



Independent Director System: An Assistant Mechanism of Corporate Governance

Yurong Chen, & Weixing Wang

School of Economics and Management, Jiangsu Polytechnic University

Changzhou 213164, China

E-mail: cyrpzh@126.com

The research is financed by the Philosophical Social Science Foundation of Jiangsu Provincial Colleges (No. 07SJB630004) and the Social Science Foundation of Jiangsu Province (No. 07EYC068). (Sponsoring information)

Abstract

As a system arrangement of the corporate governance, the independent director system has many deficiencies such as the residual claimant right doesn't correspond with the control right, the information occupations are not symmetric, the time and energy are not deficient, and the encouragement is not sufficient. In the practice that China introduces the independent director system, many obstacles such as the deficient legal references, and the shareholding structure of "dominant shareholder", and the incompatibility with the supervisory board, deficient talents, and immature market mechanism still exist. So the introduced independent director system is only a kind of assistant mechanism of corporate governance, and it can not completely improve nonstandard corporate governance and protect small investors' benefits in listed companies.

Keywords: Corporate governance, Independent director, Supervisory board, Insider control

Independent directors are not controlled by the dominant stockholders and the management personnel of the company, so they can effectively balance the dominant stockholders and supervise the management personnel to ensure that the director board will consider all shareholders' benefits and reduce the insider control and the operation of big shareholder, and effectively protect small shareholders' benefits. In August of 2001, China's Securities Regulatory Commission issued the "Establishment of Independent Director Systems by Listed Companies Guiding Opinion", that meant that as the important system to standardize and perfect the governance structure of listed company and protect small investors' benefits, the independent director system has seriously and actively entered into Chinese listed companies. At present, the introduction of the independent director system has exerted certain functions to develop and standardize the listed companies. However, the independent director system still has many congenital deficiencies, and there are many obstacles in the practice to introduce the independent director system.

1. Theoretical Deficiencies of the Independent Director System: Uneasy "Independence" and Difficult "Directions"

Theoretically, the independent director system has many deficiencies such as the residual claimant right doesn't correspond with the control right, the information occupations are not symmetric, the time and energy are not deficient, and the encouragement is not sufficient.

1.1 Residual Claimant Right Doesn'T Correspond with the Control Right

One good system arrangement is that the residual claimant right should correspond with the control right as possibly, i.e. the person who holds the residual claimant right and assumes risks should possess the control right. Contrarily, the person who holds the control right should assume the risks. It is difficult to introduce the independent director without the residual claimant right to supervise the inside directors (management personnel) who are the also the agents. Here, the residual claimant right and the control right are not corresponding, and the independent directors with the control right have not the residual claimant right and assume the risks, i.e. the distribution of the right and the responsibility (risk) is not symmetric, and the control right is also a kind of "cheap voting right", which certainly can not solve various agent problems, but only generate new agent problems and produce larger moral risk, even the first-class agents (independent directors consigned by shareholders) will collude with the second-class agents (the management personnel consigned by the director board except inside directors, i.e. the management personnel consigned by the independent directors) to damage the shareholders' benefits, and these shareholders will assume risks and possess the residual

claimant right and the control right.

1.2 The Information About Independent Directors is Not Complete or is Easily Misdirected by the Management Personnel

Independent directors don't participate in the management of the company, and they only know the situation of the company by the introduction of the management personnel or the finance reports. That is to say, the "independence" of independent directors is embodied in that they don't participate in the management or know the company according to the views constituted by the management personnel in advance. In the situations that the information is not symmetric and the contract is not complete, two behaviors of the management personnel will influence the judgment of independent directors. The first behavior is the incomplete or ill-natured information disclosure said by Williamson, especially the information disclosure with intentional misguidance, distortion, covering, and confusion. The other behavior is the non-fraudulent information misguidance or incomplete information offering said by Alchain, i.e. the large miss of information disclosure, which largely influences that the independent directors achieve really independent judgment. Under this situation, independent directors can not really effectively supervise the behaviors of the management personnel.

1.3 The Time and Energy Needed by the Supervision are Deficient

Because most independent directors are successful people with busy business, quite social status, and professional skills, it is difficult for them to pay more attention to the company. In addition, the business of modern company is more and more complex and professional, and independent directors have not sufficient time and energies to deeply know the listed company, and their judgments only depend on general experiences, common senses, and sensitive commercial brains, not concrete professional knowledge, which will certainly influence the effectiveness that independent directors make effective decisions.

1.4 The Encouragement is not Sufficient

If independent directors are required to work actively by legal responsibility, they should obtain the salary corresponding with the obligation what they assume. The salary of independent directors makes them in an embarrassing situation, i.e. the encouragement is more deficient, they will lack in more drives to work, but the encouragement is more sufficient, he will not be more independent. Because if the supervision objects of independent directors decide the salary of independent directors, their independence will certainly be suspected, and their independent supervision will certainly be impacted.

In fact, whether for the selection and appointment of independent directors or for the amount of salary in the listed company controlled by the dominant shareholder, everything is decided by the dominant shareholders' will as the name of the director board. So it is easy to be "independent vase" for independent directors, and it is difficult to realize "independent" supervision. From the practice of the independent director system in US, independent directors often could not effectively supervise the duty of the management personnel and stop improper behaviors damaging shareholder's normal benefits, and the company which independence was enhanced had not improved the governance level and performances. Even in some opinions, "the establishment of the independent director system gives a seemingly just reason for the controlling shareholders damaging others' benefits to protect themselves".

2. Deficiencies that China Introduces the Independent Director System: Various Obstacles

In the practice that China introduces the independent director system, various obstacles such as the deficient legal references, and the shareholding structure of "dominant shareholder", and the incompatibility with the supervisory board, deficient talents, and immature market mechanism still exist.

2.1 Lacking in the Support of Relative Laws

The existing laws such as the Company Law and Chinese Securities Law have not give independent directors real space and conditions, i.e. the special voting right, and the amount of independent director doesn't occupy the dominant status, so they belong to the weak group, and they are difficult to balance the inside directors in the company essentially. But in US, depending on laws, i.e. the "emperor's sword", independent directors can change their individual wills into the will of the director board even the whole company.

2.2 The Equity Structure of "Dominant Shareholder"

The listed companies in US and UK are in the market-oriented securities market, and the equity structure is very loose. The largest shareholders in US companies are some institutional investors which often hold 1% of shares of the company at most in one special company, so they have very limited voice. And according to the Investment Company Act of 1940, the stocks holding by the life assurance companies and mutual funds must be decentralized, which induces high fluidity of the equity of US companies. Because the amount of small shareholders in US companies is numerous, the issue of "hitchhiking" occurs in the supervision of company. Therefore, in US and UK, the independent director system is established to supervise, and all supervision costs are shared equally by all shareholders. At present, the

company governance structure of China is the high centralization of equity, and the state stock generally occupies the control status, and though the director board is generated by the general meeting of shareholders, but the controlling shareholders have absolute power. At the same time, the management personnel are appointed by the director board, of course, and are decided by the controlling shareholders' will. So the insider control in Chinese listed companies is the "insider control in transformation", which is essentially different with the insider control induced by the equity decentralization of US and UK, and the solving methods and measures are different. Nowadays, the main issue in Chinese corporate governance is that the controlling shareholders invade and occupy the assets of listed companies and small shareholders' benefits by various measures such as the association trading, assurance, receivable account, and replacement of assets. To solve the issue of insider control, the new "outsider" should be established by the reform of the property right system.

2.3 The Introduction of the Independent Director System is not Compatible With the System of the Supervisory Board

The independent director system is generated in the countries with the common laws, and the equity structure in the corporate governance of these countries generally adopts the director system structure of "united system", and there is no independent supervisory board in the corporate institution setting, so to strengthen the independence of the director board, the independent director system is introduced to try to improve the supervision mechanism in the existing frame of "monolayer system" and make the director board can implement the supervision responsibility for the management personnel, return the control right of shareholders, and balance the insider control. For the corporate legislation, China adopts the "binary" structure organization system in the civil law system, i.e. establishing the director board and the supervisory board under the general meeting of shareholders, which respectively exert the decision-making right and the supervision right. The supervisory board specially maintains shareholders' benefits, supervises the director board to carry out the decisions of the general meeting of shareholders, and supervises directors and managers. According to the opinions of the system economics, the function of system design is to reasonably define the boundaries of rights, and only the boundaries of rights are clear, the responsibilities can be confirmed, and the costs of system operation and the exterior effects can be reduced. But at present, if the responsibilities of the supervisory board and the independent directors are not clear, the disputations between two institutions may reduce some supervision performances to zero. So it is worthy to discuss the problem how the rights of independent directors and the supervisory board are divided.

2.4 The Talents of Independent Director are Deficient

The development of independent directors needs many high-quality talents with professional knowledge and ethics. At present, most independent directors appointed in Chinese listed companies are technical experts, which is because that the talents with professional knowledge and ethics are deficient. For the talent selection, the existing and potential independent director candidates have not been trained and educated professionally. The main function of independent directors is to perfect the corporate governance structure of the company, and it is not enough to make the technical experts mastering the main business of the company to shoulder independent directors, and especially under the situation that the equity structure is not reasonable, the listed companies need not only technical experts to advise for the development strategy of the company, but also relative objective independent directors to supervise and balance the corporate governance, capital operation, and enterprise management of the company, and accordingly the intention to perfect the corporate governance structure and protect small investors' benefits can be achieved. So it is urgent to choose and train the talents of independent directors.

2.5 The Market Selection Mechanism and the Evaluation System Have not Been Formed

For the drive source of the exertion of the independent director system, one explainable cause is the reputation mechanism, because once the independent directors would present quite independence and objectivity in listed company, their reputations will be largely protected and enhanced virtually and develop their future market. In the market economy, the formation and perfection of the market selection mechanism and the market evaluation system are the premise and essential assurance of the exertion of the independent director system. In the present stage, because the establishment and cultivation time of Chinese market economic system is short, and its perfection still needs a long time, and at the same time, the generation of the manager market, especially the manager market with high competition, still started, and the source of entrepreneur is very deficient. Correspondingly, the independent directors relatively lack in the experiences of the enterprise management, and almost the "business reputation" system of independent directors doesn't exist. Under the situation that many agent institutions such as CPA, securities traders and laws all lack in reputations and cheat investors, it is very difficult to make independent directors to exert the function of supervision. At present, whether for trying to exert the right of supervision or for cheating small investors, as rational independent directors, they may cheat together or do nothing.

3. Conclusions and Advices

The independent director system has certain limitation, so it is a kind of assistant mechanism of corporate governance for ever. Even in the US with successful experience of the independent director system, because independent directors

lack in the target of shareholder benefit maximization, its supervision behaviors are limited by time and information, and the independent function of independent directors are often challenged. At present, in Chinese listed companies, the independent director system is a kind of governance mechanism only when the function of the supervisory board is weak and the director board loses control, and it belongs to one part of the original corporate governance structure, and it is the supplement or local adjustment of original governance structure. Therefore, the independent director system should not be expected to solve all problems in corporate governance.

3.1 Strengthening and Perfecting the Supervisory Board

For Chinese listed companies, it is more important to strengthen and perfect the composing and running mechanism of the special supervision institution, i.e. the supervisory board, and exert the supervision function of the supervisory board. After all, as the supervision mechanism established in the stock companies, the supervisory board could prevent, standardize and supervise some illegal behaviors, and try to solve problems by the interior mechanism of the company, which can not only enhance the efficiency of solving problems, but save the social costs and resources. In addition, to solve problems by interior mechanism can also shield the disputations of the company, and avoid influencing investors' confidences and the image and reputation of the company, and prevent that some commercial secrets are discovered in disputations, investigations of exterior powers, or lawsuits.

3.2 Improving the Independent Director System With the Reality of the Listed Company

It may be difficult to "improve the governance structure of listed company and protect small investors' benefits" only by the introduction of the independent director system. To achieve this intention, the equity structure of "dominant shareholder" of listed structure should be changed first. The equity structure of "dominant shareholder" is the hotbed to generate "insider control", damage state and enterprise and small shareholders' benefits, and induce the management corruption, and the system obstacles to push the independent director system. For the listed companies, they should seek strategic investors, gradually increase the circulation proportion of state shares and corporate shares, and reduce the stock proportions of the country and the artificial persons by various modes. For new listed companies, the country should confirm the share upper limit of state shares and controlling shareholders according to the dominant industries and characters and the requirements of industrial policies, to make listed companies to decentralize the equity and establish the system base for the exertion of the independent director system. Second, the employment qualification and ability of independent directors should be regulated specifically. Third, the personnel with high quality who are competent for the independent directors should be cultivated and selected, not the part-time "vases" in name only. Fourth, the professionalism of independent directors should be implemented to really solve the problems such as deficient energy and asymmetric information existing in the independent director system. Fifth, the encouragement and limitation mechanism of independent director should be established and perfected. Sixth, the independent director association and the independent director firm should be established to strengthen the self-discipline supervision and management of independent directors. Seventh, the market selection mechanism and the evaluation system of independent directors should be formed and perfected. Eighth, beating power to legal behaviors in listed companies should be strengthened, and relative institutions should not only claim the delisting the listed company, but strictly trounce the illegal behaviors of damaging small investors' benefits and increase the illegal costs. Ninth, using the complaints of consumers' benefits and rights as references, the small investor benefit complaint system should be established to extensively exert small investors' supervisory function to listed companies.

References

- Chen, Yurong. (2003). Discussions to Establish and Perfect Chinese Independent Director System. *Commercial Research*, No.23.
- Hu, Meiling. (2009). On the Effective Implementation of Independent Director Institution. *Reformation & Strategy*, No.6.
- Li, Xizhi. (2009). Research of the Development Actuality and Limitation Factors of Chinese Independent Director System. *Economic Research Journal*, No.9.
- Wu, Xiaohui. (2007). Empirical Research of the Formation Mechanism of the Independent Director System Based on Non-regulatory Determinants. *China Industrial Economy*, No.11.
- Xu, Guanghua. (2007). Thinking of the Problems about Chinese Independent Director System in the Present Stage. *Public Finance Research*, No.1.
- Ye, Kangtao. (2007). Whether the Independent Director System Can Limit the Dominant Status of Large Shareholder. *Economic Research Journal*, No.4.