
5b. Independence of the Board of Directors and Globalization of China's Corporations: Lessons in Effective Corporate Governance

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As China expands its economic horizons and seeks to establish itself as a global player in the corporate and financial world, it is imperative that its legal framework, corporate and commercial practices, and financial system can hold up to international standards and scrutiny. Similarly, as China's corporations seek to become strong and profitable multi-national companies, an effective corporate governance system is needed to help ensure the profitability and growth of these corporations, their access to capital and the level of investor confidence.

This paper focuses on the key vehicles in the globalization of China's corporations-- China's listed companies. The paper will first define the scope of corporate governance and analyze the need for a sound corporate governance regime. Secondly, it will examine the background of China's corporate structure, company law and corporate governance regime. Thirdly, it will explain the importance of the independence of the board of directors in ensuring sound corporate governance practices. It argues that three factors are critical in ensuring the independence of the board: (a) the de-linking of the relations between a listed company and its controlling shareholders; (b) the balance of powers between shareholders and the board and, in particular, the protection of the rights of minority shareholders; and (c) the regime of independent directors as a "check and balance" on the board of directors. Finally, it contends that effective enforcement of the rights and mechanisms relating to the three factors is the key to the protection of the independence of the board and, ultimately, sound corporate governance.

I. Corporate Governance and Its Impact on Corporate Performance and the Growth of the Capital Markets

A narrow notion of corporate governance defines it as the relationship of the owners of the company and the mechanisms through which the owners affect the company's behaviour.¹ The corporate governance system is concerned with the creation of wealth through the maximization of economic efficiency of the company, and as the residual claimants, the shareholders have the greatest incentive to create wealth. The corporate governance system, therefore, is to ensure that management's interests are aligned with those of the shareholders. The focus is on maximizing shareholder returns.

A wider view of corporate governance states that it is concerned with the relationship between internal governance mechanisms of corporations and society's conception of the scope of corporate accountability.² Within the purview of the wider corporate governance system are not only the interests of the shareholders but other stakeholders, including employees, suppliers, creditors and all other non-shareholder individuals and groups with an interest in the company's performance. Although the definition of corporate governance may vary, it is generally accepted that corporate governance refers to the systems and processes for the operation, monitoring and control of the affairs of a company. Corporate governance is concerned with the relationships among the board of directors, management, the controlling shareholders, minority shareholders

¹ See R Roulier, "Governance Issues and Banking System Soundness", *Banking Soundness and Monetary Policy*, International Monetary Fund (1997) at 450.

² See S Deakin and A Hughes, "Comparative Corporate Governance: An Interdisciplinary Agenda", Volume 24, *Journal of Law and Society* (1997).

and other stakeholders such as employees and creditors. It should enhance business prosperity (and thereby maximize shareholder returns) while ensuring corporate accountability to its stakeholders and society.

Corporate governance mechanisms assure shareholders and other investors in companies to receive adequate returns on their investments. Empirical studies have shown a clear link between the strength of the corporate governance system of a country and the profitability of its companies and their ability to attract external financing.³ Evidence have shown that a stronger rule of law and better investment protection are ultimately related to better corporate performance of companies that require financing and to several measures of aggregate economic performance.

II. The Corporate Governance System – The Anglo-American and Civil Law Models

A corporate governance system is a framework of laws, regulatory institutions and reporting requirements that condition the way companies are managed. An important element of the corporate governance system is the monitoring of the management's activities by various stakeholders, including the board of directors, shareholders and employees. There are two major corporate governance systems in the world – the market-based system prevalent in the Anglo-American common law countries, and the bank-based system in Germany, Japan, France and other civil law countries.

The corporate governance systems in the United States and the United Kingdom are classic examples of a market-based or outsider-controlled system. A common characteristic of the capital market in a market-based system is the widely held nature of shareholdings, coupled with the relative lack of significant inter-corporate, individual or family and bank holdings. The monitoring of the management is undertaken by the board of directors and shareholders, who also monitor the board of directors through their voting powers at shareholders' meetings. Increasingly, institutional shareholders with substantial shareholdings also serve as a check on the performance of the management.

Another important characteristic of the Anglo-American system is its liquid and efficient capital market. The share price of a company is an indication of the management's success; in a sense, the capital market monitors the company. Similarly, the market for managers is effective - the management, in order to maintain its marketability, has to ensure strong corporate performance. Finally, market competition serves as an effective monitoring tool on the company. If the company performs badly in comparison to its competitors, it will lose out to competition and eventually run into financial difficulty or even bankruptcy.

In contrast, in a bank-based corporate governance system, ownership of shares is more concentrated. For instance, in Germany, there is a significant concentration of equity ownership. The ownership concentration arises through families that control a large number of companies, corporations that hold shares of other corporations as investments and banks that hold shares of companies as investments.⁴ The system is known as a bank-based one as banks monitor the performance of the management of a company through their voting powers. Banks' control is obtained through a confluence of factors. First, they are custodians of shares left with them by

³ One such detailed study was conducted by William R Emmons and Frank A Schmidt, as detailed in Stephen S Cohen and Gavin Boyd's "*Corporate Governance and Corporate Performance*", *Corporate Governance and Globalisation: Long Range Planning Issues*, Edward Elgar Publishing Ltd (2000) at 59 – 94.

⁴ For example, as at 1997, Deutsche Bank owned 28.3% of Daimler Benz, 12.5% of Allianz and more than 25% of Karstadt. See M Roe, "*The Political Roots of American Corporate Finance*", Volume 7, Bank of America Journal of Applied Corporate Finance (1997) at 23 – 29.

clients. With written authorization, they cast votes with these client shares. Secondly, in the event that shareholders adopt a special resolution that limits voting rights, such a resolution often does not apply to banks. In addition, in bank-based systems like Germany and Japan, the capital markets are not as well-developed as the Anglo-American capital markets. The less efficient capital markets in Germany and Japan cannot serve as effective monitoring mechanisms of a company's corporate governance. Similarly, without widely-held shareholdings, other than the shareholders with concentrated bloc holdings, control over the management generally comes from within the company and not external monitoring mechanisms. In respect of internal monitoring mechanisms, an important element in the German system is the two-tiered board system: the supervisory board and the management and executive committee.

There has been extensive literature on the strengths and weaknesses of the two corporate governance systems. As recent as ten years ago, some authors postulated that the German and Japanese corporate governance systems were superior to the Anglo-American market-based system. However, more recent evaluations have claimed superiority in the Anglo-American model. A very recent study, which analyzed the impact of corporate governance institutions and ownership structures on company returns on investment by using a sample of more than 19,000 companies from 61 countries,⁵ showed that the origin of a country's legal system is the most important determinant of investment performance. Companies in countries with a legal system of English common law origin earn returns on investment that are at least as large as their cost of capital. Companies in all countries with civil law systems earn, on average, returns on investment which are below their cost of capital⁶.

Each corporate governance system has its advantages and limitations. There is no ideal system which can solve all the problems in corporate governance. The goal in corporate governance should be to achieve an optimal balance in the rights and interests of stakeholders. As we delve into the evolution of China's corporate governance regime, it is apparent that the Chinese system, while akin to its German counterpart in many ways, is unique unto itself, largely because of its historical development under a centrally planned economic system and the increasing influence of Anglo-American concepts of company law, corporate structure and securities regulations.

III. Historical Development of China's Company Law and Corporate Governance Regime

In 1949, with the communist party in power, China adopted the Soviet model of the centrally planned economy. All privately-owned enterprises were converted into state-owned enterprises (SOEs). This marked the temporary "disappearance" of the corporate form in China. In 1978, China initiated economic reforms aimed at transforming the centrally planned economy into a market economy. The reform of SOEs through corporatisation came to fruition only in the late 1990s. The lengthy process to corporate reform was largely due to ideological difficulties with the Western notion of private ownership in a market economy. The main concern was that corporatisation would inevitably lead to privatisation. It was believed that corporatisation would dilute state ownership in SOEs, since the selling of shares in SOEs to individuals or private entities would inevitably lead to the transfer of state property to private owners. There was also a belief that public ownership was superior to private ownership, and public ownership was crucial to maintain social stability in the course of economic reforms. The principal goal of China's economic reforms was to develop the economy and to improve people's living standards.

⁵ See Klaus Gugler, Dennis C Mueller and B Burcin Yurtoglu, "Corporate Governance and the Returns on Investment", Volume 47, Journal of Law and Economics (October 2004) at 589 et al.

⁶ However, one should query if the finding in the above study is entirely accurate, as it would mean that companies in civil law countries, on average, are loss-making entities. The finding does not explain the flow of capital to civil law countries in this regard.

Towards this end, social justice and equality had to be upheld. As public ownership was the economic foundation of social justice, it was necessary to maintain the dominance of public ownership in China. It was feared that if the dominance of public ownership was eroded by economic reforms, social disquiet would follow.

The present Company Law,⁷ effective on July 1, 1994, is a culmination of the reform of China's enterprise structure from a state-owned one to a corporatised one. It is, to a great extent, influenced by the civil law model. Under the Company Law, companies are divided into limited companies (or private companies) and joint stock companies (or publicly listed companies). Article 64 of the Company Law also refers to wholly state-owned companies. These are limited companies intended for special products or trades and established solely by an investment institution⁸ or a department authorised by the state⁹.

The Company Law has a number of distinctive features and limitations:

- (a) In a wholly state-owned company, the function of the general meeting is delegated to the board of directors.
- (b) In other types of companies, the shareholders' meeting is the source of primary authority and has wide-ranging powers.
- (c) The powers of the shareholders' meeting and the board of directors are set out in the Company Law.
- (d) The principle of "one share, one vote" applies.
- (e) A shares, B shares, H shares and N shares are all regarded as the same class of shares. The differences among them relate to foreign exchange control restrictions.
- (f) There are many gaps in practical matters and no system of minority shareholder remedies.
- (g) The duties of directors are not spelt out in great detail.
- (h) As mentioned earlier, China has adopted the German model of the supervisory board for joint stock companies.

There are approximately 65,000 companies with the state as the majority of shareholder and annual sales above RMB 5 million. These account for almost one-third of national production, over two-thirds of assets, two-thirds of urban employment and almost three-quarters of investment.¹⁰ Although there has been much liberalization, former SOEs still dominate key parts of the industrial economy, services and infrastructure.

The Company Law, which puts in place a framework for the reform of China's corporate structure, has sought to eradicate the numerous problems associated with SOEs, many of which were on the throes of bankruptcy. Perhaps the most critical problem was the stranglehold which the state had over SOEs, bringing with it the accompanying problems of corruption, inefficiency and serious conflicts between the interest of the state and that of the SOEs. In a nutshell, the lack of "separation of powers" between the state and the SOEs was detrimental to the economic competitiveness and viability of the SOEs. In reality, however, the enactment of the Company

⁷ Adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993, revised at the 13th Session of the Standing Committee of the Ninth National People's Congress on December 25, 1999 and further revised at the 11th Session of the Standing Committee of the 10th National People's Congress on August 28, 2004.

⁸ 国家授权投资的机构。

⁹ 国家授权的部门。

¹⁰ See John H Farrar, "Developing Appropriate Corporate Governance in China", 22(3) *Company Lawyer* (2001) at 92 – 96.

Law in itself has not resolved many previously existed problems, in particular, the state's control over many former SOEs. Most listed companies in China have been restructured and transformed from SOEs, in which the state as the controlling shareholder controls both the shareholders' general meeting and the board of directors, since the members of the board are by and large nominated by the controlling shareholder. The management, too, is controlled by the controlling shareholder. The problem of control by "insiders" is a serious problem in China's listed companies. This "incestuous" corporate structure enables the controlling shareholder to enter into many related party transactions between the listed company and the controlling shareholder, often to the detriment of the interests of the company and minority shareholders. This does not bode well for the development of an effective corporate governance system.

The Chinese government has acknowledged that the lack of good corporate governance practices needs to be addressed urgently. China Securities Regulatory Commission ("CSRC"), for instance, has advocated stronger corporate governance in the country.¹¹ It has stated that the government must bring about changes in the corporate governance of China's market players in order to improve the quality of the domestic market and to gain the confidence of both domestic and international investors. Towards this end, the CSRC and the State Economic and Trade Commission ("SETC") jointly issued the *Code of Corporate Governance for Listed Companies in China* (the "Code") in January 2002. The preface to the Code clearly sets out the *raison d'être* for enacting a specific set of corporate governance rules:

"In accordance with the basic principles of the Company Law, the Securities Law and other relevant laws and regulations, as well as the commonly accepted standards in international corporate governance, the Code of Corporate Governance for Listed Companies (hereinafter referred to as "the Code") is formulated to promote the establishment and improvement of modern enterprise system by listed companies, to standardise the operation of listed companies and to bring forward the healthy development of the securities market of our country."

The Code places emphasis on the protection of shareholders' rights in its formulation of the role of corporate governance. The Code sets out, among other matters, the basic principles for corporate governance of listed companies in China, the mechanisms to protect investors' interests and rights, the basic behavioral rules and standard of conduct for directors, supervisors, managers and members of senior management of listed companies. The intent is for the Code to be the benchmark in evaluating whether a listed company has a good corporate governance structure and whether major problems exist in the company's governance structure. According to the Code, "the securities supervision and regulation authorities may instruct the company to make corrections in accordance with the Code."

However, as elaborated below, the enforcement mechanism of the Code is weak. In a similar vein, with the aim of improving the corporate governance structure of listed companies, the CSRC also formulated the *Guidelines for Introducing Independent Directors to the Board of Directors in Listed Companies* ("Guidelines for Introducing Independent Directors") in August 2001. Again, as explained below, the effectiveness of the guidelines is in question.

¹¹ A critical policy speech on corporate governance reform entitled "*The Future of China's Capital Markets and the Role of Corporate Governance*" delivered by Laura M Cha, the Vice-Chairman of the CSRC, on April 18, 2001 merits in-depth study. A transcript of the speech can be found at the CSRC's website at <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoId=1061948105100&type=CMS.STD>.

IV. The Importance of the Independence of the Board of Directors in Ensuring Good Corporate Governance

Although many former SOEs in China have made the transition to corporatisation relatively smoothly, in many cases the transformation has been in form instead of substance. The state is still the largest, and in most cases, the controlling shareholder in many listed companies. At the end of 2000, 54% of the total shares in China's stock market were held by the state. Listed companies are controlled by the management, which does not always act in the interests of the minority shareholders, in particular. To compound the problem, the management itself is often controlled by the controlling shareholder, i.e., the state, through its web of appointments to the board and the management of the company. Some listed companies do not even convene regular board of director meetings, resulting in little check on managerial power. There are also some directors who do not take the board meeting rules seriously. In some companies, all directors are elected from management. The excessive overlap between directors and executives frequently causes problems of insider control and corruption in management. In some cases, executives are employed at both the parent company and the subsidiary, which lead to conflicts of interest because what may be in the best interest of the parent company may not necessarily be so for the subsidiary.

Unlike Germany or Japan, where concentrated shareholdings are in the hands of the banks which play a relatively effective role in monitoring management, the concentration in shareholding in China rests with the state. Companies in China with highly centralized shareholding structures are faced with the problem whereby the actions and improper influence of controlling shareholders can lead to the detriment of the interests of the minority shareholders and, often, those of the company, especially when there is a conflict between the interest of the controlling shareholders and that of the company.

Sound corporate governance practices require effective “checks and balances”. No one shareholder or stakeholder should become so powerful as to undermine the proper monitoring of the company’s performance.¹² When one individual or entity becomes too powerful, abuse of that power is likely to lead to the oppression of the shareholders in a company. It is submitted that in China, the greatest hurdle to attaining a healthy corporate governance culture is the lack of independence of the board of directors from its controlling shareholder – the state. In a country where the importance of “relationships” or “*guanxi*” is pervasive at all levels of the social, economic and political strata, it is imperative that the legal, judicial and regulatory framework can effectively enforce the notion of an independent board of directors.

The corporate landscape and company law structure in China are unique, although they bear a semblance in many respects to their counterparts in Germany and other countries with a civil law tradition. An important consideration is the fact that China is in transition from a centrally planned economy to a market economy. As such, its capital market and other markets are not yet mature, although the framework is in place. In market economies, the market (be it the capital market, product market or labour market) acts as a powerful external monitoring mechanism in ensuring that a company maintains good corporate governance. This is not the case in China.

¹² A good analogy to the role played by a system of “checks and balances” is the Westminster model of government in the United Kingdom, the United States and throughout the common law world and Western democracies. The foundation of the Westminster model is the concept of separation of powers between the executive, the legislature and the judiciary. This allows each branch of government to “check” on the other two branches, ensuring that no individual or branch of government becomes too powerful, which can result in abuse of power and ultimately, oppression of the citizens in the country. In the context of the company, the “citizens” of the company are the shareholders.

Thus, it is even more crucial to have an effective internal “check and balance” system in Chinese companies, underscored by an independent board.

Many scholars have delved into the myriad of problems and limitations faced by China as it embarks on reforms in its corporate governance system.¹³ The following synopsis of these problems and limitations serves to buttress the argument that an independent board will help alleviate many of these problems. First, as mentioned earlier, despite corporatisation and the public listing of former SOEs, the state’s shareholding in these companies remains very substantial. With a concentrated shareholding and relatively weak minority shareholders, both the shareholders’ general meeting and the board of directors are effectively controlled by the state. The monitoring of the company’s performance by the shareholders or the board is thus an illusory one. As the controlling shareholder has the power to appoint members of the board and wields great influence over the appointment of senior management, it is inevitable that those in charge of the company will feel beholden to the state. As a result, there is frequent criticism that the management in these companies spends more energy in “pleasing” government officials whom they are beholden to instead of acting in the best interests of the company.

Secondly, the role of the state as a controlling shareholder and its administrative role as a regulator and policy maker often become blurred. Article 4 of the Company Law states that “the ownership right over the state assets of a company belongs to the state”. The problem arises as it is difficult to distinguish between the state’s actions as a shareholder and the state’s actions in its administrative capacity. Many of these companies are run by former government bureaucrats, appointed by the respective government agencies who are custodians of the state’s shareholdings in these companies. In such a scenario, the ownership rights of a shareholder and a company’s rights as a separate legal entity become enmeshed.

Thirdly, a limitation in China’s corporate governance framework lies in the relatively new capital, product and labour markets. Potentially, these markets can serve as effective checks on the management. However, while these markets slowly evolve and mature, these external monitoring mechanisms cannot yet be fully relied on in this respect.

The importance of an independent board of directors in China’s listed companies cannot be understated. Chapter 2(1) of the Code specifically talks about the independence of the board of a listed company. The CSRC also underlined the necessity of having an independent board when it adopted guidelines to strengthen the independence of the board through its issuance of the Guidelines for Introducing Independent Directors, which require at least one-third of the board to be comprised of independent directors.

To ensure the independence of the board, the following three factors are critical.

(a) The de-linking of the relationship between a listed company and its controlling shareholders

The inextricable nexus between many Chinese companies and their controlling state shareholders has often led to the detriment of the interests of the company and other shareholders, in what can be summarized as “omnipotent managers, little resistance”. There have been many newspaper reports of companies being run by bureaucrats who were uninterested in managing the companies

¹³ For further readings on the general problems of corporate governance in China, see (1) 于群著：《公司治理问题研究》，广东人民出版社，2004年版；(2) 滨田道代、吴志攀主编：《公司治理与资本市场监管》，北京大学出版社，2003年版；(3) 刘连煜著：《公司治理与公司社会责任》，中国政法大学出版社，2001年版。

and who plundered the companies' assets. Government bureaucrats are often board members and senior executives. Conflicts of interest like this prevent the separation of business from government. The end result is inefficiency, misappropriation of assets and lack of accountability.

Furthermore, some government agencies still treat corporatised former SOEs as traditional SOEs and control them in traditional ways using excessive administrative power. These control measures include holding on to the power to approve decisions already made by the board of directors, bypassing the general meeting of shareholders, directly appointing directors and executives and interfering with day-to-day operations. A survey conducted by the China Confederation of Enterprises in 1999 revealed that in many of these companies, the management team was still nominated by government departments instead of the board of directors. Approximately 51% of the respondents believed that their most difficult job was to maintain a good relationship with government agencies. The survey also revealed that most managers were so busy dealing with numerous and repeated inspections and examinations by government agencies that management of the company operations was compromised. Approximately 25% of the respondents reported that their companies were unable to overrule governmental decisions with respect to joint ventures, mergers, or disposal of company assets. As the survey demonstrated, the system under which traditional SOEs operated, in which the government was heavily involved in the management of the enterprises, is deeply entrenched despite efforts at corporate reform with the enactment of the Company Law.

The market-based corporate governance regime values transparency of ownership and control arrangements. This principle should be firmly rooted in China's corporate governance system as well. The de-linking of the relationship between the company and its controlling shareholder is essential to achieving corporate transparency and full disclosure. Companies must be free from unwarranted government intervention and enjoy relative autonomy as a separate legal entity. This will result in better investor protection, which will in turn help attract external capital. The Chinese government has recognized the need for corporate autonomy and for the separation of the government functions from corporate functions, as can be seen from the provisions in the Code relating to the behavioural rules of controlling shareholders. In 2003, the 10th National People's Congress approved reforms in respect of the government's role in state assets and SOEs. The aim of the reform measures is to consolidate the management of government assets under one central body – the State-Owned Assets Supervision and Administration Commission (国有资产管理委员会) --so as to establish a just, fair and transparent market environment. Towards this end, new measures emphasize the need to distinguish the government's role as a regulator from its rights as a shareholder.

To ensure that the company is free from improper control by the state, more concrete measures are needed to de-link the relationship between the two. First, regulations and guidelines should set out more specifically the role of the State-Owned Assets Supervision and Administration Commission. It is important to detail the scope of the government's rights and duties as a shareholder and differentiate these from its powers as a regulator. Secondly, in nominating board members and the management team, the state should select candidates on the basis of competence and meritocracy instead of appointing "insiders" and inexperienced government bureaucrats who are beholden to their appointers. Thirdly, the Code should be more effectively enforced. Articles 19 to 23 of the Code set out the "dos and don'ts" of a controlling shareholder. For instance, Article 20 states that the controlling shareholder is forbidden from appointing senior management personnel by circumventing the shareholders' meetings or the board of directors, and that the nominated candidates should possess certain relevant professional knowledge. The provisions in the Code will more effectively promote de-linking the relationship between the company and the

controlling shareholder if concrete regulations and guidelines to this effect (for example, in the Company Law) can be drawn up and implemented.

All in all, as agents of the state shareholder, the relevant government agencies should exercise shareholders' rights on behalf of the state shareholder but not interfere in the day-to-day management and operations of a company. The state should enjoy the same shareholder rights as private investors. However, it should refrain from exerting improper control over the business of a company.

(b) The balance of powers between shareholders and the board of directors

The need for a balance of powers between the shareholders and the board and, in particular, for the protection of the rights of minority shareholders, follows from the need to protect the autonomy of the board from improper influence of the controlling shareholder.

A strong corporate governance regime must, first and foremost, protect the interests of the company's shareholders, especially minority shareholders. This is all the more critical in China where "insider control" in companies is prevalent and where there are no well-developed external monitoring mechanisms (for instance, an effective capital market). In the United States and United Kingdom, minority shareholders' interests can be addressed through personal, representative or class actions against the company or the board of directors if their rights are infringed. They can also, in certain circumstances, bring a suit on behalf of the company against errant officers of the company who act contrary to the best interests of the company. Under this system of remedies for minority shareholders, should the board be under the improper control or influence of a controlling shareholder, the remaining shareholders can serve as a "check" on the board's actions, thereby reinforcing the independence of the board.

Article 111 of the Company Law states:

"If the resolutions of a meeting of shareholders or the board of directors have violated the law, administrative decrees or encroached upon the legitimate rights of shareholders, the shareholders concerned have the rights to sue at the people's courts, to demand that such acts of violation or infringement be stopped."

However, without detailed regulations and procedures for enforcing shareholders' litigation rights, such rights are bereft of practical benefits to the shareholders concerned. The balance of powers is hence tipped in favor of the board. Under China's Securities Law, the litigation rights of affected shareholders are not spelt out, either. In September 2001, the Supreme People's Court issued a decree which stated that the courts would temporarily not adjudicate on civil compensation claims relating to securities.¹⁴ Although the Supreme People's Court later issued another decree¹⁵ to set out the jurisdiction of the courts in handling civil compensation claims arising from securities transactions in limited circumstances (when the loss is caused by false statements or misrepresentations), the fact remains that the scope of shareholders' right to sue when their ownership rights are infringed is both limited and vague. Broader and more concrete rights to sue along the lines of such rights under the Anglo-American system should be incorporated. Without effective enforcement, the minority shareholders will have a weak position vis-à-vis the board and the powerful controlling shareholder.

¹⁴ See 《关于涉及证券民事赔偿案件暂不予受理的通知》.

¹⁵ See 《关于受理证券市场因虚假陈述引发的民事侵权案件有关问题的通知》(2002).

(c) The effectiveness of the regime of independent directors as a “check and balance” on the board of directors

The two-tiered board system in listed companies represents an internal monitoring mechanism whereby the supervisory board is supposed to monitor the performance of the board of directors. However, experience has shown that this system of supervision is not effective as it is often unclear whose interest the supervisory board represents. In many cases, the supervisory board duplicates the authority of the board of directors itself without corresponding responsibilities. In fact, the presence of the supervisory board may give the illusion of certain checks and balances in the listed company when none exists. As such, the CSRC issued the Guidelines for Introducing Independent Directors to introduce independent directors to improve the corporate governance structure and monitoring system in listed companies.

The concept of independent directors is a strong feature in Western models of corporate governance, especially in the market-based model in common law countries that do not have supervisory boards. However, the effectiveness of independent directors is not guaranteed as their true independence may be called into question. Many companies feel that their independent directors find it hard to maintain their stance on sensitive issues as they are concerned about offending the people in control of the company. First, the overwhelming majority of independent directors are recommended by controlling shareholders or other directors. Therefore, they are less likely to openly oppose the controlling shareholders. In addition, personal relationships are important in the Chinese culture. Maintaining relationships has become a priority for most independent directors and, hence, many independent directors would be reluctant to undermine their relationship with controlling shareholders or other directors.

In addition to the independence problem, independent directors are faced with other problems: (1) They do not have the necessary compensation incentives; (2) Their limited knowledge about the overall business of a listed company may prevent them from making informed decisions; and (3) They find it hard to carry out their duties and responsibilities at a time when control by insiders and the presence of a single dominating shareholder are common problems among listed companies.

Apart from limited time and energy devoted to company affairs and lack of information, independent directors have other constraints: (1) Lack of legal protection and detailed regulations in respect of the role of independent directors; (2) Drawback in independent directors' qualifications and expertise, and (3) The impact of the social and cultural environment.

To enhance the effectiveness of the regime of independent directors as a “check and balance” on the board of directors, the above deficiencies in the system should be addressed. Most importantly, the Company Law or the Guidelines for Introducing Independent Directors should stipulate specific enforcement measures when any of the rules or guidelines is breached. For instance, the nomination of independent directors by the board of directors or controlling shareholders should be based on objective criteria.¹⁶ Minority shareholders should have the right to contest the nominations or appointments of independent directors should there be any alleged impropriety. As can be seen, the effectiveness of the role of independent directors in monitoring the board of directors is complementary to the institutionalization of an independent board.

¹⁶ Part IV, Article 1 of the *Guidelines for Introducing Independent Directors* provides: “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, who will be voted at the shareholders' meeting”.

Directors, management and controlling shareholders have to act in the company's best interests, and principally for the benefit of the general body of shareholders.¹⁷ The strength of the Anglo-American corporate governance system also lies in the key role played by the judiciary in making sure that the board of directors fulfils its fiduciary duties, including the duty of care and duty of loyalty. In the United States, the state courts, and not the legislature, have primarily shaped the scope and set the benchmark for corporate fiduciary duties. More rules and regulations alone would not in themselves be sufficient to improve the quality of corporate governance in Chinese companies. To have an effective and sound regulatory system, there must be vigilance in the supervision of the companies and robustness in the government's enforcement efforts. As in the Anglo-American system, the regulatory system must be supported by a strong legal and judicial framework. It is suggested that legislation should be introduced to allow for greater judicial involvement and power to enforce corporate governance measures laid down by the regulatory regime. The relevant government agencies, together with the judiciary, should also work together to fulfil the goals laid down by the laws and regulations.

V. Conclusion

In Jim Collins' best-selling business management book, "*Good to Great: Why Some Companies Make the Leap...and Others Don't*", the author, upon studying the performance of 1,435 companies, found that for a company to make the transition from good to great, it does not require a high-profile CEO, the latest technology, innovation management or even a fine-tuned business strategy. At the heart of those rare and truly great companies is a corporate culture that rigorously finds and promotes disciplined people to think and act in a disciplined manner. Effective corporate governance requires discipline – the discipline of the board of directors to act independently of any improper influence from shareholders or otherwise, the discipline of management to act in the best interests of the company, the discipline to protect shareholders' investments and, ultimately, the discipline that will instill confidence in the company's investors. The globalization of China's companies has a bright future. The recent acquisition of IBM's personal computer business by Lenovo, China's largest maker of personal computers, is a testimony to China's determination and initial success in building up its presence in the international corporate and commercial arena¹⁸. It reflects rising global aspirations of corporate China. However, reforms in corporate governance must continue in order to improve the quality of China's markets and gain the confidence of both domestic and international investors. It is through determination and discipline that we will ensure that reforms in corporate governance will culminate in the successful globalization of not merely good, but truly great Chinese companies.

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¹⁷ Article 33 of the Code stipulates that "directors shall faithfully, honestly and diligently perform their duties for the best interests of the company and all the shareholders".

¹⁸ In an analysis of the Lenovo-IBM deal in the New York Times, "*IBM Sought a China Partnership, Not Just a Sale*" (December 13, 2004), China's initial success in creating a modern and international Chinese-owned corporation was lauded.

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