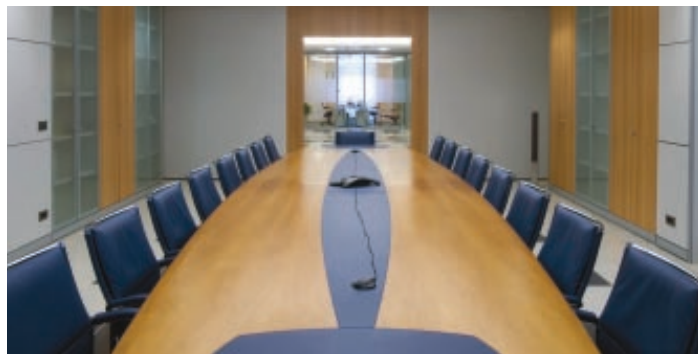
Even though China has a surprisingly long corporate tradition, corporate governance in China has developed slowly and the State has been careful not to dive headfirst into adopting Western practices.

B. Independent Directors in China: Protectors of the State?

Independent Directors in China “bear the duties of good faith and due diligence toward the listed company and all [its] shareholders. They shall... protect the overall interests of the company, and shall be especially concerned with protecting the interests of minority shareholders from being infringed.”³³ Before independent directorship was mandated, however, director requirements were not consistent—consequently, use of independent directors was effectively optional.³⁴ Because China had such a large number of State-owned and controlled businesses, corruption ran rampant because it was not possible for the government to monitor so many complex enterprises.³⁵ Today, the Independent Director Opinion mandates that every listed corporation’s board comprise at least one-third independent directors, one of whom is required to be an accounting or financial professional.³⁶

The Opinion provides significantly greater powers to independent directors over regular directors, giving them such rights as authority over major financial and auditing matters, conflict-of-interest transactions, and holding board and shareholders’ meetings.³⁷ Dean Shen notes that “[i]ndependent directors are also entitled to provide opinions regarding nomination, appointment, and dismissal of directors and senior executives, compensation of directors and senior executives, and any large loans.”³⁸ These powers define the institution of independent directors in China and differentiate the Chinese system from that of at least the United States’, where independent directors are independent in qualification but retain the same rights and powers as other directors.

Dean Shen also posits that “[s]tandards for independence vary with the legislative needs of regulating corporate governance structure.”³⁹ Indeed, for China, this observation is correct. Generally, for listed companies the accepted definition of “independency” is defined such that independent directors must be independent from stockholders, senior administrators, as well as the main business relationships of the company.⁴⁰ Unlike in the United States where significant stock ownership is not a bar to independence, China disfavors beneficial ownership by independent directors of more than 1 percent of the company stock.⁴¹ Independent directors must also have enough time to work for the company each year and cannot hold more than 5 posts concurrently.⁴² Moreover, candidates wishing to be independent directors must make a public declaration of independency.⁴³ This requirement for “independency” of



independent directors, however, is not absolute and there is no universal test for determining independence.⁴⁴

II. CHINA'S INDEPENDENT DIRECTOR SYSTEM HAS FLAWS BUT IS A POSITIVE STEP TO BETTER GOVERNANCE

Independent directorship in China is mainly about providing a check against abuse by controlling shareholders — a different concern than controlling management.⁴⁵ China and the United States’ systems, though motivated by different goals, do share this common spirit in having a system to prevent a controlling shareholder from using their control to harm other shareholders and the corporation itself.⁴⁶ Admittedly, it is a bit of a ‘catch-22.’ In a country such as China where one’s relationship — *guan xi* — in both social and business circles is so strongly stressed, as Dean Shen states, “it is difficult for the selection process of independent directors to avoid influence by controlling shareholders or management.”⁴⁷

Several other flaws in the Chinese corporate governance system prevent independent directors from successfully filling their monitoring functions.⁴⁸ For instance, one of the major problems plaguing the Chinese corporate governance system is that there is a profound lack of rules and law enforcement.⁴⁹ Another is that

Today, the Independent Director Opinion mandates that every listed corporation’s board comprise at least one-third independent directors, one of whom is required to be an accounting or financial professional.

even though the Independent Director Opinion appears to grant independent directors requisite special power by requiring that they comprise a minimum of half the members of a corporation’s audit, nomination and compensation committees, as Professor Clarke reveals, “there is no requirement that these committees even be established and a company could theoretically keep inside director control over such matters by having them decided by the entire board.”⁵⁰ A further disturbing trend is that controlling shareholders often appoint their social friends to serve as independent directors.⁵¹ This practice hardly satisfies the goals of this system and these “independent directors” likely do not have the necessary education or business experience to perform their

Independent directorship in China is mainly about providing a check against abuse by controlling shareholders — a different concern than controlling management.

duties.⁵² Thus, China must endeavor to create provisions that strengthen the independent director institution by forcing listed companies to comply and preventing controlling shareholders from flouting the rules.

China's biggest challenge, however, is coping with the plain fact that the State is the controlling shareholder in a vast majority of listed companies.⁵³ Professor Clarke quotes the Dean of the Changjiang School of Business — who serves as an independent director — as stating, “I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the State.”⁵⁴ As independent directors are effectively serving the public interest, in an ideal world they would remain completely independent and, as Professor Clarke suggests, “follow only the dictates of his or her conscience,” not those of the state.⁵⁵ In reality, however, foreign investors must be constantly reminded that this may not be the case. While China is in a state of unprecedented economic expansion, most of that expansion remains under the strict control and watchful eye of the State, and the State's motives may not align with those of the other investors. This issue is one that may take many years of reform to overcome, as it does not appear that the State intends to cede control of any of the industries it now maintains a less-than-gentle stranglehold on.

III. SUGGESTIONS FOR IMPROVEMENT

As the securities markets globalize, China's listed companies would greatly benefit from non-institutional investment by foreign investors. For the vast majority that have State controlling interests, the State could explore ways to make their interests more passive, thus allowing corporate decision-making to properly fall to publicly elected directors and management.⁵⁶ Another potential idea, considering that the State has contemplated it in other governance structures,⁵⁷ is to require independent directors to have more significant business experience. Though China has taken major steps to improve accountability and investor safety by implementing independent directors, it needs to take another step towards standardization, enforcement and expansion of its corporate governance law. If China can successfully do so, the investment climate for foreign investors will become an even better one. **BLB**

ENDNOTES: Matthew Weinstein

* Matt Weinstein is a J.D. candidate at American University, Washington College of Law. He holds a B.S. in Computer Engineering from the University of Maryland, College Park. Prior to attending law school, Mr. Weinstein founded and sold a network and telecommunications integration consulting firm. He plans to join the Washington D.C. office of Dickstein Shapiro LLP upon graduation.

¹ *Zhonghua Renmin Gongbeguo Gongs Fa* [Company Law of the People's Republic of China], [hereinafter Company Law] (adopted December 29, 1993, effective July 1, 1994) (codifying Chinese corporate law).

² See Donald C. Clarke, *The Independent Director In Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 135-137, 146-47 (2006) (discussing ownership patterns in Chinese-listed companies); Centre for Financial Market Integrity, *China Corporate Governance Survey*, 2007, <http://www.cfapubs.org/doi/pdf/10.2469/cfb.v2007.n3.4563> (stating that “[m]ore than 1,200 enterprises have raised funds through initial public offerings (IPOs)”).

³ Organisation for Economic Co-operation and Development, DRC/ERI-OECD 2005 Policy Dialogue on Corporate Governance in China, *Overview of State-owned Listed Companies in China, May 19, 2005*, <http://www.oecd.org/dataoecd/14/6/34974067.pdf> (disclosing statistics from the end of 2004 showing that among all 1,377 Chinese listed companies, 987 are controlled by State-owned holding companies, accounting for 71.7 percent of the total).

⁴ Embassy of the People's Republic of China in the United States of America, *China Unveils Top 100 Listed Companies*, [hereinafter Embassy of China] May 10, 2006, <http://www.china-embassy.org/eng/xw/t251470.htm> (discussing that in 2005, “1,339 listed companies in Shanghai and Shenzhen A-share markets possessed 4.7376 trillion RMB of assets, and their yearly revenue of major businesses equaled 21.8 percent of China's GDP that year.”). Of note, the 2005 net profits of the top 100 listed companies constituted over 70 percent of the total of all listed companies, even though the 100 make up less than one thirteenth of all listed companies in China. *Id.*

⁵ *Id.* (stating that the top twenty-one companies “covered,” or were collectively worth, 942.6 billion RMB (about US\$120 billion)).

⁶ Clarke, *supra* note 2, at 141 (noting that there is a theory that China prefers state ownership because it enables the State to use its ownership — and control — to cause the enterprise to engage in activities that a traditional Western firm might avoid, such as the sale of its products at below-market prices or eliminating unemployment in urban areas).

⁷ Yuwa Wei, *An Overview Of Corporate Governance In China*, 30 SYRACUSE J. INT'L L. & COM. 23, 26 (2003).

⁸ *Id.*

⁹ *Id.* at 27, 29 (stating by 1956, “all enterprises with private ownership were transformed into state-owned enterprises”).

¹⁰ See Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STANFORD L. REV. 127, 127, 169 (1999).

¹¹ See Wei, *supra* note 7, at 31 (explaining that the ideological debate over corporatization was a major topic in economic, legal, and political literature throughout the mid 1980's and early 1990's).

¹² *Id.*

¹³ Clarke, *supra* note 2, at 146-47.

¹⁴ See, e.g. Minkang Gu, *Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People's Republic of China*, 6 J. CHINESE & COMP. L. 59, 59 (2003) (surveying independent director theory in Chinese corporate governance).

¹⁵ Silbao Shen & Jing Jia, *Will The Independent Director Institution Work In China?*, 27 LOY. L.A. INT'L & COMP. L. REV. 223, 230 (2005).

¹⁶ See China Securities Regulatory Commission, *Guanyu Zai Shangshi Gongs Jianli Duli Dongshi Zhidu de Zhidao Yijian* [Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies] (Aug. 16, 2001) [hereinafter Independent Director Opinion] at http://www.csrc.org.cn/cn/search/search_detail.jsp?infoid=1061947864100&type=CMS.STD (disclosing dates for necessary compliance by listed companies).

¹⁷ Shen, *supra* note 15 at 234.

¹⁸ Shen, *supra* note 15 at 235. (offering that even though listed companies have appointed independent directors regulators have met resistance from a “notoriously opaque business culture” in enforcing the Independent Director Opinion.”)

¹⁹ Yuwa Wei, *The History Of The Corporation In China*, 6 UNIV. W. SYDNEY L. REV. 95 (2002), available at <http://www.austlii.org/au/journals/UWSLRev/2002/5.html>.

²⁰ *Id.* (offering that the need for more governance control is due to “growth in size and the development of technology has resulted in the separation of ownership and management”).

²¹ Shen, *supra* note 15, at 224; see also Wei, *supra* note 19 (explaining that a modern corporation divides and balances the corporate powers among shareholders, the board of directors, and management).

²² Shen, *supra* note 15, at 224 (citing Betty M. Ho, *Restructuring the Boards of Directors of Public Companies in Hong Kong: Barking Up the Wrong Tree*, 1 SING. J. INT’L & COMP. L. 507, 507 (1997)). Interestingly, despite the wide acceptance of independent directors, there is a question as to whether independent directors actually improve the corporate governance of U.S. public corporations. See Shen, *supra* note 15, at 228-29 (discussing the positives and negatives of independent director governance in the United States).

²³ *Id.* at 224 (citing Victor Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602 (1982)).

²⁴ Clarke, *supra* note 2 at 144; see also Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW 461, 463 (1992) (explaining the Authority Model and Responsibility Model).

²⁵ Chao Xi, *In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China*, 22 CONN. J. INT’L L. 1, 20 (2006) (discussing that many Western independent directors have prior executive management experience).

²⁶ Clarke, *supra* note 2 at 154 (discussing that this means “sometimes [acting] against the interests of shareholders in order to protect ... the interests of the corporation’s employees”); see also Victor Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602 (1982) (stating that one of the functions of an outside director is to affect managers’ conduct to ensure their response to other social concerns).

²⁷ See, e.g., Shen, *supra* note 15, at 224-25 (explaining that independent directors maximize wealth and make corporations socially responsible).

²⁸ Clarke, *supra* note 2 at 155.

²⁹ *Id.* at 159 (discussing that “the U.S. securities markets do not view significant stock ownership in itself as a bar to determining whether directors are independent”); see also NYSE CORPORATE GOVERNANCE RULES § 303A, available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.

³⁰ See generally NASDAQ MARKETPLACE RULES § 4350 (2007) available at <http://www.complinet.com/nasdaq/display/display.html?rbid=1705> (requiring a “[m]ajority Independent Board”).

³¹ See *id.* at § IM-4350-4, Board Independence and Independent Committees.

³² See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001) (explaining the rules for interested directors).

³³ China Securities Regulatory Commission, *Code of Corporate Governance for Listed Companies in China* § 5 ¶ 50 (2001) available at <http://www.csrc.gov.cn/n575458/n4001948/n4002030/4062964.html>.

³⁴ See Shen, *supra* note 15, at 230-231 (discussing that “officials delegated to run these corporations often took advantage of the vacuum of ownership in order to make dirty money”).

³⁵ *Id.* at 233.

³⁶ Independent Director Opinion, *supra* note 16.

³⁷ *Id.*; see also Shen, *supra* note 15 at 231 (discussing that in enforcing these powers, independent directors can independently retain outside counsel, such as auditors and lawyers).

³⁸ Shen, *supra* note 15 at 231.

³⁹ *Id.* at 236.

⁴⁰ See Overview of Governance of State-owned Listed Companies in China, *supra* note 3, at 2 (discussing the fact that 4,000 independent directors are in place — an average of over 3 per listed company — is evidence that independent directors are serving increasingly important roles).

⁴¹ See, e.g., Independent Director Opinion, *supra* note 16, at § 1(1) (forbidding any relationship with a large shareholder that would impair independence); *id.* at § 3(2) (denying independent status to holder of 1 percent of company’s shares or one of top ten shareholders or any relative).

⁴² Independent Director Opinion, *supra* note 16, at § 1(2) (limiting the number of posts independent directors can have as a way of ensuring they have time and energy to effectively perform their duties).

⁴³ Independent Director Opinion, *supra* note 16 at § 4(2) (requiring nominees to make statements that no relationship exists between them and the listed company that could affect the nominee’s independent objective judgment).

⁴⁴ See Shen, *supra* note 15, at 236; see also Brudney, *supra* note 26.

⁴⁵ Shen, *supra* note 15 at 225 (noting that controlling shareholders are targeted “because the ownership structure of listed corporations in China is highly concentrated”).

⁴⁶ *Id.*

⁴⁷ *Id.* at 237.

⁴⁸ *Id.* at 235.

⁴⁹ Clarke, *supra* note 2 at 199 (pointing out that at least four companies had not yet installed independent directors as of July 2004, “with no apparent official consequences”).

⁵⁰ *Id.* at 193-94; Independent Director Opinion, *supra* note 16, at § 5(4).

⁵¹ Xi, *supra* note 25, at 17 (discussing that this practice “jeopardize[s] the independence of directors”).

⁵² *Id.* at 19.

⁵³ Guy S. Liu & Pei Sun, *Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey*, Royal Institute of International Affairs, Asia Programme Working Paper, No. 2 (2003) (identifying, through empirical study, that approximately 85 percent of listed companies were under direct or indirect control of the State), available at http://www.chathamhouse.org.uk/files/3096_stateshareholding.pdf.

⁵⁴ Clarke, *supra* note 2 at 171-72.

⁵⁵ See *id.* at 173 (citing Ye Xiangsong & Cao Zongping, *Tuixing Duli Dongshi Zhidu, Wanshan Faren Zhili Jiegou [Promote the Independent Director System, Perfect the Legal-Person Governance Structure]*, QIU SHI ZAZHI [SEEKING TRUTH MAGAZINE], No. 6, at 30-31 (2002)) and discussing that remaining completely independent means being independent of “dominant shareholders (including the State), management, and indeed all those who have an interest in the company.)

⁵⁶ *Contra* Clarke *supra* note 2 at 2 n.3 (arguing that “it is hard to see why a policymaker who believes that State ownership ought to mean something would be satisfied with [a more passive interest] ... the State would be giving up its ability to use control not just to pursue non-economic goals, but also to defend itself from exploitation by management or controlling shareholders, or even to exploit other shareholders for its own economic benefit”).

⁵⁷ China Securities Regulatory Commission, *Provisional Code of Corporate Governance for Securities Companies* § 3 ¶ 39 (2006) (requiring that Independent Directors be “honest and creditable, and have more than 5 years working experience in ... related fields.”) available at http://www.ecgi.org/codes/documents/provisional_cgcode_cscc.pdf.

ADDITIONAL SOURCES CONSULTED

1. Eu Jin Chua, *The Laws of the People’s Republic of China: An Introduction for International Investors*, 7 CHI. J. INT’L L. 133 (2006).
2. Yuwa Wei, *Volatility of China’s Securities Markets and Corporate Governance*, 29 SUFFOLK TRANSNAT’L L. REV. 207 (2006).
3. Susan E. Carroll, Comment, *Caught Between a Rock and a Soft Place: Regulating Legal Ethics to Police Corporate Governance in the United States and Hong Kong*, 14 PAC. RIM L. & POL’Y J. 35 (2005).
4. Dina Jie Yin, Note, *Investor Regulations: An American Answer to a Chinese Problem*, 57 RUTGERS L. REV. 397 (2004).
5. Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1 (2002).
6. Yuwa Wei, *Seeking for a Practicable Chinese Model of Corporate Governance*, 10 MICH. ST. J. INT’L L. 293 (2002).
7. Harvey Gelb, *Corporate Governance Guidelines — A Delaware Response*, 1 WYO. L. REV. 523 (2001).
8. MINKANG GU, UNDERSTANDING CHINESE COMPANY LAW (Hong Kong University Press ed. 2006).