



## Study on the Independent Director System in Corporate Governance

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### **Abstract**

As a system arrangement in corporate governance, implementation of the independent director will help improve structure of corporate governance, maintain interests of all stockholders, and protect rights and interests of small-and-medium size of investors. There exist such many issues as insufficient information of independent directors, weak independence, low enthusiasm, and shortage of talents in the practice of the independent director system in China. Therefore, we should strengthen and optimize the independent director system with a Chinese characteristic.

**Keywords:** Corporate governance, Independent director, Insider control

### **1. Significance of establishing the independent director system**

The so-called independent director refers to a director who doesn't hold a managerial position in the company in which he holds the position of director, and who doesn't have a close relation with top management in terms of economics or relative interests. America is the country that established the independent director system earliest and perfect. Since 1930s, America has recommended public joint stock companies to establish "non-employee director". The reason for introduction of the independent director system in corporate governance, on one hand, was that the director should express his opinions when an independent director makes a decision, especially some significant decisions about enterprise merger, connected transaction, stock repurchase, and interest conflict between large and small stockholders. This can prevent stockholders from conducting any behavior that is unfavorable to the company and its medium and small stockholders, and can weaken contradictions of large stockholders and medium and small stockholders in the aspect of interest conflict. On the other hand, the independent director is not subject to the controlling shareholders and the top management, so he can observe, assess and supervise the top management by means of his transcendent position, so as to effectively check and balance the controlling shareholders and supervise the operators, ensure that the Board of Directors considers interests of all shareholders, reduce insider control and large shareholder manipulation, and to effectively protect interests of medium and small shareholders. In addition, the independent director can promote scientification of decisions of the Board of Directors with his professional knowledge and independent judgment, improve transparency of the Board of Directors, make his decision-making process easily understood by other external parties, and attract excellent partners and potential investors, so as to upgrade the value of the enterprise.

### **2. Practice of the independent director system in China**

On August 21, 2001, Chinese Securities and Futures Commission issued the <<Guiding Opinion of Establishment of Independent Director Systems by Listed Companies>> (short for <<Guiding Opinion>> below), which meant that independent director had entered Chinese listed companies as a significant system to standardizing and improving the governance structure of listed companies and to protect interests of medium-and-small size of investors. At present, introduction of the independent director has played a definite role in development and standardized operation of listed companies. However, as a newly born concept, the independent director is still at a groping stage, and there still exist several issues in the practice.

### *2.1 The information an independent director grasps is not sufficient.*

The independent director doesn't participate in operation and management of a company, and he comes to understand the company merely through introduction of the managerial personnel or the financial statement. That is to say, "independence" of the independent director is embodied in his not engaging in the operation and management or in his understanding of the company according to the field of vision established by the governor in advance. In the situation of information asymmetry and incomplete contract, two sorts of behaviors of the managerial personnel might affect judgment of the independent director. One sort of behavior is incomplete or distorted information disclosure mentioned by Williamson, especially purposeful misguide, distortion, concealment and confusion, etc. The other type of behavior is non-deceptive information misguide or incompleteness of information, namely, significant omission of information disclosure. Therefore, actual judgment made by the independent director is encountered with great danger of distorting the truth. Under such a circumstance, it's not possible for the independent director to effectively supervise behaviors of managerial personnel.

### *2.2 Independence of the independent director is not enough.*

Criticism on "vase" has always been perplexing the independent director of listed companies. According to relative investigation, 33% independent directors never say "No" in the decision by vote of the Board of Directors, and 35% independent directors never express any divergent opinions from major stockholders or top managers of listed companies. "Dependence" has been the primary crisis among independent directors. However, it is exactly design defect of systems which include nominating, hiring, and remuneration that result in this crisis.

### *2.3 Work enthusiasm of the independent director is not high.*

It is stipulated in the <<Guiding Opinion>> that the independent director shouldn't be absent from the Board of Directors for consecutive three times, and, meanwhile, that he has to express his special opinion as for such significant matters as associative transaction. However, it hasn't been stipulated whether the independent director should be authorized to vote when he doesn't attend a meeting, whether the independent director should review and express his special opinion about periodic report of listed companies, and how the independent director should be punished if he violates the <<Guiding Opinion>>, so some independent directors are often absent from the Board of Directors, and transfer their vote rights to chairmen and general managers who are not independent directors of the company. When there happens a problem in the company and it is put on record and investigated, the independent director is not only absent from relative meetings, but doesn't sign his name on correlative records, so he can be remitted from administrative penalty. Besides, interrelated civil accountability system is not sound, so there is no way to look into the civil liability.

### *2.4 Introduction of the independent director is incompatible with the system of Board of Supervisors.*

The independent director system originated from countries with a law system of US and UK in which the Common Law is the primary law. These countries usually adopt the Board of Directors system structure of "single system" in the shareholding organization of corporate governance and there isn't any independent Board of Supervisors in corporate organizational structuring. Therefore, the companies strengthen independence of the Board of Directors, introduce the independent director system, try to reform the supervision mechanism within the existing "single system" framework, and to enable the Board of Directors to exercise the supervision responsibility on the managerial authorities, so as to regress controlling power of the shareholders and to balance the insider control. China adopts the structural organizational framework of continental law system "binary system" in its corporate legislation, namely, to set up Board of Directors and Board of Supervisors under the General Meeting of shareholders, which respectively exercise decision-making right and supervision right. The Board of Supervisors is an especial organization to protect interests of the shareholders, to supervise the Board of Directors to perform any resolution of the General Meeting of shareholders, and to supervise the board members and managers. According to institutional economics, function of system design lies in rationally defining limit of rights, only with which can the responsibility be explicit, and can the operating cost of the system be reduced so as to decrease external effects. As things are, if rights and liabilities of Board of Supervisors and the independent directors are not clear-cut, then dispute and prevarication between these two organizations due to the psychology of "hitchhiking" might reduce the only supervision performance to nothing. As for how to coordinate relations between the independent director and the Board of Supervisors, Shenzhen Stock Exchange avoids this issue in its <<Growth Enterprise Market Trading Rules>>, while Shanghai Stock Exchange attaches the right of financial examination simultaneously to these two organizations in its <<Corporate Governance Guideline for Listed Companies>>. Therefore, both are responsible for the supervision, only with a result of wasting resources or mutual prevarication. Securities and Futures Commission doesn't mention any relation between the independent director and the Board of Supervisors in its <<Guiding Opinion>>.

### *2.5 Strength of guide and supervision of the independent director is not strong.*

Introduction of the independent director system is an innovation of the governance model in binary companies in China.

Theoretically, this innovation helps make up for disadvantages of the Board of Supervisors in terms of the subsequent supervision. However, in practice, the supervision function of the independent director is not as what is originally expected. One important reason is the fact that, after the implementation of the independent director system, the stock supervision department neglects administrative guide and supervision on the independent director, excessively believes in and depends on self-conscious play of the supervision function of the independent director, and put its constraint mostly on the moral level of the independent director.

### *2.6 There is a shortage of talents among independent directors.*

Currently, most of independent directors hired by listed companies are technical experts. The primary role of the independent director is to perfect the corporate governance structure in the company. However, it is far from enough for a technical expert to hold the position of an independent director who is merely proficient in the main business of the company. Especially, under the circumstance when the ownership structure is extremely irrational, a listed company not only requires the technical expert to give suggestions on developmental strategy of the company, but needs a relatively impartial independent director to play his supervising and balancing role in the corporate governance structure, capital utilization and management of the company, so as to achieve the target of improving its corporate governance structure and protecting interests of medium-and-small size of investors.

## **3. Improvement and perfection of thought on the independent director system**

Practice of many countries indicate that the independent director system plays an extremely important role in specialized operation of a company, in the judgment and supervision of the operators and top managerial personnel and in protecting interests of medium and small investors. However, if there isn't a series of perfect institutional arrangement for guarantee, then this system might soon become just a decoration. Therefore, full play of the role of the independent director calls for a set of independent director systems that fits in characteristics of Chinese listed companies and also for support from a harmonious external environment.

### *3.1 Reinforcement and perfection of Board of Supervisors*

The independent director system is an assistant mechanism in the corporate governance. Even in US which has successful experiences in operation of the independent director system, the role of its independent director is often challenged because there lacks the target of shareholder interest maximization in its independent directors, and their supervision is restricted by time and information. As for listed companies in China, it's most important to reinforce and perfect formulation and operation mechanism of the special supervisory organ and to play the supervision role of the Board of Supervisors. After all, as a standing supervision organ within the joint-stock company, the Board of Supervisors helps with precaution beforehand, timely standardization and subsequent supervision, and tries to resolves an issue with internal corporate mechanism, which not only increases efficiency of problem resolution and saves social cost and resources, but also may try not to publicize disputes within the company, so as to affect confidence of investors and the image and reputation of the company, and to prevent some business secrets from being divulged during internal controversy and investigation or litigation of any external power.

### *3.2 Coordination of functions of the independent director and the Board of Supervisors*

Supervision of the independent director has the characteristics of close integration of supervision beforehand, internal supervision and decision-making supervision, while the Board of Supervisors has the characteristics of frequent supervision, subsequent supervision and external supervision that the independent director system doesn't have. Full play of the arrangement functions of these two systems depends not only on perfection of each system per se, but on coordination of these two systems. In order for the independent director and the existing corporate governance structure in China to "switch in seamlessly", it is necessary not only to play the role of the independent director and the Board of Supervisors, but to avoid functional conflicts and the situation of no one being responsible. Therefore, (1) the company should define and integrate functions of the independent director and the Board of Supervisors. Since it has been expressively stipulated in the <<Common Law>> on the Board of Supervisors, then the company should take up strengthening the supervision function of the Board of Supervisors. Functions of the independent director can be concentrated on examining and approving significant associative transactions, nomination of internal board members, audit and control of salary of internal board members and managers and financial information of the company, etc. (2) The company should establish a negotiation and cooperation mechanism between the independent director and the Board of Supervisors. It is necessary to regularly hold a meeting which is only attended by the independent director and the Board of Supervisors, in which they can exchange information and report any new conditions. The meeting can be convened by the independent director and the Board of Supervisors in turns. The independent director can have access to and utilize the financial audit report of the Board of Supervisors, and can recommend the Board of Supervisors to give a specific audit on a certain financial item.

### *3.3 Perfection of selection and employment mechanism of the independent director*

What's special for the independent director is his "independence" and "being sensible". Firstly, he is required to be

“independent”. That is, he should have independent property, independent personality, independent business, independent interest and independent operation. Secondly, he is required to be “sensible”. In order for the independent director to play his proper role, he is required to have high qualifications in terms of professional ethics, professional knowledge and social qualifications, etc. The number of the listed companies in which the independent director can hold a position should exceed three, so that he can have enough time and energy to participate in the operation and decision-making of the company. He should be in good condition, with the age from 35 to 60 being the optimal choice.

Selection and employment of the independent director is the key to ensuring personality independence and exercise independence of the independent director. In order to isolate relations between the independent director and major shareholders from the selection and employment of personnel, a listed company should set up a Nominating Committee of the independent directors, which is particularly responsible for selection and supervision of board members. The Nominating Committee should be constituted by supervision organ, professional personnel and medium and small shareholders. Therefore, it is suggested that the first selection of positions should be nominated by the Board of Directors, Board of Supervisors, or those shareholders who hold above 1% of issued capital stocks individually or together with others, and also that the cumulative voting system should be introduced, so as to ensure that medium and small shareholders can select an independent director who represents their will. Afterwards, the Nominating Committee constituted by the independent directors can decide to select candidates the next independent directors, which should be submitted to the General Meeting of shareholders for vote. The General Meeting of shareholders adopts competitive election. Besides, the independent director should be regularly replaced, and his term of office should not be too long (a term of 3-5 years being best), so as to ensure his independence.

#### *3.4 Establishment and improvement of incentive and constraint mechanism of the independent director*

The independent director is not merely a consultant, because medium and small shareholders expect him to play an actual role and even to go against the controlling shareholders in terms of right-safeguarding. Therefore, the legal rights of the independent director should be effectively guaranteed in the legal system. Only if the rights of the independent director are guaranteed in the legal system, can he play a proper and due role.

Motive of the independent director originates from the reputation and remuneration mechanism. (1) Reputation mechanism. Reputation is one of the significant mechanisms to ensure implementation of a contract. As for the independent director, maintenance of his reputation is an important motive to prompt him to perform his duty. Reputation mechanism may stimulate the independent director to supervise the executive director and managers, so that collusion between the independent director and the executive director and managers can be avoided to a certain extent. In market economy, formulation and perfection of the market selection mechanism and judgment system of the independent director is a precondition and fundamental guarantee of the functioning of reputation mechanism (2) Remuneration mechanism. As a primary means to stimulate hard work of the independent director and to play his important role in the corporate governance, rationality of remuneration has a direct effect on enthusiasm of the independent director. Remuneration of an independent director is an intractable issue, because too high remuneration might result in his dependence on the company, and too low remuneration can't stimulate his enthusiasm. The role of the independent director is to supervise and restrict administrative authorities of the company. Once he is excessively dependent on the remuneration, he might lessen due inquiry and counterviews from the managerial personnel, and consequently, his independence might be destroyed. Given the above consideration, a common practice is to pay his remuneration in the form of annual fee and conference expenses, etc, nothing related to the corporate performance. However, with view to the role of the independent director that is to supervise and balance managerial personnel of a listed company, and to the fact that remuneration plays an important role in stimulating enthusiasm of the independent director, it is also feasible to offer the stock option to the independent director in addition to actual fixed monetary remuneration in order to bring interests of the independent director and shareholders into correspondence. In such way, a great variation emerges intangibly in the total remuneration of the independent director, which can stimulate his enthusiasm in taking part in decision making of the company.

As an agent, the independent director also has an opportunistic behavior just like an industrialist. In order for the independent director to exercise his rights impartially and equitably, nothing can go without a constraint mechanism in addition to above-mentioned incentive mechanism. Only when constraint on the independent director is emphasized, can the independent director be established upon the basis of the system, but not merely on the basis of the individual initiative and self-consciousness. (1) To make clear legal liabilities of the independent director and to strengthen legal constraints on him. In order to avoid nonfeasance or immoral conducts of the independent director, definite stipulation should be made on the liabilities he should assume and on the legal consequences. If an independent director doesn't properly perform his duty, doesn't fully play his role in the listed company, or is bribed by the major shareholders, then he should not only be punished in terms of his morality, but should also assume civil compensation liability for any loss of the company or other shareholders. In order to avoid the independent director from being absent from the board meeting, his absence should be considered as approval of any decision made by the Board of Directors from the

perspective of the law, and he should also assume proper obligation. To strengthen integrity and diligence obligation of the independent director. Considering the general weak consciousness of among the independent directors currently in Chinese listed companies, a lowest requirement should be made for their duty performance time each year. When on post, they are required to make a commitment that they will have enough time and energy to perform their duty. Besides, responsibility investigation mechanism should be intensified for their breach of duty. (3) The company should establish and improve performance assessment system among independent directors, and regular assessment should be made among them. Their performance assessment should be primarily based on the performance situation of their functions (supervision function, assessment function, and strategic function), together with several indices. Performance indices of the independent directors include frequency and time of their participation in the Board of Directors and in relevant committee meetings, their attitudes towards significant decisions and their votes, their suggestions on the Board of Directors and its Committee and the implementation performance, their opinions and assessment on the corporate operation, their advisory opinions on the operational strategy, and their views on authenticity of disclosed information about the listed companies. (4) To actively cultivate the independent director market. Establishment of the independent director can, on one hand, provide impartial and equitable evaluation on human capital of the independent directors, which facilitates training of talents among the independent directors. On the other hand, its establishment can connect closely the reputation and behavior of an independent director by means of the mechanism to publicize information through the market, so as to formulate a convincing constraint on the independent director.

### *3.5 Establishment of self-regulatory organization of the independent director*

For establishment of the independent director system which matches China's actual conditions, it is also crucial to establish such self-regulatory organizations as independent director association, and independent director office, etc, to work out a practice standard, to improve the market system of the independent director, to establish and improve the "business reputation" system of the independent director, and to strengthen training and self-regulatory education among the independent directors. Establishment of the independent director association with a membership system can reinforce training and education among the independent directors, which can form a specialized independent director level, intensify construction of the independent directors, standardize and restrict behaviors of the independent directors. Compared with the independent director association, operation of the independent director office tends to marketization. The independent director office can transfer liability of a natural person to liability of a legal person. It is a carrier which constrains the independent director and can replace the independent director to assume the liability. In the situation when the "business reputation" system of professional persons hasn't been established in China, the independent director can directly standardize and restrict behaviors of the independent director, which is propitious for the independent director to play the role of independent judgment, supervision and management, and which is helpful for actual implementation of professionalization of the independent director.

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