

Formal Convergence or Substantial Divergence? Evidence from Adoption of the Independent Director System in China

Jie Yuan*

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*LL.D. Candidate, Kyushu University, Japan. E-mail: duduyuanjie@hotmail.com. This paper is based on the presentation paper prepared for Kyushu University's Corporate Governance in East Asia Conference on February 10, 2007. The author would like to thank Professors James D. Cox, Kon Sik Kim, Ken Osugi, Bing Peng, and colleagues Peter Lawley and Dan W. Puchniak for their insightful presentations and comments. The author would also like to thank Professors Michiaki Abe, Caslav Pejovic and Mark Fenwick for their insightful comments on earlier drafts.

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I. INTRODUCTION

The adoption of American corporate governance institutions in other countries may give the impression that global corporate governance is converging toward the American model, especially in terms of formal structures. This is reflected in Professor Henry Hansmann and Reinier Kraakman's recent article, which uses the adoption of American institutions as evidence of convergence.¹ In particular, the prolific adoption of American institutions in developing countries, under the influence of foreign funders such as the International Monetary Fund (IMF) and the World Bank, reinforce the argument.² This article asks whether it is right to assume that the evidence of transplanted American institutions is tantamount to convergence.

The independent director system is an important aspect of American corporate governance. In 2001, China formally adopted the American independent director model into its system of corporate governance.³ The adoption of the independent director system in China provides an interesting case study in the convergence debate. An investigation into the rules and function of this adopted institution in China sheds light on the ongoing debate about whether corporate governance in China is converging towards the American model.

At first glance, the form and method of adoption of the independent director system in China seems to support the proposition that China's corporate governance institutions are converging with the American model—at least in terms of board structure.⁴ However, a

¹ See generally Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

² See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence Of Form Or Function*, 49 AM. J. COMP. L. 329, 331 (2001); Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527, 563-64 (2001).

³ Sibao Shen, *Will the Independent Director Institution Work in China?* 27 LOY. L.A. INT'L & COMP. L. REV. 223, 223 (2005).

⁴ Hansmann & Kraakman claim that “[t]here are already important indications of evolutionary convergence in the realms of board structure, securities regulation, and accounting methodologies, and even in the regulation of takeovers.” Hansmann & Kraakman, *supra* note 1, at 455.

detailed analysis reveals many differences between the American and Chinese systems. While the overall structure of the independent director system in China seems similar to its American counterpart, scholars too often overlook important differences. Some convergence advocates argue that minor differences between the independent director system adopted in China and the American version are insignificant—that convergence with the American model is merely incomplete, and China will completely modify its rules over time.

In this paper, I argue that minor differences between the implementing regulations for the independent director system in China are significant and even antithetical in many respects to American traditions. Local forces, represented by a uniquely Chinese shareholding structure, a lack of qualified candidates to fill independent director positions, and a two-tier board structure, make such differences inevitable. It seems unlikely that China will eliminate all of these differences to completely converge with the American independent director model. Differences in detailed rules demonstrate that significant divergence between the Chinese and American models remains.

My analysis proceeds as follows. In Section II, I provide a brief overview of adoption of the independent director system in China. In Section III, I compare the Chinese adopted rules with those of the United States, evaluating key differences in the detailed rules. In Section IV, I examine the actual impacts of the independent director system in China and reveal its practical shortcomings. In Section V, I analyze why differences between the American and Chinese versions of the independent director system exist, and show that such differences are determined by unique forces in China including concentrated shareholding structure, a lack of candidates, and a two-tier board structure.

II. THE ADOPTION OF THE INDEPENDENT DIRECTOR SYSTEM IN CHINA

Hansmann and Kraakman claim that because legal change requires legislative action, convergence of corporate law proceeds more slowly than convergence of governance practices.⁵ Gilson suggest that due to the significant costs of changing the form of existing institutions, convergence of function without change in underlying formal structures is generally the first response to competitive pressure.⁶ However, the experience in China shows the opposite: reform of formal corporate law preceded reform of functional corporate governance practices.

⁵ Hansmann & Kraakman, *supra* note 1, at 455.

⁶ See Gilson, *supra* note 2, at 337; John C. Coffee Jr., *The Future as History: The Prospects For Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 679 (1999).

On August 6, 2001, the China Securities Regulatory Commission (CSRC) issued the *Guidelines for Establishing the Independent Director System in Listed Corporations* (hereinafter the *Independent Director System Guidelines*).⁷ This landmark document first institutionalized the independent director system in China.⁸ It recommended that all companies listed on China's stock exchange revise their articles of association, hire qualified independent directors, have at least two independent directors on their board of directors by June 30, 2002, and ensure a board of directors comprising at least one-third independent directors by June 30, 2003.⁹ Even though the *Independent Director System Guidelines* are not compulsory, most listed corporations adhere to them. On January 7, 2002 the CSRC State Economic and Trade Commission reaffirmed the independent director system when it promulgated the Code of Corporate Governance for Chinese Listed Companies.¹⁰ The Code of Corporate Governance itself does not provide detailed rules on issues such as the directors' qualifications, procedures of election and replacement, or duties of independent director. By implication these issues are governed by the *Independent Director System Guidelines*. In 2005, China's Company Law¹¹ was revised to require that "listed corporations should have

⁷ Guanyu Zai Shangshi Gongsi Jianli Duli Dongshi Zhidu de Zhidao Yijian [Guidelines on Establishing the Independent Director System in Listed Corporations] (promulgated by China Securities Regulatory Commission, Aug. 16, 2001, effective Aug. 16, 2001) LAWINFOCHINA (last visited Dec. 22, 2006) (P.R.C.) [hereinafter *Independent Director System Guidelines*].

⁸ Sibao Shen, *supra* note 3, at 223.

⁹ *Independent Director System Guidelines*, *supra* note 7, art. 1(3).

¹⁰ Shangshi Gongsi Zhili Zhunze [Code of Corporate Governance for Chinese Listed Companies] (promulgated by China Securities Regulatory Commission & State Economic and Trade Commission, Jan. 7, 2002, effective Jan. 7, 2002) LAWINFOCHINA (last visited Dec. 22, 2006) (P.R.C.) [hereinafter *Code of Corporate Governance*]. The Code of Corporate Governance states that:

The independent directors shall bear the duties of good faith and due diligence toward the listed company and all the shareholders. They shall earnestly perform their duties in accordance with laws, regulations and the company's articles of association, shall protect the overall interests of the company, and shall be especially concerned with protecting the interests of minority shareholders from being infringed.

Id. art. 1(2). The Code of Corporate Governance is applicable to all listed companies within the boundary of the People's Republic of China and is more detailed than the *Independent Director System Guidelines* with regard to specialized committees of the board of directors.

¹¹ Company Law (promulgated by Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006) LAWINFOCHINA (last visited Dec. 22, 2006) (P.R.C.) [hereinafter *2005 Company Law*]. The 2005 Company Law represented a substantial

independent directors.”¹² As with the Code of Corporate Governance, the Company Law defers to the *Independent Director System Guidelines* for detailed requirements. Thus, while the Code of Corporate Governance and the Company Law formally institutionalize the requirement for independent directors, the *Independent Director System Guidelines* is the most important document regulating the independent director system in China.

The concept of the independent director is currently popular in China.¹³ At first glance, it appears that China has adopted the American independent director system wholesale. However, a close examination of the Chinese rules and guidelines reveals important differences in the detailed requirements.

III. DIFFERENCES BETWEEN CHINA AND THE UNITED STATES

A. *Expectations*

In the United States, corporate governance has evolved from a system of shareholder dominance to board of director dominance, then from board of director dominance to managerial dominance. The independent director system is seen as the solution to the problems inherent in managerial domination.¹⁴ Due to America’s widely dispersed shareholding structure, shareholders’ rational apathy,¹⁵ and free riding,¹⁶ the major role of the independent director is to serve as a guard against

revision of a 1993 law. Changes included registered capital requirements, corporate governance and protection for shareholders, and the introduction of one-person companies. The 2005 Company Law also introduced the principle of piercing the corporate veil.

¹² *Id.* art. 123 (requiring that “listed corporations should have independent directors, and the detailed rules will be regulated by State Department.”) The detailed rules are understood as Independent Director System Guidelines. The third draft of Company law initially stated that listed corporations *may* have independent directors, but the final version, adopted on October 27, 2005, changed the language to *should*. Thus, independent director system effectively ended up being compulsory under the 2005 Company Law.

¹³ 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)

¹⁴ See Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporate Law: The ALI’s Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 563-64 (1984).

¹⁵ Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RES. L. REV. 776, 779-83 (1979).

¹⁶ JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, *CASES AND MATERIALS ON CORPORATIONS* 527 (4th ed. 1995)

managerial indiscretion,¹⁷ i.e., solving the problem of agency cost inherent in the separation of ownership and control.¹⁸ As Berle and Means suggest,¹⁹ independent directors protect shareholders from management, not from other shareholders.²⁰

The expected role of the independent director in China differs from that in America because of core differences in corporate structures. A review of China's adoption of the independent director system sheds light on this role.

1. Large shareholder exploitation of small shareholders

Most listed companies in China are former state-owned enterprises.²¹ Large shareholders (still typically the state) control the

¹⁷ See generally American Law Institute, Principles of Corporate Governance and Structure: Restatement and Recommendations, Part III (1982) (tentative draft no. 1); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1034 (1993) (“Why then do independent directors have any corporate governance role? Because management is not perfectly faithful.”); Laura Lin, *The Effectiveness Of Outside Directors As A Corporate Governance Mechanism: Theories And Evidence*, 90 NW. U.L. REV. 898, 898 (1996); Daniele Marchesani, *The Concept of Autonomy and the Independent Director of Public Corporations*, 2 BERKELEY BUS. L.J. 315, 315 (2005).

¹⁸ Donald C. Clarke, *The Independent Director In Chinese Corporate Governance*, 31 DEL. J. CORP. L. 125, 142 (2006).

¹⁹ See Adolph A. Berle & Gardiner C. Means, *The Modern Corporation And Private Property* (Macmillan 1933).

²⁰ A competing conception holds that the independent director's duty is to protect the interests of a number of different groups, not just shareholders. See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602 (1982); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 865 (1991); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253-54 (1999). However the view of the role of the independent director—one who is independent of profit-seeking shareholders as well as independent of management—has not found fertile soil in American corporate law scholarship or practice. The dominant view has been that directors who are responsible to many constituencies are in effect responsible to none, and that while many of those who deal with the firm, such as customers, workers, and suppliers, can protect themselves through contract and the threat of terminating their association with the firm. Clarke, *supra* note 18, at 154-55.

²¹ Cai Lei, *Woguo Shangshigongsi “Guquanjizhong” Xianxiang Ji Jiejue Silu* [Phenomenon of Concentrated Shareholding And Resolution], 1 JINGJI YANJIU DAOKAN [ECONOMIC RESEARCH GUIDE] 59,59(2006); Lin Lefen, *Shangshi Goingsi Guquan Jizhongdu Shizheng Fenxi* [Empirical Research on The Degree of Concentrated Shareholding], 11 NANJING SHEHUI KEXUE [SOCIAL SCIENCES IN NANJING] 53, 57 (2005).

shareholders' general meeting and the board of directors. Major shareholders nominate directors²² and the board of directors frequently overlaps with management. This makes control by insiders a widespread problem for Chinese listed companies.

In China, abuse by dominant shareholders is pervasive. Large, dominant shareholders abuse their power by handpicking compliant board members and management personnel to operate the company in the best interests of the dominant shareholders, often at the expense of minority shareholders. Shareholder abuse in listed companies, such as large shareholders misusing their authority to empty company coffers, have caused small and medium-sized shareholders to suffer enormous losses. As of June 30, 2001, major shareholders had drained corporate funds at ninety-five of the 516 corporations listed on the Shenzhen Stock Exchange.²³ Large shareholders typically withdrew corporate assets as personal loans and then either delayed or completely failed to repay such loans. One large shareholder named Sanli Huagong acquired as much as 98.8 million RMB using this method.²⁴

Large shareholders have also abused their authority through insider dealings, such as buying materials from suppliers controlled by large shareholders or selling products to large shareholders under unfair terms.²⁵ When companies perform poorly, large shareholders have been known to order disclosure of fraudulent financial statements to keep the company from being de-listed. This has allowed some companies to raise large sums of capital by deceiving the public. The Zhengbaiwen scandal is one example of this practice. An investigation by the CSRC in 1999 and 2000 revealed that Zhengzhou Baiwen disclosed false information in several annual reports, and was involved in fraudulent financial practices.²⁶

²² See Lay Hong Tan & JiangYu Wang, *Proposing a Model for Corporate Governance in China's Listed Companies: Problems and Prospects* (March 31, 2004), available at <http://ssrn.com/abstract=526942>.

²³ He Jianliang, *Lun Shangshigongsi de Guanlianjiaoyi Jiqi Jianguan* [*Affiliated-dealings in Listed Corporation and Oversight*], ZHENGQUAN SHICHANG DAobao [SECURITIES MARKET HERALD], Jan. 2002, at 50.

²⁴ Yin Yongqiang, *ST Tong Jinma Dagudong Huankuan Xuanyi* [Doubts on Return of Funds by Big Shareholder of ST Tong Jinma], ZHENGQUAN SHIBAO [SECURITIES TIMES], May 12, 2004.

²⁵ See He Jianliang, *supra* note 23, at 50.

²⁶ See ST Zhengbaiwen Zenyang Zoushang Qiongtumolu [How Did ST Zhengbaiwen Step to the End], JINRI SHANGBAO [BUSINESS TODAY], Nov. 4, 2000, at 4; Wang Zihui, 2002, *Mudu Shangshi Gongsi Zhi Guaixianzhuang* [2002, Witness Weird Phenomena In Listed Companies], ZHONGGUO JINGJI SHIBAO [CHINA ECONOMIC TIMES], Jan. 8, 2003.

2. *Weak boards of supervision*

According to the Company Law, boards of supervision are supposed to serve as watchdogs in Chinese corporate governance.²⁷ However, boards of supervision often do not function well in supervising boards of directors and management.²⁸ One reason is that boards of supervision are selected at general shareholder's meetings,²⁹ where large, dominant shareholders typically end up appointing the supervisors.³⁰ Supervisors, in turn, typically remain loyal to the interests that appoint them which limits their independent supervision of directors and management selected by the same large shareholders.

A second reason that boards of supervision tend to be ineffective is that they do not have any real substantive powers. Even though supervisory boards and boards of directors are legally parallel organs, in

²⁷ Pursuant to the 1993 version of the Company Law supervisors shall perform the following duties:

- (1) check up on the financial affairs of the company;
- (2) supervise the law and regulation violating acts or the articles of association of directors and manager in performing their duties;
- (3) request directors or manager to remedy their acts whenever such acts harm the interests of the company;
- (4) propose the convening of an interim shareholders' meeting; and
- (5) exercise other powers as provided for in the articles of association. Supervisors shall attend the meeting of the board of directors as non-voting members.

Company Law (promulgated by Standing Comm. Nat'l Peoples' Cong., Dec. 29, 1993, effective Jul. 1, 1994) LAWINFOCHINA (last visited Dec. 22, 2006) (P.R.C.) [hereinafter 1993 Company Law], art. 126.

²⁸ Li Jianwei, *Lun Woguo Shangshigongsi Jianshahui Zhidu de Wanshan—Jianlun Dulidongshi Yu Jianshahui de Guanxi* [Modification of Supervisory Board in Listed Companies—Incidentally Discuss the Relationship Between Independent Directors And Supervisory Board], 2 FAXUE [LAW SCI.] 75, 76 (2004); Ba Jingyan, *Lun Gongsi Jianshahui Jianduquan de Wanshan* [Modification of Monitoring Powers of Supervisory Board], 4 QIANYAN [FRONTIER] 130, 131(2004); Li Kaipu, *Jianlun Woguo Jianshahui Zhidu de Buzu Yu Wanshan* [Discussion on the Weaknesses And Modification of Supervisory Board], 130 FAXUE PINGLUN [LAW REVIEW] 123, 123 (2005); Qin Rongsheng, *Gongsi Zhili Yu Jianshahui Yunzuo* [Corporate Governance and the Operation of Supervisory Board], 253 DANGDAI CAIJING [CONTEMP. FIN. & ECONOMICS] 104, 105 (2005).

²⁹ 1993 Company Law, *supra* note 27, art. 103; 2005 Company Law, *supra* note 11, art. 106.

³⁰ Qin Rongsheng, *supra* note 28, at 105.

practice, the former is a “tiger without teeth”³¹ because it lacks real authority and power.³² Chinese supervisory boards neither have the power to dismiss directors nor the right to sue directors.³³

Members of boards of supervisors are not subject to legal liability or external oversight for their actions or inactions. Consequently, supervisors are inclined to shirk their regulatory responsibilities. Without diligent outside monitoring, the reports of supervisory boards are perceived to lack both usefulness and credibility. The current supervisory mechanism is generally incapable or unwilling to identify and addressing managerial corruption.³⁴

3. Government influence

Government influence has been significant in the process of introducing the independent director system in China. Since 1998, the Chinese government has recruited outside expertise to help reform the Chinese stock market and to institute internationally accepted business practices.³⁵ Institutionalizing the independent director system into the boards of Chinese listed companies is one of the most important measures initiated by outside experts.³⁶ Some Chinese officials who have studied

³¹ Tan & Wang, *supra* note 22.

³² For example under the 1993 Company Law, when directors or managers harm company’s interests, the supervisory board could only demand directors to remedy. 1993 Company Law, *supra* note 29, arts. 54, 126. If the demand did not work, supervisors could propose an interim shareholders’ meeting and report the misconduct to shareholders. However, proposing to hold an interim shareholders’ did not mean such a meeting was inevitable: the proposal could be rejected because the power to convene an interim shareholders’ meeting was vested in the board of directors. See Ba Jingyan, *supra* note 28, at 131; Li Jianwei, *supra* note 28, at 76.

³³ See Li Kaipu, *supra* note 28, at 123.

³⁴ See Ba Jingyan, *supra* note 28, at 130; Li Kaipu, *supra* note 28, at 124; Li Jianwei, *supra* note 28, at 76-77; Cindy A. Schipani and Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 18 (2002).

³⁵ Perhaps the most famous outsider was Laura Cha, a highly respected lawyer who studied law in the United States, had legal experience in both the United States and Hong Kong, and had management experience in Hong Kong as the Hong Kong Securities and Futures Commission vice chair and president of operations. *Shi Meilun: Neng Wei Zhongguo Gushi Zhuru Shenme [What Will Be Brought Into Chinese Stock Market By Laura Cha]*, 3 JINRONG XINXI CANKAO [FIN. DIG.] 20, 20 (2001). She was hired in March 2001 as CSRC vice chair, a position equivalent to that of a vice minister. *Id.*

³⁶ In public statements, Cha strongly advocated that the adoption of the independent director system into China will greatly improve corporate governance at Chinese listed companies. Despite the fact that Cha has introduced major corporate governance reforms during her tenure at the CSRC, there is much room for improvement in the wider stock market and at performance-listed companies. Furthermore, the

corporate governance abroad (in the United States or other countries) express a favorable opinion of the American corporate model and assert that the American-style independent director system would benefit China.

4. *The official line*

Most Chinese scholars assert that the purpose of introducing the independent director system in China is as a remedy for abuses by dominant shareholders at the expense of minority shareholders.³⁷ Some scholars describe the problem as the “one-share-dominating problem”³⁸ or the “insider control problem.”³⁹ The agency problem identified by Berle and Means as the major motivation for institutionalizing the independent shareholder system in America is not a primary concern in China.⁴⁰

The government, as well as the academy, holds that the independent director system in China is principally constituted to prevent abuse by dominant shareholders at the expense of minority shareholders and to prevent the recurrence of corporate scandals. The *Independent Director System Guidelines* state a clear position on the role of the independent director system:

Independent directors should conscientiously perform their duties . . . [and] protect the whole interests of the

longlasting effects of some of Cha’s reforms are questionable and some reforms may do more harm than good. See Ya Wen, *Dou Yuan Shi Meilun?* [*All Faults of Laura Cha?*], ZHONGGUO JINGJI SHIBAO [CHINA ECONOMIC TIMES], Jan. 20, 2003. Faced with significant challenges, Cha resigned from the CSRC in 2004. See Ming Hao, *Shi Meilun Zhengshi Quzhi Gongguo Liuyu Houren* [*Laura Cha Resigned, Judgment Is Left to The Future*], 21 SHIJI JINGJI BAODAO [21ST CENTURY ECONOMIC REPORT], Sep. 16, 2004.

³⁷ See Tong LU, *Development of System of Independent Directors and the Chinese Experience*, in GONGSI ZHILI GAIGE: ZHONGGUO YU SHIJIE [CORPORATE GOVERNANCE REFORM: CHINA AND THE WORLD] 9 (Tong Lu ed., 2002) available at <http://old.iwep.org.cn/cccg/pdf/Development%20of%20System%20of%20Independent%20Directors%20and%20the%20Ch%A1%AD.pdf>.

³⁸ The main corporate governance issue for China’s listed companies is the control by major shareholders—the “one share-dominating problem.” The establishment of the independent directors system in China is (at least for the present) to address this issue. Due to this specific focus, the independent director system operates differently in China than it does in other western countries where it is employed. See Liu Junhai, *Woguo Gongsifa Yizhi Dulidongshi Zhidu de Sikao* [*Thought on the transplantation of Independent Director System In Chinese Corporate Law*], 21 ZHENGFA LUNTAN [TRIB. OF POL. SCI. & L.] 41, 43 (2003); Tan & Wang, *supra* note 22.

³⁹ Xie Xiangbin, *Woguo Duli Dongshi Zhidu de Zhidu Jichu ji Xianshi Xuqiu Yanjiu* [Institutional Base and Practical Need of Independent Director System in China], 27 SHANGYE SHIDAI [COMMERCIAL TIMES] 60, 61(2006).

⁴⁰ Clarke, *supra* note 18, at 169-171.

companies, giving special attention to see to it that the legitimate rights and interests of medium-sized and small investors are not harmed. Independent directors in China have a general statutory duty of good faith and diligence to the company and to the entire body of shareholders. In particular, independent directors have a duty to remain free from the influence of major shareholders, controlling persons, or others who have a relationship of interest with the company.⁴¹

B. Proportion of Independent Directors

In the United States, according to the Sarbanes-Oxley Act⁴² and the listing requirements of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ), all listed corporations must have boards of directors composed of a majority of independent directors.⁴³ In contrast, Chinese listing regulations require that companies have boards of directors comprised of only one-third independent directors.⁴⁴ Pursuant to the Company Law, corporate boards are limited to five to nineteen directors.⁴⁵ Therefore, some corporations just need two independent directors to satisfy the legal requirement. The proportion of independent directors on a corporate board is important because it significantly and directly influences the actual power of independent directors. A board with a higher ratio of independent directors is more likely to be hospitable to independent directors and less likely to be dominated by insiders.

C. Definitions of Independence

The independent director system in the United States has evolved from early limitations on “interested persons” in the Investment Company Act of 1940.⁴⁶ The current criteria for independent directors in America

⁴¹ Independent Director System Guidelines, *supra* note 9, art. 1(2).

⁴² Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(3)(B) (2005).

⁴³ NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A (2004) [hereinafter NYSE RULES], available at http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html. NASDAQ STOCK MARKET, INC., MARKETPLACE RULES §4350(c)(1) (Apr. 15, 2004) [hereinafter NASDAQ RULES], available at <http://www.nasdaq.com/about/MarketplaceRules.pdf>.

⁴⁴ Independent Director System Guidelines, *supra* note 7, art. 1(3).

⁴⁵ 2005 Company Law, *supra* note 11, art. 109.

⁴⁶ The Investment Company Act defines “interested persons” to include the following:

come from legislative and private regulatory sources. The Sarbanes-Oxley Act⁴⁷ as well as NYSE and NASDAQ listing standards⁴⁸ define independence. Both exchanges require board confirmation of independent directors and list disqualifying criteria. Independent directors may be disqualified because of outside employment or other individual compensation relationships, business relationships, auditor relationships, interlocking directorates, and familial relationships.⁴⁹ Independence in America is defined in relation to the corporation and its management.

China's definition of independence reflects the core values of its independent director system. The purpose of the independent director system in China is to prevent exploitation by large shareholders and to provide medium and small shareholders with a means to voice their needs and concerns.⁵⁰ In keeping with this purpose, China's regulations define independence in relation to large shareholders. Under the *Independent Director System Guidelines* a corporation's top ten shareholders and their families, top five shareholders' employees and families, all holders of at

-
- (1) an affiliated person of the investment company;
 - (2) immediate family members of an affiliated natural person;
 - (3) an interested person of the investment company's investment adviser or principal underwriter;
 - (4) a person who has acted as the investment company's legal counsel within the past two fiscal years;
 - (5) certain registered brokers or dealers who have a relationship with the investment company; and
 - (6) a person who the Securities and Exchange Commission (SEC) considers to be interested because of the person's material business or professional relationship with the investment company within the past two fiscal years.

Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(19)(A) (1994).

⁴⁷ Sarbanes-Oxley and related SEC rules use a different definition of independence that applies only to members of the audit committee and that is in some ways more stringent, though more vague, than the definitions used by the NYSE and NASDAQ.

⁴⁸ NYSE MANUAL, *supra* note 43, § 303A.02(a); NASDAQ RULES, *supra* note 43, §4200(a)(15).

⁴⁹ Harvard Law Review Ass'n, *The Independent Director! Have Congress, The NYSE, And NASDAQ Finally Figured Out How To Make The Independent Director Actually Work?* 117 HARV. L. REV. 2181, 2189-91 (2004).

⁵⁰ See Gu Minkang, *Will an Independent Director 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).

least 1 percent outstanding shares, and employees of the holders of at least 5 percent outstanding shares may not serve as independent directors.⁵¹

D. Requirements for Committee Structures

In the United States, according to NYSE corporate governance listing standards, listed companies must have a nominating (corporate governance) committee,⁵² a compensation committee,⁵³ and an audit committee.⁵⁴ Each of these three committees must be composed entirely of independent directors. In addition, the audit committee must have a minimum of three members.⁵⁵

Companies listed on NASDAQ are required to have an audit committee with a minimum of three members, all independent directors.⁵⁶ NASDAQ provides some flexibility with regard to nomination and compensation issues allowing listed companies to choose between a setup of special committees and a majority vote by all independent directors. Even though companies listed on the NASDAQ exchange have the option not to establish a nomination committee⁵⁷ or a compensation committee,⁵⁸

⁵¹ Independent Director System Guidelines, *supra* note 7, art. 3(1)-(3).

⁵² The nominating (corporate governance) committee is primarily responsible for identifying individuals qualified to become board members, consistent with criteria approved by the board. NYSE MANUAL, *supra* note 43, § 303A.04. The nominating committee then selects (or recommends to the board) the director nominees for the next annual meeting of shareholders. *See id.* The nominating committee also develops and recommends corporate governance guidelines to the board and oversees evaluation of the board and management. *See id.*

⁵³ The compensation committee's responsibilities fall into three categories. NYSE MANUAL, *supra* note 43, § 303A.05. First, the compensation committee is tasked with review and approval of corporate goals and objectives related to CEO compensation. *See id.* Second, the compensation committee also evaluates CEO performance in light of those goals and objectives, and, either as a committee or together with the other independent directors, determines and approves the CEO's compensation level based on this evaluation. *See id.* Third, the compensation committee makes recommendations to the board with respect to non-CEO executive officer compensation, incentive compensation, and equity-based plans that are subject to board approval. *See id.*

⁵⁴ The audit committee helps ensure the integrity of the company's financial statements and compliance with legal and regulatory requirements, verifies the qualifications and independence independent auditors, and oversees the performance of the company's internal audit function and independent auditors. NYSE MANUAL, *supra* note 43, §303A.06.

⁵⁵ NYSE MANUAL, *supra* note 43, §303A.07.

⁵⁶ NASDAQ RULES, *supra* note 43, §4350(d).

⁵⁷ NASDAQ RULES, *supra* note 43, §4350(c)(4). This rule is intended to provide flexibility for a company to choose an appropriate board structure and reduce resource burdens while ensuring that independent directors approve all nominations.

NASDAQ nonetheless requires that independent directors wholly control decisions on compensation and nomination.⁵⁹

The committee structure requirement is different in China. The *Independent Director System Guidelines* require that listed companies have one-half or more independent directors in subordinate committees such as remuneration, audit, or nomination committees if the board of directors chooses to set up such committees.⁶⁰ Independent directors are charged with special functions such as expressing independent opinions at board and shareholders' meetings.⁶¹ However, independent directors are limited in their actual authority by the organizational structure of the board of directors.

The Code of Corporate Governance allows the board of directors at listed companies to establish a corporate strategy committee, an audit committee, a nomination committee, a remuneration and appraisal committee, and other special committees as authorized by shareholder resolution. An independent director must chair the audit committee, nomination committee, and remuneration and appraisal committee. In addition, independent directors must constitute the majority of the committees. At least one independent director from the audit committee must be an accounting professional.⁶²

While independent directors are underrepresented on the board as a whole, they hold a larger proportional share of votes in subcommittees. Subcommittees could be a source of power for independent directors. However, boards of directors are not obligated to establish subcommittees at all. Without subcommittees, independent directors remain a minority voice. The actual influence of independent directors is limited by the will of the board at large, which is often dominated by large shareholders.

⁵⁸ NASDAQ RULES, *supra* note 43, §4350(c)(3). The rule is also intended to provide flexibility for an issuer to choose an appropriate board structure and to reduce resource burdens while ensuring independent director control of compensation decisions.

⁵⁹ NASDAQ RULES, *supra* note 43, § 4350(c)(3).

⁶⁰ If the idea of this subparagraph is to allow independent directors to monitor the committees, then it has failed because "one half or more" means that exactly half the membership will do and does not require an actual majority of independent directors.

⁶¹ Independent directors have a duty to express independent opinions on matters such as nomination, appointment and dismissal of directors; appointment and dismissal of senior management personnel; and salaries of directors and senior management personnel. *Independent Director System Guidelines*, *supra* note 7, art. 6(1).

⁶² Code of Corporate Governance, *supra* note 10, art. 52.

E. Requirements for Nomination Committees

In the United States, directors are nominated by a committee composed entirely of independent directors. In China, independent directors can be nominated by the board of directors, the supervisory board, and shareholders who independently or jointly hold more than 1 percent of outstanding shares. Independent directors in China are thus less insulated from internal corporate interests than their American counterparts.

F. Reconciling Independent Directors and Boards of Supervision

China's two-tiered board structure represents a unique local challenge to the American model independent director system. Under China's Company Law, a corporation has both a board of directors and a board of supervisors. The board of supervisors in China is a separate organ from the board of directors. Its main functions are oversight and monitoring of directors and senior management. The board of supervisors has the power to investigate company finances and to evaluate the performance of directors and senior management personnel.⁶³ The American independent director system is founded in American corporations' unitary board structure where both the decision-making and oversight roles are vested in the board of directors. It is designed to strengthen directors' independence so they can perform their supervisory function.

The function of independent directors in the United States is very close to that of the supervisory board in China: their oversight functions essentially overlap. China must reconcile an independent director system developed for America's unified structure with its own two-tiered corporate governance. Existing laws are silent on crucial questions about the relationship between the board of supervisors and independent directors such as allocation of powers and liabilities. This relationship and the many minor structural differences in the two systems support Professor West's conclusion that while a limited form of convergence may occur with regard to enabling rules, substantial statutory convergence is unlikely.⁶⁴

⁶³ See Independent Director System Guidelines, *supra* note 7, art. 5(1). The board of supervision is now encoded in the Company Law as well. See 2005 Company Law, *supra* note 11, art. 123 (“[L]isted corporations should have independent directors, and the detailed rules will be regulated by State Department.”).

⁶⁴ West, *supra* note 2, at 594.

Hansmann and Kraakman assert that convergence will take time,⁶⁵ which implies that minor differences in China's independent director rules are inevitable and unimportant⁶⁶. The latter part of this paper argues that regulatory differences are crucial and are impediments to the effectiveness of the independent director system in China. Chinese and American corporate governance systems will always diverge in some ways. Adopting American rules will not always amount to convergence.

IV. THE FUNCTIONAL EFFECTS OF THE INDEPENDENT DIRECTOR SYSTEM IN CHINA

Scholars represented by Baysinger & Butler believe that an active monitoring board with independent directors is critical factor in the relative efficiency of American corporations.⁶⁷ In the six years since China officially adopted the independent director system, it has not yet achieved similar results. This result is due to regulatory differences between the Chinese and American systems.

A. Appointment

In response to the enactment of the *Independent Director System Guidelines*, most of China's listed companies appointed independent directors to their boards. By the end of 2005, there were 4,640 total independent directors on the boards of China's 1,377 listed companies.⁶⁸ At 93.3 percent of listed companies, independent directors constituted

⁶⁵ Hansmann & Kraakman, *supra* note 1, at 459.

⁶⁶ It is my personal understanding.

⁶⁷ See generally John C. Coffee Jr., *supra* note 6, at 653; see also Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 562-66 (1984) (remarking that as corporate board independence increases, corporate financial performance tends to increase); Ira M. Millstein and Paul W. MacAvoy, *The Active Board of Directors and Improved Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1283 (1998) (demonstrating a substantial and statistically significant correlation between an active, independent board and superior corporate performance); Scott W. Barnhart & Stuart Rosenstein, *Board Composition, Managerial Ownership, and Performance: An Empirical Analysis*, 33 FIN. REV. 1, 1 (1998). But see Laura Lin, *The Effectiveness Of Outside Directors As A Corporate Governance Mechanism: Theories And Evidence*, 90 NW. U.L. REV. 898, 898 (1996); April Klein, *Firm performance and board committee structure*, 41 J. LAW & ECON. 275, 275 (1998); C.M. Daily & D.R. Dalton, *Does Board Composition Affect Corporate Performance? No!*, 24 DIRECTORSHIP 7, 7 (1998).

⁶⁸ Pan Qing, *Shangshi Gongsi Duli Dongshi Buzai "Chenmo" [Independent Directors of Listed Companies Will Be No Longer "Silent"]*, GUOJI JINRONG BAO [INTERNATIONAL FINANCIAL NEWS], Dec. 13, 2006, at 3, available at http://paper.people.com.cn/gjjrb/html/2006-12/13/content_12106333.htm.

more than one-third of board members.⁶⁹ However, research shows that only 0.66 percent of listed companies have a majority of independent directors on their boards.⁷⁰

Why do so few companies have a majority of independent directors on their boards? The simplest explanation is that the law only requires one-third.⁷¹ In addition, listed companies are reluctant to take more independent directors than necessary, and are especially reluctant to create a majority of independent directors, because shareholders' interests are at odds with independent directors' corporate watchdog function. Preserving a minority of independent directors on the board limits the threat to large shareholder control.

B. Nomination

Under the *Independent Director System Guidelines*, directors, shareholders and supervisors may all nominate independent director candidates.⁷² However, studies have shown that boards of directors, which are usually controlled by large shareholders, nominate the vast majority of candidates. Boards nominate approximately 63 percent of

⁶⁹ *Id.* June 2003 was the deadline for meeting the required number of independent directors. Independent Director System Guidelines, *supra* note 7, art. 1(3). According to data provided by CSRC, by the end of June 2003, 1,244 of China's 1,250 listed companies had hired independent directors, and the total number of independent directors was 3,839 (an average of three independent directors in each company). See *Jixu Tuidong Wanshan Duli Dongshi Zhidu—Zhongguo Zhengjianhui Youguan Bumen Fuzeren Da Jizhe Wen* [Continue to perfect the independent director system in China—China Securities Regulatory Commission officials' Response to the questions raised by reporters], ZHONGGUO ZHENGQUANBAO [CHINA SECURITIES JOURNAL], Feb. 6, 2004, at 1, [hereinafter *Response*]. Among all the listed companies that introduced independent directors, in over 800 companies more than one-third of their board members are composed of independent directors (accounting for a total 65 percent of all boards). *Id.*

⁷⁰ Chen Huifa's research also shows that more than 80 percent of listed-company boards are comprised of 30-40 percent independent directors. CHEN HUIFA, WOGUO SHANGSHIGONGSI DULIDONGSHI ZHIDU YU GONGSI YEJI DE SHIZHENG YANJIU [EMPIRICAL RESEARCH ON INDEPENDENT DIRECTOR SYSTEM AND CORPORATE PERFORMANCE IN THE LISTED COMPANY] 1 (Oct. 8, 2005), available at www.cnki.net. According to Li Changqing's research, there are an average of seven to eleven directors on Chinese boards. Li Changqing, *Shangshi Gongsi Dongshihui Tezheng ji Gaijin Jianyi* [The Characteristics of Boards in Listed Companies and Suggestions on improvement], 24 SHANGYE SHIDAI [COMMERCIAL TIMES] 17, 17 (2004). The proportion of independent directors to insiders is from 0 percent to 45.4 percent. *Id.* Chinese company law requires six to eighteen directors per board. 2005 Company Law, *supra* note 11, art. 109.

⁷¹ Independent Director System Guidelines, *supra* note 7, art. 1(3).

⁷² Independent Director System Guidelines, *supra* note 7, art. 4(1).

independent director candidates, including the 36 percent who are directly nominated by major shareholders. The remaining 37 percent of candidates are nominated by the supervisory board and by shareholders who independently or jointly hold more than one percent of company shares.⁷³ Most independent directors are therefore appointed by the very people (major shareholders) they are supposed to monitor. This calls into question independent directors' true ability to prevent abuse by major shareholders and protect the interests of medium-sized and small shareholders.

C. *Characteristics*

In China, the majority of independent directors are academics. This differs from the United States where CEOs comprise the majority. A recent survey of 856 CEOs of American Fortune 1000 firms revealed that 54 percent of sitting CEOs serve as directors on two to four boards.⁷⁴ Retired CEOs and other senior executives also frequently serve as independent directors. These candidates are attractive to American boards because of their work experience and practical knowledge.

In contrast, the academics and civil servants who most often serve as independent directors in China may have no prior experience in actually running a corporation. The China Securities Regulatory Commission reported in 2004 that 44 percent (1,689) of all independent directors were professors or scholars.⁷⁵ Another 24 percent (906) of independent directors were from accounting, law, or consulting firms (or other similar organizations).⁷⁶ Only 13 percent (480) were current or previous corporate executives.⁷⁷ Academics and civil servants often lack sufficient knowledge in operating real companies to be effective. It is very difficult for them to provide sensible judgment for a firm's critical decisions, such as related-party transactions, or mergers and acquisitions.

⁷³ Tong Ying, *Zhongguo Dudong Shengcun Xianzhuang* [*The Status quo of Independent Directors in China*], SHANGHAI ZHENGQUANBAO [SHANGHAI SECURITIES NEWS], May 27, 2004, available at http://www.cnstock.com/ssnews/2004-5-27/liuban/t20040527_571548.htm. Another investigation shows that over 55 percent of independent director candidates are selected by major shareholders, 27 percent are nominated by senior management, and only about 18 percent are nominated directly by minority shareholders. See Yang Xianfeng, *Zhongguo Shangshi Gongsi Duli Dongshi Zhidu de Xianzhuang Fenxi*, [*Status quo of Independent Director System in China*], 34(8) ANHUI NONGYE KEXUE [JOURNAL OF ANHUI AGRI. SCI.] 1675, 1675-77 (2006).

⁷⁴ Daily & Dalton, *supra* note 67, at 7-9.

⁷⁵ *Response*, *supra* note 69, at 1.

⁷⁶ *Id.*

⁷⁷ *Id.*

There are several reasons why so many independent directors in China come from academia. Scholars tend to be perceived as neutral and independent. In addition, insiders favor scholars precisely because scholars may not be very familiar with corporate operations and therefore will tend not to interfere. However, the pool of qualified academics to serve on corporate boards in China is quite limited.

D. Participation

To date, the participation of independent directors in Chinese corporate governance is quite disappointing. Independent directors tend to be passive board members. More than one-third of independent directors surveyed admitted that they have never cast an abstaining or opposing ballot in a board meeting.⁷⁸ In addition, 35 percent of independent directors stated that they have never used their position to express independent opinions that diverge from the opinions of large shareholder or senior executives.⁷⁹

Even more troubling, only a minority of independent directors (37 percent) view themselves as corporate monitors. In contrast, thirty-nine percent identify their role as that of a corporate advisor.⁸⁰ The independent directors' view of their role has resulted in independent directors using their position to draft technical plans for the company more often than actually monitoring the company.⁸¹

The participation of independent directors in China has not actually produced the expected benefits. Since the independent director

⁷⁸ It is very difficult to conduct a survey in China about the real effects of the independent director system since most independent directors hesitate to answer survey questions openly. Directors who have arguably failed to diligently perform their duties may fear being pinned a “vase director”—a director who has no real function and is, metaphorically speaking, nothing more than a decoration. On the hand, independent directors who have faithfully executed their duties may fear that airing real problem may lead to dismissal or inhibit future employment opportunities. Given this backdrop, Shanghai Securities News conducted the first-ever sample investigation among major listed corporations in China. *See* Tong, *supra* note 73. According to this study over 70 percent of independent directors did not use or intend to use the special powers authorized by CSRC (such as proposing an interim shareholders' meeting or appointing the outside auditing or consulting organization). *Id.* Another survey shows that 60 percent of independent directors at listed companies never reveal their independent opinions during board deliberations. XIE CHAOBIN, RESEARCH ON LEGAL REGIME OF INDEPENDENT DIRECTOR 315 (Law Press China 2004). Many independent directors never attended a single board meeting. *Id.*

⁷⁹ *Id.*

⁸⁰ Yang Xianfeng's research also shows that 2 percent of independent directors admit that they are “vase directors.” Yang, *supra* note 73, at 1675-77.

⁸¹ *Id.*

system was instituted in China, a significant number of listed corporations have been sanctioned for the kind of behavior that independent directors are supposed to guard against, even with independent directors on their boards.⁸² A majority of listed companies admit that independent directors have had little effect on the difficult problem of constraining dominant shareholders' power.⁸³ Independent directors have come to be known colloquially in China as "vase directors" because they are perceived by critics to be merely decorative.

There are several reasons why independent directors in China tend to be passive. First, some simply see the position as an easy job and are reluctant to spend time necessary to diligently fulfill the role. Second, as stated above, the fact that large shareholders nominate a majority of the independent directors tends to discourage true independence at board meetings.⁸⁴ Third, the low ratio of independent directors and the absence of subcommittees on most boards limit independent director influence. Even though independent directors are empowered to raise objections or cast opposing ballots they rarely do so and, in any case, they do not have enough votes to overcome an opposing majority. Fourth, the fact that most independent directors are academics creates several problems. Academic directors often lack the practical skills required to be actively involved in their roles. They rarely have been personally involved in actual corporate operations and lack experience with complex transactions and financial reports. Moreover, in order to avoid losing face, scholars may be reluctant to ask questions about things they do not understand. Fifth, the existence of the supervisory board also likely creates a free-riding problem among independent directors.⁸⁵ Independent directors may expect the supervisory board to be responsible for monitoring and thus self-limit their own monitoring activities.

⁸² Thirty-six listed companies were sanctioned by CSRC in 2002. Forty-six listed companies were sanctioned by CSRC in 2003 and 58 listed companies were sanctioned by CSRC in 2004. Yin Zhihong & Du Yan, *Dulidongshi Zhidu Youxiaoxing Shizheng Yanjiu* [Empirical Study on Effectiveness of Independent Director System], 11 JINGJI LILUN YU JINGJI GUANLI [ECON. THEORY & ECON. MGMT.] 61, 64 (2005).

⁸³ According a study by Yang Xiaojia, 75 percent of listed corporations admit independent directors have little effect. Yang Xiaojia, *Shangshi Gongsi Duli Dongshi Zhidu de Xianzhuang Yu Duice* [Present Situation and Countermeasure], ZHENGQUAN SHIBAO [SECURITY TIME NEWS], Dec. 9, 2004, at 9.

⁸⁴ See Tong, *supra* note 73; Yang, *supra* note 73, at 1675-77.

⁸⁵ CHOPER, COFFEE & GILSON, *supra* note 16, at 527; Li Kaipu, *supra* note 28, at 124.

E. Corporate Performance

Independent directors have a minimal positive effect on corporate performance as measured by share values and rate of return. A 2002 study by Gao Minghua and Ma Shouli's indicates that the performance of companies with independent directors is not significantly different from companies without independent directors.⁸⁶ Wu Yan's study also states that the performance of Chinese listed companies does not have a direct relation to independent directors.⁸⁷

Other data even suggests a negative relationship between independent directors and corporate performance.⁸⁸ A 2004 study by Luo Pinliang, Zhou Yong, and Guo Hui indicates that corporate performance after the adoption of independent directors was worse than prior performance.⁸⁹ As shown in Table 1, both the rate of net return on equity and the mean value of earnings per share decreased after corporations adopted independent directors.

⁸⁶ Gao Minghua & Ma Shouli, *Duli Dongshi Zhidu Yu Gongsu Yeji Guanxi de Shizheng Fenxi—Jianlun Zhongguo Duli Dongshi Youxiao Xingquan de Zhidu Huanjing* [*Empirical Analysis on The Relationship Between Independent Director System and Corporate Performance—Correspondingly Discussing Institutional Environment for Effective Operation of Independent Director System*], 2 NANKAI JINGJI YANJIU [NANKAI ECONOMIC STUDIES] 64,66 (2002).

⁸⁷ This research provides some random samples to show the change of the rate of net return on equity after adopting the independent director system.

⁸⁸ A few studies find a positive link between independent directors and firm performance, but these studies admit such effect is limited. For example, a study by Xiao Li indicates that independent alleviated the problem of insider control and strengthened the level of oversight on the board of directors slightly—particularly in situations where the supervisory board failed to function well. Xiao Li, *Dulidongshi Zhidu Yu Shangshigongsi Yeji: Laizi Zhongguo Shangshigongsi de Zhengju* [*Independent Director System And Corporate Performance: Evidence From Chinese Listed Companies*], 1 NANJING SHENJIXUEYUAN XUEBAO [J. OF NANJING AUDIT U.] 18, 21 (2004)

⁸⁹ Luo Pinliang, Zhou Yong & Guo Hui, *Duli Dongshi Zhidu Yu Gongsu Yeji de Xiangguanxing Fenxi: Laizi Gushi A Gu de Shizheng Yanjiu* [*The Analysis on Correlation between Independent Directors and Corporate Performance: A Empirical Study of A- Share listed companies in Shanghai Security Exchange*], 2 SHANGHAI KEXUE GUANLI [SHANGHAI MANAGEMENT SCIENCE] 20, 22(2004).

TABLE 1: Corporate Performance Before and After the Adoption of Independent Directors⁹⁰

	Mean Value of Earning Per Share (RMB)	Net Rate of Return on Equity (%)
Before adopting independent directors	0.241	8.678
After adopting independent directors	0.138	4.910

F. Replacement

Another interesting aspect of the independent director system in China is that independent directors are dismissed or resign frequently. As shown in Table 2, by the end of November 2003, independent directors had been dismissed or had resigned in approximately 24 percent of the 1,249 listed companies that had independent directors. Table 3 shows that approximately 55 percent of independent directors cited problems with the working environment or limitations of their time and ability as reasons for resigning. The frequent replacement of independent directors reveals that there might be some deeper problems in the current independent director system.⁹¹

TABLE 2: Replacement of Independent Directors in Chinese Listed Companies⁹²

	Resignation	Dismissal	Incumbent	Total
Listed companies	147	158	966	1,249
Total (%)	11.93	12.65	77.34	100.00

⁹⁰ *Id.*

⁹¹ Li Kang, Ye Ya & Zhang Mingkun, *Duli Dongshi Tuichu Xianxiang Yanjiu* [Study on resignation phenomenon of independent directors], 1048 ZHENGQUANSHICHANG ZHOUKAN [SECURITIES MARKET WEEKLY] 65, 65-67 (2004), available at <http://zhoukan.hexun.com/Magazine/ShowArticle.aspx?ArticleId=7135>. The statistics from similar research done by Shanghai Securities News also show that among the independent directors, around 10 percent of them withdrew for similar reasons. Tong, *supra* note 73.

⁹² *Id.* at 65-67.

TABLE 3: Public Reasons Given for Independent Director Resignations⁹³

Reason for Resignation	Directors	Total (%)
Pressure of dismissal	4	3.96
Change of shareholding structure	7	6.93
Work for more than five listed companies	2	1.98
No longer qualified as independent	12	11.88
Personal reasons/health problems	14	13.86
Working environment; time/ability limits	55	54.45
Death	3	2.97
Unable to exert powers	1	0.99
Attempted to resign, but not allowed to	3	2.97
Total Participants	101	100.00

G. Case Studies

The following case studies offer anecdotal evidence of the limited effects of independent directors on Chinese corporate governance.

1. The Lu Jiahao case

The Lu Jiahao case represents both the first time that an independent director was sanctioned by the CSRC and the first time that an independent director sued the CSRC.⁹⁴ This case highlights the passive role of independent directors and demonstrates how some academic directors lack the qualifications to serve effectively.

Between 1999 and 2000 the CSRC conducted a probe that concluded that Shanghai-listed plastics manufacturer and dealer Zhengzhou Bai disclosed false information in several annual reports.⁹⁵ On Sept. 27, 2001, the CSRC fined the twelve members of the company's board for malpractice.⁹⁶ Retired professor Lu Jiahao of Zhengzhou University, then serving as an independent director at Zhengzhou Bai, was ordered to pay a 100,000 yuan fine (US\$12,000).⁹⁷ Lu protested the punishment and brought an action against CSRC in Beijing's First Intermediate People's Court, claiming that the commission should

⁹³ *Id.* The data is current to November 30, 2003, according to statistics provided by Shanghai King Hing Securities.

⁹⁴ Sun Min, *Director First To Sue Securities Watchdog*, CHINA DAILY, June 21, 2002.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

withdraw its decision.⁹⁸ Lu argued that, “[he] always regarded the independent director as an honorary title,” and “did not take part in the decision-making.”⁹⁹ He also argued that he “did not directly compile the false accounting documents,” nor did he “attend the meetings that approved such documents.”¹⁰⁰ A telling element of Lu’s claim was that he was unqualified to identify the issues that eventually led to the malpractice charge. Lu stated,

I am a teacher, teaching foreign languages, and knew nothing about the operation of the company. I didn’t have the ability to understand the accounting sheets. Based on the accounting firm’s audit opinion I agreed with the annual reports. So, therefore, I should not bear the same liabilities as the other inside directors who knew the operation of the company and indeed were involved in the fraudulent financial practices.¹⁰¹

On August 12, 2002, the Beijing No.1 Intermediate People's Court rejected Lu’s suit based on the statute of limitations and dismissed the case without ruling on substantive issues.¹⁰² Lu’s appeal to Beijing’s high court was rejected.¹⁰³

2. *The Leshan Electric Power case*

The Leshan case is the first case in China in which independent directors exercised the right to invite an outside audit firm to investigate the company’s books.¹⁰⁴ Two independent directors of Leshan Electric Power Co., Ltd. were required to express opinions on an annual report without having been provided any background materials or audit

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.* (noting also that Lu Jiahao seldom attended board meetings).

¹⁰¹ See *Bufu Chufa Jueding Zhengbaiwen ‘Huaping Dongshi’ Zhuanggao Zhengjianhui* [Disagree with the Decision, “Vase Director” of Zhengbaiwen Sued CSRC], ZHONGGUO ZHENGQUANBAO [CHINA SECURITIES JOURNAL], June 6, 2002.

¹⁰² *Zhuanggao Zhengjianhui Liyou Buzu Zhengbaiwen Dongshi Bei Bohui Shangsou* [Appeal Against CSRC by the Director Of Zhengbaiwen Was Rejected Due to Lack of Reasons], ZHONGGUO ZHENGQUANBAO [CHINA SECURITIES JOURNAL], Nov. 18, 2002, available at <http://www.china.org.cn/chinese/FI-c/234008.htm>.

¹⁰³ *Id.*

¹⁰⁴ *Ledian Dudong Pinqing Zhongjie Jinchang Shenji Shouzu* [Independent Directors in Ledian Meet Difficulties When Invite Intermediary], SHANGHAI ZHENGQUANBAO [SHANGHAI SECURITIES NEWS], Mar. 5, 2004, at 8, available at http://www.cnstock.com/ssnews/2004-3-5/baban/t20040305_527813.htm.

reports.¹⁰⁵ They proposed inviting an outside audit firm to carry out a special audit, but the company ignored this proposal and presented the annual report to the board of directors' meeting for approval.¹⁰⁶ Nonetheless, the independent directors invited an outside audit firm to review the company.¹⁰⁷ The outside auditing firm, however, eventually abandoned the audit, claiming they could not obtain the necessary cooperation from the company.¹⁰⁸ Under enormous pressure, the two independent directors resigned from the company.¹⁰⁹

3. *The Xinjiang Tunhe case*

In the Xinjiang Tunhe case, a listed company ignored the opinions of its independent directors and then prevented them from resigning. Wei Jie, a well-known economics professor at Tsinghua University, served as an independent director at Xinjiang Tunhe Investment Co., Ltd. On April 23, 2004, officers and internal board members insisted that Wei sign a pre-written statement regarding the outstanding guarantees of Xinjiang Tunhe.¹¹⁰ Before signing, Wei and another independent director, Du Houwen, sent a letter to Xinjiang Tunhe requesting detailed materials

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ Even worse, under the widespread media attention, the chairman of Leshan stated on March 9, 2004 that Leshan never obstructed the outside audit firm from entering the company and suggested that the independent directors' motives were suspicious—implying that the independent directors had close relationship with big shareholders and were involved in contest for control of the company. *Id.* In response to the accusation, two independent directors solemnly declared, "We are independent." *Id.* Cheng Houbo, one of the independent directors explained:

[O]riginally this matter is a minor matter and he had not ever thought this matter can cause such greatly affects, since it is natural and reasonable for independent directors to invite outside audit form to investigate the company when independent directors doubted facticity of the materials provided by the management. This matter also pushed me to ponder more, and made me feel I really need to do something to protect the dignity of independent director system. The management tried to mislead the mass. Here I want to declare that our behaviors are just fulfilling the responsibilities and duties as an independent director.

Id.

¹⁰⁹ *Id.*

¹¹⁰ *Dudong Gushi: Wei Jie Wo Bushi Kailiu Dongshi [The Story of an Independent Director: Wei Jie I Am Not a Runaway]*, ZHONGWAI GUANLI [SINO FOREIGN MANAGEMENT], Sep. 2004 [hereinafter *Story of Wei Jie*], available at <http://finance.sina.com.cn/money/sjyy/20040930/13111059545.shtml>.

about all guarantees made since Wei and Du had been appointed as independent directors.¹¹¹ Xinjiang Tunhe never replied to the request.¹¹²

On May, 12, 2004, Wei received notice that Xinjiang Tunhe's board of directors would meet on May 14, 2004 to discuss four affiliated transactions between Xinjiang Tunhe and Delong with its subsidiaries. Wei was on business outside of Peking and unable to attend the meeting to vote on the matter. He wrote a letter to the company explaining that he suspected the affiliated transactions and (unable to verify the details himself) advised against approval. His concerns were ignored and internal members of the board approved the transactions over his objections.¹¹³

On June 24, 2004, the Shanghai Securities Exchange issued a sharp public rebuke to Xinjiang Tunhe for failing to disclose significant issues in its reports.¹¹⁴ Wei was named in the admonishment. At a board meeting following the CSRC reprimand, Wei Jie again raised questions on several measures before the board, ultimately voting against two decisions and abstaining on another. He was outvoted on all measures.¹¹⁵

Shortly after the CSRC issued its reprimand, three independent directors resigned from the Xinjiang Tunhe board on the ground of having been misled about key areas of operations. Du Houwen, stated in his resignation letter, "In the past two years, I believe the company has not been transparent in information disclosure including for independent directors. In this situation, it is difficult for me to perform my duties."

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ Wei Zeyuan & Yuan Kecheng, *Xinjiang Tunhe Sandudong Xiangjie Weihe Fandui Ju E Shougou Jihua* [Three Independent Directors of Xinjiang Tunhe Explained Why They Object to the Take-Over Project], SHANGHAI ZHENGQUANBAO [SHANGHAI SECURITIES NEWS], June 17, 2004, available at http://www.ce.cn/cjq/cjgs/gsyw/200406/17/t20040617_1089187.btk.

¹¹⁴ Zhou Yi, *Shangzhengsuo Qianze Tunhe Dudong Wei Jie Hanyuan* [Shanghai Securities Exchange Scolded Xinjiang Tunhe, Wei Jie Claimed Unfairness], XIN JINGBAO [NEW BEIJING NEWS], June 25, 2004, available at <http://news.phoenixtv.com/home/zhuanti/fhxd/bianlunquai/shijianbeijing/200407/12/290745.html>.

¹¹⁵ On June 24, 2004, Xinjiang Tunhe held another board meeting to discuss three matters: (1) transfer of 29.42 percent of Xinjiang Tianshan Cement LLC shares; (2) establishment of a tomato powder subsidiary company; and (3) the pledge of real assets held by Xinjiang Tunhe in Zhangjiajie Tunhe Pot Limited Company. *Story of Wei Jie*, *supra* note 110. Believing that the share transfer and tomato powder subsidiary were not in Xinjiang Tunhe's best interests, Wei vetoed these two issues. *Id.* Since Xinjiang Tunhe failed to provide information to Wei about the Zhangjiajie Tunhe Pot Limited Company, Wei chose to abstain from voting on the third issue. *Id.* The board approved all three measures despite Wei's positions. *Id.*

Wei Jie attempted to resign from the Xinjiang Tunhe board, although he was unsuccessful. The regulations required that he remain in his position as an independent director until a replacement was appointed.¹¹⁶

4. *Inner Mongolia Yili case*

The Inner Mongolia Yili¹¹⁷ case is the first case in China where the board of supervision proposed the dismissal of an independent director. It illustrates the conflict that exists due to the two-tiered board structure of Chinese listed companies.

Three independent directors of Inner Mongolia Yili Industrial Co., Ltd. voiced concerns at board meetings held on April 27 and May 26, 2004 about the investment of 417 million RMB in government bonds. They requested that the company explain the investments and disclose related activities by the ten top stockholders.¹¹⁸ On June 5, the independent directors received an ambiguous response, which raised their suspicions. On June 15, the independent directors issued a written request calling for the firm to allow investigation by outside accountants into the questionable investments.

On June 16, Inner Mongolia Yili convened an ad hoc board of directors' meeting to vote on a proposal by the supervisory board calling for removal of independent director Yu Bowei, who had advocated for disclosure. The board voted to submit the proposal to the shareholders at a general meeting scheduled for August 3. On the day of the board vote, Wang Bin and Guo Xiaochuan, the other two independent directors, resigned.¹¹⁹ Ironically, the supervisory board—which is supposed to function as a corporate watchdog—was used by the company to undermine the monitoring activities of its independent directors. This suggests that the coexistence of independent directors and supervisory boards does not necessarily lead to better oversight.

¹¹⁶ Under existing regulations, if the resignation of the independent director causes the number of the independent directors to become less than the minimum number required, the resignation of an independent director is not effective until a replacement is appointed. Independent Director System Guidelines, *supra* note 7, art. 4(6).

¹¹⁷ Inner Mongolia Yili Industrial Co., Ltd. (SHSE: 600887) is one of 520 key industrial enterprises and one of the 151 leading industrial enterprises in China's agricultural sector. See *Dairy Producer Confirms Scandal*, CHINA DAILY, Dec. 22, 2004.

¹¹⁸ *Yige Zaoyi Bamian de Dudong Gushi: Yu Bowei—Duli de Daijia* [The Story of an Independent Director Who Was Dismissed: Yu Bowei—The Cost of Independence], ZHONGWAI GUANLI [SINO FOREIGN MANAGEMENT], Sep. 2004 [hereinafter *Story of Yu Bowei*], available at <http://biz.163.com/40902/1/0V975TBA00020QDS.html>.

¹¹⁹ *Id.*

Divergent in practice from its American origins, the independent director system in China has not lived up to its goals. The underlying structure of the independent director system in China is at the heart of this failure. Seemingly minor differences from the American model have a significant impact. The result is formal convergence and functional divergence.¹²⁰

V. CONSTRAINTS FROM LOCAL FORCES

In China local forces such as China's concentrated shareholding structure, lack of qualified independent director candidates, and two-tier board structure have shaped China's independent director system. Since there are no signs of change in local forces, it is likely that functional differences will persist.

A. *Concentrated Shareholding Structures*

China's shareholding structure is highly concentrated. A few large, dominant shareholders hold non-tradable legal person shares while the minority small shareholders hold tradable shares (see Table 4).¹²¹ Shareholding is concentrated in the hands of large block shareholders. In the Chinese securities market, non-tradable shares constitute almost two-thirds of the market, significantly outnumbering tradable shares.

¹²⁰ This is contrary to Gilson's prediction that corporate law rules trend towards functional convergence rather than formal convergence. Gilson, *supra* note 2, at 337.

¹²¹ Shares on Chinese stock markets are officially divided into non-tradable and tradable public shares. Both state shares and legal person shares are restricted by the government and may not be traded on the Shanghai and Shenzhen Stock exchanges. Non-tradable does not necessarily mean non-transferable. State and legal person shares can be transferred to domestic institutions and foreign investors with approval from the CSRC.

TABLE 4: Capital Structure in Chinese Listed Companies, October 2005¹²²

Categories of Shares	Shares (hundreds of millions)
<u>Non-Tradable Shares</u>	
Sponsor's legal person shares	4,271.54
Private placement of legal person shares	429.38
Employee shares ¹²³	4.29
Alter-right issue shares	0.00
Former OTC ¹²⁴ non-negotiable shares	0.00
Specifically issued shares to funds	0.03
Stratagem investors' shares	0.00
Others	56.03
Subtotal	4,761.27
<u>Tradable Shares</u>	
A Shares ¹²⁵	2,199.59
B Shares ¹²⁶	218.08
H Shares ¹²⁷	415.53
Subtotal	2,833.19
Total	7,594.47

Most large share-owners in China are transformed state-owned enterprises.¹²⁸ Additionally, the state is charged under CSRC rules with

¹²² Available at http://211.154.210.238/cn/tongjiku/report/200510/e/8070304M200510_1.htm.

¹²³ Employee shares are offered to workers and managers of a listed company—usually at a substantial discount. See Sun, Qian, Wilson Tong & Jing Tong, *How Does Government Ownership Affect Firm Performance? Evidence from China's Privatization Experience*, 29 J. BUS. FIN. & ACCT.1, 10 (2002)

¹²⁴ Over-the-counter.

¹²⁵ A-shares are the ordinary equity shares mostly held and traded by individual investors in RMB on the domestic stock exchanges. Guy S. Liu & Pei Sun, *Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey 3* (Asia Programme Working Paper, No. 2, June 2003), available at http://www.chathamhouse.org.uk/files/3762_stateshareholding.pdf. Most tradable shares are still A-shares. *Id.*

¹²⁶ B-shares refer to shares that were once exclusively traded by foreign investors, denominated in foreign currencies until 2001. *Id.* Since 2001 domestic investors can also hold these shares. *Id.*

¹²⁷ H-shares are typically shares issued by Chinese corporations to foreign investors through listings on Hong Kong, New York and London Stock Exchanges. *Id.*

¹²⁸ See GUY S. LIU & SANDY PEI SUN, THE CLASS OF SHAREHOLDINGS AND ITS IMPACTS ON CORPORATE PERFORMANCE—A CASE OF STATE SHAREHOLDING COMPOSITION IN CHINESE PUBLICLY LISTED COMPANIES,

ensuring the controlling power, influence and motivation of state-owned capital in state-owned, listed companies that are fundamental to the national economy.¹²⁹ This complicates the introduction of a truly independent director system since the Chinese government has its own interest in preserving board dominance. Even though China has largely adopted the American independent director system in form, its concentrated shareholding structure that protects state control ultimately thwarts substantial convergence.

It could be argued that, over time, dispersed shareholdings will become more common in China. However, it appears that this is not the case. Even though China is currently undergoing a share-trading reform, the government has taken the position that:

The share-trading reform that is now under way is to realize trading of non-tradable shares rather than to sell state shares through the capital market, and the state does not

<http://ideas.repec.org/p/bru/bruppp/02-19.html>, 2002; See Sun, Qian, Wilson Tong & Jing Tong, *supra* note 123, at 10.; Xu Xiaonian & Wang Yan, *Ownership Structure, Corporate Governance, and Corporate Performance: The Case of Chinese Stock Companies* 3 (World Bank Policy Research, Working Paper No. 1794, May 1997), available at <http://ssrn.com/abstract=45303>.

¹²⁹ After the listing and trading of non-tradable shares, the controlling shareholders of the state-owned shareholding listed companies shall, determine reasonably the minimum proportion of shares of the listed companies under its control, according to the strategic requirements of the State for the overall arrangement of the national economy and the structural adjustment, and for the important industries and major fields concerning the nation's economy and the people's livelihood and the life line of the national economy, and the state-owned share-holding listed companies in the fundamental and backbone industries of the national economy, the state shall ensure the controlling power, influence and motivation of state-owned capital, and the shareholders of state shares may buy shares in the securities market, if necessary. The controlling shareholders in other listed companies shall also ensure the stable growth and sustainable management of the companies. The securities regulatory department shall, through necessary systemic arrangement and technical innovation, effectively control the scale and pace for the tradable shares to enter into circulation.”

Guanyu Shangshi Goingsi Guquan Fenzhi Gaige de Zhidao Yijian [Guiding Opinions on Share-trading Reform of Listed Companies], art. 4 (promulgated by the China Securities Regulatory Commission, State-owned Assets Supervision and Administration Commission, Ministry of Finance, People's Bank of China, and the Ministry of Commerce on Aug. 23, 2005, effective on Aug. 23, 2005) LAWINFOCHINA (last visited Dec.22, 2006) (P.R.C.).

consider selling the state shares to raise funds through the domestic capital market.¹³⁰

The preservation of the state as a dominant shareholder preserves China's shareholding structure. Without structural change, inherent aspects of Chinese state control limit the likelihood of substantive convergence with the American corporate governance model. This concurs with Bebchuk and Roe's assertion that corporate laws are much less likely to converge to a single model because fundamental elements like ownership structure and corporate rules are not readily amenable to change.¹³¹

B. *Lack of Candidates for Independent Directors*

Another impediment to the substantive adoption of the independent director system in China is the lack of experienced professionals available and qualified to serve as independent directors. Since the independent director system is a recent innovation in China, China does not have a readily available, experienced applicant pool. In order to address this problem, the CSRC required independent directors to undergo a training course organized by the CSRC in conjunction with Tsinghua University.¹³² As of June of 2003, the CSRC had already organized more than thirty training courses for more than 8,000 independent directors.¹³³ However, such training is hardly a substitute for experience. Ultimately, if independent directors do not have the ability to supervise management their presence has little value. Additionally, the lack of qualified candidates makes it difficult to require a majority of independent directors.

C. *Two-Tier Board Structure*

Unlike the United States, China has developed a two-tier board structure of corporate governance composed of a board of directors and a supervisory board.¹³⁴ Under Corporate Law, listed companies are required to maintain a board of directors as a decision-making organ, and set up a

¹³⁰ *Id.* art. 4.

¹³¹ See generally Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *Stan. L. Rev.* 127, 127 (1999)

¹³² Shangshi Gongsi Duli Dongshi Peixun Shishi Xize [Detailed Implementation Rules for Training of Independent Director in Listed Companies] art.3 (promulgated by the China Securities Regulatory Commission on Dec.22, 2005, effective on Dec.22, 2005) LawInfoChina (last visited Nov.28, 2007) (P.R.C.).

¹³³ *Response*, *supra* note 69, at 1.

¹³⁴ Jason Zezhong Xiao, Jay Dahyaw & Zhijun Lin, *A Grounded Theory Exposition of the Role of the Supervisory Board in China*, 15 *BRITISH J. MGMT.* 39, 39–55 (2004).

separate supervisory board as a monitoring mechanism. Supervisors may not hold positions as directors, nor serve as chief executive officer or chief finance officer for the companies they supervise.¹³⁵

The two-tier board structure in China is more similar to the German model than the American unitary board. However, the two-tier board structure in China differs from Germany's in that the German supervisory board is a superior organ with the power to appoint and dismiss directors.¹³⁶ The supervisory board in China does not have such powers.

The existence of the supervisory board in China complicates the adoption of the independent director system. Both the supervisory board and independent directors are conceptualized as insider monitoring mechanisms. In terms of oversight, the powers and duties vested with board of supervisors and independent directors significantly overlap.¹³⁷ Specifically, supervisory boards in China hold all of the powers vested in audit committees in the United States.¹³⁸ This overlap in authority creates both tension and discord between the independent director system and the supervisory system.

Furthermore, the cost of corporate governance is higher for companies with both a supervisory board and independent directors. The coexistence of two monitors can lead to free-rider problems where each institution relies on the other to fulfill the responsibility of oversight.¹³⁹ Gilson suggests that:

Changing the form of an institution, in order to enhance its own efficiency in response to changing economic conditions, initially may result in a reduction, not an increase, in overall system productivity. . . . The new form may not be complementary to the other institutions that make up the system, which can result in a reduction in the

¹³⁵ 2005 Company Law, *supra* note 11, arts. 52, 118.

¹³⁶ The German Stock Corporation Act, art. 84(1), (3), in *THE GERMAN STOCK CORPORATION ACT* (Hannes Schneider & Martin Heidenhain eds., 1996); Florian Stamm, *A Comparative Study of Monitoring of Management in German and U.S. Corporations After Sarbanes-Oxley: Where are the German Enrons, WorldComs, and Tycos?*, 32 *GA. J. INT'L. & COMP. L.* 813, 824 (2004).

¹³⁷ 2005 Company Law, *supra* note 11, arts. 55, 119.

¹³⁸ Audit committees in the United States oversee the integrity of the corporate financial statements and compliance with legal and regulatory requirements. NYSE MANUAL, *supra* note 43, §303A.06. In China supervisory boards (in addition to audit committees) have this authority. 2005 Company Law, *supra* note 11, arts. 55, 119.

¹³⁹ CHOPER, COFFEE & GILSON, *supra* note 16, at 527; Li Kaipu, *supra* note 28, at 124.

performance of even those institutions whose form remains unchanged.¹⁴⁰

This may be one reason for the poor performance of the listed companies that have adopted the independent director system.

Hansmann and Kraakman claim that there are no persuasive alternatives to the American corporate governance system¹⁴¹ and predict that the one-tier board will eventually prevail over the two-tier board.¹⁴² However, it seems unlikely even after adopting the independent director system, that China will also adopt a one-tier board system. As a practical matter, it would be difficult for China to abandon the supervisory board because of its long statutory history as a monitor. Most Chinese investors and entrepreneurs view the board of supervisors as a necessary monitoring organ. Second, recent revisions of Chinese regulations indicate no trend toward a one-tier board system. When the Company Law was significantly revised in 2005, the supervisory board's authority was strengthened and it was vested with broad new authority. Under the revised Company Law, the supervisory board may propose the removal of any director or senior manager who violates any law, any administrative regulation, or the articles of association.¹⁴³ The supervisory board may also call and presiding over shareholders' meetings when the board of directors does not exercise this function¹⁴⁴ and may put forward proposals at any shareholders' meeting, whether called by the directors or the supervisors.¹⁴⁵ Finally, the board of supervisors may initiate action against directors or senior managers at the request of shareholders.¹⁴⁶ Thus, supervisory boards in China are still the fundamental mechanism for internal monitoring. There is no sign that China will give up supervisory boards in order to move towards a one-tier board system.

¹⁴⁰ Gilson, *supra* note 2, at 339.

¹⁴¹ Hansmann & Kraakman, *supra* note 1, at 454.

¹⁴² Hansmann & Kraakman argue:

With respect to board structure, convergence has been in the direction of a legal regime that strongly favors a single-tier board that is relatively small and has a substantial complement of outside directors, but contains insiders as well. Mandatory two-tier board structures seem a thing of the past.

Hansmann & Kraakman, *supra* note 1, at 455.

¹⁴³ 2005 Company Law, *supra* note 11, arts. 54(2), 119.

¹⁴⁴ *Id.* arts. 54(4), 119.

¹⁴⁵ *Id.* arts. 54(5), 119.

¹⁴⁶ *Id.* arts. 54(6), 119.

Minor differences between the corporate governance rules in China and the United States are not inadvertent, not are they unimportant. Local forces, represented by China's concentrated shareholding structure, its lack of qualified candidates, and its two-tier board structure have shaped corporate governance in China. The persistence of large shareholders and concentrated shareholding structures has complicated or undercut stricter monitoring requirements such as majority representation by independent directors, compulsory committee structure requirements, and stricter nominating rules. The lack of candidates has exacerbated the difficulty of requiring a majority of independent directors. The two-tier board structure increases the difficulty of implementing an effective independent director system and makes it necessary to reconcile the two monitoring institutions. All of these issues contribute to why China, in adopting the independent director system from the United States, did not precisely conform to the American model. Even though the Chinese government may continue to change the rules slightly, it is difficult to predict, given the persistent influence of local forces, that China will ever eliminate all of the differences from the American model. Convergence does not appear inevitable.

VI. CONCLUSION

The adoption of the independent director system in China provides an excellent opportunity to examine the convergence debate. On one hand, China has adopted many aspects of the American independent director model. There is at least some convergence. On the other hand, China's system varies in several ways from the American model. These differences are shaped by local forces that affect the adoption and implementation of the system. Thus, there is also divergence. The adoption of American institutions in China is simply not dispositive of inevitable convergence.