The Independent Director in Chinese Corporate Governance

Donald C. Clarke
George Washington University Law School, dclarke@law.gwu.edu

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THE INDEPENDENT DIRECTOR
IN CHINESE CORPORATE GOVERNANCE

BY DONALD C. CLARKE

ABSTRACT

Corporate governance (gongsi zhili) is a concept whose time has come in China, and the institution of the independent director is a major part of this concept. Policymakers in several countries such as the United Kingdom and Japan have turned to independent directors as an important element of legal and policy reform in the field of corporate governance. In August 2001, the China Securities Regulatory Commission (CSRC) issued its Guidance Opinion on the Establishment of an Independent Director System in Listed Companies. Covering all companies listed on Chinese stock exchanges (but not Chinese companies listed overseas), it constitutes the most comprehensive measure taken to date by the CSRC—or indeed by any Chinese governmental authority—to regulate internal corporate governance through the institution of the independent director.

This article discusses the institution of independent directors, and the Independent Director Opinion specifically, as a potential solution to Chinese corporate governance problems. It begins by discussing special features of the Chinese corporate landscape and the most prominent
problems in the area of corporate governance. It then proceeds to identify differing conceptions of what is broadly termed "the independent director"—the outside director, the disinterested director, and the (more narrowly defined) independent director—and discusses the approaches taken in several different jurisdictions.

The article canvasses empirical research on the relationship between independent directors and corporate performance in the United States, as well as in China, and finds that the research yields similar conclusions: there is no strong link. The article concludes by arguing that proponents of the institution of independent directors misconceive the nature of the corporate governance problem in China, as well as the functioning of independent directors in the United States, and have not taken into account specific features of the Chinese institutional environment—particularly the legal environment—that affect the viability of any proposed solution.

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Corporate governance (gongsi zhili) is a concept whose time seems definitely to have come in China. In part, this is simply a reflection of the increasing attention being paid to the subject in academic, professional, and business circles in the West, and of the increasing integration of Chinese intellectual life with global trends. But the flood of speeches, articles, and conferences on corporate governance in China today would not be occurring if the concept did not seem to promise a way of thinking about, and remediying, a host of perceived flaws in China's legal and economic institutions.

Policymakers in several countries have turned to independent directors as an important element of legal and policy reform in the field of corporate governance. In the United States, insider-dominated boards have been rare for years, and although the New York Stock Exchange (NYSE) has required that independent directors constitute a board majority in domestic companies only since 2004, as of 2001 approximately 75% of

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1 I searched a database of Chinese periodicals in law, economics, and related subjects (the Zhongguo Qikan Quanwen Shujuku [Chinese Periodicals Full-Text Database], at http://www.cnki.net) to see in how many articles the most common Chinese term for corporate governance, gongsi zhili, appeared in the title. In 1994, the year the Company Law came into effect, there were nine such articles. In 1995, the number was 14. In 1999, the number was 107; in 2002, 643; and in 2004, 899. As of early March 2006, this database recorded 933 article titles mentioning "corporate governance" in 2005.

2 See Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 BUS. LAW. 921, 921 (1999) ("In the 1960s most [large American companies] had a majority of inside directors; today, almost all have a majority of outside directors and most have a majority of 'independent' directors.").

NYSE-listed companies already had such majorities. With the rise of takeover activity since the 1980s, disinterested directors have played an increasingly important role in related state-level litigation, and the modest role for independent directors contemplated in the listing rules of the NYSE has given way, in the wake of Enron and other corporate scandals, to federal mandates for listed companies under the Sarbanes-Oxley Act (SOA). Britain’s own set of corporate scandals led to the Cadbury Report, which recommended, along with subsequent similar reports and studies, a greater role for outside and independent directors, and the last decade has seen a number of corporate law reforms in Japan designed to enhance the role of directors and auditors not tied to management.

The increasing worldwide interest in independent directors has not gone unnoticed by Chinese policymakers. Indeed, Chinese interest preceded the corporate scandals that led to federal-level corporate governance reforms in the United States, possibly because of the many similar scandals that had already occurred among Chinese companies listed on one of the country’s two stock exchanges. In August 2001, the China Securities Regulatory Commission (CSRC) attracted attention with the issuance of its Guidance Opinion on the Establishment of an Independent Director System included in Section 303 of the Listed Company Manual. See id.

4See Joann S. Lublin, NYSE Considers Rules to Boost Power of Boards Fostering the Independence Of Directors Could Improve Governance, Advisers Say, WALL ST J., June 3, 2002, at A2 (citing report by Investor Responsibility Research Center). In a 2003 survey of its 150 members, the Business Roundtable, an organization of large American corporations, found that 80% had boards that were at least 75% independent, and that 90% had boards that were at least two-thirds independent. See Press Release, The Business Roundtable, The Business Roundtable Releases Corporate Governance Survey (July 15, 2003), available at http://www.brt.org/press.cfm/970.

5The difference between disinterested, independent, and outside directors is discussed infra Part III.B.

6See infra note 109 and accompanying text.

7See infra notes 106-07 and accompanying text.


9See infra notes 134-39 and accompanying text.

10The two Chinese stock exchanges are in Shanghai and Shenzhen.

Despite its scope, the Opinion was not the first Chinese regulatory document\footnote{The admittedly clumsy term “regulatory document” includes all rules of a normative character issued by Chinese legislative, governmental, and judicial agencies, as well as quasi-governmental variations thereon. The nature of the Chinese legal system makes such a term necessary, although this article is not the place to demonstrate the point systematically. \textit{See generally} Perry Keller, \textit{Sources of Order in Chinese Law}, 42 AM. J. COMP. L. 711, 711-12 (1994) (characterizing Chinese legislation as being in a state of “chronic disorder”).} to call for the appointment of independent directors, and the idea had been under discussion for some time in academic journals and the financial press. Although the institution of independent directors has been mooted largely as part of a solution to governance problems in listed companies, the problems in question are not necessarily unique to listed companies. As Chinese economic reform continues and the government abandons the traditional ways of managing state-owned enterprises, and as individual wealth increasingly makes possible the accumulation of private assets on a scale too large to be managed by an individual owner, there will increasingly exist corporate entities in one form or another that are run by professional managers who do not own the assets, and yet are unconstrained by the disciplines that functioned reasonably well under the system
of state planning. Thus, Chinese scholars and policymakers have been searching for new mechanisms of corporate governance and accountability not just for listed companies, but for all concentrations of assets managed by non-owners.

This article will discuss the institution of independent directors, and the Independent Director Opinion specifically, as a potential solution to Chinese corporate governance problems. I will argue that proponents of the institution misconceive the nature of the corporate governance problem in China, as well as the functioning of independent directors in the United States, and have not taken into account specific features of the Chinese institutional environment, particularly the legal environment that affects the viability of any proposed solution. The discussion of independent directors will, I hope, shed light on a number of broader issues in Chinese corporate governance, including such questions as the basic approach to the regulation of corporate activity.

Part II of this article examines basic issues of corporate governance generally as well as in China. It introduces some basic facts about the system as well as the principal problems seen by commentators. Part III looks at the specific institution of independent directors as a proposed solution, and canvases regulatory responses, including the Independent Director Opinion. Part IV pulls these strands together, discussing first the empirical evidence regarding the effect of the presence of independent directors on the board of directors, and then the policy implications for corporate governance of what we know about corporate structure and the legal system in China. Part V offers a conclusion.

II. CORPORATE GOVERNANCE IN CHINA

A. Listed Companies in China

As this article is concerned primarily with the governance of Chinese companies listed on one of the country’s two stock exchanges, an introduction to the relevant features of such companies is essential before turning to issues of corporate governance both in general and in China.

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15On constraints on management behavior under the system of state planning, see generally EDWARD S. STEINFELD, FORGING REFORM IN CHINA: THE FATE OF STATE-OWNED INDUSTRY (Cambridge Univ. Press 1998).
1. Who Are They?

Chinese companies may be listed on one of China's two stock exchanges in Shanghai and Shenzhen. They may also be listed on overseas exchanges, typically in Hong Kong or New York. As of the end of 2005, there were 1381 companies listed on China's two domestic markets.\(^\text{16}\)

To be listed and thus able to raise money directly from the public, a company must take the corporate form of a joint stock company (\textit{gufen youxian gongsi}) (JSC) under the Company Law\(^\text{17}\)—a form intended for large corporations with widely dispersed stock ownership. Thus, a traditional state-owned enterprise (TSOE)\(^\text{18}\) must reorganize itself to be listed. The vast majority of listed companies are, in fact, reorganized TSOEs. Of 1088 listed companies on both exchanges at the end of 2000, over 900 were originally TSOEs,\(^\text{19}\) and of 1160 listed companies at the end of 2001, approximately 1103 were originally TSOEs.\(^\text{20}\) A recent study concluded that approximately 84\% of listed companies were, viewed solely from the standpoint of equity ownership and not taking account of informal mechanisms of influence, directly or indirectly under state control.\(^\text{21}\)

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\(^\text{17}\)See \textit{Zhonghua Renmin Gongheguo Gongsi Fa} [\textit{Company Law of the People's Republic of China}], as amended Oct. 27, 2005, ch. 4 [hereinafter \textit{Company Law}]. Such companies are sometimes referred to as "companies limited by shares." The pre-amendment version of the Company Law, adopted in 1993 and effective from July 1, 1994 through Dec. 31, 2005, is referred to hereinafter as the \textit{1993 Company Law}.

\(^\text{18}\)By "traditional state-owned enterprise" I mean the kind of state-owned enterprise that existed prior to the Company Law: something like a cost center or a division within the loosely organized firm of China, Inc. There was no formal law governing industrial TSOEs until 1988, and there is still no formal law governing commercial TSOEs. \textit{See generally} Donald C. Clarke, \textit{Corporate Governance in China: An Overview}, 14 CHINA REV. 494, 496 (2003).


\(^\text{20}\)See \textit{Stephen Green, China's Stock Market: Eight Myths and Some Reasons To Be Optimistic} (The China Project, Royal Institute of International Affairs and Cambridge University, Feb. 2003). Jiang Qiangui, the chairman of the State Economic and Trade Commission (SETC), was recently quoted as saying that "the vast majority of listed companies are reorganized state-owned enterprises." \textit{Guojia Jing Mao Wei Fuchuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong} [SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder], JINGJI RIBAO [\textit{ECONOMIC DAILY}], Jan. 30, 2003, available at http://www.chinainfobank.com.

2. Capital Structure

As JSCs, listed companies are allowed under the Company Law to have only one class of shares. It is crucial to understand, however, that there are nevertheless several different types of shares, distinguished by rules about their ownership and trading.\(^{22}\) First, there are several types of shares known as circulating shares that may be traded freely and publicly on various stock markets. A-shares may be listed on a domestic stock exchange and owned and traded by any domestic individual, entity, or specially approved foreign institutional investor.\(^{23}\) B-shares are also listed on domestic stock exchanges and until recently could be bought only by foreigners using foreign currency; they may now be purchased by domestic investors as well with foreign currency. Other letter-designated shares include H-shares (listed in Hong Kong), N-shares (represented by American Depositary Receipts listed in New York), L-shares (listed in London), and so on.

Second, there are several types of shares known as non-circulating shares that are subject to more severe trading restrictions. These are state shares (guojia gu), which may be owned only by state organs; legal person shares (faren gu), which may be owned only by organizations with formal legal personality, such as companies; and employee shares, which generally represent accumulated profits in a state enterprise prior to its public share

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\(^{22}\)For a fuller account of share types, see CARL E. WALTER & FRASER J.T. HOWIE, PRIVATIZING CHINA: THE STOCK MARKETS AND THEIR ROLE IN CORPORATE REFORM 71-87 (John Wiley & Sons 2003).

\(^{23}\)Some analysts define A-shares broadly as shares available only to domestic investors, and include all the non-circulating shares described in the following paragraph in the text. This seems confusing to me for several reasons and I shall adopt the narrower definition here. First, popular usage of the term "A-shares" almost always refers to tradeable shares listed on stock markets. Second, state shares and employee shares (which have their origin in the corporatization of traditional state-owned enterprises) are by definition domestically held, so giving them a second label seems redundant. Third, legal person shares may, following the lifting of a prohibition lasting from 1995 to 2003, be sold to foreign entities, subject to appropriate approvals. See China Securities Regulatory Commission, Ministry of Finance, and State Economic and Trade Commission, Guanyu Xiang Waishang Zhuanrang Shangsi Guo yougu he Farengu Youguan Wenti de Tongzhi [Notice Regarding Transfer to Foreign Investors of State-Owned Shares and Legal Person Shares of Listed Companies], issued Nov. 1, 2002. Circulating shares recently became available to certain foreign entities qualifying as Qualified Foreign Institutional Investors. See China Securities Regulatory Commission and People's Bank of China, Hege Jingwai Jigou Touzizhe Jingmei Zhengquan Touzi Guanli Zanxing Banfa [Provisional Measures on the Administration of Investment in Domestic Securities by Qualified Foreign Institutional Investors], issued Nov. 5, 2002, effective Dec. 1, 2002. Whether tradeable shares can be owned by foreigners and whether legal person shares can be owned by foreigners are two different policy decisions that will likely be made separately; labeling both types by the same name does not seem to serve any useful purpose.
offering and are deemed formally owned by the collective body of enterprise employees. These shares are not tradeable at the time of listing and are generally managed by either an investment management committee or a staff union.24

It should be noted that the state share/legal person share distinction is well established in law and statistics but is conceptually problematic. Legal persons that hold shares can be state-owned and state-controlled, so in some sense many legal person shares should be seen as state shares.25 That said, it must be added that the various government bodies holding state shares do not act with one mind and may pursue conflicting objectives. Some government bodies may well be purely profit seeking, while others seek to use their share ownership to influence the company to fulfill certain government objectives such as full employment.

By the same token, apparently some shares classified as state shares are in fact held not by government agencies but by companies (e.g., parent companies of corporate groups) that are controlled by the government agency in charge of that industry.26 These should technically be called legal person shares, but they are called state shares because their voting and use is in some sense directly controlled by government. The principles governing the classification of shares as legal person shares or state shares are neither clear nor uniform.27 The bottom line of the state share/legal person share distinction, therefore, is that it does not tell us much about the nature of the ultimate controlling shareholder.28

3. Who Owns Them?

Until quite recently, the mean shareholding percentages across companies was typically about 30% for each of the state, legal persons, and

25See Yin Wenquan, Qiye Jituan Shangshi Gongsi de Guquan Jiegou Gaizao [Adjust the Governance Structure of Listed Enterprise Group Companies], in ZHONGGUO GONGSI ZHILI JIEGOU [THE STRUCTURE OF CORPORATE GOVERNANCE IN CHINA], supra note 24, at 98-111.
26See, e.g., id. at 99-100.
27See id. at 99.
28This point is explored in detail in Liu & Sun, supra note 21, at 8.
A-share holders, with 10% going to foreigners and employee shares. Although this rough average seems robust over several studies, one study finds that the standard deviation is large, showing that there are large variations in the formal ownership mix across firms.

A recent study, however, calls this stylized fact into question. Lü and Wu find that as of the end of 2002, state shares represented as much as 47.2% of outstanding shares of listed companies, down from 51.31% at the end of 1992. It seems unlikely that state share ownership dipped to somewhere around 30% in the 1990s and then rose again. Lü and Wu further put legal person shareholdings at 11.31% and circulating shares (including B-shares and H-shares) at 34.67%. Thus, the rough figure for circulating shares seems confirmed by all studies, whereas the figure for state and legal person shares is in question. Since Lü and Wu’s figure for legal person shares seems abnormally low, it may be that by "state shares"

29 See Qi et al., supra note 24, at 593. Xu and Wang come to a similar conclusion for ownership as of the end of 1995, see Xiaonian Xu & Yan Wang, Ownership Structure and Corporate Governance in Chinese Stock Companies, 10 China Econ. Rev. 75, 76 (1999), and Yin reports that as of the end of 1997, the mix was 32% state shares, 30% legal person shares, and 35% tradeable shares, see Yin, supra note 25, at 98. (Note, however, that many legal person shares are held by institutions that are themselves state-owned.) Zhang and Sun report a mix of 34% state shares and 34% circulating shares against 20.9% domestic legal person shares for 1998, with the remainder being held by foreigners, founders, and employees. See Zhang Zongxin & Sun Yewei, Guquan Jiegou Youhua yu Shangsi Gongsi Zhili de Gaijin [The Optimization of Share Capital Structure and the Improvement of Corporate Governance in Listed Companies], JINGJI PINGLUN [ECON. REV.], No. 1, 2001, at 36. Ren Haichi reports a figure of 60% state-owned shares (guoyou gu) and 35% circulating shares for all listed companies as of the end of June 2002 (note that the term “state-owned” includes both state shares and legal person shares belonging to entities owned by the state). See Ren Haichi, Ruhe Youhua Woguo Shangsi Gongsi Ziben Jiegou [How to Improve the Capital Structure of China’s Listed Companies], SHANGHAI JINRONG XUEYUAN-XUEBAO [J. SHANGHAI INST. FIN.], No. 2, 2004, at 60, 60.

CSRC statistics as of the end of December 2005 put the value of circulating shares at 1.06 trillion yuan, and the value of all shares of listed companies at 3.24 trillion yuan. See CSRC Web site, http://www.csrc.gov.cn. While it is not economically realistic to value non-listed shares at the same price as listed shares, see infra note 51, doing so does permit the conclusion that a reasonable weighted average percentage for circulating shares is about 33%.

Publicly issued (that is, tradeable) shares must account for at least 25% of all shares at the time of a public offering unless the par value of the company’s stock exceeds 400 million yuan, in which case they must account for at least 10%. See Zhonghua Renmin Gongheguo Zhengquan Fa [Securities Law of the People’s Republic of China], as amended Oct. 27, 2005, art. 50. This rule was, prior to the October 2005 revisions to both the Securities Law and the Company Law, set forth in Article 152 of the Company Law.

30 See Xu & Wang, supra note 29, at 80 (table).


32 See id.
They actually mean "state-owned shares" (guoyou gu), a term that includes legal person shares owned by state-owned entities.

While individuals, as noted above, are not permitted to hold state shares or legal person shares, institutions are allowed to hold A-shares. It is very difficult, however, to know the degree of institutional ownership of A-shares. According to one source, for example, as of the end of 1998, there were 19.9 million stock accounts at the Shanghai stock exchange. Of these, 99.75% were for individuals, with institutions holding only 0.3%. Individuals held 93.15% of A-shares by value. By the end of 2001, the reported number of A-share accounts on both exchanges was up to an astonishing 60 million, equal to about one in five urban residents between the ages of 15 and 64. Anthony Neoh, the former chairman of Hong Kong Securities and Futures Commission and a prominent advisor to the CSRC, however, was reported in December 2001 to have asserted that because of duplicate registrations and dormant or abandoned accounts, the real number was closer to 10 million. Despite these cautions, media outlets were still reporting, without qualification, account totals of 70 million in January 2005.

Walter and Howie, on the basis of a variety of data, put the number...
of actual holders of shares at five to ten million, and estimate the number of active traders to be only about one million.\(^{38}\)

The presence of official and unofficial investment funds complicates the picture further. Recent research suggests that as much as 40% to 50% of the value of circulating shares is controlled by official and unofficial investment funds;\(^{39}\) when one then adds in the value of A-shares controlled by other institutions, the amount in the hands of individuals appears to be far less.

Overall and within the non-circulating share block, ownership concentration is high in Chinese listed companies. Xu and Wang found that as of 1995, the five largest shareholders in their sample (all firms listed on the Shanghai and Shenzhen stock exchanges) accounted for 58% of outstanding shares, as compared with 57.8% in the Czech Republic, 79% in Germany, 33% in Japan, and 25% in the United States.\(^{40}\) Chen found that the largest single shareholders held on average 48% of outstanding shares, and that the largest ten shareholders held on average nearly 64% of the outstanding shares.\(^{41}\) Moreover, of the 12 largest companies on the Shenzhen stock exchange, 11 had a single shareholder owning over 50%, and in four of the largest companies, a single shareholder owned over 70%.\(^{42}\) Perhaps the best overall picture is that of Lou and Yuan, who report that as of May 10, 2001, 177 out of 1206 listed companies (15%) were more than 66% owned by a single shareholder; 510 (42%) were more than 50% owned; 742 (62%) were more than 37.5% owned; and 888 (74%) were more than 30% owned.\(^{43}\)
Within the A-share (circulating shares) block, the pattern is similar. In companies listed on the Shenzhen Stock Exchange, for example, about 9% of the shareholders own about 58% of the A-shares. Few large shareholders are individuals. In a 1997 sample of 300 companies listed on the Shenzhen Stock Exchange, only 42 companies listed individuals among their five largest shareholders. Individual investors among the ten largest shareholders still controlled only a small amount of stock: individual holdings rarely exceeded 0.5% of the total, and the aggregate holdings of such individuals constituted about 3.4% of total outstanding shares of the sample companies.

Where state share ownership exists it appears to be concentrated. Out of 541 listed companies with some state share ownership in 1999, in 312 the state shareholder was the only shareholder with a stake exceeding 5%. In over 87% of the 541 companies, the state held a controlling interest either through a majority holding or a dominant holding. Lin provides a different angle on the issue, finding that in 1997, 97% of all listed companies were state-owned, state-controlled, or had significant state share ownership, and that 75% of the outstanding (not necessarily all listed) shares of listed companies were directly or indirectly owned by the state (indirect ownership presumably including ownership through state-owned or state-controlled companies of legal person shares). Such direct or indirect ownership continued in subsequent years. By the end of June 2002, state-owned shares (i.e., state shares and legal person shares owned by state-owned entities) accounted for at least 70% of the outstanding shares of over half of the largest 112 listed companies.

There are several problems with the studies on share ownership that must be taken into account before attempting to read any significance into the results. First, political authorities retain many channels of control, both lawful and customary, through which internal corporate matters (for

44 See Walter & Howie, supra note 22, at 133-34.
45 See Xu & Wang, supra note 29.
46 See Zhang & Sun, supra note 29, at 36.
48 See Ren, supra note 29, at 60.
example, the selection of the chief executive officer) may be influenced even in the absence of a controlling share ownership.

Second, and on the other hand, a high proportion of state shares does not necessarily mean highly concentrated ownership in a practical sense. A given proportion of state shares would mean a given concentration of ownership only if the state shares were all held by the same body and subject to the same will. In fact, state shares can be held by different bodies formally representing the state but pursuing very different agendas.\textsuperscript{49} At the same time, however, effective concentration of ownership in the hands of a single state body could be higher than the statistics show, because as discussed above, the line between state shares and legal person shares is often difficult to draw in terms of the motivations and objectives of the shareholder. A governmental body could exercise influence both through directly held state shares and through legal person shares held by a controlled entity.\textsuperscript{50}

Third, the averaging of ownership concentration across companies can create severe distortions, depending upon how it is done. A simple averaging technique will yield an average ownership concentration of 50% from a tiny company that is 90% owned by its largest single shareholder and a huge corporation that is 10% owned by its largest single shareholder. Clearly, this averaging is not very helpful. Weighting by numbers of shares is equally unsatisfactory, because there is no reason why both companies could not, for example, have the same number of shares outstanding (although they would of course have different values). Finally, the most obvious technique, weighting by the value of the company, has some serious problems when applied to China because it is not clear how such value should be measured. A simple market capitalization measure—multiplying the market value of one share by the number of outstanding shares—will certainly yield a number, but the meaningfulness of that number is questionable. As noted earlier, only a small proportion of

\textsuperscript{49}This point is specifically made in Zheng Changde \& Chen Zhe, Sichuan Shangshi Gongsi Zhili Jiegou de Shizheng Fenxi [An Empirical Analysis of the Corporate Governance Structure of Sichuan Listed Companies], XINAN MINZU XUEYUAN XUEBAO: ZHEXUE SHEHUI KEJI XUE BAN [BULLETIN OF THE XINAN MINORITIES INSTITUTE: PHILOSOPHY AND SOCIAL SCIENCE EDITION], No. 12, 2001, at 176, 180.

\textsuperscript{50}Zhang and Sun, for example, speak of shares that are state-owned “in nature” but have been transferred from a state asset management organ to a state-owned group company. See Zhang \& Sun, supra note 29, at 38. Chinese government agencies themselves use inconsistent (but not irrational, given their particular policy missions) definitions of share types. When legal person shares are owned by a state-owned enterprise or other institution owned or controlled by the state, they are called “state-owned legal person shares”; they are counted as state shares by the State Assets Administration Bureau (such term to include its successor organizations) but as legal person shares by the CSRC. See Lin, supra note 47, at 23.
corporate shares—roughly one third—is tradeable on the public markets, and it is by no means clear that the non-circulating shares should be valued at the same price. Chen and his colleagues suggest that the market value of non-circulating shares is far below that of circulating shares, sometimes by as much as 90%. The true discount may be even steeper, because the price of non-circulating shares should reflect in many cases a control premium; in general, a controlling block of shares simply cannot be purchased on the stock market, and therefore control over a listed company is transferred through the sale of non-circulating shares.

Despite all these issues, the bottom line is that concentrated ownership, and therefore control, by a single state shareholder is quite common in Chinese listed companies. A study of corporate governance conducted in 2002 by the CSRC and the State Economic and Trade Commission (SETC) found that of 1015 controlling shareholders in the 1175 listed companies studied, 77% could be considered state organs (guojia xingzhi), while in 390 companies a single state shareholder held over half of the shares. Using a different approach that traced the ultimate ownership of both state shares and legal person shares, a recent study found that 84% of listed companies were ultimately under state control.

4. Relationship Between Ownership Structure and Performance

Some studies of Chinese listed companies have attempted to correlate ownership structure with performance, measured in various ways. In general, performance seems to be positively correlated with concentrated ownership, at least to some point, and negatively correlated with dispersed ownership. ("Concentrated ownership" must be understood here to mean concentrated ownership by state agencies or legal persons because concentrated ownership by individuals is virtually unknown.) The explanation typically offered is that large shareholders reduce the free rider

52 The study is reported in Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi GONGSI Chengxin Fuce de Konggu Gudong [SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder], supra note 20.
53 See Liu & Sun, supra note 21, at 2-3. Legal person shares counted toward state control if the controller of the legal person shareholder was, directly or indirectly, a state institution.
54 See, e.g., Lü & Wu, supra note 31, at 89-90 (reviewing various studies); Chen, supra note 41, at 69; Qi et al., supra note 24, at 594; Sun Yongxiang & Huang Zuhui, Shangshi Gongsi de Guquan Jieguo yu Jixiao [Shareholding Structure and Performance in Listed Companies], JINGJI YANJU [ECON. RESEARCH], No. 12, 1999, at 23-30; Xu & Wang, supra note 29, at 86-87.
problem of small, dispersed shareholders and make better monitors of management. The same studies, however, find that performance is negatively related to the proportion of state shares and positively related to the proportion of legal person shares in the total capital stock. Thus, it is not simply any large shareholder that will do. The large shareholder must be an institutional shareholder that is separate enough from the state so as not to be counted as a holder of state shares.

Several theories have been proffered to explain why companies with a high percentage of legal person shares perform better than companies with a high percentage of state shares. Generally, the explanation is that state control causes poor performance—first, because

55The poorer performance may also be the result of institutional deficiencies. Individual dispersed shareholders are more dependent on institutional support such as a well functioning legal system and an active and well informed financial press, whereas large blockholders can rely on their own strength. Djankov and Murrell show that the performance of state-owned enterprises after privatization is worse in those whose owners are less concentrated. See Simeon Djankov & Peter Murrell, Enterprise Restructuring in Transition: A Quantitative Survey, 11 J. ECON. LITERATURE 739, 741, 759 (2002).

56See, e.g., Chen, supra note 41, at 68; Qi et al., supra note 24, at 604-05; Xu Xiaonian, Gongsi Zhili Jiegou: Zhongguo de Shijian yu Meiguo de Jingyan [The Structure of Corporate Governance: China’s Practice and America’s Experience] (Zhongguo Renmin Daxue Chubanshe 2000); Xu & Wang, supra note 29, at 88. Lin and Dong have a similar result although they do not label it as such. They note that performance is better when the leading shareholder is a company limited by shares or a limited liability company (two corporate forms under China’s Company Law), and find worse performance in companies whose dominant shareholder is a so-called “group company” (jituan gongsi) or “general company” (zong gongsi). See Lin Ling & Dong Hong, Faren Zhili Jiegou yu Jingyejing Jixiao: Lai Zi Gao Keji Shangshi Gongsi de Shizheng Fenxi [Legal Person Governance Structure and Operational Results: An Empirical Analysis of High Technology Listed Companies], in GUO & WANG, supra note 33, at 204-34. The latter two entities are typically not organized under the Company Law, but are instead commercial-sounding names for what are essentially government agencies. Thus, they should be considered state shareholders. Indeed, entities with such names are frequently listed as the holders of shares designated “state shares” (guojia gu) in company reports. See, for example, the report for Guangdong Baolihua Industry Co. Ltd. in ZHONGGUO SHANGSHI GONGSI JIBEN FENXI [CHINA LISTED COMPANY REPORTS] 282 (Zhongguo Faxue Jishu Chubanshe 1999) (naming Guangdong Baolihua Group Company as holder of 71.8 million state shares (guojia gu)) or for Wenergy Co. Ltd. in SHANGSHI GONGSI JIBEN FENXI [CHINA LISTED COMPANY REPORTS] 194 (Zhongguo Faxue Jishu Chubanshe 1999) (naming Anhui Provincial Energy Investment General Company as holder of 468 million state shares).

Interestingly, Lin and Dong report that there is no apparent relationship between performance and the proportion of shares publicly listed. See Lin & Dong, supra, at 208. This necessarily implies, however, that there is no relationship between performance and the proportion of shares not publicly listed: state shares and legal person shares (with some very small exceptions). Therefore, their analysis would suggest that the key variable is not the proportion of state or legal person shares overall, but their proportions relative to each other.
the state is necessarily an ineffective monitor of management, 57 and second, because the state pursues goals other than profit maximization. 58

The second explanation seems more plausible than the first. It is no secret that one of the very purposes of state ownership of enterprises is to enable the state to use its ownership, and thereby control, to cause the enterprise to engage in activities that a profit-maximizing firm would avoid, such as the sale of essential products at below-market prices, enforcement of state birth control policies among employees, or pursuit of an urban full-employment policy.

It is not clear, on the other hand, why the state must be a more ineffective monitor than a non-state institutional shareholder. Certainly, the state official that performs the actual monitoring gets no personal benefit from doing the job well, but the same could be said of a CalPERS employee charged with monitoring the fund's holdings in a particular company. 59 In practice, of course, there are many reasons why the state may do worse. First, the monitoring individuals may well be locally employed and salaried, while the formal ownership of the shares is lodged in a higher level of government. A monitor responsible to local government will not object to corporate policies such as high employment that are beneficial to local government at the expense of the central state shareholder. Second, a monitor working in a government agency may be less able to distinguish good from bad corporate policy than a monitor in a business-oriented institutional shareholder. 60 Third, an individual monitoring on behalf of the state is much less likely to have someone at some point above him in the chain of command making a strong demand for good corporate performance in companies held by the state.


58 Qi and his colleagues note that correlation does not equal causation: it may be that the state invests in poorly-performing firms, while non-state institutional shareholders invest in well-managed ones. They test for causality by looking at changes in ownership proportions in a given firm over time, and find that as legal person shareholding increases, so does performance. See Qi et al., supra note 24, at 607-09.


60 For a fuller discussion, see Qi et al., supra note 24, at 594-95. See also Pamela Mar & Michael N. Young, Corporate Governance in Transition Economies: a Case Study of Two Chinese Airlines, 36 J. OF WORLD BUS. 280, 282 (2001) ("[A]lthough Chinese SOEs [(state-owned enterprises)] have concentrated ownership (i.e., the state) the potential positive effect of such an arrangement is absent because of the dispersal of state representation . . . . In short, many SOEs are simply monitored inadequately or ineffectively.")
Putting aside the question of the difference between legal person shareholders and state shareholders, it remains to be discussed why concentration of ownership in the hands of legal person shareholders might be positively correlated with performance. As noted above, the usual argument is that concentration of shareholdings gives the shareholder an incentive to monitor management that is absent in a small shareholder, since the benefit of monitoring is too attenuated to be worth the cost. On the other hand, it is also reasonable to be concerned that as a shareholder’s influence over the corporation rises, the reduced risk of expropriation of shareholders by management is replaced by the increased risk of expropriation of minority shareholders by majority shareholders. As Shleifer and Vishny note, “[I]n large corporations of most countries, the fundamental agency problem is not the Berle and Means conflict between outside investors and managers, but rather than between outside investors and controlling shareholders who have nearly full control over the managers.”

The prospect of dominant shareholders exploiting minority shareholders, rather than that of Berle-and-Means managers enjoying on-the-job consumption at the expense of all shareholders, is certainly the one that seems most worrisome to Chinese commentators (except where the state is the dominant shareholder, where the concern is of ineffective monitoring leading to mismanagement and asset-stripping).

Research on U.S. firms indicates that the relationship between firm performance and ownership concentration is an inverted V: as concentration rises, performance rises at first, but then declines as concentration rises still further. The explanation, according to Shleifer and Vishny, is that “as ownership gets beyond a certain point, the large owners gain nearly
full control and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders.64

This pattern has not been observed in Chinese firms—possibly because virtually all listed firms have at least 30% public shareholding, making it hard to find examples of highly concentrated ownership, and possibly because the studies simply have not yet been done. If anything, the opposite pattern has been observed. One study found that performance, as measured by the ratio of market value to book value, followed a U-shaped curve as ownership concentration by legal person shareholders increased. The study's authors hypothesized that individual investors at first feared expropriation by such shareholders—that they would use their influence to expropriate—but believed that as their stake rose, the interests of the legal person shareholders would become more congruent with theirs.65 In other words, a controlling shareholder's ability to expropriate would remain constant whether it owned 51% or 91%, but its incentive to do so would decline as its financial interest in the corporation increased. Another study found that performance peaked when the largest shareholder held 30% to 50% of the stock, and was worst when no shareholder held more than 30%.66

Until further research is done, probably the most that can be safely said is that concentrated ownership by non-state shareholders is probably by and large a good thing that should not be discouraged by the law—there is some evidence that it is valued by the market67—and that public shareholders are probably capable of taking the possibility of dominant-shareholder expropriation into account.

B. Corporate Governance in General

The concept of corporate governance is extremely broad, and a number of definitions of varying degrees of complexity and scope are possible. Perhaps the simplest definition—in words, if not in scope—is found in the report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report), which defines corporate governance as

64 Shleifer & Vishny, supra note 62, at 759.
65 See Xu & Wang, supra note 29, at 91.
66 See Lin & Dong, supra note 56, at 205.
67 See Qi et al., supra note 24, at 609; Xu & Wang, supra note 29, at 95. A problem with both of these studies is that they appear to assume that a given proportion of legal person shareholding is more concentrated than the same proportion of individual shareholding. This is probably true as an empirical matter, but it is not a necessary characteristic of legal person ownership.
"the system by which companies are directed and controlled."\(^6^8\) Margaret Blair supplies a very broad definition, calling it "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated."\(^6^9\)

A slightly narrower definition is used by institutional economists such as Oliver Williamson, who in his chapter on corporate governance sets out to examine the relationship between the firm and each of what he calls its constituencies: labor, capital (equity and debt), suppliers, customers, the community, and management.\(^7^0\) This conception of corporate governance essentially attempts to cover everyone who participates in some way in the process by which a firm's product is produced and sold. It sees these parties (with the exception of "the community") as engaging in voluntary interactions with the firm, and the question it poses is: What are the terms on which they interact, and why do those terms look the way they do? "Governance," in the work of Williamson and others writing in a similar vein, refers to the institutional structure parties set up to deal with the inevitable incompleteness of their contracting, and attempts to explain voluntary relationships in those terms.

Finally, the narrowest definition—and the one adopted in this article—centers around the relationship between stockholders, the board of directors, and senior management,\(^7^1\) and deals with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."\(^7^2\)

One of the key tensions within any system of corporate governance is the necessary tradeoff between authority and accountability. On the one hand, managers must be allowed a certain amount of leeway to make decisions and even to make mistakes; this is why they are hired to manage in the first place. Protection for minority shareholders cannot go too far because they may use their power to block the majority from undertaking reasonable and justified measures unless they are paid off. Unlimited

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\(^6^9\)Margaret M. Blair, Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century 3 (The Brookings Inst. 1996).

\(^7^0\)See Oliver E. Williamson, The Economic Institutions of Capitalism 298 (The Free Press 1985).

\(^7^1\)See Mark J. Roe, Path Dependence, Political Options, and Governance Systems, in Comparative Corporate Governance: Essays and Materials 165, 168 (Klaus J. Hopt & Eddy Wymeersch eds., Walter de Gruyter 1997).

\(^7^2\)Shleifer & Vishny, supra note 62, at 737.
protection for minority shareholders simply erases the distinction between small stakes and large stakes, and subjects all corporate decisionmaking to second-guessing by the body—perhaps a court—charged by the law with providing the protection.

On the other hand, it is equally clear that managers cannot be left wholly unaccountable. If they were, they would have no incentive to maximize anyone's interests but their own, and others would therefore have no incentive to commit resources to their management, leading to the collapse of the enterprise. Dooley sums up the paradox by positing two models of corporate governance: the Authority Model, which is concerned with giving directors and officers sufficient power to manage the corporation, given that the shareholders cannot and do not expect to do so, and the Responsibility Model, which is concerned with ensuring the accountability of directors and officers to shareholders and perhaps others. 73 As he points out, "[N]either Model exists in pristine form in the real world." 74 Elements of both are needed in a functioning regime of corporate governance. 75 But as he also points out, "Authority and Responsibility are both essential values because each responds to one of the two principal kinds of costs incurred in operating as a firm. Unfortunately, these values are also antithetical, and more of one means less of the other." 76

C. Corporate Governance in China

Any one of the definitions of "corporate governance" canvassed above could be serviceable depending on its intended purpose. For the purposes of this article, however, I will define corporate governance as the set of rules and practices regulating relationships among participants in a post-traditional Chinese business enterprise and governing decisionmaking within that enterprise. By "post-traditional" enterprise I mean any enterprise that is no longer bound tightly within the traditional state planning system and operated by its administrative superior agency essentially as a division within a larger enterprise. 77 It is an enterprise in

73 See Michael P. Dooley, Two Models of Corporate Governance, 47 BUS. LAW. 461, 463 (1992).
74 Id.
75 See id. at 463-64.
76 Id. at 464.
77 Most such enterprises are governed by China's Law on Industrial Enterprises Owned by the Whole People (Quanmin Suoyouzhi Gongye Qiye Fa), adopted Dec. 2, 1986 [hereinafter the State-Owned Enterprise Law].
which voluntary, contractual relationships are important and top-down commands from government are less important.

This definition makes clear my understanding that current discussions in China do not focus on the state-owned enterprise in its traditional form. Instead, these discussions take for granted that this form is on the way out. They do deal with state ownership of industrial and commercial enterprises, but in the capacity of a stockholder or equity owner of a company organized under the Company Law, not in the capacity of controller of a traditional state-owned enterprise governed (at least formally) by the State-Owned Enterprise Law.

Corporate governance in the post-traditional enterprise has caught the attention of policymakers and academics for a good reason. At the macroeconomic level, the focus of state economic reform policy has been to move from a system of regulation by direct command to a system of regulation by government adjustment of market signals. By the same token, the focus of reform policy at the microeconomic level has been to move from a system of governance of firms through direct administrative commands to a system of governance that works by establishing institutions that operate in relation to each other to produce the desired result. Thus, for example, the state ideally seeks to make enterprises more efficient no longer by ordering state-owned enterprise managers to reach certain profit targets, but by putting the power to select managers in the hands of directors who represent profit-oriented shareholders.

At least in form, state-owned enterprise reform has seen significant progress. Over 80% of small and medium state-owned enterprises have been transformed from a traditionally structured enterprise into a corporate entity under the Company Law or some other organizational law or regulation, and over 1200 large enterprises have restructured themselves

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78 This does not mean that state ownership of enterprises is on the way out. The government has explicitly declared its firm commitment to retaining control over enterprises in several sectors: national security-related industries, natural monopolies, sectors providing important goods and services to the public, and important enterprises in pillar industries and the high-technology sector. See Heli Bujia Tiaozheng Jiegou, Fazhan Zhuangda Guoyou Jingji—Fang Guowuyuan Guoyou Zichan Jiandu Weiyuanhui Zhuren Li Rongrong [Rationally Lay out Structural Adjustment, Develop a Great State-Owned Economy: A Visit with the Chairman of the State Council's State Asset Supervision and Management Commission, Li Rongrong], JINGJI RIBAO [ECON. DAILY], Internet ed., June 13, 2003.

79 On the policies behind reform in the state-owned enterprise sector, see generally Clarke, supra note 18.
into joint stock companies and raised funds through a public issue of shares and subsequent listing on one of China's two stock exchanges.\textsuperscript{80}

The operation of the board of directors of such companies presents complex problems. Chinese discussions of the board typically focus on two areas of concern. It is important to understand the distinction between them in order to assess the potential effectiveness of independent directors in addressing them.

One prominent complaint about the current regime governing the powers and responsibilities of enterprise managers is that there is too much "insider control" (neibu ren kongzhi).\textsuperscript{81} Because control of the firm must rest with some person or persons, and those persons are virtually insiders by definition, it is necessary to unpack this complaint a little. What is usually meant is insider control unfettered by effective accountability mechanisms, with the result that assets belonging to the corporation are converted through various subterfuges into the personal property of management. This asset-stripping, a familiar phenomenon in transition economies, is made possible by the devolution of considerable managerial authority to the enterprise level coupled with the legalization of new forms of trade and new privately-controlled entities to which the stripped assets can, by means of controlled transactions, be transferred. The complexity of property relations and ownership forms has outstripped the state's capacity to monitor, which remains designed for the simple structures of an earlier day, when private ownership of significant property was not allowed, and transfers between enterprises were physical and not financial.\textsuperscript{82} The result is the phenomenon of the "absent owner" (suoyouzhe quewei): it is not collective action problems that prevent effective shareholder monitoring, since there is a large and possibly sole shareholder, but rather organizational problems internal to that shareholder.\textsuperscript{83}


\textsuperscript{81}See, e.g., Liu Yunpeng, Cong Xiandai Qiye Lilun yu Chanquan Lilun Kan Zhongguo de Gongsi Zhili Wenji [Looking at Chinese Corporate Governance Issues from the Standpoint of the Theory of the Modern Firm and the Theory of Property Rights], in Zhongguo Gongsi Zhili Jiegou [The Structure of Corporate Governance in China] 119, 129 (China (Hainan) Reform and Development Institute ed.,Waiwen Chubanshe 1999); Xu Meizheng, Qiye Chongzu yu Gongsi Zhili Jiegou [Enterprise Reorganization and Corporate Governance Structure], in id. at 83, 83.

\textsuperscript{82}See Ding, supra note 57.

\textsuperscript{83}The same phenomenon has been noted among institutional investors in Western countries, who are often criticized for being unduly passive even when "they have strong reservations about strategy, personnel, or other potential causes of underperformance." Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors ¶ 15.22 (The Stationery Office 2003), available at http://www.dti.gov.uk/cld/non_exec_review.
If management commits waste and fraud at the expense of shareholders, this is obviously of direct concern to the state because of its large stake in the enterprises being looted. But it is also a government concern where the state is not a significant shareholder because in addition to damaging individual (and institutional) shareholders, mismanagement and asset-stripping will, by discouraging investment in corporations, raise the cost of capital in the economy generally and hinder growth.

A second complaint is that management may respond all too well to a board under the control of a dominant shareholder (yigu duda), which will use its power to exploit minority shareholders through such devices as manipulating prices in transactions with controlled entities. Indeed, when corporate governance failings are specifically studied, they typically relate to abuse by the dominant shareholder of its position, not to the depredations of management at the expense of shareholders as a whole. For example, a 2002 study of corporate governance by the CSRC and the SETC revealed, on the basis of self-reporting alone, that 40% of listed companies engaged in related-party transactions with their top ten shareholders.

A related-party transaction is not, of course, necessarily a transaction on unfair terms to the company, but given the lack of institutional safeguards that might ensure fair terms, there are legitimate grounds for concern. The CSRC/SETC study further found that 676 listed companies had had their funds misused by their parent company (the controlling shareholder) in the amount of almost US$12 billion.

The concern of the government in this case is once again that the public may lose faith in corporate stock as an investment, raising the cost

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84 See, e.g., Gu Gongyun, Gongsi Fa Xiugai Ying Jiejue de Ruogan Shiji Wenti [Several Practical Problems that Should Be Solved in a Revision of the Company Law], in GUO & WANG, supra note 33, at 57, 60.

85 At least one article laments at the same time the overconcentration of stock in the hands of large shareholders and the inability of shareholders to monitor management because of the dispersion of voting power brought about by the many varieties of share types. See Zheng & Chen, supra note 49, at 180.


87 See Guojia Jing Mao Wei fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong [SETC Vice Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling Shareholder], supra note 20.
of capital throughout the economy.\textsuperscript{88} Thus, policymakers are concerned with the consequences of both underconcentration and overconcentration of share ownership.

The picture is further complicated by the fact that although the state has an interest in preventing dominant shareholder exploitation of minority shareholders when it is a passive shareholder, it may itself be guilty of such exploitation when it is the dominant shareholder.\textsuperscript{89} Indeed, the entire project of retaining majority state ownership, and therefore control, in

\textsuperscript{88}The view of the government and most Chinese commentators—that public confidence in corporate governance procedures and the honest functioning of the securities markets is essential to the ability of firms to raise money from public investors, and therefore essential to the economy as a whole—is shared by most foreign commentators, but appears to rest more on intuition and common sense than on solid evidence. First, considerable funds have in fact been raised from public investors—US$86 billion by the end of 2002, see Li Qing, \textit{Chu Da Shang Fulin [A Preliminary Reading of Shang Fulin]}, CAIJING [FIN. & ECON.], Nos. 3-4, 2003, at 36, 36, and US$141 billion by the end of January 2005, see China Securities Regulatory Commission, \textit{Tongji Xinxu [Statistical Information], Biao 2-2: Zhengquan Shichang Chouzi Tongji Biao [Table 2-2: Table of Capital Raising in the Securities Market], available at http://www.csreg.gov.cn—even in the probable absence of substantial public confidence in corporate governance procedures. Of course, perhaps this amount would have been much higher had the public had more confidence, but the relatively high price-to-earnings ratio prevailing on the Chinese stock market (on average ranging from 40 to 50, see WALTER & HOWIE, supra note 22, at 136, considerably higher than the low-20s average prevailing on the New York Stock Exchange) suggests that public investment is being limited by supply, not by demand. Second, it is not clear that well-functioning securities markets really are, at least at present, essential to the economy as a whole. In 2001, for example, enterprises raised US$14 billion from share issues, but borrowed more than ten times that amount—US$157 billion—from banks. Figures from 2002 suggest that the stock market is actually in decline as a source of capital: IPOs and share rights issues raised only US$8.9 billion from January to September 2002, down 30\% from the same period in the previous year, while bank financing rose 55\% (well above the rate of growth) to US$170 billion (over the same period). Overall, the stock market provided about 5\% of official corporate financing. See GREEN, supra note 20. Listed companies themselves are of significant but not overwhelming importance in the economy, accounting for 8\% of GDP and 17\% of enterprise income tax receipts in 2001. See Zhongguo Shangshi Gongsi de Zonghe Jixiao Zhengzai Fashengzhe Zhi de Bianhua [Overall Results of Chinese Listed Companies Undergoing Qualitative Change], ZHONGGUO ZHENGQUAN BAO [CHINA SEC. NEWS], Nov. 1, 2002.

For an argument that weak corporate governance, insofar as it saps the confidence of investors in their ability to forestall managerial expropriation, can exacerbate financial crises, see Simon Johnson et al., \textit{Corporate Governance in the Asian Financial Crisis}, 58 J. FIN. ECON. 141, 142 (2000).

\textsuperscript{89}Mar and Young, for example, report that China Southern Airlines and China Eastern Airlines, both of which are publicly listed but in which the dominant shareholder is a state agency, can be forced to purchase aircraft they may not want from the state: “[W]hen [the Civil Aviation Authority of China] buys too much [aircraft], they have to put them somewhere.” Mar & Young, supra note 60, at 297 (quoting a Hong Kong industry analyst). The potential for a conflict of interest is explicitly recognized by one commentator, who proposes that dominant state shareholders voluntarily refrain from policies that hurt minority shareholders so as not to discourage investment in the securities markets. See Jiang Qiangui, Gongsizhi yu Guoyou Qiye Gaige, ZHONGGUO ZHENGQUAN BAO [CHINA SEC. NEWS], Internet ed., June 12, 2001. See, however, the remarks of Xiang Bing infra at text accompanying note 167.
particular firms or sectors has as its purpose the use of that control to
achieve objectives other than profit maximization—for example, full
employment or strategic control of a particular industry that for some
reason cannot be achieved through regulation.\footnote{The notion that state control will be maintained in particular sectors with the specific
intent of “influencing and guiding” the use of social capital—i.e., causing it to be used in ways
that serve the state’s interests, which are not necessarily those of small investors—was expressed
in an interview by Jiang Qiangui, vice chairman of the SETC. \textit{See Guojia Jing Mao Wei Fuzhuren Jiang Qiangui: Zuo Shangshi Gongsi Chengxin Fuze de Konggu Gudong} [SETC Vice
Chairman Jiang Qiangui: Be a Sincere and Responsible Listed Company Controlling
Shareholder], supra note 20.}

The ideological justification for retaining state majority ownership cannot lie in simple profit
maximization for the state, since there is no \textit{a priori} way of knowing whether profits
would be maximized by keeping the state's holdings in a
particular firm or by selling them, and indeed firms without dominant state
ownership have been shown in several studies\footnote{See, \textit{e.g.}, Chen, supra note 41; Qi et al., \textit{supra} note 24; Xu & Wang, \textit{supra} note 29.} to outperform firms with
dominant state ownership. Thus, as long as state policy requires the state
to stay as an active investor in firms of which it is not the sole shareholder,
meaningful legal protection for minority shareholders is going to mean
either constraints on the state's ability to do precisely those things for which
it retained majority ownership, or else a \textit{de facto} separate legal regime for
enterprises in which the state is the dominant shareholder.

III. INDEPENDENT DIRECTORS AS A SOLUTION TO CORPORATE GOVERNANCE PROBLEMS

One institution of corporate governance that has recently come to
prominence as a potential solution to many of the problems of Chinese
corporate governance is the independent director. Like many legal
borrowings, the independent director is viewed by different parties as a
solution to different specific concerns. Those problems may or may not be
related to the problems that led to the development of a concept of
independent director in the jurisdiction from which the borrowing takes
place.

A. Functions of the Non-Management Director

To understand more fully the functions and potential of the
independent director in China, it is useful to canvass other conceptions of
the independent director. To do so, we must first seek a more general term,
for not all jurisdictions place a great deal of importance on directors who
might plausibly be called "independent." Different jurisdictions and corporate governance norms speak variously of directors who are "non-interested," "independent," "outside," "non-executive," "non-employee," and "disinterested." Each of these terms is defined differently and implies a different role for the director it describes, yet they are frequently discussed together as if they were all describing the same thing, and conclusions about directors of one type are applied to directors of another.

The generic term I shall use here is "non-management" director (NMD), because it captures the one element all of the above terms have in common: the director in question is not a member of the current senior

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94 See SHOHO [COMMERCIAL CODE OF JAPAN], art. 188(2)(7.2) (2002) (using the term shagai torishimariyaku—literally, "director from outside the company").
95 See CADBURY REPORT, supra note 68, at 22.
97 See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001); MODEL BUS. CORP. ACT § 8.31 (2005).
98 Miwa and Ramseyer, for example, use data on outside directors in Japan to refute what they take to be the conventional wisdom about the role of independent directors. For statistical convenience, however, they follow what they say is the Japanese custom of defining as an "outsider" anyone who has a past or concurrent career outside the firm. This would include, for example, partners at law firms whose major client was the firm in question, who would not qualify under most definitions of "independent." Indeed, they explicitly note that the vast majority of outside directors take such directorships as full-time jobs with the firm on whose board they sit. See Yoshiro Miwa & J. Mark Ramseyer, Who Appoints Them, What Do They Do? Evidence on Outside Directors from Japan 11-14 (Harvard Univ., John M. Olin Center for Law, Economics and Business, Discussion Paper No. 374, 2002), available at http://papers.ssrn.com/abstract_id=326460. The conventional wisdom about independent directors may indeed be wrong, but no conclusion derived from a study of this kind of outside director can rigorously demonstrate it. The definition of "outside director" (shaqai torishimariyaku) in Japanese law is somewhat stricter than the Miwa-Ramseyer definition (see infra text accompanying note 134), and the distinction between outside directors and independent directors is well understood. See Shagai Torishimariyaku to Dokuritsu Torishimariyaku [The Outside Director and the Independent Director], YASASHI KEIZAI YOGO NO KAISETSU [EASY EXPLANATIONS OF ECONOMIC TERMS], at http://www.nikkei4946.com/today/0305/11.html (Japan Economic News website).

management team. This negative feature is, however, consistent with several different positive features, some of which are mutually inconsistent, and each of which contemplates a different conception of the role of the non-management director.

Before canvassing these conceptions, however, it will be useful to set forth some general ideas about the possible functions of NMDs in a corporate governance system. The particular conceptions of different jurisdictions can then be analysed in terms of which function or functions they seem to value, and whether those functions are in fact likely to be fulfilled.

The role of NMD can be analyzed according to whether the NMD is perceived as a substitute for external regulation or as an implementer of it. In American corporate law, for example, the NMD primarily functions as a substitute for external regulation. Courts and legislatures are wary of becoming too involved with the business decisions of corporate management. Thus, even the apparently fundamental and unobjectionable idea that transactions between a corporation and a director should be on terms that are fair to the corporation is not imposed on corporations as a substantive rule of law in Delaware or in the Model Business Corporation Act (MBCA) if the corporation's board has disinterested directors and a majority of them have, after full disclosure, approved the transaction.

One could also imagine NMDs as implementers of external regulation. In such a case, the relevant standard of behavior would be set externally, not by the NMDs themselves, and they would be expected to help implement those standards. This could be done in a number of ways: through exercising their voting power on the board to induce the company to act in compliance with the standards, through using their access to information to alert the authorities to non-compliance, or through using their access to information to certify compliance.

Each of these methods, however, poses difficulties. If one is to rely on NMDs to exercise their voting power in favor of compliance with external standards, then there needs to be some reason for believing that NMDs will be more likely to do so than non-NMDs. Both kinds of directors can be subject to sanctions for voting to violate clear legal obligations. If the purpose is to encourage corporations to act in accordance with principles that do not constitute legal obligations (for example, "maximize local employment"), then it is unlikely that NMDs

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99 This is, of course, what is usually meant by "non-executive" director. On the other hand, some people say "non-executive" when they really mean "independent" or "outside." I am deliberately creating a new term here so that what I mean by it can be kept clear.

100 See infra discussion at text accompanying notes 143-46.
elected by, and owing fiduciary duties to, profit-maximizing shareholders will produce this result. An entirely different constituency would have to be given the power to elect NMDs.

If the state relies on NMDs to use their access to information to alert it to corporate non-compliance with legal standards, then once again we face the problem of selecting directors who will internalize this duty. Moreover, directors whose job it is to inform on the company will find their access to information considerably decreased. Again, it is perfectly conceivable to have a rule that requires directors and others with knowledge of certain types of violations to report them to the authorities,\textsuperscript{101} but there does not seem to be any reason to distinguish NMDs from non-NMDs in this respect.

Finally, it is possible to use NMDs to certify that certain standards have been complied with—for example, that the annual report is accurate, or that the balance sheets have been prepared in accordance with proper accounting standards. In the United States, this job is generally left to independent professionals, and their duty of care is enforced, among other ways, by allowing persons to rely on the certification and to sue if that reliance results in damages. There is no particular reason why NMDs could not perform this function, but there is no particular reason why they should. If NMDs are required to back up their certification with their personal wealth, few may be willing to take on the job. If they are not, then they have little incentive to be responsible. A separate firm that specializes in the information in question—an accounting firm or a law firm, for example—can get access to the same information if the company is willing to grant it (and it would have to do so), and can better bear the risk of the occasional error leading to liability. Moreover, certification of information by a large organization with a reputation to consider is more likely to be reassuring to users of that information than certification by an unknown person of unknown resources.

\section*{B. Conceptions of the Non-Management Director}

Differing conceptions of the NMD's role are not usually mere abstract ideas. Different conceptions imply different structures within which such directors are to fulfill their contemplated role. The following discussion will not, therefore, simply canvass different definitions of the

\textsuperscript{101}See, for example, 12 C.F.R. § 208.62 (2005), which requires U.S. banks to file reports of suspected criminal activity with the Federal Reserve Bank and subjects directors and officers, among others, to disciplinary action if the bank fails to do so.
NMD. It will also bring out how those different definitions relate to the different functions of the director. By understanding the broad range of possible roles for non-management directors, we can understand more fully the actual institution of the independent director in China.

1. The "Independent" Director

A major theme in corporate governance writing is the need for non-management directors on the board to serve as a check on management in the interests of shareholders. In other words, non-management directors are there to help shareholders solve the agency problem. If such directors are to monitor management effectively, they must be independent of management. From this contemplated role stems the typical definition of independent director: one who has no need or inclination to stay in the good graces of management, and who will be able to speak out, inside and outside the boardroom, in the face of management misdeeds in order to protect the interests of shareholders.

A competing conception of the director who is independent of management holds that the director's duty is to protect the interests of a number of different groups, not just shareholders, and indeed sometimes to act against the interests of shareholders in order to protect, for example, employees. The latter view of the role of the independent director—one who is independent of profit-seeking shareholders as well as independent of management—has not, however, found fertile soil in American corporate law scholarship or practice. The dominant view has been that directors

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103 For a discussion of these competing concepts, see Victor Brudney, The Independent Director—Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 602 (1982). The “shareholder versus stakeholder” debate has been going on for over seventy years. See Adolph A. Berle, Corporate Powers as Powers in Trust, 45 Harv. L. Rev. 1049, 1049 (1932) (arguing that directors should serve shareholder interests) and E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1160 (1932) (arguing directors should serve other groups including employees, managers, and society in general). For recent contributions, see William T. Allen, Our Schizophrenic Conception of the Business Corporation, 14 Cardozo L. Rev. 261, 276-77 (1992) (discussing for whose benefit directors hold power); William T. Allen et al., The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide, 69 U. Chi. L. Rev. 1067, 1067 (2002) (discussing the debate); Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547, 565 (2003) (arguing for director primacy); Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 253-54 (1999) (arguing that directors should take non-shareholder interests into account).
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, the shareholders are uniquely unable to do so because their investment is sunk and cannot be withdrawn. 104

Both conceptions share the idea that the directors expected to perform their designated function cannot do so unless they are systematically independent of management. This idea is familiar to corporate law practitioners and scholars in the United States, but interestingly, its reach is limited almost exclusively to federal law as applied to corporations whose stock is listed on a national exchange. 105 Section 301 of the SOA requires that all members of a listed company's audit committee be independent directors. 106 and states:

In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a

104 See, e.g., HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 56 (Harvard Univ. Press 1996); Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439, 440-41 (2001). Gilson and Kraakman go beyond emphasizing the independence of the non-management director in order to stress the desirability of her lack of independence from shareholders: “[W]hile most recent efforts addressing the governance role of the board have urged increasing the independence of outside directors from management, we advocate increasing the dependence of outside directors on shareholders. In our view, corporate boards need directors who are not merely independent, but who are accountable as well.” Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 865 (1991). A recent World Bank publication makes the same point, see TENEV & ZHANG, supra note 80, as does (rarely among Chinese commentary) He Yiping & Yu Yin, Zhongguo Tuixing Waibu Dongshi Jizhi Zhiyi [Doubts About China’s Promotion of the Outside Director Mechanism], ZHEJIANG SHENG ZHENG-FA GUANLI GANBU XUEYUAN XUEBAO [BULLETIN OF THE ZHEJIANG PROVINCE POLITICAL-Legal ADMINISTRATIVE CADRES ACADEMY], No. 5, 2001, at 25, 29. The Higgs Report points up the need for such accountability: a majority (52%) of the non-executive directors surveyed never discussed company business with investors, and only one in five non-executive directors in FTSE 100 companies did so at least once a year. See HIGGS, supra note 83, ¶ 15.5. This seems to be taking independence a bit too far.

105 I deal below with state corporate law and its different concept of “disinterested director.” The Investment Company Act, a federal statute, also contains what is essentially a requirement for independent directors in investment companies, whether or not they happen to be listed. The relevant section is discussed briefly below. Finally, note that because this is an article about comparative corporate law and is not intended to be an exhaustive discussion of post-SOA reforms in American corporate governance, I discuss such reforms in general terms only and do not note the numerous exceptions and qualifications to the general rules set forth here.

106 Strictly speaking, the SOA requires that the SEC adopt rules requiring national securities exchanges and national securities associations to prohibit the listing of the securities of any issuer that does not comply with the standards for independence of audit committee members set forth in Section 301.
member of the audit committee, the board of directors, or any other board committee—

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) be an affiliated person of the issuer or any subsidiary thereof. ¹⁰⁷

Stock exchange rules must also, of course, be considered. For the sake of brevity I will look only at the NYSE’s rules. ¹⁰⁸ The NYSE’s former (that is, prior to SOA-associated reforms) and current rules on independent directors make an informative contrast. Under the former rules, independent directors were required only for audit committees, and were those who had “no relationship to the company that may interfere with the exercise of their independence from management and the company.” ¹⁰⁹ Certain per se disqualifications ¹¹⁰ could be waived by a board determination that the director’s exercise of independent judgment would not be affected.

These rules were more flexible than those of the SOA. It was not so critical to maintain a strict distribution between independent and non-independent, possibly because independent directors were not required to play so important a role. For example, the audit committee had to be composed entirely of independent directors, but it did not need to have the exclusive authority to hire, monitor, or terminate the outside directors.

In response to the requirements of the SOA, the NYSE adopted rules that mirror the SOA’s independence requirements for audit committee members, but that retain some flexibility with respect to other independent directors. ¹¹¹

¹⁰⁹NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303.01(B)(2)(a) (1999).
¹¹⁰Specifically, independence was foreclosed if the director (1) had been employed by the issuer or its affiliates in the past three years, (2) was an immediate family member of a person employed as an executive officer of the issuer or its affiliates in the last three years, (3) was employed as an executive of another company where any of the issuer's executives sat on the compensation committee, (4) had a direct business relationship with, or was a partner, shareholder, or executive officer of an organization that had a direct business relationship with, the issuer, unless the issuer's board made an affirmative determination that the relationship would not interfere with the director's exercise of independent judgment. See id. § 303.01(B)(3)(b)-(d).
¹¹¹See LISTED COMPANY MANUAL, supra note 3, § 303A.00.
Unlike the SOA, the NYSE rules (except where they mirror SOA requirements) do not contemplate specific mandatory powers for independent directors. Their duties may be limited simply to making recommendations to the board as a whole. Independent directors must, however, constitute a majority of the board as a whole.112 The theory behind the NYSE rules seems to be that corporate decisionmaking will be improved if a majority of the board can be structured so that a particular motivation, that of pleasing management, is absent. The rules do not attempt to ensure that a particular motivation is present.

While "independence" has generally proven fairly easy to conceptualize, if more difficult to define in precise legislative language, one area in which substantial disagreement exists even in principle is that of the significance to be given to stock ownership by the putatively independent director. Those who see the independent director primarily as a defender of shareholder interests against management will naturally see more share ownership as better, because it will more closely align the interests of the director with the shareholders as against management.113 Those who view the independent director as someone whose judgment should be untainted by any financial interest in the company are suspicious of share ownership.114

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112 The requirement for independent directors is subject to an exception for controlled companies, except with respect to the audit committee. See Listed Company Manual, supra note 3, § 303A.00. Controlled companies are those in which more than 50% of the voting power is controlled by a single individual, group, or company.

113 In general, ownership of stock by directors, and by independent directors in particular, appears to be positively correlated with company performance. See Sanjai Bhagat et al., Director Ownership, Corporate Performance, and Management Turnover, 54 Bus. Law. 885, 885 (May 1999); Eliezer M. Fich & Anil Shivasani, The Impact of Stock-Option Compensation for Outside Directors on Firm Value, 78 J. Bus. Law. 2229 (2005); and the review of several studies in R. Franklin Balotti et al., Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution, 55 Bus. Law. 661, 672 (2000). For a contrary view, see Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance 8 (Dec. 7, 2004), at http://ssrn.com/abstract=586423 (finding "no evidence that operating performance or firm valuation is positively related either to stock option expensing or to directors receiving some or all of their fees in stock").

114 As will be discussed below, Chinese legislation and academic commentary generally adopts the suspicious approach and disfavors stock ownership by independent directors. See, e.g., Independent Director Opinion, supra note 11, § 1(1) (forbidding any relationship with a large shareholder that would impair independence); id. § 3(2) (denying independent status to holder of 1% of company’s shares or one of top ten shareholders or relative of the latter); People’s Bank of China, Guanyu Guofenzi Shangye Yinhang Duli Dongshi he Waibu Jianshi Zhidu Zhiyin [Guidelines on the System of Independent Directors and Outside Supervisors for Commercial Banks Under the Shareholding System], issued and effective June 4, 2002 [hereinafter Commercial Bank Independent Director Guidelines], art. 2 (denying independent status to holder of 1% of company’s shares or employee of shareholder); Ma, supra note 12, at 62; Yan & Chen, supra note 12, at 26.
It is not altogether clear which view Congress took in the SOA. As we have seen, Section 301 of the SOA amends Section 10A of the Securities Exchange Act (SEA) by providing that an independent director on the audit committee may not be an "affiliated person" of the company. The SEA, for its part, states that "affiliated person" in the SEA shall have the meaning given to it by the Investment Company Act (ICA). Finally, the ICA defines "affiliated person" in part as anyone owning 5% or more of the securities of the company. Thus, Congress—assuming it was aware of this definitional chain—could be seen as viewing substantial ownership of securities as undesirable in independent directors.

The SEC, however, while retaining the ICA stock ownership threshold for independent directors of investment companies, has been much friendlier to shareholding by independent directors in other circumstances, and has created an explicit safe harbor for shareholding under 10%. Moreover, it has stated that shareholding of 10% or more will not automatically be construed to constitute an "affiliation" sufficient to prevent a director from being found "independent."

Some commentators appear to take both positions at once. Derek Higgs, in his recent report on non-executive directors commissioned by the British Department of Trade and Industry, agrees in Para. 12.26 that "shares could be helpful in aligning the interests of the director with the long-term interests of shareholders," but opposes in Para. 12.27 the holding of options by directors "because of the risk of undesirable focus on share price rather than underlying company performance." Higgs, supra note 83, ¶¶ 12.26-12.27. It is not clear why directors who own shares will be less focused on share price than directors who own options, or why shareholders would not want a director to be focused on share price. The notion of a generally knowable distinction between long-term share price and short-term share price is illusory, because the share price at any given time reflects the market's best guess as to the discounted present value of all income (not just income over the short term) that can be earned by the share, whether through dividends or ultimate sale, and thus incorporates all long-term share prices to the extent they can be estimated. A director privy to inside information might well have reason to believe that the current share price does not reflect the valuation the market would place on the stock were the information public, but any undesirable incentives created by this information asymmetry do not depend on whether the director holds stock or options. In any case, while recognizing the beneficial effect of share ownership by directors, the Higgs Report views significant share ownership as disqualifying a director from being considered independent. See id. at 37.

Two Chinese commentators take the opposite position from Higgs: independent directors should not be allowed to own stock, but should be allowed to have stock options. For reasons that are not clear, the authors believe that the independent directors' stock-based incentive structure should not match that of management, and so add the proviso that the stock options should operate differently from those held by management. See Yan & Chen, supra note 12, at 28. Other commentators oppose stock options as well. See Zhao Yu, Wanshan Duli Dongshi Zhidu Dde Ruogan Sikao [How to Improve The System of Independent Director], Feb. 7, 2005, reprinted from CAIKUAI TONGXUN [FIN. & ACCT. BULL.], available at http://doc.esnai.com/showdoc.asp?docid=7093&ucheked=true.


The NYSE is also friendly to shareholding by independent directors. Where audit committee members are concerned, it simply incorporates by reference the requirements of federal law. But where its own requirement for a majority of independent directors is concerned—a requirement not imposed by federal law—it imposes no limits on shareholding whatsoever. Indeed, in proposing its rule change, the NYSE specifically noted the views of commentators that share ownership should be viewed as desirable, and stated that "as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."

Although the SEC's rulemaking has not been actively hostile to shareholding by independent directors, it is important to note a fundamental difference in approach between the SEC and both the exchanges in their proposed rules. Both the exchanges require company boards to have a majority of independent directors except when the company is a "controlled company," i.e., when a single person, group, or company controls more than 50% of the voting power. In other words, they see independent directors as a protection for shareholders specifically against management, not against other shareholders. A shareholder who controls a company does not need an external rulemaker to protect him from a management team that he himself has the power to appoint. Minority shareholders may well need protection from controlling shareholders, but the exchanges are apparently willing to leave this task to other bodies of law, such as federal securities law requiring disclosures and state corporate law mandating certain fiduciary duties.

The SEC’s approach, however, is different. As we have seen, an "affiliated person" cannot be "independent," and the SEC defines affiliation, among other things, in terms of control. Under the SEC's principle, when stock ownership is enough to lead to control, affiliation exists and independence disappears. The NYSE's approach might be characterized as finding that when stock ownership is enough to lead to control, the director is super-independent of management—so much so that the need for paternalistic protection by a rule disappears. Thus, the SEC's view of the proper role of independent directors seems consistent with the second view canvassed earlier: that they should have ties neither with

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118 See NASD MANUAL: MARKETPLACE RULES 4350(c)(5), available at www.nasdaq.com; LISTED COMPANY MANUAL, supra note 3, § 303.00A.
For an excellent discussion of the implicit or explicit attitude toward equity ownership by independent directors in the various statutes and regulations discussed above, which takes a somewhat different view on some issues, see Chandeler & Strine, supra note 98. As is well known, Fama and Jensen argued that independent directors automatically have an incentive to protect shareholder interests, because those who are executives in other businesses and participants in the managerial labor market have an incentive to develop reputations as experts in decision control. See E.F. Fama & M.C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 315 (1983). This view has been challenged, in my view convincingly, by Bebchuk and his colleagues, here in the context of CEO compensation:

First, the signal provided by independent directorships is likely to be quite noisy, particularly when the board is large and responsibilities are diffuse. Second, and relatedly, the managerial labor market is more likely to focus on the manager's performance in his primary role rather than in his independent directorships. Third, there are likely to be a considerable number of independent directors who are interested less in establishing reputations as "expert decisionmakers" than in keeping their current board seats and perhaps joining other boards. . . . CEOs have considerable influence in the choice of independent directors and will tend to prefer candidates who are unlikely to challenge their compensation. Thus, for a director aspiring to additional board positions, the "market" for directors creates incentives not to challenge the CEO on the issue of his compensation but rather to accommodate the CEO's wishes.

Lucian Arye Bebchuk et al., Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. Chi. L. Rev. 751, 771 (2002) (footnotes omitted). Needless to say, these doubts about incentives become even stronger when there is a deliberate attempt to remove any incentive to act in the interests of shareholders.

For an interesting theory of director motivation that makes a good case for considering altruistic behavior, see Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board), 28 Del. J. Corp. L. 1 (2003).
principles in Section 1 of the Combined Code.\textsuperscript{120} A company that has not complied must specify the provisions of the code with which it has not complied. Section 1 of the Combined Code's Code of Best Practice provides that non-executive directors should constitute not less than one third of the board,\textsuperscript{121} but these are not the same as independent directors, who should constitute a majority of the non-executive directors. The Combined Code clearly distinguishes them (without rigorously defining them) by stating:

The majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be independent in this sense should be identified in the annual report.\textsuperscript{122}

Whereas the SOA contemplates a specific role for independent directors only on the board's audit committee, the Combined Code contemplates a role for them on the remuneration committee as well, which is to be composed solely of independent directors.\textsuperscript{123} Both committees are to make recommendations to the board, but the board is not obliged to follow their recommendations.

Before leaving the subject of independent directors, it is worth examining their role in the German corporate governance system in order to show that independence from management does not necessarily lead to protection of shareholder interests. German law mandates a dual-board system for large publicly-held corporations. Each corporation has an elected supervisory board (\textit{Aufsichtsrat}), which appoints a managing board


\textsuperscript{121}\textit{Combined Code, supra} note 120, \textit{Code of Best Practices} \S\ 1.A.3.1.

\textsuperscript{122}\textit{Id.} \S\ 1.A.3.2.

\textsuperscript{123}See \textit{id.} \S\ 1.B.2.2. As I am strictly distinguishing here between independent directors and non-executive directors, who may or may not be independent, I save for the following section a discussion of the nominating committee under the Combined Code, which is to be composed of \textit{non-executive} directors.
(Vorstand) composed of senior corporate managers. The role of the supervisory board is that of overseeing the management of the company, but its role is limited to just that. Its major powers are the power to appoint and dismiss members of the managing board and the power to represent the company in its dealings with members of the management board. The law explicitly allocates managerial power to the managing board. Shareholders can even overrule supervisory board decisions through a three-fourths majority vote.

Since the managing board is, by definition, composed of corporate managers, an examination of independent directors in German corporations must focus on the supervisory board. German corporate law aims to ensure the independence of its members from company management by excluding both legal representatives of enterprises controlled by the company in question and legal representatives of other corporations whose supervisory boards include members of the management board of the company in question.

It is by no means intended, however, that supervisors should be independent of all outside influence and should exercise their judgment in pristine isolation from the world around them. On the contrary, as many as one half may, under the German system of co-determination, be employee representatives whose explicit remit is to protect the interests of employees. Others may be representatives of banks and other businesses who are "chosen for the very reason that they are not independent; that is, because they or the particular constituency they represent has an existing financial or similar relationship to the company." German corporate law in this sense seems clearer about the functions of independent directors (or their equivalent) than U.S. federal law, which mainly seeks to ensure that a certain number of directors not be beholden to management.

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125 See Walter Oppenhoff & Thomas O. Verhoeven, Stock Corporations, in BUSINESS TRANSACTIONS IN GERMANY ch. 24, § 24.03 (Bernd Rüster ed., Matthew Bender 2003).
126 See AKTIENGESellschaftEN [LAW ON STOCK CorporATIONS], supra note 124, § 76(1).
127 See id. § 111(4).
128 See id. § 100(2).
2. The "Outside" Director

The concept of outside director is often confused with that of independent director, but it makes sense to distinguish the two, because they can play different roles. By "outside director" I mean any director who is not a company employee, without regard to whether she meets a standard of independence. The Cadbury Report envisages "a board made up of a combination of executive directors, with their intimate knowledge of the business, and of outside, non-executive directors, who can bring a broader view to the company's activities." Cheffins notes in a similar vein that one function of outside directors is that of "providing full-time executives with support and assistance as they carry out their managerial tasks, which entails offering specialized advice and fostering links with other organizations." While outside directors as defined above are not part of the American corporate law scene, at least in terms of mandatory requirements, they do have a role to play in British corporate governance. As noted above, the Combined Code, the degree of compliance with which must be disclosed by companies listed on the London Stock Exchange, calls for one third of the board to be composed of outside directors.

Japanese corporate law also uses the concept of "outsideness" for directors and auditors (kansayaku). An outside director is defined as

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130"Outside director" and "non-executive director" are often used interchangeably. I do not use the term "non-executive" director here because on its face such a term could include directors who were employees, but not executives—for example, worker representatives. Such directors would be neither outside directors, in the sense of being able to bring some special expertise to the board not otherwise available to the company, nor independent directors, in the sense of feeling free to oppose management. Because the role of such employee directors is very different from the role of non-employee non-executive directors, I do not favor using a term that on its face encompasses them both.

131Cadbury Report, supra note 68, ¶ 4.1.

132Cheffins, supra note 120, at 96.

133The Combined Code calls them "non-executive directors," but specifically contemplates that some will not meet a criterion of independence. See Combined Code, supra note 120. Although the Combined Code does not specifically exclude employees from the scope of non-executive directors, such seems to be the intention. Something akin to a legislative history of these provisions of the Combined Code can be found in the Cadbury Report, from which they are largely taken. Dahya and McConnell, in their study of outside directors in British companies, state that they consider a director an outsider "if he/she is listed as a 'non-executive' director, he/she is not related to the company's controlling family, and he/she was not employed by the company historically." Jay Dahya & John J. McConnell, Outside Directors and Corporate Board Decisions 9 (Aug. 29, 2003), available at http://www.mgmt.purdue.edu/centers/ciber/publications/pdf/2003-008%20McConnell.pdf.
[a] person who is currently a director but who is not executing any company business, who has not in the past been a director, manager or other employee executing any business of the company or its subsidiaries, and who currently is neither executing any business of a subsidiary nor is a manager or any other employee of the company or its subsidiaries.\textsuperscript{134}

Note that this concept of outsideness does not exclude persons such as lawyers, suppliers, and others who may do large amounts of business with the company.\textsuperscript{135}

The distinction between independence and outsideness seems to be well understood in Japan. The Revised Corporate Governance Principles of the Japan Corporate Governance Forum differentiate the two,\textsuperscript{136} and a website operated by the Nihon Keizai Shimbun (the Wall Street Journal of Japan) contains a list of definitions of economic terms where the distinction is spelled out clearly.\textsuperscript{137} Prior to recent corporate law reforms, the concept of outsideness might, however, have been more appropriate than one of independence. The only purpose it served was to define what sort of director could be subject to a more forgiving standard of care\textsuperscript{138} and, therefore, it is reasonable to focus on those who are not intimately acquainted with the affairs of the company as opposed to those who are not

\textsuperscript{134}SHÔHÔ [COMMERCIAL CODE OF JAPAN], art. 188(2)(7.2) (2002), as adapted from translation in HASHIMOTO, supra note 8, at 9.

\textsuperscript{135}Note also that this definition is not the definition of outsideness used in Miwa and Ramseyer's study of outside directors and corporate performance in Japan. Their definition includes anyone with past or concurrent careers at other institutions, apparently notwithstanding past employment at the company in question. See Miwa & Ramseyer, supra note 98, at 11.

\textsuperscript{136}See JAPAN CORPORATE GOVERNANCE FORUM, REVISED CORPORATE GOVERNANCE PRINCIPLES (Oct. 26, 2001), available at http://www.ecgi.org/codes/code.php?code_id=70. Principle 6.3 states: "The majority of directors on the nominating committee and the compensation committee should be outside directors, and there should be one or more independent directors. The majority of audit committee members should be independent directors." Principle 4 states:

1. An outside director is someone who is not and has never been a full-time director, executive, or employee of the company or its parent company, subsidiaries or affiliates (collectively, the "Company etc.").

2. An independent director is someone who can make decisions completely independently from the managers of the Company etc., and therefore necessarily does not hold any interest with respect to the company.

\textsuperscript{137}See Shagai Torishimariyaku to Dokuritsu Torishimariyaku [The Outside Director and the Independent Director], supra note 98.

\textsuperscript{138}See SHÔHÔ [COMMERCIAL CODE OF JAPAN], art. 266(18) (2002) (providing that shareholders may by resolution reduce an outside director's maximum liability to the company to twice her annual director's income, as opposed to four times the annual income for ordinary directors and six times the annual income for representative directors (daihyōtorishimariyaku)).
dependent in some way upon management's favor. In the 2002 corporate governance reforms that became effective in April 2003, however, outside directors are expected to play a role more akin to that expected of independent directors in U.S. federal securities law: companies may opt into a U.S.-style corporate governance structure in which outside directors are required to be present on nominating committees, audit committees, and compensation committees.\(^\text{139}\)

3. The "Disinterested" Director

Far more important than federal law in the United States for purposes of internal corporate governance is state law, and this for the most part—at least in terms of economic impact—means the law of Delaware. U.S. corporation law at the state level does not generally provide for the institution of independent directors as such or define them.\(^\text{140}\) Instead, state corporate statutes focus on particular conflict-of-interest transactions—transactions, for example, between a corporation and one of its directors or officers, or between a corporation and another entity in which one of its directors or officers has an interest, or the taking by corporate officers of business opportunities that arguably belong to the corporation—and provide that certain consequences will follow depending on whether those with decisionmaking power who have a conflict of interest recuse themselves from the decisionmaking process.

Modern state statutes typically operate by displacing the common law rule on conflict-of-interest transactions—that they may be set aside at the instance of any stockholder\(^\text{141}\)—and permitting them provided certain conditions are met. These conditions usually pertain to disclosure of the

\(^{139}\)See HASHIMOTO, supra note 8, at 10.

\(^{140}\)A limited exception can be found in Michigan, where corporations may, subject to certain requirements, designate one or more directors as "independent directors," upon which certain statutory consequences follow. See Scott J. Gorsline, Statutory "Independent" Directors: A Solution to the Interested Director Problem?, 66 U. DET. L. REV. 655, 659 (1989); Cyril Moscow et al., Michigan's Independent Director, 46 BUS. LAW. 57, 57 (1990).

\(^{141}\)See, e.g., Wardell v. R.R. Co., 103 U.S. 651, 658 (1880) ("The law, therefore, will always condemn the transactions of a party on his own behalf when, in respect to the matter concerned, he is the agent of others, and will relieve against them whenever their enforcement is seasonably resisted."). Note that the law did not prohibit such transactions. Like many "rules" of company law, this rule is simply the provision of a private cause of action, not an outright prohibition. The common law rule made conflict-of-interest transactions very vulnerable to attack by shareholders.
The Delaware General Corporation Law (DGCL) announces in Section 144 that a transaction in which a director or officer stands on both sides\textsuperscript{143} shall not be voidable by reason of a conflict of interest if one of the following conditions are met: (1) the relevant facts are known to the board and a majority of disinterested directors approve; or (if, for example, the entire board has a conflict of interest) (2) the relevant facts are known to the shareholders, and a majority of disinterested shareholders approve; or (if for any reason neither of the first two occurs) (3) the terms of the transaction are, as of the time it is authorized by the directors or the shareholders, fair to the corporation.\textsuperscript{144}

The Model Business Corporation Act has an entire subchapter (Subchapter F) devoted to directors’ conflicting interest transactions. Like the Delaware statute, it provides that transactions are not voidable on the grounds of a conflict of interest provided that there was sufficient disclosure followed by approval of a majority of disinterested directors.\textsuperscript{145} Both the DGCL and the MBCA, then, have a concept of independence, but it amounts only to disinterest in a particular conflict-of-interest transaction—something quite different from abstract independence. Both attempt to deal with such transactions generally through disclosure to, and approval by, directors who are not involved in the transaction. But they do not assume that such directors will always be the same person, and do not require the institution of abstractly independent directors. Instead, they take a transaction-by-transaction approach, and ask in each case whether there was approval by directors (or other decisionmakers) who were

\textsuperscript{142}See DEL. CODE ANN. tit. 8, § 144 (2001). It is important to note that if the conditions are \textit{not} met, the transaction is not for that reason unlawful. It merely means that a court may apply the common law rule to the transaction if a shareholder brings suit to set it aside. But the common law rule is whatever the court says it is, and it is not at all clear that American courts of the early twenty-first century will find such transactions as offensive per se as did American courts of the nineteenth century. Thus, modern state corporation statutes provide a safe harbor for conflict-of-interest transactions, but one cannot assume that transactions falling outside the safe harbor are necessarily all barred.

\textsuperscript{143}The statutory definition is more complicated, but this simplified version will do for present purposes.

\textsuperscript{144}See DEL. CODE ANN. tit. 8, § 144 (2001). The Delaware statute, deliberately or not, contains no requirement that shareholder approval be by \textit{disinterested} shareholders only, but this requirement has been read into the statute by case law. See, e.g., Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) ("[A]pproval by fully-informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule and limits judicial review to issues of gift or waste with the burden of proof upon the party attacking the transaction.").

\textsuperscript{145}See MODEL BUS. CORP. ACT subch. F.
See, for example, In re Oracle Corp. Derivative Litigation, in which Vice Chancellor Strine spoke of Delaware's "flexible, fact-based approach to the determination of directorial independence," 824 A.2d 917, 937 (Del. Ch. 2003), and added:

This contextual approach is a strength of our law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors might reasonably be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue.

_id_ at 941. See also Krasner v. Moffett, 826 A.2d 277, 286 (Del. 2003) (Veasey, C.J.) ("The independence of the special committee involves a fact-intensive inquiry that varies from case to case.").


See Adolph A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (Macmillan 1933). As has been shown above, China has few, if any, such listed corporations. Indeed, it is not clear how dominant they are even in the United States. See, e.g., Randall Morck et al., Management Ownership and Market Valuation: An Empirical Analysis, 20 J. FIN. ECON. 293 (1988) (finding a modest concentration of ownership even among the largest U.S. firms); R. LaPorta et al., Law and Finance, 106 J. POL. ECON. 1113, 1146 (1998) (finding that ownership of the three largest shareholders in the ten most valuable U.S. companies has a mean average of 20% and a median of 12%).

In Unitrin, Inc. v. American General Corp., for example, the Delaware Supreme Court granted extra deference to the views of outside directors who held "substantial equity stakes" in a corporation that was the target of a takeover bid, presuming that they would "act in their own best economic interests" as stockholders and not out of a desire to entrench existing management. See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1380-81 (Del. 1995); see also Chandler & Strine, supra note 98, at 51-53 (favoring stock ownership by independent directors and questioning the suspicious approach of the SOA); Balotti et al., supra note 113, at 672, 677 (reviewing empirical evidence in support of link between substantial equity ownership and improved director monitoring and decisionmaking, and arguing in favor of presumption of due care for directors with substantial equity ownership); J. Travis Laster, Exorcizing The

disinterested in the transaction in question. Recent cases have also stressed the need for a fact-intensive inquiry. Although this approach has costs, it also has hidden savings: the cost of policing an abstract independence requirement in the many companies where it will never be needed.

C. The Independent Director in China

As we have seen in the United States, the NMD has traditionally been seen as the solution to the problem of managerial domination of the board. This model assumes the existence of the paradigmatic Berle-and-Means corporation, where powerful managers exploit dispersed and rationally apathetic shareholders. This explains why, as far as American law is concerned, it is generally considered a good thing, not a bad thing, for NMDs to own stock in the company on whose board they sit. When
the law's concern includes dominant shareholder exploitation of minority shareholders, the concept of the abstractly defined independent director fades away, to be replaced by the notion of a disinterested director—disinterested not in the abstract, but with respect to a particular challenged transaction.

The abstractly defined independent director is quite common in U.S. federal law and the national securities markets, but as discussed above the concern of the law seems to be to defend the interests of the shareholders as a whole against management self-seeking, not to defend minority shareholders against dominant shareholders.

The Chinese literature and regulations contemplate a number of roles for independent directors. One sees generalities about how they will reduce corruption, bring an objective view to board meetings, dare to ask uncomfortable questions, criticize company management, and ensure good corporate governance practices, but specific, measurable goals and predictions are few. Yet one cannot design and evaluate rules about independent directors without knowing what problems the institution is designed to address.

As discussed above, a major perceived problem in Chinese corporate governance is the dominance of large shareholders. This is sometimes confused with the problem of insider control, although that problem stems from the inability of shareholders to supervise management effectively. Many Chinese commentators appear to view concentrated ownership as almost perverse and unnatural, and see the stereotypical Berle-and-Means corporation as the ideal ownership structure.  

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Omnipresent Specter: The Impact of Substantial Equity Ownership by Outside Directors on Unocal Analysis, 55 BUS. LAW. 109 (1999) (discussing a series of cases in which Delaware courts have given deference to decisions by directors on the grounds that their substantial equity ownership aligned their interests with those of other shareholders).

In Stroud v. Grace, the Delaware Court of Chancery addressed a party's argument that a corporate charter provision requiring independent directors on the board but forbidding them from owning stock should be invalidated. The court found the provision to be unusual, but not unlawful. The prohibition in that case stemmed from the particular needs of the dominant shareholder in a family-controlled close corporation. See Stroud v. Grace, No. 10,719 (Del. Ch. Nov. 1, 1990), reprinted in 16 DEL. J. CORP. L. 1588 (1991).


151 See, e.g., Li Jianming, Gongshihua Guizao Yilai Woguo Qiy e Zhi Jiegou de Shizheng Fensi [An Empirical Analysis of the Corporate Governance Structure of Chinese Enterprises Since the Corporatization Reform], GAIGE [REFORM], No. 4, 1999, at 34, 41; Ma, supra note 12, at 62; Zheng & Chen, supra note 49, at 180. One Chinese academic asserts (incorrectly) that corporate law in the United States prevents large shareholders from dominating by prohibiting any person from exercising over 20% of shareholder voting rights. See Gu, supra note 84, at 60.
Independent directors will, it is hoped, represent the interests of small shareholders and prevent the recurrence of corporate scandals.\textsuperscript{152}

A study conducted by the Shanghai Securities Exchange identified the following major problems in Chinese corporate governance, several of which are evidently connected with the exploitation of small shareholders by large shareholders: (1) irrational shareholding structure,\textsuperscript{153} (2) lack of independence (presumably from management) of the board of directors; (3) inability of the board of supervisors to play its proper role; (4) relative weakness of oversight role of creditors; (5) unlimited powers of key management personnel; (6) low level of transparency and professionalism in investment decisions; (7) lack of a market for corporate control; (8) lack of a market for management services; (9) skewed system of incentives; (10) lack of protection of interests of small shareholders; (11) lack of a system for accountability; and (12) lack of a shareholder culture and corporate governance culture.\textsuperscript{154} Thus, many of the criticisms of existing independent directors center around their powerlessness to protect the interests of small and medium shareholders from the depredations of large shareholders and management.\textsuperscript{155} They are said to fail in this mission because, among other things, they are a minority on the board and they are nominated by controlling shareholders.\textsuperscript{156}

The emphasis on the need to protect the small shareholder from the dominant shareholder or shareholders is no doubt due to the shareholding structure of stock companies in China. Companies with widely dispersed public ownership where no individual owns a controlling block of shares

\textsuperscript{152}See, e.g., Jiang, supra note 89; Yan Fuhai, Yang Yao Nan Yi Zhongguo Bing [Foreign Medicine Can’t Cure a Chinese Sickness], FAZHAN [DEVELOPMENT], No. 8, 2002, at 41; Ye Xiangsong & Cao Zengping, Tuixing Duli Dongshi Zhidu, Wanhan Faren Zhiili Jiegou [Promote the Independent Director System, Perfect the Legal-Person Governance Structure], QIU SHI ZAZHI [SEEKING TRUTH MAGAZINE], No. 6, 2002, at 30-31.

\textsuperscript{153}It is not clear what this is intended to mean, but probably means the presence of dominant shareholders in large numbers of companies.

\textsuperscript{154}See Shoufen Gongsi Zhiyiin Chutai [First Guide to Corporate Governance Appears], ZHONGGUO JINGJI SHIBAO [CHINA ECON. TIMES], Nov. 6, 2000. It is not clear what the study meant by “shareholder culture” and “corporate governance culture” that is not included in the preceding stated problems.

\textsuperscript{155}See, e.g., Ruhe Rang Zhongguo Duli Dongshi Fahui Youxiu de Duli Zuoyong [How to Have the Independent Director in China Play an Effective Independent Role], JINGJI RIBAO [ECON. DAILY], June 16, 2001.

are virtually, and perhaps completely, non-existent. Thus, the agency problem identified by Berle and Means in their classic work, *The Modern Corporation and Private Property*,157 is not a major concern. As demonstrated above, Chinese listed companies typically have a few large, dominant shareholders (often holding unlisted state or legal person shares) and a minority of small shareholders holding listed shares. Certainly the perception in the literature seems to be that there is a serious problem of abuse of power by dominant shareholders, who handpick compliant boards and management who will operate the company in a way that favors those dominant shareholders. Thus, the problem to be addressed by the institution of the independent director is that of abuse of dominant share ownership at the expense of small shareholders.158

A major problem with this approach is that it starts from the notion that control of the company by any particular large shareholder is itself bad. The literature is full of lamentations that shareholder votes are mere formalities because one shareholder owns an overwhelming block. But directors, independent and otherwise, are supposed to be elected by shareholders. For the majority shareholder to out-vote minority shareholders is precisely the intended consequence of the voting system set forth in China’s *Company Law*159 and the corporate laws of other countries. Thus, the complaints of some commentators that companies with dominant shareholders are not run “democratically,”160 or lack true collective decisionmaking,161 seem based on a conception of the company as a political enterprise, not as an economic one.162

157BERLE & MEANS, supra note 148.

158See, for example, the remarks of Laura Cha (Shi Mei lun), the deputy head of the CSRC, who spoke of “egregious behavior” by controlling shareholders of listed companies, as reported in Richard McGregor, *China Plans New Market Rules*, FIN. TIMES, Apr. 19, 2001, at 25.

159See *Company Law*, supra note 17, art. 104.


162Ma complains that the board represents the interests of only a numerical minority (*shao bufen*) of the shareholders. *See* Ma, supra note 12, at 63. In economic terms, of course, the board may represent all too effectively the interests of the majority holder. It is the political conception of the company that makes the number of small shareholders, regardless of their holdings, significant.
Given that large shareholders get to choose directors, it is hard to see how directors representing minority shareholders could be elected to the board in the first place unless the basic principles of director selection were changed. Cumulative voting is a possible solution—it is in fact encouraged by the Corporate Governance Principles but this system will at best elect directors representing a concentrated minority, not a dispersed minority, and even then such directors will be in a minority on the board and can always be outvoted.

Obviously, even one isolated director can provide a degree of protection to minority shareholders by publicizing, or threatening to publicize, majority shareholder abuses of which he or she becomes aware. It is not clear, however, if this is the kind of strong protection envisaged by advocates of the independent director system, some of whom propose that independent directors should constitute a majority of the board, even while expecting them to serve the interests of minority shareholders.

This view also ignores the problems with dispersed share ownership pointed out so long ago by Berle and Means, as well as the considerable evidence that having a controlling shareholder may be good for corporate performance.

Finally, this view runs up against the special position the state wants to reserve for itself when it is the dominant shareholder. The Dean of the Changjiang School of Business, who serves as an independent director, was recently quoted as saying, "I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the

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163 See China Securities Regulatory Commission, Shangshi Gongsi Zhili Zhanze [Principles of Corporate Governance for Listed Companies], art. 29, issued Jan. 7, 2002 [hereinafter Corporate Governance Principles]. The CSRC never explained how cumulative voting could be carried out consistently with article 106 of the old Company Law, which mandated one vote per share. Fortunately, the October 2005 revisions to the Company Law have eliminated this problem by explicitly permitting cumulative voting. See Company Law, supra note 17, art. 106.

164 See, e.g., Hu Ruyin et al., Zhongguo Shangshi Gongsi Zhili Mianlin De Wenti Yu Duice [Corporate Governance Problems Confronting Chinese Listed Companies and Measures to Address Them], in GUO & WANG, supra note 33, at 172, 188.

165 See, for example, TENEV & ZHANG, supra note 80, at 110. See also supra Part II.A.4.

166 The view that independent directors have a role to play in counteracting the (presumably deleterious) effects of state shareholding is not unique to Chinese commentators. See, for example, Harry G. Broadman, Lessons From Corporatization and Corporate Governance Reform in Russia and China 23 (unpublished manuscript, prepared for the International Conference on Corporate Governance Development in Vietnam, Hanoi, Oct. 11-12, 2001) (calling for the election of "independent, non-state representatives" to the board of directors).
large shareholder, because the large shareholder is the state."167

A second proposed function for independent directors is to monitor related-party transactions, where there could be a conflict of interest.168 Note that if independent directors are to perform this function effectively, "independence" cannot be an abstractly defined concept referring to independence from management. A transaction-based approach that looks at the director's interest in a particular transaction is required; otherwise a director wholly independent of management would be deemed fit to vote on a transaction between the company and himself.

A third function for independent directors frequently mentioned is that of brain trust or consultant.169 This is an often-touted virtue of outside directors as well.170 In either case, however, it is not clear why the company would not do better hiring consultants and other experts for advice, instead of having them sit on the board until such time as they might be needed.171 What incentives do such directors have to devote time and resources to their advisory task? If outside or independent directors who give valuable advice are compensated any differently from directors who do not, then they may cease to meet the definition of outside or independent director. Furthermore, if giving advice is the appropriate role, why do the directors need to satisfy any criterion of independence at all?172


168See Yan, supra note 152; Ye & Cao, supra note 152.

169See, e.g., Wu et al., supra note 160; Yan & Chen, supra note 12, at 26; Ye & Cao, supra note 152.

170See supra text accompanying note 131.


172Although outside directors are common in Japan, the Revised Corporate Governance Principles of the Japan Corporate Governance Forum specifically view their advisory function as secondary: "In Japan, although there is a strong bias towards requesting managerial advice from outside directors, this phenomenon is, at best, a secondary function, and managers and employees alike in Japan need to be reminded that the primary role of outside directors is that of governance." JAPAN CORPORATE GOVERNANCE FORUM, supra note 136, at 7. Miwa and Ramseyer, however, cast doubt on the primacy of the governance role at least as a descriptive matter. Noting that outside directors often come from companies and institutions that are customers of the company in question, they hypothesize that outside directors are useful to Japanese companies because of their understanding of customer needs. Such directors need not be in any way independent of management in order to fulfill this function, and indeed such directors apparently assume full-time employment as company directors—that is, they resign any
Finally, a fourth function sometimes mentioned is that of serving the public interest.\textsuperscript{173} I use this broad category to include concepts of the independent director as a kind of agent of state regulatory bodies\textsuperscript{174} or as a kind of mole operating on behalf of the state to monitor its assets and prevent managerial waste. As Han points out, however, this is exactly what the directors appointed by the state shareholder—and in many cases, there will be a dominant state shareholder perfectly capable of appointing whatever directors it pleases\textsuperscript{175}—are supposed to be doing. Why does there need to be a special independent director to carry out this task?

Where the director serves the "public interest," arguably he or she should be independent of everyone—dominant shareholders, management, and indeed all those who have an interest in the company—and follow only the dictates of his or her conscience.\textsuperscript{175} Assuming accountability to be a good thing, however, it is hard to see how such a director could properly be made accountable.\textsuperscript{176} In the real world, of course, any director without security of tenure will, in the absence of counterincentives and assuming that the position is desirable, tend to be accountable to whoever was responsible for appointing him or her.

A final issue to be addressed here concerns the relationship between the independent director and the board of supervisors in the Chinese company. Chinese company law provides for a two-tier board structure, with a board of supervisors (elected by shareholders) as well as a board of directors, and contemplates a relatively active managerial role other positions—upon taking their position. See Miwa & Ramseyer, supra note 98.

\textsuperscript{173}See, e.g., Yan Zheng, Wo Ruhe Xuezhe Dang "Duli Dongshi" [How I Am Learning to Be an "Independent Director"]. KAIFANG [OPENING] No. 7, 2002, at 34. Yan is the head of the Fujian Academy of Social Sciences, which makes him a senior academic of national standing. He writes with pride of his position as the only independent director on the seven-member board of the Shuikou Electric Power Generating Company, a limited liability company (youxian zeren gongsi) with only two shareholders. According to the article, Yan believes he can be legally liable for his votes at board meetings, yet accepts no fee for his position and is honored to feel that he is making a contribution to the state. For the story of Lu Jiahao, another academic who despite no experience in business was asked to serve as an independent director, did so without compensation, and ended up being fined 100,000 yuan by the CSRC for his troubles, see Wu Guofang, Cong Lu Jiahao An Fansi Duli Dongshi Zhida [Reflections on the Independent Director System from the Lu Jiahao Case], JANCHA RIBAO [PROCURATORATE DAILY], Nov. 20, 2002, and Wei Yahua, Duli Dongshi Bei Fa Da Yi An [The First Case of an Independent Director Being Fined], ZHONGGUO L HI WANG [CHINESE LAWYER NET], Dec. 13, 2002, at http://www.chineselawyer.com.cn/article/200212135599.html. See also Appendix 1 (discussing directors' liability in China).

\textsuperscript{174}Mentioned but ridiculed by Han, supra note 171.

\textsuperscript{175}This argument is made in Ye & Cao, supra note 152, at 30.

\textsuperscript{176}He and Yu point out that there is no reason to think that a director accountable to nobody will do more for corporate results than an inside director. See He & Yu, supra note 104, at 29.
for the board of directors. The oversight role is to be played by the board of supervisors. Although Chinese commentators often compare China's two-tier model to Germany's, the Chinese structure differs in a crucial way: the Company Law expects that the board of supervisors will perform a supervisory role by simply saying that it will, without actually giving the board any significant powers or providing structurally for its independence from those it supervises. The German board of supervisors, by contrast, has the power to appoint and dismiss members of the management board.

Possibly because of its impotence, the board of supervisors seems to play no important role in corporate governance in China. In enterprises dominated by state ownership—a significant number—the supervisors are enterprise employees and are subordinate to the head of the board.

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178 The powers of the board of supervisors were set forth in Article 126 of the original Company Law as follows:

The supervisory board shall exercise the following powers:

1. examine the finances of the company;
2. exercise supervision over the actions of directors or the manager when they are performing their duties, which actions violate laws, regulations or the articles of association;
3. request directors and the manager to remedy a situation when the acts of such directors or manager harm the interests of the company;
4. propose the convening of special shareholders' meetings; and
5. other powers stipulated in the articles of association.

Supervisors shall attend board of directors meetings.

The October 2005 revisions to the Company Law brought a modest increase to these powers, but no qualitative change. See supra Part II.A.3.

179 As can be seen, the board of supervisors may criticize directors and officers and call on them to correct their errors, but has no power to require them to do so. See Liu Wen & Wu Man, Shangshi Gongsi Jianshihui yu Duli Dongshe de "Gongsheng" Wenti [The Problem of the "Co-Existence" of the Board of Supervisors and Independent Directors in Listed Companies], CAIJING KEXUE [FIN. & ECON. SCI.], ZENG KAN [SUPP.], July 2002, at 99; Wang & Feng, supra note 43; Wang Yuhong & Kang Jianhui, Qianghua Jianshihui Zhineng, Jianquan Gongsi Zhili Jiegou [Strengthen the Functions of the Board of Supervisors, Improve the Structure of Corporate Governance], XIANDAI QYE [MODERN ENTERPRISE], No. 10, 2000, at 13, 13; Zhang Jianwei & Xiang Jing, Jianshihui yu Duli Dongshe Zhidu de Gongneng Bijiao ji qi Jiazhi Qushe [A Comparison of the Functions of the Board of Supervisors and Independent Directors and an Assessment of Their Values], LUOHE ZHIYE JISHU XUEYUAN XUEBAO (ZONGHIE BAN) [J. LUOHE VOCATIONAL & TECH. INST. (GEN. ED.)], No. 1, 2002, at 52, 54.

178 The board of supervisors is elected by shareholders, and there is no reason to expect the interests that dominate director voting to fail to dominate supervisor voting.

180 See supra Part II.A.3.
enterprise. Indeed, a recent study showing that over half the companies surveyed maintained supervisory boards with only the legal minimum number of members suggests that this institution plays no real role in corporate governance.

Clearly, the hope is that independent directors will be able to play the monitoring role that the board of supervisors has been unable to play. Some commentators fear that having two monitoring institutions will lead to conflicts and duplication of functions, but such fears are generally expressed only vaguely, without specific examples of harmful conflicts that could arise. While vagueness, ambiguity, and confusion are bad, redundant systems per se are not. Given the weakness of the board of supervisors, it is not even clear that there is any real redundancy in the first place. While it may be unfortunate that JSCs are saddled with a poorly thought-out structure that serves no useful purpose, its existence does not make the institution of independent directors any more or less effective.

IV. REGULATORY RESPONSES

In Western studies of corporate governance, the dominant explanation for the current corporate landscape is a Darwinian one: the structures and institutions we see are presumed to be the efficient ones that survived in the course of competition with less efficient forms, and the challenge is to explain the source of that efficiency. This approach has

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181 See Jiang, supra note 89; Gao, supra note 12, at 9. Wang and Feng write: The actual situation is that the great majority of the supervisors are representatives of the union and of the congress of staff and workers, and the chairman of the union has the right to call meetings. Because the chairman of the union works under the leadership of the Party secretary and the Chairman of the Board of Directors, it is impossible for him to be independent. His livelihood and that of the staff and worker representatives is in the hands of management; if one day they should dare to offend management and exercise the sacred functions given to them by the law, perhaps the day after proposing to inspect the finances of the company they wouldn't even have their job at the company, and therefore wouldn't be able to continue to represent the staff and workers. Wang & Feng, supra note 43, at 120.

182 Lin & Dong, supra note 56, at 225.

183 See, for example, Ma supra note 12, at 63, who fears at the same time that duplicative functions could result in (1) insufficient monitoring on a theory of backpassing, and (2) excessive monitoring on a theory of too many cooks spoiling the broth. This seems little more than guesswork; the author does not provide any analysis of the incentives facing independent directors and supervisors that would lead to either result.

been cogently criticized as tautological and Panglossian—whatever is, is efficient—and certainly Chinese governmental authorities have not been willing to wait to see which institutions of corporate governance survive in market competition. Instead, they have taken active steps to encourage or require companies and other business entities to establish internal governance procedures that will, in the view of the authorities, produce desirable business decisions. This Part will review several of such initiatives to the extent they bear on the issue of independent directors, and will conclude with an examination in detail of the CSRC’s Independent Director Opinion.

A. Stock Exchange Initiatives

Stock exchanges can be an important source of corporate governance norms that are law-like in nature. The stock exchanges in Shanghai and Shenzhen are not independent self-regulating institutions; rather, they were established by government, are protected by government, and serve governmental purposes. Unlike the National
People’s Congress, they cannot back up their corporate governance directives by granting investors and others a legal right of action, but they do possess a powerful, if blunt, weapon: the threat of delisting.

In November 2000, the Shanghai Securities Exchange issued a set of draft guidelines on corporate governance (SSE Guidelines) for companies listed on the exchange. The SSE Guidelines stipulate that each listed company must have at least two independent directors, and that independent directors should constitute not less than 20% of the board of directors (30% where the chairman of the board and the general manager are the same person). Independent directors may be nominated by the board’s nominating committee or by shareholders holding at least 5% of the stock. Controlling shareholders may not, however, nominate more than one director, indicating that the SSE Guidelines contemplate independent directors as a shield against dominant shareholder abuses as well as management abuses.

The SSE Guidelines contemplate a major role for independent directors. All subcommittees of the board of directors—including those for compensation, nomination, and investment decisions, which are specifically mentioned—are to be composed principally of, and chaired by, independent directors. It is thus unfortunate that the SSE Guidelines do not define “independent director.”

The substantive prescriptions of the SSE Guidelines are not mandatory. They are to be enforced, if at all, through the mechanism of disclosure: listed companies are to disclose the extent to which they have followed the guidelines and implemented a set of corporate governance "best practices" on the basis of the SSE Guidelines.

In early 2001, the Securities Regulatory Office of Shenzhen promulgated the "Guidelines for the Implementation of an Independent Director System in Listed Companies" (Shangshi Gongsi Duli Dongshi Zhidu Shishi Zhiyin). These provided detailed rules respecting the qualifications and functions of independent directors and presumably applied to companies listed on the Shenzhen Stock Exchange. In June 2004, the Shenzhen Stock Exchange promulgated the "Instruction on Building Trust by Companies Listed on the Shenzhen Stock Exchange..."
Small and Medium-Sized Enterprises Board," which called for one third of directors in listed companies to be independent, with at least one of those directors a qualified accountant.\(^{191}\) The mandatory force of this document, however, is questionable.

B. Regional Government Initiatives

There have been various corporate governance initiatives involving independent directors at the level of local government as well.

- In May 2000, the Jiangxi provincial government issued a document calling for an "appropriate number" (shidang shuliang) of independent directors to be put on the boards of large enterprises that had been converted to companies under the Company Law, with the objective of making company decisionmaking more "scientific and objective."\(^{192}\)

- In October 2000, the Fujian provincial government issued a document on the management of state-owned enterprises under provincial jurisdiction. Such enterprises are controlled by provincially established holding companies, and the document states that such holding companies must have an unspecified number of independent directors who are experts or "well-known personages in society" (shehui zhiming renshi).\(^{193}\)

- In December 2000, the Guangdong provincial government issued policy guidelines for the administration of state-controlled listed companies under its jurisdiction. These guidelines called for the installation of independent directors on the boards of such companies, and specified that such directors should be responsible


to the whole body of shareholders, giving priority to the interests of small and medium shareholders in case of conflict.  

- Also in December 2000, the government of Hebei Province issued measures purporting to be mandatory and stating that companies should have experts in such fields as economics, finance, law, and securities as independent directors. They decline, however, to specify a particular proportion of independent directors on the board, leaving that instead to the articles of association.

- In January 2001, the Shenzhen Municipal Government issued a document on the reform of SOEs in Shenzhen and calling for "some" independent directors to be added to the boards of state asset management companies "as appropriate."

- In March 2002, the Jinan municipal government called for the gradual introduction of outside directors and independent directors onto the boards of large enterprises in the city, but did not define or distinguish them.

- In July 2002, the Hangzhou municipal government called for enterprises to improve their governance through having outside directors (waibu dongshi) and independent directors (duli dongshi), but made no attempt to distinguish them.

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• In August 2002, the Gansu provincial government, in a non-binding document, called on local enterprises to install independent directors and creditor representatives on their boards.\textsuperscript{199}

• In January 2003, the Beijing municipal government issued a document prescribing governance standards for enterprises it owned or controlled. This document called for at least one third of directors to be persons not employed at the enterprise, and said that enterprises "may" have independent directors who are both independent of the enterprise's shareholders and not employed at the enterprise.\textsuperscript{200}

What all these regulations and policy statements tend to have in common is that they rarely go beyond vague exhortations to install independent directors, and rarely specify numbers or specific powers. They seem grounded more in a notion in the minds of the drafters that independent directors are a good thing and therefore should be recommended or required. Since virtually all of the regional regulations apply to enterprises in which the major shareholder is the local government—the issuing body—it is hard to understand why a system designed to create opposition would be welcome.\textsuperscript{201} A possible conclusion is that the drafters simply have not thought much about the issue, or else do not expect independent directors to oppose government policies.

C. Central Government Ministry Initiatives

A few central government ministries (and equivalent bodies) have issued documents calling for independent directors in enterprises under their jurisdiction. For example, in 2002 the Ministry of Agriculture called for the restructuring of township and village enterprises into LLCs and

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\textsuperscript{201}Recall that "independence" in Chinese definitions virtually always includes independence from major shareholders. See supra note 114. A Guangdong provincial government document applying specifically to listed companies in which the controlling shareholder is a state body specifically calls for independent directors to put the interests of small and medium shareholders above those of the controlling shareholder. See Guangdong Corporate Governance Opinion, supra note 194, and accompanying text.
JSCs under the Company Law with "independent directors who are independent of company shareholders and are not employed within the company" on their boards.²⁰²

The People's Bank of China (PBOC), until recently in charge of bank regulation in China, in 2002 issued two documents it characterized as "guidelines": the Commercial Bank Independent Director Guidelines and the Commercial Bank Corporate Governance Guidelines. Both address the issue of independent directors in commercial banks with a shareholding structure. The Independent Director Guidelines prescribe rather stringent qualifications for such directors and view stock ownership and lengthy service (three years) as destructive of the desired independence. They further provide that each bank must have at least two independent directors (as well as two outside supervisors), and that a single shareholder may nominate no more than one independent director or outside supervisor. Unlike the CSRC, the PBOC is content to check on the qualifications of independent directors after they have assumed office instead of before.²⁰⁶

Like many other independent director rules and policies, the Independent Director Guidelines do not specify any concrete powers for independent directors. The only specific power they are given is the ability of a majority to request that the board of directors call a special shareholders' meeting, but since they cannot require the calling of such a meeting, the effect of this power is quite limited. The Corporate Governance Guidelines, on the other hand, do provide for a somewhat

²⁰³See, e.g., Commercial Bank Independent Director Guidelines, supra note 114, art. 1 (calling for at least five years of relevant work experience and the ability to read and analyze lending data and financial statements).
²⁰⁴See id. art. 2; People's Bank of China, Guanyu Gufenzhi Shangye Yinhang Gongsi Zhili Zhiyin [Guidelines on Corporate Governance for Commercial Banks Under the Shareholding System] art. 30, issued and effective June 4, 2002 [hereinafter Commercial Bank Corporate Governance Guidelines].
²⁰⁵See Commercial Bank Independent Director Guidelines, supra note 114, at art. 9. Michigan's independent director statute bars independent status after three years on the board. See Mich. Comp. Laws Ann. § 450.1107(3)(d) (2002). See also supra note 140. The Cadbury Report expresses the same policy concern without adopting a prohibition: "Non-executive directors may lose something of their independent edge, if they remain on a board too long." CADBURY REPORT, supra note 68, at ¶ 4.16. See also Gao, supra note 12, at 11 (arguing that social pressures will make independent directors sympathetic to management); He & Yu, supra note 104, at 28 (same).
²⁰⁶See Commercial Bank Independent Director Guidelines, supra note 114, art. 11.
²⁰⁷See id. art. 22.
larger role. Bank boards are to establish committees to handle, among other things, related party transactions and board nominations. Both such committees must be chaired by an independent director. Moreover, their members may not be directors nominated by the controlling shareholder.

Interestingly, the Corporate Governance Guidelines do have a concept of disinterested director along with that of independent director. Directors with a substantial interest in a matter may not vote on it, and resolutions on such matters must be approved by a majority of directors without a substantial interest. This rule does not appear to have been well thought out: if only disinterested directors may vote, even a unanimous vote of such directors might be insufficient to constitute a majority of the board, and the Company Law states that a board majority is necessary for the passage of any resolution. Company law statutes in other jurisdictions typically deal with conflicts of interest by applying quorum and majority requirements to the body of disinterested directors only, but China's Company Law does not do so, and the PBOC has no authority to make exceptions to its requirements.

Independent directors are supposed to pay special attention to the interests of depositors and of small and medium shareholders, but there is no mechanism to push them in this direction. The Independent Director Guidelines state that independent directors should, before taking office, make a declaration to the board of directors and the board of supervisors guaranteeing that they have sufficient time and energy to carry out their duties, and promising that they will perform them with diligence. It is difficult, however, to see this promise, if made, as a potential source of civil

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208 Approval of the committee on related party transactions is needed only for "large" transactions, as defined in the company's articles of association. See Commercial Bank Corporate Governance Guidelines, supra note 204, art. 41.

209 Curiously, the guidelines appear to contemplate that committee members will not all be directors, since they specify that the chairman should be a director. See id. art. 40.

210 See id. It is hard to see how this provision could be workable unless the bank has a very large board, since each committee must have at least three members. Nor is it clear how it will be enforced, since the guidelines do not provide any incentives for shareholders or others to police this requirement and determine whether a particular shareholder is in fact a controlling shareholder.

211 See id. art. 41.

212 See Company Law, supra note 17, art. 112 (similar in relevant part to Article 117 of the 1993 Company Law). Article 112 also creates difficulties in requiring a majority of all directors, not just those present at a board meeting that satisfies quorum requirements, for the passage of a board resolution.

213 See Commercial Bank Corporate Governance Guidelines, supra note 204, art. 30.

214 See Commercial Bank Independent Director Guidelines, supra note 114, art. 10.
or administrative liability, and the PBOC has no legislative power to create such liability on its own.

D. CSRC Initiatives

The CSRC has also been interested for some time in substantive regulation of corporate governance and considered such matters within its jurisdiction. To that end, it has issued (or proposed to issue) a number of regulations relating to corporate governance in listed companies (the only companies that are under its jurisdiction), and in these regulations has addressed the issue of independent directors.

1. CSRC Guidelines for the Articles of Association of Listed Companies

The CSRC made its first major foray into corporate governance regulation several years ago, on December 16, 1997, with the promulgation of its "Guidelines for the Articles of Association of Listed Companies" (Shangshi Gongsi Zhangcheng Zhiyin) (1997 Guidelines). According to the notice accompanying the 1997 Guidelines, listed companies were required to adopt their provisions (with minor changes in wording allowed) unless permitted to do otherwise by the CSRC. The CSRC further announced that it would enforce this requirement by refusing to accept submissions and filings from companies whose articles of association contained unauthorized deviations from the 1997 Guidelines.

The 1997 Guidelines say little about independent directors. They provide only that the company may establish independent directors in accordance with its "actual needs," and provide that certain persons may not act as independent directors: (1) shareholders or those employed by shareholding entities; (2) "internal personnel" of the company (such as the manager or an employee); and (3) persons with a "relationship of interest" (liyi guanxi) with affiliates or management of the company.

215On August 27, 1994, the State Council's Securities Commission (Zhengquan Weiyuanhui), the former parent organization of the CSRC, issued (jointly with the State Commission on Reform of the Economic System) the Mandatory Articles of Association for Companies Listing Overseas (Mandatory Articles). These have nothing to say, however, about independent directors.

216The Chinese text is ambiguous here. It may mean "those employed by shareholders or shareholding entities." The meaning suggested above is more probable, given the CSRC's later view expressed in Section 3(2) of the Independent Director Opinion, which prohibits anyone holding over 1% of the company's shares from qualifying as an independent director.

The provisions of the 1997 Guidelines relating to independent directors must be considered weak. They do not, for example, say what the point of having such independent directors might be, although the prohibition on shareholding suggests the focus is on abusive practices by dominant shareholders. They do not set forth any special powers for independent directors, such as the sole power to approve certain transactions. Key terms such as "affiliate" (guanlian ren) and "relationship of interest" (liyi guanxi) are undefined.\(^{218}\)

2. CSRC/SETC Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas

On March 29, 1999, the CSRC and the SETC jointly issued the Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas (Overseas Company Reform Opinion or OCRO), the mandatory status of which is not clear. The document is labeled "Opinion," which normally indicates that it is not of an absolutely binding character. Nevertheless, it is clearly intended to have some effect.

The OCRO addresses the issue of independent directors in surprisingly strong terms. "Outside directors" (waibu dongshi) (not defined) must constitute at least half of the board of directors, and at least two members of the board must be independent directors (defined to mean independent of the shareholders of the company and not holding any position within the company).\(^{219}\) The OCRO provide that any transaction between the company and an affiliate of the company (gongsi de guanlian

\(^{218}\)Although the latter problem has been rectified in the Independent Director Opinion, the term "affiliate" remains undefined in the Independent Director Opinion as well.

\(^{219}\)See China Securities Regulatory Commission, State Economic and Trade Commission, Guanya Jinyibu Cujin Jingwai Shangshi Gongsi Guifan Yunzu he Shenhua Gaige de Yijian [Opinion on Further Promoting the Standard Operation and Deeper Reform of Companies Listed Overseas], art. 6, issued Mar. 29, 1999. Interestingly, exactly the same language is used in article 1(7) of a later SETC document, where it is provided that companies "may" institute independent directors. State Economic and Trade Commission, Guoyou Daohongxing Qiye Jianli Xundai Qiye Zhida he Jiaqiang Guanli Jiben Guifan (Shi Xing) [Basic Standards for Establishing a Modern Enterprise System and Strengthening Management in Medium- and Large-Sized State-Owned Enterprises (for Trial Implementation)], issued Sept. 28, 2000.
must be approved by the independent directors before it is effective.221

A spot-check of a few Chinese companies listed overseas is useful for understanding the scope of what the CSRC will insist on. The articles of association of China Telecom Corporation Limited (CTCL) provide for two independent directors, but say nothing about outside directors constituting half the board.222 While the OCRO require independent director approval of all transactions with affiliates, CTCL’s articles require such approval only of board resolutions pertaining to such transactions,223 and the articles do not require board approval of all such transactions. The articles of association of neither China Petroleum and Chemical Corporation224 nor China Unicom225 call for independent directors to constitute at least half the board.

3. CSRC Draft Rules for Companies Seeking Listing on a Secondary Board

On August 23, 2000, the People’s Daily reported on a draft set of rules for companies seeking listing on a proposed secondary board.226 These rules stated that fully two thirds of directors in such companies had to be independent, and defined independent directors as directors other than those who (1) were shareholders; (2) were directly related, or collaterally related within three generations, to company directors, supervisors

220 The OCRO do not specify whether such approval must come from at least one, a majority, a supermajority, or all of the independent directors. The articles of association of one company subject to the OCRO, China Telecom Corporation Limited, specify approval by all independent directors. See CHINA TELECOM CORP. LTD., ARTICLES OF ASSOCIATION art. 96 (June 20, 2003), available at http://www.sec.gov/Archives/edgar/data/1191255/000102140803008986/dex2.txt.

221 It is not clear if the OCRO really mean that the transaction will be a legal nullity absent such approval. Such a rule is rare in Chinese law, and it is not clear if the CSRC and the SETC have the legislative authority to override the standard rules of contract and civil law. One could imagine a rule stating that the directors could be sued by shareholders for transactions with affiliates unaccompanied by independent director approval, but that is not this rule.

222 See CHINA TELECOM CORP. LTD., ARTICLES OF ASSOCIATION, supra note 220, art. 94.

223 See id. art. 96.


(jianshi), or officers; (3) were directors, supervisors, or officers of affiliated enterprises (guanxi qiye), a term that was not defined; or (4) were any person that was manipulable by the company.

The draft rules do not appear to contemplate any special function for independent directors other than to attend board meetings and vote as directors. They do not spell out any transactions that need approval from some number of independent directors.

It is not clear how the proposed rules are to be enforced. Most likely, the CSRC will require compliance in order to be listed on the secondary board, and non-compliance will result in de-listing. A secondary board was established in Shenzhen on May 17, 2004, but to the author's knowledge the draft rules have not been finalized and applied. Thus, the applicable rules are those of the Independent Director Opinion and the various rules that implement it.

4. CSRC Guidelines for Internal Controls for Securities Companies

On January 31, 2001, the CSRC issued rules governing the internal structure of securities companies, which are entities specifically subject to regulation by the CSRC. These rules, the Internal Controls Guidelines, mentioned only the need to "bring into full play the monitoring function of independent directors."

5. CSRC Guidelines for Internal Controls for Fund Management Companies

On December 19, 2002, the CSRC issued rules governing the internal structure of fund management companies (Fund Managers Internal Controls Opinion), which, like securities companies, are subject to its jurisdiction. These rules, like the Internal Controls Guidelines applicable

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to securities companies, mention merely the need to "bring into full play the function of independent directors," but have no specific requirements.

6. CSRC Measures on the Administration of Securities Companies

On June 20, 2001, the CSRC issued a draft for comment of its proposed Measures on the Administration of Securities Companies (Securities Companies Draft Measures), followed by the release on December 28, 2001 of the final version (Securities Companies Measures). Apparently, the comments convinced the CSRC that the draft version was unreasonably strict. The final version of the rules contains an explicit requirement that independent directors constitute not less than one quarter of the board of directors in the following circumstances: (1) the chairman of the board and the chief executive officer are the same person; (2) internal directors constitute at least one fifth of the board; or (3) the department in charge of the company, its shareholders' general meeting, or the CSRC deems it necessary.

While the draft measures contained detailed rules on who could qualify as an independent director, the final version is much simpler: an

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232 The Chinese text is ambiguous; it may mean "more than one fifth," but probably not.

233 The Securities Companies Draft Measures had two additional circumstances: "the company has been sanctioned for unlawful activity or certain extraordinary situations have occurred; [or] the reputation of the company is seriously deficient such that the interests of clients and shareholders are affected." Securities Companies Draft Measures, supra note 231, at 88.

234 A person must meet the following standards to qualify as an independent director under the Securities Companies Draft Measures: (1) he (or she) meets the conditions stipulated in the Company Law; (2) he is not an employee of an entity that holds shares in the company; (3) he is not currently, nor in the last three years has been, employed by the company; (4) he has no relationship of interest (liyi guanxi) with other company directors, supervisors (jianshi), or senior officers, or persons who are responsible for finances or auditing in the company; (5) he is not employed within any organization that has a major relationship of interest with the company; (6) he has at least five years of experience in finance, law, or accounting, and has sufficient time and energy to perform the duties of a director; and (7) he meets other conditions stipulated by the CSRC. See Securities Companies Draft Measures, supra note 231, at 88.

The "conditions stipulated in the Company Law" means the disqualified persons defined in 1993 Company Law, supra note 17, arts. 57, 58, and Company Law, supra note 17, art. 147. They include persons subjected to punishment for certain property crimes or to deprivation
independent director is someone who holds no position in the company other than director, and who has no relationship with the company or its majority shareholder that would compromise his independence.\textsuperscript{235} Similarly, while the draft version gave independent directors a defined role to play in approving specific transactions such as loan guarantees or related-party transactions,\textsuperscript{236} the final version took this role away.


\textsuperscript{236}The draft measures provided that the following matters required approval by a majority of the independent directors: (1) matters relating to audits, (2) transactions with affiliates, loan guarantees, and the granting of a security interest when borrowing, (3) the hiring and firing of senior officers, (4) salaries and other emoluments for directors and senior officers, (5) the engagement or replacement of the company's accounting firm, (6) other matters stipulated in the company's articles of association, and (7) other matters stipulated by the CSRC. The Chinese term I have translated as "majority," \textit{banshu yishang}, could be read to include 50%, but in my judgment probably does not mean that here. Securities Companies Draft Measures, supra note 231, at 88.
7. CSRC Corporate Governance Principles

On September 11, 2001 (after the release of the Independent Director Opinion discussed below), the CSRC released for comment a draft of its Principles of Corporate Governance for Chinese Listed Companies (Zhongguo Shangshi Gongsi Zhili Zhunze) (Draft Corporate Governance Principles). This draft was followed by the release on January 7, 2002 of the final version (Corporate Governance Principles). According to contemporary commentary, these Principles are based on the OECD Principles of Corporate Governance, as modified by appropriate principles drawn from specific foreign jurisdictions and China’s own particular situation. As is often the case with CSRC documents, there is some purposeful ambiguity about the degree to which its implementation is mandatory. Listed companies are to disclose the extent to which their rules of governance do not conform to the Principles, and the CSRC presumably will bring various kinds of pressure to bear on companies that do not amend their articles of association in conformity with the Principles.

The Corporate Governance Principles require companies to "establish an independent director system in accordance with relevant rules." This is a weakening of the rule in the draft version, which required at least half of the directors to be independent when the chairman of the board of directors is also the chief executive officer. Other provisions make it clear by implication that at least some independent

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237 See infra Part IV.E.
238 See Shan Yuqing, Youguan Zhuanjia Zhichu Shangsi Zhili Jiegou de Quexian Shi Zhongguo Ziben Shichang Fazhan Mianlin de Juda Tiaozhan [Relevant Experts Point Out that Shortcomings in the Governance Structure of Listed Companies Are a Great Challenge Facing the Development of Capital Markets in China], ZHONGGUO JINGJI SHIBAO [CHINA ECONOMIC TIMES], July 9, 2001; Tang, supra note 177.
239 Tang writes that the Corporate Governance Principles are unlike the OECD Principles of Corporate Governance on which they are modeled precisely in that they are intended to be mandatory, but questions whether the CSRC has the tools to enforce compliance. He also raises the broader issue of whether the CSRC has the legal authority under Article 167 of the Securities Law (now Article 179 following the October 2005 amendment) even to regulate at all in this area. See Tang, supra note 177. Zhang and Xiang view the Corporate Governance Principles as being "for guidance only" and not technically legally binding. Indeed, they go so far as to argue that because the Company Law gives shareholders the right to elect whomever they please as directors, the CSRC has no right to require them to elect independent directors. See Zhang & Xiang, supra note 178, at 54. This view is interesting theoretically, but any Chinese governmental authority called upon to decide whether the CSRC has such authority is likely to back the CSRC.
240 Corporate Governance Principles, supra note 163, art. 49.
directors are required. For example, company boards are required to establish certain committees; among them, independent directors must sit on the auditing committee (shenji weiyuanhui) and the compensation and assessment committee (xinchou yu kaohe weiyuanhui). Independent directors must constitute a majority within the compensation and assessment committee, the chair of which must also be an independent director. At least one member of the auditing committee must be an independent director who is an accountant.242

Although the Corporate Governance Principles contain many duties for independent directors, they do not list any special powers for them as a collective body. To be sure, their presence is required on two committees, but in no case is an independent director's vote counted any differently from the vote of a non-independent director. There are no situations (such as, for example, conflicting interest transactions) in which the approval of a majority of independent directors is required.243

The Principles seem to adopt the position that independent directors should be independent of everyone. An independent director is defined—not very rigorously—as a person who is independent of the company and of its major shareholders. The independent director may not have any position in the company other than director.244 Moreover, the Principles state that "[t]he independent director should exercise his functions independently, and not be influenced by the company's major shareholders, its de facto controlling parties, or other units (danwei) or individuals who have a relationship of interest in the company" (i.e., stakeholders in general).245

E. The CSRC Guidance Opinion on the Establishment of an Independent Director System in Listed Companies

On August 16, 2001, the CSRC issued its "Guidance Opinion on the Establishment of an Independent Director System in Listed Companies" (Independent Director Opinion). The Opinion covers Chinese companies listed in China; it does not cover Chinese companies listed overseas. It constitutes the most comprehensive measure taken to date by the CSR—or indeed, by any Chinese governmental authority—to regulate internal corporate governance through the institution of the independent director.

242 See Corporate Governance Principles, supra note 163, art. 49.
243 See, by way of comparison, the discussion of the role of disinterested director voting in Delaware law in supra Part III.B.3.
244 See Corporate Governance Principles, supra note 163, art. 49.
245 Id. art. 50.
In analyzing the Independent Director Opinion, considerable insight can be gained by comparing the final version with an earlier draft released by the CSRC in May 2001 (Draft Independent Director Opinion) in order to solicit comments.

1. Basic Requirement of Independent Directors

The basic rule of the Independent Director Opinion is set forth in Sec. 1(3): listed companies are to revise their articles of association to provide for independent directors. At least one of these should be an accounting professional. Listed companies were required to have at least two independent directors by June 30, 2002, and such directors were to constitute at least one third of the board by June 30, 2003.\footnote{The Company Law provides that JSCs should have five to thirteen directors.}

2. Whose Interests Are the Independent Directors to Serve?

The independent directors are said to owe a duty of good faith (chengxin) and diligence (qinmian) to the company and to the entire body of shareholders, but the Opinion singles out for special attention the interests of small and medium shareholders, and states that the independent directors are not to be influenced by major shareholders, controlling persons, or others who have a relationship of interest with the company.\footnote{See Independent Director Opinion, supra note 11, § 1(2).} To the extent that the drafters have considered the question at all, the Opinion seems to come down clearly in favor of viewing the independent director as independent from everyone with a significant interest in the company, and as the protector of small shareholders against both management and dominant shareholders.

3. Qualifications of Independent Directors

Unlike, for example, the corporate law and jurisprudence of most states in the United States (but like various U.S. federal statutes and regulations), the Opinion defines “independence” in a single way, instead of taking a purposive transaction-by-transaction approach. The Opinion takes a positive approach and a negative approach to the qualifications of independent directors. On the positive side, an independent director must (1) be qualified to serve as a director pursuant to the Company Law and other regulations; (2) possess the independence
required by the Opinion itself;^{248} (3) possess basic knowledge relevant to the operations of the listed company, and be familiar with relevant laws and administrative rules and regulations; (4) possess at least five years' work experience in law, economics, or other fields necessary for the proper exercise of his functions as independent director; and (5) possess other qualifications stipulated in the company's articles of association.^{249} In a later press release, the CSRC stated that independent directors must also undergo a training course organized by the CSRC in conjunction with Tsinghua University.^{250}

On the negative side, the following persons may not serve as independent directors: (1) a person who holds a position in the listed company or its subordinate affiliates as well as the direct relatives of, and those with important social connections^{251} to, the former; (2) a person, or the direct relative of a person, who directly or indirectly holds at least 1% of the company's stock or is among the top ten shareholders of the company;^{252} (3) a person, or the direct relative of a person, who is employed by an entity that directly or indirectly holds at least 5% of the company's stock or is among the top five non-natural person shareholders of the company; (4) a person about whom any of the above conditions have been met within the last year; (5) a person who supplies accounting, legal, consulting, or other similar services to the company or its subordinate affiliates; (6) any other person specified in the company's articles of association; and (7) any other person specified by the CSRC.

Although the Opinion forbids independent directors from having relationships with affiliates (guanlian ren) of the company,^{255} it does not

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^{248}One might well wonder where, if not in the positive requirements, such independence was defined. First, Section 1(2) states that independent directors "are not to be influenced by major shareholders, controlling persons, or others who have a relationship of interest with the company." Second, the negative requirements of Section 3 specify further elements of the definition. Independent Director Opinion, supra note 11, §§ 1(2), 3.

^{249}See id. § 2.


^{251}"Direct relatives" are defined as a "spouse, mother, father, son, daughter, etc." Independent Director Opinion, supra note 11, § 2. It is not clear to me what the "etc." is intended to cover. "Important social connections" are defined as "brother, sister, father-in-law, mother-in-law, son-in-law, daughter-in-law, spouse of a brother or sister, brother or sister of a spouse, etc." Id. Again, it is not clear how far the "etc." is intended to reach.

^{252}The Chinese here is ambiguous; it could be "over 1%." Id.

^{253}"Natural person shareholders" may be meant here. Id.

^{254}The Chinese here is ambiguous; it could be "over 5%." Id.

^{255}See Independent Director Opinion, supra note 11, § 5(1)(i).
define the term. The prohibition on relationships with affiliates appeared much earlier, in the 1997 Guidelines, but the term was also not defined there. Does it mean only the company's affiliated enterprises, or is it meant to include any natural person with a connection to the company? If it means the latter, the definition is extremely sweeping and may cover far more persons than is necessary for its purpose.

The Draft Independent Director Opinion stipulated that independent directors should spend at least fifteen days per year on the business of the company, but this was changed in the final Independent Director Opinion to a prohibition "in principle" on persons serving as independent director of more than five listed companies. While the former rule seems unenforceable in practice, the latter rule serves little purpose, since it says nothing about what else the independent director might be doing with his or her time. In practice, independent directors seem to spend much less time on company business, while at the same time not being excessively distracted by other directorships. According to a 2001 study by the Shenzhen Stock Exchange, eight independent directors from its sample served on five boards, 95 served on two boards only, and 212 served on a single board. A more recent study found roughly similar numbers: 63% of the independent directors surveyed served on only a single board. The same study found that independent directors typically spend nowhere near fifteen days per year on the business of the company; they spend five to nine days attending board meetings and one to five days working at the company offices on other matters.

4. Special Powers

The Independent Director Opinion seems to give special powers to independent directors by requiring that they constitute at least half of the

\[\text{256 See Shangsi Gongsi Zhangcheng Zhiyin [Guidelines for the Articles of Association of Listed Companies], supra note 217, art. 112.}\]
\[\text{257 See Independent Director Opinion, supra note 11, § 1(2).}\]
\[\text{258 See Quanjing Wangluo [Panorama Net], Du Dong Duiwu Jisu Kuorong [Ranks of Independent Directors Quickly Enlarged], Mar. 22, 2003, at http://www.p5w.net/p5w/home/dissertation/company/200303220172.html. These numbers are, of course, incomplete in not including figures for three boards, four boards, and more than five boards, and we do not know if they come from a random sample. As with many of the figures cited in this paper, they were probably not obtained through a rigorous methodology and should be considered only very roughly indicative of what is really going on.}\]
\[\text{259 See Jin Xin Securities, supra note 156.}\]
\[\text{260 See id.}\]
\[\text{261 "Possibly "more than half." The Chinese term (er fen yi yishang) is ambiguous. Independent Director Opinion, supra note 11.}\]
members of a board’s audit, nomination, and compensation committees. On the other hand, there is no requirement that these committees be established, so a company could keep inside director control over such matters by having them decided by the entire board.\textsuperscript{262}

In addition, independent directors are to have the following powers: (1) to pass on important transactions with affiliates, defined as transactions with affiliates (\textit{guanlian ren}) where the amount at stake is more than 3 million yuan or more than 5\% of the net asset value of the company according to its most recent audit report; (2) to recommend engagement or dismissal of the company’s accounting firm; (3) to recommend the holding of interim shareholders’ meetings; (4) to recommend the holding of board meetings; (5) to hire outside auditors and consultants (at the company’s expense); and (6) to solicit proxies prior to a shareholders’ meeting.

Some of these powers are quite ambiguous. For example, the independent directors apparently do not have the power to actually call a meeting of shareholders or the board; they have only the power to recommend to the board that such a meeting be called. More importantly, the Opinion does not actually confer these powers on independent directors. It calls on companies to confer these powers, presumably through provisions in their articles of incorporation or other internal rules. A company that does not do so may encounter pressure from the CSRC to make appropriate changes, but it would not be acting illegally in failing to do so.

The powers listed above cannot be exercised by individual independent directors; their exercise must receive the consent of a majority\textsuperscript{263} of the independent directors as a body. This is an interesting change from the Draft Independent Director Opinion, which required unanimous approval. On the other hand, the Draft Independent Director Opinion did not require independent director approval for important transactions with affiliates, stipulating only that the independent directors should express their independent views about such transactions and that such views should be disclosed. The final Opinion is more ambiguous; it may well be that the failure of independent directors to approve a transaction with an affiliate, for example, needs merely to be disclosed, and is not a bar to the transaction.\textsuperscript{264} This appears to be the CSRC’s usual

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\textsuperscript{262}A survey of listed companies showed that as of mid-May 2003, about half had not established any of the board committees on which independent directors have a special role under the Independent Director Opinion. \textit{See} Jin Xin Securities, supra note 156.

\textsuperscript{263}Possibly “at least half.” The Chinese term (\textit{er fen yi yishang}) is ambiguous. \textit{Independent Director Opinion, supra} note 11.

\textsuperscript{264}\textit{See} id. § 5(3).
approach to the role of independent directors and is reflected in other CSRC rules and policy documents.265

5. Selection Process

The provisions of the Opinion relating to the selection of independent directors reveal some of the conceptual weaknesses behind the scheme. As noted earlier, the fundamental impetus behind the institution of independent directors in China seems to be a desire to protect small shareholders from exploitation by dominant shareholders and management. Yet directors are elected by shareholders, and dominant shareholders, by definition, dominate shareholder voting. Where management or dominant shareholders desire independent directors to signal their integrity to investors and thereby lower the firm's cost of capital, or where they desire them because their approval of conflict-of-interest transactions can be a shield against liability,266 there is no conceptual problem with having management or the dominant shareholder nominate independent directors the same way they nominate other directors. Chinese regulators are thus faced with a dilemma: if simply any stockholder is allowed to nominate a candidate for independent director, then a profusion of candidates could give inordinate power to dominant shareholders by scattering the votes of small shareholders. But if only major stockholders are allowed to nominate candidates, then they are unlikely to nominate candidates who will see their duty as owed to small shareholders.

In the Draft Independent Director Opinion, the CSRC took the second option, stipulating that individuals or groups representing at least 5% of the shares could nominate independent director candidates;267 in the final version, however, it lowered the threshold to 1%.268

It is not clear in the Opinion, or indeed in the Company Law, how exactly such directors might be elected once nominated, assuming multiple nominations. Presumably, any director must be elected to office by a vote of the majority of shares at a shareholders' meeting; this is the way


266See infra discussion in the text accompanying notes 331-32.


268See Independent Director Opinion, supra note 11, § 4(1).
shareholder action is generally accomplished under the Company Law. Yet it is far from clear how this requirement would play out in elections of independent directors.

6. Tenure of Independent Directors

The provisions of the Opinion regarding tenure of directors contained a potential conflict with the Company Law. Article 115 of the 1993 Company Law provided that a director could not be removed from office “without reason” before the expiration of his term (which could not exceed three years). Although this sentence was removed in the October 2005 revision to the Company Law, it is not clear that the rule itself has for all practical purposes disappeared. Both the former and the present Company Law also provide that the number of directors of a company may not exceed nineteen.\textsuperscript{270} The Opinion provides that if an independent director ceases to meet the definition of “independent,” the company shall appoint additional independent directors if necessary to meet the prescribed ratio.\textsuperscript{271} What happens, then, if a company has nineteen directors, seven of whom qualify as “independent,” thus meeting the requirement of one third, but one of whom subsequently loses that status? It cannot appoint an additional director, since that would exceed the limit stipulated in the Company Law. Nor is it likely that it can dismiss the newly-disqualified director, or indeed any other director, since the loss of independent status probably does not count as the “cause” justifying

\textsuperscript{269}Just as removal “for cause” in American corporate law means removal for legitimate cause, so presumably does “without reason” (\textit{wugu}) mean without legitimate reason. Unfortunately, legitimacy is not a self-defining term. We know, for example, that in American corporate law a new controlling shareholder’s desire to get rid of directors nominated by a previous controlling shareholder is not deemed legitimate cause for their removal if cause is required. See R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations and Business Organizations §§ 4.4, 4-12 (Prentice-Hall Law & Bus. 1999 & Supp. 2004). But it is not obvious that every other legal system would or should reach the same conclusion. For Chinese views on this subject, see infra note 272.

\textsuperscript{270}See 1993 Company Law, supra note 17, art. 112; Company Law, supra note 17, art. 109.

\textsuperscript{271}See Independent Director Opinion, supra note 11, § 1(4).
removal. The Company Law forbids it from meeting the demands of the Independent Director Opinion.

The Opinion further provides that an independent director's resignation from the board, if it would result in the number of independent directors falling below the required number, may not take effect until a substitute independent director takes his place. It is far from clear that the CSRC possesses the authority to regulate the effectiveness of a director's resignation from the board, and it is equally unclear what the practical effect of not allowing the resignation to be effective might be. The director could simply stop attending meetings, which, indeed, under Section 4(5) of the Opinion would be grounds for removal from the board. And of course the director could take some step to disqualify himself as an independent director, in which case he would become just an ordinary director whose resignation would be effective when desired.

7. Enforcement

A key question that is often not clearly answered in the various standards for corporate governance is how, if at all, they shall be enforced. The Independent Director Opinion, by its very name—a "guidance opinion"—suggests that it is not strictly mandatory, even though listed companies are invited to implement it. There is nothing in the Opinion to suggest what kind of sanctions might follow upon a company's failing to implement its provisions. The Draft Independent Director Opinion provided that if a company failed to implement the provisions "without a proper reason," it would be publicly criticized by the CSRC and ordered to implement the provisions within a specified time, and would be required to

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272 Neither the Company Law nor any developed body of jurisprudence in China defines the meaning of "without reason." Various sources suggest the kinds of reasons that might justify removal upon the vote of a majority of shares: violation of law or regulations, violation of the company's articles of association, or demonstrated lack of diligence with resultant great harm to the company. See, e.g., Gongsi Fa Xin Shi yu Li Jie [A New Interpretation of the Company Law with Explanatory Cases] 215-16 (Deng Tao ed., Tongxin Chubanshe 2000) (discussing a litigated case concerning improper discharge of director); Gongsi Fa Ji Peitao Guiding Xin Shi Xin Jie [A New Interpretation and Explanation of the Company Law and Associated Rules] 703 (Kong Xiangjun et al. eds., rev. ed., Renmin Fayuan Chubanshe 1998). One case reportedly found that shareholder dissatisfaction with a director's business acumen, absent a violation of law or the company's articles of association, does not constitute adequate cause. See Yu Shengyong & Zhou Gang, Gongsi Fa Shiwu yu Anli Pingxi [Company Law: Practical Matters and Case Analysis] 397-99 (Zhongguo Gong Shang Chubanshe 2002). Neither the sources that I have seen nor the Independent Director Opinion itself suggests that failure to qualify as "independent" constitutes a reason justifying being voted out of office by shareholders.

273 See Independent Director Opinion, supra note 11, § 4(6).
note the circumstances in its public disclosures.\textsuperscript{274} Even this rule did not specify exactly how the CSRC would back up its order if it were disobeyed, and in any case the rule disappeared from the final version. The only place where disclosure appears to be used as an enforcement mechanism is in Section 5(3), where a company is required to disclose any failure to grant independent directors the powers listed in that section.\textsuperscript{275}

It could be that the CSRC intends to use its powers over listed company filings to enforce the Opinion: in other words, it would reject filings from companies that did not implement the provisions of the Opinion. This is precisely the threat it made in the 1997 Guidelines.\textsuperscript{276} Yet, given that the CSRC apparently knows of this enforcement mechanism and is capable of explicitly invoking it, it is curious, and possibly significant, that it did not do so in the Opinion. According to one CSRC official with whom I spoke, the sanction of an official reprimand from the CSRC—a possible alternative to the sanction of rejecting a filing—remains powerful, because most company officers are still in effect civil service bureaucrats working in state enterprises, and are therefore sensitive to anything that might blot their record and affect their chances for promotion.

Ultimately, however, management that chooses not to install independent directors may do so with impunity. As noted below, four companies had still not installed independent directors as of the end of July 2004, with no apparent official consequences. The most well known of those, Sichuan Changhong, was even specifically instructed in 2003 by the regional office of the CSRC to come into compliance, but failed to do so.\textsuperscript{277}

The Opinion requires companies to submit to the CSRC (as well as to its local branch office and the exchange where the company is listed) a list of proposed independent director nominees and their qualifications. The CSRC is then to vet the nominees and indicate approval or disapproval within fifteen days.\textsuperscript{278} Candidates disapproved by the CSRC may not be independent directors, but may still be directors. The company's board of

\textsuperscript{274}Draft Independent Director Opinion, supra note 267.

\textsuperscript{275}Independent Director Opinion, supra note 11, § 5(3).

\textsuperscript{276}See Mandatory Articles of Association for Companies Listing Overseas, supra note 215.

\textsuperscript{277}For more details on Sichuan Changhong's circumstances and that of the other three delinquent companies, see Changhong de Duli Dongshi Zai Nali? Zai Rongzi Jianghui Shoudao Yingxiang [Where Are Changhong’s Independent Directors? Their Subsequent Capital Raising Will Be Affected], GUOJI JINRONG BAO [INT’L FIN. NEWS], July 6, 2004, available at http://finance.sina.com.cn/roll/20040706/0048851431.shtml (describing the Independent Director Opinion as a "soft constraint" (ruan yueshu)).

\textsuperscript{278}See Independent Director Opinion, supra note 11, § 4(3).
directors must report the CSRC’s disapproval to shareholders at the meeting where the directors are to be elected.\textsuperscript{279}

The timetable for approval, as well as the deadline for the introduction of independent directors, was tight, but by and large seems to have been met. The first study of board composition appears to have been conducted in 1996 by the CSRC, which found that out of China’s 530 listed companies, 22.1% had all inside directors, and 78.2% had over half inside directors.\textsuperscript{280} As of 2001, China’s over 1200 listed companies were still a long way from having the requisite number. The total number of independent directors nationwide was quite small—a survey by the Shanghai Securities Exchange showed that only 0.3% of directors surveyed could be classified as “independent”\textsuperscript{281} (other sources suggest 0.99%\textsuperscript{282} and 3%\textsuperscript{283}) and another claimed that only 314 existed in the whole country.\textsuperscript{284} Moreover, only a small number of listed companies—perhaps 40,\textsuperscript{285} perhaps 56,\textsuperscript{286} perhaps 204\textsuperscript{287}—had any directors at all that might qualify as independent. Commentators at the time expressed doubts that

\textsuperscript{279}Id. \S 4(3).

\textsuperscript{280}See Li, supra note 151, at 39–40. Similar numbers for 1998 (20.4% and 78.2% respectively) are reported in another source. See Lin Ling & Chang Cheng, Duli Dongshi Zhidu Yanjiu [Research into the Independent Director System], ZHENGQUAN SHICANG DAobao [SECURITIES MARKET HERALD], Sept. 2000, at 16, 16. The exact similarity of both the sample size (530 companies) and the figure for the percentage of boards with over half inside directors (78.2%), however, coupled with the authors’ failure to provide a source for their figures, leads me to conclude that they are probably just repeating the 1996 numbers from the CSRC study.

\textsuperscript{281}See McGregor, supra note 158; Ni Jianlin, Gongsi Zhi Li Jiegou: Falü Yu Shihuan [The Structure of Corporate Governance: LAW AND PRACTICE] 117 (Falü Chubanshe 2001). This and other statistics here cannot be viewed as terribly reliable.


\textsuperscript{283}See, for example, the figures cited in Xie Chaobin, Shanghai Gongsi Faren Zhili Jiegou Yu Gudong Quanyi Baohu [The Corporate Governance Structure of Listed Companies and the Protection of Shareholders’ Rights] (Paper for 21st Century Commercial Law Forum, Tsinghua Univ., Beijing, Nov. 18, 2001).

\textsuperscript{284}See Duli Dongshi yu Duli Jianshi [Independent Directors and Independent Supervisors], GUANGMING RIBAO [ENLIGHTMENT DAILY], Sept. 18, 2001. Citing annual reports for the year 2000, another source puts the number at 103. See Touzizhe Repan Duli Dongshi [Investors Eagerly Look Forward to Independent Directors], supra note 282.

\textsuperscript{285}See Li Yining: Shangshi Gongsi Duli Dongshi Zhi Shang Nan Fahui Zuoyong [Li Yining: It Is Still Difficult for the Listed Company Independent Director System to Play Its Proper Role], supra note 150.

\textsuperscript{286}See Touzizhe Repan Duli Dongshi [Investors Eagerly Look Forward to Independent Directors], supra note 282.

\textsuperscript{287}See Duli Dongshi yu Duli Jianshi [Independent Directors and Independent Supervisors], supra note 284; Xie, supra note 283.
companies governed by the Opinion could find qualified persons in the time available.\(^{288}\)

As of June 30, 2002, all 1187 listed companies were reported to have met the deadline for having at least two independent directors on the board: 80% had two such directors and the rest had more than two.\(^{289}\) As of mid-May 2003—about six weeks prior to the June 30 deadline for having a one-third independent board—companies appeared close to reaching the target number. The average number of directors was 9.95, and the average number of independent directors was 3.07—less than one third but not by much. Fully 62% of a sample of companies surveyed were already at one third.\(^{290}\) Many of the remaining companies may well have made up the difference by June 30, 2003, the last possible day, when 140 companies—a record number—scheduled shareholder meetings.\(^{291}\) Nevertheless, some non-compliance seems to remain. By the end of July 2004, 1382 out of 1386 listed companies had independent directors on the board (i.e., four companies still had no independent directors at all). There were 4559 independent directors in total, yielding an average of just over three per company.\(^{292}\)

Most companies have met—or at least have so reported—the requirement for having an independent director trained in accounting. According to one report, 70% of all listed companies had put an accounting specialist on the board by June 30, 2002. A later report states that as of mid-May 2003, 84% (58 companies) of a sample of 69 listed companies had such an independent director.

The CSRC can probably handle the workload in terms of processing paper. Local offices, which will handle the approval process and have fifteen days to vet nominees, probably have over 1200 staff

\(^{288}\)See, for example, the comments to this effect by Li Yining, the chief architect of the Securities Law, in Li Yining: "Shangshi Gongsi Duli Dongshi Zhi Shang Nan Fahui Zuoyong [Li Yining: It Is Still Difficult for the Listed Company Independent Director System to Play Its Proper Role], supra note 150. See also Ni, supra note 281, at 120-21.

\(^{289}\)See Du Dong Duiwu Jisu Kuorong [Ranks of Independent Directors Quickly Enlarged], supra note 258.

\(^{290}\)See Jin Xin Securities, supra note 156. The information contained in this report is based on a survey of 69 listed companies. One cannot tell from the report whether the companies were randomly selected, but I judge it unlikely. Among other things, all the companies may have been from the Shanghai Stock Exchange.

\(^{291}\)See Bai Duo Jia Gongsi Tuji Xuan Dongshi [Over 100 Companies Select Directors in Sudden Attack], ZHENGQUAN SHIBAO [SECURITIES TIMES], July 2, 2003, available at http://www.p5w.net/p5w/home/stime/today/200307020234.html.

members who could perform reviews, or about one per listed company, on average. The real issue lies in whether, given the many and subtle ties that may exist between nominees and company management, independence can really be ascertained in the abstract on the basis of paper submissions by management, and whether independence so ascertained is really very meaningful.

**V. CAN INDEPENDENT DIRECTORS FUNCTION AS HOPED?**

Despite the great effort being put into developing the institution of independent directors, it is far from clear that it will function as expected. This Part will first briefly canvass empirical research in the United States and in China, and then discuss specific institutional reasons why an externally imposed requirement of independent directors may not make much of a difference.

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293Personal communication, CSRC staff member, July 2003. These numbers are very approximate, but useful for providing a rough idea of the CSRC's capacity. Interestingly, Section 4 of the Draft Independent Director Opinion provided for a different procedure that would have meant less work for the CSRC. Independent directors once elected were to be reported to the local branch of the CSRC, which would then indicate its approval or disapproval. Disapprovals could be appealed to the CSRC itself. Thus, there was no need to waste time reviewing the qualifications of nominees who were not elected. For the story of two independent director nominees who were voted down by the same controlling shareholder that nominated them, see Chen Daofu, Zhi Duli Dongshi Yu Hedisi? [What Is Being Done to Independent Directors?], JINGJI YUEBAO [ECON. MONTHLY], No. 8, Aug. 2003, available at http://www.em99.com/zhengwen/yuekanliulan/2002/8mu.htm.

294The Special Litigation Committee directors found insufficiently independent in *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 921 (Del. Ch. 2003), for example, would have passed any existing objective test of independence, but because they and the defendant directors shared ties with Stanford University, the Delaware Court of Chancery found "a social atmosphere painted in too much vivid Stanford Cardinal red for the SLC members to have reasonably ignored it." *Id.* at 947. Similarly, RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. (2003), available at http://www.thecorporatelibrary.com/spotlight/scandals/Restoring_Trust_Final-WorldCom.pdf, notes that the chairs of WorldCom's compensation committee and audit committee (like 80% of the board in the Ebbers era) both satisfied contemporary definitions of "independence," and would probably have satisfied the proposed NYSE and Nasdaq definitions. Nevertheless, they had both been involved in business with CEO Bernard Ebbers for years, and "seemed to be more solicitous of Ebbers' wishes than shareholder interests." *Id.* at 28 n.27, 30.
Board independence is clearly no guarantee of corporate success. As one commentator recently noted:

[B]oard independence has done little to prevent past mismanagement and fraud. For example, thirty years ago the SEC cast much of the blame for the collapse of the Penn Central Company on the passive nonmanagement directors. No corporate boards could be much more independent than those of Amtrak, which have managed that company into chronic failure and government dependence. Enron had a fully functional audit committee operating under the SEC’s expanded rules on audit committee disclosure.

Anecdotal examples of failure do not, of course, prove the absence of success. More to the point are the results of several studies of the effect of independent directors on corporate performance in the United States: the overall weight of their findings is that there is no solid evidence suggesting they improve it. Some studies have even found a negative correlation
between board independence and corporate performance. The most recent comprehensive study is that of Bhagat and Black, who in a review of other studies as well as with their own research find, among other things, that:

- there is no evidence that greater board independence leads to better firm performance. Poor performance is correlated with subsequent greater independence, but there is no evidence that this strategy works to improve performance.
- having insiders on the board can add value.
- independent directors with significant stock positions may add value, whereas others do not.

A study by April Klein finds that the traditionally outsider-dominated monitoring committees (audit, nomination, and compensation) have little, if any, effect on firm performance, regardless of how they are staffed. Indeed, in direct contrast to conventional wisdom, Klein found a positive correlation between firm performance and the presence of insiders on board finance and investment committees. Evans and Evans found that the presence of independent directors on board or compensation

companies following the issuance of the Cadbury Report. See Dahya & McConnell, supra note 133, at 23-27. Note that these studies are not necessarily all about the same thing. Studies of directors who meet a criterion of outsideness do not, strictly speaking, tell us about directors who meet a criterion of independence, since the latter group excludes those (and those who represent companies) doing extensive business with the company in question, whereas the former group does not.

It is worth noting that the results of these studies have been reported in the Chinese corporate governance literature. See, e.g., Ni, supra note 281, at 115.


298 See Bhagat & Black, supra note 296, at 263.

299 See id. This finding is also supported by Baysinger & Butler, supra note 147, at 578.

300 See Bhagat & Black, supra note 296, at 265-67.


302 See id.
committees had no effect on CEO pay levels. 303

2. China

Intriguingly, researchers have also failed to find empirical support in China for the effectiveness of independent directors in enhancing corporate performance. Tian and Lau looked at the results for 1996 and 1997 of the 207 companies that went public on one of China's two exchanges in 1996, and found no positive correlation between reported performance and the proportion of independent directors on the board. 304 He and Wang studied the 56 listed companies that had independent directors as of the end of 2000 and found that there was no obvious link to the economic performance of the company or to dividends. 305 Gao and Ma examined all 1151 reporting companies on the two Chinese exchanges (yielding an effective sample of 1018 companies), 83 of which had appointed independent directors in the previous three years. 306 They found no support for the hypotheses that (a) there is a clear difference in performance between companies with independent directors and those without, or that (b) there is a positive correlation between percentage of independent directors on the board and corporate performance. 307 Most recently, Luo, Zhou, and Guo examined 81 listed companies that had had independent directors since 2000 or before, and found that the establishment of an independent director system was followed by a subsequent decline in corporate performance as measured by earnings per

303 See Robert Evans & John Evans, The Influence of Non-Executive Director Control and Rewards on CEO Remuneration: Australian Evidence (unpublished manuscript, EFMA 2002 London Meetings, Working Paper Series, Mar. 12, 2001), available at http://ssrn.com/abstract=263050. Interestingly, the authors did find a link between compensation structures for non-executive directors (as they defined them) and CEO pay. Where such directors have equity stakes, CEO pay tends to be lower. Where they do not, CEO pay tends to increase with director pay.


306 See Gao Minghua & Ma Shouli, Duli Zhidu yu Gongsi Jixiao Guanxi de Shizheng Fenxi [An Empirical Analysis of the Relationship Between the Independent Director System and Corporate Results], NANKAI JINGJI YANJIU [NANKAI UNIVERSITY ECONOMIC STUDIES], No. 2, 2002, at 64-68.

307 See id.
share and return on equity. They also found no relationship between the proportion of independent directors on the board and corporate performance. Finally, Xiao found that while the degree of independence of independent directors (measured by whether or not they were nominated by the controlling shareholder) was significantly (although very modestly) related to corporate performance, the proportion of independent directors on the board was not.

Doubtless all these studies are subject to measurement problems. All one can really study is the relationship between the number of persons who are labeled independent directors and reported corporate results, and in each case what is reported may not reflect reality. It remains true, nevertheless, that to date there does not appear to be any strong empirical support for the view that independent directors in China enhance corporate performance.

B. Why Don't Independent Directors Seem to Work?

The preceding section canvassed the lack of empirical evidence in support of the usefulness of independent directors in the United States and China. There are a number of factors, both measurable and unmeasurable, that might be adduced to explain these results. This section explores those factors.

1. Characteristics of Independent Directors

It has been argued that independent directors are reluctant to oppose those who selected them because their fees are high. The evidence on this point is mixed. One study reports annual director fees in

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308 See Luo Pinliang et al., Duli Dongshi Zhidu yu Gongsi Yeji de Xiangguanxing Fenxi: Laizi Hushi A-Gu De Shizheng Yanjiu [An Analysis of the Relationship Between Independent Directors and Corporate Performance: An Empirical Study of A-share Performance in the Shanghai Stock Market], SHANGHAI GUANLI KEXUE [SHANGHAI MGMT. SCI.], No. 2, 2004, at 20-23. The study was based on reported results as of the companies' annual reports for 2002. Needless to say, a sequence in time does not establish causation. Unfortunately, the authors do not have a control group of companies that did not introduce independent directors, thus leaving open the possibility that the performance of many companies may have suffered simply due to economic conditions.

309 See id.


311 See Han Zhiguo, Duli Dongshi Bu "Duli" [Independent Directors Are Not "Independent"], FAZHAN [DEVELOPMENT], No. 8, 2002, at 40.
the range of 5000 to 12,000 yuan. This is between US$600 and $1,500 at current exchange rates—in the range of a junior white-collar worker's monthly salary. In view of other studies, however, this figure seems low. A survey of 69 listed companies reports that over half paid between 20,000 and 40,000 yuan per year to independent directors, while another 31% paid between 40,000 and 60,000 yuan. A study conducted in 2001 by the Shenzhen Stock Exchange reportedly found annual director fees in the range of 20,000 to 50,000 yuan. Another 2001 study of 130 listed companies is reported to have found that 18 companies paid between 10,000 and 20,000 yuan, 26 paid between 20,000 and 30,000 yuan, 49 paid between 30,000 and 40,000 yuan, 21 paid between 40,000 and 50,000 yuan, and 16 paid more than 50,000 yuan.

In the 56 companies with independent directors studied by He and Wang, only 13 independent directors received fees (or at least were reported to have received fees). The other 80 did not receive any compensation from the company. A study of disclosure of independent director compensation by 1116 listed companies found that 777 (70%) did not disclose one way or the other, 137 (12%) reported that they compensated directors, and 202 (18%) reported that their independent directors received no compensation. Of the top twenty companies in terms of compensation, the highest paid 265,000 yuan per year, while the lowest paid 60,000 yuan. Fifteen of the top twenty paid between 60,000 and 80,000 yuan per year. Thus, this amount would seem to represent the general maximum, aside from a few outliers. The bottom twenty reporting companies all paid less than 10,000 yuan per year, but this number does not include companies that paid nothing and companies that did not disclose.318

312 See Wu et al., supra note 160.
313 See Jin Xin Securities, supra note 156. For a caveat about the methodology of this survey, see supra note 284.
314 See Du Dong Daiwu Jisu Kuorong [Ranks of Independent Directors Quickly Enlarged], supra note 258.
316 See He & Wang, supra note 305.
317 See id.
A later survey is that of Yue,319 based on data as of July 30, 2002 from a random sample of 500 listed companies. He found that directors’ fees averaged 31,900 yuan per year, with a highest reported fee of 200,000 yuan and a lowest reported fee of 5000 yuan.

The most recent study is based on data from the annual reports for 2002 of 81 listed companies that had independent directors since at least 2000.320 The authors found that over half the companies paid less than 30,000 yuan annually to each independent director.

Perhaps more telling are the personal characteristics of independent directors. Unlike independent directors in U.S. companies, who often, but not always, share personal characteristics such as education and business experience with inside directors, independent directors in China are typically quite different from their fellow directors. In a survey of the occupational background of independent directors, Shi found that almost half were teachers in institutions of higher education or researchers in scientific institutes (see Figure 1).321 A CSRC study in 2002 found a similar number, with accountants, lawyers, and other intermediaries making up another 30%. Only 10% were executives from other companies.322 Shi’s study found that some 22% were from the world of business, and another 15% were current or former government officials, whereas the CSRC study found that 10% were company executives and only 5% were "other," a residual category that included retired government officials (current government officials are not supposed to be independent directors). A more recent study based on a random sample of 500 listed companies found that 45% of independent directors were university professors or researchers from institutes, similar to the figure in previous studies. Other (presumably industrial) companies were the source for 28% of the independent directors, while lawyers, accountants, and other service industry professionals accounted for 14%.323

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320Luo et al., supra note 308. For a further breakdown, see infra Figure 4.


322See Du Dong Daiwu Jisu Kuorong [Ranks of Independent Directors Quickly Enlarged], supra note 258. A 2003 study put the number of professors at 39%; this is not necessarily inconsistent with the other studies, since the category "professors" may have been more narrowly defined than the category "professors and technical specialists." See Jin Xin Securities, supra note 156.

323See Yue, supra note 319.
Also striking were differences in educational background (see Figures 2a, 2b, and 2c, from different studies with consistent results)\(^{324}\) and age (see Figure 3). In short, the numbers appear to bear out the common stereotype of independent directors as perhaps well-meaning but ultimately ineffectual academics and celebrities brought onto boards for their prestige value and perhaps to satisfy the CSRC, but for little else.

2. Institutional Factors

In a recent paper, Kanda and Milhaupt suggest a useful way of thinking about legal transplants in terms of micro-fit (compatibility with the existing legal infrastructure), macro-fit (compatibility with existing political and economic institutions), the availability of substitutes for the transplanted doctrine, and the motivations of those responsible for the transplanting and those who might be in a position to make it an active element of the host country's legal system.\(^{325}\) While independent directors in China are less a legal transplant than an institutional transplant, the above guidelines are nevertheless a useful way of ordering the discussion.

2.a. Motivations

The best place to start might be with the motivations of those responsible for introducing the independent director system. From a bureaucratic perspective, one can, of course, speculate that in imposing this requirement, the CSRC was simply looking for another handle with which to grasp the companies under its jurisdiction and thus increase its power over them. It is just one more requirement with no private law consequences\(^{326}\) that CSRC officials can choose to enforce strictly or not, depending on the company's degree of cooperation on other fronts. If this theory is correct, the requirement will be more a regulatory bargaining chip than a categorical imperative.

\(^{324}\)Two studies show the percentage of independent directors with a master's degree or higher to be respectively 49 (Figure 2a) and 60 (Figure 2b). Oddly, however, a news report dated Aug. 18, 2002 (well after the data for the two studies was taken) states that in Shanghai listed companies, where one would expect the educational level of independent directors to be high, over one third (but presumably not close to or over one half) had a master's degree or above. See *Shanghai Shangshi Gongsi Quanbu Shishi Duli Dongshi Zhidu* [Shanghai Listed Companies Fully Implement Independent Director System], *Jiefang Ribao* [Liberation Daily], Aug. 23, 2002, available at http://www.chinainfobank.com.

\(^{325}\)See Kanda & Milhaupt, *supra* note 13, at 9-10.

\(^{326}\)See *infra* text accompanying note 329.
It is also important not to overlook the possibility of mixed and possibly contradictory motivations, perhaps driven, like the Sarbanes-Oxley Act in some respects, by the desire simply to do something even if it is not clear that the medicine will cure the disease. As shown in Section 4 above, regulations and policy documents calling for independent directors were being issued long before the Independent Director Opinion. Thus, looking at the CSRC's motivations is not enough. It seems that independent directors as part of the solution to corporate ills were part of the zeitgeist that had reached China by the late 1990s, and they were promoted, apparently without much serious consideration, as a weapon against abuse by dominant shareholders by precisely those same dominant shareholders (for example, local governments).

In sum, although the motivation for adopting an independent director system seems straightforward at first glance, upon closer examination it is surprisingly amorphous and unclear. This lack of clarity is likely to impair the successful transplantation of the institution.

b. Micro-Fit

The micro-fit of independent directors in China is poor. This is so for two reasons. First, the micro-fit of the borrowed institution—indeed directors—even in the home country is not terribly good. The U.S. legal system at the state level (usually the state of Delaware) is quite at home with the notion of disinterested directors and has various mechanisms in place, such as enforceable recusal requirements and shareholder lawsuits, for making their presence meaningful. Independent director requirements imposed by federal law and stock exchange listing rules, however, are much harder to police, and are not backed up by a plausible theory of motivation.

Second, China's independent director system is not tied into any system of incentives that would make it function as expected. Corporate officers and fellow directors have few incentives to listen to independent directors because independent directors have little in the way of veto power over corporate actions. Independent directors may have the fear of liability

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328 See supra Part IV.B.

329 See supra note 119 and accompanying text.
as an incentive not to sign off on questionable deals, but inside directors have the same incentive. Finally, those in control of the corporation have little incentive to appoint truly independent directors because there is no institution with the capacity to make the fine individualized determinations of who is truly independent, and controlling parties would get no benefit from having such truly independent directors. China does not now have the kind of legal institutions that could make the independent director requirement meaningful, and even if it did, the rules at present do not contemplate a significant role for legal institutions. They contemplate a role only for the CSRC.

In thinking about the kind of legal institutions that could make an independent (or disinterested) director requirement meaningful, it is useful to think about how such rules are made meaningful (or not) by legal institutions in the United States. Let us imagine an American company, for example, whose board of directors is dominated by management. Why would management ever want to appoint independent directors? There are a few answers, of course: it might be that this is a bonding device whereby management signals to potential investors that it is willing to be monitored effectively, and thereby reduces the firm's cost of capital, making it more competitive with other firms and thus more likely to survive.330

Another answer, however, is that management engages independent directors in order to protect itself from liability in shareholder suits.331 A company's management often does, and sometimes must (for example, in the case of compensation), engage in transactions that either are or look very much like self-dealing or in some other way implicate a conflict of interest. In such cases the blessing of independent directors can be invaluable. As noted above, corporate statutes in the United States do not prohibit self-dealing transactions outright and do not even necessarily require approval by independent directors. Instead, they provide a safe harbor for transactions that are approved by directors who are disinterested in the transaction in question. The good-faith use by management of independent directors is recognized by courts and extremely valuable.332

330This is essentially the story told by law-and-economics scholars such as Easterbrook and Fischel. See Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law (Harvard Univ. Press 1991).

331This is the view of Miwa and Ramseyer, who label such suits “legalized extortion.” See Miwa & Ramseyer, supra note 98, at 8.

332Consider the recent admonition of the Chief Justice of the Delaware Supreme Court, Norman Veasey:

I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in
Consider also that, as I have argued above, the jurisprudence of disinterested directors is far more developed than the jurisprudence of independent directors. An important reason is that disinterested directors are a concept in Delaware's corporate law, and Delaware has courts and a responsive legislature that sees problems and responds to them. The NYSE rules, by contrast, carry with them no system for spotting problems and resolving disputes through a fair process resulting in written decisions. The same applies to the rules of the SOA: they come from a source that cannot be changed quickly.333 Furthermore, if Delaware wants disinterested directors, it can give incentives to shareholders to sue if they do not get them. But the exchanges have only the blunt tool of delisting for the enforcement of their rules.

However Congress may have contemplated that the independent director requirements of the SOA would be enforced—through SEC action, through private litigation under the federal securities laws, or through some other method—it is important to note the possible interplay of state law with federal law here. Law firms are already warning their clients that penalties in one forum can turn into penalties in another. For example, the SOA mandates the stock exchanges to require corporations to adopt internal governance rules on pain of delisting. A director might well not be protected by the business judgment rule for actions she took that resulted in delisting; she might be held to have a fiduciary duty to prevent such an occurrence.334 As Chandler and Strine predict:

court from a properly presented complaint.

Peter Olson, What's Wrong with Executive Compensation?: A Roundtable Moderated by Charles Elson, 18 HARV. BUS. REV., Jan. 2003, at 68, 76 (citing Norman Veasey). The wisdom of Chief Justice Veasey's advice can be seen by looking at the fate of the management buyouts of Macmillan, Inc. and RJR Nabisco, Inc. In the former case, management hand-picked the board committee that was to negotiate the terms of the deal and in other ways exercised control over the process; as a result, the board was found to have breached its fiduciary duties in accepting management's bid even though it was nominally higher than a competing bid. See Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1281 (Del. 1988). In the latter case, by contrast, the president and CEO of the company leading the buyout group had no role in the selection of the board committee and the members of that committee had no direct or indirect financial interest in the transaction. As a result, although the board rejected a nominally higher bid, its decision was protected by the business judgment rule. See In re RJR Nabisco, Inc. S'holders Litig., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. 1989), reprinted in 14 DEL. J. CORP. L. 1132 (1989). For a detailed discussion of the two cases, see Stephen M. Bainbridge, Independent Directors and the ALI Corporate Governance Project, 61 GEO. WASH. L. REV. 1034, 1076-79 (1993). On the insulating effect of disinterested directors generally, see CHANDLER & STRINE, supra note 98, at 35.

333The arguments in this paragraph are made more fully in CHANDLER & STRINE, supra note 98.

It is unlikely that stockholder-plaintiffs will be content to leave enforcement of the 2002 Reforms entirely to the SEC and the Exchanges. Rather, if history is any guide, the active corporate plaintiffs' bar will be creative and aggressive in deploying the Reforms as a tool in shareholder litigation under state law.\footnote{335}{CHANDLER \& STRINE, supra note 98, at 44.}

In the United States, therefore, one can see that the requirements of the SOA are already being viewed by judges, plaintiffs' lawyers, and defendants' lawyers in terms of their liability implications in the hands of different institutions. This makes it all the more important to note that virtually none of these mechanisms is available in China, or if available, contemplated by the Independent Director Opinion or other rules and policy documents calling for independent directors.

Most importantly, the Opinion is a policy document to be administered by the CSRC. It grants no private rights. It operates by giving the CSRC leverage to require companies to revise their articles of association to accommodate independent directors, and to put them on their boards. The only body with the authority to judge whether companies have met the requirements of the Opinion, and to make consequences follow from their failure to do so, is the CSRC. As discussed above, even if the CSRC has the manpower to ensure that independent directors meet its standards at the time of appointment, it can hardly be expected to carry on monitoring to ensure that they \textit{continue} to meet the standards, much less to investigate every transaction approved by the board to ensure that the independent directors were also \textit{disinterested} directors.

Shareholders and courts cannot be expected to carry this burden within China's legal system for several reasons. First, shareholders have no right to sue if companies do not comply with the Opinion. The CSRC has no legislative power to grant such rights, and even if it had such power, it has not done so. Second, it is not clear that shareholders have a right to sue if companies do comply with the Opinion by revising their charters and appointing independent directors, but then fail to allow the independent directors to play their contemplated role. All the Opinion seems to require is that such failure be disclosed, and the CSRC is evidently not requiring listed companies to commit to more than that in their charter revisions.\footnote{336}{See, for example, the charter revisions of a Shenzhen listed company reported in \textit{Guanyu Xiugai Gongsi Zhangcheng De Yuan [Resolution on Amendment of the Company's Articles of Association]}, ZHENGQUAN SHIBAO [SECURITIES TIMES], July 29, 2003, at 25, available at http://www.p5w.net/p5w/home/stime/today/200307290030.html.}
Thus, even if charter violations gave rise to a cause of action in Chinese courts, the failure to heed the views of independent directors will for many companies probably not be a charter violation, provided the failure is disclosed.

Not only do shareholders have no right to compel companies to allow diligent independent directors to fulfill their role, but they also have no real right to sanction independent directors who, whether negligently or deliberately, fail to do so. The Independent Director Opinion states that independent directors have a duty of good faith and diligence, but the CSRC has no authority to establish civil law standards. Such standards might operate to create liability if adopted in the company's charter, but so far no such cases have been reported. Article 123 of the Company Law provides the directors have a duty to carry out their duties "in good faith," but it is far from clear that this language creates a private right of action.337

Thus, the incentive for management and dominant shareholders to install directors who will pass an individualized after-the-fact examination of independence does not really exist in China. Chinese corporate law contains no doctrine under which shareholders can sue management for engaging in self-dealing transactions, and no doctrine under which management could cite independent director approval in legitimization of some action. Because shareholder suits are already extremely difficult in China,338 Chinese courts and regulators have not developed a doctrine of deference to board decisions, and thus have not developed any theory about what kind of procedures are worthy of deference in particular cases. In this

337 For more on the enforcement of the duty of care of independent directors, see infra Appendix 1.

338 The recent history of shareholder suits in China is complex. Originally disfavored by courts, they were made even more difficult by a Supreme People's Court (SPC) notice of September 21, 2001, ordering lower courts to cease accepting all shareholder suits under the Securities Law bringing claims of fraud (including, apparently, false or misleading disclosures), insider trading, or market manipulation. See Supreme People's Court, Guanyu She Zhengquan Minshi Peichang Anjian Zan Bu Yu Shouli de Tongzhi [Notice on Temporarily Not Accepting Securities Cases Involving Civil Suits for Damages], issued Sept. 21, 2001 [hereinafter 2001 Securities Litigation Notice]. In January 2002, however, the SPC issued another notice allowing shareholders, under certain strictly limited conditions, to bring suits against listed companies and others for false or misleading disclosures. See Supreme People's Court, Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Qinquan Jiufen Anjian Youguan Wenti de Tongzhi [Notice on Issues Relating to the Acceptance of Civil Cases in Tort Arising out of False Representations in Securities Markets], issued Jan. 15, 2002 [hereinafter 2002 Securities Litigation Notice]. In January 2003, the SPC followed up with yet another notice elaborating on the notice of the previous year. See Supreme People's Court, Guanyu Shouli Zhengquan Shichang Yin Xujia Chenshu Yinfa de Minshi Peichang Anjian de Ruogan Guiding [Several Provisions on the Adjudication of Civil Suits for Damages Arising out of False Representations in Securities Markets], issued Jan. 9, 2003 [hereinafter 2003 Securities Litigation Notice]. The issuance of notices (tongzhi) is an accepted form of rulemaking by the SPC.
case, therefore, there is no market pressure in the form of legal liability on management and dominant shareholders to appoint independent directors. While the absence of market pressure might be adduced in support of a government-imposed requirement, by the same token it implies that implementation of this requirement will be particularly difficult, since it does not serve the purposes of those who are expected to carry it out—management and dominant shareholders—and will require the constant expenditure of resources by the CSRC to ensure that nominated directors meet the requirements of independence and continue to meet them over time.

This problem highlights yet another difference between the Chinese model of independent directors—and indeed of corporate regulation in general—and the U.S. model, particularly that of state corporate law. Although Delaware statutory and case law gives an important role to disinterested directors, the Delaware authorities need not spend a penny on ascertaining whether any particular director is disinterested unless a particular dispute arises. Thus, there is no need to spend resources on companies where problems do not arise; the existence of a dispute signals the existence of a problem (regardless of which party is ultimately determined to be right). Moreover, when a dispute arises it is quite within the province of courts to make careful and individualized determinations of the disinterestedness of particular directors with respect to the challenged conflict-of-interest transaction. While prevention is often considered superior to after-the-fact remediation, the latter approach offers some significant cost savings of its own.

The approach of the Independent Director Opinion is preventative, not remedial. By requiring the presence on the board of certain directors who meet a test of independence, it aims to keep problems from occurring in the first place. But the problem with this approach is that it can be terribly wasteful. The CSRC will invariably be examining the qualifications of directors in many companies where problems will never arise. And continued monitoring will be required to make sure that the independent directors stay independent. This is because after-the-fact remediation through litigation has been made so difficult. Yet it is hard to imagine this avenue being opened up. The Chinese legal system in general is wary of individualized rights-driven dispute resolution carried on through courts. Even now, it remains impossible to seek civil damages for acts such as market manipulation or insider trading, and damages for misleading disclosures may be sought only where a government organ has already made a formal finding of a violation.339

339See 2003 Securities Litigation Notice, supra note 338.
c. **Macro-Fit**

The macro-fit picture is bleak as well. As discussed above, Fama and Jensen have hypothesized that independent directors will be motivated to perform as expected by reputational incentives. Whatever the plausibility of this hypothesis in the political economy of the United States, Chinese commentators agree that the conditions for such incentives, such as a market for directors, do not now exist in China.

More importantly, the dominance of state shareholding, coupled with the priority placed on the interests of the state, means that China's corporate governance regime can never wholeheartedly sanction a system in which independent directors can obstruct the wishes of dominant shareholders. Such a system might be possible were state-dominated companies governed by a different regime from non-state-dominated companies, but a key goal of enterprise reform in China has been to unify the legal regime governing each type of company.

d. **Availability of Substitute Institutions**

In the Kanda-Milhaupt framework, whether a transplanted legal doctrine will be used or not depends in part on the ready availability of substitutes. Applying this framework to the transplanted institution of independent directors yields interesting insights. First, one must ask: substitutes for what? Because the answer is "independent directors," one must then identify the function of independent directors in order to be able to identify substitute institutions. If that function is one of monitoring and restraining dominant shareholders, the fact is that substitute institutions are not strongly present. The board of supervisors is weak and dominated by management. Shareholders, even if not suffering from collective action problems, have few legal remedies. Neither the criminal law nor the CSRC's powers are appropriate for the fine-tuned monitoring tasks that independent directors are intended to undertake. The various markets often relied upon by theorists to play disciplining functions, such as equity markets, cannot be expected to play a strong role. In the classical story, dominant shareholders who abuse their power will be punished in the

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340 For skeptical comments, see Bebchuk et al., supra note 119, at 787-88.
341 See, e.g., Tian & Lau, supra note 304, at 259; Yan & Chen, supra note 12, at 26.
342 In a non-random sample of companies, Tenev and Zhang found that 70% of directors were appointed by holders of state shares or state-owned legal person shares. See Tenev & Zhang, supra note 80, at 83.
343 See Clarke, supra note 18, at 495-96.
equity markets by being forced to pay a higher price for further capital from skittish investors. In China, however, companies rely very little on the equity market for financing. Moreover, given the prevalence of controlling-shareholder abuse, it is quite possible that stock prices in general already reflect a discount for expected abuse. If it is also costly for investors to obtain information about which individual companies do not suffer from such abuse, a dominant shareholder that refrained from abusing its control would get no benefit from doing so.

From the lack of good substitutes it does not automatically follow, however, that independent directors will play their expected role. There must be a force pushing for that monitoring and restraining role to be played, and independent directors have to be capable of playing it. For the reasons discussed above, the institution of independent directors in China as currently designed is not really capable of playing that role. Nor is a force pushing for it apparent. The state in its capacity as dominant shareholder does not want or need it; neither do non-state dominant shareholders. There are no laws or practices such as Delaware's jurisprudence of disinterested directors that make independent directors desirable to those in control of a company's board composition. Small investors might benefit, or at least think they benefit, but they do not constitute a force. The only real force pushing strongly for independent directors seems to be the CSRC, whose authority over internal corporate governance matters has been questioned and which in any case has not required companies to give independent directors real power.

VI. CONCLUSION

It is difficult to imagine that the Independent Director Opinion will have a great effect on the way listed companies are run. Whether it represents a laudable, if flawed, effort to protect shareholders depends on one's confidence in the possibility of market solutions to the problems it addresses. One could propose a vision of corporate governance rules in which their only function was to provide a set of default rules, which participants in a corporation could alter if they chose in the corporation's articles of association. The content of the initial rule—requiring or not requiring independent directors—would matter only where the transaction

344See Green, supra note 20, at 8-9.

345As discussed above in notes 328-30 and accompanying text, the Independent Director Opinion requires companies to insert in their charters a provision mandating disclosure of failure to respect certain powers to independent directors, but does not require a provision mandating actual respect of those powers.
costs of bargaining were too high for the parties to negotiate around the rule. Individual corporations would choose whatever rule made the most economic sense for them; if they chose wrongly, the resulting relative inefficiency would lead to their elimination in competition.

The Chinese government has never, however, had much faith in market solutions. Its approach to corporate governance has been no different. In the case of Chinese companies listed overseas, for example, it has promulgated mandatory articles of association that must be adopted by all companies, no matter what their business or other particular circumstances. Now it is requiring independent directors without any real evidence that the presence of such directors will have the intended effect. Research on U.S. companies has failed to show that independent directors have any effect upon any of several measures of corporate performance. This may, of course, be due to particular features of the legal, economic, and political environment for corporate governance in the United States that are not present in China. Perhaps, for example, the problems that could be solved by independent directors are already solved more efficiently in the United States by such institutions as shareholder derivative suits, the market for corporate control, or the managerial labor market, none of which exist in a developed form in China. Nevertheless, given the substantial cost to the CSRC of monitoring the implementation of this regulation, there should be some reason other than intuition for believing it will be effective.

There is a further potential downside to the implementation of the Independent Director Opinion if it turns out to have any real effect. The usual substitutes for shareholder monitoring as a means of disciplining managers—shareholder litigation, the managerial labor market, the input and product market, and the market for corporate control—do not, with the exception of the input and product market, function at all well in China. Regulatory authorities have limited resources, and civil litigation by shareholders is tightly restricted. Because these methods of monitoring management and making it accountable do not work well, the state should not place constraints around the one mechanism that might work well: large shareholding. It should not block concentration of shareholding or make it difficult for large shareholders to exercise control over the company by making the board too independent. At the same time, a better system for preventing abuse of that control, including after-the-fact remedial litigation, should be developed. In short, the state should pay more attention to the formulation often repeated in the official media: consider China's particular conditions, and develop a system of "corporate governance with Chinese characteristics."
Figure 1: Occupation of Directors
Source: Shi, *supra* note 321
Figure 2a: Educational Level of Directors
Source: Shi, supra note 321
Figure 2b: Educational Level of Independent Directors

Source: Chen Zhengrong, Xianqi 500 Wei Duli Dongshi de Miansha [Lifting the Veil on 500 Independent Directors], FAZHAN [Development], No. 8, 2002, at 38-39
Educational Level of Independent Directors

Source: Yue, supra note 319
Figure 3: Age Structure of Boards
Source: Shi, supra note 321
Figure 4: Independent Director Annual Compensation
(in thousands of yuan)
Source: Luo et al., supra note 308
Appendix 1

Standards of Liability for Directors

Chinese law and regulatory practice remains unclear on the issue of standards of liability for independent directors, and indeed for directors in general. The recent case of Lu Jiahao, a retired language professor who, despite no experience in business, was asked to serve as an independent director, sheds some light. Lu served without compensation on the board of Zhengzhou Baiwen Corporation, a company listed on the Shanghai Stock Exchange that was involved in a false disclosure scandal, and was among the directors fined 100,000 yuan by the CSRC for his involvement. Lu's defense was essentially that his position was purely honorary, and that he had neither expected nor been expected to play any substantial role in company management or oversight. The CSRC's position was essentially that of the New Jersey Supreme Court in Francis v. United Jersey Bank:

Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act." It rejected the notion of an honorary director and in effect insisted that any director who feels unable to perform the duties of the position should resign and make way for someone who can.

It is worth noting first of all that Lu was not sued by shareholders. The action against him was purely governmental. Lu was fined by the CSRC and appealed his fine within the administrative system. Failing there, he brought suit in the Beijing Intermediate-Level People's Court as allowed under the Administrative Litigation Law to have the CSRC's administrative decision overturned. He lost in the first instance and appealed to the Beijing Higher-Level People's Court, but lost again on appeal.

The CSRC's authority to impose fines on violators of laws and administrative regulations in the field of securities stems from a set of 1998

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346 See Wei, supra note 173; Wu, supra note 173.
348 See supra text accompanying note 347.
State Council regulations. These rules give ministry-level status to the CSRC and state that it is the body with authority over the regulation of securities and futures. Section 2(11) of the rules gives the CSRC authority to investigate and punish violations of laws and regulations relating to securities and futures. Article 177 of the original Securities Law (in effect from July 1, 1999) stated that a fine of 30,000 to 300,000 yuan could be imposed on those directly responsible for disclosure violations. Although it did not state which authority could impose the fine, it was well understood that the CSRC was empowered to do so.

Lu's punishment was specifically grounded in a set of 1993 regulations, Article 74 of which lists a number of offenses, including that of making misleading disclosures in the course of stock issuance or trading. It states that any unit or individual who commits one of these offenses may be punished by a number of methods, including a fine. (It does not specify directors, but does not exclude them.) The regulations also name the CSRC as the body in charge of implementation. Although Article 77 gives a private right of action for civil damages to anyone who is damaged by a violation of (apparently) any provision of the regulations, this provision has never to my knowledge been the basis of any such lawsuit.

It is not clear whether the CSRC applied a fault standard or a strict liability standard. Neither the original CSRC decision (First Decision) nor the CSRC decision upon administrative appeal (Second Decision) go into a great amount of detail on the relevant standard. The standard appears to be one of liability for any director who does not register an objection to the offending practices at a board meeting.

The First Decision recites the facts of the misleading disclosures and simply states that Lu Jiahao was among those directly responsible. It does not provide any explanation of the standard of responsibility applied.

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to Lu, and does not explain why other persons who held board positions prior to the company's listing were not punished.\footnote{353}

The Second Decision, dealing exclusively with Lu, is a little more enlightening. It summarizes the First Decision as finding that violations occurred, and that Lu Jiahao "as a director . . . bears direct responsibility."\footnote{354} The Second Decision does not, however, state that Lu's being a director is all that is required. It first recites Lu's arguments: that an independent directorship is an honorary position, that he received no compensation, and that he had no duties at the company. Lu further argued that he was absent at a board meeting at which listing materials were discussed, and that he did not sign the listing application.

The Second Decision then rejects all these arguments. It notes that Lu, who was appointed in 1995,\footnote{355} attended board meetings in the spring of 1996, 1997, 1998, and 1999 to approve the previous year's financial report, and expressed no objection to the proceedings. His occasional absence from board meetings could not be grounds for exculpation. The misleading disclosure materials were discussed at board meetings, and therefore directors should be responsible. The fact that Lu had no duties in the company and received no compensation was irrelevant. Moreover, neither the First Decision nor the Second Decision make anything of the fact that Lu was an independent director. The First Decision never uses the term at all, calling him simply a director. The Second Decision at one point calls him an independent director, but the point is of no relevance to its reasoning. To all appearances, therefore, the CSRC's position seems to be that all directors, independent or not, should be subject to the same standard.

Other sources make the CSRC's position a little clearer. At the hearing of Lu's appeal to court of the Second Decision, the CSRC's representative argued that the punishment was not based on whether or not the director gained financially. A person about to become a director should know what is expected and whether he or she is capable of doing the job.\footnote{356}
Again, the CSRC did not propose a different standard for independent directors. An unnamed CSRC official muddied the waters by arguing to reporters that Lu was not in any case an independent director because he held 10,000 shares of company stock, but this was probably more of a belt-and-suspenders argument than a considered position. At the times in question, there was no settled and uniform definition of independent director. Even if one were to apply the standards of the Independent Director Opinion, Lu's 10,000 shares were far below the 1% disqualifying ceiling of the Opinion.

A CSRC official (writing in an unofficial capacity) addressed several of Lu's arguments in an article in the Procuratorate Daily in late 2002. First, he repeated the CSRC's position that there was no basis in law for distinguishing between independent directors and other directors when assigning liability. Second, he noted that Lu's not signing the listing application materials was not irrelevant, and was indeed the reason why he had not been held criminally liable as had been the chairman of the board and the CEO of the company. Third, he argued that Lu had not been held liable for any board decisions taken at meetings at which he had not been present or for documents that he had not signed.

Unfortunately, for procedural reasons the CSRC's position has never had to face a proper challenge in adversarial proceedings. First, Lu himself turned down the opportunity to make his case before the CSRC when it was in the stage of deciding administrative punishments. The company was at the time in question undergoing a restructuring involving a third-party savior, and Lu stated later that he had received several telephone calls from Zhengzhou city officials and others instructing him not to rock the boat and to consider the interests of the company's 6.8 million stockholders as well as its employees. These calls appear to have been rather threatening; Lu told a reporter, "I received telephone calls from many different circles. I can only tell you that much; I can't be more specific."

Finally, no court has ever ruled on the merits of the CSRC's position with respect to Lu Jiahao. The Beijing No. 1 Intermediate People's Court rejected his initial suit to quash the Second Decision on the grounds

357 See id. Lu apparently had purchased his 10,000 shares in 1992, well before he became a director. See Wei, supra note 173.
358 See Wu, supra note 173.
359 See "Huaping Dongshi" Lu Jiahao Gai Fu Sha Ziren [What Responsibility Should the "Flower Vase Director" Lu Jiahao Bear], supra note 353.
that the applicable time limit had expired, and that rejection was upheld on appeal.
