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# Will the Independent Director Institution Work in China?

SIBAO SHEN \* AND JING JIA \*\*

## I. INTRODUCTION

In recent years, China has joined the corporate governance debate and introduced the independent director institution to improve the corporate governance of listed corporations.<sup>1</sup> On August 6, 2001, the China Securities Regulatory Commission (CSRC) issued the Guiding Opinion on Establishing the Independent Director Institution in Listed Corporations ("the Opinion").<sup>2</sup> This landmark document formally established the independent director institution in China under which a minimum of one-third of each listed corporation's board members shall be independent directors.<sup>3</sup> Despite insufficient practical and theoretical bases, many people—including the regulators—hope the independent director institution will be a panacea to the

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\* © 2004. Professor of Law, Dean of Law School, University of International Business and Economics (Beijing, China); Vice President and Senior Arbitrator, China International Economic and Trade Arbitration Commission; Master of Law, Peking University (Beijing, China); Bachelor of Law, Peking University; Fulbright Scholar (1999-2000), Columbia Law School; Visiting Scholar (1981-1983), Columbia Law School.

\*\* Doctor of Law candidate, University of International Business and Economics; LL.M. candidate, University of Connecticut Law School; Master of Law, University of International Business and Economics; Bachelor of Law, Southwestern University of Political Science and Law (Chongqing, China); Visiting Researcher (2003-2004), Boston University School of Law.

1. See Minkang Gu, *Will an Independent Director Institution Perform Better than a Supervisor? Comments on the Newly Created Independent Director System in the People's Republic of China*, 6 J. CHINESE & COMP. L. 59, 59 (2003) (surveying independent director theory in Chinese corporate governance).

2. See CHINA SEC. REGULATORY COMM'N, GUIDELINES FOR INTRODUCING INDEP. DIRS. TO THE BD. OF DIRS. OF LISTED COS., Zhengjianfa No. 102 (2001), available at <http://www.csrc.gov.cn/en/jsp/detail.jsp?infoId=1061947864100&type=CMS.STD> [hereinafter GUIDELINES FOR INTRODUCING DIRECTORS].

3. *Id.*

corporate governance problems entangling Chinese listed corporations.<sup>4</sup>

The concept of independent director carries no clear meaning, even among its proponents.<sup>5</sup> Several terms, such as independent director, outside director, and non-executive director, are used interchangeably, though the terms have different meanings. Outside directors and non-executive directors are similar in that they are not involved in the day-to-day operations of a corporation. Neither position, however, guarantees independence. Some individuals appear to be outsiders, but are in fact insiders, such as former employees, outside counsel providing financial or legal services, or close families of senior management members.<sup>6</sup> In terms of their relationship with management or controlling shareholders, outside directors further divide into affiliated directors and unaffiliated directors.<sup>7</sup> Only the unaffiliated, outside directors are independent directors.<sup>8</sup> In China, an independent director does not assume any position other than director in a corporation, and who has no relationship with the corporation or its controlling shareholders that might affect his or her independent, objective judgment.<sup>9</sup>

Independent directors first appeared in the United States to cure the corporate governance problems of public corporations, which have widely dispersed shareholders.<sup>10</sup> Independent directors were created to monitor the integrity and performance of management in order to make public corporations a more effective wealth-maximizing instrument for shareholders, and a more socially responsible instrument for the public.<sup>11</sup> The rationale behind the independent director institution in China differs from

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4. Gu, *supra* note 1, at 59.

5. Victor Brudney, *The Independent Director – Heavenly City Or Potemkin Village?*, 95 HARV. L. REV. 597, 599 (1982) (arguing for the importance of regulatory controls in corporate governance in view of the inadequacy of “independent directors.”).

6. See BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS: GOVERNANCE & REGULATION, § 2:26 (2d ed. 2004); see also Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 29 (1987).

7. OLSON, *supra* note 6.

8. *See id.*

9. Tong Lu, *Development of System of Independent Directors and the Chinese Experience*, in CORPORATE GOVERNANCE REFORM: CHINA AND WORLD (2002), available at Ctr for Int'l Private Enter., [http://www.cipe.org/china/cg\\_book.htm](http://www.cipe.org/china/cg_book.htm).

10. See Betty M. Ho, *Restructuring the Boards of Directors of Public Companies in Hong Kong: Barking Up the Wrong Tree*, 1 SING. J. INT'L & COMP. L. 507, 507 (1997).

11. Brudney, *supra* note 5, at 602.

that in the United States: the institution in China primarily targets controlling shareholders, rather than management.<sup>12</sup> Instead of dispersed share ownership, the ownership structure of listed corporations in China is highly concentrated.<sup>13</sup> The major corporate governance problem is that controlling shareholders use their advantageous positions to expropriate the assets of listed corporations to the detriment of minority shareholders.<sup>14</sup> Therefore, the introduction of the independent director institution into China reflects the spirit of the U.S. independent director institution—its purpose is to prevent controlling shareholders from using their advantageous positions to the detriment of both the corporation and of minority shareholders.<sup>15</sup>

This Article argues that the importation of the independent director institution to China is an important step toward improving corporate governance. Unfortunately, it is unrealistic to count on independent directors to completely prevent exploitation by controlling shareholders and management, especially when listed corporations have not yet solved their share structuring problems, and China has yet to formulate a sound legal environment. Under these circumstances, the independent director institution in China cannot avoid the same defects existing in the independent director institution in the United States—namely, an inability to monitor and a lack of independence and incentive to remain objective.<sup>16</sup> Even in the United States, where the legal and social environment is far better for independent directors to function properly, the effectiveness of the independent director institution is highly disputed.<sup>17</sup> Thus, it is doubtful whether independent directors can meet their expectations in China.

This Article discusses the defects of the independent director institution and provides some suggestions for its improvement in China. Particularly, this Article discusses whether and how independent directors and the supervisory board can co-exist in China's corporate governance structure. China, with civil law

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12. See Gu, *supra* note 1, at 60.

13. See *id.*

14. See Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 27, 36-37 (2002).

15. See Gu, *supra* note 1, at 70; see also Danhan Huang, *Problems Concerning Independent Directors Institution and Its Legal Environment*, in CORPORATE GOVERNANCE REFORM: CHINA AND WORLD (2002), available at Ctr for Int'l Private Enter., [http://www.cipe.org/china/cg\\_book.htm](http://www.cipe.org/china/cg_book.htm).

16. See Ho, *supra* note 10, at 518-21.

17. See *id.* at 518.

traditions, has a similar model to that of civil law countries where a supervisory board is established in corporate governance law.<sup>18</sup> Because of many drawbacks, the supervisory board institution does not function well in China.<sup>19</sup> Since both supervisors and independent directors serve as monitors, the functions of independent directors and supervisors overlap.<sup>20</sup> Some critics argue that it is more cost-effective for a corporation to choose between the two institutions.<sup>21</sup> This Article, however, suggests that the supervisory board institution, after improving its power and structure, would be a good supplementary institution to alleviate the defects of the independent director institution.

Part I briefly outlines the debates in the United States on independent directors. Part II analyzes their importation into China. Part III discusses the defects of the independent director institution and provides suggestions to improve the institution in China. Part IV discusses the issue of co-existence of independent directors and the supervisory board in China's corporate governance structure. Part V concludes that the independent director institution is only one among many measures China needs to take in order to improve the corporate governance of its listed corporations.

## II. AMERICAN DEBATE

The concept of the independent director was first seen in the United States in the early 20th century.<sup>22</sup> The U.S. economy is characterized by highly developed capital markets, which has led to highly decentralized share ownership.<sup>23</sup> The dispersed shareholding structure weakens the control that the shareholders maintain over the board of directors and management.<sup>24</sup> Due to this dispersed shareholding structure, with the consequence of divorce between ownership and control, the inherent agency problems in the corporate context are highlighted: managers of corporations were "tempted to shirk and to steal, '[consuming]

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18. See Gu, *supra* note 1, at 74.

19. *Id.*

20. *Id.* at 74-75.

21. See *id.*

22. *Id.* at 61.

23. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 127, 135 (1933) (observing that the corporate mechanism has evolved into one where there are many shareholders).

24. Lu, *supra* note 9.

excess leisure, perquisites and in general [being] less dedicated to the goal of wealth maximization than they would be if they were not simply agents.”<sup>25</sup> Under these circumstances, independent directors ensure that the board of directors functions as a faithful delegate of the shareholders; independent directors also perform two major monitoring functions: “goad managers to perform adequately their wealth-maximizing task, in both long-run and short-run terms; and . . . ensure managers' integrity in dividing corporate assets between themselves and stockholders.”<sup>26</sup> The addition of independent directors to corporate boards is also expected to solve the problem of corporate social responsibility, although scholars have never agreed on how much social responsibility is sufficient.<sup>27</sup>

The independent director institution has been accepted within a surprisingly short time in the United States, particularly after the 1970s, in response to the increasing criticism of the evils attributed to the exercise of unbridled corporate power uncovered in the Watergate investigation and foreign bribery cases.<sup>28</sup> Although neither state law nor federal law makes any provision for the composition of the board (except that the Investment Corporation Act requires that no more than 60% of the directors of a registered investment corporation be “interested persons”), the independent director institution is firmly followed in practice.<sup>29</sup> The U.S. Securities Exchange Commission (SEC) has actively promoted the structuring of corporate governance in order to forestall the abuse of power by major corporations. As early as 1977, with the SEC's approval, the New York Stock Exchange (NYSE) introduced a stipulation that all listed corporations establish and maintain an auditing committee composed entirely of independent directors.<sup>30</sup> In 2002, in response to the well-published corporate scandals, the NYSE tightened its listing standards to require that each listed corporation have a majority of

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25. Ho, *supra* note 10, at 508-09 (quoting Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262 (1982)).

26. Brudney, *supra* note 5, at 602.

27. *Id.* at 605.

28. *See id.*; *see also* Richard Guo, *Disinterested? Or Uninterested? Some Thoughts on the CSRC's Independent Directors Guiding Opinion*, CHINA L. & PRAC., Oct. 2001, at 71, reprinted in 3 PERSP. 5 (2002), at <http://www.oicyf.org/Perspectives/law.htm> (June 30, 2002).

29. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.01 (Proposed Final Draft 1992) [hereinafter PRINCIPLES].

30. Lu, *supra* note 9.

independent directors and three committees—nomination, compensation, and audit—composed exclusively of independent directors.<sup>31</sup> The National Association of Securities Dealers Automated Quotations (NASDAQ) has similar changes in its listing rules.<sup>32</sup> The American Law Institute also recommends that “the board of every large publicly held corporation should have a majority of directors who are free of any significant relationship with the corporation’s senior executives.”<sup>33</sup> Today, most U.S. public corporation boards consist of a majority of independent directors, and an increasing number have only one or two inside directors.<sup>34</sup>

Despite its wide acceptance, whether independent directors improve the corporate governance of U.S. public corporations is disputed.<sup>35</sup> Some commentators argue that independent directors have played important roles in improving corporate governance.<sup>36</sup> For example, a 1998 study of 154 U.S. public corporations discovered that corporations with an active and independent board of directors were more successful in business than those corporations with a passive board of directors that lacked independence.<sup>37</sup> Another study, conducted in 2000, showed that corporations whose board contained a high percentage of independent directors were relatively more comprehensive in financial disclosure.<sup>38</sup>

Other commentators, however, have raised questions about the effectiveness of independent directors: a study of independent special litigation committees, for example, found that almost all special litigation committees ruled in favor of defendant-directors and concluded that this could only have been attributed to the bias of the independent directors.<sup>39</sup> Empirical research on independent directors of 934 American public corporations from 1983 to 1993—

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31. HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1:195 (2d ed. 2004).

32. *Id.*

33. PRINCIPLES, *supra* note 29, at § 3A.01.

34. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-term Firm Performance*, 27 J. CORP. L. 231, 232 (2002).

35. Lu, *supra* note 9.

36. *Id.*; see Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Largest Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1298 (1998).

37. Lu, *supra* note 9.

38. *Id.*

39. Ho, *supra* note 10, at 523.

including such names as General Motors, IBM, Kodak, Chrysler, and Westinghouse—concluded that large, American, public corporations could not improve their corporate governance efficiency and raise their performance by absorbing an increasing number of independent directors.<sup>40</sup> A recent 2002 empirical study revealed that low profitability corporations responded by increasing the independence of boards; however, corporations with more independent boards often did not improve profitability, and there was some indication that these companies performed worse.<sup>41</sup> In every recent headlining boardroom scandal, beginning with *Texas Gulf Sulfur*, there was a preponderance of outsiders on the board at the time of the scandal.<sup>42</sup> For example, the inside/outside balance was two to ten at Texas Gulf Sulfur (insider trading violation), five to twelve at Lockheed (illegal political contributions), four to eighteen at Penn Central (financial disaster), three to six at Northrup, six to eleven at W.T. Grant (bankruptcy), three to nine at Gulf Oil (both involving bribes to foreign officials), and two to fifteen at Enron (accounting irregularities).<sup>43</sup>

There have been several criticisms of the independent director institution. First, critics claim that independence does not really exist because management has significant control over selection of independent directors, and independent directors are not socially independent no matter how tight the criteria for independence. Second, independent directors do not possess adequate incentive to actively monitor management because they do not have a genuine interest in the corporation. Finally, even truly independent and diligent directors lack information and resources to effectively monitor management.

Therefore, despite the wide acceptance of the independent director institution in the United States, many critics remain unconvinced and have presented persuasive arguments that the institution contains insurmountable defects, and may even be futile. If independent directors are not effective directors, why are they so well-accepted among U.S. public corporations? As some critics point out, one reason is, ironically, insiders of public corporations welcome independent directors because they shield

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40. Lu, *supra* note 9.

41. Bhagat & Black, *supra* note 34, at 233.

42. OLSON, *supra* note 6, at § 2:26.

43. *See id.*

management from the aura of impartiality and legal liability.<sup>44</sup> For example, the board can often prevent a shareholder's derivative action by appointing a "disinterested" committee.<sup>45</sup> The committee is supposed to determine whether continuing the action is in the corporation's "best interests," which, not surprisingly, rarely occurs.<sup>46</sup> The American Bar Association also counsels that a nominating committee is good for self-protection: "The existence of a properly constituted Nominating Committee should be an important factor in securing judicial acceptance of the overall fairness of the decision-making process."<sup>47</sup>

### III. IMPORTATION TO CHINA

#### A. *Following the Trend*

Not until the early 1990s did developed countries other than the United States, e.g., Canada, the United Kingdom, and Australia, begin to lay down detailed provisions on the ratio, credentials, roles, and responsibilities of independent directors.<sup>48</sup> The trend of establishing the independent director institution spread to developing countries in the late 1990s.<sup>49</sup> The Asian financial crisis gave developing countries, especially Asian emerging-market countries, a lesson on the importance of a sound corporate governance system. India, Malaysia, Thailand, Korea, Philippines, Singapore, and Mexico all made stipulations concerning independent directors on the board of directors of listed companies within several years.<sup>50</sup> China also followed this trend.

The concept of the independent director appeared, for the first time, in the Guiding Opinion for Listed Corporations' Articles of Incorporation issued by the CSRC in December 1997. It suggests that listed corporations may retain independent directors at their option. The 1993 Corporation Law of China does not specially address independent directors. Before the CSRS's Guiding Opinion was published, provisions concerning

44. See Pease, *supra* note 6, at 35-40.

45. OLSON, *supra* note 6, at § 2:26.

46. *Id.*

47. *Id.*

48. Lu, *supra* note 9.

49. *Id.*

49. *See id.*

50. *See id.*

independent directors were scattered in various rules and regulations. The Guiding Opinion for Governance of Listed Corporations, issued by the Shanghai Stock Exchange on November 3, 2000, suggests that there should be at least two independent directors, and the number of independent directors should account for at least 20% of the entire board membership.

On August 6, 2001, the CSRC issued the Opinion, requiring each listed corporation to have at least one third of its board comprised of independent directors prior to June 30, 2002. Of these independent directors, at least one must be an accounting professional. The Opinion assigns more powers to independent directors than regular directors. Independent directors have the right to, among other things, approve or disapprove of any major conflict of interest transactions, make recommendations to hire or dismiss auditors, hold board meetings, and request that the board hold interim shareholders' meetings. Independent directors shall also provide their opinions regarding the following important matters: nomination, appointment, and dismissal of directors and senior executives; compensation of directors and senior executives; and any large loans. To exercise their powers, independent directors can independently retain outside counsel, such as auditors and lawyers.

Chinese regulators have high expectations for the independent director institution to resolve the corporate governance problems which have entangled the listed corporations since corporation reform began in the early 1990s. The regulators, particularly the CSRC, have hailed the establishment of the independent director institution as a key step towards improving corporation governance. In February 2004, the State Council of China issued "Some Opinions on Promoting the Reform, Opening and Steady Growth of the Capital Market."<sup>51</sup> This document strengthens the importance of independent directors in the reform and development of China's capital market.

#### *B. Roles of Independent Directors in Corporate Governance*

The shareholding structures of China's listed corporations are far different from the ones in the United States. Instead of dispersed shareholding, the shareholdings of Chinese listed

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51. See Liu Dongkai, *Capital Market Reform Touches Hard Core of China's Economic System*, XINHUA NEWS AGENCY, Feb. 3, 2004, available at 2004 WL 68250769.

corporations are highly concentrated.<sup>52</sup> The state or state-owned enterprises hold significant percentages of shares of most listed corporations.<sup>53</sup> According to one study, the largest shareholding stake in listed corporations average close to 50% compared to the second largest shareholder, who typically owns less than 10%.<sup>54</sup> As may be expected, controlling shareholders dominate the board. Typically, controlling shareholders appoint 70% of the directors.<sup>55</sup> Controlling shareholders also select management, which highly overlaps the board. This governance structure facilitates self-dealing transactions by enabling controlling shareholders to manipulate the shareholders' general meeting and the board at the expense of the interests of the corporation and minority shareholders.<sup>56</sup>

Since the major corporate governance problem of Chinese listed corporations resides with controlling shareholders, the establishment of the independent director institution primarily targets controlling shareholders, rather than management.<sup>57</sup> In the United States, management controls the board, while in China, the controlling shareholders control the board. So the establishment of the independent director institution in China aims to prevent controlling shareholders from exploiting their control to cause detriment to the corporation and its minority shareholders. The Opinion has made it clear that independent directors should conscientiously perform their duties according to relevant laws and regulations. The Opinion and the articles of incorporation protect the whole interests of the corporation, and give special attention to ensure that the legitimate rights and interests of medium-sized and small investors are not harmed.<sup>58</sup>

A less important role of independent directors in China is to monitor management integrity and performance. Despite the fact that controlling shareholders dominate the board, the problem with the divorce of management from shareholders still prevails in

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52. See Linan Yan, *Corporate Governance Under Chinese Law: Problems and Prospects*, 7 HARV. ASIA Q. (2003), available at <http://www.fas.harvard.edu/~asiactr/haq/200302/index.htm>.

53. See Huang, *supra* note 15.

54. *Id.*

55. See *id.*

56. For example, one listed corporation purchased from an affiliated corporation of the controlling shareholder more raw materials than what it could use for the next several hundred years. Schipani & Liu, *supra* note 14, at 47.

57. See Gu, *supra* note 1, at 60.

58. See *id.* at 71.

China.<sup>59</sup> One characteristic of Chinese corporate governance is that the controlling shareholders of most listed corporations are either state or state-owned enterprises.<sup>60</sup> It is impossible for the state to pay proper attention to the operations of such a large amount of state-owned enterprises. The officials delegated to run these corporations often take advantage of the vacuum of ownership in order to make dirty money.

Therefore, in China, independent directors primarily play two monitoring functions: (1) preventing controlling shareholders from taking advantage of their controlling position to do things detrimental to minority shareholders, and (2) bringing management under independent supervision to alleviate “insider” problems.<sup>61</sup> Xiangbin Yin, an independent director of a Chinese listed corporation, describes his experiences: the State—the largest shareholder—expects him to be a “KGB” in the corporation, i.e., to ensure the integrity of the executives, while the individual minority shareholders expect him to be a “white knight,” i.e., to fight against the exploitation from the controlling shareholder and from insiders.<sup>62</sup> It is interesting that a state-owned enterprise based in Shenyang has appointed a deputy director of the Anti-Corruption Bureau of the District Prosecutor as its independent director.<sup>63</sup> It is said that the Anti-Corruption Bureau is an institution devised by the District Prosecutor to prevent job-related crimes and to oversee the operations in state-owned enterprises.<sup>64</sup> This solution may go a bit too far because candid board discussion would be strangled with a prosecutor sitting in the boardroom.

It seems that some Chinese listed corporations are confused by the monitoring roles of independent directors. Many listed corporations select technical experts as independent directors; one survey shows that about 42.6% of independent directors are technical experts.<sup>65</sup> These technical experts may play an important role in drafting and advising business strategy plans, but they are

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59. *See id.* at 60.

60. *See id.*

61. Huang, *supra* note 15.

62. Yian Deng, *Du Li Dong Shi Bi Pin Du Li Jian Shi* [*Independent Directors Compete with Independent Directors*], FIN. & ECON. TIMES, available at <http://business.sohu.com/60/29/article200442960.shtml> (Mar. 29, 2002).

63. Huang, *supra* note 15.

64. *Id.*

65. Lu, *supra* note 9.

relatively weak in monitoring because many of them do not have knowledge or experience in business operations.

Independent and non-independent directors play different roles in the corporate governance structure. Any director will perform one of three different functions: executive, instrumental, and monitoring.<sup>66</sup> Executive directors may be managers or other insiders who can provide the board of directors with information concerning the business situation of a corporation. Instrumental directors may be a legal advisor, consultant, or financier, who is instrumental in the decision-making and operation of a corporation. Monitoring directors are outside directors who may be public directors or experts whose main task is to carry out independent supervision and examination of the performance of the corporation.<sup>67</sup>

In the United States, the central task of independent directors is to monitor inside directors and management.<sup>68</sup> Technical experts act as instrumental directors rather than monitoring directors.<sup>69</sup> Currently, the primary role of independent directors in China is to monitor the conflicts of interest in corporations. When selecting independent directors, these corporations should keep in mind the monitoring role of independent directors and choose directors who are familiar with the business operations. The possibility cannot be excluded that some controlling shareholders and insiders intentionally choose technical experts, who would naturally speak on technical issues rather than business matters. It is the job of the regulators to further elaborate the roles and requirements of independent directors.

The independent director institution has been in operation for several years in China. As of June 2003, 1244 of 1250 corporations listed in the two stock exchanges had independent directors on their boards.<sup>70</sup> Independent directors are now given more voice in

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66. See Gu, *supra* note 1, at 61-62.

67. Lu, *supra* note 9.

68. See Ho, *supra* note 10, at 514-15; PRINCIPLES, *supra* note 29, at § 3A.01. See generally Brudney, *supra* note 5 (arguing for the importance of regulatory controls in corporate governance in view of the inadequacy of independent directors.); see generally James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsels*, 48 VILL. L. REV. 1077, 1082 (2003).

69. See Gu, *supra* note 1, at 61.

70. Jian Lin, *Zheng Jian Hui You Guan Fu Ze Ren Ti Chu Yi Si Da Cuo Shi Wan Shan Du Dong Zhi Du* [Head of CSRC Raises Four Issues to Improve the Independent Director Institution], SHANGHAI SECURITIES DAILY (Feb. 6, 2004), at <http://finance.sina.com.cn/y/20040206/0722619309.shtml>.

corporate governance. For example, when two corporations listed in the Shenzhen Stock Exchange, Kelong and Nanhuaxi submitted their mid-term disclosures in 2002,<sup>71</sup> all of the independent directors chose to abstain when directors voted for the corporation's financial reports.<sup>72</sup> In contrast, in August 2003, at the insistence of two of its independent directors, ST Nanhua—a corporation listed on the Shanghai Stock Exchange—successfully removed the chairman of the board, an unprecedented move.<sup>73</sup> The regulators have met resistance in enforcing the Opinion from China's listed corporations, which has a notoriously opaque business culture.<sup>74</sup> Thirty-six per cent of listed corporations missed the deadline to fill at least a third of their board positions with independent directors by June 2003.<sup>75</sup> Even the CSRC admitted that some of the listed corporations with independent directors withheld negative information from them, in some cases even refusing to invite them to board meetings.<sup>76</sup>

Because the independent director institution has functioned in China for only a relatively short amount of time, it is difficult to access its effectiveness on China's corporate governance environment. Many problems exist even though many people favor this new institution. Yet, most independent directors do not, or cannot, fulfill their monitoring role in corporate governance due to the internal or external defects of the institution.

#### IV. CRITICISMS AND SUGGESTIONS

This Article criticizes the independent director institution on the following: (1) true “independence” for independent directors does not exist; (2) independent directors lack the information and skill required to effectively function; and (3) independent directors lack incentive to defy insiders and controlling shareholders.<sup>77</sup>

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71. Yongli Sun, *Du Li Dong Shi Zai Fa Yan* [*Independent Directors Are Raising Voices*], NEGOTIABLE SECURITIES TIMES (Jul. 5, 2002), at <http://business.sohu.com/07/87/article202008707.shtml>.

72. *Id.*; see also Lei Wang, *ST Nan Hua Du Dong Ban Dao Dong Shi Zhang* [*ST Nanhua's Independent Directors Drove Away Chairman of Board*], SECURITIES TIMES (Aug. 22, 2003), available at <http://www.p5w.net/p5w/home/stime/today/200308220248.html>.

73. Wang, *supra* note 72.

74. Bei Hu, *Independents Shunned by China Firms*, S. CHINA MORN. POST, Feb. 7, 2004, available at 2004 WL 55518220.

75. *See id.*

76. *Id.*

77. *See generally* Brudney, *supra* note 5.

### A. Independence

The independence of independent directors is not absolute and there is no universal test for independence.<sup>78</sup> The standards for independence vary with the legislative needs to regulate corporate governance structure.<sup>79</sup> For example, in the United States, where the major concern is independence from management, the NYSE does not view significant stock ownership in itself as a bar to determining whether a director is “independent.”<sup>80</sup> Contrast this to the Opinion in China, which requires that where the independent director institution targets controlling shareholders, an independent director shall not hold more than one percent of the shares and shall not be affiliated with any controlling shareholders.<sup>81</sup>

The apparent requirements on the independence of directors resolve only part of the potential conflict of interest. Since the purpose of the independent director institution is to safeguard the whole interests of the corporation, the selection of independent directors should be free from influence of controlling shareholders or management. Some critics argue that in the American system, “independence” exists only in theory because management maintains significant control over the selection of directors. As one scholar indicated, “no definition of independence yet offered precludes an independent director from being a social friend of, or a member of, the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess.”<sup>82</sup> Managers “can easily find directors who are neither subordinates, relatives, nor suppliers, who will support almost anything that the executives propose, and who will resign in extreme cases rather than oppose the executives who have invited them to the board.”<sup>83</sup> Moreover, since studies show that the majority of outside directors are themselves chief executive officers (CEOs), these “directors are unlikely to monitor others more energetically than they believe

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78. *Id.* at 599.

79. *Id.* at 645.

80. See generally NYSE CORPORATE GOVERNANCE RULES § 303A, available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> (last visited Jul. 25, 2005). It is interesting that Nasdaq tightened the criteria of independence by excluding large shareholders in 2002. Press Release, Nasdaq Takes New Actions on Corporate Governance Reforms (July 25, 2002), at <http://www.nasdaq.com/newsroom/news/2002.stm>.

81. Gu, *supra* note 1, at 64.

82. Ho, *supra* note 10.

83. OLSON, *supra* note 7, at § 2:26.

they should be monitored by their own boards.”<sup>84</sup> While independent nominating committees have been introduced to ensure the independence of the director selection process, their effectiveness has been criticized.<sup>85</sup> The committee normally solicits suggestions from the CEO as to potential candidates. Nominating committees “may make the CEO work harder, but over time he gets the board he wants.”<sup>86</sup>

In China, besides management, independence means independence from controlling shareholders.<sup>87</sup> In a country where the relationship--known as *guan xi*, in both social and business circles--is strongly emphasized, it is difficult for the selection process of independent directors to avoid influence by controlling shareholders or management. Although the Opinion provides strict requirements for independence, true independence of directors is difficult to achieve. There is no independent nomination committee in listed corporations. Neither cumulative voting nor withdrawal mechanisms have been adopted by Chinese listed corporations. Article 4 of the Opinion provides that independent directors are to be nominated by the incumbent board of directors, the board of supervisors, or the shareholders jointly or individually owning a one percent equity interest.<sup>88</sup> In reality, independent directors are solely selected by controlling shareholders, either by themselves or through the board.<sup>89</sup> Controlling shareholders and management try to select those with some connection to them and who will side with them.<sup>90</sup> The CSRC admitted that: “Many corporations’ independent directors were nominated by major shareholders or management. Such a mechanism cannot guarantee the independence of the appointees.”<sup>91</sup> Each year, the CSRC rejects some appointments of independent directors because of various “under the table” connections with controlling shareholders or management.<sup>92</sup> Last

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84. Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 915 (1996).

85. Ho, *supra* note 10, at 519.

86. *Id.*

87. *Id.*

88. Guo, *supra* note 28, at 71.

89. Ho, *supra* note 10, at 520.

90. Lu, *supra* note 9.

91. Hu, *supra* note 74.

92. Ocean Net, *Zhang Ji Zhong Jia Ping Wa Yao Ke Chuan Mou Gong Si Du Li Dong Shi* [Jizhong Zhang and Pingwa Jia Will Be Independent Directors of a Corporation] (May 13, 2003), available at <http://cn.ent.yahoo.com/030513/127/1lx6q.html>.

year, an entertainment corporation based in Xi'An selected a famous TV producer as its independent director.<sup>93</sup> When he was questioned about his qualifications to be a director, the TV producer frankly declared: "The manager is my good friend!"<sup>94</sup>

To ensure true independence, the focus of regulation should be on the procedure of selection and election of independent directors. An independent nomination committee consisting of entirely independent directors is in a better position, for the sake of minority shareholders, to nominate candidates of independent directors. To make the selection of independent directors free from the influence of controlling shareholders, controlling shareholders should not be allowed to nominate independent directors, nor should they be allowed to vote for the independent director candidates they nominated. In electing independent directors, cumulative voting and withdrawal institutions could also be adopted. After independent directors are elected onto the board, constant monitoring is necessary. Regulatory institutions such as the CSRS and the stock exchanges are effective but are short of resources to monitor every listed corporate board. A private cause of action may be given to shareholders, particularly minority shareholders, to challenge the independence of incumbent directors. Because independent directors represent minority shareholders' interests, it is logical to give minority shareholders the right to remove those independent directors whom they no longer trust.

### *B. Incentive*

The more independent a director is, the fewer incentives exist for that director to maximize shareholder interest, and vice versa, more incentive equals less independence.<sup>95</sup> This "Catch-22" points out an inherent dilemma of the independent director institution.

In the United States, critics claim that independent directors lack adequate incentive for maximizing shareholder interests.<sup>96</sup> It is well accepted that independent directors should be those who do not derive the majority of their income from the corporation.<sup>97</sup> Without financial gain, the only incentive for independent

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93. *Id.*

94. *Id.*

95. Ho, *supra* note 10, at 512.

96. Lu, *supra* note 9.

97. *See generally* Gu, *supra* note 1.

directors to act is their professional reputation. But they can always protect themselves by resigning from the board and claiming innocence, due to management's withholding of information. Who remembers the names of those sitting as independent directors on the boards of Enron and Worldcom? And how many of them are blamed for their failure to take action? Moreover, the potential liability in relation to the benefits of independent directors is too disproportionate for directors to be anything but risk averse. Therefore, even where a director is truly independent, active, and informed regarding corporate affairs, prudent judgment often dictates that the director follow the course of action endorsed by management. Incentives to veto the management strategy rarely exist. One study suggests that "rather than manage, boards react; they render advice when solicited and replace the CEO only amid dire emergencies."<sup>98</sup>

In China, there is a striking range in the level of independent director compensation; the average annual pay ranges from 1,000 RMB (about 121 USD) to more than 80,000 RMB (about 9,674 USD).<sup>99</sup> Most independent directors earn between 40,000 RMB (about 4,838 USD) and 50,000 RMB (about 6,046 USD) a year.<sup>100</sup> While some independent directors are volunteers without any compensation, Zhenbaiwen—a corporation listed in the Shanghai Stock Exchange—pays its independent directors a base compensation of 120,000 RMB (about 14,510 USD) per year plus additional compensation for each board meeting they attend in that year.<sup>101</sup> Candidates for independent directors are sure to think about economic incentives, in addition to professional ethics, in weighing whether or not it is worth being an independent director and in how they will perform their duties. If the compensation is too low, independent directors lack economic incentives. If the compensation is too high, the independence is eroded. The Opinion prohibits a person from sitting as an independent director on more than five listed corporate boards. Besides ensuring that independent directors have enough time and energy, this prohibition also prevents people from becoming "professional

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98. OLSON, *supra* note 7, at § 2:26.

99. Lu, *supra* note 9.

100. *Id.*

101. Yongqiang Yi, *PT Zheng Bai Wen (600898): Du Li Dong Shi Chou Xin Qi Zheng Yi* [*PT Zhengbaiwen: The Independent Directors' Compensation Is Controversial*], NEGOTIABLE SECURITIES TIMES (June 25, 2002), available at <http://business.sohu.com/72/52/article201845272.shtml>.

independent directors," whose income may come primarily from one or more listed corporations.

The flip side of compensation is liability. Establishing a liability institution may, to a certain extent, discourage independent directors from acting as "ornamental vases" and make them truly fulfill their due roles. Liability, however, is a double-edged sword. If the liability imposed on them is too high, independent directors will tend to be conservative in executing their responsibilities. For example, an independent director might strike down all conflict of interest transactions to avoid risk. Many people would be deterred from pursuing independent director positions, and this would result in difficulty finding appropriate candidates. Listing companies would in turn have to pay more for suitable candidates. In 2002, Jiahao Lu, an independent director of Zhengbaiwen, was fined 100,000 RMB (about 12,091 USD) by the CSRC because he failed to take any action when the corporation submitted a false accounting report.<sup>102</sup> Lu subsequently sued the CSRC for this decision, but the No. 1 Intermediate People's Court of Beijing dismissed the lawsuit.<sup>103</sup> Lu was the first independent director punished in China. He is a retired professor with a monthly income of only 1,500 RMB (about 181 USD). Lu had received no compensation from Zhenbaiwen as its independent director.<sup>104</sup> Right after this incident, at least sixty-six independent directors resigned from listed corporations.<sup>105</sup> Zhengbaiwen is now paying over 14,000 USD to its independent directors, much more than other listed corporations do. To avoid this result, an entirely independent compensation committee should be established under the board to decide the compensation of both directors and management. It does not make sense for controlling shareholders and management to decide the compensation of the very

102. Gu, *supra* note 1, at 70-71; see also Lu, *supra* note 9.

103. *Zheng Bai Wen Yuan Dong Shi Zhuang Gao Zheng Jian Hui – Fa Yuan Bo Hui Lu Jia Hao Su Zhuang* [The Court Dismissed Jiahao Lu's Suit], LANZHOU MORNING PAPER (Aug. 13, 2002), available at <http://www.gansudaily.com.cn/20020813/501/2002813A00502014.htm>.

104. *Zheng Bai Wen Yuan Dong Shi Lu Jia Hao Bu Fu Zheng Jian Hui Chu Fa An Kai Ting* [The Hearing Is Held Today Where the Ex-director Jiahao Lu Sues the CSRC], (June 20, 2002), available at <http://www.chinanews.com.cn/2002-06-20/26/196639.html>.

105. Chen Wenfang, *Shang Ban Nian Du Li Dong Shi Li Zhi 37 Ren – Du Li Dong Shi Bu Hao Dang Le* [Thirty-Seven Independent Directors Leave Post in First Half of Year—It Is Not Easy to Be an Independent Director], NEGOTIABLE SECURITIES TIMES, at <http://www.szs.com.cn/200208/ca159075.htm> (last visited Jul. 25, 2005); *The Hearing Is Held Today Where the Ex-director Jiahao Lu Sues the CSRC* (June 20, 2002), at <http://www.chinanews.com.cn/2002-06-20/26/196639.html>.

independent directors who monitor their performance. In terms of the compensation method, equity compensation such as restricted stock and stock options is more appropriate for independent director compensation than cash.<sup>106</sup> Stock ownership may align independent directors with shareholder interests and promote an incentive to monitor.<sup>107</sup> In China, independent directors are designed to protect minority shareholder interests.<sup>108</sup> Equity ownership would put independent directors in the shoes of the minority shareholder, which would give them a "shareholder orientation" and "a genuine interest" in the corporation.<sup>109</sup>

The regulators should expand the scope of independent director liability. Under the current Corporation Law of 1993, it is unclear how much duty of care a director owes.<sup>110</sup> In the *Lu* case, the CSRC fined Lu based upon the Shares Issuance and Exchange Regulation Ordinance (for Trial Implementation), an administrative regulation. The ordinance was published in 1993 and a large part of it was superseded by the Securities Law of 1997.<sup>111</sup> It is disputed whether the CSRC had jurisdiction over Lu and whether the CSRC had power to impose such a big fine.<sup>112</sup> China's regulators should explicitly provide for independent director liability in the corporation or securities laws. They should also distinguish independent director and non-independent director liabilities.

### *C. Ability*

In the United States, many independent directors are no match for insiders in terms of knowledge and purpose of the corporation. Also, due to limitations of time and information, it is very difficult for independent directors to monitor corporate operations. Management has a virtual monopoly on information and selectively reveals information to independent directors. It is common for an independent board to be the last to know about

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106. See Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 870 (2003).

107. *Id.* at 869-71.

108. Gu, *supra* note 1, at 70.

109. See Letter from Warren E. Buffett, Chairman of the Board, to the Shareholders of Berkshire Hathaway Inc. 10 (Feb. 27, 2004), available at <http://www.berkshirehathaway.com/letters/2003ltr.pdf>.

110. See Gu, *supra* note 1, at 64-68.

111. See *id.* at n.16.

112. *Id.* at 70-71.

any corporate difficulties. Agenda control by inside directors, coupled with lack of time or expertise by independent directors, adds up to the worst possible mix for frank discussions on the board or decision-making as a board.<sup>113</sup> These outsiders know little about the actual business situation of their corporations and end up observing problems from the perspective of management. Independent directors cannot solve the problem of asymmetrical information.

Certain boardroom norms exacerbate this disparity. For example, “[independent] directors usually do not contact fellow [independent] directors outside meetings, whereas inside directors and the CEO are in constant communications with one another.”<sup>114</sup> Consequently, “the chances of a majority of [independent] directors acting together to oppose any management initiative or even convey criticism are slim.”<sup>115</sup> One commentator finds that, “[s]ocial psychologists and management experts would dub these meetings as very poor decision-making forums. The purpose of a group discussion of an issue is to discuss diverse points of view openly, and to confront and resolve differences of opinions.”<sup>116</sup> As Warren E. Buffett said, despite “the lapdog behavior” of independent directors, they are not bad people but the boardroom atmosphere “sedates their fiduciary genes.”<sup>117</sup>

In China, a large number of independent directors are professors and scholars from universities.<sup>118</sup> The problem here is two-fold. First, these academics lack time as they concurrently hold other full-time positions. Second, they do not necessarily possess the knowledge and experience of a business operation. Many of them are excellent in their respective fields but are not familiar with the operations of listed corporations and do not know how to act as a director.<sup>119</sup> However successful the independent director may be in his own field, it is doubtful whether the independent director has the ability to challenge another equally successful person in an entirely different field. Would a university president be competent to monitor the

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113. Ho, *supra* note 10, at 512.

114. *Id.* at 512.

115. *Id.*

116. *Id.* at 513.

117. See Letter from Warren E. Buffett to the Shareholders, *supra* note 109, at 8.

118. According to the CSRC, about 42% of independent directors of listed corporations are academics. Hu, *supra* note 74.

119. See *id.*

management of a vertically integrated natural resources corporation? This doubt cannot be dispelled. On questions of probity, if auditors are nervous about their ability to detect fraud when they have full access to the corporate books, how can an independent director be expected to detect dishonesty hidden in the neat and professionally turned-out documents presented to him for board meetings?

Because China's modern corporate institution is so young, it lacks experienced and qualified experts in business operations. The CSRC has already begun to cooperate with institutions of higher learning in offering training courses to independent directors, indicating a trend towards allowing only those who have received training to fill the posts of independent directors. This might be a feasible way to improve the qualifications problem of independent directors although the effectiveness of these short-term training courses is limited. Since 2001, more than 1000 listed corporations, unlisted public corporations, and fund managers have been competing for approximately 10,000 graduates from thirty training courses to serve as independent directors.<sup>120</sup> But not all graduates have met other requirements for becoming an independent director.<sup>121</sup>

Even assuming sufficient time and skills, independent directors find it very hard to play their role in a board controlled by a single dominating shareholder. The Opinion only requires that one third of the board members be independent directors.<sup>122</sup> Insiders still dominate the other two thirds of the board seats. In the United States, where outside directors prevail over inside directors in number, insiders can still influence the board through a variety of means.<sup>123</sup> How can we expect two or three independent directors, a minority on the board, to fight against insiders? The ratio of independent directors on the board is still too low. The CSRC should require each listed corporation to have a majority of independent directors. Entirely independent committees, such as compensation and audit committees, should also be established under the board. These independent directors will find it easier to express dissenting opinions without the presence of controlling shareholders and insiders whom they are supposed to monitor.

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120. *Id.*

121. *Id.*

122. *Id.*

123. Lu, *supra* note 9.

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Additionally, such independent directors, as members of a special committee, can develop a solid base of knowledge by studying specialized topics.

In summary, although the independent director institution is politically correct, the nexus between directors and managers is burdened with personal and financial entanglements. It is difficult for independent directors to be effective monitors of management. Director independence is a method for promoting good corporate governance, but it does not ensure the most effective result. Regardless, the independent director institution is a major step towards improving the corporate governance structure in China. It is unrealistic to expect independent directors to completely prevent control by controlling shareholders and insiders when listed corporations have not yet solved problems in their own share structures, and China has yet to formulate a sound legal institution.

#### V. A SPECIAL ISSUE: THE SUPERVISORY BOARD

The independent director institution is the legacy of common law countries, where corporations are usually controlled by boards of directors. In contrast, civil law countries, such as Germany and France, have developed a supervisory board institution. China has also adopted a model similar to that of civil law countries, where the board of directors is under the supervision of a supervisory board. Following the introduction of the independent director institution, China is among the few nations which have established both the independent director and supervisory board institutions. Some commentators argue that it is more cost-effective to choose between the two institutions because their oversight functions overlap.<sup>124</sup> Under the existing corporate law in China, however, a more effective way toward good corporate governance is to regard the supervisory board as a supplementary institution, rather than add the institution of independent director and to place all hope upon it.<sup>125</sup>

In China, however, the supervisory board institution did not function well from day one.<sup>126</sup> Supervisory boards have quite limited powers compared to their counterparts in Germany and

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124. Lu, *supra* note 9.

125. See Gu, *supra* note 1, at 74.

126. See *id.*

France.<sup>127</sup> The supervisors in China are appointed by shareholders and recommended by employees. Their supervisory role is not "external[]" in nature.<sup>128</sup> Furthermore, under the current legal structure, the supervisory board does not have any substantial power. The board is unable to directly veto the decisions made by the board of directors and management.<sup>129</sup> As Gu states, "[f]or example, when directors or managers have done something that is not in their corporations' best interest, supervisors [can] only demand that they remedy the harm."<sup>130</sup> Furthermore, "[i]f this demand does not work, supervisors [can] propose to hold an interim shareholders' meeting and report the misconduct to shareholders."<sup>131</sup> The proposal to hold an interim shareholders' meeting, however, can be rejected, because the power to convene an interim shareholders' meeting is vested in the board of directors.<sup>132</sup> Moreover, Chinese supervisory boards do not have the power to dismiss directors, unlike the supervisory boards in Germany,<sup>133</sup> nor do they have the right to sue directors or management.<sup>134</sup>

Most of the supervisory board members are trade union presidents and employees' representatives. In China, trade unions are not independent of corporations and not as powerful as their counterparts in western countries.<sup>135</sup> Instead, trade union presidents are employees of corporations and their stature within the corporation is low, while employee representatives are usually chosen from junior managers.<sup>136</sup> It is doubtful that such a

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127. *Id.* at 66-67.

128. See CO. L. OF THE P.R.C. (1993), art. 124, reprinted in LEGIS. AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONG., THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1993, at 296 (1995).

129. See *id.* art. 126 (3), at 296.

130. Gu, *supra* note 1, at 66.

131. *Id.*

132. See CO. L. OF THE P.R.C. (1993), arts. 47, 112, reprinted in LEGIS. AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONG., THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1993, at 279, 293 (1995).

133. Gu, *supra* note 1, at 66.

134. *Id.*

135. See generally Lei Jiang, *Min Jian Shi You Shang Hui Cheng Yuan Sheng Xian Xi - Can Ye Ji Jin Ji Hua Shou Cuo* [Disputes Arise Among Members of an Oil Trade Union - Plan for Accumulating Industrial Investment Fund Is Set Back], FIN. & ECON. TIMES (Dec. 18, 2004), [http://www.ce.cn/new\\_hgj/guonei/cyj/200412/18/t20041218\\_2610520.shtml](http://www.ce.cn/new_hgj/guonei/cyj/200412/18/t20041218_2610520.shtml).

136. See generally Dong Hu Gao Xin (600133) *Jian Shi Hui Huan Jiai De Jue Yi Gong Gao* [Re-election Notice of the Supervisory Committee of Donghu Gaoxin], NEGOTIABLE SECURITIES TIMES (Jan. 13, 2005), <http://finance.sina.com.cn/stock/shannounce/20050113/09081291106.shtml>.

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supervisory board could challenge the decisions made by the boards of directors and senior management.

Since both the supervisory board and independent directors serve as monitors, their role and function overlap, thereby increasing the cost of corporate operation. Some commentators thus argue that it is more cost-effective to choose between independent directors and supervisors.<sup>137</sup>

The CSRC also suggests that the supervisory board institution will eventually be replaced by the independent director institution.<sup>138</sup> However, the monitoring roles of independent directors and supervisors are distinct. Independent directors function during the decision-making process while supervisors play their roles after the decisions have been made. Independent directors work more closely with insiders while supervisors are more akin to outsiders. The independent director institution can co-exist with the supervisory board institution well if some improvements are made.

First, supervisory boards should consist of only independent supervisors. Only if supervisory boards maintain their independence can they play the monitoring role effectively.

Second, the relevant laws and regulations should clearly state the different powers and functions of supervisors and independent directors. For example, the supervisory board should be given the power to nominate independent directors. Supervisory boards should also have the power to sue directors or management if internal remedies are exhausted. The supervisory board institution may be able to remedy or at least alleviate the defects of the independent director institution. For example, to ensure the independence and qualifications of independent directors, independent supervisors should have the power to nominate or even appoint independent directors. To maintain the incentive of being an independent director, independent supervisors should have the power to set the compensation level and bring actions against independent directors if necessary. In this situation, the additional supervisory board institution will be like "adding wings to a tiger," and corporate governance will be substantially perfected.

Therefore, an effective method to improve corporate governance in China is to regard the supervisory board institution

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137. Lu, *supra* note 9.

138. Guidelines for Introducing Directors, *supra* note 2.

as a supplementary institution to the independent director institution. Ignoring this important matter and shifting the attention to the newly created independent director institution will give people a false image that the new independent director institution is a panacea to cure all the problems of corporate governance. Chinese regulators are missing the lessons as they hurry from creating one institution to another. Compared with the supervisory board institution, the independent director institution is not inherently better. The regulators need to get to the root of the problems, which include the irrational share structure and immature legal environment.

#### V. CONCLUSION

It is unrealistic to expect too much from independent directors. How much can outsiders--who devote a total of perhaps two weeks in a year to the corporation--uncover, particularly as they are selected by and their information mainly comes from controlling shareholders and the management whose performance they are supposed to be monitoring. A basic presumption of the independent director institution is that directors who keep some distance from controlling shareholders and management are better able to ask the right questions and evaluate the answers than those who are closer to the corporation. So long as independent directors do not actually manage the corporation, and so long as they rely on insiders for their information, it is unrealistic to expect that the independent director institution will necessarily lead to dramatic improvements in corporate governance.

An independent director is an important part of the corporate governance structure, but it does not complete it. To improve corporate governance in China, the independent director institution is only the first step. Also necessary are a fully developed market economy, a sound legal institution, and a fair judiciary, as well as a fine cultural environment for corporate governance. It is unrealistic to expect the independent director institution alone to solve all the corporate governance problems in China.

At present, the overly concentrated shareholding structure in listed corporations is one of the root causes of the corporate governance problem. To address this issue, the key appears to be eliminating, or at least decreasing, state ownership of listed corporations. Chinese regulators should first try to alter the

imbalanced shareholding structure and proscribe insiders (i.e., controlling shareholders and their agents) from exerting disproportionate influences on the business of listed corporations. They should also impose fiduciary duties on those people in control. Only with this primary objective in mind can corporate governance in China be approached in the right direction. Another issue confronting listed corporate governance is the lack of efficient and effective judicial intervention. Legal mechanisms, such as derivative suits, appraisal rights, and class actions, are often the last line of defense for the interests of investors. They have undergone a long journey of development and have become meaningful choices and powerful weapons for investors in western countries. But they are still not viable options in China. It is necessary to formulate a sound legal institution for the independent director institution to work.