EXPLORATION OF CORPORATE GOVERNANCE BETWEEN DEVELOPED NATIONS AND THE PEOPLE’S REPUBLIC OF CHINA

by

Manjiang Li

A thesis submitted in conformity with the requirements for the degree of Master of Law
Graduate Department of Faculty of Law
University of Toronto

© Copyright by Manjiang Li (2010)
Exploration of Corporate Governance Between Developed Nations And the People’s Republic of China

Manjiang Li
Master of Law
Faculty of Law
University of Toronto
2010

Abstract

This article explores the corporate governance in the developed countries and China from a comparative perspective. Following detailed analysis in principal-agent model at the core of corporate governance theories, this article examines the dispersion-to-concentration ownership span to explore the concentration degree with influence on the majority/minority ownership construct and the shareholder/manager conflicts. This article compares the positive and negative edges of concentrated shareholding with empirical analysis of corporate practice in Canada, the U.S., and China, and finds the different roles of institutional shareholders in various countries. Two-tier agency model is another way to enhance corporate governance. Compared with the vertical two-tier construct with the vanguard of Germany, this article illustrates that the supervisory board in China is in horizontal position paralleled to the board of directors, which loses its original supervising purpose in corporate governance. This article finally explores the independent director system. The independent director has already demonstrated its positive influence upon corporate governance in developed countries, while in China, this system still lacks legal protection and is not effective as expected.
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table of Contents</td>
<td>iii</td>
</tr>
<tr>
<td>1 Introduction</td>
<td>1</td>
</tr>
<tr>
<td>2 Literature of Corporate Governance</td>
<td>4</td>
</tr>
<tr>
<td>2.1 Framework in Developed Countries</td>
<td>4</td>
</tr>
<tr>
<td>2.1.1 Shareholder Oversight – Principal Agent Model</td>
<td>4</td>
</tr>
<tr>
<td>2.1.2 Market Mechanisms to Corporate Governance</td>
<td>6</td>
</tr>
<tr>
<td>2.1.3 Role of Corporate Law</td>
<td>8</td>
</tr>
<tr>
<td>2.1.4 Common Law</td>
<td>10</td>
</tr>
<tr>
<td>2.1.5 Conclusion</td>
<td>14</td>
</tr>
<tr>
<td>2.2 Literature on China</td>
<td>14</td>
</tr>
<tr>
<td>3 Concentrated Shareholding in Corporate Governance – Institutional Shareholders</td>
<td>19</td>
</tr>
<tr>
<td>3.1 Ownership Concentration Theory: Dispersion-To-Concentration Construct</td>
<td>19</td>
</tr>
<tr>
<td>3.1.1 Free-Rider Problem around Vertical And Horizontal Agency Costs</td>
<td>19</td>
</tr>
<tr>
<td>3.1.2 How to Minimize the Horizontal And Vertical Agency Costs?</td>
<td>21</td>
</tr>
<tr>
<td>3.2 Theoretical Analysis of Institutional Shareholding</td>
<td>23</td>
</tr>
<tr>
<td>3.2.1 The Positive Edge of The Sword</td>
<td>23</td>
</tr>
<tr>
<td>3.2.2 The Negative Edge of The Sword</td>
<td>24</td>
</tr>
<tr>
<td>3.3 Situations in Various Countries</td>
<td>27</td>
</tr>
<tr>
<td>3.3.1 Canada:</td>
<td>27</td>
</tr>
<tr>
<td>3.3.2 The U.S.:</td>
<td>29</td>
</tr>
<tr>
<td>3.3.3 China:</td>
<td>29</td>
</tr>
<tr>
<td>4 Two-tier System in Corporate Governance – Management Board and Supervisory Board</td>
<td>34</td>
</tr>
<tr>
<td>4.1 Two-Tier Agency Model Theory</td>
<td>34</td>
</tr>
</tbody>
</table>
4.2 Corporate Supervision in China ................................................................. 35

5 Independent Director System in Corporate Governance .................................. 38

5.1 Theoretical Analysis of Independent Director System .................................. 38
    5.1.1 The Argument in Favour of Independent Director System ...................... 39
    5.1.2 The Argument against Independent Director System .......................... 40
    5.1.3 Conclusion ......................................................................................... 42

5.2 Literature of Independent Director System in Developed Countries ............... 43
    5.2.1 Statutory Law in The U.S. ................................................................... 43
    5.2.2 Statutory Law in Canada ................................................................. 45
    5.2.3 Common Law ..................................................................................... 46

5.3 The Application of Independent Director System in China ............................. 47
    5.3.1 Definition of Independent Director ..................................................... 47
    5.3.2 The Way to Create Independent Directors ......................................... 49
    5.3.3 “Dependent Ties” of Independent Directors ........................................ 50
    5.3.4 Statutory Power of Independent Directors .......................................... 51

6 Conclusion ....................................................................................................... 52

Bibliography ....................................................................................................... 53
1 Introduction

This article seeks to address the theoretical studies and the practice in corporate governance between developed nations and China in the process of global economic development. Corporation growth marked the continuous economic development in various countries. However, corporate scandals in the nineteen-nineties and the global financial crisis in recent years warn people to reconsider corporate governance in developed countries. On the other hand, sustainable rapid economic development in China attracts legislators, courts, practitioners, administrators, and scholars to re-examine the corporate governance theories and the practical corporate reform in China. This article proposes to explore the corporate governance theories and the practical experience with the comparative analysis between some developed countries including Canada, the U.S., and Germany, and China.

This article begins with a discussion of the principal-agent theory to illustrate the current fundamental situations in corporate governance. Under the agency model, a big vacuum is left to the managers who might expropriate from the corporation at the expense of the other corporate stakeholder, or shirk from active corporate management. To make an integral corporate governance picture, this article illustrates the functional roles of the markets instruments as well as corporate law in disciplining and improving corporate governance. This article involves the representative cases in Canada and the U.S. to evaluate the key issue in corporate governance: to whom the directors owe their corporate duties. It further introduces the establishment and reform of corporation scheme in the Chinese transitional economy. As to the Chinese corporate governance, this article will focus on the listed companies in China.
The second part of this article brings out the corporate ownership dispersion-to-concentration span and analyzes the influence on corporation governance. Due to the free rider problem under dispersed ownership, concentrated ownership helps to reconcile the vertical conflicts between shareholders and managers while the vertical conflicts might increase along a different axis. Thus how to locate the optimal level in the dispersion-to-concentration span is still an unsettled issue with various disputes and explorations in different countries. In the U.S., dispersed ownership marked the public corporations and vertical agency conflicts dominate corporate governance. While in Canada, public corporations are commonly controlled by institutional shareholders, thus the horizontal costs are the main issue in corporate governance. While in China, most public corporations are controlled by governmental institutional shareholders. This special corporate ownership structure makes the corporate governance more complicated in China. Various conflicts of majority/minority shareholders and shareholders/managers, as well as the fiduciary conflicts of directors and managers mark the corporate monitoring in China.

The third part of this article tries to analyze the two-tier corporate agency model with the vanguard of Germany. This is an effective construct in enhancing corporate governance and China also applies such agency model on its civil law exploration road. Nonetheless, various perspectives demonstrate that the Chinese supervisory board is situated on a horizontal level with the board of directors and different from that of Germany. Thus two-tier agency construct in China does not realize its effective monitoring functions to enhance corporate governance.
The final section focuses on the independent director system which is another way to mitigate the corporate conflicts. It compares the positive with the negative effects of the independent director system upon corporate governance, as well as the public and private practice in the U.S. and Canada. While in China, due to the dependent characteristics of independent directors, the empty legislative protection, and the weak legal enforcement, this system can only be regarded as an experimental attempt in Chinese corporate development and further reform is still required.
2 Literature of Corporate Governance

2.1 Framework in Developed Countries

2.1.1 Shareholder Oversight – Principal Agent Model

At the core of corporate governance is the issue of assuring the managers’ accountability to the corporation. According to the modern corporate governance hierarchy, the chain of power is as follows: managers are appointed by the board of directors, who are elected by shareholders. In the abstract, this chain of power provides shareholders, as owners of the corporation, with sufficient control to monitor management. So, why have policymakers, legislators, practitioners, and scholars devoted themselves to the research and exploration of managerial accountability to large companies for nearly one hundred years?

A simple answer is the separation of ownership and control of large corporations with their dispersed shareholders. This dispersed shareholder ownership leaves corporate managers a vacuum of control in which to pursue their own welfare at the expense of the corporation. Berle and Means analogize such shareholder and manager relation into the principal and agency theory.

---

1 Canada Business Corporations Act, R.S.C. 1985, c. C-44, [CBCA] s.102.(1) entitles directors to manage or supervise corporate affairs; CBCA s.106.(3) requires that directors are elected by shareholders.
model, and view shareholders as principals while managers as their agents. This seminal theory was advanced and soon accepted widely during the period when the high degree of share ownership dispersion marked the large industrial corporations in the U.S. in the 1920s and 1930s. The challenge of the principal-agent model is that managers are invisibly vested with “unfettered discretion” but accountability to any stakeholders except themselves.

Under the principal-agent model, agency costs arising from the gap between shareholders and managers were caused by mainly two types of managerial misbehaviours. One is diversion of corporate assets for the managers’ own welfare. Upon the separation of control from ownership, shareholders are situated further from corporate management, while managers may be expropriating corporate assets for self-interest. Another type of mismanagement is shirking “by failing to render [manager’s] maximum effort in the performance of her duties qua manager”. It involves the slack job and the safe business decisions not in pursuit of maximized profits. Quoting Berle and Means, Jeffery G. MacIntosh noted that “[m]anagers, in their view, constituted a virtually autonomous organ of the company.”

---


After nearly half of a quiet century without influencing controversy, law and economic scholars noted that besides the direct shareholder oversight, a variety of market control mechanisms also discipline managerial behaviours. The challenge of Berle and Means to agency problem is thus reconciled more by market instruments.

2.1.2 Market Mechanisms to Corporate Governance

Confronting the challenges of principal and agency corporate model, From the 1970s and 1980s, law and economics scholars advanced that capital markets, managerial labour markets, and corporate markets are helpful instruments to militate against the agency conflicts and discipline managers to maximize shareholders’ welfare. Notwithstanding this article does not focus on market control, as the realization of its monitoring role depends on corporate law as shareholder oversight does, I will mention the main functions of marketing control in the following part to make an integral corporate governance picture.

First, capital market control is of pivotal significance. If capital markets are efficient, share price will perfectly reflect all of the available public information about the corporation as a price signal. Shareholders and potential investors can count on the share price to see whether managers are doing a good job. If the share price underperforms the industry, managerial incompetence

---

6 Ibid.
might exist. Shareholders can exit or exercise their right to vote out management. In perfect capital market, all agency costs are priced into share prices. Therefore, shareholders do not bear the costs of managerial *diversion* or *shirking* because these costs were already impounded into the share price at the time of purchase.

A typical example in practice is stock exchanges which demonstrate how a vital instrument the capital market plays for capital liquidity in the whole business world. “Stock exchanges can be an important resource of corporate governance norms that are law-like in nature.” Shareholders and potential investors depend seriously on the stock exchange index to make the rational allocation of their funds. Listed corporations are even more careful about their share price movement which is a barometer to exhibit their management performance, attract potential investors, and prevent hostile takeover.

In China, however, stock exchanges are not typical example as a capital market instrument as the stock exchanges in China are not self-regulation institutions but more regulated by the government. In addition, weak legal enforcement also dulls the controlling functions of Chinese capital market. As China is in the process of emerging economies and has not fully opened its markets, market mechanism, especially capital markets, is not yet working efficiently.

---

8 Further discussion about stock exchange markets in China in the following parts.
Moreover, managerial labour markets can also directly control agency costs by imposing penalties on managerial opportunism. To the extent that managers acquire a reputation for *diversion* or *shirking*, they should expect commensurate reductions in the value of their human capital, because they will earn lower salaries in the future. Similarly, to the extent that others in the corporation aspire to be managers, there is an incentive for them to detect and report managerial misconduct. However, how and to whom to report such misconduct? Isn’t the fear of losing job going to keep them from losing job? That might just be why whistle-blower legislation came into being post Eron event. That is actually a typical example that the efficient managerial labour markets depends on the protection of corporate law.

A final way to exert market control is corporate markets – takeovers. Takeover artists identify a poorly-managed company with depressed share prices due to agency costs. They earn profits by taking it over, raise the share price through better management and, and lower the agency costs. Firms benefit even when they are not taken over, because their management team is disciplined by the threat of a takeover accompanied by losing job if they do a poor job in managing the corporation. Corporate takeovers are especially important in disciplining the managers of widely-held firms: these types of firms make particularly attractive takeover targets due to the fact that no “control premium” has to be paid to a controlling shareholder.

### 2.1.3 Role of Corporate Law
From the law and economics perspective, corporate law serves an indirect role providing legal protection for various market mechanisms to realize the controlling functions. In addition, corporate law serves a direct role facilitating, monitoring, and controlling managerial action and fills the gap between ownership and control to limit the scope of manager’s opportunism.

First, the efficient functioning of many market rules depends on the effective protection of shareholders in corporate law. For example, in front of the red flag signaling mismanagement by the various market instruments, shareholders can vote out the present management team according to corporate law protecting their voting rights.

In addition, corporate law can play an enabling role in circumstances where there is market failure as illustrated above. With respect to the enabling role, corporate law can avoid the costs of repeated negotiation and comprehensive specification. If one views the corporation as a contract between shareholders and managers, corporate law provides a “standard form contract” that saves the cost of repeated negotiations. Shareholders can adopt the standard form (as embodied in corporate statutes), or contract out the rule in some cases.

In conclusion, corporate law provides a cheap way of adopting such provisions. If markets are not efficient, there is a need for mandatory law. If the parties do not do a good job of protecting

---

shareholders, there must be regulations that corporations adopt sensible rules. Both shareholder oversight and market control mechanism require the protection from the corporate law.

2.1.4 Common Law

At the core of corporate governance in Common law is the discussion that to whom the directors and managers owe their managing duty.

In *Peoples Department Stores Inc. (Trustee of) v. Wise*,¹⁰ the Supreme Court of Canada interpreted directors’ fiduciary duty to “act honestly and in good faith with a view to the best interests of the corporation”¹¹ as a duty not owed solely to shareholders, but rather to the corporation as a whole. The duty does not shift in the vicinity of insolvency, and continues to exist only to the corporation, and not to any particular stakeholder. Directors do not have a fiduciary duty to creditors, but they may have a duty of care¹². The court rejects fiduciary duty but admits duty of care to the creditors in the *Peoples* case.

---


¹¹ See *supra* note 1, CBCA s. 122(1)(a).

¹² *Ibid*, s. 122(1)(b).
The court says that the duty directors owe is found in the statute: directors must act in the best interest of the corporation. The court held that this should not be interpreted to apply narrowly as necessarily in the interests of shareholders only. But the corporation is a legal personality. Acting in the best interests of an entity created by statute is a legal paradox: the corporation itself cannot benefit from the running of a corporation. Instead it is the stakeholders who benefit and whose interests may not be aligned.

Upon insolvency, creditors become residual claimants. However, in most cases negligent decisions will not do creditors any harm, unless it is a particularly awful business decision. Generally standing will only be granted to an individual or group of individuals who have suffered a loss or will suffer a loss as a result of a particular corporate decision. In this scenario, the court would have to determine what the loss to the individual creditor would be, which might be problematic; courts may lack general business acumen as well as the difficulty in determining what the value of the bond would have been without the corporate decision. However, unless there is a chance of insolvency, directorial negligence does not affect creditors.

The Supreme Court of Canada cites the Teck case\(^{13}\) for the proposition that it is legitimate to consider other stakeholders’ interests. However, the Teck case also cites Parke\(^{14}\), which says that the interests of the company are the interest of the shareholders. However, this has no place in the Peoples case. The Supreme Court of Canada in Peoples does not explain what the


corporation’s interests mean, but merely rejects that the interests of the corporation only means the interests of the shareholders.

The *BCE* decision\(^{15}\) is basically a reinforcement and elucidation of the decision in *Peoples*.

First, the Supreme Court of Canada appears to differentiate between the interests of shareholders, other stakeholders, and those of the corporation itself. The Supreme Court says that the duty of directors is to act in the interests of the corporation, but does not define what that duty is, or how to define the interests of the corporation. The directors could have arguably approved the transaction, or not approved it. It could have been approved because it improved the welfare of shareholders. It could not have been approved because it made creditors worse off. In the *Teck* case, there was the idea that duties extended beyond shareholders. But the Supreme Court in *BCE* offers very little guidance on what this duty actually requires of directors. The *BCE* case offers a literalist reading of the statute. The statute simply refers to a duty to the corporation, so the court does as well. The Supreme Court explicitly states that directors have a great deal of freedom in their actions, except that the corporation should act as a responsible corporate citizen. Even in a takeover situation, the duties of the directors extend to the corporation as a whole, and not to any particular stakeholder such as shareholders.

\(^{15}\) *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69, [BCE].
Second, the Supreme Court may want to enforce the fiduciary duty more carefully in some situations, for example in the case of takeovers. However, the *BCE* decision does not appear to allow a more strict enforcement, as it is not clear what “in the interests of the corporation”\(^{16}\) means. In reality, directors will respond to the interests of shareholders as shareholders elect directors. To protect a corporation, directors must spend some time looking at how a significant action might impact all stakeholders. I think directors must respond to the interests of all the stakeholders. But in the end, the responsibility of the directors is to the corporation as a whole, and to be specific, it is to the shareholders.

Third, the Supreme Court states that the corporation should act as a responsible corporate citizen. Does this require the corporation to take account of the interests of the creditors? The Supreme Court does not provide any answers. Part of the reason for the murkiness is that the court found that the board of directors did take into account the interests of the bondholders. The board ensured that the contractual rights of the creditors were respected and held meetings with the creditors to hear their concerns. But did they have a duty to the creditors? The answer is unclear – the court just refers to good corporate citizenship.

\(^{16}\) See *supra* note 11.
Actually, the traditional answer to this question is that in Anglo-Saxon jurisdictions, directors and managers owe duties to the corporation which means shareholders. And the only standard in common coherence and normality is to maximize shareholders’ wealth.

2.1.5 Conclusion

One critique is that the market mechanisms which ostensibly control agency costs in fact do not operate with the necessary degree of efficiency. Capital and product control markets do not perfectly reflect agency costs, and corporate control markets only operate above certain threshold levels of agency cost. Consequently, managers are to some extent still unfettered, and some agency costs still exist. The fact that the present system is imperfect does not mean that an alternative system would be superior. The economic model of separation between ownership and control permits specialized management and risk diversification.

2.2 Literature on China

---


18 Ibid.
Due to robust economic growth, the Chinese legal system has attracted extensive interest within domestic academia and across countries in the new millennium. As one of the main forms of business entity in the Chinese economic world, the corporation has been making great contributions to the continuing rapid economic development and the corporate performance has experienced rapid progress over the past ten years or more. Great amounts of statistics from official and private resources demonstrate that Chinese companies are much more formal and mature than ten years ago.

Institutional reform in corporate legislation started in 1994 when the first company law in China was promulgated, and then revised in October, 2006.\(^\text{19}\) SZSE was established in 1990.\(^\text{20}\) In 1998, Chinese legislators and policymakers consolidated the securities market regulations in the hands of the Chinese Securities Regulation Committee (CSRC) and enacted the Securities Law in 1999. Other main course of actions taken by the Chinese government includes the establishment of the independent director system in 2001. Following the business organization statues of developed countries, especially the German company law, and combined with Chinese special economic ecology, Chinese corporate governance is forming into a separate legal system based on civil law system.


In spite of the extensive reform in business law, different voices from domestic and overseas legal academia have never ceased criticizing the Chinese corporate legal system. The Chinese corporate governance presents a great deal of indeterminacies.

The Chinese governmental authorities are taking large-scale and active steps to cultivate and require corporations to effect corporate governance in the purpose of higher business productivity. Such big steps are regarded against the legal evolution of Darwinian Theory by some western scholars who posit that the Chinese government is not waiting to see which business institutions will survive under market competition. Since it is still within a short period of time after China opened its economic market in the nineteen-eighties and the business statutes came out merely over ten years ago, it is early to retrospect the legal evolution influencing the Chinese economic development now. But Chinese government measures per se in legal system reform to assist the economic progress are still running on the track of Darwinian Theory. The amendment of 2006 version of China’s Company Law just originated from the legal and business practice in the past ten years of implementation of the China’s Company Law 1994.

Ownership issue in corporate governance issue – agency problem also exists in China. Besides the vertical costs, horizontal conflicts between major and minor shareholders are also prevalent.

---

in China. Area Financial Report of China 2009 [2009 Zhongguo Quyu Jinrong Yunxing Baogao] released that there have been 1718 companies listed in Shanghai or Shenzhen Securities Exchanges by the end of 2009. Two-thirds of the listed companies are controlled by state-owned entities – one of the main institutional controlling shareholders. That means a large percentage of Chinese enterprises are private firms where the conflicts between major and minor shareholders are more critical. Moreover, statistics in 2009 based on the data of the first 100 listed companies in China demonstrate that the largest controlling shareholders hold 76.8 per cent shares of the company on average. That makes the horizontal conflicts even more pivotal to Chinese corporate reform.

From the law and economic perspective, Chinese stock exchanges are not yet efficient capital market in Chinese whole economic environment.

In mainland China, the two stock exchanges are Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE). “The stock exchanges in Shanghai and Shenzhen are not independent self-regulating institutions; rather, they were established by government, are protected by government, and serve governmental purposes.” SHSE and SZSE are running under the shade of the state and Chinese government has not opened the stock market


24 See supra note 7, at 176.
completely. Hence, Chinese stock exchanges are not, at least to some large extent, efficient capital market and cannot act as helpful instrument for corporate governance as discussed above.

To take the example of SHSE, the Articles of Association of SHSE 1993 states that the board of members, which is comprised of all the listed corporations (exchange-members), represents the highest authority of SHSE,\textsuperscript{25} but does not grant any specific power to the board of members. Rather, the chairman of the board of members shall be the chairman of the council\textsuperscript{26} which is the executive management organ of SHSE.\textsuperscript{27} And the chairman of the council is nominated by the government.\textsuperscript{28} In addition, the council is constituted of exchange-members and non-exchange-members,\textsuperscript{29} and non-exchange-members of the council are all nominated by the government.\textsuperscript{30} Thus, Chinese stock market has not been opened and its index is not an efficient instrument in corporate governance.

\begin{flushleft}
\textsuperscript{25} Articles of Association for Shanghai Securities Exchange 1993, [Shanghai Zhengquan Jiaoyisuo Zhangcheng], (hereinafter AASHSE 1993), art. 13.
\textsuperscript{26} Ibid, art. 16.
\textsuperscript{27} Ibid, art. 19
\textsuperscript{28} Ibid, art. 23
\textsuperscript{29} Ibid., art. 21
\textsuperscript{30} Ibid., art. 22
\end{flushleft}
3 Concentrated Shareholding in Corporate Governance – Institutional Shareholders

3.1 Ownership Concentration Theory: Dispersion-To-Concentration Construct

3.1.1 Free-Rider Problem around Vertical And Horizontal Agency Costs

To realize the controlling roles of the legal and market mechanism in corporate governance, voting rights are fashioned as the main instrument for shareholders to control the management. Shareholders need true and sufficient information to exercise their voting rights for rational decisions. But information collection generates cost. Due to a free-rider problem among shareholders, no shareholders want to bear the information-gathering cost from collective action that would enable all the shareholders to vote rationally. Particularly in a widely-held corporation, the costs of forming shareholder coalitions to bear the cost of investigation are high and the free-rider problem generally exists. Thus shareholder oversight might cause prohibitively high costs to him/herself but benefits all the shareholders of the corporation. Therefore, shareholders’ “rational apathy” cannot be mitigated through legal and marketing instruments as discussed above.

This “rational apathy” theory originated from R. C. Clark. Dispersed shareholders are apathetic to contribute time, energy, and money to monitor management where subsequent returns are

31 See supra note 5, at 152, quoting R. C. Clark, Corporate Law (Boston, Little & Brown, 1986), at 390-96.
shared with other shareholders. This free-rider problem readily leads to the consideration of concentrated ownership, which in turn should lower the agency cost. Indeed, the separation of ownership and control and the incidental agency conflicts are just the results of the growing ownership dispersion. From the early twentieth century, private firms with limited shareholders started to dilate into publicly-held corporations with dispersed investors through capital exchange and the agency conflicts turn to be serious. The regression to concentrated shareholding transforms the vertical agency costs from the threat of the exploitation of shareholders by managers into the horizontal costs from the threat of the exploitation of minority shareholders by majority shareholders.  

Quoting Randall Peerenboom, D. C. Clarke posits that:  

mitigating one kind of agency cost may mean increasing the other. Dispersed shareholding, for example, can lead to high vertical agency costs, because collective-action problems make it hard for shareholders to monitor management. But one solution—concentrated shareholdings—may result in higher horizontal agency costs.

32 See Donald C. Clarke, “The Ecology of Corporate Governance in China”, [2008], The George Washington University Law School, Public Law and Legal Theory Working Paper, No. 433, at 4; also see supra note 5, at 155, about the discussion of conflict axis changes from manager against shareholder to controlling shareholder against minority shareholder.

3.1.2 How to Minimize the *Horizontal* And *Vertical* Agency Costs?

Based on the theory discussed above, at the core of corporate governance is how to mitigate the horizontal and vertical agency conflicts on both sides.

From the law and economic perspective, to solve the free-rider problem that shareholders are reluctant to bear the controlling *vertical* agency costs – rational apathy, is to control them up to the point where the marginal cost of control equals the marginal benefit of control to the shareholder. The ideal situation is where the benefits of agency just exceed the costs. Referring to corporation governance, in the abstract, this function of costs to benefits to shareholders in collective action can be applied to pursue the ideal point where the *vertical* costs and the *horizontal* costs are reconciled in an even balance. That is corporate governance reaches the ideal situation that vertical and horizontal costs are minimized.

In a utopian business unit, there is a balanced point in the ownership span between dispersion and concentration where corporate governance reaches the most ideal level for the goal of the corporation. The more dispersed, the higher *vertical* agency cost; the more concentrated, the higher *horizontal* agency cost.\textsuperscript{34} Along the direction of ownership dispersion, *vertical* costs from

\textsuperscript{34} This ownership span is not an unlimited X axis. In stock market, countless investors are allowed to enter into public companies as shareholders and there is no limit of the number of shareholders to a certain company. On the other hand, the minimum number of shareholders in a public company is not unlimited. That can be one-person
agency conflicts increase continuously till the “highest” point and the management is completely out of shareholders’ control. On the other side, when shareholder ownership is completely concentrated, which is the one-person company, *vertical* agency problem disappears. The majority shareholder interest thus reaches the maximum, as there is only one shareholder. Therefore, locating the balancing level between dispersion and concentration is just the goal of corporate governance.

In practice, however, it is hard to locate the balancing point in the dispersion-to-concentration span of shareholder ownership, or it is impossible to realize perfect corporate governance, because there are a great number of unstable and uncontrollable factors influencing the corporation. For example, the ownership structure of a public corporation is in fluctuation at any moment in the stock market. Moreover, shareholders have different oversight capabilities in corporate governance. In addition, influence from market control mechanism is always changing and unpredictable. In short, achieving the optimal corporate governance in the capricious corporate ecology turns to be infeasible. As a result, legislators, courts, practitioners, and scholars take various attempts to find ways in an effort for more rational corporate governance. Two-tier corporate model and independent director system are both practical ways to enhance corporate governance.

35 *Ibid.* This is a virtual point that does not exist.
3.2 Theoretical Analysis of Institutional Shareholding

Institutional shareholders, in corporate academia, usually refer to those financial units with investment in a corporation. In this article, the discussion of institution shareholders includes those business organizations and financial units, which are meant to distinguish from the individual shareholders.

3.2.1 The Positive Edge of The Sword

Large institutional shareholders may have better incentives to monitor the management at least due to two reasons. First, based on one-share-one-vote policy, holding larger stake exerts greater influence on voting results. Second, the ratio of monitoring cost to its benefits is lower. From one hand, the monitoring costs are lower. Due to fewer shareholders with concentrated ownership, coordination costs among shareholders are reduced. Besides that, the other monitoring costs are relatively fixed.36 So, the total monitoring costs are reduced. On the other hand, the incidental benefits from monitoring costs increase in proportion to the holding stake. Thus the net worth of large institutional shareholders from their monitoring the management is increased. Third, since the large shareholding, large institutional shareholders would lose a great deal from mismanagement, they are more willing to exercise their managerial oversight power over poor

36 See supra note 5, at 154.
Therefore, greater power in voting decisions and the higher benefits from collective action constitute better incentives for large institutional shareholders’ contribution to monitoring the management.

### 3.2.2 The Negative Edge of The Sword

First of all, besides expropriating minority shareholders, controlling shareholders might lower the corporate efficiency. Empirical studies prove that when shareholder rights are weak – controlling shareholder conducts are relatively unchecked, shareholder ownership tends to be more concentrated.\(^{38}\) This is because due to the lack of strong control of shareholder rights, controlling shareholders can exploit more from the corporation. In addition, studies also show that corporation values are lower when shareholder rights are weak or relatively unchecked.\(^{39}\) That means controlling shareholder expropriation does more than just damage to minority shareholders, it might also impair the corporate governance.

Secondly, pursuit of non-monetary return by individual controlling shareholders may impair the corporation. Controlling shareholders may seek to harvest more than monetary returns from the corporation.

---

\(^{37}\) Ibid, at 155.

\(^{38}\) See supra note 3, at 606, quoting Rafael La Porta \textit{et al}, in “Corporate Ownership Around the World” (1999) 54 \textit{J. Fin.} 471.

corporation. They might pursue psychic returns as well,\textsuperscript{40} such as the hunger of power, desire to control the destinies of others, seek of fame, etc. Monetary return interests may allocate a larger corporate pie to controlling shareholder at the expense of minority shareholders while psychic return pursuit may make the whole corporate pie smaller at the expense of the corporation. These “side effects” of individual controlling shareholders are hard to avoid in corporate governance.

Thirdly, institutional shareholders are not exempted from being free-ridden, when more than one institution holds shares of the same corporation.\textsuperscript{41} Along the dispersion-to-concentration span, the existence of several institutional shareholders still represents dispersion. Within this “group” dispersion – dispersed by institutions, the incentive to engage in active monitoring is suppressed unless a “bigger” institutional shareholder outweights in the ownership of the whole corporate pie compared with the other institutional shareholders. That means it holds a larger percentage of the shares than the other institutional shareholders and hence stands to get more return from active monitoring.\textsuperscript{42}

Nonetheless, more than one institutional shareholder generally do not constitute free rider problem in China. That is because the Chinese institutional shareholders are more of governmental units who are usually overweighted in a particular corporation ownership.

\textsuperscript{40} See supra note 5, at 156.
\textsuperscript{41} Ibid, at 158.
In addition, different from individual shareholders, institutional shareholders confront fiduciary conflicts of interests. All corporate directors owe the fiduciary duties to the corporations they serve. On the other hand, a fiduciary director of the institutional shareholder also holds fiduciary responsibilities to act in the best interests of the invested corporation. When the fiduciary responsibilities to the investor and the invested corporation are incompatible, fiduciary conflicts of interest arise. This is one of the concerns of which the institutional shareholders consider to determine the assignment of directors and managers sitting on the board of their invested corporations.

Indeed, these fiduciary conflicts of interests are more serious in public corporations in China. As many Chinese public corporations have controlling shareholders representing the government, most public corporations are under the management with serious fiduciary conflicts of interest. The assigned directors and managers by the governmental institutional shareholders perform their corporate management first to the best interests of the institutional shareholders who play the multiple roles of the government. This multi-purposes include public interests, politics, labour, etc.. Under the fiduciary conflicts of interests, institutional directors sitting on the board of the invested corporation might sacrifice the interest of the corporation while perform their monitoring duties to the institutional shareholders.

43 See supra note 5, at 161.
44 See supra note 1, CBCA s. 122.
45 See supra note 5, at 146, quoting K.E. Montgomery and D.S.R. Leighton, "The unseen revolution is here" (1993).
3.3 Situations in Various Countries

Concentrated ownership in corporate governance has been an attractive topic to corporate scholars across countries. In Canada, the institutional shareholding has been experiencing staggering growth since the 1970s. While in China, concentrated ownership is regarded as the most critical issue in Chinese corporate governance. Large percentage of institutional shareholding by the direct and indirect state shareholders brands into Chinese corporations.

3.3.1 Canada

Controlling shareholder is common in Canadian corporations. Following the U.S. counterparts, Canadian policymakers adopt proxy voting to improve corporate governance.

The Canadian institutional market has been growing at the expense of the retail market in the past decades and it is pervasive that Canadian corporations have controlling shareholders.

46 Ibid., at 146, based on statistics collected from the Bank of Canada.

The biggest institutional shareholders include trusteeed pension plans, life insurance companies, and mutual funds.\textsuperscript{50}

First, more people choose to invest in financial institutions rather than making direct investments. Also, the average investment in financial institutions increases while the average retail investment shrinks. In addition, more retirement savings are placed in financial institutions.

La Porta et al find that concentrated ownership construct which prevails in Canada is the norm. Daniels and MacIntosh subsequently suggest that “in Canada, corporate disputes will more often consist of minority/controlling shareholder disputes than shareholder/manager disputes.”\textsuperscript{51}

Therefore, Canadian corporations commonly have controlling shareholders, particularly institutional controlling shareholders. Both the vertical and the horizontal agency conflicts exist in Canadian corporate governance, while the disputes between minority and majority shareholders are more serious.

\textsuperscript{48} See supra note 5, at 151.

\textsuperscript{49} See supra note 3, at 601.

\textsuperscript{50} See supra note 5, at 152, quoting R. C. Clark, \textit{Corporate Law} (Boston, Little & Brown, 1986), at 149.

3.3.2 The U.S.

In the U.S., large capital markets are mostly dominated by widely held companies and the main agency cost comes from the vertical conflicts.\textsuperscript{52}

3.3.3 China

In transitional economies of the rest of the world, horizontal costs dominate.\textsuperscript{53} China is not exceptional to this pattern. Nonetheless, its exceptional nature is the governmental entity of the institutional shareholders. Chinese public companies are typically controlled by a few large shareholders who usually hold unlisted state shares or legal person shares, while the minority shareholders holding listed shares.\textsuperscript{54}

\footnotesize

\textsuperscript{52} See \textit{supra} note 3, at 602; also see \textit{supra} note 32, at 4.

\textsuperscript{53} Rafael \textit{at al.}, “Corporate Ownership Around the World”, Harvard Institute of Economics, Research Paper No. 1840, [August 1998], contents of abstract; also see \textit{supra} note 32, at 4.

\textsuperscript{54} See \textit{supra} note 7, at 170.
Indeed, most public companies in China were derived from state-owned enterprises (SOEs).\textsuperscript{55} Although the share issue privatization (SIP) started in the 1990s, institutional-controlling shareholder phenomena in listed companies are still widespread now.\textsuperscript{56} SIP means the government sells shares of the SOEs to the private investors through IPOs. It has been the most prevalent channel for privatization of Chinese corporations and evidently successful in improving the corporate governance and productivity in China.\textsuperscript{57} After IPO the listed company shall be peeled off from the SOEs. In practice, nonetheless, it turns to be still controlled by the former parent entities which are called institutional-controlling shareholder. That means the ownership transition from the SOEs to the SIPs (companies after SIP) does not result in effective corporate transition from the state to the private sectors. Therefore, the governmental institutional shareholders still represent the concentrated ownership in Chinese corporations.\textsuperscript{58}


\textsuperscript{57} \textit{Ibid}. see the content of the introduction part.

\textsuperscript{58} Since it is still the early stage of the corporate reform, the SIPs in China might be regarded as experimental and need further reform.
With this governmental institutional shareholding, state representative directors and managers are harder to be displaced under the mechanism of hostile takeovers or proxy contests. Hence, besides their multi-goals serving the government as well as the corporation with the fiduciary conflicts of interests, governmental directors and managers might also consume private benefits from managerial control without fear of being replaced.\textsuperscript{59} That makes the corporate governance in Chinese public corporations more complicated and thus leaves big monitoring space for the governmental directors and managers.

Consequently, it is always regarded that the main corporate governance issue in China is how to completely get rid of the control of the government. That is also what the Chinese government is pursuing in its transitional economy. Going to the public to obtain dispersed shareholdings is one of the effective ways for Chinese corporations to peel off from the government.

However, government interference might not be completely wrong. For example, due to the issue of environment protection, government-oriented corporations might turn to business decisions for the public interests, and environment issue could receive more regards and be better protected.\textsuperscript{60} Also, the global financial crisis advent since 2007 leads to a resurgence in Keynesian economics which advocates the role of the government. On the other hand, the emerging market economy under some degree of public sector control in China has boosted a

\textsuperscript{59} See supra note 3, at 605.

\textsuperscript{60} Most generalizations admit of exceptions. In the Dodge v. Ford Motor Company, 204 Mich.459, 170 N.W.668, 3 A.L.R.413(1919), Ford directors made the business decisions to create more jobs and sell cars at lower price, and the corporation is dedicated to the social welfare.
great economic progress. Thus, government interference in corporate governance is still under discussion in both developed countries and China.

Besides the purpose to get expanded capital resources and to break loose till completely separated from the governmental control, going to the public stock exchanges is also helpful for Chinese corporations to obtain better corporate monitoring. That is because listed corporations are required to disclose the necessary corporate information to shareholders as well as the potential shareholders. As private corporations lack strict legal enforcement in China, the transparent and objective information disclosure required by the dispersed shareholders is particularly beneficial for corporations to keep effective corporate governance.

To give an example of a Chinese initial public offer with the purpose of public discipline by the dispersed shareholders: New Oriental Education and Technology, the biggest private education corporation in China, went to public on NYSE in 2006.\(^{61}\) This is a typical educational institution in language training without any financial problem in corporate operation, as they have good cash flow from their thousands of students having great dreams to learn English across the country. However, this company still pursued IPO after more than ten years of profitable running just for the purpose of the open and public information disclosure, which is unanimously regarded as the best way to discipline the corporate governance by the New Oriental board and management.

As to the studies of shareholding structure in China, there are still great gap in data collection. For example, the ratio of the institution shareholder’s assets to the assets in the public corporations, the average institutional shareholding percentage of a public corporation, etc.. More working data collection is critically required for the concentrated shareholding studies in China.
4 Two-tier System in Corporate Governance – Management Board and Supervisory Board

A practical attempt to improve corporate governance is the two-tier corporate system. This is a pervasive and typical corporate structure in Germany. As Chinese legal system has been mostly following the legal system of Germany in its civil law exploration and development, Chinese corporate scheme also applies the two-tier model. However, such corporate model is different from the German construct due to the various practical grounds.

4.1 Two-Tier Agency Model Theory

Under the principal-agent theory, corporate governance in developed countries takes two different forms: one-tier and two-tier governance structure. The one-tier board system refers to the single board of directors elected from and by the shareholders. The board of directors represents the interest of the shareholders and implements the managerial functions for the corporation. Many common law countries apply the one-tier structure such as the U.S., Canada, the U.K.

---

62 Under one-tier agency model, it is usually called the board of directors, and in the two-tier model jurisdiction, it is mostly addressed the management board. In China, although two-tier model is applied, it is called the board of directors because of its empty structure and the impotence in corporate oversight.

63 Independent directors are complementary capacities to complete the one-tier agency model.
The two-tier principal agent scheme extends the single-tier theory into the management board and the supervisory board. The supervisory board is composed of shareholder and employee representatives. It appoints the members of the management board and monitors their management behaviours. It acts as a principal of the corporation and also as an agent of the shareholders. Hence, the two-tier agency model is a vertical hierarchy in German law and the “[c]o-determination between shareholders and employees on the supervisory board” features the two-tier corporate governance scheme. In the Anglo-Saxon jurisdictions, corporate governance scheme focuses on the maximization of the shareholders’ interests, while the German legislation aims to maximize the interests of the various stakeholders. The two-tier agency model is prevalent in civil law jurisdictions with the vanguard of Germany.

4.2 Corporate Supervision in China

Chinese corporate law does not provide sufficient protection for shareholders to monitor managers as Canadian statutes allow. Different from Canadian legal scheme and following German statute, Chinese company law establishes the supervisory board [jianshi hui] to fortify the monitoring function. However, this legislative design turns to be a decorative organ in the corporate governance reform.


65 Marc Goergen et al, “Recent Developments in German Corporate Governance”, International Review of Law and Economics, Vol. 28, Iss. 3, [September 2008], at 175.

66 Ibid.
Following German legislation, Chinese corporate law applies the two-tier governance scheme. All public corporations are required to have a supervisory board [jianshi hui] which shall contain at least three supervisory members. In addition, the number of employee representatives shall not be lower than one third of the whole supervisory board.

However, the Chinese supervisory board [jianshi hui] does not realize effective monitoring function. It is a horizontal two-tier governance structure different from the stereotypical model in Germany. In addition, the Chinese legislation does not grant any substantive power of managing and monitoring function to the supervisory board [jianshi hui].

First of all, the Chinese two-tier agency model takes the form of horizontal two-tier pattern. Although the supervisory board [jianshi hui] in China is also composed of shareholder and employee representatives, the employee representatives are elected by the workers congress, an organization that does not hold any power in managing or monitoring the corporation. In German jurisdiction, the management board is appointed by the supervisory board and reports to it, while the Chinese board of directors is elected directly by the shareholders. That places the supervisory board [jianshi hui] and the board of directors on a parallel level, rather than a vertical monitoring function.

---

67 See The China’s Company Law 2006, ss.118.(1).
68 Ibid., ss.118.(2).
69 Ibid; Workers Congress is the Chinese traditional organization on behalf of the working staff. Most Chinese social entities, no matter the business units or the non-profit organizations have Workers Congress to protect the interests of the working staff.
hierarchy. Only the shareholders have the power and incentives to supervise the board of directors, while the supervisory board has no power in monitoring. Thus the Chinese supervisory corporate structure is substantially more close to the single-tier agency model of Anglo-Saxon jurisdictions though in the form of two-tier structure.

Furthermore, Chinese legislation provides few regulations about the supervisory board. Under the Company Law 2006, the supervisory board may attend the board meetings.\textsuperscript{70} Regarding the “monitoring” functions to the board of directors, Chinese statute merely grants the supervisory board the power of inquiry and proposal.\textsuperscript{71} It is like to lay the supervisory board onto the high shelf as a “vase”.

With the weak legal infrastructure, the Chinese horizontal two-tier agency model consequently leads to the monitoring incapacity of the supervisory board \([jianshi hui]\). Notwithstanding the Chinese public corporations are required to have supervisory boards \([jianshi hui]\) by statute, studies show that over half of the companies maintained the supervisory boards with only the minimum number (three) of members.\textsuperscript{72} In result, Chinese public corporations are actually “saddled with a poorly thought-out structure”\textsuperscript{73} – two-tier agency model – under which the supervisory board does not make the corporate oversight capacity any more or less effective.

\textsuperscript{70} Ibid, ss.55.(1).
\textsuperscript{71} Ibid, ss.55.(1)
\textsuperscript{72} See supra note 7, at 175, quoting Ling and Dong report.
\textsuperscript{73} See supra note 7, at 175.
5 Independent Director System in Corporate Governance

Starting from the corporate theories, both the concentrated ownership scheme and the two-tier agency construct are legal development in corporate governance. In addition, another practical exploration in corporate governance is the independent director system which has been more accepted and applied in various developed countries as well as China.

A significant recent reform to solve corporate governance problems is the requirement that boards include a minimum number of independent directors. Legislators, regulators, practitioners, scholars, and courts place great significance on director independence which is regarded as an effective tool to shore up corporate governance and increase the board oversight function. Independent directors are deemed a type of “gatekeeper” to evaluate and criticize management behaviours for the goals of the corporation.

5.1 Theoretical Analysis of Independent Director System

Independent director system is designed to solve the problems of corporate governance. The primary function of independent directors is to mitigate the conflicts between the shareholders and the management, which lead to the vertical costs, and to restrict the abuse of power against minority shareholders by the majority shareholders, which brings out the horizontal costs.

---

5.1.1 The Argument in Favour of Independent Director System

First, due to the “independent” characteristic, independent directors do not hold any interests of the corporations and can mitigate the conflicts between majority and minority shareholders. On the other hand, they are not management team member or employee of the corporation. There is no rational apathy threat of the independent directors. Such independent authority shall be helpful to reduce the corporate agency cost.

The secondary function of independent directors is to provide objective managerial consultation. Most independent directors are experts with prominent managing experience and good reputation in the cognate area. Their wealth of working experience and knowledge are deemed a type of intangible assets to the corporation. Their consultation can form rational managerial decisions for the corporation.

Therefore, the independent director system can mitigate the corporate governance problems in reducing both vertical and horizontal costs. In addition, independent directors are the intangible wealth in managerial consultation for the corporation.

75 See supra note 7, at 172, discussion the contents of the footnote.
5.1.2 The Argument against Independent Director System

There are mainly three reasons which weaken the monitoring functions of the independent directors.

First, the way to create the independent directors makes them not that independent even in legally and economically developed jurisdictions, because the independent directors are nominated by the shareholders through shareholder meetings. The one-share-one-vote policy readily results in satisfying the large shareholders outvoting the minority shareholders. Being created by the shareholders makes the independent directors still fettered, at least influenced, by the power of majority shareholders. Thus the independent director system may not be able to reduce the horizontal costs as effectively as designed.

Second, considering the methods to realize the monitoring functions, independent directors are imagined, in the abstract, to play the role of establishing the external regulations to discipline the corporation. For example, due to the deference of business judgment rule, courts usually do not get deeply involved in business activities by the corporate management. Thus the corporate decisions made by the board with the independent directors are regarded as external regulations established by objective authority. Nonetheless, that makes no difference of such decisions or regulations from those made by a board without independent directors. Courts to some extent respect the decisions of the board of directors because the board represents the corporation from

\[\text{See supra note 7, at 152-53.}\]
the business perspective, rather than the existence of the independent directors. In short, confronting the deference of business judgment rule, independent directors cannot reinforce their business and managerial decisions compared with those made by the “inside” directors (non-independent directors).

However, when the business decisions made by the “inside” directors are deemed the regulations respected by the court, those made by the independent directors can be regarded as external regulations also respected by the court. In front of business judgment rule, these decisions and regulations have no difference before the court.

Similarly, independent directors are conceived as implementer of external regulations or consultants. As experts, independent directors provide some certification, such as the examination and approval of annual financial statements. They might also be requested of managerial advice. Such certification and managerial advice are ostensibly reassuring because of the independent directors do not hold any interest to the corporation. However, how about the certification or the consultation coming from some external financial experts or an outsourcing professional firm? The latter option should be more convincible, reputable, and reliable. Therefore, the role of independent directors as implementers of external regulations lacks of the apparent advantages over outsourcing parties to the corporation.

Finally, the identity of true independence is of critical inquiry. The independent directors receiving financial returns from the corporation does not make them much different from the

---

77 See supra note 7, at 152-53 and 172.
78 See supra note 74, at 456.
management team getting salary through their work. Remunerations to the independent directors by the corporation is accepted and common in both developed countries and China. It is called director fees or pension in developed countries and remuneration in China.\(^79\) This financial relationship apparently dyes the “independent” role with dependent colour of the corporation against the purpose of its policymakers.

In conclusion, the independent directors are elected and pointed by the shareholders and have a born relationship with the shareholders. In addition, as external regulators and implementers, independent directors do not practice more effective functions in contrast to inside directors (non-independent directors) or outsourcing parties. Finally, financial returns from the corporation make the “independent” directors not independent.

5.1.3 Conclusion

In dependent director system is a double edged sword. From one hand, independent director system helps to reduce both the vertical and horizontal costs of the corporation. In addition, independent directors provide rational managerial and business consultation to the corporation. On the other hand, it is hard for independent directors to play an effective role in solving the corporate governance problems. Independent directors are, at least to some extent, fettered by

\(^79\) Remuneration to independent directors is widely accepted in China, but there is no legislation about this issue. In practice, remuneration in China is mostly in fixed amount regardless of the corporation performance. Further discussion in the following part.
large shareholders. Neither can they demonstrate advantages over “inside” directors (non-independent directors) in front of business judgment rule, or over outsourcing parties in providing optimal corporate decision for the goals of the corporation. Furthermore, getting remuneration from the corporation makes “independent” directors dependent parties to the corporation.

5.2 Literature of Independent Director System in Developed Countries

5.2.1 Statutory Law in The U.S.

In the 1990s, large-scale mergers and acquisitions in the U.S. stood out the role of independent directors in the boardrooms of public corporations. In the wake of corporate scandals including Enron and WorldCom, independent directors sitting on boards were required of listed corporations by policymakers in some developed countries.

In 2002, the Sarbanes-Oxley Act (SOX) came into being as a set of new and enhanced standards for all the publicly-held corporations in the U.S.. SOX 2002 requires the listed corporations to
constitute a board with independent directors.\textsuperscript{80} Under SOX, the audit committee of listed corporations must be constituted entirely by the independent directors.\textsuperscript{81} In addition, SOX prohibits the independent director to accept any compensatory fees (excluding director fee) from the listed company and its affiliated entities.\textsuperscript{82}

In this regard, the securities exchange markets in the U.S. provide individual rules for listed companies about independent directors in accordance with those of SOX. The New York Stock Exchange (NYSE) requires a majority of independent directors of the boards.\textsuperscript{83} The NYSE rules also require the audit committee, the nominating/corporation governance committee, and the compensation committee comprised entirely of independent directors.\textsuperscript{84} The NYSE rules take the standard of “material relationship” to test the qualification of director independence.\textsuperscript{85} Material relationships include working for the listed company in the previous three years; having an immediate family member who was an executive officer of the listed company in those years; receiving direct compensation of over $100,000 except directors’ fees and pensions in any twelve-month period in those years; working for company’s auditor; serving as an executive officer of any other company whose compensation committee contains the present executive officer.

\textsuperscript{80} See \textit{supra} note 7, at 127-28; Also see Marc I. Steingberg & Matthew D. Bivona, 'Disney' Goes Goofy: Agency, Delegation & Corporate Governance (April 17, 2008), \textit{SMU Dedman School of Law Legal Studies Research Paper No. 00-39}, at 38.

\textsuperscript{81} \textit{See Securities Exchange Act of 1934} § 10A(m)(3)(A),\textsuperscript{81} \textit{Ibid}, § 10A(m)(3)(B); Chinese regulation about independent directors does not pour any ink to the compensation issue. Further discussion in the following part.


\textsuperscript{84} \textit{Ibid}, §§ 303A.04(a), 303A.05, 303A.07(b).

\textsuperscript{85} \textit{Ibid}, §§ 303A.02(a).
officer of such listed company; and being employed by a company which paid to or was paid by the present company within the previous three years if those payments were over $1,000,000 or 2 per cent of the present company’s consolidated gross revenues. Immediate family members of independent directors are also required to meet such criteria.\textsuperscript{86}

Under the NASDAQ Stock Market (NASDAQ) rules, independent directors shall constitute a majority of the board of listed companies,\textsuperscript{87} and the audit committee and the compensation committee are required to be comprised entirely of independent directors.\textsuperscript{88} As to the definition of independent directors and the relevant requirement, the NASDAQ rules apply similar criteria to those of NYSE.\textsuperscript{89} The NASDAQ rules require, in accordance with those of NYSE, that the independent directors be present at any executive meeting of the board.\textsuperscript{90}

\textbf{5.2.2 Statutory Law in Canada}

Canadian securities regulation also contains the requirements of independent directors of listed companies. The corporate governance guidelines in Canada are similar in substance to the listing

\textsuperscript{86} Ibid, §§ 303A.02(b).
\textsuperscript{87} NASDAQ, Inc., Manual Rule 4350(c) (2003).
\textsuperscript{88} Ibid, 4350(c)(3), (d).
\textsuperscript{89} Ibid, 4200(a)(15).
\textsuperscript{90} See supra note 80, §§ 303A.03; also see supra note 84, 4350(c)(2).
standards of NYSE and reflect current North American practices in corporate governance. Under Canadian securities rules, an independent director is the director who has no direct or indirect material relationship with the corporation. A material relationship refers to the person who could “in the view of the issuer’s board, be reasonable expected to interfere with the exercise of a member’s independent judgment.” 91 Similarly with the SOX, the CNI also requires the following committees of the board of listed companies to be comprised solely of independent directors: the audit committees, the nominating/corporate committees, and the compensation committees. 92 Indeed, boards of directors in Canada now generally establish special committees of independent directors to deal with specific transactions to lessen the possibility of damaging conflicts of interest. 93

5.2.3 Common Law

Except for financial and familial relationship, nonetheless, the legislations and regulations in the U.S. and Canada do not preclude the social ties with the corporation which might militate to the director’s independence. The Disney case in 2003 exposed the serious risk to the corporation of personal friendships between directors and the management team. 94 The CEO of Disney, Michael Eisner, appointed Michael Ovitz as the president, who had a close friendship with him

92 Ibid.
93 Glen Johnson & Leslie McCallum, Course Book for Securities Regulation 2010, at 400.
94 In Re Walt Disney Co. Derivative Litig., 825 A.2d, at 275 (Del. Ch. 2003).
for more than twenty-five years. Eisner breached his fiduciary duty twice in this case. He first offered a handsome employment contract to Ovitz. One year later, he again offered Ovitz a generous severance package.\textsuperscript{95} This social relation does not breach the regulation of the U.S. corporate statutes and the NYSE rules but seriously impaired the corporate governance of the corporation.

5.3 The Application of Independent Director System in China

This increasingly application of independent director system in developed countries has not gone unnoticed by Chinese government. In order to satisfy the fast economic development, the Chinese government has been trying the independent director system to improve the corporate governance on its progressing legal road.

5.3.1 Definition of Independent Director

Independent director has many different definitions and also implies different terms with the same meaning of “non-management” director across countries.\textsuperscript{96} The independent director legal system in China was established when the Chinese Securities Regulation Committee (CSRC),

\textsuperscript{95} Ibid, at 279, 282-83.

\textsuperscript{96} See supra note 7, at 150-51.

Section 1.(1) of *The Guidance Opinion* stipulates that “an independent director is a person who does not hold any other position in the company and does not have relations with either the company or major shareholders that could impede his own judgment.”  

Section 3 of *The Guidance Opinion* states a list of affiliated people who cannot assume the office of independent directors.  

It requires the independent characteristics of the independent directors. Any persons with the following conditions cannot assume the office of independent directors:

1. Persons who work at the listed company or its affiliating companies, such persons’ direct relatives, and the persons who have social relationship with such persons. (Direct relatives refer to spouses, parents, children, etc.; social relationship refers to the relation between siblings, parents-in-law, children-in-law, siblings-in-law, etc.);

2. Natural persons who directly or indirectly hold not less than 1 per cent of the outstanding shares, or who are listed among the ten largest shareholders of the listed company, and such persons’ direct relatives;

---

97 See *supra* note 7, at 128; also see *infra* note 98.
99 *Ibid*, see *the Guidance Opinion*. 
(3) Institutions who directly or indirectly hold no less than 5 per cent of the outstanding shares, or who are listed among the five largest institutional shareholders of the listed company, the persons who work in such institutions, and such persons’ direct relatives;

(4) Any persons who have the above circumstance in the latest last year;

(5) Persons who provide financial, legal, or other consulting services to the listed company or any affiliates of such listed company;

(6) Other persons stated by the company articles; and

(7) Other persons stated by the Chinese Securities Regulation Committee.

Therefore, Chinese policymakers have formally established the independent director system which is especially designed to increase the monitoring function of controlling board of directors.

5.3.2 The Way to Create Independent Directors

According to the Chinese statute, the independent directors are nominated by large shareholders and elected by the shareholder meeting. The Guidance Opinion stipulates that “board of directors, supervisory board, and shareholders holding individually or jointly 1 per cent of the
outstanding shares of the listed company have the right to nominate candidates of independent directors who shall finally be selected by the shareholder meeting.” Thus the independent directors are “born” related with the larger shareholders and represent their rights. However, the independent director system is designed to reduce the agency costs of director/manager and minority/majority conflicts. Under the current way of creating the independent directors, they are actually “born” with dependent characteristics.

5.3.3 “Dependent Ties” of Independent Directors

Compared to the corresponding legislation and policies of the U.S. and Canada, which provide detailed restriction on independent director remunerations, neither CRSC rules nor the China’s Company Law 2006 pour any ink on the financial returns of independent directors. The current practice in China is that independent directors get fixed annual remunerations regardless of the company performance. This fixed allowance is harmless to keep the characteristics of independence and advance the objective corporate oversight, but might be detrimental to motivate the monitoring work of the independent directors.

---

100 Ibid, Section 4. (1).
5.3.4 Statutory Power of Independent Directors

Chinese legislation neither grants substantive power to independent directors, nor provides any prescription about the procedures for practical abidance. The only statute about the independent directors’ power says that “[a] listed company shall have independent directors, the specific method of which shall be determined by the State Council.” 102 The State Council has not promulgated regulations about independent directors till now.

The Chinese legislation does require the listed companies to establish the independent directors. But the empty statutory prescription makes the independent directors “decorative players” in a corporation. In result, the independent directors in China normally only attend the board meeting once a year, or sometimes even never attend any corporate meeting. 103 They are merely regarded as a type of reputation representing the company to the outside world. "I have never thought that the independent director is the protector of medium and small shareholders; never think that. My job is first and foremost to protect the interests of the large shareholder, because the large shareholder is the state." 104

102 See supra note 17, article 123.

103 See supra note 7, at 171-72.

104 See supra note 7, at 171-72, quoting in the notes discussing “Are Independent Directors Just Decorative?” by Xiang Bing.
6 Conclusion

This article compares the various attempts to enhance corporate governance. Based on the principal-agent model, it explores the concentrated ownership, the two-tier agency construct, and the independent director system, which are all designed to mitigate the corporate agency conflicts and improve the corporate management.

Along the dispersion-to-concentration ownership span, corporations in the U.S. are dominated by more serious vertical agency conflicts, as most of them are owned by highly dispersed shareholders. A different situation has been demonstrated in Canada that institutional shareholders dominate the public corporations and conflicts between majority and minority shareholders are the main corporate governance issue. While in China, corporate governance forms a different situation, as most of the public corporations are controlled by the governmental institutional shareholders. Further reform for the Chinese corporations to peel off from their parent corporations is still required. In the attempt to the two-tier agency model, China follows the vanguard of Germany to establish the supervisory board. Nonetheless, it is designed on a horizontal level with the board of directors and cannot realize effective supervision functions. Chinese policymakers have also been trying the independent director system. However, due to the dependent characteristics, the empty legislative protection, and the weak legal enforcement, independent directors, independent director system is still regarded as a decoration of corporation governance in China.
Bibliography

Legislation


*Articles of Association for Shanghai Securities Exchange 1993*, [Shanghai Zhengquan Jiaoyisuo Zhangcheng 1993],

*Securities Exchange Act of 1934*

*NYSE, Inc., Listed Company Manual*

*NASDAQ, Inc., Manual Rule*

*Canadian National Instrument*


Jurisprudence


*BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69


In *Re Walt Disney Co. Derivative Litig.*, 825 A.2d, at 275 (Del. Ch. 2003)

Secondary Material: Monographs


R. C. Clark, *Corporate Law* (Boston, Little & Brown, 1986)


Glen Johnson & Leslie McCallum, *Course Book for Securities Regulation* 2010

**Secondary Material: Articles**


Donald. C. Clarke, “The Director in Chinese Corporate Governance”, *Delaware Journal of Corporate Law*, [2006], vol. 31


Rafael La Porta et al., “Corporate Ownership Around the World” (1999) 54 *J. Fin. 471*

Rafael La Porta et al., “Investor Protection and Corporate Valuation” (2002) 57 *J. Fin. 1147*


K.E. Montgomery and D.S.R. Leighton, “The unseen revolution is here” (1993)

Ronald J. Daniels and Jeffrey G. MacIntosh, “Toward a Distinctive Canadian Corporate Law Regime” (1992) 29 *Osgoode Hall L. J. 863*


Patrick Velte, “The Link between Supervisory Board Reporting and Firm Performance in Germany and Australia”, *Eur J Law Econ*, vol.29, [2010]

Marc Goergen *et al.*, “Recent Developments in German Corporate Governance”, *International Review of Law and Economics*, Vol. 28, Iss. 3, [September 2008]


Xiang Bing, “Are Independent Directors Just Decorative?”

**Other Material**

“The Shanghai Stock Exchanges Established”, New Peking News at SinaNews


“New Oriental IPO at NYSE”, Sina Technology News, Sina.com