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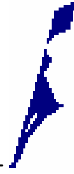

INDEPENDENT DIRECTORS? SUPERVISORS? WHO SHOULD MONITOR CHINA'S BOARDS?

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Abstract

After the collapse of a number of well-known companies such as Enron and WorldCom, there has been much debate over which is the most effective model of corporate governance in monitoring the board of directors from misconduct: the Anglo-American model of independent directors or the German model of supervisory boards. Most countries have chosen to adopt one either the Anglo-American or the German model. However, the People's Republic of China ("China") has adopted both models of corporate governance. This paper seeks to explore the differences between the two models as they apply in China. Further, it examines the challenges which these two models face with regard to their implementation. Finally, an evaluation will be made to ascertain whether the two models encounter the same problems and whether either or both of these two models would be able to effectively monitor Chinese boards.

Keywords: directors, independence, monitoring, China

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Introduction

The People's Republic of China ("China") has come a long way in its strive for a western style of corporate governance for companies listed in China. It has been commented that the new corporate governance rules and structures are highly impressive to foreign observers *(see endnote 1)*. Further, China's strong desire to adopt western style of corporate governance has also been questioned as, after all, the laws and regulations dealing with this area are mandatory and, more seriously, companies failing to comply with them risk the prospect of heavy fines and penalties. This has puzzled some people, as one commentator put it:

Measured by purchasing power parity, China is already the world's second largest economy after the US and has experienced one of the fastest industrializations in history. So no one could argue that good governance is necessarily critical to economic development. (see endnote 2)

This question may be answered by the fact that many Chinese Chief Financial Officers see corporate governance as a means to attracting foreign capital *(see endnote 3)*. However, one foreign observer has expressed a different view and has commented that:

China has 1160 publicly listed state-owned enterprises... Currently, all of these 1160 companies are majority owned by the Chinese state. Hence, corporate governance, far

from providing protection for minority shareholders, is in fact simply providing a mechanism whereby the state can prevent enterprise management from stealing from it. (see endnote 4)

Regardless of the reasons for China's adoption of western style corporate governance, China had been very keen to adopt such style. In fact, when it comes to the means of monitoring the board of directors, it had adopted both the Anglo-American model of having independent directors on the board, as well as the German model of supervisors to look over the board. This paper examines the legal and regulatory regimes dealing with this area, as well as the differences between independent directorship system and the supervisory system as they apply in China. It also seeks to explore the challenges encountered during the implementation of these systems. Finally, an evaluation will be made to ascertain which system is perhaps the more effective in monitoring the board of directors in China.

Legal and Regulatory Regimes

Independent Directorship System

The main regulation dealing with independent directors in China is the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies ("Guidelines"), issued by China Securities Regulatory Commission ("CSRC") on 16th August 2001. These Guidelines are mandatory and all listed companies in China are required to comply with the requirements set out in the Guidelines *(see endnote 5)*. These Guidelines make it compulsory that, by 30th June 2002, at least two directors of the board must be independent directors; and, by 30th June 2003, at least one third of the board must be independent directors *(see endnote 6)*.

The Guidelines define an "independent director" to be a director who holds no posts in other company other than the position of director, and who maintain no relations with the listed company and its major shareholder that might prevent them from making objective judgment independently *(see endnote 7)*. To be an independent director of a listed company in China, apart from satisfying the above definition, he/she must also satisfy the "independence" requirements listed below:

- He/she must not hold a position in the listed company or its affiliated enterprises, nor can their direct relatives *(see endnote 8)* or their major social relations *(see endnote 9)* hold such position in such enterprises *(see endnote 10);*
- He/she must not hold more than 1% of the outstanding shares of the listed company directly or indirectly *(see endnote 11);*
- He/she must not hold a position in a unit which holds more than 5% of the outstanding shares of the listed company directly or indirectly, or of the unit which ranks as one of the five largest shareholders of the listed company *(see endnote 12);*
- He/she must also not satisfy any of the above conditions in the immediate proceeding year *(see endnote 13);*
- He/she must not provide financial, legal or consulting services to the listed company or its subsidiaries *(see endnote 14);*
- He/she must not be the person stipulated in the articles of association as some one who is inappropriate to take up such position *(see endnote 15);*
- He/she must not be the person determined by the CSRC as an inappropriate person for such post *(see endnote 16).*

Supervisory System

In contrast with the independent directorship system, which is governed mainly by the Guidelines, the supervisory system in China is governed by both the Company Law of the People's Republic of China *(see endnote 17)* ("Company Law") as well as the Code of Corporate Governance for Listed Companies in China *(see endnote 18)* ("Corporate Governance Code"). Unlike the case with independent directorship system, the Corporate Governance Code does not appear to have specified the number of supervisors which a company must have. Nevertheless, the Company Law does deal with one type of company in this respect, as article 124 stipulates that a joint stock company limited *(see endnote 19)* must have a supervisory committee, which must have at least three persons and be made up of shareholders' representatives and representatives of staff and workers. To ensure the representation of shareholders and workers at the supervisory committee, some officers in the company, such as directors, manager and financial officers, cannot serve concurrently as supervisors *(see endnote 20)*. The spirit of supervisory system appears to be different from that of independent directorship system, in that, in the case of independent directors, they are directors appointed to monitor the conduct of executive directors. Supervisors, on the other hand, seem to be appointed for the purpose of providing some representation by the shareholders and workers at the company's decision-making level. Thus, the question which naturally follows, that is, the powers possessed by these two groups, i.e., independent directors and supervisors, is examined below.

Powers of Independent Directors vs. Powers of Supervisors

According to the Guidelines, once a person becomes an independent director of a listed company in China, he/she is obliged to exercise the powers stipulated in the Company Law, as well as being

permitted to have the power to perform the following functions:

- Approve major related party transactions *(see endnotes 21, 22);*
- Put forward the proposal to the board of directors relating to the appointment or removal of the accounting firm *(see endnote 23)*;
- Propose to the board of directors to call an interim shareholders' meeting *(see endnote 24)*;
- Propose to call a meeting of the board of directors *(see endnote 25)*;
- Appoint an outside auditing or consulting organization independently *(see endnote 26)*;
- May choose to solicit the proxies before the convening of the shareholders' meeting *(see endnote 27).*

Regarding the powers and roles of supervisors, on the other hand, the Corporate Governance Code appears to prescribe very similar power to those possessed by independent directors, in which "the supervisory board may ask directors, managers and other senior management personnel, internal auditing personnel and external auditing personnel to attend the meetings of supervisory board and to answer the questions that the supervisory board is concerned with" *(see endnote 28).* On this point, the Company Law seems to provide a more comprehensive list of powers which supervisors have, either acting alone or as a committee, as article 126 states that supervisors may exercise the following powers:

- Check up on the financial affairs of the company;
- Supervise over acts of directors and manager to ensure that they do not violate laws, regulations or the company's articles of associations;
- Request remedies from directors or manager where their acts have harmed the company;
- Propose the convening of interim meetings of the board of directors; and,
- Other powers as provided for in the articles of association *(see endnote 29).*

Challenges with Implementation

While the Anglo-American model of independent directorship and the German model of supervisory board are both in place in China, it is worthwhile examining whether either or both of these models have been effectively and successfully implemented. It is also useful exploring whether some of the difficulties with implementation encountered by one model are also experienced by another model, as, after all, the middle kingdom had (almost) always done things its own way and thus the transplantation of any "foreign" system may be fraught with similar sets of challenges in China.

Independent Directorship System

The main challengers encountered by China when attempting to implement the Anglo-American model of independent directorship system include: lack of qualified personnel able to take up such posts, state influence and independent directors unable to properly perform their tasks. These challenges are discussed in detail below.

Lack of qualified independent directors

The Guidelines issued by CSRC dealing with independent directors are mandatory and apply to all companies listed on domestic exchanges in China *(see endnote 30).* Article I(3) expressly stipulated that "by 30 June 2003, at least one third of board members must be independent directors *(see endnote 31).*" This requirement had, indeed, put tremendous pressure on the large number of companies listed in China (over 1200 companies in 2003 *(see endnote 32*) to try to find a sufficient number of "qualified" independent directors to fill such posts. While the CSRC appears to be optimistic at the time of issuing the Guidelines, this certainly created enormous challenges on the companies trying to comply with these requirements and, as a result, the decision to have the required number of independent directors on board as part of a sweeping campaign to improve corporate governance was delayed in 2001 due to difficulties in finding qualified independent directors *(see endnote 33).*

Given majority of listed companies in China already experienced enormous difficulties in trying to have sufficient number of qualified independent directors on board to satisfy CSRC's mandatory requirements, the fact that the CSRC later on took a tough stance in enforcing its Guidelines meant that it made it even more difficult for companies to fill such posts. A well-known example demonstrating CSRC's enforcement efforts is the case of Professor Lu, an independent director in a Shanghai-listed department store. On this case, it was reported that:

In September [2001]… CSRC fined an independent director for the first time. Lu Jiahao of Shanghai-listed store Zhengzhou Baiwen was fined RMB 100,000 for failing to fulfil his fiduciary duties…

More than 10 independent directors have resigned in the past year *(see endnote 34).* The relative mass scale resignation of independent directors is not surprising given that "most directors are paid less than RMB 50,000 a year. None of these independent directors receive more than this amount" *(see endnote 35).* As directors, particularly the independent directors, are not remunerated highly for their responsibilities, the fact that a fine can be more than twice their annual income, it is not surprising that people are reluctant to take up such posts.

The end result appears that it may be even more difficult for Chinese-listed companies to find sufficient number of qualified independent directors to fulfil the "quota" requirement imposed by the CSRC.

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State Influence

The State's influence over companies appears to be prevalent in China. According to the findings of the World Bank and the International Finance Corporation, *(see endnote 36)* they concluded that:

Local governments were responsible for selecting which companies were to be listed... Thus the companies that are listed on China's stock exchanges are mostly SOEs. They have strong links with the government, especially local governments, and their boundaries with their parent groups are relatively new and often artificial (see endnote 37).

The survey conducted by the above two organization of 257 companies listed on the Shanghai Stock Exchange found that "in more than 95% of the cases, the state is directly or indirectly in control of listed companies" *(see endnote 38).*

Further, it was also found that the state plays a significant role in the selection of directors and supervisors of listed companies, as can be demonstrated from the table below:

Table 1. Selection of Directors and Supervisors of Listed Companies (per cent) *(see endnote 39)*

	Total	Executive Directors	Non-Executive Directors	Supervisors
State Shares *(see endnote 40)*	28	36	16	25
State-owned Legal Person Shares *(see endnote 41)*	45	44	54	44
Public Legal Person Shares	18	13	27	12
Internal Employee Shares	3	3	1	11
Publicly Circulating Shares	6	5	2	7

Given the extent of the influence which the state appears to have been able to exert over the listed companies in China, both in terms of the selection of which companies are to be listed to the selection of who should take up a position on the board of directors, it is questionable whether independent directors would be able to have "independence" required to properly perform their jobs as required by the Guidelines. On a related note, such a challenge does not seem to be unique to China's independent directors. Whilst in many other countries, the influence of the state may not be as prevalent, if at all, many independent directors in other countries still face the difficulties of not being able to perform their tasks properly. Some described independent directors to be living in a paradox state of "Jekyll-and-Hyde": boardroom-friendly by day and a shareholders' informant by night; and bearing the responsibilities of being a policeman and the golfing partner as the same time *(see endnote 42)*. Further, as independent directors are, in effect, "outsiders" to the management of the company, they may rarely be given all of the relevant information to allow them to properly perform their jobs. Therefore, it appears that, in respect to the issue of independent directors not being able to perform their jobs properly, Chinese independent directors may not be alone.

Supervisory System

While supervisory committees in Chinese companies normally consist of shareholders' and workers' representatives, a recent study *(see endnote 43)* found that such supervisors can be categorised into four types, namely: (1) an honoured guest *(see endnote 44)*; (2) a friendly advisor *(see endnote 45)*; (3) a censored watchdog *(see endnote 46)*; and, (4) an independent watchdog *(see endnote 47)*. It was found that most supervisory boards tend to be of the first three types *(see endnote 48)*, and therefore, the effectiveness of such supervisory system in monitoring the conducts of directors and executives may be questionable. Unlike the independent directorship system where lack of qualified personnel was a serious problem, under the supervisory system, such does not appear to be an issue, as the supervisors may simply be appointed from the large pool of shareholders and workers. However, it appears that many other challenges encountered by independent directors, in an attempt to ensure that the board of directors and/or controlling shareholders do not abuse their powers, are also experienced by the supervisory boards. The most predominant reasons behind the perceived ineffectiveness of the supervisory system may also stem from the strong state influence as well as the supervisors unable to properly perform their jobs. These are discussed below:

Challenges with Effective Implementation of Supervisory System

The State appears to have direct control (and thus substantial power) over the supervisors, as can be demonstrated by the fact that the state, through various means of shareholding structures, is still largely responsible for the selection of supervisors. This has been shown in Table 1. Further, such control appears to also be present in certain companies which issue B-shares to foreign investors *(see endnote 49)*. In addition, as the state also effectively controls the appointment of the Chairman and Deputy Chairman *(see endnote 50)*, it is questionable whether supervisors would be able to effectively monitor the conducts of the directors and/or controlling shareholders. Compounding to the difficulties described above, it appears that there is a perception that supervisors occupy an inferior

position in the corporate governance power structure and are seen as subordinates of directors and senior managers *(see endnote 51)*, therefore, making the effectiveness of supervisory boards' monitoring of other executives even more difficult. This may be demonstrated with the following case.

As a background, CSRC requires all listed companies in China are required to include a Supervisory Board Report (SBR) in their annual reports *(see endnote 52)*. As such, a supervisor with a strong accounting background of a particular company was reported to have revealed:

Last year's SBR was quite frank but it was killed when the cadres of the factory met. This year's report was accepted straight with no amendment at all. This report is against my will...In fact, last year's SBR was revised following the rejection. But even so, not all of the revised version was included in the annual report. The Secretary to the Board of Directors made some cuts... The managers of the factory wanted me to state in the report that "there are no illegal acts in the company". I dared not to write it that way. So I reported "No illegal acts were discovered" instead. (see endnote 53)

In addition to the perceived inferiority of position of the supervisory board, there appears to be other reasons why the supervisors may not be as effective as they perhaps could be. One of the most obvious reasons may be the type of people that ended up taking the appointment of a supervisor. For example, in case of an "honoured guest", he/she has only a mere physical existence and is normally technically incompetent or retiring with little motivation *(see endnote 54)*. As such, it has been reported that in one company:

Our supervisory board basically does nothing. Even when they review the annual financial statements, it was [the Financial Controller] who gave them a brief introduction. They only meet twice a year, one before the semi-annual report is released and the other before the publication of the annual report. Each meeting lasts for about half an hour. It is merely a formality...It is the secretary to the Board of Directors who drafts the SBR... It really is of little use. As financial controller, I tell supervisors what I should and never inform them what I do not think I should tell. (see endnote 55)

Despite the challenges encountered by supervisory boards to effectively monitor the boards in general, there appears to be one type of supervisory board which may prove to be more effective, namely, the category being identified as independent watchdog. This type of supervisory boards tended to be in companies that predominantly issue B-shares, H-shares or shares listed in foreign exchanges *(see endnote 56)*. These companies are more likely to be subject to strict monitoring by foreign auditors and investors, supervisory boards in these types of companies may be more independent compared with supervisory boards in other types of companies, such as A-share companies *(see endnote 57)*. However, it was found that very few supervisory boards fell into this group *(see endnote 58)*. Therefore, it seems that supervisory boards may be experiencing the same level of difficulty when it comes to monitoring the board and/or controlling shareholders as independent directors.

Conclusion

In pursuit of western styled corporate governance practices, China has adopted both the Anglo-American model of independent directorship as well as the German model of supervisory boards. Whilst the source of recruits to fill the posts of independent directors and supervisors appear different, many of the roles that they are expected to play seem similar. Further, both seem to face similar challenges when it comes to their ability to effectively monitor the board and the controlling shareholders. As the state remains ultimately responsible for the selection of both independent directors and supervisors, their ability to independently and effectively keep an eye on the board and controlling shareholders may be constrained. Further, like other people who play the same role elsewhere in the world, a predominant challenge which they also face, irrespective of whether they are independent directors or supervisors, is that they are often being treated as an "outsider", therefore, rarely given sufficient update information about the company for them to properly perform their jobs. Perhaps the existence of both these two western styled corporate governance practices in China may be summed up by an observation – "by fusing together American and German corporate practices with "Chinese characteristics", the government hopes to balance enterprise autonomy with government control, centralization with collaboration and economic with socio-political objectives" *(see endnote 59)*.

Endnotes

[1] M Hutchinson, "The Bear's Lair: Do We Need Governance?", *United Press International*, 4 March 2002.

[2] J Plender, "Capitalism, Higgs and the China Syndrome: Home Thoughts, Oriental Habits", *Financial Times*, 27 January 2003, p. 24.

[3] A survey conducted by the Association of Chartered Certified Accountants (ACCA) found that, "China had a whopping 90% of their CFOs saying they had performed post-Enron formal reviews. The respondents from mainland China do see corporate governance as a business issue to attract capital markets." – L Lin, "Management: NED Need to Play Larger Role", *The Edge Malaysia*, 16 December 2002.

[4] M Hutchinson.

[5] Preliminary, Guidelines.

[6] Article I(3), Guidelines.

[7] Article I(1), Guidelines.

[8] Direct relatives refer to their spouse, father, mother and children, etc. (Article III(1), Guidelines).

[9] Major social relations refer to their brothers, sisters, father-in-law, mother-in-law, daughter-in-law, son-in-law,

spouse of their brothers, sisters, and their spouse's brothers and sisters, etc. (Article III(1), Guidelines).
[10] Article III(1), Guidelines.
[11] Article III(2), Guidelines.
[12] Article III(3), Guidelines.
[13] Article III(4), Guidelines.
[14] Article III(5), Guidelines.
[15] Article III(6), Guidelines.
[16] Article III(7), Guidelines.
[17] Company Law of the People's Republic of China, adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993 and came into effect on 1 July 1994. ("Company Law")
[18] Issued by China Securities Regulatory Commission and State Economic and Trade Commission on 7 January 2001.
[19] A joint stock company limited is one type of "company" recognized under the Company Law of the People's Republic of China. The other type is a limited liability company (Article 2, Company Law). Both types of companies are regarded as enterprise legal persons (Article 3, Company Law). For a joint stock company limited, the entire capital is divided into shares of equal amount and the shareholders bear responsibilities to their company within the scop of the number of shares they hold and the company bears responsibilities for its debts with company assets (Article 3).
[20] Article 124, Company Law.
[21] Major related party transactions refer to transactions that the listed company intends to conclude with the related party and whose total value exceeds RMB three million or 5% of the company's net assets audited recently. (Article V(1)(a), Guidelines)
[22] Article V(1)(a), Guidelines.
[23] Article V(1)(b), Guidelines.
[24] Article V(1)(c), Guidelines.
[25] Article V(1)(d), Guidelines.
[26] Article V(1)(e), Guidelines.
[27] Article V(1)(f), Guidelines.
[28] Article 67, Corporate Governance Code.
[29] Article 126, Company Law.
[30] Preliminary, Guidelines.
[31] Article I(3), Guidelines.
[32] J Plender, at 24.
[33] C Li, "Independent Directors Quit as CSRC Gets Tough", *South China Morning Post (Hong Kong), Business Post*, 2002, p 4.
[34] Ibid.
[35] "Corporate Governance: A Question of Control", *China Economic Review*, 23 August 2002.
[36] S Tenev and C Zhang, "Corporate Governance and Enterprise Reform in China", World Bank and International Finance Corporation, Washington, 2002, at 75.
[37] Ibid.
[38] Ibid, at 76.
[39] Ibid, at 84.
[40] State shares are held by central and local governments, which are represented by local financial bureaus, state asset management companies, or investment companies. State shares can also be held by the parent of the listed company, typically an SOE: ibid, at 76.
[41] Legal person shares are held by domestic institutions, such as industrial enterprises, securities companies, trust and investment companies, foundations and funds, banks, construction and real estate development companies, transportation and power companies, and technology and research institutes. These institutions are further classified according to their ownership structure as SOEs, state-owned non-profit organizations, collectively owned enterprises, private enterprises, joint stock companies, and foreign-funded companies: ibid.
[42] P Ham, "Wary Watchdog is Just What Boards Need – Corporate Governance: Business Survey Series", *The Australian*, 23 May 2003, p. 14.
[43] J Dahya, Y Karbhari, J Xiao and M Yang (2003) "The Usefulness of the Supervisory Board Report in China", *Corporate Governance*, Volume 11 Number 4, 308-321.
[44] As an honoured guest, the Supervisory Board has only a mere physical existence. The Supervisory Board briefly meets twice a year, and the supervisors are technically incompetent, or retiring with little motivation. They are not provided with updated information about the activities of the company, its directors and executives: J Dahya, Y Karbhari, J Xiao and M Yang (2003) "The Usefulness of the Supervisory Board Report in China", *Corporate Governance*, Volume 11 Number 4, at 313.
[45] The friendly advisors convene supervisory board meetings at least twice a year. In addition, they attend meetings of the board of directors. Although they are not empowered to vote at such meetings, they do have freedom to air their views. However, they are strongly dependent on the board of directors or the CEO, and thus are not in a position to monitor the board of directors and executives: Ibid.
[46] This type of supervisory board is particularly strong in terms of technical expertise. The supervisors attempt to undertake their legal duties diligently. However, the board of directors and/or senior executives play a dominant role. Although the supervisory board is allowed to exercise monitoring, it is not permitted to disclose faithfully their finding in the Supervisory Board Reports: Ibid, at 315.
[47] The distinguishing feature of these types of supervisory boards is that they tended to be in companies that predominantly issue B-shares, H-shares or shares listed in foreign exchanges: Ibid.
[48] Ibid, at 313.
[49] Ibid, at 317.
[50] Ibid.
[51] Ibid.
[52] This is a requirement stipulated by CSRC in its "Standards on the Content and Format of Information Disclosure by Public Issuing Companies. No. 2: Annual Reports", 1998.
[53] J Dahya, at 315.
[54] Ibid, at 313.
[55] Ibid.
[56] Ibid, at 315.
[57] Ibid.
[58] Ibid.
[59] J Matias (1999) "From Work-Units to Corporations: The Role of Chinese Corporate Governance in a Transnational Market Economy", 12 New York International Law Review, Volume 1 (obtained from Westlaw, at 12).