

## TABLE OF CONTENTS

ABSTRACT .....	iii
ACKNOWLEDGMENT .....	iv
TABLE OF CONTENTS .....	v
LIST OF TABLES AND FIGURES.....	ix
CHAPTER 1: INTRODUCTION.....	1
1.1 Introduction .....	1
1.2 Evolution of Corporate Governance and Independent Directors .....	3
1.2.1 The United States .....	9
1.2.2 New Zealand .....	13
1.2.3 China .....	16
1.3 Objectives of the Research .....	22
1.4 Scope and Contribution of the Research .....	23
1.5 Structure of the Research .....	24
1.6 Restraint of the Research .....	25
CHAPTER 2: THEORIES AND EMPIRICAL STUDIES .....	26
2.1 Introduction .....	26
2.2 Corporate Governance and Corporate Control .....	26
2.2.1 Definition of Corporate Governance and Independent Directors .....	26
Corporate Governance .....	27
Independent Directors .....	28
2.2.2 Corporate Control .....	30
Internal Control .....	31
External Control .....	32
Summary .....	33
2.3 Theories and Models of Corporate Governance .....	33
2.3.1 Theories .....	33
2.3.1.1 Ownership Structure versus Board Structure .....	34
2.3.1.2 Shareholder versus Stakeholder .....	38

2.3.1.3 Agency Costs versus Shareholder Activism .....	41
2.3.1.4 Managerial Hegemony versus Effective Monitor .....	44
2.3.1.5 Convergence versus Path Dependency .....	48
2.3.2 Models of Corporate Governance .....	51
Unitary Model .....	51
Two-Tier Model .....	52
Hybrid Model .....	52
2.4 Independent Directors and Corporate Performance .....	53
2.5 Independent Directors in China .....	55
Reasons .....	55
Problems .....	56
Puzzles .....	57
2.6 Conclusion .....	59
CHAPTER 3: RESEARCH METHODOLOGY .....	60
3.1 Introduction .....	60
3.2 Comparative Analysis in Corporate Law .....	61
3.3 Meta-Empirical Study in Corporate Governance .....	64
3.4 Justification for the Combined Methodology .....	66
3.5 Research Method Design .....	68
3.6 Data Sources and Samples .....	70
3.7 Summery .....	71
CHAPTER 4: OWNERSHIP STRUCTURE .....	73
4.1 Introduction .....	73
4.2 Ownership and Control of Corporations .....	74
4.3 Share Classification and Ownership Structure .....	80
4.4 Ownership Concentration and Corporate Control .....	90
4.5 Shareholder Identification .....	100
4.6 Problems Associated with Ownership Structure .....	109
4.7 Conclusion .....	113
CHAPTER 5: THE BOARD OF DIRECTORS .....	115
5.1 Introduction .....	115
5.2 The Board of Directors as a Corporate Control Device .....	116
5.3 Characteristics of the Board of Directors .....	117
5.3.1 Role of the Board of Directors .....	118
5.3.2 Role of Independent Directors .....	122
5.3.3 Roles of Chairperson and CEO .....	126
5.3.4 Roles of Board Committees .....	130

5.4 The Board of Directors: Some Statistical Evidence in China .....	134
5.4.1 Board Size .....	135
5.4.2 Board Composition .....	138
5.4.3 Board Leadership Structure .....	142
5.4.4 Board Committees .....	145
5.5 Effectiveness of the Board of Directors .....	150
5.6 Conclusion .....	153
 CHAPTER 6: BOARD INDEPENDENCE .....	 155
6.1 Introduction .....	155
6.2 Law and Regulation on Board Independence .....	156
United States .....	157
New Zealand .....	159
China .....	160
Comparison and Contrast .....	161
6.3 Elements Impacting on Board Independence .....	163
6.3.1 Independent of Management .....	163
6.3.2 Dependent on Shareholders .....	169
6.3.3 Access to Information .....	176
6.3.4 Incentive to Monitor .....	180
6.4 Independent Directors as a Governance Mechanism in China .....	187
6.4.1 Attendance at Board Meeting .....	187
6.4.2 Independent Opinion .....	192
6.5 Efficiency and Effectiveness of Independent Directors .....	196
6.6 Conclusion .....	200
 CHAPTER 7: THE SUPERVISORY BOARD .....	 202
7.1 Introduction .....	202
7.2 Characteristics of the Supervisory Board of Chinese Listed Companies .....	202
7.3 Interplay of Independent Directors and the Supervisory Board .....	206
7.4 Conclusion .....	210
 CHAPTER 8: INDEPENDENT DIRECTORS AND CORPORATE PERFORMANCE IN CHINA: A META-EMPIRICAL STUDY .....	 211
8.1 Introduction .....	211
8.2 International Literature Review .....	212
Positive Correlation .....	213
Negative Correlation .....	214
No Correlation .....	216

8.3 Sample Collection of Chinese Research .....	217
8.3.1 Sample Sources .....	218
8.3.2 Sample Description .....	219
8.4 Discussion and Analysis .....	223
8.4.1 Board Independence and Firm Performance .....	224
The Proportion of Independent Directors .....	224
The Number of Independent Directors .....	230
The Adoption of the Independent Director Institution .....	231
8.4.2 Independent Directors' Background and Firm Performance .....	232
8.4.3 Independent Directors' Characteristics and Firm Performance .....	238
8.4.4 Independent Directors' Compensation and Firm Performance .....	242
8.5 Conclusion .....	244
 CHAPTER 9: CONCLUSION .....	 245
9.1 Introduction .....	245
9.2 Answers to Research Questions .....	246
9.3 Findings and Policy Implications .....	251
9.4 Limitations of the Research .....	254
9.5 Suggestions for Further Research .....	256
 BIBLIOGRAPHY .....	 259

## LIST OF TABLES AND FIGURES

### Tables

Table 4.2.1 Institutional Holdings of Outstanding Equity in the US Corporations 1950-2009 .....	76
Table 4.2.2 Institutional Ownership Concentration in the Top 1,000 US Corporations 1987-2009 .....	77
Table 4.2.3 Control Types of New Zealand Listed Companies 1962-2009 .....	79
Table 4.3.1 Basic Types of Shares in the Standard Opinion .....	81
Table 4.3.2(a) Ownership Structure of Listed Companies in China (2003-2011) .....	88
Table 4.3.2 (b) Ownership Structure of Listed Companies in the United States (2003-2011) .....	89
Table 4.4.1 Ownership Concentration Indices of Top Ten Shareholders of listed companies in China (2003-2011) .....	94
Table 4.4.2 Ownership Concentration Indices of Top Ten Negotiable Shareholders of Listed Companies in China (2003-2011) .....	98
Table 4.4.3 Yearly Changes of H Indices of Top Ten Negotiable Shareholders of Listed Companies in China (2003-2011) .....	99
Table 4.5.1 Shareholding of Top Ten Shareholders by Identity in Chinese Listed Companies (2003-2011) .....	104
Table 4.5.2 Distribution of the First Largest Shareholder by Identity in Chinese Listed Companies (2003-2011) .....	105
Table 4.5.3 Distribution of the Controlling Shareholder by Identity in Chinese Listed Companies .....	107
Table 4.5.4 Distribution of Control Pattern by Real Controlling Shareholder in Chinese Listed Companies (2003-2011) .....	108
Table 5.4.1(a) Distribution of Board Size of Chinese Listed Companies (2002-2011) .....	137
Table 5.4.1(b) Frequency of Board Size of Chinese Listed Companies (2002-2011) ....	137
Table 5.4.2(a) Distribution of Independent Directors of Chinese Listed Companies (2002-2011) .....	140

Table 5.4.2(b) Frequency of Independent Directors of Chinese Listed Companies (2002-2011) .....	142
Table 5.4.3(a) Frequency of CEO Duality of Chinese Listed Companies (2002-2011) .....	144
Table 5.4.3(b) Yearly Change of CEO Duality of Chinese Listed Companies (2002-2011) .....	145
Table 5.4.4(a) Distribution of Board Committees of Chinese Listed Companies (2002-2011) .....	147
Table 5.4.4(b) Frequency of Board Committees of Chinese Listed Companies (2002-2011) .....	148
Table 5.4.4(c) Frequency of Corporate Strategy, Audit, Nomination, and Remuneration and Appraisal Committees of Chinese Listed Companies (2002-2010) .....	150
Table 6.4.1(a) Distribution of Independent Directors Attending Board Meetings in Chinese Listed Companies .....	189
Table 6.4.1(b) Frequency of Independent Directors Attending Board Meetings in Chinese Listed Companies .....	190
Table 6.4.1(c) Frequency of Board Meeting Attendance of Independent Directors of Chinese Listed Companies .....	191
Table 6.4.2(a) Subject Matters of Independent Opinions of Independent Directors of Chinese Listed Companies (2002-2012) .....	194
Table 6.4.2(b) Classification of Independent Opinions of Independent Directors of Chinese Listed Companies .....	196
Table 8.3.2.1 Descriptive Distribution of 30 Selected Empirical studies on the Correlation between Independent Directors and Firm Performance .....	220
Table 8.3.2.2 Results of 30 Selected Empirical Studies on the Relationship between Independent Directors and Firm Performance .....	223
Table 8.4 Classification of 30 Selected Empirical Studies on the Correlation between Independent Directors and Firm Performance .....	223
Table 8.4.1 Board Independence and Firm Performance .....	229
Table 8.4.2 Independent Directors' Background and Firm Performance .....	235
Table 8.4.3 Independent Directors' Characteristics and Firm Performance .....	240
Table 8.4.4 Independent Directors' Compensation and Firm Performance .....	243

## **Figures**

Figure 4.3.1 The Relationship between the Basic Types of Shares and Sub-Types of Shares .....	82
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# CHAPTER 1

## INTRODUCTION

### 1.1 Introduction

Conventional wisdom holds that independent directors can improve corporate governance in companies, which is logically sound in theory but may not be practically true in reality. Independent directors are essentially concerned with their monitoring role over management in dealing with the agency problem<sup>1</sup> produced by the “separation of ownership from control”.<sup>2</sup> Because the separation of ownership from control diverges the interests of owners and of ultimate managers of firms, many checks formerly used to limit the use of powers by management have disappeared.<sup>3</sup> This means that managers are potentially left with unbridled power that is not checked. Not only is this detrimental to corporate value of firms but it also jeopardizes the corporate governance of a company. Moreover, it may cause serious negative effects on the proper functions of capital markets.<sup>4</sup>

Berle and Mean (1932) drew attention to this important corporate governance problem. There has been public concern in searching for a mechanism to bridge the separation by holding managers accountable for their performance. The predominant answer to this accountability problem has been unanimously that independent directors elected by shareholders should perform the monitoring role of limiting the abuse of unchecked powers

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<sup>1</sup> Agency problem was first raised by Adam Smith in his book “An Inquiry into the nature and Causes of the Wealth of Nations” published in 1766. As a theory, it was developed by Ross in 1973 and subsequently expanded by Jensen and Meckling in 1976. See: Stephen A. Ross “The Economic Theory of Agency: The Principal’s Problem” (1973) 63(2) American Economic Review at 134-139. See also: Michael C. Jensen and William H. Meckling “Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3(4) Journal of Financial Economics 305-360.

<sup>2</sup> Adolf A. Berle & Gardiner C. Means *The Modern Corporation and Private Property* (Revised ed, Harcourt, Brace & World, New York, 1967) at 5.

<sup>3</sup> At 7.

<sup>4</sup> For example, the fall of Lehman Brothers triggered the slump of capital markets and caused the Credit Crunch that resulted contagiously in the recent financial crisis worldwide. Lehman Brothers was described as “One-Man” Company and its independent directors were all in fact dormant on their role of monitoring over the management. See “Curtain falls on the One-Man Show at Lehman Brothers” (14 September 2008) <http://finlayongovernance.com/?p=513>.



by managers <sup>5</sup> with the expectation that this will improve corporate governance of companies. The question however remains whether such independent directors enhance corporate management as expected. Attention has been therefore focused on the efficacy of the role of independent directors in relation to good corporate governance not only by academic researchers (Vance 1983, Bhagat & Black 2002 and Gordon 2008) but also by capital markets regulators (such as SEC, FMA and China Securities Regulatory Commission (CSRC)) and policy makers (such as the US Congress, New Zealand Parliament and China's State Council).

The most recent capital markets meltdown worldwide has demonstrated repeatedly the severity of the corporate governance problem that may arise not only from the conflicts of interests and motivations between managers and shareholders, but may also arise from the inefficiency of the monitoring role of independent directors over management. <sup>6</sup> In view of this, consensus grows that it is important to strengthen the role of independent directors in order to improve corporate governance.<sup>7</sup>

Literature is rich in research on the role of independent directors in corporate governance and most of the research is focused on the dispersed shareholding ownership structure in common law countries such as the US, the UK and New Zealand,<sup>8</sup> which is distinguished from the concentrated shareholding ownership structure in civil law countries such as Germany, France and China. Research has been carried out mainly by an analysis of the

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<sup>5</sup> Florence Shu-Acuaye "The Independent Board of Directors and Governance in the United States: Where is this heading?" (2005-2006) 27 *Whiter Law Review* 725 at 736.

<sup>6</sup> Finlay on Governance, above n 4. There are also spates of other various corporate failures in history such as Enron, WorldCom to show this.

<sup>7</sup> Followed the scandals of Enron and WorldCom came in the Sarbanes-Oxley Act 2002 (SOX), which requires that audit committees should comprise solely of independent directors (§. 301), and the collapse of Lehman Brothers heralded the Dodd-Frank Act 2010 (Dodd-Frank), which demands that the members of compensation committees should all be consisted of independent directors, too (§. 952).

<sup>8</sup> E.g. Bhagat and Black conducted the long-horizon study of the first large-sample of 928 US listed companies to test whether the degree of board independence correlates with the long-term performance of large American firms. See: Sanjai Bhagat and Bernard Black "The Non-Correlation Between Board Independence and Long-Term Firm Performance" (Winter 2002) 27 (2) *Journal of Corporate Law* 231-274. Musteen et al. analyzed a sample of 324 US listed companies in the *Forbes* and identified that companies with a better reputation had a larger number of independent directors. See also: Musteen, M., Datta, D., & Kemmerer, B. "Corporate Reputation: Do Board Characteristics Matter?" (2010) 21 (2) *British Journal of Management* 498 at 498. Anderson and Reed studied S&P 500 companies with founding family shareholders and found that companies valued high had a balanced presence of independent directors and family representatives on the board. See also: Ronald C Anderson and David M Reeb "Board Composition: Balancing Family Influence in S&P 500 Firms" (2004) 49 (2) *Administrative Science Quarterly* 209-237.

role of independent directors on corporate management from either legal and historical or managerial and empirical perspectives.<sup>9</sup> However, the outcome of this research is limited to differentiating the efficiency of the role of independent directors on corporate performance in the dispersed shareholding ownership structure with regard to particular dimensions. It does not attempt to identify the differences between different shareholding ownership structures and examine why these differences exist or how they arise.

Empirical studies have expanded the scope of legal research on corporate governance. This indicates that the quality of corporate governance, which can be measured by a number of indicators of such related elements as the board of directors, independent directors and corporate performance, is an important determinant of corporate value and the growth of an economy.<sup>10</sup> It is obvious that this legal research and these empirical studies are conducive to a consensus on the efficacy of independent directors in corporate governance. But there is little research into independent directors in corporate governance in the Chinese context, especially the transplantation of the independent director institution from the Anglo-American's unitary model of corporate governance to Germany's two-tier model of corporate governance adopted in China and whether this transplantation works in light of the practices of the transplanted.

## **1.2 Evolution of Corporate Governance and Independent Directors**

The phrase "corporate governance" came into vogue in the 1970's and it was first used in a judicial opinion in 1977.<sup>11</sup> It appeared, however, in academic literature early in 1960.<sup>12</sup> Concerns about corporate governance and striving for good corporate governance were not a new phenomenon even that time. Corporate governance has existed in business since the

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<sup>9</sup> Ibid. See also: Jeffrey N. Gordon "The Rise of Independent Directors in the United States, 1950-2005: of Shareholder Value and Stock Market Prices" (2008) 59 *Stanford Law Review* 1465-1569.

<sup>10</sup> Rafael La Porta et al. "Law and Finance" (1998) 106 *Journal of Political Economy* 1113-1154.

<sup>11</sup> *Wilson v. C. I. R.*, 560 F.2d 687 (5th Cir. 1977) at 690. Also see: William C. Greenough and Peter C. Clapman "The Role of Independent Directors in Corporate Governance" (1980) 56 *The Notre Dame Lawyer* 916 at 917, n 6.

<sup>12</sup> Richard Eells *The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise* (Columbia University Press, New York, 1960) at 108. "Corporate governance" was used to denote "the structure and functioning of the corporate polity".

birth of the limited liability form of the modern corporation.<sup>13</sup> Arguably, it existed in early corporations with the occurrence of shareholders in joint stock companies that gave rise to the issue of separation of ownership from control identified by Adam Smith in 1766. This can track its root to the East India Company (the then name of the Governor and Company of Merchants of London, Trading into East Indies), which received a royal charter from Queen Elizabeth in 1600 AD (dated the 31<sup>st</sup> December in the 43<sup>rd</sup> year of Her Reign) to commence its trading business.<sup>14</sup> The charter provided that the company established a Court of Committees of twenty-four to be “elected and appointed” by Governor or his deputy to manage and handle the company’s businesses,<sup>15</sup> following a well-established precedent in calling for the use of a governing body composed of twenty-four consuls and assistants elected annually like that of Russia Company chartered by Philip and Mary in 1554.<sup>16</sup>

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<sup>13</sup> Praveen B Malia *Corporate Governance: History, Evolution and India Story* (Routledge, 2010) at 33. See also: Ron Harris “The English East Indian Company and the History of Company Law” in Ella Gepken-Jager et al (eds) *VOC 1602-2002: 400 Years of Company Law* (Kluwer Legal Publishers, 2005) vol. 6 at 225. Ron Harris pointed out that it is no wonder the charter did not include the limitation of liability of members of the company since the modern doctrine of limited liability had not yet emerged. But it was clear by implication that the debts of the company were not identical to the debts of its members, as a group or individually. In the same book, Ella Gepken-Jager (at 43) also considered that Dutch East India Company (Verenigde Oostindische Compagnie (VOC)) established in 1602 was regarded as being the first limited liability public company in Dutch legal literature. See also: Louis De Koker “The Limited Liability Act of 1855” (2005) 26(5) *Company Lawyer* at 130-131. It was the first time by legislature that the Limited Liability Act 1855 of the UK granted limited liability to members of a company that met certain conditions. But this Act was shortly repealed and was incorporated in an amended form in the Joint Stock Companies Act 1856, which was the first modern English Companies Act that retained in legislation the principle of limited liability and therefore marked formally the birth of the limited liability of modern corporations. A limited liability company is an association which is formed and incorporated by a group of persons (stockholders or shareholders) for the purpose of carrying on trade or business to make profits for the benefits of these persons and the liability of such persons is limited by the quota of their shares or the guarantee of their share contributions. Historically, the idea of the limited liability originated from the emergence of chartered joint-stock venture companies in the Middle Ages because the only way of raising large sums of money from investors for risky colonization was to protect them (Micklethwait & Wooldridge, 2005, at 18). As a legal opinion it existed much earlier than the formal legislation of the Limited Liability Act 1855 and this can be evidenced at least in *Edmunds v Brown and Tillard* (83 E.R. 385; (1667) 1 Lev. 237), where the plaintiff brought the action against the defendants for personal liabilities, two principals of the Company of Woodmongers being dissolved, and the Chief Justice at Nisi Prius ruled that the plaintiff could not do so (the corporation is dissolved, the particular persons not chargeable. 1 Stra. 434. Show. 174. 3 Wils 269).

<sup>14</sup> Great Britain “Charters Granted by Queen Elizabeth, to the Governor and Company of Merchants of London, Trading into the East India” in *Charters relating to the East India Company from 1600 to 1761* (Government Press, Madras, 1887) at 1. Prior to the first general registration Act 1844, companies were incorporated either by Royal Charter or by special Act of Parliament in England. See also: Praveen B Malia *Corporate Governance: History, Evolution and India Story* (Routledge, 2010) at 5-6.

<sup>15</sup> Great Britain at 7.

<sup>16</sup> Franklin A. Gevurtz “The Historical and Political Origins of the Corporate Board of Directors” [2004] *Bepress Legal Series* 1 at 22. <http://law.bepress.com/expresso/eps/319>. A council of twenty-four governed

The charter of East India Company seems to pioneer the exemplar of the Court of Committees as a governing body of a company, similar to the board of directors of the present-day companies. Granting charters to venturing companies (societies of ventures) put governance of enterprises into the hands of groups of peers and this kind of vesting authority was unique to British governance of corporations, a derivation from the Magna Carta (1215).<sup>17</sup> The Court of Committees was an executive body charged with making policies and directing operations in the company,<sup>18</sup> which established a body of executives (committees) on behalf of the company to run business for the benefit of its stockholders. Its occurrence was based on the existence of the limited liability company owing to the separation of ownership from control and it was probably the rudimentary form of the board of directors in today's corporations.

In fact, it could be argued that the development of corporate governance can be traced back to the Royal Charter granted to the Bank of England in 1694, which provided that a Court of Directors of twenty-four order the affairs of the Bank,<sup>19</sup> and indeed this Charter seems to have initiated the term “director” in English legal literature.<sup>20</sup> The Court of Directors was the developed form of the Court of committees—since the term “committee” was replaced by the term “director”, a modern usage—and it was considered as the centre of governance of companies. This is because corporate boards such as the Court of Committees or the Court of Directors were developed originally as a governance mechanism for merchant societies (like the hanse) or merchant cartels (like the Dutch East India Company) and later evolved into the governance mechanism for large business

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a company as a system of board governance was adopted by a joint venture company called the Merchants of the Staple as earliest as in 1363 (Gevurtz, 2004, at 29) but the role of such a council was just legislative (passing ordinances to regulate the membership) and adjudicative (hearing disputes involving the members) rather than monitoring management on behalf of passive investors (Gevurtz, 2004, at 64) of trading companies.

<sup>17</sup> Stanley C. Vance *Corporate Leadership: Boards, Directorships and Strategy* (McGraw-Hill Book, New York, 1983) at 1.

<sup>18</sup> Great Britain, above n 14. See also: K. N. Chaudhuri *The Trading World of Asia and the East India Company, 1660-1760* (Cambridge University Press, Cambridge, 1978) at 27. In this book, Chaudhuri stressed that Court of Committees is responsible for central managerial direction of the Company but its title was changed in 1709 to that of Court of Directors, which was composed of twenty-four stock-holding members of elected annually. It is clear that this followed the suit of the Bank of England.

<sup>19</sup> Great Britain “An Abstract of the Charter to the Governor and Company of the Bank of England”, available at: <http://quod.lib.umich.edu/e/eebo/A23868.0001.001/1:1?rgn=div1;view=fulltext> at 3.

<sup>20</sup> Gevurtz, above n 16 at 17.

ventures with passive investors.<sup>21</sup> Over time, the Court of Directors was replaced by the board of directors,<sup>22</sup> which has become the board-centred model of corporate governance.

This board-centred model of corporate governance is not merely the universal norm in British corporate law. Roughly paralleled to its development in England, board-centred corporate governance was developing in continental Europe even in such an early stage as the Charter of Dutch East India Company, which provided for a board of Seventeen Directors nominated by six chambers (i.e., associations of earlier companies) to deal with all affairs of the United Company,<sup>23</sup> just two years after the formation of the English East India Company. The structure of the company was highly oligarchic and the board of Seventeen Directors, from some governors of six Chambers, made decisions for the Chambers to implement. There was hardly any supervision of the governors since the shareholders of the company had no rights.

This scenario led to the Committee of Nine (Commissie van Negen) to be created to supervise the governors in 1623 when the 1602 licence was extended.<sup>24</sup> Noticeably, the so-called Accounting Committee (Rekening-committee) was also appointed the same year and the governors were obliged to account for their policies and responsibilities to the Accounting Committee.<sup>25</sup> The Committee of Nine had powers such as sitting in on the meetings of Seventeen Directors to give advice and make recommendations and it therefore was regarded as the precursor of the existing supervisory board of modern corporations,<sup>26</sup>

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<sup>21</sup> At 32.

<sup>22</sup> *The Queen v. the Londonerry and Coleraine Railway Company* 116 E.R.1544 (1849) 13 Q.B. 998. It was in this case that “Board of Directors” as a legal term appeared probably the first time in common law. See also: Charles Favell Forth Wordsworth *The law of joint stock companies, as altered by the Act of 1862: including banking, insurance, mining, and general companies: with the whole law of winding-up* (10th ed. London, 1865) at 90. British Law: Corporations. The early use of the term of Board of Directors in academic literature can be seen by Charles F.F. Wordsworth to exposit that “Board of Directors” can make the resolution of calling on an original allotment of shares that were still pending by shareholders under the Articles of Association of a limited company, according to the Act of 1862.

<sup>23</sup> The United Netherlands “The License Granted by the States General to the Dutch East India Company on March 20 1602” (English translation) in Ella Grepken-Jager et al (eds) *VOC 1602-2002: 400 Years of Company Law* (Kluwer Legal Publisher, 2005) vol. 6 at 30.

<sup>24</sup> Ella Grepken-Jager “The Dutch East India Company” in Ella Grepken-Jager et al (eds) *VOC 1602-2002: 400 Years of Company Law* (Kluwer Legal Publisher, 2005) vol. 6 at 56.

<sup>25</sup> At 56.

<sup>26</sup> At 57.

which nurtured the two-tier board structure just like that of Germany's two-tier board model of corporate governance nowadays.<sup>27</sup>

English and Dutch corporations were chartered to establish colonies worldwide, especially those English trading companies (such as the Hudson's Bay Company, the Russia Company and South Sea Company) which not only evidenced the use of corporate governing boards but also established the use of boards as the governance mechanism for the business corporation.<sup>28</sup> Board governance was adopted by these colonizing companies which meant that the notion of corporate governing board influencing other parts of the world such as North America, Europe, South Africa and East Asia. Indeed, it is obvious that the board of directors, as the central control mechanism of corporate governance, had been widely used had to wait the growth of the number and scale of industrial enterprises<sup>29</sup> and the structure of such corporations has evolved to a point where total control is given to such a governing body: the board of directors.<sup>30</sup> Indeed, when the multi-divisionalization of modern corporations comes into existence to adapt to the growth of the scope and scale of economy, which needs a central internal control device to direct and manage a multi-divisionalised corporation, the board of directors has been widely adopted by large modern corporations.

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<sup>27</sup> Julian Franks et al. "The Origins of the German Corporation-Finance, Ownership and Control" [2006] *Review of Finance* 537 at 540. Germany was not unified until 1871 and the Common German Commercial Code (*Allgemeines Deutsches Handelsgesetzbuch*) of 1861 introduced a voluntary two-tier board structure, i.e., management board (*Vorstand*) and supervisory board (*Aufsichtsrat*). The First Joint-Stock Modification (*Erste Aktiennovelle*) of 1870 introduced free corporation but obliged joint-stock companies to have two levels of control and made the two-tier board structure mandatory. The supervisory board was made of big shareholders and assorted interest groups such as banks, cartel partners, politicians and trade unions and it even gained more powers by the Second Joint-Stock Modification (*Zweite Aktiennovelle*) in 1884. Some evidence showed that the idea of the two-tier board structure evolved accidentally by a suggestion of introducing a mandatory supervisory board for associations limited by shares in the Nuremberg Conference in 1857, and that the so-called supervisory board was where large shareholders met to resolve their different interests. See also: John Micklethwait & Adrian Wooldridge "The Company, A Short History of a Revolutionary Idea" (Modern Library, New York, 2005) at 93.

<sup>28</sup> Gevurtz, above n 16 at 21-23.

<sup>29</sup> Vance, above n 17 at 2. One of the very first colonial "corporations" the Philadelphia Contributionship for the Insurance of Houses' board is the epitome of the SEC's "ideal board"; all members of the board but one, the chief executive officer (CEO), was outside directors.

<sup>30</sup> Susan Watson "The significance of the source of the powers of boards of directors in UK company law" (2011) 6 *J.B.L.* 597 at 610.

The term “independent director”, in the context of a governance mechanism of the board of directors, appeared in the corporate governance lexicon early in the 1930s as the kind of director capable of performing the supervising role over management.<sup>31</sup> Until then, the board of directors was divided into “inside” and “outside” directors. This dichotomy created a dilemma wrestled with those founders of companies’ boardrooms and ultimately occurred in 1776, as pointed out by Stanley C. Vance, when there was a conflict happened between the inside-director’s on-the-scene authority and the outside-director’s absentee’s authority.<sup>32</sup> This difference caused the conflict between inside-directors and outside-directors concerning the supervision authority of outsider-directors on inside-directors, which caused the dilemma concerning how to supervise the inside-director’s on-the-scene authority by the outside-director’s absentee’s authority. A board of directors consisting of outside directors, who play an overseeing role, can probably be dated back to the Society for Establishing Useful Manufactures, a nobly named corporation which received its charter from the New Jersey legislature in 1791, and its collapse provides an early example of the failure of outside directors to monitor management in the US corporate history.<sup>33</sup>

Outside directors were nothing new in the 1970s. Most American corporations had majority outside boards as early as the mid-1950s when the monitoring board was created and outside directors are a logical corollary to the monitoring board.<sup>34</sup> But only those who are independent of management are considered being capable of carrying out the monitoring role of the board. Independent directors<sup>35</sup> are independent outside directors who have no

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<sup>31</sup> William O. Douglas “Directors Who Do Not Direct” (1934) 47(8) *Harvard Law Review* 1305 at 1312, 1314.

<sup>32</sup> The inside-director’s on-the-scene authority was the managing power carried out by those directors in joint stock companies trading abroad and the outside-director’s absentee’s authority was the oversight power retained by those outside directors staying at home. The conflict was finally ended with the result that the absentee authority gave way to the on-scene authority. For example, an early evidence of on-scene-authority in replace of absentee outside director control can be found in Mayflower Compact, where the Pilgrims selected their own government and officer-directors by will of the majority. The absentee authority was an outside directorate similar to what is presently referred to as an “oversight” board. (Vance, above n 17 at 2). It seems to suggest that the need of this absentee authority to control the on-scene authority was the main reason for using outside directors at that time.

<sup>33</sup> Gevurtz, above n 16 at 17 and Vance, above n 17 at 3.

<sup>34</sup> Lawrence E. Mitchell “the Trouble with Boards” (GWU Legal Studies Research Paper No. 159, September 9 2005) 1 at 4-5. <http://ssrn.com/abstract=801308>.

<sup>35</sup> Melvin A. Eisenberg “The Modernization of Corporate Law: An Essay for Bill Cary” (1983) 37 *University of Miami Law Review* 187 at 205 - 206. Melvin A. Eisenberg mentioned (note 43) that NYSE’s Listed

relationships with and interests in companies that they serve<sup>36</sup> and thus are considered as a necessary component of the monitoring board, while other outside directors are not.

The existence of independent directors lies in the need to deal with the divergence of different interests between managers and owners of companies caused by separation of ownership from control that raises the problems of overseeing management and reducing agency cost in the dispersed shareholding ownership structure of companies. While the use of independent directors in monitoring management evidently traces back to American corporate practice, it would be a mistake to give the Americans sole credit for developing this kind of corporate governance mechanism that is also used by other jurisdictions with dispersed shareholding ownership structures like Britain, Australia and New Zealand, and even by those with concentrated shareholding ownership structures like France,<sup>37</sup> Japan<sup>38</sup> and China.

### 1.2.1 The United States

The early American corporations apparently found the root of using the board of directors in similar provisions to English corporate charters. One such an example was the Charter of the First Bank of the United States established in 1791, which provided that the size of the board of directors was twenty-five-persons (simply having added one to the size of the board of directors of the Bank of England in order to avoid tie votes).<sup>39</sup> These directors were elected by the shareholders or proprietors of the Bank to govern and order the affairs of the Bank.<sup>40</sup> Undisputedly, board governance was not unique to banks; it was also accepted by other corporations such as the Society for Establishing Useful Manufactures,

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Company Manual B-23 (June 15, 1966) impliedly prescribed that an audit committee must have two independent directors, which is probably the early use of the term of “independent director”.

<sup>36</sup> Investment Company Act 1940 (US), §§. 10, 2 (19). Section 10 requires that “interested persons” should not be more than 60% of a board, i.e., at least 40% of a board should be composed of outside directors. Section 2 (19) defines the “interested persons”. The SEC [www.sec.gov/about/laws/ica40.pdf](http://www.sec.gov/about/laws/ica40.pdf).

<sup>37</sup> Charles Piot & Franck Missonier-Piera “Corporate Governance, Audit Quality and the Cost of Debt Financing of French Listed Companies” (Sep. 2009) [ssrn.com.ezproxy.auckland.ac.nz/abstract=960681](http://ssrn.com.ezproxy.auckland.ac.nz/abstract=960681) at 9.

<sup>38</sup> Stephen P. Ferris et al. “Managerial Power in the Design of Executive Compensation: Evidence from Japan” (2007) 12 *Advances in Financial Economics* 3 at 11.

<sup>39</sup> Gevurtz, above n 16 at 17.

<sup>40</sup> The United States “An Act to Incorporate the Subscribers to the Bank of the United States” (Philadelphia, 1791) at 2-3. The Making of the Modern World website.



whose board consisted of thirteen directors elected by the shareholders.<sup>41</sup> As American's first real industrial corporation that was given life by the New Jersey Legislation on November 28, 1791, The Society for Establishing Useful Manufactures employed some modern boardroom functions such as audit committees, especially a truly independent Committee of Inspectors that was consisted of five stockholders with the rights of accessing all the books and examining all affairs of the company.<sup>42</sup> This governance structure was continuously adopted by the individual legislatively-granted charters of corporations and became the common governance pattern, which had been codified by the New York legislature in 1811.<sup>43</sup>

At the turn of the twentieth century, United States Steel Corporation was midwived as the epitome of outside-director control and its board of directors was built and shaped as the ideal outside-director type of board from its inception (1901-1902), which provided both a structural and a functional design for thousands of boardroom emulators.<sup>44</sup> This kind of board structure provides a model of corporate governance of companies, especially those public corporations listed in stock exchanges because such a functional board structure gives a signal to investors that the board's oversight role is in place to ensure their confidences in investments. The stock market crash of 1929 and many of the frauds committed against public investors in the 1920s greatly undermined investors' confidence in the board's oversight function on management, which resulted in Congress enacting such federal securities laws as the Securities Act of 1933 and the Securities Exchange Act of 1934 to launch corporate governance reform during the New Deal in the 1930s to protect public investors, marking the start of federal regulations on financial markets in the United States.<sup>45</sup> The significance of the reform was not only the mandatory requirement of information disclosure and creation of accounting and auditing standards of listed public

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<sup>41</sup> Gevurtz, above n 16 at 17.

<sup>42</sup> Vance, above n 17 at 3.

<sup>43</sup> Gevurtz, above n 16 at 16.

<sup>44</sup> Vance, above n 17 at 4.

<sup>45</sup> Prior to the stock market crash in 1929, there were no federal regulations on financial markets, which were primarily unregulated, and public investors were not concerned about the threats of their investments in such unregulated markets. See Zabihollah Rezaee *Corporate Governance, Post-Sarbanes-Oxley, Regulations, Requirements, and Integrated Processes* (John Wiley & Sons, Hoboken, 2007) at 248.

companies but also the establishment of the Securities and Exchange Commission (SEC) to oversee the securities industry in order to improve corporate governance.

In 2001-2002, there were corporate scandals associated with Enron, WorldCom and other publicly traded corporations that caused another round of corporate governance reform by Congress to enact the Sarbanes-Oxley Act of 2002 with the purpose of rebuilding investor confidence and protecting investors by reinforcing the monitoring role of the board of directors.<sup>46</sup> The fall of Lehman Brothers caused by the credit crunch in 2008 triggered a further round of corporate governance reform, which resulted in the passing of the Dodd-Frank Act of 2010 by Congress to further strengthen the monitoring role of the board of directors over management on behalf of shareholders, especially executive compensations.<sup>47</sup>

There is a clear demand for independent directors under this board-centered model of corporate governance, which can be shown even in the early part of the Twentieth Century. Inspired by a so-called unmitigated bias on a fundamental tenet by the American Institute of Management in 1955 that the majority of the members of any board should be drawn from outside the company, Stanley C. Vance pioneered the first analytical studies of inside- and outside- director value of 200 major industrial corporations between 1925 and 1950 and found that the era of trusts and the first great merger waves put the focus on outside directors.<sup>48</sup> In his book, Vance pointed out clearly that it was the movements of trusts and the first great merger waves that made outside directors become more popular in the US public held corporations, which was evidenced by his studies that there were 884 outside directors, 39.48% of a total of 2,239 directors, among the 200 boards of his sample companies in 1925.<sup>49</sup>

The great interest in this undertaking has been developed by the Investment Company Act of 1940<sup>50</sup> by virtue of the then corporate scandals caused by the failure of insider control of companies' boards of directors. America apparently realized that outside directors as

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<sup>46</sup> Sarbanes-Oxley Act 2002 (US), § 301 at [www.sec.gov/about/laws/soa2002](http://www.sec.gov/about/laws/soa2002).

<sup>47</sup> Dodd-Frank Act 2010 (US), § 952 at [www.sec.gov/about/laws/doa2010](http://www.sec.gov/about/laws/doa2010).

<sup>48</sup> Vance, above n 17 at 49.

<sup>49</sup> Stanley C. Vance "Trend in Boards: More Insiders" (26 November 1955) *Business Week* at 128.

<sup>50</sup> Investment Company Act, above n 36.

external professionals can play an irreplaceable role of supervision of their other colleagues on the management of companies in corporate governance. Starting roughly from the mid-1960s, due to the corruption resulting from long dominance over corporations by professional managers, calls were made for stronger monitoring of professional managers and higher transparency, which accelerated the trend toward outside directors.<sup>51</sup> The SEC has been prominent in the introduction of the use of outside directors to represent shareholders rather than management interest (Estes 1973 and Barr 1976). Since then, the composition of the board of directors gradually changed and seats for independent directors increased in an effort to curb misconduct by professional managers. The New York Stock Exchange in 1977 and The Business Roundtable and American Attorney Association commercial law branch in 1980s, strengthened the role of the independent director. In 1989 the Michigan Business Corporation Act legalized the independent director system and this was followed by other states. Accordingly, the independent director has played a significant role and is regarded as the cornerstone of corporate governance.

The events of Enron and WorldCom threw the role of the independent director open to challenge, especially the dysfunction of the monitoring role over financial frauds in accounting. But the Sarbanes-Oxley Act of 2002 made some apparent amendments. The Sarbanes-Oxley Act is important because it not only develops the role of independent director but also makes a variety of corporate functions mandatory, which vastly increases their legal complexity and consequently enhances the requirements of corporate judgment that can withstand question or challenge. However, the efficacy of these improvements is now called into question by an examination of the current financial crisis in view of Lehman Brothers' failure, which must ultimately be seen as a failure in corporate governance, considering the monitoring role of independent directors in particular. The Dodd-Frank Act aims to address this failure by effectuating the role of independent directors but its effect still remains to be seen.<sup>52</sup>

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<sup>51</sup> Ibid.

<sup>52</sup> Above n 7.

### 1.2.2 New Zealand

Twenty years after the colonisation of New Zealand by Great Britain in 1840, the Joint Stock Companies Act of 1860 was passed by the General Assembly of New Zealand to provide for incorporation and regulation of joint-stock companies and other associations, which marked the beginning of company legislation in this country.<sup>53</sup> The Act followed Britain's Joint Stock Companies Act of 1856.<sup>54</sup> It was inevitable that New Zealand, as a colony intended to serve the economic interests of the imperial order, would have colonial legislation based on the imperial model.<sup>55</sup> This formed a long-standing tendency that continued even after New Zealand gained its dominion status from the United Kingdom in 1947 and passed its Companies Act of 1955. That Act was still an almost exact copy of the UK Companies Act of 1948. The rationale was that such a legal heritage on company regulation gave confidence to British investors, who were the primary outside source of capital investments in New Zealand,<sup>56</sup> because the governance of corporations in New Zealand followed the British model of corporate governance.

In the early part of the Twentieth Century, scale and scope economics, scientific management, multidivisional structure and large-scale high throughput production revolutionized the US corporations. They were not closely emulated by British businesses until the period of 1950-80, especially the multidivisional structure that has had an impact on managerial behavior via alterations in governance and monitoring arrangements.<sup>57</sup> Corporate governance was generally weak during this period in the UK, as the lack of market liquidity prevented the shareholder exit and the dispersed shareholdings undermined the voice aspect of governance, and further impetuses to the process of the

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<sup>53</sup> The first "New Zealand Company" was granted a charter by British Parliament to a group of distinguished English businesspersons for agricultural and commercial purposes in 1825 and it was directly succeeded later the same year by E. C. Wakefield's "New Zealand Company", an undoubtedly well-known company of the pre-1860 era in New Zealand.

<sup>54</sup> Gordon Walker et al *Commercial Applications of Company Law in New Zealand* (2nd ed., CCH New Zealand, 2005) at 28.

<sup>55</sup> John Farrar and Susan Watson (ed.) "Introduction" in *Company and Securities Law in New Zealand* (2nd ed., Thomson Brookers, Wellington, 2013) at 1.

<sup>56</sup> Walker, above n 54 at 27.

<sup>57</sup> Steve Toms and Mike Wright *Corporate Governance, Strategy and Structure in British Business History, 1950-2000*, (Frank Cass, London, 2002) Business History vol.44 (3) at 91.

revolution had to wait until the corporate reforms of the 1980s.<sup>58</sup> New Zealand also followed suit and was slower off the mark in corporate governance. In 1973, the UK joined the European Union (EU) and harmonized its domestic systems with those of the EU, which made the UK model no longer attractive and relevant to New Zealand.<sup>59</sup> After consideration of the more complex Australian Companies Code 1981, New Zealand passed the Companies Act 1993 and shifted to the Canadian model based on the Canadian Business Corporations Act 1975,<sup>60</sup> which was also heavily influenced by the Model Business Corporations Act that was prepared by the Committee on Corporate Laws of the American Bar Association.<sup>61</sup> In 2002, the Securities Commission made a statement on Corporate Governance, which was followed by the New Zealand Exchange's Best Practice Code in 2003. In 2004, Corporate Governance in New Zealand—Principles and Guidelines was issued. Significantly, the Financial Market Authority (FMA) was established on 1 May 2011 to supervise financial markets with purpose of improving corporate governance. FMA took over the role of the Securities Commission, which was disestablished.

Similar to corporate governance, the development of independent directors in New Zealand also lagged behind as in the UK. Britain in the 1970s (Sheikh 2002) experienced a debate on corporate governance with a series of draft policies and proposals on disclosure and transparency in the boardroom but with little attempt to address the role of the non-executive director (NED)<sup>62</sup> within the corporate governance system. There was a widespread approval of recommendations within the accounting profession about the greater use of the NED, which reflected the effect of developments of outside directors in the United States. This growing interest in the NED role on company boards was confirmed by the report of the Company Affairs Committee of the CBI, *The Responsibilities of British*

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<sup>58</sup> At 106.

<sup>59</sup> Farrar, above n 55 at 1.

<sup>60</sup> The Canadian Business Corporations Act 1975 discarded the outdated English model that based on the ancient and out-moded letters patent model, which was 125 years old. See Bruce Welling *Corporate Law In Canada: the Governing Principles* (3rd ed., Scribblers Publishing, 2006) at 55.

<sup>61</sup> Kevin P. McGuinness *Canadian Business Corporate Law* (LexisNexis, 2007) at 17. The original model Act was first published in 1950 and eventually influenced legislation in more than 36 years since there is no federal corporate law statute in the United States.

<sup>62</sup> Non-executive directors in the UK and New Zealand are the equivalent name of independent directors or outside directors in the US.

*Public Company* (the Watkinson Report), published in 1973.<sup>63</sup> However, it was much harder to detect the implications of the Report in practice because there was no statutory definition of the NED and the degree of independence was hard to assess. This was the case even after Companies Acts of 1985 and 1989. It was not until January 2003 that the Higgs review addressed this and concluded that while self-regulation is the preferable method for ensuring the proper functioning of the NED role, partial statutory regulation of the NED ought to be put on the statutory agenda.

After the 1970s, the New Zealand Law Commission released the Report on Company Law Reform and Restatement in 1989 with one of its purposes to specify and highlight the director's role in corporate governance. This specification was brought about partly due to a lack of adequate oversight by boards of directors which caused the spate of corporate collapses that characterized the New Zealand economy in the late 1980s and early 1990s (Hermalin & Weisbach 1991, Baysinger & Hoskisson 1990). Consequently, the Companies Act of 1993 was passed, along with the NZX's Corporate Governance Best Practice and the Securities Commission's set of nine principles entitled *Corporate Governance in New Zealand – Principles and Guidelines*. This legislation had significant implications for independent directorship, aiming to provide a comprehensive framework for companies to develop sound corporate governance practices but their impact was found to be negligible on independent directors and firm performance, although the proportion of independent directors on companies' boards increases (Rao & Hossain 2002). The Act highlights the directors' role in corporate governance, which impacts greatly on independent directors. Some argued that the Act imposing stricter penalties on inadequate oversight and monitoring<sup>64</sup> would frighten away quality independent directors (Marsden & Prevost 2005, p. 264) and make it difficult for companies to find suitable independent directors for their boards, especially in view of the scarcity of qualified independent directors in New Zealand.

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<sup>63</sup> R. I. Tricker *The Independent Director, A Study of the Non-Executive Director and of the Audit Committee*, (Tolley Publishing, 1978) at 77. The Report concluded that "the inclusion on the board of public companies of non-executive directors is highly desirable ... by virtue of the fact that ... they are in a better position to see the company as a whole and to take a critical view of it". Tricker pointed out that 35% of companies in *The Times 1000 1975-76* had more than two non-executive directors.

<sup>64</sup> Steven F. Cahan and Brett R. Wilkinson "Board Composition and Regulatory Change: Evidence from the Enactment of New Companies Legislation in New Zealand" (1999) 28(1) *Financial Management* 32 at 34.

### 1.2.3 China

In the late Nineteenth and early Twentieth centuries, China began its attempt to create a modern system of corporate governance, an effort that continues to the present day. China is now still dealing with some issues that existed in 1904,<sup>65</sup> when the Company Code of Great Qing (*Daqing gongsi Lü*, hereafter called the Company Law 1904) was passed by the then Qing dynasty.<sup>66</sup> The Company Law 1904 should not be viewed as the beginning of corporate capitalism in China but a top-down revision of the course of a large-scale Chinese business enterprises that had already freely interacted with and been adopted from Western-style business models for the previous three decades.<sup>67</sup> Motivated to compete with rather than imitate the West, the then Tongzhi reign attempted first to build large-scale industrial enterprises to serve its military and defence purposes during so called “Self-Strengthening Movement” between 1862 and 1874.<sup>68</sup> Notably, these initial industrial enterprises were under the government sponsorship and supervision and the part of these enterprises’ shares<sup>69</sup> issued to Chinese merchants were neither floated on nor funded through an initial public offering (IPO) in the Shanghai Stock Exchange<sup>70</sup> at that time.

The Shanghai Stock Exchange was open for foreign-registered companies and became one of the world’s most active equity markets. The burst of China’s first stock market bubble

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<sup>65</sup> Dwight H. Perkins “Comment” in Randall K. Morck (ed) *A History of Corporate Governance around the World* (The University of Chicago Press, Chicago & London, 2007) at 184.

<sup>66</sup> This is China’s first Company Law, which was issued on January 21, 1904 and based on the UK Limited Liability Act 1855 and Companies Act 1862, and the Japan Commercial Code 1899.

<sup>67</sup> William Goettmann & Elisabeth Köll “The History of Corporate Ownership in China, State Patronage, Company Legislation and the Issue of Control” in Randall K. Morck (ed.) *A history of Corporate Governance around the World* (The University of Chicago Press, Chicago & London, 2007) at 162.

<sup>68</sup> The three then biggest enterprises: the China Merchants’ Steamship Navigation Company facilitated the government to transfer the grain; the Jiangnan Arsenal manufactured modern arms to improve China’s military strength; and the Kaiping Coal Mines provided the power to facilitate national transportations.

<sup>69</sup> These shares did trade publicly and seemed to have been part of China’s first stock market “bubble”.

<sup>70</sup> The first list of “shares and stocks” under the title of “Monetary & Commercial” appeared in *The North-China Herald* in June 1866, which marked the beginning of share dealing in Shanghai, and a regular system of dealing in shares did not start until February 1871 when J.P. Bisset & Co was given as the source of information and the title was changed to the “Share Market”. The germ of an association called the Shanghai Shareholders’ Association appeared in 1890 but a formal body was set up as the Stock & Shareholders’ Association in 1898, which carried the official seal of “the Shanghai Stock Exchange”. See William A. Thomas *Western Capitalism in China, A History of the Shanghai Stock Exchange* (Ashgate Publishing, 2001) at 93, 98.

in November 1871, triggered by a monetary panic as a result of speculations and price manipulations of some companies' major shareholders who were also managers of the companies, resulted in new industrial enterprises established in 1870s -1880s adopting the government-sponsored form known as “*guandu shangban*”, i.e., government supervision and merchant management, which usually became joint-venture businesses. These types of enterprises were mainly financed by private investors who managed their investments but were under the government supervision. This kind of supervision introduced bribes, corruptions and inflexible management into these enterprises, and made rather limited profits to the private investors (Goetmann & Köll 2007, p. 158). The turning point came in 1895, when there was a significant shift from government-sponsored enterprises to enterprises with private involvement in ownership and management, especially in light and consumer goods industries, and it was not until the post-1900 Qing reforms that China experienced substantial industrialization and private businesses were openly encouraged.<sup>71</sup>

The Company Law 1904 made use of a Western-style code to adopt an international financial and managerial technology for Chinese business needs as a result of the existence of large-scale domestic enterprises in competition with the presence of Western business ventures. But this law fell short of expectations because it did not sufficiently shift ownership and control from managers, previously empowered by government patronage, to shareholders.<sup>72</sup> This meant that the government intervention through patronage and sponsorship still existed in corporate governance.<sup>73</sup> Some evidence suggests that most new enterprises did not have the governance structure, managerial expertise and independence from the government control to allow them to compete effectively against their foreign counterparts.<sup>74</sup> Three years after Qing dynasty was overturned by the Nationalist in 1911, the Company Law 1904 was replaced by the Ordinance Concerning Commercial Associations (*Shanghai Tiaoli*) enacted in 1914, based on the German model of corporate

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<sup>71</sup>Goetmann & Köll, above n 67 at 159-160.

<sup>72</sup> At 151.

<sup>73</sup> This characteristic of Chinese government sponsorship to and intervention in corporate enterprises in 1904 is helpful to better understand the ownership and control of today's companies in China from its historical origin.

<sup>74</sup> William N. Goetmann, Andrey D. Ukhov & Ning Zhu “China and the World Financial Markets 1870-1939: Modern Lessons from Historical Globalization” (2007) 60 (2) *Economic History Review* 267 at 274.



legislation.<sup>75</sup> To promote state capitalism, the Nationalist passed the Company Law in 1929, attempting to protect small shareholders and limit the rights of large shareholders<sup>76</sup> with an exemption for the shares held by the government. The Company Law 1929 was revised in 1946 but then was abolished after the Communist take-over in 1949.

After a three-year economic recovery since the establishment of the People's Republic of China (PRC), the Communist government began the reform of private enterprises and consequently nationalized nearly all private enterprises into either State-Owned Enterprises (SOEs) or Collective-Owned Enterprises (COEs). Both SOEs and COEs were not independent legal entities but just the subsidiary units of the departments of the central and local governments and they carried out the functions of completing the allocated quotas of production, manufacture, processing and services in all industries, according to the country's planned economy. The governance structures of both followed exactly the bureaucratic structures of the governments at different levels under what was called "One-Man Management System" (OMMS) of the Soviet model. It was replaced by the "Director Responsibility System under the Leadership of the Party" (DRSULP) in 1956.<sup>77</sup> The directors of these enterprises were all appointed by the relevant governments and they were also the officials of the related governments. The enterprises were completely under the dominance of the Communist Party of China (CPC) through the CPC committees at the different level but not under the governance of the board of directors.<sup>78</sup> The directors had to be the members of the CPC, which made them more interested in their future with the CPC rather than in the interests and profits of the enterprises. The corporate legislation

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<sup>75</sup> William C. Kirby "China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China" (1995) 54(1) *The Journal of Asian Studies* 43 at 49.

<sup>76</sup> Company Law 1929 (PRC), Art 129.

<sup>77</sup> John Child *Management in China during the age of reform* (Cambridge University Press, 1994) at 61.

<sup>78</sup> The concept of the board of directors did not exist at that time and the enterprises were governed by what was called "Three Congresses" (*shanhui*), i.e., the congress of the CPC, the congress of the trade union and the general assembly of workers. The functions of all three congresses were to pass the resolutions already decided by the CPC committees. The trade union also had the function to coordinate the relationship between the management and the labors, following the resolutions of the CPC committees. All delegates of the Three Congresses were elected in name but selected by the CPC committees in fact. In reality the whole enterprise was under the control of one person—the secretary of the CPC committee, under either the OMMS or the DRSULP.

lacked a focus on corporate governance in this era and even for many years after the end of the “Cultural Revolution” in 1976.

China started the economic reform in 1978 to reintroduce markets and incentives within the domain of direct state ownership and control, and the DRSULP was formally adopted again the same year, which was modified by the relevant regulations in 1982-1983. The directors were given the power to charge the enterprise operation but were still subject to the leadership of the CPC committees. In May 1984, the “Director Responsibility System” (DRS) was adopted on a trial basis in some selected enterprises and it was formally adopted by the Enterprise Law, passed in April 1988, and hence extended to all SOEs. The DRS marked the beginning of the “separation of party from management”, which meant that directors were no longer directly under the leadership of the CPC committees. But this just diluted the formal powers of the CPC in enterprises and the secretaries of the CPC committees still carried out the responsibilities to guarantee and supervise directors in implementing the policies of the CPC and the state.<sup>79</sup> The economic reform also resulted in the emergence of a significant private sector during this period and some SOEs were allowed by law to become shareholding enterprises through a process of shareholding transformation (*gufenhua*) in 1984, which used stocks to raise funds partly from private sectors that led to some ownership diversification of these enterprises.<sup>80</sup>

In 1993, China began to further the reform of the SOEs by incorporating them into either limited companies or shareholding companies, aiming to address the problem of the government’s unlimited responsibility for the survival of enterprises. Correspondingly, a new round of administrative reform also took place the same year to transform government functions called *Zhengqi Fenkai*, i.e., separation of government from enterprises—which began in 1984. The enterprises gradually became independent corporate entities and market competitors but the government still reserved the control power over the selection of the top management and strategic decision-making of the enterprises. The idea behind the

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<sup>79</sup> Child, above n 77 at 68.

<sup>80</sup> The stocks of these enterprises were allowed to be sold to the public and the first public issue of shares was made in Shanghai in 1985 and the Shanghai Stock Exchange was reestablished in December 1990, followed by the Shenzhen Stock Exchange in July 1991.

shareholding system would allow profit-oriented shareholders to select a board of directors which in turn would select top management of the government-controlled enterprises.<sup>81</sup> The PRC's first Company Law promulgated on 29 November 1993, which followed the German's two-tier model of corporate governance, underpinned for the first time the concept of a legal entity of the modern corporation and adopted the above two corporate forms. The supervision regulations issued by the government in 1994 also showed a tendency to move toward an indirect and delegated form of control in line with the tenet of separation of ownership from management.<sup>82</sup>

China's accession to the World Trade Organization (WTO) in late 2001 indicated its transition toward a market-based system and the commitments under the WTO access made China subsequently deepen the reforms of corporatization and ownership diversification, which brought the issue of corporate governance to the forefront. The corporatization resulted in the SOEs being publicly listed and changed their ownership structures, but the government as the majority shareholder still retained the ultimate control of these partially privatized SOEs through the appointment of the members of their boards of directors. In April 2005, China announced the reform of the split share structure, expecting to better align the interests between shareholders and managers and minority interests by diluting the shareholding of the non-tradable shares held by the government so as to improve the listed companies' corporate governance. On 27 October, 2005, the amended Company Law introduced comprehensive Western corporate governance rules and mechanisms such as cumulative voting, derivative action and the independent director institution, though their functions still remain to be tested.

The board of directors is the critical link between ownership structure and corporate governance, where corporate governance takes place and some solutions to problems of corporate governance can be sought. Independent directors are considered to be such a solution used to solve the problem of monitoring over management, particularly in the

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<sup>81</sup> Shahid Yusuf, et al *Under New Ownership: Privatizing China's State-Owned Enterprises* (Stanford University Press, 2006) at 72.

<sup>82</sup> Stoyan Tenev et al *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (World Bank and the International Finance Corporation, 2002) at 17.

dispersed shareholding ownership structure. The growing interest in independent directors was by no means limited to where the dispersed shareholding ownership structure is dominant but undeniably permeated into where the concentrated shareholding ownership structure has been espoused like China.

A board of directors that is comprised of independent directors is a fairly new corporate governance mechanism for listed companies in China. 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, which suggests that listed corporations may retain independent directors at their option. As of the end of 2000, approximately 5 per cent of the listed companies had introduced independent directors, but their capabilities and independence remain questionable. The two pioneer official documents concerning independent directorship in listed companies in China are the “Guidance Opinion on the Establishment of an Independent Director System in Listed Companies” and “Corporate Governance Guidelines for Listed Companies” announced by the CSRC on August 16, 2001 and January 7, 2002, respectively. On August 16, 2002, the CSRC released the Guidelines of Implementing the Independent Directors System in Listed Companies, which requires at least one third of directors to be “independent”. Correspondingly, independent directors are now in place in most listed companies but their role is still far from satisfactory because of the inherent problem of sole-controlling shareholders and accompanying problems such as money-tunneling (money-appropriating) and disregarding minority shareholders’ interests (see Section 2.5). These problems hinder the effectiveness and efficiency of independent directors as effective monitors.

The Company Law 2005 provides that listed companies should have independent directors in place, aiming to complementarily interplay to the dysfunction of the supervisory board of Chinese listed companies. However, the detail of its enforcement in law remains to be established. This no doubt has left it open to scrutiny in corporate governance because of the controversy about this mixture of the transplantation of independent directors from the unitary board model to the two-tier board model in China. The issue is whether this

transplantation would be successful and therefore set up a new model of corporate governance; there has been little evidence of this so far.

### **1.3 Objectives of the Research**

Corporate governance aims to improve corporate performance and independent directors are considered an important internal control mechanism in order for corporate governance to achieve this goal. This thesis argues that independent directors may play an important role in improving corporate governance in theory but not in reality. The inefficiency of independent directors lends no benefit to sound corporate governance no matter what kind of corporate governance model is adopted. Therefore, the main research aim is to explore how corporate governance and independent directors were formed and evolved in China and to identify the key factors that have significantly influenced the efficacy of corporate governance and efficiency of independent directors, compared with the United States and New Zealand.

The argument is to be carried out by addressing research questions and conducting a meta-empirical study identified through a comprehensive literature review, which shows clearly a need for academic research about independent directors in corporate governance under China's hybrid model of corporate governance. This constitutes the contribution of this research in this field of law by entailing an extensive comparative law research between the US and New Zealand and China combined with a meta-empirical study on independent directors and firm performance in Chinese listed companies, which will show that the transplantation of one model of corporate governance from one shareholding ownership structure to another is subject to path dependency. Such a model is only effective where it is fit and adapted to the heritage of the country adopted the model. The detailed objectives of this research therefore are:

- to review and analyze theories relevant to corporate governance and independent directors and set out the major themes of the research;

- to examine the key issues that may have significant influence on corporate governance and independent directors in China in comparison with the US and New Zealand;
- to compare and contrast the efficacy of corporate governance and the efficiency of independent directors between the US and New Zealand and China;
- to identify and explore the relationship of independent directors and firm performance currently in China;
- to make some suggestions to improve corporate governance and independent directors in China.

#### **1.4 Scope and Contribution of the research**

Based on understanding the nature of the research objectives, the scope of the research<sup>83</sup> is mainly focused on the role of independent directors in effectuating corporate governance<sup>84</sup> because this is an essential part of the role of the board of directors in accomplishing its overseeing role on management for best practice in corporate governance both in the US and New Zealand and in China. Keeping this in mind, this thesis examines such research questions as: (1) what are the relative advantages and disadvantages of the role of independent directors in China compared with that of the US and New Zealand; (2) which corporate governance model upholds the role of independent directors in either the US and New Zealand or China; (3) what factors affect the role of independent directors in corporate governance in either the US and New Zealand or China; (4) to what extent Chinese listed companies may experience a positive transition to good corporate governance.

Specifically, the examinations are to be carried out mainly on ownership structure, the board of directors and board independence, followed by discussion on the basic principles of corporate governance in the context of their effectiveness as corporate governance mechanisms. Where applicable, empirical data will be examined and analyzed in connection with these governance mechanisms, particularly China's current practice. Moreover, the

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<sup>83</sup> The scope of this research is limited to the US, New Zealand and China, except otherwise mentioned.

<sup>84</sup> This means that other aspects of corporate governance such as acquisition and mergence will not fall into the scope of this research. Accordingly, the role of independent directors is also focused on the monitoring role over management and other roles such as the advisory role are not considered by this thesis.

examination is made meta-empirically on the empirical research on the correlation between independent directors and firm performance so as to evaluate the empirical research on the efficiency of independent directors in corporate governance after the adoption of a hybrid model of corporate governance by the formal legislation in the Company Law 2005 in China. The significance of this research is to reduce the gap in this field of law in academic literature and also provide suggestions on how to improve corporate governance in China.

### **1.5 Structure of the Research**

The structure of this thesis is as follows. Chapter One explores the evolution of corporate governance and independent directors in the US, New Zealand and China, which provides the relevant background to the scope of the current research undertaken. Chapter Two discusses the theories and empirical studies in relation to corporate governance and independent directors to establish the key themes to be investigated. They have impact on corporate governance and independent directors and are essential to understand the influences corporate governance and independent directors worked. Chapter Three explains the methodologies used in this thesis and describes the research procedures and data collection process.

Chapter Four examines the distinctive characteristics of ownership structures of listed companies and explores specifically the issues of ownership structure relevant to corporate governance in China. Ownership structure is important in corporate governance (La Porta et al 1999) because the type of corporate control is based on the ownership structure (Berle and Means 1932), both of which are to be analyzed in line with the classification of shareholdings. Chapter Five investigates the characteristics of the board of directors and analyses how the board of directors functions to effectuate good corporate governance. The cognizance is that the board of directors has the power to resolve the conflict of interests between management and shareholders and therefore economizes the agency costs associated with separation of ownership from control, as claimed by Jensen and Meckling. Chapter Six scrutinizes the factors that have influences on board independence, especially on the independence-in-fact of independent directors, which is crucial to the efficiency of the monitoring role of the board of directors displayed by independent directors.

Chapter Seven discusses the supervisory board with focus on the interplay between the roles of independent directors and the supervisory board in the hybrid board model in China. The key question is whether these two parallel oversight institutions can complement each other in the hybrid board model. Chapter Eight supplements the comparative law studies with a meta-empirical study to review and analyze the current empirical research on the correlation between independent directors and corporate performance in China. The purpose is to generalize the impact of the role of independent directors on corporate governance. Chapter Nine comes to conclusions, which will draw out some findings based on this research and make relevant suggestions on how to improve the role of independent directors in corporate governance in China.

### **1.6 Restraint of the Research**

This section explains for readers what this PhD project does not examine. As clearly mentioned in footnotes 83 and 84 of this thesis, the scope of this research is limited to the monitoring role of independent directors in corporate governance in the targeted jurisdictions. Even so, this research is also not able to examine every aspect of the monitoring role of independent directors in corporate governance in the targeted jurisdictions, especially those only marginally connected with the monitoring role of independent directors in Chinese listed companies. In the interests of page space, it is only possible for this research to examine those aspects of the monitoring role of independent directors which are most closely related to three themes set in Section 2.6 of this thesis. Therefore, other aspects of corporate governance and independent directors do not fall into the reach of this research. Specifically, they include but are not limited to the following:

- a. Many other aspects of corporate governance such as insider dealing, market for corporate control, corporate social responsibility and business ethics,
- b. Other roles of independent directors such as their advisory role of independent director,
- c. Other attributes of independent directors such as the gender, concurrent appointments, and citizenship.



## CHAPTER 2

### THEORIES AND EMPIRICAL STUDIES

#### 2.1 Introduction

This chapter begins with an overview of the definitions of independent directors and corporate governance in Section 2.2. It also deals with the corporate control mechanisms of corporate governance. Section 2.3 then discusses some particular problems of independent directors in corporate governance from a variety of theoretical perspectives, including such theories as ownership structure versus board structure, shareholder versus stakeholder, agency cost versus shareholder activism, managerial hegemony versus effective monitor and path dependency versus convergence. In addition, this Section investigates the main models of corporate governance, especially the mixed model in China. Section 2.4 provides a broad view of the relationship of independent directors and corporate performance, and examines the contribution of independent directors as a corporate control mechanism in dealing with corporate governance problems.<sup>85</sup> Section 2.5 analyses independent directors in corporate governance currently in China. Section 2.6 concludes by introducing the key themes of this thesis derived from the theoretical and empirical framework reviewed in this chapter.

#### 2.2 Corporate Governance and Corporate Control

##### 2.2.1 Definition of Corporate Governance and Independent Director

There are no universally recognized conceptualizations of “corporate governance” and “independent director”. It is recognized that substantial differences in definition exist in different economies and that these differences have driven different institutions, interest groups and individuals with different perspectives to formulate no single accepted definition

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<sup>85</sup> Chapter 8 gives a detailed literature review on the relationship between independent directors and corporate performance.

of either corporate governance<sup>86</sup> or independent director.<sup>87</sup> The following definitions selected from the existing corporate governance literature are influential to the development of corporate governance and independent director systems in the relevant jurisdictions.

### Corporate Governance

The generally accepted definition of “corporate governance” comes from the seminal Report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report), which provides that<sup>88</sup>

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

This is the most basic definition that views corporate governance as a set of internal arrangements dealing with the relationship between management and investors with respect to the control of corporations. It focuses on shareholder primacy, a realistic and open-ended description of corporate governance from Anglo-American perspective where the dispersed shareholding structure is adopted such as the United States and New Zealand, but the absence of a reference to other stakeholders is obvious.

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<sup>86</sup> Jill Solomon *Corporate Governance and Accountability* (2nd ed. John Wiley & Sons, 2007) at 12. Traditionally, corporate governance is restricted to the relationship between a company and its shareholders and narrowly expressed in “agency theory”. It is referred to control of corporations and to systems of accountability by those in control (John Farrar *Corporate Governance: Theories, Principles and Practice* (3<sup>rd</sup> ed. Oxford University Press, 2008) at 3). In contrast, corporate governance is seen as a net of relationships between a company and its stakeholders, including not only shareholders but also employees, customers, suppliers, bondholders and society at large and broadly expressed in “stakeholder theory”. It is referred to the system of regulating and overseeing corporate conduct and of balancing the interest of all internal stakeholders and other parties who can be affected by the corporation's conduct (Jean du Plessis, Anil Hargovan and Mirko Bagaric *Principles of Contemporary Corporate Governance* (2<sup>nd</sup> ed. Cambridge University Press, 2011) at 10). In a legal sense, corporate governance refers to the complex of legal rules and constitutional provisions that regulate the internal affairs of the company (Paul Redmond *Companies and Securities Law: Commentary and Materials* (6th ed., Lawbook, 2013) at 239).

<sup>87</sup> Donald C. Clarke “Three Concepts of the Independent Director” (2007) 32 *Del. J. Corp. L.* 73 at 78. Donald C. Clarke claims that there is no single concept of independent director and no single model of what independent directors should do that applies across all the stated fields in different jurisdictions.

<sup>88</sup> “Report of the Committee on the Financial Aspects of Corporate Governance” (1 December 1992) ECGI <http://www.ecgi.org/codes/documents/cadbury.pdf> at 2.5.

In recognition of stakeholders' concern, the Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance states that <sup>89</sup>

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

This definition broadens the traditional limitation on shareholder primacy and realizes stakeholders as an integral part of corporations' existence and long-term prosperity. It emphasizes stakeholder primacy, a proposition firmly espoused in Germany and China where the concentrated shareholding structure is prevailing. However, the weak protection of minority shareholders' interests is also conspicuous and this is especially the situation in China.

#### Independent Director

The definition of the independent director is a collective legal concept which is developed from federal legislation, state law, SEC regulations and stock exchanges' listing rules in the United States. A director may be "independent" when he/she has no relationship with the company and its management other than his/her directorship.

The Investment Company Act of 1940 defines independent directors as those who are not "interested persons" <sup>90</sup> without familial or economic ties to the company and its executives. These persons therefore may "supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs". <sup>91</sup>The aim is to ensure independence from those who manage the company's funds

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<sup>89</sup> "The Organization for Economic Cooperation and Development Principles of Corporate Governance" (2004) OECD <http://www.oecd.org/dataoecd/32/18/31557724.pdf> at 11.

<sup>90</sup> Investment Company Act, above n 36. The definition of "interested persons" is much too complicated to be detailed here and the present description is relatively enough for the current purpose of the thesis. The same is true to the Delaware definition of "disinterested directors" and Michigan definition of "independent directors" in the intra-text.

<sup>91</sup> S. REP. No.91-184 (1969) (legislative history), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4927

<sup>92</sup> and to provide the protection of stockholders in conflict transactions. Delaware law refers those who are not “interested persons” as “disinterested directors”<sup>93</sup> and evaluates the practical constraints on such directors' ability to function effectively in a specific contract or transaction in view of director independence. To deal with the problem of directors' conflict of interests, Michigan law introduces statutorily defined “independent directors”—a parallel to “disinterested directors”,<sup>94</sup> attempting to enhance stockholder protection.

The SEC makes clear that<sup>95</sup>

[A] board of directors, at least 40% of whom must not be ‘interested persons’ of the company under section 2(a)(19) of the Investment Company Act of 1940 (the ‘Act’) (i.e., ‘independent directors’). ... [A] person is an ‘interested person’ due to a material business or professional relationship with a fund or certain persons or entities.

In the wake of widely publicized failures of corporate oversight, the Sarbanes-Oxley Act (SOX) of 2002 requires that the accounting committee completely consist of independent directors to strengthen the structural requirement of board independence.<sup>96</sup>

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<sup>92</sup> Clarke, above n 87 at 95.

<sup>93</sup> DEL. CODE ANN. tit. 8, § 144 (1983). <http://delcode.delaware.gov/title8/c001/sc04/index.shtml#144>. § 144(a) (1) stipulates that “the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors”.

<sup>94</sup> Michigan Business Corporation Act 1972, Act 284, Eff. Jan. 1, 1973; -- Am. 1989, Act 121, Eff. Oct. 1, 1989. [http://www.legislature.mi.gov/\(S\(kot55lmt1yogt1bfusy4wsea\)\)/mileg.aspx?page=getobject&objectname=mcl-450-1107&query=on](http://www.legislature.mi.gov/(S(kot55lmt1yogt1bfusy4wsea))/mileg.aspx?page=getobject&objectname=mcl-450-1107&query=on). § 450.1107(3) sets out the definition of “independent directors.”

<sup>95</sup> SEC Interpretation: Matters Concerning Independent Directors of Investment Companies, SEC 17 CFR Part 271[Release No. IC-24083], Eff.: Oct. 14, 1999 <http://www.sec.gov/rules/interp/ic-24083.htm> at 1.

<sup>96</sup> Sarbanes-Oxley Act 2002 (US), above n 46. §301(3)(A) provides that “(e)ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent”. See also Dodd-Frank Act 2010 (US), above n 47. Dodd-Frank Act 2010 further enhances the structural requirement of board independence by mandating the compensation committee fully composed of independent directors. §952 amends the Securities Exchange Act of 1934 by inserting §10C after §10B. §10C(a)(2)(B) provides that the Commission “shall require that each member of the compensation committee of the board of directors of an issuer be ... independent.” Under §10C(a)(1), the Commission “shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer, other than an issuer that is a controlled company, limited partnership, company in bankruptcy proceedings, open-ended management company that is registered under the Investment Act of 1940, or a foreign private issuer that provides annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee, that does not comply with the requirements of this subsection.”

Correspondingly, the SEC requested that the NYSE and NASDAQ review and modify corporate governance standards. In response, the NYSE tightened the definition of independent directors so that<sup>97</sup>

No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).

In a similar way, the NASDAQ restates that<sup>98</sup>

“Independent director” means a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The distinction can be seen in the NYSE and NASDAQ definitions, though the independence test is applied to both.<sup>99</sup> The former stresses that no material relationship exists between independent directors and the company. The latter highlights that no relationship would interfere with a director’s independent judgment. This may lead to no consistent single definition of the independent director.

## 2.2.2 Corporate Control

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<sup>97</sup> NYSE Corporate Governance Requirements, § 303A.02 (a), January 11, 2013 (NYSE-2012-49) <http://nysemanual.nyse.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F>.

<sup>98</sup> NASDAQ Corporate Governance Requirements, § 5605 (a) (2), Jan. 11, 2013 (SR-NASDAQ-2012-109) <http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F3%5F8&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F>.

<sup>99</sup> See notes 97 and 98. Both definitions are dominant in the United States and also export overseas. For example, the CSRC imports them into China and officially defines that “Independent directors of the listed company refer to the directors who hold no posts in the company other than the position of director, and who maintain no relations with the listed company and its major shareholder that might prevent them from making objective judgment independently”. (Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001, Art 1.1, CSRC Zhengjianfa [2001] No. 102. [http://www.csrc.gov.cn/pub/csrc\\_en/newsfacts/release/200708/t20070810\\_69191.htm](http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.htm))

Variations in the definitions of corporate governance and independent directors indicate different perspectives on policy considerations concerning corporate control in corporate governance. These considerations can be observed from the effects of corporate control with regard to oversight over management so that shareholders/stakeholders' interests are protected. Capital markets, product and factor markets, legal/political/regulatory system and the board of directors are four control forces that operate on corporations to resolve problems such as agency costs caused by a divergence between managers' decisions from shareholders' interests. Such forces are classified in terms of internal and external controls that are used to protect the rights of shareholders given the separation of ownership from control.<sup>100</sup> Both are interdependent in the monitoring of top management and the external control has the differential effects on the effectiveness of the internal control.<sup>101</sup>

### Internal Control

Internal control is designed to solve the problem of ineffective governance of companies owing to the conflict of interests between managers and stockholders. To solve the problem, the board of directors is considered the mechanism of internal control for oversight on management in order to make corporate governance effective. The board of directors is central to corporate control in market economies and is presumed to exercise the monitoring function on behalf of shareholders because of the free-rider problem if shareholders are expected to monitor managers.<sup>102</sup> However, the effectiveness of boards' monitoring function is determined by board independence, which is measured by the presence of independent directors in the boardroom and the degree of board independence. Independent directors therefore are relied on by law to act as the means of the internal control to check against managerial indiscretion when the potential conflict of interests between managers and stockholders arises.

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<sup>100</sup> Michael C. Jensen "The modern industrial revolution, exit and failure of internal control systems" (1993) 48 (3) *Journal of Finance* 831 at 850.

<sup>101</sup> Rajeeva Sinha "Regulation: The Market for Corporate Control and Corporate Governance" (2006) 16 (3) *Global Finance Journal* 264 at 265.

<sup>102</sup> Kose John & Lemma W. Senbet "Corporate Governance and Board Effectiveness" (1998) 22 (4) *Journal of Banking & Finance* 371 at 373, 379.

As the governance mechanism on behalf of the board of directors to monitor management, independent directors are regarded as less susceptible to shirking on account of their independence from management and therefore in a better position to monitor managers. But managers have developed internal entrenchment practices such as altering person, situation and performance assessments and neutralizing internal control mechanisms to work against the efficiency of independent directors.<sup>103</sup> Thus, the efficacy of such a governance mechanism has been called into question<sup>104</sup> and “independent directors often turn out to be lapdogs rather than watchdogs”<sup>105</sup> in light of many corporate scandals and financial failures over time. Empirical studies<sup>106</sup> overwhelmingly support the proposition that the internal control mechanisms such as the board of directors and independent directors have generally failed to make managers maximize governance efficiency and corporate value.

### External Control

The market for corporate control (MCC) by means of mergers and acquisitions (M&A) is one of the external controls used to correct the dysfunction of the board of directors’ oversight on management. As a discipline of last resort for the failure of internal control, the MCC provides additional disciplining on management as well as the board by what are termed as the “kick-in-the-pants effect” or the “substitution effect”.<sup>107</sup> The former predicts that the presence of an active MCC may lead to the board being dismissed by a successful acquirer, who views the incumbent board as lax for its leniency toward its managers; the latter envisages that the existence of the MCC can shift the burden of replacing inefficient managers from the board to potential acquirers.<sup>108</sup> There is a complementary interaction between the internal and external control mechanisms, especially the MCC which places a

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<sup>103</sup> James P. Walsh & James K. Seward “On the Efficiency of Internal and External Corporate Control Mechanisms” (1990) 15 (3) *Academy of Management Review* 421 at 431-432.

<sup>104</sup> Nicola F. Sharpe “Rethinking Board Function in the Wake of the 2008 Financial Crisis” [2010] *Journal of Business & Technology Law* 99 at 108.

<sup>105</sup> Sanjai Bhagat & Bernard Black “The Uncertain Relationship Between Board Composition and Firm Performance” (1999) 54 *Business Law* 921 at 922.

<sup>106</sup> At 921. See also supra footnote 100. Rajeeva Sinha provides (in footnote 30) a partial list of references.

<sup>107</sup> David Hirshleifer & Anjan V. Thakor “Corporate Control through Board Dismissal and Takeovers” (1998) 7 (4) *Journal of Economics and Management Strategy* 489 at 493.

<sup>108</sup> Ibid.

direct risk on top management of being disciplined for its abuse of discretion and its mismanagement. But managers have invented such external entrenchment practices as greenmails, poison pills, spin-offs, sell-offs and golden parachutes to subvert the MCC. These practices make the MCC costly and prohibitive to operate so that management can become immune to external control.<sup>109</sup>

## Summary

Although different in definitions, corporate governance and independent directors involve a set of internal and external control mechanisms to check managerial misbehaviors so as to promote efficient business operation and maximize shareholders/stakeholders' interests. In the dispersed shareholding structure, corporate governance is defined narrowly and independent directors as the internal control mechanism are designed to serve the interests of shareholders. This is the system in jurisdictions such as the United States and New Zealand. In the concentrated shareholding structure, corporate governance is defined broadly and independent directors as the internal control mechanism to serve the interests of stakeholders. This is the system in jurisdictions such as China.

In a market economy, the external control mechanisms such as the MCC can operate interdependently with the internal control mechanisms such as independent directors, though the external entrenching practices (greenmail, poison pill, spin-off, and golden parachute) are resistant in jurisdictions like the United States. In a non-market economy like China, the external control such as the MCC is absent. The M&A process is policy-oriented and market forces don't work. There is no interdependence to complement the malfunction of such internal control mechanisms as independent directors.

## **2.3 Theories and Models of Corporate Governance**

### 2.3.1 Theories

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<sup>109</sup> Walsh & Seward, above n 103 at 437-441.



Theories that have impact on corporate governance and independent directors are to be probed because they are essential to understand the bases on which the model of corporate governance and the role of independent directors work. These theories are ownership structure versus board structure, shareholder versus stakeholder, agency cost versus shareholder activism, managerial hegemony versus effective monitor and path dependency versus convergence.

### 2.3.1.1 Ownership Structure versus Board Structure

The theory is that the ownership structure emerges as “an endogenous outcome of competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm”.<sup>110</sup> Ownership structure represents the relative amounts and fraction of equity claims held by inside management and outside investors with no direct role in the management of the firm.<sup>111</sup> It is a natural course of historically competitive selection in which shareholders of the corporation balance their preferences of the separation of ownership and control to diversify their capitals, depart with their property rights and free themselves from their monitoring responsibilities. The endogenous outcome of the selection for an equilibrium organization of the firm is the decision that reflects the influence of shareholders’ preferences and of trading on the market for shares,<sup>112</sup> which is the choice between the dispersed and concentrated ownership structures.

The emergence of ownership structures, either concentrated or dispersed, is influenced by the profit-maximizing interests of shareholders<sup>113</sup> in terms of cash flow and voting rights according to their shareholdings. These rights form private benefits of control and the size and degree of these benefits influences the choice of ownership structure by founders of

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<sup>110</sup> Harold Demsetz “The Structure of Ownership and the Theory of the Firm” (1983) 16 *Journal of Law & Economics* 375 at 384.

<sup>111</sup> Jensen & Meckling, above n 1 at 357.

<sup>112</sup> Harold Demsetz, Belén Villalonga “Ownership structure and corporate performance” (2001) 7 (3) *Journal of Corporate Finance* 209 at 210.

<sup>113</sup> *Ibid.*

corporations.<sup>114</sup> When private benefits of control are high, the concentrated ownership structure might be a preference to maintain a lock shareholding for fear of a control grab by outside investors; while private benefits of control are low, the dispersed ownership structure could be favored in order to pursue corporate efficiency in ignoring the possibility of a control grab.<sup>115</sup>

Law also affects the choice of ownership structures. Jensen & Meckling (1976) pointed out that ownership structure might be chosen to minimize the sum of agency costs and diversification costs. Mark J. Roe (1990, 1994) observed that legal rules in the US make lock shareholding costly and difficult, which differentiates the ownership structure in the US from other countries. Furthermore, where the protection of minority shareholders is strong, the dispersed ownership structure is accepted; where the protection of minority shareholders is weak, the concentrated ownership structure is predominant.<sup>116</sup>

History plays a crucial role in investors' choices of the ownership structures of firms and this can be evidenced by the "Corporation Revolution" in 1880-1930 in the US<sup>117</sup> and the "Land of Cartels" from the early 1870s to World War I in Germany.<sup>118</sup> As an endogenous outcome of competitive selection in a great merger wave of the "Corporation Revolution",

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<sup>114</sup> Lucian A. Bebchuk "A Rent-Protection Theory of Corporate Ownership and Control" (1999 Paper 260) Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series, [http://lsr.nellco.org/harvard\\_olin/260](http://lsr.nellco.org/harvard_olin/260) at 1.

<sup>115</sup> At 2.

<sup>116</sup> Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer "Corporate Ownership around the World" (1999) 54 (2) *Journal of Finance* 471 at 496-497.

<sup>117</sup> Brian R. Cheffins "Mergers and Corporate Ownership Structure: the United States and Germany at the Turn of the 20th Century" (2003) 51 *Am. J. Comp. L.* 473 at 478. While the concentrated ownership structure based on family-oriented companies was the norm at the beginning of this period, a great merger wave occurred in 1897-1903 arguably was critical to yield what is called outsider/arm's length corporate governance pattern of managerial control and dispersed ownership structure that now distinguishes the U.S corporate economy from that of most other countries.

<sup>118</sup> John F. Wilson *British Business History, 1720-1994* (Manchester University Press, Manchester (UK) 1995) at 72. See also David G. Gerber *Law and Competition in Twentieth Century Europe* (Oxford University Press, 1998) at 74. Since its unification, Germany used the cartel via collusive activities as the primary agent when confronted with strong competitive pressures. Awareness in Germany was that an amalgamation by the cartel could produce a managerially centralized corporation used to rationalize production in industry and the cartelization could soften and stabilize the industrialization process to protect the vested interests of participating companies. This cartelization arrangement kept ownership structure concentrated on and corporate control remained with founding families of firms, which formed what is termed as the "insider/control-oriented" pattern of corporate governance and continues as the norm today.

the dispersed ownership has been taken as the norm of the widely held ownership structure for dealing with observed or alleged agency cost problem in the governance of U.S. corporations, pronounced by Berle and Means in 1932. In contrast, Germany kept to the concentrated ownership structure in order to remain free of agency costs and take hold of corporate control even in fierce corporate acquisitions during the late 19<sup>th</sup> century and early 20<sup>th</sup> century. These two examples show that the initial choice of the corporate ownership structure in a legal system is influential to the development of its corporate ownership structure in that legal system. That is, history matters.

The private benefits of control influence not only the choice of ownership structure but also the choice of board structure in view of “the interdependence of ownership structure and board structure”<sup>119</sup> and the “significant effects of ownership structure on the composition of corporate boards”.<sup>120</sup> Board structure denotes the composition of the board of directors based on the ratio of insiders (executive directors) and outsiders (independent directors), which is a signal of the degree of board independence. According to Raheja, the optimal board structure is the tradeoff between insiders’ maximum incentive to be informed of their private benefits, minimum coordination costs among outsiders and outsiders’ maximum ability to reject inferior projects.<sup>121</sup> Private benefits measure effort aversion and managerial perks to insiders from inferior projects.<sup>122</sup> Jensen (1986) argues that private benefits such as free cash flow motivate insiders to consume those private benefits themselves rather than to create wealth for shareholders because such benefits cause agency conflicts. High private benefits decrease insiders’ incentive to disclose information, increase outsiders’ coordination costs and decrease outsiders’ ability to verify projects.<sup>123</sup> In other words, the higher the opportunity of insiders to consume private benefits the lower the possibility that monitoring costs will increase and the lower the opportunity of outsiders to monitor.

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<sup>119</sup> David Hillier & Patrick McColgan “An Analysis of Changes in Board Structure during Corporate Governance Reforms” (2006) 12 (4) *European Financial Management* 575 at 576.

<sup>120</sup> Jiaotao Li “Ownership Structure and Board Composition: A Multi-country Test of Agency Theory Predictions” (1994) 15 (4) *Managerial and Decision Economics* 359 at 366.

<sup>121</sup> Charu G. Raheja “Determinants of Board Size and Composition: A Theory of Corporate Boards” (2005) 40 (2) *Journal of Financial and Quantitative Analysis* 283 at 283-284.

<sup>122</sup> At 298.

<sup>123</sup> At 299.

Thus, “firms with high private benefits to insiders require a board structure with better incentives for insiders to inform even though this decreases the incentive for outsiders to verify projects”.<sup>124</sup> That is, board structure is positively related to insiders' private benefits and negatively related to the cost of monitoring. However, effort aversion and managerial perks drive insiders to minimize the outsiders in the boardroom because board structure is used to maximize shareholders' wealth. This is especially true when insiders also are majority shareholders or representatives on behalf of majority shareholders. But the representation of outsiders on the board decreases the power of management in terms of the CEO-tenure and voting control and increases the power of outsiders backed by outside investors-venture capital.<sup>125</sup> There is a tradeoff, or what is called “a game of bargaining between the CEO and outside directors.”<sup>126</sup> Some argue that this is the distribution of voting powers among different shareholder groups regarding their bargaining positions on board composition.<sup>127</sup> The outcome of the bargaining game is to arrive at an endogenous equilibrium of board independence measured by the proportion of independent directors on the board. When equilibrium is reached, there are an agreed proportion of outsiders on the board and the board structure is termed as a “One-Tier Board (or Unitary Board), which is usually associated with the dispersed ownership structure. When equilibrium is broken, there is no agreed proportion of outsiders on the board and the board structure is called a “Two-Tier Board” on account of a concomitant board to supervise management, which is connected with the concentrated ownership structure. However, board structure evolves overtime and changes in board structures may happen in between when equilibrium is in standstill and the bargaining between insiders and outsiders is nip and tuck. As a compromise, a hybrid board structure, a combination of a One-Tier Board and a Two-Tier Board, may occur.

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<sup>124</sup> At 298.

<sup>125</sup> Malcolm Baker & Paul A. Gompers “The Determinants of Board Structure at the Initial Public Offering” (2003) 46 (2) *Journal of Law and Economics* 569 at 569.

<sup>126</sup> Benjamin E. Hermalin & Michael S. Weisbach “Endogenously Chosen Boards of Directors and Their Monitoring of the CEO” (1998) 88 (1) *Am. Econ. Rev* 96 at 96, 104.

<sup>127</sup> Robert Kieschnick & Rabih Moussawi “the Board of Directors: A Shareholder Perspective” (paper presented at the FMA meeting, the University of Texas, Dallas, 2006) 1 at 23.

History matters in this type of bargaining game. The great wave of mergers in the “Corporation Revolution” in the US promoted the development of the One-Tier board structure as the corporate control mechanism aiming to protect investors’ interests. In contrast, the movement of the “Land of Cartel” in Germany inherited the traditional Two-Tier board structure suggested at the Nuremberg Conference in 1857 with the purpose of caring about stakeholders concerned. In case of China, the Ordinance Concerning Commercial Associations (*Shanghai Tiaoli*) enacted in 1914 formally followed the German model of Two-Tier board structure. However, China’s commitments under the WTO entry in late 2001 changed this model to a hybrid one by a transplantation of the One-Tier board structure from overseas combined with the existent Two-Tier board structure.

Therefore, an understanding of theories of ownership structure and board structure is essential to investigate how the ownership and the board of corporation are structured, how the ownership structure influences the board structure, what the connections between the ownership and board structures on one hand and the models of corporate governance on the other hand are, the advantages and disadvantages of these structures and models, whether one type of structure or model is better than the other, and how they have changed over time. These are the issues investigated in Chapter Four and Chapter Five, respectively.

### 2.3.1.2 Shareholder versus Stakeholder

The nature and purpose of the corporation are the core issues of corporate governance and they are also the focus of shareholder and stakeholder theories. The shareholder theory views the nature of the firm as the system of relationships when entrepreneurs organize the distribution of resources according to the price mechanism in an exchange economy,<sup>128</sup> which was expounded as “a contractual structure”<sup>129</sup> or a “nexus of contracts”<sup>130</sup> to

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<sup>128</sup> R. H. Coase “The Nature of the Firm” (1937) 4 (16) *Economica, New Series* 386 at 397.

<sup>129</sup> Armen A. Alchian & Harold Demsetz “Production, Information Costs, and Economic Organization” (1972) 62 (5) *Am. Econ. Rev.* 777 at 794.

<sup>130</sup> Eugene Fama & Michael Jensen “Separation of Ownership and Control” (1983) 26 (2) *J.L. & Econ* 301 at 302.

emphasize the essential contractual nature of firms. Correspondingly, the purpose of the firm is to maximize the shareholders' wealth, which is represented as "shareholder primacy." In contrast, the stakeholder theory regards the nature of the firm as the "*pactum subjectionis*",<sup>131</sup> a mutual agreement under which stakeholders, who make firm-specific investments, yield control over both those investments and the resulting output to the corporation's internal governing hierarchy to stress the hierarchical nature of corporations. It means that a firm is a team of people who enter into a complex agreement to work together for their mutual gain through a process of "team production."<sup>132</sup> Consequently, the purpose of the firm is to maximize the wealth of the firm *per se* but not only the wealth of shareholders.<sup>133</sup>

The shareholder theory is based on the theories of agency and property rights, while the stakeholder theory finds support from the "communitarian" or "progressive" school of corporate governance scholars. In support of shareholder primacy, Berle argues that managers owe fiduciary duties to shareholders as beneficiaries of the corporation and managerial powers are held in trust only for the ratable benefit of shareholders as their interests appear.<sup>134</sup> This is because shareholders are owners of the corporation and managers' obligations to shareholders stem from their role as trustees or agents. His effort is to establish a legal control that will effectively constrain managers' shirking their trusteeship responsibilities to corporate beneficiaries and prevent their rent-seeking for their own profits but not for corporate stockholders. Espousing stakeholder theory, Dodd advocates that "those who manage our business corporations should concern themselves with the interests of employees, consumers, and the general public, as well as of the

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<sup>131</sup> Margaret M. Blair & Lynn A. Stout "A Team Production Theory of Corporate Law" (1999) 85 (2) *Virginia Law Review* 247 at 320. The phrase of "*pactum subjectionis*" refers to the supposed pact that existed between the king and his subjects in medieval Europe. See *United States v. Standard Oil Co.*, 60 F. Supp. 807, 811 (S.D. Cal. 1945), rev'd, 153 F.2d 958 (9th Cir. 1946), aff'd, 332 U.S. 301 (1947).

<sup>132</sup> Alchian & Demsetz, above n 129 at 779.

<sup>133</sup> Michael C. Jensen "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2001) 14 (3) *Journal of Applied Corporate Finance* 8 at 8. Jensen defines firm wealth as "the sum of the values of *all* financial claims on the firm – debt, warrants, and preferred stock, as well as equity." See also Jeffrey N. Gordon "The Contestable Claims of Shareholder Wealth Maximization: Evidence from the Airline Industry" (working paper, Nov. 25, 2002). Gordon shows that employee value can also be incorporated into firm wealth.

<sup>134</sup> Adolf Berle "Corporate Powers as Powers in Trust" (1931) 44 *Harv. L. Rev.* 1049 at 1049, 1074.

stockholders”.<sup>135</sup> This is because public opinion views “the business corporation as an economic institution which has a social service as well as a profit-making function” and law takes the position that “business is a public profession rather than a purely private matter”.<sup>136</sup> In his view, a businessman owes a legal duty to give adequate service at reasonable rates rather than be free to obtain all the profits because business is a service to the community but not a source of profit to its owners. Therefore, the effort of a team of people entering into a mutually binding agreement in the corporation is to reduce wasteful shirking and unscrupulous rent-seeking by relegating to the internal hierarchy the right to determine the division of duties and resources in the joint enterprise.<sup>137</sup>

According to the shareholder theory, shareholder value is the overriding imperative in corporate governance and the board of directors as the corporate control mechanism is legally responsible only to shareholders and accountable for monitoring managers running the corporation in the best interests of shareholders. In the view of those who espouse the stakeholder theory, it is a short-term strategy to treat shareholders as sole owners of the firm since it can undermine shareholder value from long-term planning of corporate development. Management may risk maximizing shareholder value at the expense of other stakeholders who have interests in the firm. Some contend that a stakeholder approach applies a structured interaction between management and all stakeholders in decision-making to sustain a long-term development of the firm.<sup>138</sup> Hence, the board of directors should act as the mediating hierarchy to balance team members' competing interests for the benefits of the corporation itself but not shareholders only.<sup>139</sup>

Shareholder primacy focuses on the board of directors' responsibilities for minority shareholder protection in common law countries such as the US and New Zealand, while stakeholder primacy ignores the board of directors' accountabilities for minority shareholders' interests in civil law countries like Germany and China. Arguably, the

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<sup>135</sup> Merrick Dodd “For Whom are Corporate Managers Trustees?” (1932) 45 *Harv. L. Rev.* at 1156.

<sup>136</sup> At 1148.

<sup>137</sup> Blair & Stout, above n 131 at 278.

<sup>138</sup> Detomasi, D. “International Institutions and the Case for Corporate Governance: Toward a Distributive Governance Framework?” (2002) 8 (4) *Global Governance* 421 at 431.

<sup>139</sup> Blair & Stout, above n 131 at 281-282.

shareholder theory is connected with the dispersed ownership structure and is heralded as an exemplar in Anglo-American corporate cultures; while the stakeholder theory is linked with the concentrated ownership structure and is presaged as paradigm in continental and Asiatic business values. This may suggest that law matters in shareholders' choices of corporate ownership structure in connection with either shareholder primacy or stakeholder primacy. Where law upholds shareholder primacy the dispersed ownership structure prevails because shareholders are protected by law but not by their shareholdings. Where law sustains stakeholder primacy the concentrated ownership dominates because law provides little protection on shareholders, whose interests are protected by the stake of their shares.

Currently, corporate governance in China is built on the stakeholder theory with a hybrid board structure brought about by the transplantation of independent directors from the US's one-tier board structure into its existing two-tier board structure, with the expectation that minority shareholder protection will be improved. Whether this transplantation will instill the shareholder theory into the stakeholder theory in China is of great interest both from a theoretical and practical perspective and it is also the subject of this research. Thus, the shareholder and stakeholder theories are considered in this thesis.

#### 2.3.1.3 Agency Costs versus Shareholder Activism

Separation of ownership and control brings about the issue of agency costs on the one hand and provides the basis for shareholder activism on the other. The driving concerns of the agency costs theory and the shareholder activism theory are the fundamental issues of monitoring costs and means of reducing them in solving the problems of shirking and monitoring in corporate management.

Agency costs stem from where there is a principal-agent relationship when the agent does not act in the best interest of the principal but rather in his/her own interests. It behooves the principal to monitor the agent's aberrant behaviors by establishing appropriate



incentives to limit the agent from diverging from the principal's interests.<sup>140</sup> This obligation gives rise to agency costs as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss to the principal occasioned by the agent's divergence from the principal's interests.<sup>141</sup> It fits the relationship between stockholders and managers of a corporation in association with the separation of ownership and control in the modern diffused ownership corporation.<sup>142</sup> In a principal-agent relationship, agency costs are an inevitable consequence of the delegation of corporate management by stockholders to managers who are professionals in running businesses and whose interests are in conflict with those of delegators. This is because the nature of the diffuse ownership structure and the lack of professional skills make it unrealistic for shareholders themselves to run day-to-day corporate operations. In addition, the free-rider problem creates a moral hazard for shareholders to monitor management either individually or collectively. These cause agency costs which are prohibitively high. Agency costs not only occur in the dispersed ownership corporation but they also happen in the modern concentrated ownership corporation as a result of the existence of similar principal-agent relationships. In a company completely owned by one shareholder, there is no principal-agent relationship and agency costs are consumed by the owner him/herself. However, this is usually not the case in modern concentrated ownership companies which also have minority shareholders, especially publicly held companies. The difference is that the principal-agent relationship is between majority shareholders and minority shareholders.

Agency costs give rise to the efficiency problem of the manager-shareholder relationship in corporate operations<sup>143</sup> owing to “faithless” managers pursuing their own perks at the expense of shareholders’ wealth.<sup>144</sup> Therefore, the central focus in corporate governance “is reducing ‘agency costs’ by keeping directors and managers faithful to shareholders’ interests”.<sup>145</sup> The agency costs theory is based on shareholder primacy and seeks ways to

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<sup>140</sup> Jensen & Meckling, above n 1 at 309, 310.

<sup>141</sup> Ibid.

<sup>142</sup> Ibid.

<sup>143</sup> Blair & Stout, above n 131 at 258.

<sup>144</sup> Christopher R. Leslie “Cartels, agency costs and finding virtue in faithless agents” (2007-2008) 49 (5) *Wm. & Mary L. Rev.* 1621 at 1636.

<sup>145</sup> Blair & Stout, above n 131 at 248-249.

minimize the risks and costs of managers' opportunistic behaviors. Traditionally, one way of reducing agency costs is for the board of directors, on shareholders' behalf, to monitor managers acting appropriately. Independent directors are considered as the best agents for dispersed shareholders to perform the monitoring role of the board of directors. However, the effectiveness of this governance strategy depends heavily upon shareholder activism and this in turn rests upon shareholders' ability to coordinate and act to lower agency costs.<sup>146</sup> The reasoning is that the efficacy of independent directors' monitoring role is not only independent of management but also dependent on shareholders. But prohibitively high agency costs may discourage shareholder activism.

Shareholder activism is viewed as representing a continuum of responses to corporate performance and the potential for shareholder activism arises when shareholders believe that the board of directors has failed in its duty, i.e., shareholders voice their dissatisfaction with the performance of the board of directors.<sup>147</sup> Put another way, shareholders exercise their "voice" by taking positive actions or interventions rather than relying on the market for corporate control<sup>148</sup> to change the *status quo* without a change in corporate control. Shareholder activism is argued as a necessary countervailing force to combat the agency problem in widely held public companies and a form of market-based governance intended to monitor management.<sup>149</sup> The motivation is to defend against managerial deviations from wealth maximization for shareholders. As an internal governance mechanism characterized by a form of market-based discipline, shareholder activism originates primarily from institutional investors rather than from individual shareholders, who are deterred by prohibitively high agency costs to wage a shareholder activism campaign individually. Two distinct approaches generally used to voice dissatisfactions are shareholder proposals and jawboning as constraints on corporate managers.<sup>150</sup>

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<sup>146</sup> Stuart Chan "Corporate Agency Costs –An Unresolved Problem" (2010) 7 *Inter Alla Summer* 102 at 113.

<sup>147</sup> Stuart L. Gillan & Laura T. Starks "A Survey of Shareholder Activism: Motivation and Empirical Evidence" (1998) 2 (3) *Contemporary Finance Digest* 10 at 11-12.

<sup>148</sup> Albert O Hirschmann *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press, 1970) at 46.

<sup>149</sup> Iris H-Y Chiu *The Foundations and Anatomy of Shareholder Activism* (Hart Publishing, 2010) at 7.

<sup>150</sup> Bernard S. Black "Shareholder Activism and Corporate Governance in the United States" in Peter Newman (ed.) *The New Palgrave Dictionary of Economics and the Law* (Macmillan, London, 1998) vol. 3 at 460, 461. Shareholder proposal is to present or threatening to present a corporate governance issue at a company's annual shareholder meeting. Jawboning is to put pressure through private negotiation on a

Institutional investors are governance-centric and their voice is usually related to the appointment/removal of directors or the composition of the board of directors.<sup>151</sup> In this way, institutional shareholder activism can speak against the inertia of the board's monitoring role, either through shareholder proposals or jawboning, to change board composition so that independent directors are included in order to improve board independence and so as to minimize agency costs and maximize shareholder wealth. Critics of shareholder activism claim that institutional investors may be reluctant to voice their dissatisfaction<sup>152</sup> because the costs of shareholder activism are likely to exceed the benefits.<sup>153</sup> It is only possible for institutional investors to launch a shareholder activism campaign when the potential benefits gained are much larger than the impending costs incurred. Even in the US, the headstream of shareholder activism where large publicly traded companies with absentee owners prevails, the overall level of institutional shareholder activism is quite low because of the problems of agency costs and collective action.<sup>154</sup> In other countries like China shareholder activism is absent. The empirical literature provides little evidence that shareholder activism has much effect on targeted firms' operations.<sup>155</sup> Therefore, the proposition that board independence is dependent on shareholders, i.e., shareholder activism, is still subject to justification and Chapter Six takes this perspective into consideration based on the theories of agency costs and shareholder activism.

#### 2.3.1.4 Managerial Hegemony versus Effective Monitor

The received wisdom is that board independence means that independent directors are

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company's managers or board of directors to achieve a change in management or strategy. Both are usually the ways that institutional investors take advantage of their shareholdings to put pressure on management of their portfolio companies, aiming to make changes in the corporate governance of those companies.

<sup>151</sup> Chiu, above n 149 at 132.

<sup>152</sup> Stuart L. Gillan & Laura T. Starks "The Evolution of Shareholder Activism in the United States" <http://ssrn.com.ezproxy.auckland.ac.nz/abstract=959670> at 13.

<sup>153</sup> Roberta Romano "Less is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance" (2001) 18 *Yale Journal on Regulation* 174 at 231.

<sup>154</sup> Black, above n 150 at 473.

<sup>155</sup> Jonathan M. Karpoff "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings" (18 August 2001) <http://ssrn.com.ezproxy.auckland.ac.nz/abstract=885365> at 27.

independent of management, but managerial hegemony challenges board independence by undermining independent directors as effective monitors. The managerial hegemony theory describes the board of directors as “something of a legal fiction”<sup>156</sup> or “necessary but unimportant legal appendage”<sup>157</sup> that is merely “a creature of the chief executive.”<sup>158</sup> This theory depicts the board of directors as an institution with *de jure* power which “tend to temper the inclinations”<sup>159</sup> of the dominant management with *de facto* power, in spite of its nominal governing power over management on behalf of stockholders.<sup>160</sup> Under the managerial hegemony theory, the CEO controls who sits in the boardroom while he/she dominates in power. Consequently, “the Board of Directors is normally the passive instrument of the management”<sup>161</sup> and plays an ineffective role in monitoring management by rubber-stamping the action of management. This view of the corporate board is influential in emphasizing the growth of corporate control by management as corporate ownership becomes more dispersed.

It is claimed that the ineffectiveness of the board to monitor management comes from the deficiency of board independence. This is consistent with the managerial hegemony theory that the board's ineffectiveness is a result of management's control over the selection of independent directors, which makes independent directors lack independence from the incumbent management. As pointed out by Mace, the CEOs flaunt their powers of control to select independent directors “who are known as noncontroversial, friendly, sympathetic, [and] congenial” but not those “known as boat-rockers or wave-makers” who may ask “discerning, challenging, and abrasive questions” to embarrass them, jeopardize their tenures or threaten their positions.<sup>162</sup> This means that independent directors selected in this way are unlikely to be critical of management unless they are “prepared to resign.”<sup>163</sup>

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<sup>156</sup> Smith, E. E. “Management’s least-used asset: the board of directors” in *The Dynamics of Management Report* (Management Report Number 14, American Management Association, New York, 1958)) at 49.

<sup>157</sup> Myles L. Mace *Directors: Myth and Reality* (Division of Research, Graduate School of Business Administration, Harvard University, Boston, 1971) at 84.

<sup>158</sup> Smith, above n 156.

<sup>159</sup> Mace, above n 157 at 181.

<sup>160</sup> Edward S. Herman *Corporate control, corporate power: A Twentieth Century Fund Study* (Cambridge University Press, Cambridge & New York, 1981) at 28.

<sup>161</sup> John Kenneth Galbraith *The new industrial state* (2nd ed., André Deutsch, London, 1972,) at 149.

<sup>162</sup> Mace, above n 157 at 69, 108, 181 and 196.

<sup>163</sup> At 69.

Bearing in mind that the prestige and financial rewards of a seat on the board have been bestowed by the CEOs, independent directors are usually reluctant to confront management but comfortable as “attractive ornaments on the corporate Christmas tree”<sup>164</sup>. The CEOs then are satisfied that “Nor should the board do anything except go along with management”.<sup>165</sup> Under managerial hegemony, the board is powerless in checking managerial overreaching because it is unavoidably controlled by management. So, it can only passively exercise its control over management and therefore is ineffective in the eyes of stockholders.

Corporate law depends on the board of directors as the representative of stockholders to oversee management performance and protect shareholder interests. Effectively monitoring conflicts of interest between managers and shareholders is an important means of aligning management incentives with shareholder preferences. The board of directors, as “the only genuine, proactive internal mechanism of corporate governance”<sup>166</sup>, is “uniquely suited” to perform its “principal function” of conflicts monitoring<sup>167</sup> and is regarded as the guardian to guarantee corporate management without engaging in what is seen as unconscionable conduct.<sup>168</sup> This guarantee however is dependent on whether independent directors are effective monitors of management performance.

The “effective monitor” theory suggests that independent directors “might best be regarded as professional referees whose task is to stimulate and oversee the competition among the firm’s top management”<sup>169</sup> since independent directors “can be trusted to monitor effectively rests on noblesse oblige”.<sup>170</sup> The reasoning is that the effective separation of top-level decision management and control makes independent directors have incentives to carry out tasks involving serious agency problems between internal managers and

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<sup>164</sup> At 107.

<sup>165</sup> At 69.

<sup>166</sup> Seth W. Ashby “Strengthening the Public Company board of Directors: Limited Shareholders Access to the Corporate Ballot vs. Required Majority Board Independence” [2005] *U. Ill. L. Rev.* 521 at 540.

<sup>167</sup> Melvin A. Eisenberg *The Structure of the Corporation-A legal Analysis* (Little Brown & Co, Boston, 1976) at 162, 172.

<sup>168</sup> Mace, above n 157 at 181.

<sup>169</sup> Eugene F. Fama “Agency problems and the theory of the firm” (1980) 88 *Journal of Political Economy* 288 at 293.

<sup>170</sup> Ronald J. Gilson & Reinier Kraakman “Reinventing the Outside Director: An Agenda for Institutional Investors” (1990-1991) 43 *Stan. L. Rev.* 863 at 874.

residual claimants because they have incentives to develop reputations of expertise in decision control and value the human capital of their directorships as signals to internal and external markets for decision agents that they are decision experts.<sup>171</sup> The law also relies on independent directors to serve as effective monitors to prevent managerial indiscretion.<sup>172</sup> According to this theory, independent directors are motivated to further shareholder interests and have an incentive to effectively monitor management performance with the purpose of safeguarding their own “reputation capital”<sup>173</sup> as directors and decision-making experts in order to increase their own value in the market for independent directors. This means that directorships held by independent directors can serve as a measure of their reputation as good monitors<sup>174</sup> because they “are in their turn disciplined by the market for their services which prices them according to their performance as referees”.<sup>175</sup>

Some argue that good character of reputation capital and financial reward of more directorships may be necessary conditions for effective monitoring, but these are hardly sufficient given independent directors’ dependence on management for their tenure as directors, their shared board culture and connected social ties with management, and especially their weak incentive to monitor effectively for an immaterial financial award.<sup>176</sup> Moreover, information dissymmetry and non-expertise in complex corporate decisions are impediments for independent directors to be effective monitors.<sup>177</sup> For independent directors to be effective, the incentive is the key to increase their willingness to monitor.<sup>178</sup> Thus, some propose that institutional investors select independent directors as professional directors on their behalf to solve the incentive problem.<sup>179</sup> Empirical evidence is mixed and contradictory in supporting the proposition that independent directors are an effective

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<sup>171</sup> Fama & Jensen, above n 130 at 315.

<sup>172</sup> Laura Lin “The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence” (1996) 90 (3) *Northwestern University Law Review* 898 at 904.

<sup>173</sup> At 917.

<sup>174</sup> Anil Shivdasani “Board composition, Ownership Structure, and Hostile Takeovers” (1993) 16 *Journal of Accounting and Economics* 167 at 175

<sup>175</sup> Fama, above n 169 at 289.

<sup>176</sup> Gilson & Kraakman, above n 170 at 874-875.

<sup>177</sup> Lin, above n 172 at 914.

<sup>178</sup> John C. Coffee, Jr. “Liquidity versus Control: the Institutional Investor as Corporate Monitor” (1991) 91 *Columbia L. Rev.* 1277 at 1360.

<sup>179</sup> Gilson & Kraakman, above n 170 at 886. Eisenberg, above n 167 at 150.

governance mechanism to provide careful monitoring of management behaviors.<sup>180</sup> Under this line of argument, the effective monitor theory seems convincingly to stand fast by the challenge of the managerial hegemony theory and both are to be explored in Chapter Six.

### 2.3.1.5 Convergence versus Path Dependency

Globalization increases comparative pressures of product and capital markets on firms towards the efficient model in corporate governance so as to avoid being forced to opt-out of international markets in competition. The force of competition would lead national systems to adopt a single efficient form.<sup>181</sup> An important indication can be seen from board structure in the direction of a legal regime strongly in favor of the US unitary model that substantially consists of independent directors.<sup>182</sup> This forms a trend of corporate governance that leads to the prediction of convergence in moving towards the dominant US model,<sup>183</sup> an innovative application of the convergence theory in corporate law.

The convergence theory proposes that the level of structural uniformity among relatively modernized societies increases when the level of modernization increases,<sup>184</sup> a process of isomorphic change in which the structures of such societies become “more alike (converging)”<sup>185</sup> or “similar”<sup>186</sup>. That is: “[t]he world as a whole shows increasing structural *similarities of form* among societies without, however, showing increasing

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<sup>180</sup> Yang Ni and Lynnette Purda “Are Independent Directors Effective Monitors? New Evidence from Firm Risk” (2012) <http://ssrn.com/abstract=1986289> at 2.

<sup>181</sup> Ronald J. Gilson “Globalizing corporate governance: convergence of form or function” (2001) 49 (2) *The American Journal of Comparative Law* 329 at 331.

<sup>182</sup> Henry Hansmann & Reinier Kraakman “The End of History for Corporate Law” in Jeffrey N. Gordon & Mark J. Roe (eds.) *Convergence and Persistence in Corporate Governance* (Cambridge University Press, Cambridge, 2004) at 52.

<sup>183</sup> Roberta S. Karmel “Is it Time for a Federal Corporation Law?” (1991) 57 *Brook Law Reviews* 55 at 90.

<sup>184</sup> Marion J. Levy *Modernization and the Structure of Society* (Princeton University Press, Princeton, 1966) at 709.

<sup>185</sup> John Henry Merryman “On the Convergence (and Divergence) of the Civil Law and the Common Law” (1981) 17 *Stan. J. Int'l L.* 357 at 359.

<sup>186</sup> B. S. Markesinis “Learning from Europe and Learning in Europe” in B. S. Markesinis (ed.) *The Gradual Convergence: Foreign Ideas, Foreign Influences, and English Law on the Eve of the 21<sup>st</sup> Century* (Clarendon Press, Oxford, 1994) at 30.

equalities of outcomes among societies”<sup>187</sup> because the common nature of human beings leads to such similarities in social structures including laws and legal systems.<sup>188</sup> Convergence in laws and legal systems means that countries otherwise similar in important aspects arrive at similar legal ways of perceiving and dealing with similar legal problems, i.e., the increase of similarity in terms of legal framework and institutions. Transplantation of legal frameworks or institutions from developed countries to developing countries is one of such legal ways.<sup>189</sup> In corporate governance, convergence refers to the increase of similarity in corporate control in widely held public companies from different jurisdictions. Researchers have made a distinction between convergence in form and convergence in function and claimed that governance convergence in national governance systems has turned out to be more persistent in form than adaptive in function.<sup>190</sup> The former relates to increasing similarity in terms of legal framework and institutions while the latter suggests that countries with different laws and legal institutions may perform the same function such as ensuring information disclosure or board independence. Generally speaking, functional convergence is possible to achieve in practice but formal convergence is difficult to reach in reality. The movement of the Single Market in Europe is evident in illustrating this point of view given that there is certain harmonization of legal institutions but failure in codifying European corporation law within member states.

Contrary to the convergence theory is the path dependence theory. “Path dependence means that history matters”<sup>191</sup> or history is “non-ergodic”,<sup>192</sup> i.e., history becomes “the determining factor when there are multiple solutions or multiple fixed points in the proportions-to-probabilities mapping”.<sup>193</sup> It assumes that “what has happened at an earlier

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<sup>187</sup> John W. Meyer & Michael T. Hannan “National Development in a Changing World System: An Overview” in John W. Meyer & Michael T. Hannan (eds.) *National Development and the World System: Educational, Economic, and Political Change, 1950-1970* (The University of Chicago Press, 1979) at 15.

<sup>188</sup> Merryman, above n 185 at 361. See also: A. Passerin D'Entreves, *Natural Law* (1951).

<sup>189</sup> At 365, 367.

<sup>190</sup> Gilson, above n 181 at 332.

<sup>191</sup> Douglass C. North *Institutions, Institutional Change and Economic Performance* (Cambridge University Press, Cambridge, 1990) at 100.

<sup>192</sup> W. Brian Arthur “Self-Reinforcing Mechanisms in Economics” in P. W. Anderson, Kenneth J. Arrow & David Pines (eds.) *Economy as an Evolving Complex System* (Addison-Wesley Publishing, 1988) vol. V at 11.

<sup>193</sup> W. Brian Arthur *Urban Systems and Historical Path-Dependence* (paper No.0012, Stanford University, 1983) at 9.



point in time will affect the possible outcomes of a sequence of events occurring at a later point in time”.<sup>194</sup> That is, the initial position of a system or institution in a situation determines its final “equilibrium”.<sup>195</sup> Along with this theory, the existing systems and institutions in a country are determined not only by its initial conditions but also by the path it took at the time, which are influential and free of intervention by alternative options even if those options are more advanced and efficient. The path dependence theory is of interest especially when initial steps taken are not the superior ones in terms of efficiency and it rejects the notion that the most efficient, the fittest, will survive by necessity.<sup>196</sup> Thus, the particular path initially chosen by a country for its systems or institutions is persistent overtime and prevents them from converging on efficient equilibrium in that country.

In the context of law, the path dependence theory reveals that the early legal systems can become locked-in and resistant to change, which suggests that the opportunity for significant legal change in such legal systems is brief and intermittent, occurring during critical junctures when new legal issues arise or advanced legal rules intercede.<sup>197</sup> For example, the doctrine of *stare decisis* in common law is just such an explicitly path-dependent process. In corporate governance, the path dependence theory holds to the evolution of governance structures and routines. The role played by path dependency in maintaining differences in corporate structures is by way of the structure-driven path dependence and the rule-driven path dependence,<sup>198</sup> which show “how the corporate structures that an economy has at any point in time are likely to depend on those that it had

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<sup>194</sup> William Sewell “Three Temporalities: Toward A Sociology of the Event” (CSST working paper No. 58 University of Chicago, 1990) at 16.

<sup>195</sup> Amitava Krishna Dutt “Equilibrium, Path Dependence and Hysteresis in Post-Keynesian Models” in *Markets, Unemployment and Economic Policy* (Routledge, 1997) at 248.

<sup>196</sup> John Goenewegen & Jack Vromen “Theory of the firm Revisited: New and Neo-institutional Perspectives” in Lars Magnusson & Jan Ottosson (eds.) *Evolutionary Economics and Path Dependence* (Edward Elgar Publishing, 1997) at 50.

<sup>197</sup> Oona A. Hathaway “Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System” (2000-2001) 86 *Iowa Law Review* 601 at 605.

<sup>198</sup> Lucian A. Bebchuk & Mark J. Roe “A theory of Path Dependence in Corporate Ownership and Governance” in Jeffrey N. Gordon & Mark J. Roe (eds.) *Convergence and Persistence in Corporate Governance* (Cambridge University Press, 2004) at 77. The structure-driven path dependence means the ways in which initial ownership structures in an economy directly influence subsequent ownership structures. The rule-driven path dependence means corporate rules that can influence corporate ownership and governance structures.

at earlier times”.<sup>199</sup> Therefore, path dependence is a driving force in keeping a system or institution in divergence but not in convergence in a country and the path dependence theory may provide such a justification.

### 2.3.2 Models of Corporate Governance

Different corporate ownership structures lead to different corporate governance models. Thus, corporate ownership is fundamentally the factor that corporate governance model is determined. Traditionally, there are predominantly two models of corporate governance under the dichotomy of diffused and concentrated ownership structures, i.e., Anglo-American’s unitary model and Rhine-Nordic’s two-tier model. Recent events and market forces are moving towards increased harmonization of corporate governance<sup>200</sup> that results in what is called the “hybrid model” of corporate governance emerging.

#### Unitary Model

The unitary model is based on the shareholder theory and prevails in common law countries. The United States is referred as the exemplar. The two essential characteristics of the unitary model are dispersed ownership and one-tier board. First, corporate ownership is dispersed amongst many outside stockholders who are not directly involved in corporate management but delegate it to professional managers who directly run corporations. Second, board structure is built by a single board system that is comprised of executive directors and independent directors. The board of directors is the highest authority and the only governance mechanism of internal corporate control in the firm. Independent directors are presumably best fitted to perform the monitoring function on management, delegated by the board of directors on behalf of widely diffused stockholders. Law strongly protects minority shareholders and promotes the efficiency of capital markets. The unitary model is considered to be the most favorable model to maximize shareholder wealth for firms with the diffused ownership structure.

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<sup>199</sup> At 112.

<sup>200</sup> A Payne “Corporate Governance in the USA and Europe: they are closer than you might think” (2006) 69 *International Journal of Effective Board Performance* at 70.

## Two-Tier Model

The two-tier model is embodied in the stakeholder theory and is predominant in civil law countries. Germany is regarded as “prototypical”.<sup>201</sup> Counter to the unitary model, the two essential characteristics of the two-tier model are concentrated ownership and the two-tier board. First, corporate ownership is mainly in the hands of block stockholders who are directly involved in corporate management either by themselves or by their delegates. Second, board structure is constructed by a dual board system, i.e., management board and supervisory board. The former consists of executive managers who are involved in daily running of the business operations while the latter is comprised of independent supervisors who are representatives of employees and other stockholders and who perform the monitoring role over management. The supervisory board is the highest authority in the company and undertakes corporate control by subjecting the management board to its supervision. Block shareholders grab all private benefits of corporate control without regard for minority shareholders. Legal protection is weak for minority shareholders and there is less efficiency in capital markets. The two-tier model is viewed as the ideal model to maximize all stakeholder wealth for firms with the concentrated ownership structure.

## Hybrid Model

The hybrid model is presumed to be the construct of “natural convergence” in “combining ‘best’ with ‘second best’ practices from Anglo-Saxon and Continental corporate governance models”.<sup>202</sup> The theoretical basis on which the hybrid model is built is the cross-reference hypothesis, which assumes that corporate systems are divisible and mutually adaptive.<sup>203</sup> Thus, the hybrid model can be formed by borrowing best practices from between the two archetypical models<sup>204</sup> without necessarily making major legislative

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<sup>201</sup> Eisenberg, above n 167 at 178.

<sup>202</sup> Lucian Cernat “The emerging European corporate governance model: Anglo-Saxon, Continental, or still the century of diversity?” (2004) 11 (1) *Journal of European Public Policy* 147 at 149, 156.

<sup>203</sup> Lutgart Van Den Berghe *Corporate Governance, in a Globalizing World: Convergence or Divergence? A European Perspective* (Kluwer Academic Publishers, Hingham, 2002) p. 15.

<sup>204</sup> Cernat, above n 202 at 156.

or structural changes to existing governance rules or institutions.<sup>205</sup> Accordingly, the hybrid model can come from either the Anglo-American unitary model or the Rhine-Nordic's two-tier model and be evolving into both directions. Arguably, some trends can be evident that the unitary model moves towards greater concentration in shareholding in pursuing long-term shareholder value while the two-tier model becomes more market-oriented for devices to ameliorate failures of block-holding systems.<sup>206</sup> Remarkably, China's transplantation of independent directors to complementarily interplay with its existing supervisory board provides a real life example of such a trend. Hence, the current hybrid model of corporate governance in China is a subject of great interest both in theory and in practice, and is the main subject matter of this thesis.

#### **2.4 Independent Directors and Corporate Performance**

Corporate governance aims to improve corporate performance and independent directors are expected to act as the effective corporate governance mechanism to achieve this goal. However, controversy exists as to the effectiveness of independent directors as such a governance mechanism. Empirical evidence is also mixed with regard to the relationship between independent directors and corporate performance in corporate governance. Empirical research on the relationship of independent directors and corporate performance essentially attempts to test whether independent directors are effective monitors and consequently better corporate performance results by aligning managers' interests with shareholders' so as to either prevent managers from pursuing their own interest (shirking problem) in firms with diffused ownership structure or prevent majority shareholders from expropriating minority shareholders (diverting problem) in firms with concentrated ownership structure.

Some empirical studies directly examine the relationship of independent directors and corporate performance and assume that there will be a significant implication between both by measuring independent directors' function on the financial performance of the firm in

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<sup>205</sup> Eisenberg, above n 167 at 356.

<sup>206</sup> Berghe, above n 203 at 16.

terms of Tobin's Q (a ratio to measure a firm's assets in relation to its market value) and/or accounting measures like return on assets (ROA) and/or return on equity (ROE).<sup>207</sup> A couple of studies argue that there is a positive relationship between independent directors and firm performance<sup>208</sup> but most researchers proclaim that there is no or a negative relationship between independent directors and firm performance.<sup>209</sup> Some empirical researchers examine indirectly how board composition affects the board of directors' behaviours on discrete tasks such as CEO replacement, executive compensation, takeover-bid defense or market response to independent director appointment,<sup>210</sup> which may have indirect impact on firm performance. All empirical studies have sought to find either a direct or indirect relationship between independent directors and corporate performance to support the conventional wisdom that independent directors are effective monitors who are able to contribute to best corporate governance and good corporate performance. Nonetheless, empirical investigations have overall produced no convincing evidence that independent directors enhance *ipso facto* corporate performance.<sup>211</sup>

The implication from empirical research is that independent directors may add value

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<sup>207</sup> See: Victor Dulewicz & Peter Herbert "Does the composition and practice of boards of directors bear any relationship to the performance of their companies?" (2004) 12 (3) *Corporate Governance* 263–280. Anup Agrawal & Charles R. Knoeber "Outside Directors, Politics, and Firm Performance" (April 1998) <http://papers.ssrn.com.ezproxy.auckland.ac.nz/abstract=85310> 1-37. Barry D. Baysinger & Henry N. Butler "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition" (1985) 1 (1) *Journal of Law, Economics and Organization* 101-124. Sanjai Bhagat & Bernard Black "The Non-Correlation between Board Independence and Long Term Firm Performance" (2002) 27 (3) *Journal of Corporation Law* 231-273. Catherine M. Daily & Dan R. Dalton "The Relationship Between Governance Structure and Corporate Performance in Entrepreneurial Firms" (1992) 7 *Journal of Business Venturing* 375-386. Benjamin E. Hermalin & Micheal S. Weisbach "The Effects of Board Composition and Direct Incentives on Firm Performance" (1991) 20 (4) *Financial Management* 101-112. April Klein "Firm Performance and Board Committee Structure" (1998) 41 (1) *Journal of Law and Economics* 275-304. Ira M. Millstein & Paul W. MacAvoy "The Active Board of Directors and Performance of the Large Publicly Traded Corporation" (1998) 98 *Columbia L. Rev.* 1283-1321.

<sup>208</sup> Ibid, see Baysinger & Butler (1985).

<sup>209</sup> Above n 207.

<sup>210</sup> See: Michael S. Weisbach "Outside Directors and CEO Turnover" (1988) 20 *Journal of Financial Economics* 431-460. John W. Byrd & Kent A. Hickman "Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids" (1992) 32 *Journal of Financial Economics* 195-221. Vijaya. Subrahmanyam, Nanda Rangan & Stuart Rosenstein "The Role of Outside Directors in Bank Acquisitions" (1997) 26 (3) *Financial Management* 23-36. Harry A. Newman & Haim A. Mozes "Does the composition of the Compensation Committee Influence CEO Compensation Practices" (1999) 28 (3) *Financial Management* 41-53. Stuart Rosenstein & Jeffrey G. Wyatt "Outside Directors, Board Independence, and Shareholder Wealth" (1990) 26 *Journal of Financial Economics* 175-191.

<sup>211</sup> Jeffrey Lawrence & Geof Stapledon "Do Independent Directors Add Value?" (Research Report, Centre for Corporate Law and Securities Regulation, the University of Melbourne Faculty of Law, 1999) at 13.

indirectly to firms in performing some specific tasks such as removing poorly performed CEOs and defending against hostile takeover-bids, but they lead to no net advantage in directly improving firm performance in particular and corporate governance on the whole. Chapter Eight includes a meta-empirical study in order to review and analyze the empirical research on the relationship between independent directors and corporate performance in Chinese listed companies, aiming to find out through empirical evidence whether the current hybrid model of corporate governance in China works in comparison with the United States' unitary model of corporate governance and whether there are any advantages and disadvantages in both models.

## **2.5 Independent Directors in China**

Independent directors were imported into China in 1993 and Qingdao Brewery was the first listed company in China to appoint independent directors in order to meet the relevant requirement of the listing rules of Hong Kong Stock Exchange (HKSE). Ever since then, Chinese listed companies both at home and abroad began to incorporate independent directors into their boardrooms and the Company Law 2005 formally establishes the current hybrid model of corporate governance in legislation, i.e., the combination of the board of directors, which is composed of executive directors and independent directors, and the supervisory board. Independent directors are completely bizarre exotics to China. To understand independent directors in China, it is necessary to have a brief look into reasons that they were brought in China, problems that are limiting their function and puzzles that cast a cloud on their future.

### **Reasons**

Objectively, there are four main reasons that may be accountable for the acceptance of independent directors by listed companies in China, i.e., the need of domestic companies to list abroad, the need to bring about domestic legal system reform under China's WTO entrance commitments, the need to attract overseas investors especially Qualified Foreign

Institutional Investors (QFIIs) and the need to deal with the dysfunction of the supervisory board of listed companies.

Listing in foreign stock exchanges for funds is the most important reason why Chinese companies initially introduced independent directors into their boardrooms. This is because there were limited funds available from the domestic stock exchanges, which just started to develop in the early 1990s and which could not meet the increasing demand of Chinese companies to finance their increasing growth both in scale and in scope. The experience of the economic reforms since 1978 made Chinese companies realize that the easiest, most economical and most efficient way to finance their growth was to list on the mature stock exchanges in those market economies and that the only price they need to pay is to meet the relevant listing rules in those jurisdictions. Under its WTO entrance commitments, China needs to reform its legal systems so as to meet the criteria of the market economy. The adoption of the independent director institution is such a legal reform brought about to be consistent with the legal practice in a market economy. To develop its capital markets, China needs to encourage investment from abroad in order to boost its stock markets. Legal protections provided to diffused stockholders is the key factor in attracting foreign investors, particularly QFIIs. Some research shows that a board of directors consisting of independent directors is crucial when institutional investors make their investment decisions on targeted listed companies. This is because listed companies with independent directors in place can give an appearance of good corporate governance, which can give comfort to foreign investors. In addition, the dysfunction of the supervisory board of Chinese listed companies is a Gordian knot in corporate governance and the introduction of independent directors into China is expected to be secondary to the function of the supervisory board.

### Problems

The problems identified here that may thwart the function of independent directors in China include the fact that the only big shareholder in most Chinese listed companies is the government, the agency problem between majority shareholders and minority shareholders,

the supplementary role of independent directors to the supervisory board and the separation of independent directors from minority shareholders.

The government, at the different levels, is directly or indirectly the biggest shareholder of most listed companies in China. This ownership structure creates what is termed “the only big shareholder problem”, a corollary of the partial privatization of former biggest State-Owned Enterprises (SOEs). This ownership structure has concentrated the majority shareholding in the government and the government takes on the responsibility of corporate control in those listed companies. Associated with this kind of shareholding concentration is an endogenous syndrome, an agency problem of interest conflict between majority shareholders and minority shareholders, under which controlling shareholders unscrupulously divert corporate assets by a whole “bag of tricks” to themselves without paying any attention to other shareholders. Minority shareholders are helpless when they face controlling shareholders’ looting and legal systems provide little protection to them in reality. Independent directors are limited in performing their monitoring role over management because they are but expected to undertake the secondary role in supporting the function of the supervisory board and thus are usually referred as “vase directors” in practice. This backlash against independent directors probably stems from the fact that they are separated from minority shareholders and have little motivation to act on behalf of minority shareholders. Shareholder activism seems to be ignored and there is no voice from minority shareholders on the selection of independent directors because majority shareholders control the nomination of independent directors. Institutional investors are viewed as speculative avarices and they are only interested in manipulating stock prices to grab greatest profits at the cost of other individual stockholders.

### Puzzles

Puzzles arise about the adaptation of independent directors in China in view of the solution of the sole-large-shareholder problem, the alignment of majority interests with those of minority, the conflict of monitoring role between independent directors and the supervisory board, and the fit of the current hybrid model.



The sole-large-shareholder problem is still obsessed over by the Chinese government because the government is reluctant to part with the private benefits of control in those SOEs listed on stock exchanges even after the share-split structure reform in 2005. Some celebrate the success of the share-split structure reform, where the government has released a margin of its non-tradable shares to promote capital market liquidation. But the celebrators appear oblivious to the fact that the government is still directly or indirectly the controlling shareholder of those SOEs listed on stock exchanges. In light of this, it is uncertain how far the split-share structure reform will go in the future. Correspondingly, it is also unclear how to align majority shareholders' interests with minority shareholders' interests better, because this alignment problem is coupled with the only big shareholder problem and it is believed that the solution to the former is dependent on the latter. This might of course be misleading about the direction of the main role of independent directors, either consulting for management or monitoring over management. This is because the government, as the only big shareholder of listed companies in China, expects that independent directors mainly play a consulting role rather than a monitoring role over management. This is consistent with the policy that stock markets in China should promote the development of the state capitalism in China and any corporate governance reform including the share-split structure reform should serve the purpose of this policy.

Currently, independent directors are mainly playing a consulting role for management in China. This is because independent directors are designed in legislation to play the complementary role to interplay with the supervisory board. It has to be admitted that the legislation design is perfect in theory. According to this design, the supervisory board supervises the internal affairs and independent directors monitor the external affairs of the firm. But the lack of specification in legislation on independent directors' responsibilities blurs the demarcations between the monitoring roles played by the supervisory board and independent directors, which also may cause the free-rider problem. So, whether independent directors and the supervisory board interplay with each other to the level expected in the legislation design remains to be seen. This leads to the last puzzle, which is whether the current hybrid model of corporate governance fits China. As suggested from

the path dependency theory, this hybrid model seems to be a “misfit” in corporate governance in China. So, its survival is still a mystery that is of course left to history but to which this thesis tries to find some evidence.

## **2.6 Conclusion**

Given the preceding theoretical and empirical framework of independent directors in corporate governance, this thesis focuses on the following themes to address the research questions set in the thesis: (a) ownership structure and the role of shareholders; (b) board structure and board independence and (c) independent directors and corporate performance.

The first theme aims to address research question two. It starts with the nature of the ownership structure and specifies that the ownership structure is crucial to the choice of board structure, which is influential on internal corporate control. The role of shareholders in wielding their rights to nominate the members of the board of directors, especially independent directors, is important to the internal control in corporate governance. The second theme aims to address research questions one and three. It deals with the characteristics of the board of directors and the determinants of board independence, which have essentially impacted on the monitoring role of independent directors. The last theme aims to address the research question four and analyses the relationship between independent directors and corporate performance by way of a meta-empirical study. It reviews and analyses the relevant empirical research and tries to find evidence in support of the propositions of theories as regards independent directors in corporate governance that hold, i.e., independent directors improve corporate governance and hence corporate performance, regardless of the model/models of corporate governance.

## CHAPTER 3

### RESEARCH METHODOLOGY

#### 3.1 Introduction

In this Chapter, descriptions are given for the methodological procedures that are used for investigation and examination of the research themes set in Chapter Two. Specifically, it addresses the following methods and procedures to be used in this research: (a) comparative analysis in corporate law, (b) meta-empirical study in corporate governance, (c) justifications for the combined methodologies, (d) research method design, and (e) data sources and samples.

The combination of comparative analysis in corporate law and meta-empirical study in corporate governance is a relatively new combined research methodology to be employed in this research, attempting to make a contribution to the academic literature. It suggests that corporate governance not only can be a legal institution defined by law but may also be measured empirically assessed through meta-empirical analysis. Legal rules and institutions that are either designed in statute or derived from law aim to protect the efficiency of allocation of scarce resources in a society so as to maximize their value and minimize their cost to society. Comparative analysis in corporate law examines substantially the efficiency of legal rules and legal institutional frameworks that affect those governance mechanisms in corporate governance in different jurisdictions. Meta-empirical study in corporate governance analyzes the evidence provided by the empirical research in measuring the efficiency of corporate governance mechanisms in corporate operation.

The combined methodology of comparative analysis in corporate law and meta-empirical study in corporate governance applied in this research is novel in studies on independent

directors in corporate governance in China. It attempts to make comparisons both qualitatively and quantitatively of the characteristics of corporate governance mechanisms of listed companies between the United States, New Zealand and China and to probe into how these corporate governance mechanisms are formed, interact and evolve in these countries. This combination is intended to develop awareness that the theoretical framework in corporate law can be understood in combination with an economic analysis of corporate governance with the expectation that it will improve methodically comparisons of corporate governance mechanisms between/among different jurisdictions. The unique characteristic of this combined research approach is distinguished from other research and the detail of this methodology to be used in the research is explained in the following sections.

### 3.2 Comparative Analysis in Corporate Law

Comparative analysis in corporate law is the study of corporate law by applying the comparative law method or “comparative method in law”.<sup>212</sup> Comparative law suggests “an intellectual activity with law as its object and comparison as its process”,<sup>213</sup> i.e., a scientific *recouplement* (cross-checking) involving studying one institution in a given society to discover “concomitant variations” when certain changes occur and then applying such institution to other legal systems confirmed with some slight differences (*recouplement*) to formulate the general law taking account of these differences.<sup>214</sup> Thus,

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<sup>212</sup> Frederick Pollock “The History of Comparative Jurisprudence” (1903) 5 (1) *Journal of Society of Comparative Legislation (N.S.)* 74 at 79. It seems that comparative method in law can be traced back in ancient Greece when the Greek cities imitated or adopted more advanced laws or legal institutions from other States. The earliest comparative researches can be found in such seminal works as Plato’s *Laws*—a comparison of the laws of the Greek city-states, Aristotle’s *Politics*—an examination of the constitutions of no less than 153 city-states and Theophrastus’s *On Laws*—an attempt of discovering the general principles in the various Greek legal systems. See Konard Zweigert & Hein Kötz *An Introduction to Comparative Law* (North-Holland Publishing, 1977) vol.1 at 42. The impetus of the modern method of comparative law came around the middle of the 19th century and modern comparative law is usually recognized as having begun in 1900 at the International Congress of Comparative Law held in Paris, See: Peter de Cruz *Comparative Law in a Changing World* (Cavendish Publishing, 1999) at 14, 15.

<sup>213</sup> *Ibid*, Zweigert & Kötz at 2.

<sup>214</sup> Pierre Lepaulle “The Function of Comparative Law, with a Critique of Sociological Jurisprudence” (1921-1922) 35 *Harvard L. Rev.* 838 at 852-853.

comparative law provides “a method of study and research”,<sup>215</sup> primarily a heuristic method of legal science making critical evaluation of what has been discovered by way of comparisons.<sup>216</sup> The objective is to incorporate discoveries, comparisons, analyses and evaluations of legal rules or institutions in different jurisdictions so as to refresh legal knowledge and deepen shared understanding of similarities in and differences between legal systems. This can lead to the identification of gaps in legal knowledge and point to potential directions for possible solutions in the development of legal systems. As observed by Glendon, “[the] attraction of comparative law has never been just the study of foreign law as such. It has also been the allure of a glimpse into the origins of legal norms; the prospect of a better understanding of the efficacy and limits of law; and the hope of insight into the connections among law, behavior, ideas, and power. In other words, comparative law belongs not only to international legal studies, but to basic research in law.”<sup>217</sup>

However, it seems that practice rather than knowledge has been conceived as the main objective of comparative law,<sup>218</sup> where its chief function is to facilitate legislation and the practical improvement of law by way of examination and comparison of laws.<sup>219</sup> Such comparisons need to indicate or highlight the functional similarities or dissimilarities among/between different systems. Zweigert & Kötz emphasize that “[t]he basic methodological principle of all comparative law is that of *functionality*”.<sup>220</sup> This suggest that comparative law method would go further than purely descriptive works by providing a means of just explaining how individual rules or institutions are adopted or ratified to solve particular problems individually in different legal systems. To understand the differences between these legal rules or institutions and their impact on different legal systems, it is necessary to look beyond the details of individual rules or institutions *per se*

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<sup>215</sup> H.C. Gutteridge *Comparative Law: An Introduction to the Comparative Method of Legal Study & Research* (The University Press, Cambridge, 1946) at 1. See also Rudolf B. Schlesinger *Comparative Law: cases-text-materials* (2nd ed., Stevens & Sons, London, 1960) at 1. “Strictly speaking, the term Comparative Law is a misnomer. It would be more logical to speak of the Comparative Method.”

<sup>216</sup> Zweigert & Kötz, above n 212 at 40.

<sup>217</sup> Mary Ann Glendon “General Report” [1993] *BYU L. Rev.* 385 at 387.

<sup>218</sup> Pollock, above n 212 at 74.

<sup>219</sup> Henry Summer Maine *Village-communities in the East and West: six lectures delivered at Oxford, to which are added other lectures, addresses and assays* (Henry Holt & Co, New York, 1889) at 4, 5.

<sup>220</sup> Zweigert & Kötz, above n 212 at 25.

and investigate what lies behind this approach taken by individual legal systems.<sup>221</sup> Indeed, comparative method in law has been never just explaining what facts of different legal systems are such; it also provides better understanding of why such differences across jurisdictions exist, and suggests potential solutions to specific legal issues in individual jurisdictions.

To make the comparative method effective, the comparison should ascertain and summarize the essential similarities and diversities in order to compare and contrast. In providing guidance on how to strengthen the quality of comparative law studies, Reitz identifies nine basic principles of comparative method.<sup>222</sup> To focus on both similarities and differences while in making comparison, light should be cast on both the special or unique natures of the legal systems being compared and their commonalities with respect to the issue in question. These lead not only towards defining the distinctive features of each legal system but also towards appreciating the commonalities of legal systems and discerning the fundamental aspects of the particular legal issue in question.<sup>223</sup> For good comparison, a significant legal analysis is required to investigate thoroughly reasons for similarities and differences and seek to assess their significances. The fascination of comparative law studies is to discover from and rejoice in comparisons, which inspires a quest for rationales and explanations in order to end up with an illuminating inquiry and enable a fresh outlook in the study of the operation of different legal systems.<sup>224</sup>

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<sup>221</sup> Robert R. Drury & Peter G. Xuereb (eds.) "Introduction" in *European Company Laws: A Comparative Approach* (Dartmouth Publishing, 1991) at 8.

<sup>222</sup> John C. Reitz "How to Do Comparative Law" (1998) 46 *American Journal of Comparative Law* 617 at 618-635. The nine principles are summarized as follows: 1) draw explicit comparisons; 2) focus careful attention on the similarities and differences among the legal systems being compared by taking account of the possibility of functional equivalence; 3) lead to conclusions about (a) distinctive characteristics of each individual legal system and/or (b) commonalities concerning how law deals with the particular subject under study; 4) push the analysis to broader levels of abstraction through its investigation into functional equivalence; 5) lead to even more interesting analysis by giving reasons for the similarities and differences among legal systems or analyzing their significance for the cultures under study; 6) establish what the law is in each jurisdiction under study by (a) describing the normal conceptual world of the lawyers, (b) taking into consideration all the sources upon which a lawyer in that legal system might base her opinion as to what the law is, (c) taking into consideration the gap between the law on the books and law in action and (d) important gaps in available knowledge about either the law on the books or the law in action; 7) require strong linguistic skills and maybe even the skills of anthropological field study in order to collect information about foreign legal systems at first hand, or rely on secondary literature in languages to read; 8) be organized in a way that emphasizes explicit comparison; 9) be undertaken in a spirit of respect for the other.

<sup>223</sup> At 624.

<sup>224</sup> Cruz, above n 212 at 239.

### 3.3 Meta-Empirical Study in Corporate Governance

Comparative method in law investigates and assesses what law is and how law evolves rather than how law ought to be. That is, it does not explain how to measure whether legal rules or institutions function well in a legal system or whether alternative legal rules or institutions work more effectively on the same or similar legal issues in other legal systems. This calls for extra-legal methodologies such as the meta-empirical study to measure and evaluate the effectiveness of such legal rules or institutions in solving the same or similar legal issue in a legal system or different legal systems. The purpose is to aid comparative law studies quantitatively for better understanding qualitatively the evolution and adaptation of legal rules and institutions to changes to which different legal systems react.

The meta-empirical study refers to a study that takes the resulting text of the empirical research (by experiments and/or observations) as the material of its study so as to interpret the resulting text of and draw scientific conclusions from experiments and/or observations described by the original empirical research. Thus, the meta-empirical study is not just a straight-forward empirical study, because the target of the meta-empirical study does not directly constitute the “data base”, which is instead the original representation of the empirical research as captured and elaborated by empirical researchers, i.e., meta-empirical.<sup>225</sup> Neither is it an analysis of the literary text of the empirical research, nor are the thoughts of the empirical researcher the interests of the meta-empirical study. The literary representation of empirical researchers is taken as the model of the meta-empirical study. The subject matter of the meta-empirical study is the empirical research itself. The objective is to examine the advantages and disadvantages of the empirical researches carried out by empirical researchers so as to provide evidence to support the propositions of the current researcher.<sup>226</sup> In this thesis, the target of the meta-empirical study is empirical researchers who conducted their empirical research on independent directors and

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<sup>225</sup> Wolfgang Wangner & Andrés Mecha “On Discursive Construction, Representation and Institutions: A Meta-Empirical Study” in J. Laszlo & W. Wagner (eds.) *Theories and Controversies in Societal Psychology* (Budapest, New Mandate, 2003) at 2.

<sup>226</sup> Risto Seppänen, Kirsimarja Blomqvist & Sanna Sundqvist “Towards Measuring Inter-Organizational Trust – A Review and Analysis of the Empirical Research in 1990-2003” PDF from [impgroup.org](http://impgroup.org) at 1.

corporate performance of listed companies in China and the “data base” consists of their articles.

Meta-empirical study has been used in the field of corporate law in view of its strong interdisciplinary links in which the fruits of empirical research are routinely employed by legal academics to enrich their view of subject such as corporate governance. There is some meta-empirical research using this methodology to review and analyze empirical researchers in relation to how to examine the correlation either between corporate governance and corporate performance, or between individual corporate governance mechanisms (the board of directors, board structure, independent directors or shareholding ownership) and corporate performance. For instance, Bhagat and Romano examined empirical studies of corporate law by collecting twenty six sample articles from twenty five empirical researchers who employed the event study to review and analyze these empirical researches on corporate and securities law.<sup>227</sup> The event study is an empirical research methodology that is one of the most successful uses of econometrics in policy analysis. Bhagat and Romano used the meta-empirical study and discussed the strengths and limitations of the event study methodology for policy analysis. Using the same methodology, Bhagat, Bolton and Romano also reviewed and analysed some sample articles written by seventeen empirical researchers on the effectiveness of corporate governance indices in predicting corporate performance and highlighted their methodological shortcomings where those researchers have claimed to have identified a relationship between particular governance measures and corporate performance.<sup>228</sup> Their conclusion is that there is no consistent relation between governance indices and measures of corporate performance. Particularly, Karpoff surveyed twenty empirical studies written by forty two authors on the impact of shareholder activism on corporate governance of the targeted companies and concluded that most empirical evidence shows that shareholder

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<sup>227</sup> Sanjai Bhagat & Roberta Romano, “Empirical Studies of Corporate Law” in A. Mitchell Polinsky and Steven *Handbook of Law and Economics* (Elsevier, 2007) vol. 2 945-1012.

<sup>228</sup> Sanjai Bhagat, Brian Bolton & Roberta Romano “The Promise and Peril of Corporate Governance Indices” (2008) 108 (8) *Columbia Law Review* 1803-1882.



activism can prompt small changes in target firms' governance structures but has negligible impacts on share values and earnings.<sup>229</sup>

The rationale of using the meta-empirical study is to review and analyze if the empirical research can provide a metric to measure efficiently the application of legal rules in practice, for example, how the empirical research can measure whether board independence can improve corporate governance by way of corporate performance. Statutes and case law are *per se* not sufficient as a means of discovery about how legal rules work and legal practitioners conduct themselves, i.e., theory can have a lack of evidence to support it in practice. This is where the empirical legal research can step in to fill up the gap. The meta-empirical study can review and analyze the performance of the empirical research. The meta-empirical study applied in this thesis is to examine the research questions identified in Chapter 1. This will be done by way of review, analysis, discussion and evaluation on the empirical research of the collected sample articles written by some empirical scholars in this respect.

### **3.4 Justification for the Combined Methodology**

The combined methodology of comparative analysis in corporate law and meta-empirical study in corporate governance is a relatively new analytical approach in legal research. It conducts critical analyses on the measurements of empirical researches on the efficiency of legal rules and institutions in different legal systems, which is located at the frontier of current legal research and makes a methodological contribution to the field of comparative law. The justification for the combined methodology used by this research is to complement the limits of comparative law study and empirical research, individually or even combined, so as to meet the purpose of this thesis.

As a critical method of legal science, comparative law juxtaposes and comments on the law of the various jurisdictions.<sup>230</sup> It is a method of thinking that is concerned with the

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<sup>229</sup> Jonathan M. Karpoff "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings" (August 18, 2001) <http://ssrn.com.ezproxy.auckland.ac.nz/abstract=885365>.

<sup>230</sup> Zweigert & Kötz, above n 212 at 24, 36.

principles whose application gives the right results but not a method of working that actually sets about a task in comparative law, i.e., any guidance on setting to work efficiently.<sup>231</sup> In other words, comparative law does not provide any guideline to measure the function of the law in a jurisdiction and/or other jurisdictions; it also does not provide any guideline to assess the efficiency of such a measurement if it does exist. This is because “[t]he prime virtue of Comparative Law is the understanding of the nature of law and especially of legal development”.<sup>232</sup> To supplement this limit of comparative law study, empirical research makes available as an economic analysis of law to measure the efficiency of legal rules and institutions in a legal system or various legal systems.

Indeed, empirical research turns out to be economically “a powerful tool of normative analysis of law and legal institutions”<sup>233</sup> with a view to understand “how they operate and what effects they have”.<sup>234</sup> Legal rules and institutions are the black-letter law as such and comparative law study is but to study the law on the books. Empirical research in law focuses on what actually happens in the legal system and hence studies the law in action. So it is popular in the study of corporate law, especially in the field of corporate governance. However, the limitation of empirical research is that each empirical research makes economic analysis of law individually and so may produce contradictory or mixed results from each other. Moreover, it cannot provide a whole picture as regards all the same and/or similar empirical research on the same legal rules or institutions so as to have a general understanding of the efficiency of such legal rules or institutions in whole. This is what meta-empirical study can do.

Meta-empirical study is a review study which aims at generalization and practical simplicity and its essential character is to make an analysis of the summary findings of various empirical researches on the same or similar research issues. The goal of meta-empirical study in any area is to produce an integrated summary of empirical findings

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<sup>231</sup> At 24, 25.

<sup>232</sup> Alan Watson *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh, 1974) at 16.

<sup>233</sup> Richard A. Posner *Economic Analysis of Law* (Little Brown & Co, 1972) at 6. (The citation has been deleted from the latest 8th edition.)

<sup>234</sup> Baldwin J and Gwynn D “Empirical research in law” in *The Oxford Handbook of Legal Studies* (Oxford University Press 2003) at 881.

carried out in that area, i.e., a theoretical analysis of how accumulative empirical evidence fit together. It is used in this research to examine the research questions identified in Section 1.4 so as to corroborate the law and regulation on the independent director in corporate governance by changing the law on the books to the law in action in the relevant jurisdictions. This is to be done by way of review, analysis and discussion on the empirical research of the collected sample articles written by empirical researchers on the topic in order to explore the efficiency of the targeted legal issues as a whole. The purpose is to help gain a better understanding of comparative analysis in corporate law and this is why the combined method of comparative analysis in corporate law and meta-empirical study in corporate governance is used in this thesis.

### **3.5 Research Method Design**

The discussion of the comparative analysis in corporate law in Section 3.2 describes clearly how to carry out comparisons among different legal systems, which serves as the guideline in this research to uncover the legal and institutional frameworks in the targeted jurisdictions. This is to identify the allocation of corporate control rights between shareholders and the board of directors such as the right to ownership structure, the right to board structure and the right to board independence. In view of that, the focus of this research is correspondingly on the internal corporate control mechanism of listed companies in corporate governance adopted by the relevant legal systems and explores how the interest conflicts between shareholders and managers or between majority shareholders and minority shareholders are mediated under such internal corporate control mechanisms.

Comparative analysis in corporate law is to better understand how the same or similar legal issues are addressed by competing legal and institutional frameworks in different legal systems. Bearing this in mind, this research first investigates the corporate structure of listed companies in the legal systems of the United States, New Zealand and China, aiming to find out how internal corporate control power is allocated and whether shareholder activism is effective in allocating such internal corporate control powers in the relevant

jurisdictions. Subsequently, explorations of functional equivalents of legal and institutional frameworks in the relevant countries are conducted to scrutinize the effectiveness of shareholder activism in influencing internal corporate control mechanisms to check management's skirting and diverting at the expense of shareholder interest. To be specific, comparisons are carried out to identify legal elements that are influential to legal and institutional frameworks in the targeted jurisdictions in the following areas: 1) shareholding ownership and classification of shareholders. Focus is on shareholding ownership structure, corporate control devices, shareholder identification and problem of shareholding ownership structure and 2) the board of directors and its independence. Emphasis is on the characteristics and role of the board of directors such as the role of chairperson, CEO, independent directors and committees of the board and elements impacting on board independence such as management dominance, proportionate ratio of insiders and outsiders of the board, information disclosure, shareholder activism and independent directors' incentive to monitoring. Attention is paid to the impact of path dependency on China's transplantation. The primary sources for comparisons are company laws, securities laws and regulations, listing rules, codes of corporate governance and case laws in the relevant jurisdictions. While in need, empirical evidences are used to check legal claimants in practice.

Meta-empirical study in corporate governance seeks to review and analyze the findings of empirical research on the relationship between independent directors and corporate performance in China so as to examine in general the current empirical findings on the role of independent directors in practice. Section 3.3 describes and explains the meta-empirical study as a relevant new research methodology of review studies to be used in corporate law and especially in the field of corporate governance. Currently, there are no set-procedures to conduct the meta-empirical studies. In their studies, Bhagat, Bolton and Romano, and Karpoff set their procedures how to conduct meta-empirical studies and this research mainly follows their procedures. More specifically, review will be focused on the empirical research in identifying areas of concerns and attitudes with regard to the role of independent directors in place by incorporating the examination of listed companies in the Stock Exchanges in China. Analysis will be concentrated on how empirical research

methodologies have been applied in finding out the significant differences in the factors that influence the role of independent directors of the targeted companies under China's hybrid model. Assessment will be on the advantages and disadvantages of the empirical research on distinguishing discrepancies and/or convergence of the corporate governance model so as to establish whether there is any model that will most likely uphold the role of independent directors in corporate governance.

### **3.6 Data Sources and Samples**

As explained in Section 3.3, the "data base" is the original representation of the empirical research conducted by empirical researchers. So, the "data source" of this meta-empirical study correspondingly is academic journals where empirical research is published. The purpose of identifying the "data source" is to find articles published by empirical researchers who examine the relationship between independent directors and corporate performance. Thus, the articles of those empirical researchers establish the "data base" which is consisted of samples of this meta-empirical study.

The data sources used in this research include: Google Scholar at <http://scholar.google.com.nz.ezproxy.auckland.ac.nz/>, Social Science Research Network (SSRN) at <http://papers.ssrn.com/sol3/DisplayAbstractSearch.cfm>, Heinonline at <http://heinonline.org.ezproxy.auckland.ac.nz/HOL/Welcome?collection=journals>, Scopus at <http://www-scopus-com.ezproxy.auckland.ac.nz/home.url> and ProQuest at [http://proquest.umi.com.ezproxy.auckland.ac.nz/pqdweb?RQT=302&COPT=U01EPTY\\_mSU5UPTAmVkVSPTImREJTPUcw&clientId=13395&cfc=1](http://proquest.umi.com.ezproxy.auckland.ac.nz/pqdweb?RQT=302&COPT=U01EPTY_mSU5UPTAmVkVSPTImREJTPUcw&clientId=13395&cfc=1). These sources are used to search sample articles written in English. There are two reasons to choose these sources. One is that the topic of this research is interdisciplinary, i.e., both law and business management. So, any single subject source may not cover the interdisciplinary source completely and thus be able to meet the aim of this research. Another is these sources are internationally peer-viewed academic websites which can provide academic research works with quality. However, these sources have produced very limited sample articles because almost sample articles have been written in Chinese. English sources fail to

include these relevant academic research works in Chinese. Thus, the primary sources used in this meta-empirical study are CNKI at [http://www.cnki.com.cn/CJFD/CJFD\\_index.htm](http://www.cnki.com.cn/CJFD/CJFD_index.htm) and China Academic Journal Electronic Publishing House at <http://www.cnki.net>.

Sample articles have been searched and downloaded from the above sources. For the quality of academic research, three criteria are set for choosing the sample articles used in this meta-empirical study. First, the sample articles selected are those that examine directly the relationship between independent directors and corporate performance. Thus, empirical research that examines indirectly the relationship between independent directors and corporate performance has not been chosen. Second, the sample articles selected are those from academic scholars who investigate empirically the relationship of independent directors and firm performance. So, empirical research by students (excluding doctoral theses) has been excluded. Third, the sample articles selected are those that have been conducted in private academic research. Therefore, empirical research by governmental institutions has also been left out. These three criteria are mandatory that the selected sample article must meet. In addition, additional alternative criteria, such as endogeneity control, multi-performance measure and robustness check, have also been set for the purpose of improving the credibility of the result of empirical research (see Section 8.3.1). According to these criteria, 30 empirical studies on the correlation between independent directors and firm performance in Chinese listed companies have been identified and selected as shown in Table 8.3.2.1 for this meta-empirical study.

### **3.7 Summary**

This Chapter explains the research methodology employed in this thesis that combines two research methods of comparative analysis in corporate law and meta-empirical study in corporate governance. Comparative analysis in corporate law analyses by comparison legal rules and institutions in different legal systems to better understand the application of these legal rules and institutions in different jurisdictions. Meta-empirical study in corporate governance reviews empirical evidence on the effect of legal rules and institutions and evaluates the efficiency of empirical research measuring the effect of legal rules and

institutions. Using this combined methodology, this research aims to expound the political, economic and legal environments from which independent directors have developed in corporate governance in China, compared with the United States and New Zealand. Comparative analysis in corporate law allows this research to identify similarities or discrepancies of the role of independent directors in corporate governance between the United States, New Zealand and China. Meta-empirical study enables this research to recognize whether legal transplant of independent directors from the United States and the current hybrid model of corporate governance are effective in China.

## CHAPTER 4

### OWNERSHIP STRUCTURE

#### 4.1 Introduction

The ownership structure theory, discussed in Section 2.3.1.1, involves the choice of ownership structures. It suggests that equity claims of shareholders reflect the influences of shareholders' preferences in terms of shareholdings held by investors in a firm in a course of competitive selection for an equilibrium organization of the firm. This means that shareholdings held by individual investors in a firm not only represent shareholders' positions in a course of competitive selection of the organization of the firm but also reflect their preferences in choosing such an organization, which determines the corporate governance pattern of the firm. This choice demonstrates that shareholders of the corporation balance their preferences in the separation of ownership and control, which plays an important role in corporate governance. This Chapter examines ownership structure and corporate control and focuses on ownership nature, shareholding concentration and shareholder identification of listed companies in China, compared with that of the United States and New Zealand.

Difference of ownership nature, degree of shareholding concentration and distinction of shareholder identification are used in this research to elucidate problems in connection with the relevant ownership structure and corporate control and capacities of the relevant shareholders to deal with such problems in corporate governance. The statistics presented in this Chapter show that ownership structure and corporate control of listed companies in China is substantially different from the United States and New Zealand. This is especially because of the role of state capitalism via the SOEs' shareholdings of listed companies in China, which has a significant impact by the government, either directly or indirectly, on corporate governance of listed companies. This finding suggests that ownership structure and corporate control of listed companies are in essence still under government control in



China, either directly or indirectly, even after the share structure split reform of listed companies by the end of 2006. This is because the reform has not fundamentally changed the fact that state shares have still been the mainstream of the types of shares of Chinese listed companies.

## 4.2 Ownership and Control of Corporations

Since Adam Smith first proposed in 1776 the notion that managers may not act in the best interests of stockholders owing to separation of ownership and control in the dispersed ownership structure in companies, management control has nevertheless come to prevail in Anglo-American modern corporations over time. Berle and Means in 1932 identified five main corporate control types. These are by means of control through: (1) almost complete ownership; (2) majority control; (3) control through a legal device (such as the use of non-voting stock, a voting trust or the device of “pyramiding”); (4) minority control; and (5) management control, based on the ownership structure of corporations.<sup>235</sup> They pointed out that the first three types of control rest on a legal base but the last two rest on a factual base. According to this classification, management control was dominant in (total number) 44% and (total wealth) of 58% of the largest 200 corporations in the United States in 1929.<sup>236</sup> This gives evidence to support Adam Smith’s proposition that management may be left with uncontrollable powers to pursue their own interest, which will divert from that of stockholders.<sup>237</sup> Management control is based on the existence of a widely dispersed ownership structure that diffuses stockholders’ power to impose corporate policy on managers. “Where ownership is sufficiently sub-divided, the management can thus become a self-perpetuating body even though its share in the ownership is negligible”.<sup>238</sup> The nature of this ownership structure makes it unrealistic for widely diffused stockholders to retain a block stock individually that is large enough to participate in corporate management in large publicly traded corporations. Berle and Means theory suggests that

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<sup>235</sup> Berle & Means, above n 2 at 67. These are five types of corporate control patterns identified by Berle & Means.

<sup>236</sup> At 109.

<sup>237</sup> At 116.

<sup>238</sup> At 82.

ownership structure potentially influences corporate control in corporations, which consequently has impact on corporate governance in a country's legal system.

Berle and Means corporations became the dominant corporate paradigm in the US in the following decades. Subsequent empirical research revealed a similar picture and documented evidence for this trend.<sup>239</sup> For example, Larner claimed that management control increased substantially to 84.5% of total number and 85% of total assets of the top 200 non-financial corporations and thus became the overwhelming predominant type of corporate control in corporations in the United States in 1963.<sup>240</sup> In a similar study fifteen years later, Herman also conducted an investigation of the 200 largest nonfinancial corporations in the US in the mid-1970s and found that 82.5% of them were controlled by management.<sup>241</sup> These studies indicate that the concentration of corporate wealth and control power is accompanied by the diffusion of ownership in corporations. Thus, “a greater degree of outsider control is gradually being introduced into systems that have hitherto been mostly insider-controlled”<sup>242</sup> in the field of corporate governance since the turn of the twentieth century and this type of corporate control is described as “Strong Managers, Weak Owners”<sup>243</sup>. However, dissident voices cast doubts on this corporate paradigm in view of the rise of institutional ownership on the growth of management control even during the era of Berle and Means corporations' dominance in the US.<sup>244</sup>

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<sup>239</sup> See: TNEC “The Distribution of Ownership in the 200 Largest Non-Financial Corporations” (the TNEC, Monograph No.29, 1940) <http://archive.org/details/investigationofc2902unit>. Robert A. Gordon *Business Leadership in the Large Corporation* (The Brookings Institution, Washington DC, 1945). Robert J. Larner “Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963” (1966) 56 *The American Economic Review*. Robert J. Larner *Management Control and the Large Corporation* (Dunellen Publishing, New York, 1970). Robert Sheehan “Properties in the World of Big Business” (15 June 1967) *Fortune* 178-183, Chevalier, J. M. “The Problem of Control in Large American Corporations” (1969) 14 *Anti-Trust Bulletin*. Philip H. Burch *The Managerial Revolution Reassessed* (Lexington Books, 1972).

<sup>240</sup> Larner, above n 239 at 780.

<sup>241</sup> Herman, E.S. *Corporate Control, Corporate Power: A Twentieth Century Fund Study* (Cambridge University Press, 1981) at 66.

<sup>242</sup> Heike Schweitzer & Christoph Kumpan “Changes of Governance in Europe, Japan, and the US: Discussion Report” in Klaus J Hopt et al. (eds.) *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US* (Oxford University Press, 2005) at 687, 693.

<sup>243</sup> Mark J. Roe *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, Princeton, 1994).

<sup>244</sup> See: Charles H. Schmidt & Elaenor J. Stockwell “The Changing Importance of Institutional Investors in the American Capital Markets” (1952) 17 *Law & Contemp Probs* 3-25. Lewis H. Kimmel *Share Ownership in the United States* (Brookings Institution, 1952). Edwin B. Cox *Trends in the Distribution of Stock*

Recent studies show that ownership re-concentration in the hands of institutional investors has already reversed the separation of ownership from control at the heart of the Berle and Means' critique.<sup>245</sup>

Indeed, Cox commented that there has been a shift in shareholding in common and preferred shares from individuals, fiduciaries and brokers to nominees and institutions since 1922 and this declining shareholding of dispersed shareholders reflects the rising importance of institutional investors and investment companies in corporate ownership American.<sup>246</sup> This is especially true after the Investment Company Act came into force in 1940, which allowed the formation of mutual funds and insurance companies that led to a substantial expansion of institutional shareholdings at market value from less than 0.1% in 1922 to 4.2% in 1945.<sup>247</sup> Table 4.2.1 and Table 4.2.2 give details of the growth of institutional shareholding and the institutional ownership re-concentration and indicate that Berle and Means Corporation, based on the dispersed shareholding structure, arguably no longer reflects corporate ownership in America.

**Table 4.2.1 Institutional Holdings of Outstanding Equity in the US Corporations 1950-2009**

	1950	1960	1970	1980	1990	2000	2007	2009
Total								
Outstanding Equity (US\$ billions)	142.7	421.7	859.4	1,534.7	3,530.2	17,627.0	25,576.5	20,227.6
Total								
Institutional Equity (US\$ billions)	8.7	52.9	166.4	436.2	1,432.9	8,631.4	13,473.0	10,238.7
Total								
Outstanding Equity (Percentage %)	6.1	12.6	19.4	28.4	40.6	49.0	52.7	50.6
Compound Annual Growth Rate of Total Outstanding Equity (Percentage %)	-	11.4	7.4	6.0	8.7	-9.7	5.1	28.2

Source: edited from The 2010 Institutional Investment report: Trends in Asset Allocation and Portfolio Composition, The Conference Board, available at: <http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1872>.

*Ownership* (University of Pennsylvania Press, 1963). Ragnar D Naess "Changing Patterns of Individual Equity Investment" (1964) 20 (4) *Financial Analysis Journal* 74-83.

<sup>245</sup> James P. Hawley & Andrew T. Williams *The Rise of Fiduciary Capitalism, How Institutional Investors Can Make Corporate America More Democratic* (University of Pennsylvania Press, 2000) at 43. Also see: Gerald F. Davis "The Twilight of the Berle and Means Corporation" (2011) 34 *Seattle University Law Review* 1121-1138. Aviv Pichhadze "The Nature of Corporate Ownership in the USA: the Trend towards the Market Oriented Blockholder Model" (2010) 5 (1) *Capital Markets Law Journal* 63-88.

<sup>246</sup> Cox, above n 244 at 53.

<sup>247</sup> Hawley & Williams, above n 245 at 48, 53.

Three main observations can be made from Table 4.2.1. First, institutional shareholding in the US corporations in 2009 is about 1,176.9 times than that in 1950 while total outstanding equity of the US corporations in 2009 is about 141.7 times than that in 1950. In comparison, total institutional holdings of outstanding equity in the US corporations are 8 times than that of total outstanding equity of the US corporations during this period of 5 decades, which shows that the growth of institutional investments in stock markets is faster than the growth of total outstanding equity of the US corporations in the US stock markets. Second, the percentage of institutional holding of total outstanding equity in the US corporations was only 6.1 in 1950 but it increased to 50.6 in 2009, which is about 8.3 times than that in 1950. At the same time, the Compound Annual Growth Rate (CAGR) of Total Outstanding Equity held by institutional investors in 2009 is 28.2% more than that the year before. Thus, it can be seen that the percentage of institutional ownership has increased significantly in the ownership structure of the US corporations since 1950. Third, the CAGR of Total Outstanding Equity held by institutional investors in 2000 is -9.7% and this means that the CAGR decreased, compared with that the year before; the percentage of institutional holding of total outstanding equity in the US corporations was 52.7% in 2007, the highest percentage in 50 years, but the CAGR was only 5.1%, the relevant lowest CAGR in the same period. These statistics imply the sensitivity of institutional stockholding to the US stock market, frustrated by Southeast Asian financial crisis in 2000 and excited before the credit crunch in 2008. It is interesting that the CAGR in 2009 is the highest, which implies that institutional corporate stockholding had already recovered from the 2008 market crash.

**Table 4.2.2 Institutional Ownership Concentration in the Top 1,000 US Corporations 1987-2009**

	Average institutional holdings (percentage %)									
	1987	1990	1992	1997	2000	2004	2007	2009	1987-2009 Variation	2000-2009 Variation
Top 50	48.7	50.1	52.1	56.7	54.2	59.7	63.3	63.7	15.0	9.5
Top 100	53.6	54.8	55.5	59.6	58.0	61.8	67.5	66.9	13.3	8.9
Top 250	52.8	54.8	55.6	63.0	61.9	64.4	71.8	69.3	16.5	7.4
Top 500	51.8	52.9	55.3	62.3	63.1	66.7	75.3	72.8	21.0	9.7
Top 750	49.6	51.1	53.6	61.1	63.0	68.4	76.2	73.9	24.3	10.9
Top 1,000	46.6	49.5	52.8	59.9	61.4	69.4	76.4	73.0	26.4	11.6

Source: edited from The 2010 Institutional Investment report: Trends in Asset Allocation and Portfolio Composition, The Conference Board, available at: <http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1872>.

Table 4.2.2 shows that institutional investors have boosted corporate ownership in America

to a historically high of their ownership record in the largest 1,000 U.S. corporations in 1987-2009. In this period, institutional holdings of the top 1,000 US corporations have substantially and consistently increased from 46.6% in 1987 to 73.0% in 2009, which is about 156.7% of the institutional holdings in 1987, and reached an unprecedented record of 76.4% in 2007, the year just before the most recent financial crisis worldwide. The variation of institutional ownership concentration between 1987 and 2009 is 26.4% while the variance between 2000 and 2009 is 11.6%. The increase of institutional ownership concentration can also be seen from the distribution from the top 50 to top 1,000 US corporations during this period, with the exceptions of 1987 and 1990 when there were a marginally decrease between the top 50 and top 1,000 groups.

As seen from the above, the ownership structure has changed arguably from a dispersed pattern to a concentrated pattern because institutional investors have emerged as the largest stockholder of corporations in the United States since the middle of last century. Doubtless, this redistribution and re-concentration of corporate ownership in America makes institutional investors become fiduciary stockholders (stockowners in record) on behalf of beneficiary stockholders (stockowners in fact), which does change the ownership structure of the US corporations and potentially pose the threat, through institutional activism, to management control in corporate America. Some argue that this change of ownership structure has brought the restructuring of ownership and control in corporations<sup>248</sup> that may lead to a functional convergence of corporate ownership towards a hybrid model of corporate ownership worldwide.<sup>249</sup>

In contrast to the United States, corporate ownership and control are relatively concentrated and more minority-controlled but less management-controlled in New Zealand companies since 1962. Table 4.2.3 shows this trend. In the early 1960s, there was a trend towards

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<sup>248</sup> At 43.

<sup>249</sup> Aviv Pichhadze “The Nature of Corporate Ownership in the USA: the Trend towards the Market Oriented Blockholder model” (2010) 5 (1) *Capital Market Law Journal* 63 at 64. Pichhadze argues that the US equity market gravitated in the 20<sup>th</sup> century towards a hybrid form of corporate ownership structure referred as the Market Oriented Blockholder Model (MOBM).

management control.<sup>250</sup> In 1962, 39.5% of 43 listed companies in NZX were management-controlled but 48.8% in 1974—the highest management control in the period of 1962-2009; while majority-controlled companies reduced from 16.3% in 1962 to 7.0 and minority-controlled changed slightly from 32.6% to 30.2%.<sup>251</sup> But this trend greatly decreased in the next 35 years. In 1990, 54.5% of 134 listed companies in NZX were majority-controlled—the highest majority control in the period of 1962-2009, compared with that 38.8% was minority-controlled and 3.7% was management-controlled, which decreased sharply from the highest in 1974 to the lowest (2.6%) in 1993.<sup>252</sup> Although there was a significant increase of management control (24.0%) in 2009 but it was not a dominant control type, compared with minority control, which was 38.0% in 2009.<sup>253</sup>

Table 4.2.3 Control Types of New Zealand Listed Companies 1962-2009

Control Classification	1962 <sup>a</sup>		1974 <sup>a</sup>		1981 <sup>b</sup>		1985 <sup>c</sup>		1990 <sup>c</sup>		1993 <sup>c</sup>		2009 <sup>d</sup>	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Majority	7	16.3	3	7.0	45	22.1	54	37.8	73	54.5	50	50.0	6	12.0
Minority	14	32.6	13	30.2	78	38.2	69	48.3	52	38.8	48	41.4	19	38.0
Joint	5	11.6	6	14.0	19	9.3	10	7.0	4	3.0	7	6.0	13	26.0
Management	17	39.5	21	48.8	62	30.4	10	7.0	5	3.7	3	2.6	12	24.0
Number Of Companies	43		43		204		143		134		116		50	

Source: <sup>a</sup>Fogelberg (1980); <sup>b</sup>Chandler & Hehshall (1982); <sup>c</sup>Fox (1996); <sup>d</sup>Giles & Watson (2011).

It should be noted that minority control is relatively dominant and consistent during the period of 1962-2009, except in 1990 when majority control was dominant and in 1974 when management control was predominant. Thus, minority control should be the mainstream of the control type of listed companies in New Zealand during this 48-year period. This finding is of course not consistent with Fogelberg's traditional notion of corporate control.

<sup>250</sup> Graeme Fogelberg "Ownership and Control in 43 of New Zealand's Largest Companies, 1962 and 1974" (1980) 2 *New Zealand Journal of Business* at 69.

<sup>251</sup> Ibid.

<sup>252</sup> Mark A. Fox "Corporate control and Financial Performance of New Zealand Companies" (Department of Economics and Marketing Discussion Paper No. 4, Lincoln University, Canterbury, 1996) at 4.

<sup>253</sup> Caroline Giles & Susan Watson "Evidence of Ownership and Control in the Top Fifty NZX Non Financial Listed Corporations" (November 2011) <http://ssrn.com.ezproxy.auckland.ac.nz/abstract=2042338> at 6.

There is a different story regarding corporate ownership and control in China that is distinguished from both the United States and New Zealand. Before the economic reform in 1978, there were two types of corporate ownership referred as state-owned and collective-owned in Chinese corporations. Corporate control in connection with these two types of corporate ownerships has been the model of government control, which is completely different from the Berle and Means' five main types of corporate control. Privately-owned companies were only introduced after the 1978 economic reform and the partial privatization of SOEs later on changed the corporate ownership and control of the state-owned and collective-owned companies to some extent, especially the share structure split reform of listed companies in 2005. However, the government under state capitalism has still controlled the mainstream of Chinese corporations in the type of majority control either directly or indirectly, especially listed companies. Section 4.4 discusses this issue in detail.

### **4.3 Share Classification and Ownership Structure**

Ownership structure and control are in connection with the type of share held by shareholders and share classification identifies shares categorized by corporate law that may affect shareholders in choosing corporate ownership and control. Because the type of share is related to such private benefits as the right to vote and the right to dividend that shareholders choose. The law then provides that different types of shares carry different types of voting and dividend rights. Hence, the identification of the type of share is related to shareholders' choice of ownership structure and control.

Countries may adopt in their laws different types of shares. In China, there is a unique classification of shares that is significantly different from that of the United States and New Zealand. The standard classification of share types in China is provided by the Standard Opinion for Companies Limited by Shares (Standard Opinion) issued by State Committee for the Restructuring of the Economic System (SCRES) in May 15 1992. According to Article 24 of the Standard Opinion, there are four basic share types based on the nature of

investors, i.e., state share, legal person share, individual share and foreign share.<sup>254</sup> Table 4.3.1 shows the distribution of four basic types of shares.

From the four basic types of shares evolve over time such a multiplicity of shares as state owned legal person share, domestic legal person share, foreign legal person share, staff (employee) share, A-share, B-share, H-share, L-share, N-share and S-share. These elaborate types of shares are further classified into two main categories based on the liquidity of shares, i.e., tradable (or negotiable) shares and non-tradable (or nonnegotiable) shares. According to the economic nature of assets invested in companies, state shares and state owned legal person shares are together called state-owned shares.<sup>255</sup> Article 23 of the Standard Opinion provides that a company can issue common shares and preferred shares.<sup>256</sup> Figure 4.3.1 shows the relationships between the basic types of shares and sub-types of shares.

Table 4.3.1 Basic Types of Shares in the Standard Opinion

Share Type	Shareholder	investment
State	Departments or agencies of central or local governments and their delegates	State assets including tangibles, intangibles and cash
Legal Person	Organizations with legal person status	Organizations' assets including tangibles, intangibles and cash
Individual	Natural persons including public retail investors, and employees who invest in their own companies	Domestic currency
Foreign	Foreign investors	Foreign currency

Source: Article 24 of Standard Opinion for Companies Limited by Shares.

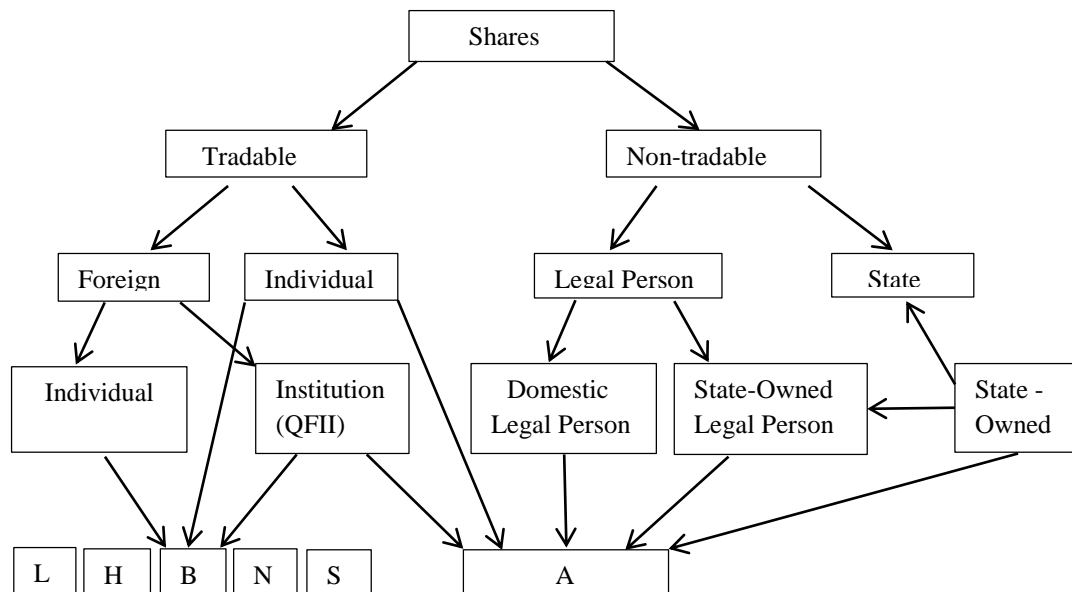
<sup>254</sup> Standard Opinions for the Companies Limited by Shares 1992, Art 24 (in Chinese) State Committee for the Restructuring of the Economic System (SCRES) [www.lawtime.cn](http://www.lawtime.cn).

<sup>255</sup> Interim Measures of the State Council on the Management of Reducing Held State Shares and Raising Social Security Funds 2001, Art 2 (in Chinese) State Council <http://vip.chinalawinfo.com/>.

<sup>256</sup> SCRES, above n 254.



Figure 4.3.1 the relationship between the basic types of shares and sub-types of shares



State shares are shares that have been issued by a company and held by a department or agency of either the central government or local governments on behalf of the state to invest the state assets into the company.<sup>257</sup> State shares came from three situations by way of restructuring and incorporating,<sup>258</sup> according to the reform of enterprise system after the promulgation of Company Law of 1993. First, shares were converted from the entire net assets of existent SOEs which were established by the authorized agencies or departments of the state and restructured into joint stock limited liability companies.<sup>259</sup> Second, shares were converted from more than 50% of net assets of existent SOEs which were established by the authorized agencies or departments of the state and restructured into joint stock limited liability companies.<sup>260</sup> Third, shares originated from the direct investments of the authorised agencies or departments of the state to incorporate new joint stock limited companies.<sup>261</sup> According to the Standard Opinion, state shares should be common shares and are held by the agencies or departments authorised either by the state council or local

<sup>257</sup> Ibid.

<sup>258</sup> Interim measure for administering the rights of state shares in joint stock limited liability companies 1994, Art 8 (in Chinese) SCRES <http://vip.chinalawinfo.com/>.

<sup>259</sup> Art 8, s1 (1).

<sup>260</sup> Art 8, s1 (2).

<sup>261</sup> Art 8, s2 (1).

governments, which can delegate their share representatives.<sup>262</sup> State shares have been essentially reduced in most listed companies after the share structure-split reform in 2005 and has been only remained in some targeted listed companies by the state.

Legal person shares<sup>263</sup> are shares where a corporation or other organizations with a legal person status invest their legitimately controllable or manageable assets in a joint stock limited company.<sup>264</sup> Legal person shares include state-owned legal person shares and domestic legal person shares. Similar to state shares, state-owned legal person shares also came from three situations by way of restructuring and incorporating.<sup>265</sup> First, shares were converted from less than 50% of net assets of existent SOEs which were established by the authorized agencies or departments of the state and restructured into joint stock limited liability companies.<sup>266</sup> Second, shares were converted from the entire or partial net assets of existent state-owned legal persons, including their wholly owned or controlled subsidiaries and sub-subsidiaries, which were restructured into stock limited liability companies.<sup>267</sup> Third, shares were converted from direct investments, the legitimately occupied legal person assets, of existent SOEs to incorporate new joint stock limited companies.<sup>268</sup> Shares that should be issued as state shares cannot be issued as state-owned legal person shares.<sup>269</sup>

State shares or state-owned legal person shares can be either controlling shares or non-controlling shares. The former is termed as state-owned shares by control (*guoyou konggu*) while the latter is termed as state-owned shares by participation (*guoyou cangu*).<sup>270</sup> State-

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<sup>262</sup> SCRES, above n 254.

<sup>263</sup> The term of legal person share came from the fact that this kind of share cannot be traded at Shanghai and Shenzhen stock exchanges but can only be traded between companies with a legal person status (not natural persons) within STAQ and NET Securities Trading Systems through computer network systems in Beijing. STAQ began to operation on July 1, 1992 and NET on April 28, 1993 but both stopped operation on September 9, 1999.

<sup>264</sup> SCRES, above n 254.

<sup>265</sup> SCRES, above n 258.

<sup>266</sup> Art 8, s1 (2).

<sup>267</sup> Art 8, s1 (3).

<sup>268</sup> Art 8, s2 (2).

<sup>269</sup> Art 9.

<sup>270</sup> Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies 2007, Arts 8 and 10 (in Chinese) SASAC & CSRC <http://www.sina.com.cn>.

owned shares by control are further classified into two sub-categories, i.e., state-owned shares by absolute control and state-owned shares by relative control. The former includes: (1) assets invested by the state into a company are more than 50% of all paid-up capital of the company, and (2) assets invested by the state and another investor into a company are both equal to 50% of all paid-up capital of the company but there is no clear agreement on the controlling shareholder.<sup>271</sup> The latter includes: (1) control by agreement, i.e., assets invested by the state are less than 50% of all paid-up capital of the company but the state holds the real control share by agreement, and (2) relative control, i.e., assets invested by the state are relatively larger than any other individual investors.<sup>272</sup> Under the category of relative control, state-owned shares can become the controlling shares just because they are the biggest shares no matter how slightly bigger they are than any other kind of individual shares in a company. State-owned shares by participation are shares that are converted from investments of the state in a company and the state has no controlling interest in the company but some strategic considerations such as state subsidies to certain industries. State-owned shares can be legitimately transferred according to the main purposes of promoting the optimization and collocation of the state resources<sup>273</sup> and adjusting strategically the distribution and structure of the state economy<sup>274</sup>.

Compared with state-owned legal person shares, domestic legal person shares are shares that are owned by non-state legal person, including private companies, institutions and other social organizations with a legal person status. Institutional shares begin to grow but their influence in corporate governance is ignorable just like that of individual shareholders because institutional investors play no role in corporate governance in China. Domestic legal person shares can be traded or transferred with restrictions in stock exchanges within several years after the share structure split reform in 2005.

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<sup>271</sup> Notice of the National Bureau of Statistics on Issuing the Measures for Classification of Publicly and Non-publicly Controlled Economy in Statistics 2005, Art. 4 (in Chinese) National Bureau of Statistics (NBS) <http://vip.chinalawinfo.com/newlaw2002/slc/slc.asp?db=chl&gid=59759>

<sup>272</sup> Art 5.

<sup>273</sup> SASAC & CSRC, above n 270, Art 1.

<sup>274</sup> Law of the People's Republic of China on the State-Owned Assets of Enterprises 2008, Art 52 (in Chinese) National Congress of People's Representatives (NCPR) <http://vip.chinalawinfo.com/>.

Individual shares are shares that are converted from legitimate assets of a natural person including general public and employees of companies to invest in companies limited by shares.<sup>275</sup> Individual shares are also called “social public shares” because they are freely tradable shares on the Shanghai and Shenzhen stock exchanges, except for employee shares with a restriction period of 3 years after the initial subscription. Employee shares include management shares which are usually not allowed to be transferred during their tenures. Individual shares are the minority shares whose rights as minority shareholders are usually undermined by majority shareholders who hold the controlling share. In terms of foreign shares, they are a kind of special share that is from investments (in the form of foreign currency) of either foreign natural person or foreign institution, including those from Hong Kong, Macao and Taiwan, to acquire this kind of special share (nominated in Chinese currency) of a company.<sup>276</sup> The initial foreign share is the B-share, which can be traded freely by foreign investors at both Shanghai and Shenzhen stock exchanges and Chinese investors are not allowed to trade B-shares until 2001. Foreign shares also include H-shares, L-shares, N-shares and S-shares, which are shares of Chinese companies listed in Hong Kong, London, New York and Singapore stock exchanges, respectively. These foreign shares are all tradable shares and can only be freely traded in foreign currencies at the relevant stock exchanges. Of four basic types of shares, state shares, legal person shares and individual shares are A-shares, which are only open to domestic investors and foreign investors are not allowed to trade in A-shares. As Qualified Foreign Institutional Investors (QFIIs), foreign institutions are permitted to trade in A-shares at Shanghai and Shenzhen stock exchanges since 1 December 2002.

Listed companies in China have a complex ownership structure which is composed of three basic types of shares, i.e., state shares, legal person shares and individual shares. Foreign shares are not common in most listed companies. Among them, state-owned shares were absolutely dominant before the share structure split reform in 2005 but this dominance has changed significantly since then. Table 4.3.2 (a) shows the change. In 2004, state-owned shares were 49.4% of the total market capitalization of all listed companies and thus are

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<sup>275</sup> SCRES, above n 254, Art 24.

<sup>276</sup> Ibid.

absolutely the majority share. State-owned shares decreased to 4.17% in 2006 and further decreased to 0.13% in 2011. Thus, state-owned shares have become the minority share in terms of non-negotiable shares after the share structure split reform in 2005. However, this probably is only half the story in consideration of the unlisted shares in terms of negotiable shares because the unlisted share is generally state-owned shares before the share structure split reform. In 2004, 0.07% of the total market capitalization of all listed companies was the unlisted share but it was 68.35% in 2006 and 24.35% in 2011, respectively. This means that there has been still 24.35% of the total market capitalization of all listed companies in the types of state shares and legal person shares, which are relatively non-tradable by the end of 2011. In addition, it is not clear how big the percentage of shares are state-owned shares in the category of listed shares in terms of negotiable shares which is 75.42% of the total market capitalization of all listed companies by the end of 2011. Considering this potential, the percentage of state-owned shares in total should be much bigger. Therefore, it seems that state-owned shares have almost disappeared from the types of shares of listed companies but they arguably are still the main type of share in fact, compared with other types of shares. This suggests that the share structure split reform in 2005 has generally shifted state-owned shares from the absolutely majority share to the relatively majority share up to the end of 2011, which means that corporate ownership structure is still relatively, even not absolutely, concentrated in China.

In contrast, the types of shares in the United States and New Zealand are not as complicated as China. Traditionally, corporate statutes in the US classify the types of shares of corporations into common stocks and preferred stocks based on whether they are distinguishable from each other in either the right to vote or the right to participate in assets distribution of corporations upon dissolution.<sup>277</sup>

The Modern Business Corporation Act Annotated breaks away from this perceived inheritance by making limited substantial changes so as to reflect the actual flexibility in

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<sup>277</sup> Model Business Corporation Act Annotated Third Edition, § 6.01 (vol. 1, 2000/01/02 supplement) at 6-3.

the creation of the types of shares existing in modern corporate practice.<sup>278</sup> Thus, the distinction between common shares and preferred shares is not strictly followed. Delaware General Corporation Law provides that every corporation may issue one or more classes or series of stock within any class or series of stocks with or without voting rights or preferences thereof.<sup>279</sup> Usually, these stocks are issued as common shares in nature, which are mainly held by institutional investors and insiders (see Table 4.3.2(b)). By the end of January 2011, institutional investors and insiders own 45.26% and 8.90% of total market capitalization of all public listed companies in the US stock exchange and the US government remains no corporate ownership. Ownership patterns are re-concentrated in the form of institutional shares. But this re-concentration in the form of institutional fiduciary ownership is in essence different from the concentrated ownership in the form of the state-owned share either directly or indirectly in China. Nonetheless, individuals are still major stockholders in public listed companies in the United States, although most of them are in the form of beneficiary ownership under the trusteeship of institutional investors.

In New Zealand, the types of shares include ordinary shares and preference shares<sup>280</sup> and ordinary shares are the same as common shares in the US. The difference between the US and New Zealand is that the minority ownership in the form of concentrated ownership structure are relatively dominant in comparison with other types of ownerships in New Zealand, which shows that New Zealand's attitude towards the management control in the form of the dispersed ownership structure is "hesitant and cautious".<sup>281</sup>

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<sup>278</sup> At 6-4, 6-5.

<sup>279</sup> Delaware General Corporation Law (US), §151, <http://delcode.delaware.gov/title8/c001/index.shtml>.

<sup>280</sup> Companies Act 1993 (New Zealand), ss. 36, 37 (Wellington, 2007) at 43, 44.

<sup>281</sup> Giles & Watson, above n 253 at 10.

Table 4.3.2(a) Ownership Structure of listed companies in China (2003 – 2011)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Number of Listed Companies <sup>a</sup>	1287	1377	1381	1434	1530	1625	1718	2063	2342
Total Capitalization (100 million of CNY) <sup>a</sup>	42,458	37,056	32,430	89,404	327,141	121,366	243,939	265,423	214,758
(100 million of US\$) <sup>b</sup>	5,130	4,477	4,019	11,455	44,789	17,788	35,732	40,278	34,121
Negotiable share (%) <sup>c</sup>	34.28	35.09	48.63	93.63	98.06	99.09	99.46	99.68	99.77
Listed share*	34.09	35.03	37.43	35.28	39.22	45.56	68.38	71.35	75.42
A-share	30.66	31.56	33.73	32.40	36.43	43.07	66.13	69.56	73.85
B-share	3.43	3.48	3.70	2.94	2.80	2.50	2.25	1.80	1.57
Non-listed share**	0.19	0.07	11.20	68.35	58.84	53.53	31.08	28.33	24.35
A-share	0.18	0.07	11.20	68.35	58.84	53.53	31.08	28.33	24.35
B-share	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Non-negotiable share (%) <sup>c</sup>	65.72	64.91	51.37	6.37	1.94	0.91	0.54	0.32	0.23
State share	26.46	24.80	19.51	1.25	0.33	0.11	0.02	0.01	0.01
State-owned Legal Person's Share	24.28	24.60	19.34	2.92	0.59	0.25	0.20	0.16	0.12
Domestic Legal Person's Share	13.96	14.26	11.38	1.85	0.91	0.49	0.27	0.12	0.07
Foreign Legal Person's Share	0.89	1.16	1.18	0.35	0.10	0.05	0.05	0.03	0.03
Staff Share	0.13	0.09	0.06	0.00	0.01	0.01	0.00	0.00	0.00
Others	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total (%) <sup>c</sup>	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: edited and calculated from

<sup>a</sup> Annual Reports (2003-2011) of China Securities Regulatory Commission (CSRC), available at: [http://www.csrc.gov.cn/pub/csrc\\_en/about/](http://www.csrc.gov.cn/pub/csrc_en/about/)<sup>b</sup> Annual Statistics Reports (2003-2011) of World Federation of Exchanges, available at: <http://www.world-exchanges.org/statistics/annual><sup>c</sup> Annual Reports (2004-2011) of China Securities Depository and Clearing Corporation Limited, available at: <http://www.chinaclear.cn>

\* Shares can be tradable without restriction in stock exchanges.

\*\* Shares can be tradable with restriction in stock exchanges.

Table 4.3.2(b) Ownership Structure of listed companies in the United States (2003 – 2011)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Number of Listed Companies <sup>a</sup>	6159	6097	5434	6005	5965	5472	5179	5093	4988
Amex <sup>*</sup>	557	575	595	592	599	486			
NASDAQ	3294	3229	3164	3133	3069	3023	2852	2778	2680
NYSE	2308	2293	2270	2280	2297	1963	2327	2317	2308
Total Capitalization <sup>a</sup> (100 million of US\$)	142,660	163,215	170,009	195,690	202,223	115,903	15,773	172,835	156,407
Amex	929	830	863	2,828	2,578	1,324			
NASDAQ	28,442	35,329	36,040	38,650	43,137	22,490	32,395	38,894	38,451
NYSE	113,290	127,056	133,106	154,212	156,508	92,089	118,378	133,941	117,956
Common Share (%) <sup>b</sup>									
Government <sup>c</sup>	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Institution <sup>d</sup>	27.74	37.17	31.46	31.93	41.24	42.41	43.52	42.38	45.26
Insider <sup>d</sup>	1.57	9.86	10.05	10.12	9.56	9.21	9.24	9.03	8.90
Individual	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Preferred Share <sup>**</sup> (%) <sup>c</sup>	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Others (%)									
Rest of the World	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: edited and calculated from

<sup>a</sup> Annual Statistics Reports (from 2003 to 2011) of World Federation of Exchanges, available at: <http://www.world-exchanges.org/statistics/annual>.

<sup>b</sup> Includes common share A and common share B.

<sup>c</sup> Compustat.

<sup>d</sup> Aswath Damodaran, available at: [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/data.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html)

<sup>\*</sup> American Stock Exchange (Amex) was acquired by NYSE Euronext on October 1, 2008.

<sup>\*\*</sup> Includes cumulative, redeemable, convertible and participating shares.

<sup>\*\*\*</sup> Not available.

Note:

Government means agencies and organizations controlled by government. Institution means institutional investors including mutual fund, pension fund, hedge fund, certain bank, insurance company and investment advisor. Insider means director, officer and more than 5% of shareholding. Individual means individual person investor.



#### 4.4 Ownership Concentration and Corporate Control

Ownership structure refers to the distribution of shareholdings among shareholders in a company and it usually denotes (1) the degree of shareholding concentration, i.e., the percentage of shares held by various shareholders, and (2) the composition of shareholders' identities, i.e., the position of the nature of various shareholdings (See Section 4.5). The ownership structure theory suggests that ownership concentration influences corporate control because the degree of shareholding concentration is in connection with the private benefit of control in grabbing of voting rights and cash flow. So, shareholders' rights in corporate control are closely related to the shares that they have owned proportionately. As mentioned in Section 4.2, this section discusses in detail the ownership concentration and corporate control in Chinese listed companies under the state capitalism during the period of 2003-2011 in China.

Ownership concentration plays an important role in corporate control. The more concentrated the ownership is, the more likely it is that the owners of shares can utilize corporate control, either unilaterally or collectively, and the private benefit of control more achievable for shareholders. Thus, ownership concentration reflects the distribution of corporate control in corporations. By analyzing ownership structure, corporate control can be assessed through ownership concentration in terms of the percentage of shareholdings held by shareholders, which is the most common way to measure ownership concentration in a company. Corporate control can also be assessed in terms of how the distribution of control power is affected by the distribution of shareholdings. The percentage of shares is usually calculated as each shareholder's shareholdings held in the total outstanding shares of a company either by volume or by value in a stock exchange. Thus, the distribution of control power can be measured through calculating the ownership concentration indices, which are used to measure the degree of control or the power of influence in corporations. These indices are calculated on the basis of the percentages of a number of top shareholders' shareholdings in a company, usually the top ten shareholders. The calculation of the indices is based entirely on shareholders' shareholdings and excludes *de facto* control such as bank

control in Germany and other forms of control such as control implied or agreed by agreement in China.

There are usually two main ways to measure corporate control in terms of ownership concentration indices that are used to measure the degree of control or the power of influence in a company. They are: (1) fixed rule (or shareholding ratio) and (2) variable rule, i.e., Herfindahl-Hirschman Index (H\_Index). Fixed rule<sup>282</sup> infers corporate control from the largest shareholding block, which depends on its percentage of the total shareholdings in a company, composed of either by the percentage of the largest shareholding only or by the percentages of a number of the largest shareholdings. Generally speaking, ownership structure is highly concentrated if more than 50% (including 50%) of shareholding is held by the largest shareholder; while it is relatively concentrated if the percentage of shareholding is from 49% to 20% and dispersed if the percentage is below 20%.

H\_Index<sup>283</sup> describes the degree of ownership concentration and the equilibrium of the distribution of ownership concentration. The purpose of H\_index is to see if there exists the Matthew Effect after the percentage of shareholding has been squared, i.e., the bigger the percentage of the biggest shareholding the smaller the percentage of the smallest shareholding, and thus increases significantly the difference between shareholders. H\_Index is measured between 1 and 0 (in decimal), or between 10,000 and 0 (in integer). Referred to the Merger Guidelines 2010 in the US, shareholdings in a company is either highly dispersed if H Index is below 0.01 (or 100) or unconcentrated if H Index is below 0.15 (or 1,500) or moderately concentrated if H Index is between 0.15 to 0.25 (or 1,500 to 2,500) or highly concentrated if H Index is above 0.25 (or above 2,500).<sup>284</sup> Alternatively,

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<sup>282</sup> Fixed rule is usually denoted by CR<sub>n</sub>. CR means concentration ratio while n represents 1, 2 ... n. For example, CR<sub>1</sub> means the percentage of the largest shareholding and CR<sub>3</sub> means the sum of the percentages of the three largest shareholdings, CR<sub>10</sub> means the sum of the percentages of the ten largest shareholdings and so on.

<sup>283</sup> Herfindahl-Hirschman Index, better known as Herfindahl Index, is the sum of squares of shareholding percentages of a number of top shareholders. For instance, H<sub>5</sub> index means the sum of squares of shareholding percentages of the top 5 shareholders, H<sub>10</sub> index means the sum of squares of shareholding percentages of the top 10 shareholders.

<sup>284</sup> Horizontal Merger Guidelines 2010 (US), § 5.3 at 19.

transactions that increase H Index by more than 0.01 (or 100) in moderately concentrated stock markets potentially raises significant ownership concentration concerns while transactions that increase H Index by more than 0.02 (or 200) in highly concentrated stock markets are presumed to be likely to enhance ownership concentration of listed companies,<sup>285</sup> i.e., equity ownership may be still presumed relatively concentrated.

In addition, Z Index and S Index<sup>286</sup> are also used here to measure the power of influence in terms of the shareholding concentration. Z Index reflects the relative power of control of the largest shareholder, compared with that of the second largest shareholder or a number of other shareholders. The bigger the Z Index the bigger the difference between the largest shareholder and the second biggest shareholder or a number of other largest shareholders. The smaller the Z Index the smaller the difference between the largest shareholder and the second largest shareholder or a number of other largest shareholders. The big Z Index reveals that the largest shareholder is predominant in corporate control and *vice versa*. S Index reflects the degree of check and balance that a number of other largest shareholders (excluding the largest shareholder) may wield on the largest shareholder. The bigger the S Index the stronger the degree of check and balance of a number of other largest shareholders on the largest shareholder. The smaller the S Index the weaker the degree of check and balance of a number of other largest shareholders on the largest shareholder.

For the purpose of this research, CR<sub>1</sub>(ShrCR1), CR<sub>3</sub>(ShrCR3), Z Index, S Index, H Index and H\_5 Index are chosen to measure the ownership concentration of Chinese listed companies from 2003 to 2011 and all statistics of these six indices used in this Section are calculated based on the data collected from the CSMAR database.

Table 4.4.1 shows the ownership concentration of top ten shareholders of Chinese listed companies during the period of 2003-2011. From Table 4.4.1, some observations can be drawn. First, the equity ownership of Chinese listed companies is highly concentrated in the hands of the top three shareholders who have absolutely got hold of corporate control,

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<sup>285</sup> Ibid.

<sup>286</sup> Z Index and S Index come from CSMAR database and are used in corporate ownership studies in China.

especially the largest shareholder. This can be seen from the means of both ShrCR3 and ShrCR1, which were all more than 52% and 36% from 2003 to 2011, respectively. The ratio of means of ShrCR1 to ShrCR3 is 0.6923, which means that the first largest shareholder has got hold of 69.23% of control power and was in an absolutely dominant position among the three largest shareholders. The mean of shareholding percentages of the first largest shareholders reduced 6.10% in 2006 but remained approximately constant from then till 2011. The mean of shareholding percentages of the three largest shareholders reduced 6.51% in 2008 but increased 2.29% in 2011, an interesting reverse of ownership concentration. These three figures show that the first largest shareholder or the three largest shareholders have no intention to further reduce their shareholdings. The maxima of ShrCR1 and ShrCR3 were still 99% and 100% in 2011, respectively. This indicates that some listed companies were completely owned and controlled by the first largest shareholder or the first three largest shareholders even in 2011. The minima of ShrCR1 and ShrCR3 were 2.20% and 3.65% in 2011, respectively. This shows that the ownership structures of some listed companies are highly dispersed.

Second, the degree of ownership concentration of Chinese listed companies has reduced significantly but was still moderately concentrated during the period of 2003-2011, according to the US Horizontal Merger Guidelines 2010. The means of H Index and H\_5 Index both were between 0.15 and 0.25. As shown from Table 4.4.1, the degree of ownership concentration of Chinese listed companies has just reduced slightly more than one fourth during the period of 2003-2011. The maxima of H Index and H\_5 Index were 0.9801 and 0.9802 in 2011, respectively; while the minima of both indices were 0.000483 and 0.000549 in 2011, respectively. This indicates that some listed companies are still highly concentrated and that the Matthew Effect does exist in Chinese listed companies. The difference between the first largest shareholder and other shareholders is still significant.

Table 4.4.1 Ownership Concentration Indices of Top Ten Shareholders of listed companies in China (2003 – 2011)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>ShrCR1</b>									
Mean	42.65410	41.90285	40.46199	36.55514	36.19073	36.36298	36.608374	36.671585	36.301128
Maximum	85.00	85.00	84.98	98.86	100.00	86.42	95.10	95.95	99.00
Minimum	1.06	2.25	4.24	4.54	0.82	3.74	3.64	3.50	2.197
<b>ShrCR3</b>									
Mean	58.68637	58.98303	57.55642	53.07849	52.43614	52.17201	52.709677	54.02658	54.461048
Maximum	94.37	95.99	96.00	101.70	100.00	97.849	100.00	100.00	100.00
Minimum	3.03	4.63	9.69	5.95	2.34	9.48	6.67	4.03	3.652
<b>Z Index</b>									
Mean	42.89986	38.35801	31.21133	19.14028	17.72284	24.68784	16.05242	14.584016	13.459015
Maximum	1,392.10	994.4284	817.00	604.6364	883.2258	11,931	297.65	608.7857	397.1875
Minimum	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
<b>S Index</b>									
Mean	18.54005	19.86826	20.0793	20.24477	20.13766	19.46399	20.019403	22.131931	22.858484
Maximum	65.95	66.03	63.55	63.00	80.34	70.20	80.18	79.51	74.16
Minimum	0.40	0.36	0.50	0.72	0.00	0.017	1.10	0.72	0.97
<b>H Index</b>									
Mean	0.211285	0.203732	0.189966	0.157397	0.155376	0.156403	0.1598579	0.160303	0.1752377
Maximum	0.7225	0.7225	0.72216	0.97733	1.00	0.746842	0.904401	0.92064	0.9801
Minimum	0.000112	0.000506	0.001798	0.002061	0.000067	0.001399	0.001325	0.001225	0.000483
<b>H_5 Index</b>									
Mean	0.231485	0.225475	0.211617	0.176367	0.173511	0.173994	0.177917	0.1800142	0.1769996
Maximum	0.722573	0.722559	0.722206	0.977371	1.00	0.759838	0.906802	0.922281	0.9802
Minimum	0.000228	0.000659	0.003059	0.00221	0.000127	0.002317	0.002709	0.001246	0.000549

Source: calculated from CSMAR Database.

Note:

ShrCR1 is the shareholding percentage of the largest shareholder. ShrCR3 is the sum of shareholding percentages of top five shareholders. Z Index is the ratio of shareholding percentage of the largest shareholder to that of the second largest shareholder. S Index is the sum of shareholding percentages from the second largest shareholder to the tenth largest shareholder. H Index means Herfindahl Index which is the sum of squares of shareholding percentage of the largest shareholder. H\_5 Index means Herfindahl\_5 Index which is the sum of squares of shareholding percentage of top five shareholders.

Third, the relationship between the first largest shareholder and other nine largest shareholders has relatively changed but not in essence, and the degree of check and balance that other nine largest shareholders may wield against the first largest shareholder has also increased relatively but it has still been weak absolutely. The mean of the Z Index reduced to 13.4590 in 2011, which means that the relationship between the first largest shareholder and the second largest shareholder has changed significantly, a relatively 318.74% improvement.

However, the mean of the Z index in 2011 is still an absolute 1,345.90% of dominance that the first largest shareholder had to the second largest shareholder. The mean of the S Index has increased 123.29% in 2011, which means that the degree of check and balance that other nine largest shareholders may wield against the first largest shareholder increased 23.29 times in 2011 than that in 2003. However, this increase is still rather weak if taking comparison of the S Index with the ShrCR1 Index by calculating the ratio of the minimum mean of ShrCR1 to the maximum mean of S Index during the period of 2003-2011. This ratio measures the minimum degree of dominance that the first largest shareholder may have over other nine largest shareholders to the maximum degree of check and balance that may be wielded by other nine largest shareholders against the first largest shareholder during a period of time. The minimum mean of ShrCR1 and the maximum mean of the S Index are both in 2011 during the period of 2003-2011. So, the ratio of both is 1.5881, which means that the first largest shareholder takes more 58.81% of advantage than that of other nine largest shareholders. The result of this ratio makes nil the increase of 23.29 times degree of check and balance that other nine largest shareholders have achieved, which again gives evidence that the first largest shareholder is reluctant to give up their advantage position of absolute dominance. The maximum of the Z Index was 11,931 in 2008 and the minimum is 1 through the period of 2003-2011, which mean that the first largest shareholder is absolutely predominant or at least in tie with the second largest shareholder. The maximum of S Index was 80.34 and the minimum was 0 both in 2007, which means that the degree of check and balance that nine other largest shareholders can exercise is very strong in some listed companies.

Table 4.4.2 shows the ownership concentration of top ten negotiable shareholders of Chinese listed companies from 2003 to 2011. First, the equity ownership of Chinese listed companies has become more dispersed but is still relatively concentrated. Both NegshrCR1 and NegshrCR3 increased 1,130.21% and 923.53% from 2003 to 2011, respectively. This means that more nonnegotiable shares have become negotiable shares and thus the ownership concentration has been greatly reduced in general. This is the expected result of the share structure split reform of 2005. But there is a strong trend that the ownership concentration has relatively shifted to the three largest negotiable shareholders. This is evident that the maxima of NegshrCR1 and NegshrCR3 were 86.35% and 97.81% in 2011, respectively. The minima of NegshrCR1 and NegshrCR3 were both below 0.40%, which demonstrates that the ownership of some listed companies has become highly dispersed in this period of time.

Second, the degree of ownership concentration of Chinese listed companies was still relatively moderately concentrated during the period of 2003-2011, according to the US Horizontal Merger Guidelines. It seems that there was no any degree of ownership concentration in Chinese listed companies in the period of 2003-2011 because the means of NegshrH and NegshrH\_5 are both well below 0.15. In fact, the maxima of NegshrH and NegshrH\_5 were both well beyond 0.15 from 2003 to 2011 and showed a very strong trend of steadily increase of ownership concentration of Chinese listed companies in the period. This means that the equity ownerships of some companies were moderately concentrated and some were highly concentrated. Furthermore, the means of yearly changes of NegshrH, NegshrH\_3, NegshrH\_5 and NegshrH\_10 were all well beyond 0.1(or 100) after 2007 (See Table 4.4.3). Noticeably, the yearly changes of these indices were all greatly beyond 0.045 in 2008-2009. Thus, the equity ownership of Chinese listed companies was still relatively moderately concentrated on the whole in this period.

Third, the relationship between the first largest negotiable shareholder and other nine largest negotiable shareholders has changed significantly and the degree of check and balance that other nine largest negotiable shareholders may wield against the first largest negotiable shareholder has also increased considerably. However, the first largest

negotiable shareholder still has absolutely dominance over any other largest negotiable shareholder individually. The mean of the NegshrZ Index increased 2.23 times from 2003 to 2011, which demonstrates that the first largest negotiable shareholder has still overridden the second largest negotiable shareholder. The maximum of the NegshrZ Index is more than 400 and the minimum of the NegshrZ Index is 1 throughout the period of 2003-2011, which shows that the relationship between both shareholders is at least in tie each other.

Both the mean and the maximum of the NegshrS Index increased more than 4 times and 2 times from 2003 to 2011, respectively. The ratio of the minimum of NegshrCR1 in 2003 to the maximum of the NegshrS Index in 2011 is 0.1544, an overwhelming increase of the power of check and balance of other nine largest shareholders who may exercise against the first largest shareholder in the period. This generally reflects the result of the share structure split reform of 2005 but it may conceal the real equilibrium of check and balance between the first largest negotiable shareholder and other nine largest negotiable shareholders. For example, the mean of NegshrCR1 was still higher than that of NegshrS in 2011, which reveals that the power of check and balance of other nine largest negotiable shareholders against the first largest negotiable shareholder was still weak.

From the analysis above, it can be seen that the share structure spilt reform in 2005 has in deed changed significantly the ownership concentration and the degree of control of Chinese listed companies from high concentrated to moderately or relatively concentrated ownership and control. Technically, this change makes possible that the other nine largest shareholders of Chinese listed companies as a coalition do have potentially the power of control over or the power of check and balance on the first largest shareholder, either nonnegotiable or negotiable. But in reality, this is probably difficult in a non-mature stock market in China because the first largest shareholder has usually kept dominance over other shareholders, either absolutely or relatively, as shown from the statistics above. It is particularly true in view of the unclear nature of the identity of the real owners of Chinese listed companies who actually exercise the right of corporate control, which is crucial to understand the ownership concentration and corporate control in the Chinese



Table 4.4.2 Ownership Concentration Indices of Top Ten Negotiable Shareholders of Listed Companies in China (2003 – 2011)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>NegshrCR1</b>									
Mean	1.704507	1.801622	2.018368	2.616318	4.028392	7.278962	16.771543	18.071564	19.264425
Maximum	42.7879	58.38	58.38	61.5528	49.45	73.97	80.3755	86.20	86.35
Minimum	0.0397	0.0393	0.0481	0.0746	0.105	0.0797	0.0019	0.0002	0.0006
<b>NegshrCR3</b>									
Mean	2.991991	3.360978	3.944647	4.884049	8.870648	13.46794	24.38467	26.015301	27.632062
Maximum	43.8483	58.6853	58.8149	69.5373	63.643	85.5828	96.5242	97.6518	97.8145
Minimum	0.1855	0.1769	0.2046	0.3123	0.3641	0.268	0.0019	0.0009	0.0031
<b>NegshrZ Index</b>									
Mean	5.21121	5.555927	4.980022	5.592943	4.811339	6.46794	12.125608	11.220772	11.616496
Maximum	673.9066	689.7498	433.2544	350.9843	659.9141	422.5463	694.1396	358.1333	404.1165
Minimum	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
<b>NegshrS Index</b>									
Mean	2.072369	2.469431	3.077904	3.522865	7.246403	8.694442	10.187813	10.572219	11.03722
Maximum	26.9972	29.8836	30.9352	48.9858	41.5652	48.5072	60.7077	66.2248	61.3787
Minimum	0.2608	0.2529	0.3153	0.3644	0.053	0.1302	0.0102	0.0009	0.0056
<b>NegshrH Index</b>									
Mean	0.002469	0.002824	0.002982	0.005437	0.004403	0.01395	0.0588117	0.0661619	0.0711253
Maximum	0.18308	0.340822	0.340822	0.378875	0.24453	0.547156	0.646022	0.743044	0.745632
Minimum	0.00	0.00	0.00	0.000001	0.000001	0.000001	0.00	0.00	0.00
<b>NegshrH_5 Index</b>									
Mean	0.002597	0.00301	0.003251	0.005985	0.005726	0.016551	0.0642924	0.0723183	0.0776076
Maximum	0.183109	0.340824	0.340827	0.38613	0.244534	0.547238	0.646294	0.755961	0.758561
Minimum	0.00	0.00	0.00	0.000002	0.000002	0.000001	0.00	0.00	0.00

Source: calculated from CSMAR Database.

Note:

NesshrCR1 is the shareholding percentage of the largest negotiable shareholder. NegshrCR3 is the sum of shareholding percentages of top five negotiable shareholders. NegshrZ Index is the ratio of shareholding percentage of the largest negotiable shareholder to that of the second largest negotiable shareholder. NegshrS Index is the sum of shareholding percentage from the second largest negotiable shareholder to the tenth largest negotiable shareholder. NegshrH Index means Herfindahl Index which is the sum of squares of shareholding percentage of the largest negotiable shareholder. NegshrH\_5 Index means Herfindahl\_5 Index which is the sum of squares of shareholding percentage of top five negotiable shareholders.

Table 4.4.3 Yearly Changes\* of H Indices of Top Ten Negotiable Shareholders of Listed Companies in China (2003 – 2011)

	NegshrH Index	NegshrH_3 Index	NegshrH_5 Index	NegshrH_10 Index
2003 – 2004	0.000355	0.000397	0.000413	0.000427
2004 – 2005	0.000158	0.000220	0.000241	0.000260
2005 – 2006	0.002455	0.002713	0.002734	0.002742
2006 – 2007	-0.001034	-0.000451	-0.000259	-0.000096
2007 – 2008	0.009955	0.010742	0.010825	0.010845
2008 – 2009	0.044862	0.047692	0.047741	0.047733
2009 – 2010	0.007350	0.008001	0.008030	0.008050
2010 – 2011	0.004963	0.005283	0.005289	0.005291
Means				
Sub-mean				
Before 2006	0.000989	0.001110	0.001129	0.001143
After 2007	0.011322	0.014253	0.014325	0.014382
Grand Mean	0.008633	0.009325	0.009377	0.009407

Source: calculated from CSMAR Database.

\*The yearly change is defined as the difference between the H indices of a year and that of the year before by subtracting the latter from the former.

Note:

NegshrH Index means Herfindahl Index which is the sum of squares of shareholding percentage of the largest negotiable shareholder. NegshrH\_3 Index means Herfindahl\_3 Index which is the sum of squares of shareholding percentage of top three negotiable shareholders. NegshrH\_5 Index means Herfindahl\_5 Index which is the sum of squares of shareholding percentage of top five negotiable shareholders. NegshrH\_10 Index means Herfindahl\_10 Index which is the sum of squares of shareholding percentage of top ten negotiable shareholders.

corporate governance system. This leads to the identification of shareholders, especially the largest shareholders or the real controlling shareholders, of Chinese listed companies, which is discussed in the following section.

#### **4.5 Shareholder Identification**

The identification of shareholders designates the nature of shareholding of share owners, which indicates not only the composition of different shareholdings but also the position of various shareholders. The shareholding composition reflects the structure of the types of shareholders and the shareholders' position demonstrates the influence of their shareholdings. Thus, an examination of the identities of shareholders can reveal the exact nature of corporate ownership and discover the shareholder who exercises the power of corporate control, especially the largest shareholder or the real controlling shareholder. Under the concentrated corporate ownership, the largest shareholder or the real controlling shareholder normally has the power or influence over corporate management.

As seen from Section 4.4, ownership concentration, though it is now not as high as before, is still a distinguishable characteristic of corporate China even after the reduction of state shares in the share structure split reform, which has been hailed as the successful solution of dealing with the reduction of state shares in Chinese listed companies. The question remains is whether the unclear nature of the identity of the real owners of Chinese listed companies has been solved, i.e., who is the real owner of "Legal Person Shares" and "A-Shares", even "Foreign Shares", and who is the largest shareholder or the real controlling shareholder. The answer is still uncertain as seen in Table 4.3.2(a), where state shares were officially reported as only 0.01% in 2011, whereby it seems that state shares nearly disappeared from the types of shares. However, it is untrue because there was no report what percentage of state shares included in A-shares which were 98.20% in 2011.

In China, the standard classification of the types of shares is misleading about the identification of shareholders because it confuses the types of shares and fails to identify the real shareholder of the share. For example, domestic legal person shares usually include

state shares. Foreign shares also contain Chinese listed companies registered abroad, which are owned or controlled by the state.<sup>287</sup> In addition, A-shares are not an individual type of share, according to the standard types of shares, but a medley of all four standard types of shares. Research so far, either empirical or theoretical, has failed to uncover the real identity of the largest shareholder or the real controlling shareholder of Chinese listed companies under the standard types of shares. To identify the identity of the largest shareholder or the real controlling shareholder, it is necessary therefore needs not only to identify who are the largest shareholders but also to lift the veil of the types of shares, i.e., looking behind the facade of the types of shares and identify the actual natures of shareholdings under the type of shares. By using data from the CSMAR database, a detailed analysis enables this research to further examine the real nature of shareholder identification of Chinese listed companies under the standard types of shares.

To examine the shareholder identification, an investigation is taken step by step on the data regarding the distributions of shareholdings of top ten shareholders by identity, the first largest shareholder by identity, the controlling shareholder by identity and the control pattern by the real controlling shareholder of Chinese listed companies from 2003 to 2011. The purpose is to look into the true identity of the real controlling shareholders behind the standard classification on the types of shares.

Table 4.5.1 shows a general picture of the average shareholding percentage of the ten largest shareholders by identity in Chinese listed companies from 2003 to 2011. As the first largest shareholder, the state held maximally 47.20% in 2003 and minimally 39.61% of all shares of Chinese listed companies in 2008 but increased its shareholding since then to 42.20% in 2011, with an average of 43.67% during the period of 2003-2011. This firmly demonstrates the policy of the state-owned share by control in Chinese listed companies. In comparison, the minimum percentage of domestic legal person as the first largest

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<sup>287</sup> Taking an example of Beijing Foods Sanyuan Co. Ltd. (Stkcd: 600429). By the end of 2011, 41.33% of its shares has been held by Beijing Enterprises (Dairy) Limited, which is registered in Virgin Islands (British) and therefore classified as foreign legal person under the standard types of shares. But the controlling shareholder of Beijing Enterprises (Dairy) Limited is Beijing State Assets Supervision and Administration Committee (SASAC Beijing). Therefore, the real controlling shareholder of Beijing Foods Sanyuan Co. Ltd. is in fact the SASAC Beijing.

shareholder was 24.72% in 2005 and the maximum was 40.00% in 2011, with an average of 33.74% in this period. Foreign and individual as the first largest shareholder held 33.14% in 2006 and 23.60% in 2005 in minimum and 46.63% in 2011 and 33.00% in 2010 in maximum, respectively; the averages of both were 38.21% and 28.46%, correspondingly, in the same period. By this token, it has been seen that the general trend is that the state as the majority shareholder has been the mainstream of the first largest shareholders in Chinese listed companies in the period. Taking into consideration of the undisclosed uncertainty of the state as the first largest shareholder included in both domestic legal person shares and foreign shares, this trend will be further strengthened. In addition, Table 4.5.1 also provides evidence that the state also takes the relevant advantageous position than either domestic legal person or foreign or individual as other largest shareholders from the second to the tenth in general, which clearly indicates the policy of the state-owned share by participation in Chinese listed companies. That is, even in a position as the largest shareholder from the second to the tenth, the state shares are still in a relative advantage in its shareholdings compared with other shareholders. This is to maintain the state's influence on Chinese listed companies in order to carry out the national economic policy.

From Table 4.5.1, it can be seen how the shareholding percentages of the ten largest shareholders have been distributed under the standard classification on the types of shares from 2003 to 2011 in China. But it cannot tell exactly how the shareholding percentages of the ten largest shareholders have been distributed under the standard types of shares, including A-shares. It is particularly of interest to look into the true identity of the first largest shareholder or the real controlling shareholder behind the veil of types of shares, especially A-shares (see the following). Table 4.5.2 takes this into account by calculating the number and the percentage of the first largest shareholders distributed under the types of shares including A-shares in the period. The number and percentage of the state as the first largest shareholder has been reduced significantly from 881 and 68.51% in 2003 to 374 and 15.94% in 2011, respectively. Although the number of domestic legal persons as the first largest shareholder has slightly increased from 372 in 2003 to 414 in 2011 the percentage has greatly decreased from 28.93% in 2003 to 17.65% in 2011. In contrast, the number and percentage of foreign and individual as the first largest shareholders have

increased in the period. Remarkably, the number and percentage of the first largest shareholder behind A-share has soared from 5 and 0.04% in 2003 to 1,027 and 43.78% in 2011, which make the shareholder identification become much more complicated, especially the identity of the state as the first largest shareholder or the controlling shareholder.

These statistics suggest that the extent that the state was the first largest shareholder did decrease and the domestic legal person, foreign and individual as the first largest shareholder did increase over time. But this is only one side of the story because A-shares also increased considerably and it does include the first largest shareholders under all standard types of shares, which is the other side of the story. In view of this, there is a need for a further investigation.

Table 4.5.3 describes how the controlling shareholder by identity under the standard types of shares, adding that of A-shares, has distributed in Chinese listed companies from 2003 to 2011. It is now open-and-shut to see the identities of the first largest shareholder under the standard types of shares and even those behind the veil of A-shares. Clearly, the state as the first largest shareholder or the controlling shareholder exists in all types of shares and A-share except for individual share. The maximum number and percentage of the state as the controlling shareholder under the type of domestic legal person share were 110 and 7.91% in 2005, which were accountable for 22.87% in number and 22.86% in percentage of the total of domestic legal person as the controlling shareholder that year. The minimum number and percentage were 22 and 0.94% in 2011, 4.65% both in number and in percentage of the total of domestic legal person as the controlling shareholder the same year. As for the state as the controlling shareholder under the type of foreign share, the maximum number and percentage were 7 and 0.50% in 2004, accounting for 36.84% in number and 37.04% in percentage of the total of foreign as the controlling shareholder that year. The minimum number and percentage were 1 and 0.04% in 2011, 2.08% in number and 1.95% in percentage of the total of foreign as the controlling shareholder the same year.

Table 4.5.1 Shareholding of Top Ten Shareholders by identity in Chinese Listed Companies (2003-2011)

	Percentage (%) in Average									
	First	Second	Third	Fourth	Fifth	Sixth	Seventh	Eighth	Ninth	Tenth
2003										
State	47.20	12.99	5.95	3.33	2.15	1.22	1.07	0.96	0.88	0.82
DLP	33.37	9.47	4.63	2.54	1.64	1.27	1.00	0.75	0.64	0.54
Foreign	33.36	18.61	8.57	5.48	3.43	3.05	0.95	1.30	1.04	0.56
Individual	23.61	11.84	11.84	4.32	2.83	1.98	1.81	1.37	1.31	0.85
2004										
State	46.94	12.78	5.68	3.66	2.05	1.45	1.14	0.85	0.91	0.74
DLP	33.90	10.20	4.84	2.75	1.74	1.23	1.00	0.79	0.63	0.54
Foreign	35.27	18.53	9.58	4.08	4.57	1.80	0.93	0.77	0.87	0.78
Individual	26.23	12.82	6.92	4.55	2.88	2.52	1.66	1.48	1.32	1.17
2005										
State	45.31	12.94	5.67	3.26	2.17	1.31	1.13	0.91	0.79	0.79
DLP	24.72	1.90	1.20	0.97	0.73	0.61	0.48	0.41	0.34	0.31
Foreign	34.42	18.60	9.31	4.10	3.73	2.02	1.80	1.85	0.35	1.02
Individual	23.60	10.67	6.56	3.92	2.67	2.10	1.54	1.38	1.34	1.11
2006										
State	40.17	11.84	5.50	3.36	2.22	1.38	1.09	0.97	0.76	0.70
DLP	32.00	9.60	4.63	2.65	1.90	1.43	1.14	0.92	0.79	0.68
Foreign	33.14	17.64	7.63	3.95	3.56	2.60	1.44	1.38	1.56	1.39
Individual	24.96	11.73	6.88	4.46	2.73	2.23	1.73	1.28	1.04	0.98
2007										
State	39.64	12.70	6.56	4.00	2.71	1.71	1.60	1.61	1.15	1.15
DLP	32.13	10.59	5.44	3.20	2.32	1.83	1.43	1.20	1.07	0.88
Foreign	35.53	17.73	9.53	5.16	4.21	3.41	1.81	1.51	0.63	0.41
Individual	29.66	12.08	7.03	4.00	2.99	2.11	1.78	1.32	1.25	1.06
2008										
State	39.61	12.81	7.34	4.14	2.79	1.79	1.68	1.23	1.34	1.21
DLP	32.74	11.63	5.97	3.69	2.40	1.91	1.47	1.26	0.98	0.85
Foreign	35.93	18.49	7.67	5.44	4.12	3.50	0.74	1.79	1.10	0.78
Individual	31.29	12.09	6.95	4.31	2.80	1.99	1.88	1.33	1.15	0.96
2009										
State	41.21	12.72	5.96	3.74	2.98	2.68	1.15	1.64	1.72	1.59
DLP	35.80	11.26	5.89	4.04	2.52	2.14	1.79	1.54	1.09	0.91
Foreign	43.71	19.55	8.07	5.89	4.85	2.73	1.76	0.96	0.33	1.00
Individual	31.90	13.06	7.16	4.38	3.08	2.42	1.97	1.62	1.36	1.02
2010										
State	41.76	11.94	5.93	3.72	2.81	2.50	1.94	1.64	1.43	1.32
DLP	39.00	11.61	6.05	4.10	3.09	2.42	1.95	1.68	1.28	1.14
Foreign	46.16	20.28	9.00	7.42	4.22	4.06	2.13	1.42	1.38	1.14
Individual	33.00	12.35	6.52	4.35	3.13	2.49	2.11	1.66	1.50	1.31
2011										
State	42.20	12.25	5.36	3.85	2.84	2.09	1.87	1.53	1.43	1.17
DLP	40.00	11.16	6.16	4.10	2.98	2.38	1.91	1.51	1.29	1.18
Foreign	46.63	19.57	10.24	6.89	4.67	2.35	2.32	2.05	2.43	1.68
Individual	31.92	12.65	6.93	4.44	3.20	2.47	1.99	1.64	1.38	1.17

Source: calculated from CSMAR database.

Note: "State" means that the shareholder is the state including state owned legal person. "DLP" means that the shareholder is domestic legal person. "Foreign" means that the shareholder includes both foreign legal person and foreign natural person. "Individual" means that the shareholder is domestic natural person.

**Table 4.5.2 Distribution of the First Largest Shareholder by Identity in Chinese Listed Companies (2003-2011)**

	Total		State		DLP		Foreign		Individual		A Share	
	N	%	N	%	N	%	N	%	N	%	N	%
2003	1286	99.65	881	68.51	372	28.93	16	1.24	12	0.93	5	0.04
2004	1372	99.58	870	63.41	448	32.65	18	1.31	30	2.17	6	0.04
2005	1385	98.05	842	60.79	461	33.29	19	1.37	31	2.24	5	0.36
2006	1442	99.56	864	59.92	499	34.60	25	1.73	47	3.26	7	0.05
2007	1554	99.60	890	57.27	533	34.30	35	2.25	89	5.73	7	0.05
2008	1612	100	875	54.28	515	31.95	36	2.23	101	6.27	85	5.27
2009	1758	100	546	31.06	383	21.79	38	2.16	168	9.56	623	35.44
2010	2115	100	456	21.56	401	18.96	46	2.17	346	16.36	866	40.95
2011	2346	100	374	15.94	414	17.65	47	2.00	484	20.63	1027	43.78

Source: calculated from CSMAR database.

Note: "State" means that the first largest shareholder is both the state and state owned legal person. "DLP" means that the first largest shareholder is domestic legal person. "Foreign" means that the first largest shareholder includes both foreign legal person and foreign natural person. "Individual" means that the first largest shareholder is domestic natural person. "A Share" includes the first largest shareholder who has not been clearly identified as any one category of State, DLP, Foreign and Individual. "Total" means the sum of State, DLP, Foreign, Individual and A Share. "N" represents the number of the first largest shareholders and "%" represents the percentage of the first largest shareholders.



Noticeably, the state is the controlling shareholder under the veil of A-shares. The maximum number and percentage were 571 and 24.39% in 2011, accountable for 58.15% both in number and in percentage of the total of the controlling shareholder under the veil of A-shares that year. The minimum number and percentage were 3 and 0.22% in 2005, accountable for 50% in number and 51.16% in percentage of the total of the controlling shareholder under the veil of A-shares the same year. The difference both in number and in percentage between the minimum and the maximum is remarkable, which are 190 times and 111 times, respectively. It suggests that a huge number of cases of the state as the controlling shareholder have hidden their real identities under the veil of A-shares.

There is also evidence that the total number of listed companies with the state as the controlling shareholders was still 979, 41.82% of a total of 2,341 controlling shareholder under all types of shares including A-shares in Chinese listed companies in 2011. This means that the state still controlled more than two fifths of all listed companies in China by the end of 2011. Compared with the state, the number and percentage of domestic legal persons, foreign and individual as the controlling shareholders have also increased over time but they are less by comparison. By the end of 2011, the numbers and percentages of them were 485 and 20.72%, 87 and 3.72% and 744 and 31.78%, respectively, which are much less than that of the state as the controlling shareholder and thus have little influence on the dominance of the state control over Chinese listed companies on the whole.

In China, the controlling shareholder exercises its control mainly in two patterns, i.e., absolute control and relative control. According as the criteria discussed in Section 4.3, “absolute control” is defined as the controlling shareholder who owns more than or equal to 50% of the total shares of a listed company and “relative control” is defined as the controlling shareholder who owns less than 50% of the total shares of a listed company.

**Table 4.5.3 Distribution of the Controlling Shareholder by identity in Chinese Listed Companies (2003-2011)**

		Percentage (%) in average								
		2003	2004	2005	2006	2007	2008	2009	2010	2011
State:	N	884	882	849	868	903	886	562	476	385
	%	67.53	62.73	61.08	58.77	56.70	56.72	31.59	22.53	16.45
DLP:	N	391	464	481	526	554	523	407	448	473
	%	29.87	33.00	34.60	35.61	34.91	33.48	22.88	21.20	20.21
Include:										
State:	N	90	106	110	81	74	55	43	26	22
	%	6.88	7.54	7.91	5.48	4.66	3.52	2.42	1.23	0.94
Foreign:	N	15	19	19	28	36	37	39	41	48
	%	1.15	1.35	1.37	1.90	2.27	2.37	2.19	1.94	2.05
Include:										
State:	N	1	7	6	7	7	5	1	2	1
	%	0.07	0.50	0.43	0.47	0.44	0.32	0.06	0.09	0.04
DP:	N	15	36	5	46	87	29	164	310	453
	%	1.15	2.56	2.52	3.11	5.48	1.86	9.22	14.67	19.35
A Share:										
N		4	5	6	9	7	87	607	838	982
	%	0.31	0.36	0.43	0.61	0.44	5.57	34.12	39.66	41.95
Include:										
State:	N	3	4	3	6	4	45	402	552	571
	%	0.23	0.28	0.22	0.41	0.25	2.88	22.60	26.12	24.39
DLP:	N	0	0	0	0	0	4	18	27	34
	%	0	0	0	0	0	0.26	1.01	1.28	1.45
Foreign:	N	0	0	1	1	1	1	17	34	40
	%	0	0	0.07	0.07	0.06	0.06	0.96	1.61	1.71
DP:	N	1	1	2	2	2	37	170	243	291
	%	0.08	0.07	0.14	0.14	0.13	2.37	9.56	11.50	12.43
Sub Total										
State:	N	978	999	968	962	988	991	1008	1056	979
	%	74.71	71.05	69.64	65.13	62.26	63.44	56.66	49.97	41.82
DLP:	N	301	358	371	445	480	472	382	449	485
	%	22.99	25.46	26.69	30.13	30.25	30.22	21.47	21.24	20.72
Foreign:	N	14	12	14	22	30	33	55	73	87
	%	1.07	0.85	1.01	1.49	1.89	2.11	3.09	3.45	3.72
DP:	N	16	37	7	48	89	66	334	553	744
	%	1.22	2.63	0.50	3.25	5.61	4.23	18.77	26.17	31.78
Total										
N		1309	1406	1390	1477	1587	1562	1779	2113	2341
	%	100	100	100	100	99.80	100	100	100	100

Source: calculated from CSMAR database.

Note: "State" means that the controlling shareholder includes both the state and the state-owned legal person. "DLP" means that the controlling shareholder is the domestic legal person. "Foreign" means that the controlling shareholder includes both foreign legal person and foreign natural person. "DP" means that the controlling shareholder is domestic natural person (individual). "N" represents the number of controlling shareholders. "%" represents the percentage of the number of controlling shareholders.

Table 4.5.4 reports the distribution of control pattern by the real controlling shareholder in Chinese listed companies from 2003 to 2011 after the veil of types of shares has been lifted. As the real controlling shareholder, the state has shifted its control position from absolute dominance to relative dominance in this period. In 2003, the number and percentage of Chinese listed companies under the absolute control by the state as the real controlling

shareholder were 438 and 33.74% in 2003 but they were 291 and 12.30% in 2011. The differences are 147 and 21.44%, respectively. The number of Chinese listed companies under the relative control by the state as the real controlling shareholder increased from 541 in 2003 to 746 in 2011 but the percentage decreased from 46.46% in 2006 to 31.54% in 2011. The ratio of absolute control to relative control by the state is 0.39, which means that third fifth of corporate control exercised by the state is in the pattern of relative control. In terms of control pattern exercised by domestic legal person, foreign and individual, the number and percentage of companies under either absolute control or relative control had all increased in the period, except for the percentage of companies under relative control by domestic legal person since 2009.

Table 4.5.4 Distribution of Control Pattern by Real Controlling Shareholder in Chinese Listed Companies (2003-2011)<sup>288</sup>

		2003	2004	2005	2006	2007	2008	2009	2010	2011
Percentage in average										
State										
AC:	N	438	432	393	273	269	275	288	293	291
	%	33.74	30.64	28.18	18.43	17.01	16.82	16.22	13.72	12.30
RC:	N	541	566	573	688	715	712	707	742	746
	%	41.68	40.14	41.08	46.46	45.22	43.55	39.81	34.75	31.54
DLP										
AC:	N	45	56	54	48	60	65	65	94	103
	%	3.47	3.97	3.87	3.24	3.80	3.98	3.66	4.40	4.36
RC:	N	255	305	318	395	417	401	301	306	317
	%	19.65	21.63	22.80	26.67	26.38	24.53	16.95	14.33	13.40
Foreign										
AC:	N	0	0	1	1	4	6	16	26	31
	%	0.00	0.00	0.07	0.07	0.25	0.37	0.90	1.22	1.31
RC:	N	3	14	16	25	29	30	39	51	72
	%	0.23	0.99	1.15	1.69	1.83	1.83	2.20	2.39	3.04
Individual										
AC:	N	0	0	0	1	10	20	48	108	146
	%	0.00	0.00	0.00	0.07	0.63	1.22	2.70	5.06	6.17
RC:	N	16	37	40	50	77	126	312	515	660
	%	1.23	2.62	2.87	3.38	4.87	7.71	17.57	24.12	27.91
Total:										
	N	1298	1410	1395	1481	1581	1635	1776	2135	2365
	%	100	99.99	100	100	99.99	100	100	99.99	100

Source: calculated from CSMAR database.

Note: State, DLP, foreign and individual (DP) are defined as same as that in Table 4.5.3. "AC" means "Absolute Control" and "RC" means "Relative Control". "N" and "%" are also defined as same as that in Table 4.5.3.

<sup>288</sup> This is an abridged table and the summary of the redistribution of the real controlling shareholder under the standard types of shares, just for the purpose of the current analysis. The full table that contains the details of calculations on the real controlling shareholder distributed in all types of shares and A-shares has not been reported here.

Shareholder identification is very complicated in China. In contrast, it is relatively simple in the United States and New Zealand. Institutions and individuals are usually the two kinds of identities of shareholders in both countries, though there are also a small number of government shareholders (on behalf of the state) and family shareholders (on behalf of the family members) in New Zealand. The largest shareholders in the United States are institutional investors who are not the controlling shareholders but the fiduciary shareholders on behalf of individual investors and the state usually holds no shares in public listed companies (see Table 4.3.2(b)). Noticeably, the 2008-2009 government bailouts under the Capital Purchase Program (CPP) of the Troubled Asset Relief Program (TARP) made it become a “reluctant shareholder”<sup>289</sup> of some publicly traded companies. The government ownership in private corporations is historically rare<sup>290</sup> and only occurs in exigent circumstances such as the government’s role under the Emergency Economic Stabilization Act of 2008 (EESA) as the lender of last resort in this financial crisis. Institutional investors as the largest shareholders play no part in corporate control, which falls on corporate management. In New Zealand, the state as the largest shareholder or the controlling shareholder controls a small numbers of listed companies. For example, 73.09% of shares of Air New Zealand Ltd were held by the Minister of Finance on behalf of the state in October 2012.<sup>291</sup> Corporate control is in the type of minority control (see Table 4.2.3), which suggests that largest shareholders may play a positive role in corporate management.

#### **4.6 Problems Associated with Ownership Structure**

Ownership and control come into existence together and corporate ownership structure is inevitably linked to corporate control pattern. The extent to which shares are held by shareholders determines the choice of the ownership structure and thus distributes the power of corporate control in a firm. Generally speaking, dispersed ownership structure is linked to the pattern of management control while concentrated ownership structure is

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<sup>289</sup> Barbara Black “The U.S. as “Reluctant Shareholder”: Government, Business and the law” (2010) 5 *Entrepreneurial Bus. L.J.* 561 at 565.

<sup>290</sup> J.W. Verret “Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice” (2010) 27 *Yale Journal on Regulation* 283 at 293.

<sup>291</sup> Company Office <http://www.business.govt.nz/companies/app/ui/pages/companies/104799/shareholdings>

connected with the pattern of majority control, which is evident in the preceding discussion and analysis in this Chapter.

From the preceding discussion and analysis based on the relevant statistics, it is apparent that dispersed ownership structure is distinguished from concentrated ownership structure as regards shareholder identification and corporate control pattern, which indicates that the problem in association with ownership structure is also differentiated between both.

In the United States, the ownership structure is dispersed and the problem associated with it is the classical Berle and Means problem, i.e., the conflict of interests between management and shareholders and therefore the efficacy of shareholder activism on the hegemony of managerialism accompanied with this classical problem. With the remarkable growth of institutional investors as seen in Section 4.2 who have replaced individual investors as the largest shareholders in public listed companies in the US, the identities of shareholders have also changed significantly. Although this change has not changed the pattern of corporate control in corporate governance, it has significantly changed the ownership structure of public listed companies in the US. It suggests that the classical Berle and Means problem seems to have become the conflict of interests between management and institutional investors, whose institutional activism instead of shareholder activism should potentially play a positive role on checking the hegemony of management in corporate governance. Interestingly, the efficacy of this institutional activism, particularly its efficacy on the function of the board of directors, has remained to be seen in view of the recent credit crunch in corporate America.

In New Zealand, the ownership structure is not as classically dispersed as that of the US but relatively concentrated. The state also has a hand in corporate ownership and make it somewhat complicated concerning the ownership structure of listed companies. The management has been usually controlled by either majority or dominant shareholders.<sup>292</sup> Correspondingly, the problem associated with the ownership structure is the conflict of

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<sup>292</sup> Giles & Watson, above n 253 at 10. The dominant shareholder refers to an individual shareholder or a group of shareholders such as family shareholder who holds a shareholding percentage sufficient to dominate the management through their interests that are represented on board of directors. A total of 76% of NZSX50 listed companies have owners who are represented in corporate management.

interests between majority or dominant shareholders and minority shareholders. Shareholder activism in terms of minority shareholder activism plays little role in corporate governance.

In contrast, the ownership structure in corporate China is highly concentrated, although the degree of ownership concentration has relatively decreased overtime, especially the reduction of the state-owned share in the share structure split reform in 2005. The reform has not changed the nature of the ownership structure of Chinese listed companies but has just changed it from highly concentrated to relatively concentrated. The state has still had a big hand in corporate ownership and thus corporate control in China. As shown from the statistics in Section 4.5, state shares have not completely stepped out of corporate ownership structure of Chinese listed companies but has just relatively reduced its holdings and has then hidden its real identity behind other types of shares and mainly A-shares. It makes the shareholder identification of Chinese listed companies much more complicated than before. This speaks volumes for the fact that the state has no intention of quitting both corporate ownership and stock markets. The corollary is that corporate ownership becomes dispersed and that stock markets mature in China are still to be seen.

The rationale behind the continuity of the holding of shares by the state is based on the policy of the state capitalism, which has been undoubtedly espoused by the recent legislation, Law of the State-Owned Assets of Enterprises 2008. This law makes clear from the very beginning that its purpose is to give play to the leading role of state-owned economy in the national economy and promote the development of the socialist market economy,<sup>293</sup> a disguised name of the state capitalism. The safeguard of the leading role of the state-owned economy is that the state invests as shareholders of enterprises or companies, especially those biggest ones.<sup>294</sup> The form of the investment by the state is in the form of shares held by the state that include the state-owned-only share, the state-owned share by control and the state-owned share by participation.<sup>295</sup> Thus, the leading role of the state-owned economy must be guaranteed even the state as the investor is only in the form of the state-owned share by participation, which can be seen from Table 4.5.1 that the

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<sup>293</sup> NCPR, above n 274 Art 1.

<sup>294</sup> Art 4

<sup>295</sup> Art 5.

distribution of the state-owned share has gone through all top ten shareholders, no matter how small the shareholding percentage held by the state has been.

The reduction of state shares and the reform of the ownership structure and corporate control of listed companies have been subject to the policy of the state capitalism which leads the direction of the mainstream of the national economy. It implies that the state-owned share by participation would have potentially become the state-owned share by control. In other words, the participating interest may have become the controlling interest, which can be done by way of either appointing or proposing to appoint the members of the board of directors and the supervisory board.<sup>296</sup> Therefore, it seems unrealistic that state shares would have been reduced to zero and the ownership structure of corporate China would have become dispersed or converged to dispersion. It also looks impractical that the state would have held no controlling interests in Chinese listed companies and that the stock market in China would have become a completely freely liquidated stock market like that in the United States.

The problem associated with the current ownership structure of Chinese listed companies is still a cliché as mentioned in Section 2.5, i.e., the “only big shareholder” problem which is in the form of new wine in old bottles. That is: the state as the largest shareholder or the real controlling shareholder has shifted its identity from its own to that of A-shares. The “only big shareholder” problem has not been resolved and the traditional conflicts of interests between the majority shareholders and the minority shareholders have still remained there. Just as suggested in the path dependency theory discussed in Section 2.3.1.5, traditional state ownership under its legal system ensures the continued dominance of the state in the national economy and the path dependency of corporate ownership structure but displays the beneficial interests of the state in Chinese listed companies. Today’s reduction of state-owned shares in the reform of share structure split upheld by Chinese government has done the same thing as yesterday’s “government supervision and merchant management” (*guandu shangban*) sponsored by the late Qing Dynasty, i.e., to liquidate the bureaucracy of the SOEs (see Section 1.2.3). The reduction of the state-owned

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<sup>296</sup> Art 22(3).

share has indeed greatly reduced the degree of the “Only Big Shareholder” problem but it has not essentially changed the nature of the problem.

Therefore, the conflict of interests between majority shareholders and minority shareholders that have derived from the “Only Big Shareholder” problem has still puzzled Chinese listed companies and has been sustainably dominant in corporate governance in China. Provided the current corporate ownership structure and the corporate control pattern have significantly threatened the state’s beneficial interests in listed companies, there is no reason to expect that this problem would have been fundamentally resolved. In other words, only the state shares and the majority shareholder control have fundamentally impeded the development of the national economy can the current corporate ownership structure and the corporate control pattern be significantly changed in Chinese listed companies. Therefore, the most important thing under the current framework of the corporate governance system in China is to effectively strengthen the legal protection of the interests of minority shareholders, legally curb the abuse of majority shareholders’ discretion at the expense of minority shareholders and truly give play to the positive role of shareholder activism in corporate governance.

#### **4.7 Conclusion**

This Chapter has examined ownership structure in terms of ownership and control, share classification, ownership concentration and shareholder identification. The result of this examination shows that there are different characteristics of ownership structure and corporate control between the US, New Zealand and China. In the United States, corporate ownership has indeed concentrated on institutional investors but this ownership concentration has not essentially changed the nature of dispersed ownership structure of corporate America and thus has not changed the pattern of corporate control, i.e., management control. The government corporate ownership policy is only to respond to financial crisis and seeks to exit swiftly with no purpose of long-term holding. Because institutional investors on behalf of individual investors have had no interest in corporate control as that of majority shareholders as in the conventional concentrated ownership structure in China and the classical Berle and Means situation the problem of the conflict of interests between management and shareholders has remained unchanged. In New



Zealand, the ownership structure is relatively concentrated and corporate control is mainly minority control. Both are fundamentally different from that in China. The state has not been the main source of corporate ownership in New Zealand and minority control in listed companies has been usually in the form of family shareholders.

Based on the relevant statistics from the CSMAR database, the ownership structure of Chinese listed companies has changed from the highly concentrated ownership to the relatively concentrated ownership. Correspondingly, the share structure spilt reform has changed the pattern of corporate control from purely absolute control to mainly relative control in combination with absolute control. In essence, it has not changed the nature of corporate control, i.e., majority control in the form of control by the largest shareholder or the real controlling shareholder. Consequently, the problem of the separation of ownership and control has still been the traditional conflict of interests between the majority shareholder and the minority shareholder. Although the reduction of state shares has significantly changed the ownership structure of Chinese listed companies and has made it become more dispersed but state shares have still been held constantly at the relatively dominant level. This means that the dynamics of stock markets such as the market for corporate control, an external control mechanism to compensate for the dysfunction of the internal control mechanism such as the board of directors, have little possibility to be brought into play. This is because the minority shareholders have had little chance and ability in competition with the majority shareholders, either to express a voice in corporate decision-making or to replace the management through M&A, a market discipline on failed managers. Therefore, the market for corporate control still remains dormant and the correction of the dysfunction of the board of directors has not been available in China.

## CHAPTER 5

### THE BOARD OF DIRECTORS

#### 5.1 Introduction

The ownership structure theory explains the shareholding types of share owners, which are classified as either dispersed or concentrated. Correspondingly, the board structure theory explains the composition of the board of directors, which is based on the distribution of voting powers among various groups of shareholders regarding their bargaining positions via shareholdings on board composition (see Section 2.3.1.1). Board structure is the basis on which the model of corporate governance is connected with, either the one-tier model or the two-tier model. Conventionally, the board of directors is recognized as an effective corporate control mechanism in solving the agency problem because it has the power to resolve the conflict of interests between management and shareholders and therefore economizes the agency costs associated with the separation of ownership and control.

As required by law, the board of directors is legally the ultimate authority of corporate control and business management in a company. However, the function of the board of directors, especially its function as an internal corporate control device to monitor management, has been called into question for its paradoxical combination of “individual competence and collective impotence”<sup>297</sup> in practice. This classic board dilemma still exists and persists in corporate governance in view of many recent corporate catastrophes. Even so, “the system works, although there are still crucial ambiguities”<sup>298</sup> and the perplexity of this dilemma remains to be resolved. To make the board of directors function more effectively, it is important to properly identify the characteristics and roles of the board of directors. Consequently, board size, board composition, board leadership,

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<sup>297</sup> William A Dimma *Tougher Boards for Tougher Times: Corporate Governance in the Post-Enron Era* (John Wiley & Sons Canada, 2006) at 24.

<sup>298</sup> Farrar, above n 86 at 92.

independent director and board committees are recognized as the main characteristics of the board of directors and their roles are essential in effectuating the function of the board of directors. This chapter examines these issues in turn.

## **5.2 The Board of Directors as a Corporate Control Device**

Originated from the Court of Committees of the East India Company at the beginning of the seventeenth century, the board of directors has developed as a governing body charged with making policies and directing operations in modern corporations. The board of directors emerges endogenously in response to the agency problem inherent in governing a corporation. From its birth, the board has been designed to separate its directing role from managing role in modern corporations with the dispersed ownership structure. There is a difference between managing and directing a corporation. The former is a managerial role played by managers who run the day-to-day operation of a business and the latter is a directorial role played by professionals who supervise and direct the managing of a corporation. This is clearly evident in case law in the United States.<sup>299</sup> Thus, a widespread consensus nowadays is that in publicly traded corporations the management function is vested not in the board of directors but in executives.<sup>300</sup>

Based on a comparative advantage in terms of partly as a managing organ and partly as a monitoring organ, the board of directors is well suited to monitor management on an ongoing and close basis on behalf of shareholders.<sup>301</sup> In corporations with the concentrated ownership structure, the board of directors has played both managing and directing roles but has separated the supervising role from its directing role and shifted its supervising role to the supervisory board. In this scenario, the board of directors functions mainly as an executive board. Nonetheless, the directorial role is the main role of the board of directors in modern corporations with either the dispersed ownership structure or the concentrated

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<sup>299</sup> *Francis v. United Jersey Bank*, 87 N.J. 15,432 A.2d 814 (1981). New Jersey Supreme Court states that “Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies”.

<sup>300</sup> Melvin A. Eisenberg “The Board of Directors and Internal Control” (1997-1998) 19 *Cardozo L. Rev.* 237 at 237.

<sup>301</sup> At 238.

ownership structure. Thus, the board of directors has been regarded not only in practice but also in law as the central governance mechanism in good corporate governance that shareholders can primarily use to exercise corporate control over management in a market economy. Correspondingly, the efforts of improving the function of the board of directors so as to solve the classic board dilemma continue.

The board as the central corporate governance mechanism is based on the delegation of shareholders who delegate their decision-making power of controlling managerial decisions to the board as an internal control mechanism. There are two reasons, information asymmetry and managerial opportunism, why the board should be vested with this responsibility.<sup>302</sup> Asymmetric information misleads the board's evaluation and decision. "[I]f the executives control the information the board receives, the board's monitoring and decision-making functions often will be little more than nominal."<sup>303</sup> Managerial opportunism pursues managers' short-term benefits at the cost of shareholders' long-term interests. Managers may regard profitmaking as a gratification and disregard the uncertainty cost of the violation of corporate policies and legal rules.<sup>304</sup> Thus, both information asymmetry and managerial opportunism need to be restrained by an internal control mechanism. To vest the responsibility of internal control in management would defeat the very purpose of an internal control mechanism to monitor managers. Unless there are other alternatives available, such as the majority shareholder or the supervisory board in the concentrated ownership structure, the board of directors is the only choice to perform the role of internal control. When the board fails to function effectively, the market for corporate control can step in as an external control mechanism to replace the dysfunctional board in a mature stock market. Otherwise, the managerial hegemony dominates and the board is but a ceremonial "rubber-stamp". This is true of any kind of stock markets, either developed or developing or undeveloped.

### **5.3 Characteristics of the Board of Directors**

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<sup>302</sup> At 244, 247.

<sup>303</sup> At 246.

<sup>304</sup> At 247.

Many factors may have an impact on the function of the board of directors. Political influence, legal and regulatory tradition, culture heritage, financial market turmoil, to mention just a few, are all external factors that may affect the efficacy of the function of the board. It would not be appropriate here to examine them in detail for the purpose of this research. However, some internal factors regarding the characteristics of the board can be identified so as to examine the efficacy of the board's function. The role of the board of directors, the role of independent directors, the role of chairperson and CEO, and the role of board committees are generally considered as the main characteristics of the board. To understand how the board of directors functions properly, it is important to recognize these distinguished characteristics of the board in corporate governance.

### 5.3.1 Role of the Board of Directors

Conventionally, the board of directors, as “a kind of legislatively ordained aristocracy or group of Platonic guardians”,<sup>305</sup> has been assigned in common law the role of agents on behalf of diffused stockholders with the main responsibility of monitoring management's performance in a public corporation. It suggests that although stockholders abdicate their responsibilities of day-to-day business operation on account of separation of ownership and control, they still retain some stake and undoubtedly a vested interest in the affairs of corporations, which subjects directors and managers to a corporate system of check and balance. Publicly traded corporations provide such a framework in terms of corporate governance whereby the monitoring among stockholders, the board of directors and management serves this purpose. As delegated monitors on behalf of stockholders, the board of directors performs its monitoring role more than just in the sense of checking and verifying the accuracy of financial information and the adequacy of internal control but in the reasonable assurance of taking the situation under control.<sup>306</sup> Without such an assurance in monitoring, management may pursue their opportunistic behaviors and the board of

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<sup>305</sup> Robert A. Kessler “The Statutory Requirement of A Board of Directors: A Corporate Anachronism” (1960) 27 (4) *University of Chicago Law Review* 696 at 696-697.

<sup>306</sup> L. A. A. Van den Berghe & Tom Baelden “The Monitoring Role of the Board: one approach does not fit all” (2005) 13 (5) *Corporate Governance* 680 at 681.

directors may be derelict in their dedicated undertakings; both may have attendant impact on stockholders. Furthermore, the board can maximize stockholder wealth and minimize agency cost.<sup>307</sup> Compared with the market for corporate control, it is not so “crude” and “costly” in reducing agency costs,<sup>308</sup> between these two alternative corporate control mechanisms, for the board of directors to undertake the monitoring role on management.

In the United States, there has been a modern trend of increasingly recognizing the monitoring role of the board of directors for decades and this has been reflected by the development of the Revised Model Business Corporation Act (RMBCA) and the American Law Institute’s Principles of Corporate Governance (ALI’s Principles).<sup>309</sup> Corporate laws traditionally provide that the board of directors shall manage the business and affairs of corporations.<sup>310</sup> But this does not accord with reality because the business and affairs of corporations are in fact managed by corporate officers, especially in large corporations<sup>311</sup> and “the responsibility of the board is limited to overseeing such operation”.<sup>312</sup> Based on the then effective California statute,<sup>313</sup> the RMBCA takes this reality into account and provides that<sup>314</sup>

All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation ...

This revision recognizes that the board’s proper role is supervision, review and policy making, by changing the traditional commend of “Thou Shalt Manage” and emphasizing

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<sup>307</sup> Morten Huse & Violina P. Rindona “Stakeholders’ Expectations of Board Role: The Case of Subsidiary Boards” (2001) 5 *Journal of Management and Governance* 153 at 157.

<sup>308</sup> Benjamin M. Oviatt “Agency and transaction Cost Perspectives on the Manager-Shareholder Relationship: Incentives for Congruent Interests” (1988) 13 (2) *The Academy of Management Review* 214 at 221.

<sup>309</sup> Farrar, above n 86 at 94.

<sup>310</sup> E.g., N.Y. Bus. Corp. Law § 717 (1963); Ga. Code Ann. § 22-701 (1968); N.C. Gen. Stat. § 55-24 (1955).

<sup>311</sup> Douglas M. Branson *Corporate Governance* (Law Publishers, Charlottesville, 1993) at 229.

<sup>312</sup> American Bar Association “Corporate Directors Guidebook” (1978) 33 *Bus. Law*. 1591 at 1603.

<sup>313</sup> Cal. Corp. Code § 300 (a): “the business and affairs of the corporation shall be managed by and all corporate powers shall be managed under the direction of the board.”

<sup>314</sup> MBCA § 8.01(b) at 490. This section is a further revision on MBCA § 35 (1975) by changing “a board of directors” to “its board of directors” and “except as may be otherwise provided” to “any limitation set forth”, and thus carries over the slightly more restrictive language.

the monitoring role of the board.<sup>315</sup> Similarly, the ALI's Principles specify that<sup>316</sup>

The management of the business of a publicly held corporation [§ 1.31] should be conducted by or under the supervision of such principal senior executives [§ 1.30] as designated by the board of directors ...

Thus, a basic function of the board of directors is to “oversee” the performance of these principal senior executives in terms of “general observation and oversight, not active supervision or day-to-day scrutiny.”<sup>317</sup> Monitoring has now become the board's principal role and this monitoring model<sup>318</sup> is, as it has evolved, increasingly the paradigm for larger corporations.<sup>319</sup> Delaware statutes further strengthen this monitoring model.<sup>320</sup>

In New Zealand, the board of directors' role in effective corporate governance has only come into discussion in the recent law reform. This is because the institutional and market environment in New Zealand, i.e., high equity ownership concentration, is quite different from that in the United States. The Companies Act 1993 makes the board of directors collectively responsible for the direction and supervision of companies. It assigns to the board the central power of direction of the business and affairs of the company,<sup>321</sup> although it has not always fully recognized the central role of the board because the separation of ownership and control is not adhered to in practice.<sup>322</sup> However, the Act intends to enhance the monitoring role of the board by raising expectations of directors' duty of care beyond the common law level of gross negligence and increasing the potential risk of liabilities on the board for directors' breaches of their duties. This has significant implication for the

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<sup>315</sup> Branson, above n 311 at 229, 230.

<sup>316</sup> ALI Corp. Gov. Proj. § 3.01.

<sup>317</sup> § 3.02, comment d, at 89.

<sup>318</sup> Eisenberg, above n 167 at 170. The idea of the monitoring board was clearly formulated and put forth as the appropriate description of the board's function by Melvin A. Eisenberg in 1976, who probably provides the first coherent statement of the monitoring model. See also: Harvey J. Goldschmid “The Greening of the Board Room: Reflections on Corporate Responsibility” (1973)10 *Colum. J. L. & Soc. Probs.* 15 at 24-25.

<sup>319</sup> Branson, above n 311 at 230, 231.

<sup>320</sup> Del. Gen. Corp. Law § 141(a): “The business and affairs of every corporation ... shall be managed by or under the direction of a board of directors ... ”

<sup>321</sup> The companies Act 1993, s 128(1): “The business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company”.

<sup>322</sup> Susan Watson “Allocation of Power Within The Company” in Farrar (ed.), above n 55 at 225, 226.

board's oversight on management because directors will be penalized for their failure of exercising appropriate oversight and monitoring of managerial malfeasance and poor financial decisions. Thus, the reform places greater accountability on the board and elevates its role as a monitoring agent.<sup>323</sup>

In contrast, the board of directors<sup>324</sup> of Chinese listed companies by nature functions as a management board following Germany's two-tier board model, although it now has independent directors exported from the United States. Accordingly, the board in reality performs the advisory role to rather than the monitoring role over management (see Section 5.4). Arguably, the importation of independent directors to the management board of Chinese listed companies does not aim to enhance the board's monitoring role so as to protect minority's interests but in fact to meet the government requirements and satisfy the advisory need of top management. This is because CEOs of Chinese listed companies are typically political appointees with no expertise in management skills<sup>325</sup> and they have a great need for advice and expertise. Some empirical research provides evidence in support of this proposition.<sup>326</sup> Furthermore, the members of the board are majority shareholders or their representatives, who have completely controlling interests in maximally snatching the private benefit of control at the expense of minority interests. They have no interests in monitoring their own behavior of channeling and skirting. The Company Law 2005 states clearly that a joint stock limited company shall have a board of directors,<sup>327</sup> which has not been charged with the monitoring role but with the managing role.<sup>328</sup> The monitoring role

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<sup>323</sup> Andrew K. Prevost, Ramesh P. Rao and Mahmud Hossain "Board Composition in New Zealand: An Agency Perspective" (2002) 29 (5) & (6) *Journal of Business Finance & Accounting* 731 at 738.

<sup>324</sup> The term board of directors first received the statutory recognition in the Company Law of 1904 as the guiding corporate organ responsible for directing the business management of a company (art. 67) in the late Qing dynasty. This role of the board remained the same in the corporate legislations of post-Qing China until Communist takeover in 1949. It reappeared in legislation in The Law on Equity Joint Venture Enterprises of 1979, which provides that an equity joint venture should have a board of directors (art. 6). But this only applies to companies with foreign investment and foreign orientated companies.

<sup>325</sup> Xu, L.C., Zhu, T. and Lin, Y. M. "Politician control, agency problems and ownership reform: Evidence from China" (2005) 13 (1) *Economics of Transition* 1 at 11.

<sup>326</sup> Jing Liao, Martin R. Young and Qian Sun "The Advisory Role of the Board: Evidence from the Implementation of Independent Director System in China" (March 17, 2009) Massey U. College of Business Research Paper No. 1, available at: <http://ssrn.com/abstract=1361202>, 1-35.

<sup>327</sup> The Company Law 2005 (PRC), Art 109.

<sup>328</sup> Art 47.



is in legislation the responsibility of the supervisory board.<sup>329</sup> In legislation, the board of directors is the highest executive organ of the company “to implement the resolutions of the shareholders meetings”<sup>330</sup> and “the manager shall be responsible to the board of directors.”<sup>331</sup> In reality, the board discharges its responsibility only as an advisory body (or a think tank) to the manager general, the chief executive officer of the company.

### 5.3.2 The Role of Independent Directors

It goes without saying that the role of independent directors is dependent on the role of the board of directors. Legislative design on the independent director institution serves the legislative purpose of the board of directors system, which is also self-evident. Law cannot but be the development of economy and serves its demands. This is the order of nature and things go athwart their purposes if they are against this law of nature. The board of directors comes from the birth of joint-stock companies, a corollary of market demand for governing such corporations. It acclimatizes itself to the environment of modern corporations in the market economy. So do independent directors in the diffused corporate ownership structure and the supervisory board in the concentrated corporate ownership structure.

In corporate governance, a central issue is concerned about the actual and potential roles played by independent directors in controlling managerial behavior.<sup>332</sup> As the delegates of the board of directors on behalf of stockholders, independent directors are expected to be effective monitors watching-over managers’ misbehaviour undermining the maximization of shareholder wealth. As suggested by the effective monitor theory, independent directors may have incentives to become “noblesse oblige”, who are professional referees with good character respected as effective monitors, for their reputational capitals. This is because the effective monitor theory (see Section 2.3.1.4) suggests that independent directors may have incentives to develop their reputations as professional referees as effective monitors. Based

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<sup>329</sup> Art 54.

<sup>330</sup> Art 47(2).

<sup>331</sup> Art 50.

<sup>332</sup> Barry D. Baysinger and Henry N. Butler “Revolution versus Evolution in Corporation Law: The ALI's Project and the Independent Director” (1983-1984) 52 *Geo. Wash. L. Rev.* 557 at 562.

on this expectation, law places its reliance on independent directors who as the board's delegates should effectively play the monitoring role over management, a logical corollary to the monitoring board. To perform this role, independent directors as the indispensable component of the board of directors is typically a legal requirement of publicly held corporations with widely dispersed ownership.

The Investment Company Act of 1940 (1940 Act) relies on independent directors, by requiring that at least 40% of the board must be comprised of “disinterested persons” (i.e., independent directors) as checks against possible conflict of interests between shareholders and managers of investment companies in the United States.<sup>333</sup> Under the 1940 Act, independent directors as members of the board serve the central role of the board in monitoring management such as approving investment contracts and selecting persons to fill certain board vacancies.<sup>334</sup> This disinterested representation on behalf of shareholders in management constitutes an important investor protection and independent directors are thus characterized as “independent watchdogs”,<sup>335</sup> who do not “hesitate to bark or bite – even to the extent of voting to fire the CEO.”<sup>336</sup> As developed in law, “they are responsible not only for their individual decisions as to how they themselves shall play their roles as board members, but also for the board’s collective decisions as to the kind of control it will try to exert in the company.”<sup>337</sup> In performing the oversight role of corporate legal compliance, independent directors are not only obligated to act in good faith and best interest of corporate stockholders but also required to provide independent and impartial judgments to challenge or question managerial decisions.

To be capable of fulfilling these duties and responsibilities, the issue of “independence”, i.e., independent of management, is at the heart of independent directors’ monitoring role. To be independent, independent directors should satisfy the independence test provided by

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<sup>333</sup> Investment Company Act, above n 36, §§. 10, 2 (19).

<sup>334</sup> §§.15(c), 16(b).

<sup>335</sup> *Burks v. Lasker*, 441 U.S. 471 at 483 (1979). Congress places independent directors “in the role of ‘independent watchdogs’ ... to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.”

<sup>336</sup> Marvin Chandler “It’s time to clear up the boardroom” (1975) 53 (5) *Harvard Business Review* 73 at 73.

<sup>337</sup> Robert M. Estes “Outside directors: more vulnerable than ever” (1973) 51 (1) *Harvard Business Review* 107 at 108.

statutes and regulations (see Section 2.2.1). To ensure the effective implementation of independent directors' monitoring role, the ALI's Principles recommend that the majority of the board of directors should be composed of independent directors in the large publicly held corporation.<sup>338</sup> The Sarbanes-Oxley Act 2002 and Dodd-Frank Act 2010 make this recommendation mandatory on the corporate board of the publicly held corporation.<sup>339</sup> The objectives are not only to enhance the independence and effectiveness of the board and improve its ability to monitor but also to protect shareholder interest and oversee management effectively in a publicly traded corporation. The SEC provides the rationale behind this mandate that "independent watchdogs" would furnish an independent check upon the management and provide a means for the representation of shareholder interests in the company.<sup>340</sup>

The interest in the monitoring role of independent directors emerges relatively recently in New Zealand.<sup>341</sup> It is recognized that independent representation is an important contributor to board effectiveness, but this interest should only be considered in "a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively".<sup>342</sup> This suggests that director independence is not considered as the central element in effectuating the board's function. In view of this consideration, there is no legislation which clearly provides either the definition of independent directors or the role of independent directors. The board of a listed company has the responsibility to identify who should be independent directors and determine their independence.<sup>343</sup> When choosing independent directors, the board should have an appropriate balance of executive and non-executive directors.<sup>344</sup> The duties and responsibilities of executive directors and non-executive directors (including independent directors<sup>345</sup>) are the same in legislation. This indicates that directors, either executive or non-executive, have the same

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<sup>338</sup> ALI Corp. Gov. Proj. § 3A.01 (a).

<sup>339</sup> SOX and Dodd-Frank, above n 7.

<sup>340</sup> The SEC, above n 95.

<sup>341</sup> Prevost et al, above n 323 at 733.

<sup>342</sup> Securities Commission "Corporate Governance in New Zealand: Principles and Guidelines" (reprinted February 2011) [www.seccom.govt.nz](http://www.seccom.govt.nz) at 2, 11.

<sup>343</sup> NZSX/NZDX Listing Rules 2012, rule 3.3.2.

<sup>344</sup> Securities Commission, above n 342 at 9.

<sup>345</sup> In New Zealand, independent directors are not equivalent to non-executive directors but just part of them.

duty and responsibility to perform the same role. In a high equity concentration company, executive directors are either large shareholders or their representatives, who can consume agency costs themselves and are reluctant to share the benefits thereof with other directors. In addition, non-executive directors are often nominees of large shareholders.<sup>346</sup> These may leave uncertainty about independent directors performing their monitoring role in practice as expected by law and regulation.

The independent director system in China was not initiated by the market but designed by the government mainly to meet its requirements. Although the Company Law 2005 clearly provides that a listed company shall have independent directors, the stipulation of specific measures has been delegated to the state council.<sup>347</sup> In jurisprudence, delegated legislation is subordinated to primary legislation in force and effect.<sup>348</sup> It means that independent directors in the legislative design may only play a supplementary role to the function of the supervisory board which, clearly required by law, supervises the activities of directors and senior executives.<sup>349</sup> This implies that legislators have no intention in legislation to place the role of independent directors ahead of the role of the supervisory board. According to Guidance Opinion on the Establishment of an Independent Director System in Listed Companies, independent directors should mainly play the monitoring role over management, aiming to protect the interest of minority shareholders.<sup>350</sup> The uncertainty is how the law can expect independent directors to perform the monitoring role over management in an environment of the management board in nature where managerial hegemony is overriding. There is little empirical evidence to support this. In practice,

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<sup>346</sup> Susan Watson (ed.) *The Law of Business Organisations* (5<sup>th</sup> ed., Palatine Press, Auckland, 2009) at 223.

<sup>347</sup> Company Law, above n 327, Art 123.

<sup>348</sup> There are two levels of legislations in China, i.e., primary legislation and delegated legislation. The former are laws enacted and passed by the National Assembly of People's Representatives of China and its Standing Committee—the highest legislature. The latter are regulations (including decisions, guidelines and measures) and bylaws enacted and passed by the state council (including the departments and agencies of the central government) and local governments—the secondary legislature.

<sup>349</sup> Art 54(2).

<sup>350</sup> Guidance Opinion on the Establishment of an Independent Director System in Listed Companies 2001, arts. 5, 6. [http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305\\_77981.htm](http://www.csrc.gov.cn/pub/newsite/xxfw/fgwj/bmgz/200803/t20080305_77981.htm) Articles 5 and 6 provide that the powers and obligations of independent directors are mainly to: 1) ratify major related transactions; 2) request a convention of the board's meeting; 3) request the board to convene an interim shareholders' meeting; 4) propose to appoint or dismiss an accounting firm; 5) engage independent counsels; 6) solicit proxies and 7) deliver independent opinions.

independent directors rarely play a monitoring role but an advisory role at most. Based on an empirical study on 494 listed companies in the period of 1999-2004, Liao et al argue that advisory requirements will be the main incentive for firms to recruit independent directors.<sup>351</sup> This of cause conflicts with legislative expectation but accommodates to the reality of listed companies in China.

### 5.3.3 Roles of Chairperson and CEO

All things being equal, the role of independent directors is determined by and dependent on the roles of chairperson and chief executive officer (CEO) based on the board leadership structure of the company. Contemporary wisdom dictates two prevailing board leadership structures in modern corporations, i.e., chairperson independence and CEO duality.<sup>352</sup> The former separates the posts of chairperson and CEO both of whom play different roles. The latter integrates the posts of chairperson and CEO and the CEO plays the roles of both. The separation of the roles of chairperson and CEO follows agency theory which installs the chairperson as the independent guardian of shareholder interest, attempting to decouple the board's impotence from the CEO's hegemony. The integration of the roles of chairperson and CEO adheres to the steward theory which empowers the CEO as the ultimate decision-maker of the board, aiming to disengage the CEO's discretion from the board's monitoring and control.

Accordingly, two different forms of board governance perceptions derive from this dichotomy as to whether a company is best served by its board with either strong leadership or effective monitoring.<sup>353</sup> Under the chairperson independence structure, general consensus is that the primary role of chairperson is to run the board and that of the CEO to manage the company. That is, the chairperson plays the role of strategic decision control with the authority to ratify and monitor the decisions made by the CEO and the CEO plays

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<sup>351</sup> Liao et al, above n 326.

<sup>352</sup> Paul L. Rechner and Dan R. Dalton "CEO Duality and Organizational Perspective: A Longitudinal Analysis" (1991) 12 *Strategic Management Journal* 155 at 155.

<sup>353</sup> Catherine M. Daily and Dan R. Dalton "CEO and board chair roles held jointly or separately: Much ado about nothing? (1997) 11 (3) *The Academy of Management Executive* 11 at 12.

the role of operational decision management with the responsibility to manage the day-to-day business operation by setting and implementing the company's strategies. Under the CEO duality structure, the CEO plays not only the role of decision management but also that of decision control. It gives license to the CEO "to carve and shape the corporation into a structure uniquely fitted to his or her goals and personality"<sup>354</sup> and thus creates a structural impediment to board independence, particularly the role of independent directors. Given that the board's central role is to monitor the management, the CEO duality compromises the desired system of check and balance. Although the leadership structure is no panacea for the board to be effective, the chairperson independence structure may provide a dynamic boardroom culture for board members to challenge and counter the CEO's dominance.

In the unitary board model, CEO duality is really and truly a threat to the board in exercising its independent judgment in matters of monitoring the management. This is because the CEO's dual role of managing and monitoring simultaneously suggests a conflict of interests when management independently monitors and objectively evaluates its own performance. This is exactly the reality in the US management and leadership literature where the CEO duality is the common corporate practice. Research has indicated that 80% of 6,703 listed companies in NYSE had the CEO duality structure in 2005.<sup>355</sup> Strangely, in such a monitoring model board sits a "one-man" dominance of the CEO. This "one-man" dominance of the US corporations has been heralded to represent the American value of a powerful hero figure who exercises a personalized and idiosyncratic influence on the US corporate board, an epitome of the US political presidential analogy.

However, research shows that the CEO duality tops the list of reasons for corporate scandals owing to the failure of the board's monitoring function and calls to tackle this problem have been on the rise. Although CEO duality has been under attack for its accountability for financial debacles in the recent decade, it still survives. Interestingly,

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<sup>354</sup> Ralph D. Ward *21<sup>st</sup> Century Corporate Board* (John Wiley & Sons, New York, 1997) at 112.

<sup>355</sup> Nada K. Kakabadse and Andrew P. Kakabadse "Chairman of the board: demographics effects on role pursuit" (2007) 26 (2) *Journal of Management Development* 169 at 175.

corporate laws are silent on the matter of dealing with the CEO duality and even Sarbanes-Oxley Act 2002 and Dodd Frank Act 2010 have sidestepped this problem. For a compromise in practice, the NYSE listing guidelines require that a “lead director” or “presiding director” leads some meetings of independent directors, attempting to separate power over management from power in the boardroom. Logically, it is hard to imagine that the board can be able to monitor the CEO under the CEO duality of board leadership structure, even where there is such a lead independent director. Just as said by a CEO of a US insurance company: “My greatest concern is to make sure that I carry the board with me! Being chairman and CEO, to have your board go against you causes real problems”.<sup>356</sup> Following the same line of logic, it is also hard to expect independent directors to perform their monitoring role under the CEO duality even if they may be independent of management and are absolutely the majority of the board. Empirical evidence is quite weak in this regard.

Until the late 1980s, the separation of the roles of chairperson and CEO were not commonly observed in New Zealand’s corporate environment.<sup>357</sup> The board with CEO duality tends to be stacked with ineffective inside directors, who are unlikely to be critical of the CEO’s performance, rather than outside directors being introduced, who may elevate the board’s role as a monitoring agent. This propensity of board culture further entrenched the dominance of the CEO’s dual role. The 1987 stock market crash increased public pressure on the CEO duality that “may have retained some ability to control board composition in favor of inside directors in 1990s”.<sup>358</sup> In response, legislative stimulus in the law reform aims to enhance board monitoring by increasing the representation of outside board members and separating the roles of chairperson and CEO. Consequently, boards with CEO duality reduced approximately two third, according to an empirical research on a sample of 284 listed companies in NZSX in the period of 1991-1995.<sup>359</sup> NZSX/NZDX Listing Rules then clearly requires that a director should not simultaneously hold the

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<sup>356</sup> At 181.

<sup>357</sup> Prevost et al, above n 323 at 735.

<sup>358</sup> At 751.

<sup>359</sup> At 750.

positions of chairperson and CEO of the same board,<sup>360</sup> which is indeed in favor of uplifting law's expectation on the chairperson's role of directing the board's monitoring role.

The CEO duality is common in 1990s in Chinese listed companies, which were restructured from SOEs and which inherited their leadership bureaucracy. Although CEO duality is generally seen as a barrier to effective corporate governance effort in tackling this issue has been limited in China. In fact, it seems that the legislation in China encourages CEO duality. Strikingly, the appointments of chairperson and manager general (CEO) are mandated by legislation in China.<sup>361</sup> In law, the legal representative of a company is the ultimate authority who exercises all powers of directing and managing the whole business affairs of the company. Thus, the greedy desire for power, which is the origin of wealth, drives the legal representative getting involved with the company's daily affairs no matter how trivial they would be. The legal status of the board chairperson makes this craving stronger. According to the Company Law 2005, the position of legal representative of the company may be held by either the board chairperson or the executive director or the manager general of the company.<sup>362</sup> In practice, the concentration of powers is generally in the hands of the chairperson who is considered more reputable than the manager general in the legacy of Chinese corporate culture.

Furthermore, the law also allows one of the board members to be concurrently appointed by the board as the manager general of the company,<sup>363</sup> which indicates that the board leadership structure may take the form of the CEO duality at the choice of the company. However, no matter what form of board leadership to be taken there is only one voice in dictating the company, the board chairperson.<sup>364</sup> This is because the position of the board chairperson is a full-time position and the manager general "shall be responsible to the

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<sup>360</sup> NZSX/NZDX, above n 343 at Appendix 16, rule 2.1.

<sup>361</sup> Company Law 2005, above n 327 arts. 110, 114. Article 110 states that "the board of directors shall have one chairman" and Article 114 states that "a joint stock limited company shall have a manager".

<sup>362</sup> Art 13.

<sup>363</sup> Art 115. Article 115 provides that "the board of directors may decide that one of its members shall concurrently serve as the manager of the company".

<sup>364</sup> In reality, the board chairperson's power is described as what is called "One-Pen-Examines-and-Approves", i.e., only can the board chairperson's pen sign as the ultimate authority in a company.



board of directors” and “shall attend meetings of the board of directors as a non-voting attendee”.<sup>365</sup> In other words, the manager general is legally subordinate to the board which is under the leadership of the board chairperson who is also the employee of the company. In light of this, it seems to be no real meaning in differentiating board leadership structures in practice. This is because the separation of positions of chairperson and manager general, if adopted, is usually in name only, even though there has been an increasingly trend of this separation in Chinese listed companies in recent years.

#### 5.3.4 Roles of Board Committees

Board structure is the key to effective board governance and board committees are the way by which the board of directors strengthens its governance role. It is generally accepted that the establishment of board committees as an appropriate mechanism can enable the board to delegate its specific task to a small group of directors in the form of board committee so as to effectuate the specific aspect of board governance. The role of a board committee is to assist and support the board in discharging its governance role. Thus, this delegation splits the board’s specific roles and improves the efficiency of the board’s work through individual board committees with expertise. In addition, “[b]oard committees—particularly the audit, compensation, and nominating committees—can be used to help the firm maintain its legitimacy and to protect directors from exposure to liability.”<sup>366</sup>

Board committees can be formed by the board at its option, though some may be required by law or regulation. The board may form as many board committees as it needs and there is no law which mandates how many board committees are required to be established. Audit committee, compensation committee and nomination committee are three core board committees that are usually created by the board to delegate its oversight function in public held corporations. These three committees not only improve board efficiency but also enhance board independence through the detachment of management involvement. So, the

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<sup>365</sup> Company Law 2005, above n 327 art 50.

<sup>366</sup> J. Richard Harrison “The Strategic Use of Corporate Board Committees” (1987) 30 *California Management Review* 109 at 112.

establishment of these three committees is common in most publicly held corporations no matter what kind of corporate ownership structure it is. However, the specific roles played by these three committees may not be identical in practice between the dispersed and concentrated ownership structures in corporate governance, depending on what kind of the central role played by the board, either monitoring or advising, which frames the activities of these three committees.

As discussed above, the central role of the board of directors is to monitor top management and this role is mainly carried out by independent directors in publicly held corporations with the diffused ownership structure. To implement this role, independent directors are usually grouped as the members of audit, compensation and nomination committees in which they carry out their oversight duties by providing independent and objective judgments efficiently and expeditiously as expected.<sup>367</sup> In corporate America, board committees play an increasingly large role in the management of publicly held corporations. Statutes provide that the board of directors has the authority to establish its committees<sup>368</sup> and consequently board committees “are ubiquitous in American corporate life”.<sup>369</sup> Among them, the audit committee has been seen as “a centerpiece of the monitoring model”<sup>370</sup> to “implement and support the oversight function of the board by reviewing on a periodic basis the corporation’s processes for producing financial data, its internal controls, and the independence of the corporation’s external auditor”.<sup>371</sup> The SEC once advocated that the responsibility of the audit committee is to review all corporate press releases concerning financial matters.<sup>372</sup> The Treadway Commission, a special commission formed by the SEC, proposed that the audit committee might be instrumental in effectively dealing with fraudulent financial reporting,<sup>373</sup> i.e., “cooked books”.<sup>374</sup>

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<sup>367</sup> The Committee on Corporate Laws “The Overview Committees of the Board of Directors” (1979) 34 *Bus. Law.* 1837 at 1862.

<sup>368</sup> E.g., Cal. Corp. Code § 311; Del. Gen. Corp. Law § 141 (c); N. Y. Bus. Corp. Law § 712; RMBCA § 8.25.

<sup>369</sup> Branson, above n 311 at 198.

<sup>370</sup> At 234.

<sup>371</sup> ALI Corp. Gov. Proj. § 3.05.

<sup>372</sup> SEC v. Killearn Properties, Inc., Fed. Sec. Reg. & L. Rep. (BNA) No. 421, at D-2 (N.D. Fla. 1977) at 3.

<sup>373</sup> “Report of the National Commission on Fraudulent Financial Reporting (NCFRR)” (October 1987) at 40-42. The NCFRR was chaired by the former SEC commissioner James C. Treadway, Jr.

<sup>374</sup> James C. Treadway, Jr., “‘Cooked Books’: No New Recipes” (Remarks to the Third Annual Northwest Securities Institute on Feb. 26, 1983) <http://ftp.sec.gov/news/speech/speecharchive/1983speech.shtml> at 1.

Obviously, the audit committee plays a role critical to the integrity of the company's financial reporting and the audit process. Nomination and compensation committees are other two critical elements of this monitoring model to aid the board in maintaining independence from management so that the board can better perform its oversight function. The former helps to assure that the board "can objectively evaluate the performance of the senior executives" by better electing, evaluating and, if necessary, removing them.<sup>375</sup> Accordingly, the main task of the nomination committee is to identify and nominate right candidates for service on the board. The latter helps to ensure that the board can review and approve the compensation of senior executives in a meaningful and truly independent way on a regular basis with special competency on compensation issues.<sup>376</sup> Thus, the principal responsibility of the compensation committee is to make senior executives adequately compensated dependent on their abilities and performance. To make the three committees effective, legislation and regulation commit themselves to heighten the independence requirements of these committees. The listing rules of NYSE and NASDAQ tighten the definition of independence to the members of the three committees. Sarbanes-Oxley Act 2002 and Dodd Frank Act 2010 set stringently the independence requirement for the composition of these committees. The expectation of both legislation and regulation is that the three committees are able to function effectively in assisting and supporting the board's oversight role.

Currently, there are no mandatory requirements in statutes that board committees should be established by the board of directors in listed companies in New Zealand. However, the Securities Commission New Zealand (SCNZ) encourages corporate boards to "use committees where this would enhance its effectiveness in key areas while retaining board responsibility".<sup>377</sup> Particularly, the SCNZ emphasizes that the accountability of the board as a whole must be maintained by the work undertaken by committees in an efficient way.<sup>378</sup> Albeit no legislative requirement for corporate boards to establish board

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<sup>375</sup> ALI Corp. Gov. Proj. § 3A.04, comment c.

<sup>376</sup> § 3A.05, comment c.

<sup>377</sup> Securities Commission, above n 342 at 13.

<sup>378</sup> At 14.

committees, NZSX/NZDX adopts Corporate Governance Best Practice Code which requires that listed companies shall establish audit committees comprised of a majority of members who are independent directors.<sup>379</sup> The audit committee is expected to ensure audit processes in place and monitor those processes so that the board is properly and regularly informed and updated on corporate financial matters.<sup>380</sup> There is no requirement for other board committees by the NZSX/NZDX listing rules. Practically, remuneration and nomination committees are increasingly being used in New Zealand.<sup>381</sup>

Board committees were virtually not existent in Chinese listed companies before the implementation of Code of Corporate Governance for the Listed Companies in China (the Code) issued by the CSRC on January 7, 2001. There is no legislation on the issue of board committees. In the Code, the CSRC specifically recommends that the board of directors of a listed company may establish four subcommittees, i.e. corporate strategy committee, audit committee, nomination committee, and remuneration and appraisal committee.<sup>382</sup> These recommendations are not mandatory but discretionary and board committees may be established by the board of directors of a listed company in accordance with the resolutions of the shareholders' meetings of the company.<sup>383</sup> However, the board has no discretion but obligation to follow the resolutions of the shareholders' meetings as to whether to establish board committees or not. There are also no mandatory requirements as to which board committees may be established. This is significantly different from the United States where the audit, nomination and compensation committees are formed by the board of directors of a publicly held corporation under the requirements of statutes and regulations.

The Code provides that the responsibilities of each board committee are to study, review, appraise, recommend or monitor specific issues related to that committee.<sup>384</sup> However, the

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<sup>379</sup> NZSX/NZDX, above n 362 at rules 3.6.1, 3.6.2 (c). Noticeably, independent directors in New Zealand are not independent in view of the definition of independent directors in the US and China.

<sup>380</sup> Rule 3.6.3 (a).

<sup>381</sup> Securities Commission, above n 342 at 14.

<sup>382</sup> Code of Corporate Governance for the Listed Companies in China, Art 52. The CSRC (Zhengjianfa No.1 of 2002) [www.csrc.gov.cn](http://www.csrc.gov.cn).

<sup>383</sup> Ibid.

<sup>384</sup> Arts. 53, 54, 55, 56. (Citations omitted.)

main role of the board committees is to conduct research and provide advice to the board of directors. Because the Code makes clear that each specialized committee shall be accountable to the board of directors and shall submit its proposals to the board for review and approval,<sup>385</sup> which means that each specialized committee cannot play the board's role individually on behalf of the board but can only play the advisory role to the board. This is probably because the board of directors is not only the management board in nature under the two-tier board model but also the standing organ of the ultimate authority in charging the daily operation of the company. Thus, the board of directors does not delegate its powers but its responsibilities to the specialized committees, which discharge these responsibilities as their own as the units of the company but not on behalf of the board of directors. The Code requires that each of three core subcommittees shall be chaired by an independent director and shall consist of a majority of independent directors.<sup>386</sup> However, whether this requirement has been strictly followed has not been reported in corporate disclosure. These requirements are also remarkably distinguished from the United States. Apparently, the institutional design on this kind of board committees by the Code cannot make them play independently an oversight role but an advisory role. In practice, it is difficult for these board committees to perform an oversight function on top management in a generally high concentrated corporate ownership controlled by the largest or controlling shareholder in China.

#### **5.4 The Board of Directors: Some Statistical Evidence in China**

This section conducts an investigation of the main characteristics of the board of directors of Chinese listed companies, i.e., board size, board composition, board leadership structure and board committee, during the period of 2002-2011. The purpose is to present some statistical evidence on the implementation of the Code of Corporate Governance for the Listed Companies in China 2001 by Chinese listed companies and the impact of the implementation on the role of the board of directors, especially the role of independent directors, reflected by the main characteristics of the board in corporate governance.

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<sup>385</sup> Art 58.

<sup>386</sup> Art 52.

#### 5.4.1 Board Size

The board of directors functions critically as a monitor over and an advisor to top management, depending on ownership concentration and corporate control of a corporation as both of which are connected with the main functions of the board. As a basic measure of board structure, board size arguably plays a crucial role in affecting the board's ability to function effectively. Many factors may have impact on board size and one of them is the main function that the board performs, either monitoring or advising. In recognizing this, the general consensus is that smaller boards are more effective at monitoring while larger boards offer better advice to top management. Arguably, smaller boards are more cohesive, productive and effective in monitoring than large boards which have such problems as social loafing and higher co-ordination costs;<sup>387</sup> while large boards include more outsiders "who can offer good advice and counsel"<sup>388</sup> to top management otherwise unavailable from corporate staff, especially valuable experience and expertise to the board. Some argue that large boards are more capable of monitoring managers' activities since large boards make it more difficult for top management to dominate in decision-making by consensus to impair shareholder interest.<sup>389</sup>

However, there exist two main sources of the board-size effect as board size increases, i.e., increased problems of communication and coordination, and decreased ability of the board to control management,<sup>390</sup> which make the board dysfunctional. In view of this, Jensen hypothesizes that the board is unlikely to be effective when it has more than seven or eight

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<sup>387</sup> Jeffrey L. Coles, Naveen D. Daniel and Lalitha Naveen "Boards: Does one size fit all?" (2008) 87 *Journal of Financial Economics* 329 at 331.

<sup>388</sup> Benjamin E. Hermalin and Michael S. Weisbach "The determinants of board composition" (1988) 19 (4) *RAND Journal of Economics* 589 at 590.

<sup>389</sup> Shaker. A. Zahra and John. A. Pearce II "Boards of Directors and Corporate Financial Performance: A Review and Integrative Model" (1989) 15 (2) *Journal of Management* 291 at 311.

<sup>390</sup> Theodore Eisenberg, Stefan Sundgren and Martin T. Wells "Large board size and decreasing firm value in small firms" (1998) 48 *Journal of Financial Economics* 35 at 37.

members.<sup>391</sup> Empirical findings support Jensen's hypothesis.<sup>392</sup> Thus, some suggests an optional board size that is determined by a trade-off between minimizing coordination costs and maximizing the board's ability to control management.<sup>393</sup> However, it seems that little empirical evidence shows what the optimal board size may be from an effective monitoring perspective.

Normally, board size is measured by the number of directors on the board. In China, the board of directors of a joint stock limited company should be composed of 5 to 19 directors.<sup>394</sup> Table 5.4.1(a) shows the distribution of board size of Chinese listed companies from 2002 to 2011. It can be seen from Table 5.4.1(a) that the average board size is about 9 members although there is a trend of slight decrease in the board size of Chinese listed companies' boards in this period. Both mean and median are a bit more than Jensen's hypothesis. The average minimum number in the period is 3.8, a 24% lower than the minimum requirement stipulated by the Company Law 2005. By the end of 2011, all listed companies had to have at least 5 directors sitting in their boardrooms. The average maximum number in this period is marginally more than 19, just meeting the maximum requirement provided by the Company Law 2005. Noticeably, from Table 5.4.1(a), it seems that the Company Law 2005 has little influence on the board size of Chinese listed companies.

Table 5.4.1(b) presents the frequency of board size of Chinese listed companies in the same period. Apparently, the average percentage of board size which is less than Jensen's hypothesis is only accounted for 5.11% of all listed companies in the period of 2002-2011. In other words, about 95% of all listed companies have more than 7 directors in their boardrooms in this period. Among them, the average percentage of board size that falls into the category of Jensen's hypothesis is about 17.70%. Most popular board size is 9,

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<sup>391</sup> Michael C. Jensen "The modern industrial revolution, exit and the failure of internal control systems" (1994) 6 (4) *Journal of Applied Corporate Finance* 4 at 20.

<sup>392</sup> Eisenberg et al., above n 390 at 35-54. Also see: D. Yermack "Higher market valuation of firms with a small board of directors" (1996) 40 *Journal of Financial Economics* 185 – 211; Y. Wu "The impact of public opinion on board structure changes, director career progression, and CEO turnover: Evidence from CalPERS' corporate governance program" (2004) 10 *Journal of Corporate Finance* 199 – 227.

<sup>393</sup> Charu G. Raheja "Determinants of Board Size and Composition: A Theory of Corporate Boards" (2005) 40 (2) *Journal of Financial and Quantitative Analysis* 283 at 283,284.

<sup>394</sup> Company Law 2005, above n 327 art. 109.

which is consisted of 47.46% in average of all listed companies in the same period and there is also a strong trend of this size of the board on the rise steadily. The second most popular board size is 11, which is accountable for 13.87% in average of all listed companies in the period but this type of board size is on the decrease significantly. Board size that is 10 and more than 12 is composed of 15.86% of all other listed companies; among them, board size is more than 15 is rare and is only 0.98%. These types of board sizes are also on the decrease constantly.

Table 5.4.1(a) Distribution of Board Size of Chinese Listed Companies (2002 - 2011)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
N	1219	1283	1372	1369	1443	1535	1577	1760	2106	2347
Mean	9.86	9.86	9.70	9.57	9.42	9.39	9.26	9.15	9.08	8.99
Median	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00	9.00
Minimum	3.00	4.00	3.00	5.00	4.00	3.00	4.00	3.00	4.00	5.00
Maximum	19.00	19.00	19.00	19.00	19.00	19.00	19.00	20.00	19.00	19.00

Source: Calculated on data collected from CSMAR.

Table 5.4.1 (b) Frequency of Board Size of Chinese Listed Companies (2002 - 2011)

Board Size	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Less than 7	40	51	60	68	79	80	96	110	116	141
%	3.28	3.98	4.37	4.97	5.47	5.21	6.09	6.25	5.51	6.01
7 -8	252	171	216	208	239	263	269	333	442	503
%	20.67	13.33	15.74	15.20	16.52	17.13	17.06	18.92	20.99	21.43
9	400	568	614	647	693	751	806	917	1099	1247
%	32.81	44.27	44.75	47.26	48.02	48.93	51.11	52.10	52.18	53.13
10	64	47	51	51	49	54	49	41	45	47
%	5.25	3.66	3.72	3.73	3.40	3.52	3.11	2.33	2.14	2.00
11	235	211	193	190	213	210	206	201	240	250
%	19.28	16.45	14.07	13.88	14.76	13.68	13.06	11.42	11.40	10.65
12-15	206	217	222	197	160	160	138	144	146	143
%	16.90	16.91	16.18	14.39	11.09	10.42	8.75	8.18	6.93	6.09
Large than 15	22	18	16	8	10	17	13	13	18	16
%	1.80	1.40	1.17	0.58	0.69	1.11	0.82	0.74	0.85	0.68
Total	1219	1283	1371	1369	1443	1535	1577	1760	2106	2347
%	99.99	100	100	100	99.95	100	100	99.94	100	99.99

Source: calculated on data collected from CSMAR.



Therefore, it seems to suggest that the common board size of Chinese listed companies is between 9 and 11, which are evident from Table 5.4.1(b). Although this type of optional board size is about one fourth more than Jensen's hypothesis, it can be used to serve the board's main function as an advisor to the top management of Chinese listed companies. This is because Chinese listed companies, especially those controlled by the state either directly or indirectly, usually have a need for experience and expertise on companies' administration and strategic development in view of the fact that top management are usually political appointees.

#### 5.4.2 Board Composition

As discussed in the preceding section, board size may measure the efficiency of board structure, which may affect the effectiveness of the board's functions. Another basic measure of board structure is board composition, which may have impact on board independence. The standard view is that board independence is essential to the effectiveness of the board's oversight function on management and the extent to which board independence is measured by board composition. As generally acknowledged, board composition is ordinarily defined as the proportion of independent directors to total directors of the board <sup>395</sup> and this ratio may be an important indicator of board independence.<sup>396</sup> For that reason, board composition has always been considered to be highly important with regard to the board's ability to monitor. The primary function the board performs will determine—the extent to which board independence may be different—board composition.

From a logistical perspective, the monitoring of top management is always a primary function of the board of directors in a company with the diffused ownership structure so as to minimize the agency costs problem and align the conflict of interests between managers

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<sup>395</sup> Baysinger & Butler, above n 207 at 104.

<sup>396</sup> Dan R. Dalton and Idalene F. Kesner "Composition and CEO Duality in boards of Directors: An International Perspective" (1987) 18 (3) *Journal of International Business Studies* 33 at 35.

and stockholders. To change board composition by increasing the representation of independent directors seating in the boardroom can increase board independence and thus improve the effectiveness of the board's monitoring function. The expectation is that this change can not only influence the quality of the board's deliberations and decisions but also determine the board's ability to exercise controls over top management. The notion of the monitoring board model that regulators and legislators have espoused and adopted in the United States is based on this expectation.

Board composition under the monitoring board model is supposed to have a majority of independent directors on the board of directors in a company. It suggests that at the point of the majority of independent directors the degree of board independence can be effective in activating the board's monitoring function. Empirical research explores the relationship between board composition and the board's monitoring function, aiming to provide evidence on the importance of board independence in corporate governance and particularly on the role of independent directors as suggested by the effective monitor theory.

To examine the influence of board independence on the board's ability to monitor, Bhagat and Black differentiate two degrees of board independence, i.e., the majority-independent board with at least 50% of independent directors and the supermajority-independent board with only one or two inside directors.<sup>397</sup> The motivation behind this distinction is to investigate whether the degree of board independence is different in affecting the board's monitoring ability.<sup>398</sup> Empirical support for either the majority-independent board or the supermajority-independent board is weak because "independent directors often turn out to be lapdogs rather than watchdogs".<sup>399</sup> Even so, the trend toward the supermajority-independent board has been continuously strengthened in corporate America. As proudly trumpeted by an editorial of Wall Street Journal, 85% of the member companies of the

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<sup>397</sup> Sanjai Bhagat and Bernard Black "The Uncertain Relationship between Board Composition and Firm performance" (1999) 54 *Business Lawyer* 921 at 923.

<sup>398</sup> At 940.

<sup>399</sup> At 923.

Business Roundtable had boards with no less than 80% of independent directors in 2007.<sup>400</sup> To be true, the increasing trend of improvement of board independence, no matter what degree of board independence has been adopted, can also be evident outside of the boundaries of the United States, not only in companies with the dispersed ownership structure but also in companies with the concentrated ownership structure. Correspondingly, literature recognizes the importance of board composition in respect of what the contribution of independent directors should be and how the independent board should be implemented in improving corporate governance.

Table 5.4.2 (a) Distribution of Independent Directors of Chinese Listed Companies (2002-2011)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
N	1218	1283	1372	1369	1443	1537	1577	1760	2106	2348
Mean	2.30	3.21	3.30	3.31	3.30	3.34	3.33	3.31	3.29	3.28
Median	2.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Minimum	0.00	0.00	0.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Maximum	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00

Source: Calculated on data from CSMAR.

When the spillover effect of the monitoring board model spreads across the Pacific Ocean it has indeed reached China and nonetheless changed the board composition of Chinese listed companies. In China, the Guidance Opinion requires that the board of directors of a listed company should have at least two independent directors by June 30th, 2002 and have at least one third of directors who are independent directors by June 30th, 2003.<sup>401</sup> Table 5.4.2(a) shows the distribution of independent directors of Chinese listed companies from 2002 to 2011 and reports the implementation of the Guidance Opinion's requirements on the board composition since 2002. It can be observed that the average number of independent directors seating in boardrooms of Chinese listed companies is 3.20 in the period of 2002-2011, which meets the Guidance Opinion's requirement that the board should have at least two independent directors in its boardroom by the end of June, 2002. However, some listed companies have not met this requirement even by the end of 2011,

<sup>400</sup> John J. Castellani "Market Risk" (Jan. 20, 2007) *Wall St. J.* at A10.

<sup>401</sup> Guidance Opinion, above n 350 art. 1(3).

which is evident that the minimum number of independent directors is zero from 2002 to 2004 and one from 2005 to 2011, respectively.

Table 5.4.2(b) presents the frequency of independent directors of Chinese listed companies and reports the degree of board independence reflected on board composition of Chinese listed companies in the same period. From 2005, all listed companies have been required to have at least one independent director. Even though 23.46% of Chinese listed companies did not meet the Guidance Opinion's requirement that the board of directors of a listed company should have at least one third of directors who are independent directors by June 30th, 2003, this percentage reduced to 0.94% by the end of 2011. This means that more than 99% of listed companies met this requirement but some still did not in 2011.

Among those meeting this requirement, the board with the proportion of independent directors between  $1/3$  to  $1/2$ , which is referred here as the minority independent-board, has increased significantly through the period and reached 94.46% by the end of 2011, 4.83 times than that in 2002. This means that almost all Chinese listed companies have a minority independent-board. Although having increased in the period, boards with the proportion of independent directors between  $1/2$  and  $2/3$ , which meets Bhagat and Black's majority-independent board, was up to 4.34% by the end of 2011. There was only 0.21%, the biggest percentage in the period, of boards with independent directors whose proportion is larger than  $2/3$  in 2011, which may be presumed as Bhagat and Black's supermajority-independent board. This is significantly different from corporate America, where publicly held corporations normally have either a majority-independent board or a supermajority-independent board. Obviously, the common board composition of Chinese listed companies is in the form of the minority-independent board and the degree of board independence of them is only at the minority level. It is logically unclear how independent directors can be able to perform their monitoring role effectively as claimed by Chinese regulators under this degree of board independence. In practice, it is difficult for independent directors to be effective monitors in the form of the minority-independent board.

Table 5.4.2 (b) Frequency of Independent Directors of Chinese Listed Companies (2002 - 2011)

Proportion	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
None	25	5	4	0	0	0	0	0	0	0
%	2.05	0.39	0.29	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Less Than 1/3	950	301	195	124	108	71	54	40	33	22
%	78.00	23.46	14.21	9.06	7.48	4.62	3.42	2.27	1.57	0.94
1/3 to 1/2	238	960	1156	1223	1305	1425	1468	1651	1986	2218
%	19.54	74.82	84.26	89.34	90.44	92.71	93.09	93.81	94.30	94.46
1/2 to 2/3	3	16	16	22	30	38	54	67	86	102
%	0.25	1.25	1.17	1.61	2.08	2.47	3.42	3.81	4.08	4.34
Large than 2/3	2	1	1	0	0	1	1	2	1	5
%	0.16	0.01	0.01	0.00	0.00	0.01	0.01	0.11	0.00	0.21
Total	1218	1283	1372	1369	1443	1537	1577	1760	2106	2348
%	100	99.93	99.94	100	100	99.81	99.94	100	99.95	99.95

Source: Calculated on data from CSMAR.

### 5.4.3 Board Leadership Structure

Agency theory argues that separation of the roles of chairperson and CEO guarantees an adequate board leadership structure of check and balance, which attempts to dissociate the board's impotence from the CEO's hegemony. Certainly, chairperson independence can weaken CEO dominance by diluting the CEO's power in the boardroom, which reduces the potential of managerial hegemony in undermining the function of the monitoring board model. The CEO duality creates too much power in the hands of the CEO and thus poses "[a] very real threat to the exercise of independent judgment by the board of directors" when "the top managerial officer of the corporation simultaneously serves as chairperson of the board which has the charter of monitoring and evaluating top management".<sup>402</sup> Consequently, the CEO duality is not only in conflict with the essence of the monitoring board model in theory but also disables the function of the monitoring board model in practice. In the US, "the role of 'lead director' to act as the go-between between the chairman/CEO/president and the other board directors"<sup>403</sup> has been introduced to

<sup>402</sup> Dan R. Dalton and Idalene F. Kesner "Composition and Duality of Boards of Directors: An International Perspective" [1987] *Journal of International Business Studies* 33 at 35.

<sup>403</sup> Kakabadse and Kakabadse, above n 355 at 178.

accommodate the threat of the CEO duality to the function of the monitoring board model. The model of “lead director” is intended as a compromise resulting from shareholders’ increased pressure on the US boards and is intended to obviate the need for the separation of roles of chairperson and CEO.<sup>404</sup> This suggests that the adoption of the lead/presiding director institution is just to find a way of moderating shareholders’ pressure on the reform of the CEO duality problem in the US publically held corporations. The question remains whether the role of “lead director” has impact on the CEO’s hegemony. There is little research either theoretically or empirically on the effectiveness of this institutional arrangement under the CEO duality.

Undeniably, there seems to be a controversy as regards the CEO duality under the monitoring board model. Clearly, CEO duality communicates a signal to external communities that “the firm has strong leadership and a clear sense of direction”.<sup>405</sup> Paradoxically, it is also presumably an indicator that the board is dysfunctional in “effective monitoring”, a failure of the monitoring board model. Though controversial, it may be argued that the CEO duality can cater for the need of the advisory board model whose main function is not monitoring but advising top management. The recent trend in the board leadership structure of Chinese listed companies may be explained for this argument. In China, neither law nor regulation provides that the positions of chairperson and CEO should be strictly separated, which is determined at the option of the board of directors of the company (see Section 5.3.3). In general, CEO duality is not very high in the board leadership structure of Chinese listed companies in practice. Table 5.4.3(a) shows the frequency of CEO duality of Chinese listed companies from 2002 to 2011.

Indeed, CEO duality is much lower in Chinese listed companies than that in the US. In the period of 2002-2011, the average percentage of Chinese listed companies which did not adopt the CEO duality as their board leadership structure was 84.44%. It means that only 15.56% of Chinese listed companies adopted CEO duality as their board leadership

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<sup>404</sup> Ibid. Kakabadse and Kakabadse.

<sup>405</sup> Catherine M. Daily and Dan R. Dalton “CEO and board chair roles held jointly or separately: Much ado about nothing?” (1997) 11 (3) *The Academy of Management Executive* 11 at 13.

structure. Interestingly, there was an opposite trend between Chinese listed companies which adopted the CEO duality as their board leadership structure and those which did not. Although the number of Chinese listed companies which did not adopt the CEO duality as their board leadership structure increased constantly the percentage of them instead decreased continuously. While the number increased to 60.66% the percentage decreased 15.63% from 2002 to 2011. In contrast, the number of Chinese listed companies which did adopt the CEO duality as their board leadership structure increased constantly and the percentage of them also increased persistently. Both the number and the percentage increased 342.64% and 132.39%, respectively, in the same period.

Table 5.4.3(a) Frequency of CEO Duality of Chinese Listed Companies (2002 - 2011)

CEO Duality	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
No	1093	1132	1208	1200	1249	1311	1353	1437	1641	1756
%	89.44	88.58	88.05	88.17	86.62	84.42	84.09	81.60	77.99	75.46
Yes	129	146	164	161	193	242	256	324	463	571
%	10.56	11.42	11.95	11.83	13.38	15.58	15.91	18.40	22.01	24.54
Total	1222	1278	1372	1361	1442	1553	1609	1761	2104	2327
%	100	100	100	100	100	100	100	100	100	100

Source: Calculated on data from CSMAR.

The influence of the Company Law 2005 on the CEO duality is also evident. The percentages of Chinese listed companies which adopted the CEO duality as their board leadership structure before and after the Company Law 2005 were 11.60% and 107.44%, respectively, and the ratio of both was 10.80%. This means that the increase of Chinese listed companies adopting the CEO duality as their board leadership structure before the Company Law 2005 was a bit more than 1/10 of those after the Company Law 2005 and the adoption of the CEO duality has been on the rise in the boardroom of Chinese listed companies in the period of 2002-2011. Table 5.4.3(b) provides further evidence of this increasing trend. The average yearly growth rate of the adoption of the CEO duality by Chinese listed companies is 18.61% from 2002 to 2011; while the average yearly growth rate of those which did not adopt the CEO duality is 4.70%. The ratio of both is 3.96, which means that the former is about 4 times of the latter in the yearly growth rate. Therefore, there has been a strong reversed trend of increasing adoption of the CEO duality as the

board leadership structure in Chinese listed companies in this period. The rationale behind this trend is probably that there is an increasing demand of the CEO duality as the preferred board leadership structure to better serve the advisory board model of Chinese listed companies. If taking account of Chinese listed companies which do not adopt the CEO duality but in name, referred here as the “chairperson duality” in fact,<sup>406</sup> this trend will be further strengthened and entrenched.

Table 5.4.3 (b) Yearly Change of CEO Duality of Chinese Listed Companies (2002 - 2011)

Years	Yes		No		Total	
	N	%	N	%	N	%
2003-2002	17	13.18	39	3.57	56	5.12
2004-2003	18	12.33	76	6.71	94	8.30
2005-2004	-3	-1.83	-8	-0.66	-11	-0.91
2006-2005	32	19.88	49	4.08	81	6.75
2007-2006	49	25.39	62	4.96	111	8.89
2008-2007	14	5.79	42	3.20	56	4.27
2009-2008	68	26.56	84	6.21	152	11.23
2010-2009	139	42.90	204	14.20	343	23.87
2011-2010	108	23.33	115	7.01	123	7.50

Source: calculated on Table 5.4.3(a).

Note: Yearly change is defined as the year minus the year before. “N” means the number of the yearly change and “%” means the percentage of the yearly change.

#### 5.4.4 Board Committees

Board committees play a key role in supporting the board of directors in performing its functions and the structure and composition of board committees can also be important indicators of board independence. As discussed in Section 5.3.4, the board of directors cannot specifically discharge its functions but delegate its powers and responsibilities to specialized board committees to perform these powers and responsibilities. The reason for the board to delegate its powers and responsibilities to its subcommittees is owing to its endogenous limitation as an instrument of decision-making body to discharge its functions

<sup>406</sup> See note 383. Although separated, the board chairperson plays the roles of both chairperson and CEO.



when it is in session (i.e., when the board holds its meetings). That is, the board can only make decisions when it is in session and no decisions should be made otherwise. Put it another way, “the board was indeed a power center, but it was powerful as a tool, not as a distinct entity”.<sup>407</sup>

In view of this institutional design, two main drawbacks are obvious. First, the number of board meeting are very limited, usually several times a year, and the time of each meeting is rather short, often several hours each time. The members of the board have limited time to discuss managerial proposals in detail and make well-informed decisions, which limits the board’s ability to perform its functions effectively. In practice, a board meeting is a mere formality and only a vote for proposals proposed by top management either under the CEO duality or the chairperson duality. Indeed, this practice is conducive to the efficiency of the board’s decision-making, which is however not advantageous to the board’s monitoring function. Second, the board is limited in performing its functions when it is not in session. This is especially true of corporate America, where most members of the board are part-time outsiders who are usually “busy directors” of their own companies. It is difficult to expect them to put much time and energy into companies that they serve as outsiders. This is particularly the case in corporate America where independent directors usually come from CEOs of other publicly traded companies, even post-Sarbanes-Oxley. The nickname of “vase director” given to independent directors in Chinese listed companies also provides an example to explain this viewpoint.

So, there is a need of some standing organs subordinate to the board, which can perform the board’s functions when the board is not in session. This is because “many of the critical processes and decisions of board of directors do not derive from the board-at-large, but rather in subcommittees (e.g., audit, compensation, nominating, executive)”.<sup>408</sup> Board committees just meet this need and adapt to this reality, even in the board composed of directors who are mainly insiders like China.

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<sup>407</sup> Ward, above n 354 at 39.

<sup>408</sup> Dan R. Dalton, Catherine M. Daily, Alan E. Ellstrand and Jonathan L. Johnson “Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance” (1998) 19 (3) *Strategic Management Journal* 269 at 284.

A board committee is structured to meet the main function of the board, which is embodied from the composition of a board committee, i.e., the proportion of insiders to outsiders in the boardroom. In the monitoring board model, a board committee which is delegated the board's oversight function and is usually composed of independent directors, presents a very strong degree of board independence. This is the case of corporate America where it is common practice that audit, compensation and nominating committees are almost all consisted of independent directors in publicly traded corporations nowadays. In the advisory board model, board committee is mainly to serve the advisory need of the board and the composition of board committee is thus composed of less independent directors than that in corporate America, indicating a rather weak degree of board independence. This is the case in corporate China where independent directors are still not dominant in these three committees, which are presumed by Chinese regulators to assist the board's oversight function.

In China, the Code issued by the CSRC in 2001 recommends that the board of directors of a listed company may establish such board committees as the corporate strategy committee, audit committee, nomination committee, and remuneration and appraisal committee. Table 5.4.4(a) shows the distribution of board committee of Chinese listed companies from 2002 to 2011. It can be observed that boards that have established the four committees have increased significantly and the average committees established is 3.01 in this period. However, some listed companies still have none of these four committees by the end of 2010.

Table 5.4.4 (a) Distribution of Board Committees of Chinese listed Companies (2002-2011)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
N	1216	1227	1303	977	1043	1428	1530	1749	2120	2362
Mean	1.17	1.78	2.10	2.99	3.22	3.59	3.79	3.78	3.82	3.86
Median	.00	1.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Minimum	.00	.00	.00	.00	.00	.00	.00	.00	.00	1.00
Maximum	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00

Source: Calculated on data from CSMAR.

Table 5.4.4(b) shows the frequency of board committees of Chinese listed companies in the same period. Apparently, all listed companies have at least one board committee by the end of 2011. Listed companies with one and two board committees decreased and were only accounted for 2.29% and 4.36% in average, respectively, in this period. In contrast, listed companies with three and four board committees increased and were accounted for 9.45% and 65.42% in average, respectively, in the same period. Remarkably, 88.95% of Chinese listed companies have all four board committees recommended by the Code by the end of 2011.

Table 5.4.4 (b) Frequency of Board Committees of Chinese listed Companies (2002 -2011)

Frequency	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Zero	777	595	522	163	119	57	4	2	1	0
%	63.90	48.49	40.06	16.68	11.41	3.99	0.26	0.11	0.00	0.00
One	61	53	54	42	31	16	4	7	4	4
%	5.02	4.32	4.14	4.30	2.97	1.12	0.26	0.40	0.19	0.17
Two	48	55	66	52	59	73	62	61	76	67
%	3.95	4.48	5.07	5.32	5.66	5.11	4.05	3.49	3.58	2.84
Three	50	78	93	104	129	168	162	231	215	190
%	4.11	6.36	7.14	10.64	12.37	11.76	10.59	13.21	10.14	8.04
Four	280	446	568	616	705	1114	1298	1448	1824	2101
%	23.03	36.35	43.59	63.05	67.59	78.01	84.84	82.79	86.04	88.95
Total	1216	1227	1303	977	1043	1428	1530	1749	2120	2362
%	100	100	100	99.99	99.99	99.99	100	100	99.95	100

Source: Calculated on data from CSMAR

Table 5.4.4(c) illustrates specifically the frequency of corporate strategy, audit, nomination, and remuneration and appraisal committees of Chinese listed companies from 2002 to 2010. By the end of 2010, 99.86% of Chinese listed companies have established all audit committees. Similarly, 99.10% of those listed companies have had the remuneration and appraisal committee (equivalent to the compensation committee in the US) in the same year. This situation is almost the same as that in the US. There were only 0.14% and 0.90% of Chinese listed companies which have none of these two board committees by the end of 2010, respectively. 71.22% of Chinese listed companies have established the nomination

committee and 28.78% of Chinese listed companies have not by the end of 2010. This situation is to some extent lagging behind that in the US.

Nonetheless, most Chinese listed companies have audit, remuneration and appraisal, and nomination committees, which are presumed to assist the board of directors in discharging its monitoring function. The uncertainty is if these three board committees can effectuate their oversight responsibilities as presumed. There is still a need for empirical research to test this presumption. The current practice of Chinese listed companies seems to suggest the opposite. As for the corporate strategy committee, 71.69% of Chinese listed companies have established it and 28.31% of Chinese listed companies haven't by the end of 2010. From this figure, it is obvious that the corporate board is orientated in the form of the advisory board model. As a consequence of this orientation, the composition of audit, remuneration and appraisal, and nomination committees usually consists of independent directors, if seated, who do not create the majority of the board of directors. Thus, the degree of board independence as embodied through the composition of these three board committees is too much lower, which is incomparable with their counterparts in the United States. These three board committees are commonly considered where independent directors are able to play their monitoring role. Technically, it is a puzzle how they can be able to perform this role effectively in such board committees with much lower degree of board independence.

Table 5.4.4 (c) Frequency of Corporate Strategy, Audit, Nomination, and Remuneration and Appraisal Committees of Chinese Listed Companies (2002 - 2010)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
AC: Yes	340	509	635	689	784	1390	1586	1745	2106
%	28.22	40.21	46.86	51.00	54.67	89.79	99.00	99.66	99.86
No	865	757	720	662	650	158	16	6	3
%	71.78	59.79	53.14	49.00	45.33	10.21	1.00	0.34	0.14
RAC: Yes	375	551	666	728	834	1366	1570	1719	2090
%	31.12	43.52	49.15	53.89	58.16	88.24	98.00	98.17	99.10
No	830	715	689	623	834	182	32	32	19
%	68.88	56.48	50.85	46.11	58.16	11.76	2.00	1.83	0.90
SC: Yes	307	473	580	619	697	1070	1301	1517	1512
%	25.48	37.36	42.80	45.82	48.61	69.12	81.21	86.64	71.69
No	898	793	775	732	737	478	301	234	597
%	74.52	62.64	57.20	54.18	51.39	30.88	18.79	13.36	28.31
NC: Yes	276	421	526	563	641	999	1262	1477	1502
%	22.90	33.25	38.82	41.67	44.70	64.53	78.78	84.35	71.22
No	929	845	829	788	793	549	340	274	607
%	77.10	66.75	61.18	58.33	55.30	35.47	21.22	15.65	28.78
Total: N	1205	1266	1355	1351	1434	1548	1602	1751	2109
%	100	100	100	100	100	100	100	100	100

Source: Calculated on data from Peking University China Center for Economic Research (CCER)

Note: AC means audit committee. RAC means remuneration and appraisal committee. SC means corporate strategy committee. NC means nomination committee.

## 5.5 Effectiveness of the Board of Directors

The efficiency of corporate governance mechanisms has focused on the function of the board of directors and the effectiveness of the board of directors which is at the heart of corporate governance. There are a number of factors that potentially affect the way the board discharges its function effectively. Literature suggests that the effectiveness of the board as an internal governance mechanism mainly relies on such characteristics of the board as size, composition, leadership structure and subcommittees.<sup>409</sup> These are structural measures assumed as important means to improve the board's function and hence protect

<sup>409</sup> The effectiveness of the board of directors are affected by many other factors except for the characteristics of the board, which are only one factor to be considered in this thesis.

stockholders' interests.<sup>410</sup> Changes in these structural measures may have impact on not only the board's function but also the board's effectiveness. Accordingly, concerns come to attention as regards how to structure the board appropriately and to what extent changes in board structure influence the board's function. Thus, it comes as no surprise that corporate governance reforms are usually connected with the structural adjustments of the board such as the numbers of directors, the proportion of independent directors, the separation of the positions of chairperson and CEO, the setting-up of board committee and the structure of board committee, aiming to enhance the board's power to function effectively.

Board effectiveness is mainly concerned with the board's task outcome and "occurs via the execution of a role set"<sup>411</sup> of the board. This role set is often not defined as an integrated set of activities but based on diverging theoretical assumptions.<sup>412</sup> As commonly accepted, the board's role is classified to include three broadly defined functions: control, service and strategy.<sup>413</sup> Control refers the board's oversight function; while service and strategy generally denote the board's advisory function as the strategy role "is normally subsumed under the 'advising' role".<sup>414</sup> In general, the board of directors performs both oversight and advisory roles. While the board is required to perform within the spectrum of this role set, each board need an emphasis mainly on one of these two roles, depending on the board model, either monitoring or advising, which clearly has a different combination of these two roles. This emphasis may change at times and over the life of a company. That is, what main task that the board needs to implement and what outcome that the board aims to achieve. As a result, the task outcome can indicate the degree of the board's success in carrying out its oversight or advisory function. Hence, board effectiveness occurs with the task outcome via the board in performing these two key roles and it can simply refer to the

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<sup>410</sup> James. D. Westphal "Board games: how CEOs adapt to increases in structural board independence from management" (1998) 43(3) *Administrative Science Quarterly* 511 at 511.

<sup>411</sup> Gavin C. Nicholson and Geoffrey C. Kiel "Breakthrough board performance: how to harness your board's intellectual capital" (2004) 4 (1) *Corporate Governance – An International Review* 5 at 6.

<sup>412</sup> Abigail Levrau and Lutgart Van Den Berghe "Corporate Governance and Board Effectiveness: Beyond Formalism" (Working paper, 2007/448) *Vlerick Leuven Gent Management School of Ghent University* 1 at 11, 12.

<sup>413</sup> Zahra and Pearce II, above n 389 at 303.

<sup>414</sup> Nicholson and Kiel, above n 411 at 8.

degree that the board reaches its objectives. The structural adjustment of the board may have impact on the board's task outcome and accordingly influence the board's ability to achieve its objectives effectively. The board structural adjustment aims to change structural board independence, which can increase the board's overall power in its relationship with top management and accordingly its ability in confrontation with the managerial hegemony.

Empirical research has explored how structurally independent boards might limit top management's ability to rely on the exploitation of structural bases of managerial powers to maintain ultimate control over the board, such as dictating the agenda of board meetings, concealing negative information from the board and mandating passivity among directors by advising them not challenging managerial preferences.<sup>415</sup> Some argue that "greater structural board independence may not necessarily enhance the board's overall power in its relationship with CEO" because it "may prompt the CEO to use interpersonal influence tactics that significantly blunt or offset the effect of structural independence on the board's overall power".<sup>416</sup> Indeed, literature is rich in support of this argument and the failure of greater structural board independence is also evident in view of financial debacles in recent years. Conversely, this implies that greater structural board independence does have impact on the managerial hegemony, even if it is just in procedure but not in essence. This is because it prompts top management "to initiate specific interpersonal influence attempts, such as ingratiation and persuasion, toward board members" so as to avoid "losing structural sources of power as a result of greater structural board independence".<sup>417</sup>

This shows that structural adjustment of the board can potentially enhance the board's power in the execution of its functions and increase the degree of board independence in procedure. Although not guaranteed to work, this adjustment is a prerequisite to increasing the board's overall power over and thus its degree of independence from top management.<sup>418</sup> It is potential because the increase of board independence by way of structural adjustment of board structure provides procedural protection for independent

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<sup>415</sup>Westphal, above n 410 at 512.

<sup>416</sup> Ibid.

<sup>417</sup> At 513.

<sup>418</sup> Chapter Six discusses board independence in detail.

directors to carry out their monitoring role over management at least in procedure. In the monitoring board model, there is a real need for the greater structural board independence to provide this procedural guarantee so that the board can be able to constrain managerial hegemony in order to perform its monitoring role effectively, which is clearly the case in the United States. In the advisory board model, there is no need for the greater structural board independence because the structural adjustment of the board is mainly to meet the demand of the board's advisory role. To increase the degree of board independence by means of the structural adjustment of the board needs to serve the efficiency of this demand, which can be manifested in China. Thus, board effectiveness can be achieved through the task outcome of the board's role set via its structural adjustment to reach its objectives.

## **5.6 Conclusion**

In this chapter, both the legal status of the board of directors and board practice have been examined. The focus has been on the characteristics and roles of the board of directors that have impact on board effectiveness in connection with the board as the central governance mechanism of internal control in corporate governance in the United States, New Zealand and China. The examination of the board's legal status is through a functional comparative analysis on the relevant laws and regulations in the targeted jurisdictions while the examination on board practice is conducted mainly by an investigation on Chinese listed companies in the period of 2002-2011, compared with that of the US and New Zealand throughout this chapter. The examination shows that there does exist some difference on the corporate board system in the three countries and each board system has its unique characteristics.

In the US, the corporate board system is prototypically the unitary board in the form of the monitoring board model characterized by the dominance of independent directors who are composed of the majority or supermajority of the board. The structural adjustment of the board aims to uplift the degree of board independence so as to improve the effectiveness of the board in discharging its monitoring function. The controversy is that the structural adjustment of the board avoids the open problem of the CEO duality, which this research



suggests is the heart of board impotence in the structural adjustment of the monitoring board model in corporate America. The logic is simple and obvious that the CEO duality can easily defeat the majority-independent board or supermajority-independent board, even though the institution of the lead independent director has been introduced with the aim of compromising the threat of the CEO duality on board effectiveness. In New Zealand, the corporate board system is not identical to that in the US although it is also in the form of the unitary board model. The board is expected to perform the monitoring role over management in listed companies but the structural adjustment of the board seems not to stress strictly board independence. This suggests that the board's ability to perform its monitoring function may be limited in matching this expectation.

Compared with the US, the Chinese corporate board system is archetypally the hybrid board in the form of the advisory board model characterized by the dominance of inside directors who are composed of the absolute majority of the board. The structural adjustment of the board aims to improve the degree of board independence at the minority level so as to safeguard the effectiveness of the board in performing its advisory role. It is claimed that the introduction of independent directors into the boardrooms of Chinese listed companies improves the board's monitoring role. Technically, it seems that this claim has not been supported from the statistical evidence from the investigation in Section 5.4 on the structural adjustment of the board of directors of Chinese listed companies from 2002 to 2011. This suggests that even in procedure the board of directors of Chinese listed companies find it difficult to perform its monitoring role as claimed, to say nothing of the CEO duality or the chairperson duality in fact.

## CHAPTER 6

### BOARD INDEPENDENCE

#### 6.1 Introduction

The ability of the board of directors to discharge its oversight function effectively is directly associated with board independence, which is assumed to be an important and effective governance mechanism because it signals the quality of monitoring. Board independence suggests that the presence of independent directors in the corporate boardroom improves the board's overall ability to retain its objective judgments free of managerial hegemony. As is well recognized, it generally denotes two meanings. One is that the board should consist of a majority of independent directors and another is that an independent director should be independent of management.

Board independence is a boardroom dynamic that requires the board to be composed of enough board members who have an independent mind, willing to actively provide an objective judgment independently. Without the adequate proportion of independent directors who have been present in the boardroom, board independence cannot be achieved. The philosophy of this dynamic is that board independence can primarily accomplish three functions, i.e., “clear accountability to shareholders, informational transparency, and increased shareholder voice in corporate decisionmaking”.<sup>419</sup> This implies that directors should see their role as a monitor for shareholders. The accountability function enables the board to reduce agency costs by “enlisting the self-interest of directors and management in conducting themselves properly”<sup>420</sup> and thus hold management accountable to shareholders. The information transparency function helps the board to serve as an informational conduit

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<sup>419</sup> Harvard Law Review “Beyond “Independent” Directors: A Functional Approach to Board Independence” (2006) 119 *Harvard Law Review* 1553 at 1561.

<sup>420</sup> Irwin Borowski “Corporate Accountability: The Role of the Independent Director” (1984) 9 *J. CORP. L.* 455 at 456.

between managers and investors by supplementing and reinforcing existing disclosure regimes, aiming to achieve the outcome of market efficiency.<sup>421</sup> The shareholder voice function assists the board to effectuate shareholder primacy by ensuring an independent presence in the boardroom so as to increase shareholder voice in corporate governance.<sup>422</sup> In delivering these three functions, board independence enables the board to reinforce its essential function as the central internal governance mechanism to monitor top management.

As discussed in the previous chapter, the structural adjustment of the board can provide the procedural safeguard for carrying out these primary functions of board independence but it cannot make available the substantive safeguard for discharging them. The substantive safeguard is to ensure the function of the element that has the essential influence on board independence. Otherwise, board independence is only in form but not in substance, even though there has been the procedural safeguard in place. Thus, it is important that board independence is not only just in procedure but also in substance. Literature has identified some elements which have substantial influence on board independence and they are mainly independent of management, dependent on shareholder, access to information and incentive to monitor. As generally known, these elements are critical for board independence provided that the board's primary function is to monitor top management. This chapter will examine these elements in detail. The rest of this chapter goes as follows: Section 6.2 explores law and regulation on board independence, Section 6.3 scrutinizes the elements that have impact on board independence, Section 6.4 investigates independent directors as a governance mechanism in China, Section 6.5 evaluates the efficiency and effectiveness of independent directors and Section 6.6 provides a conclusion.

## **6.2 Law and Regulation on Board Independence**

Corporate governance reformers generally presume that independent boards are better than non-independent boards and that the more independent a board is, the better, which position

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<sup>421</sup> Harvard Law Review, above n 419 at 1563.

<sup>422</sup> At 1564.

board independence as a status that can be defined *ex ante*.<sup>423</sup> Based on this presumption, legislators and regulators tend not to question this conventional wisdom but instead focus on refining the independence standard of the board in order to arrive at the “true” board independence. Obviously, board independence is not just a minimum standard that the board should meet the legal and regulatory requirements concerning board composition but rather emphasizes the board’s “best practice” characterized by effectively putting the primary elements of board independence into play. Surely, the independence standard required by law and regulation cannot guarantee that the board’s best practice achieves actual independence. However, the history of mankind reveals that the “inertia” nature of human beings usually ignores the commitments of their duties and responsibilities without the binding force and effect of law and regulation. Legal rules may provide the means to cure this inertia but autonomy or self-regulation may not. This may be true for board independence.

Critics can argue that legal rules such as the independence standard stipulated by law and regulation can only achieve board independence in form. Nevertheless, one cannot draw a circle without a caliper, and law and regulation just serve this utility. This is why law and regulation emerge from the dawn of the civilization of human society thousands years ago. Undisputedly, the independence standard at least provides the legal means by which board independence can be tested, even though just in form. Thus, lawmakers and regulators have tried to curb this inertia of the corporate board by refining the standard of board independence with focus on refining the independence standard on a director *per se* for decades, aiming to get at board independence not just in form but “truly” in substance.

#### United States

Indeed, the need for active, independent corporate boards has become prevailing wisdom based on the belief that board independence can defeat managerial supremacy in the corporate governance literature. This belief has been the foundation on which corporate

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<sup>423</sup> Usha Rodrigues “The Fetishization of Independence” (2008) 33 *The Journal of Corporation Law* 447 at 452, 453.

governance reforms have shaped the modern corporate landscape ever since the Investment Company Act 1940 in the US. Historically, the evolution of the institutionalization of independent directors has witnessed the justification of this belief, from the disinterested directors present in the boardroom required by the Investment Company Act 1940 to the majority-independent board recommended by the ALI's principles 1994 until the current majority- or supermajority-independent board mandated by the Sarbanes-Oxley Act 2002 and Dodd-Frank Act 2010. Over six decades, the NYSE and NASDAQ listing rules have refined the independence standard for testing board independence of publicly traded corporations listed in the US stock exchanges. To satisfy the test for board independence, a member of a board of directors should meet the independence standard required by these listing rules so as to qualify as an independent director. Specifically, a director is not independent if the director or an immediate family member:

- a) is an employee or executive officer of the listed company within the last three years;
- b) has received the fees (excluding committee fees and pension or other deferred compensation) more than \$120,000 from the listed company during any twelve-month period within the last three years;
- c) is a partner or employee, currently or within the last three years, of a firm which is the listed company's internal or external auditor;
- d) is an executive officer, currently or within the last three years, of another company where any member of the listed company's executives is or was the member of that another company's compensation committee; or
- f) is an employee or executive officer, currently or within the last three fiscal years, of another company which has made payments to or receive payments from the listed company with the value greater than \$1 million or 2% of that another company's consolidated gross revenues.<sup>424</sup>

In applying the independence test, boards need to “broadly consider all relevant facts and

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<sup>424</sup> NYSE, above n 97, § 303A.02 (b). See also NASDAQ, above n 98, § 5605 (a) (2) (A), (B), (C), (D), (F) and (G).

circumstances” that might “signal potential conflicts of interest” or might “bear on the materiality of a director’s relationship with the listed company”.<sup>425</sup> As the concern is independence from management, boards should consider if the materiality of this relationship would impair a director’s ability to make independent judgments, in determining the director’s independence. This requires that “the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation”.<sup>426</sup>

### New Zealand

There is no similar independence standard for testing board independence of listed companies in New Zealand. The Securities Commission requires that an issuer’s board should include directors who meet formal criteria for “independent directors”.<sup>427</sup> In the Securities Commission’s view, “Independence of mind is a basic requirement for directors”.<sup>428</sup> According to the Securities Commission (now Financial Markets Authority),

A non-executive director being formally classified as independent only where he or she does not represent a substantial shareholder and where the board is satisfied that he or she has no other direct or indirect interest or relationship that could reasonably influence their judgment and decision making as a director.<sup>429</sup>

According to NZSX/NZDX Listing Rules, board independence should be determined in the board’s view of an issuer.<sup>430</sup> This means that the board of directors of a listed company should determine at its discretion whether a member of its board is an independent director or not. However, there may be three uncertainties as regards how to apply this formal criterion for the board of an issuer to determine board independence. First, there are no specific criteria to evaluate whether a director who may represent a substantial shareholder

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<sup>425</sup> NYSE, above n 97, § 303A.02 (a) (ii) Commentary.

<sup>426</sup> *Ibid.*

<sup>427</sup> Securities Commission, above 342 at 9. The Securities Commission guidelines are not legally binding.

<sup>428</sup> At 11.

<sup>429</sup> *Ibid.*

<sup>430</sup> NZSX/NZDX, above n 343.

or not. Second, there are no specific standards to judge whether or not a director may have no other direct or indirect interest or relationship that could reasonably influence his/her judgment and decision-making. Third, there is no specific test to examine what kind of interest or relationship may reasonably influence a director's judgment and decision-making to be independent. This suggests that the independence standard for testing board independence is completely under the board's subjective judgment of an issuer who has the responsibility to "make the necessary arrangements to require its Directors to provide sufficient information to the Board to make a determination".<sup>431</sup> The question is what the definition of "sufficient information" is and either law and regulation or listing rules are silent on this. Thus, it is unclear what independence standard that the board of directors of an issuer applies to test its board independence, although the issuer shall specify in the notice of a director's nomination "the Board's view on whether or not the nominee would qualify as an Independent Director".<sup>432</sup>

## China

The introduction of independent directors into the boardrooms of Chinese listed companies is expected to increase board independence and thus improve board effectiveness. Without board independence, there lacks an environment in the boardroom for a director to provide an independent and objective judgment on management. However, board independence can only be achieved if a director is truly independent of management (the largest or controlling shareholder in the China case) not only in form but also in substance. This is because top management in Chinese listed companies is usually controlled by the largest or controlling shareholders. To increase board independence, the CSRC provides the Guidance Opinion detailing an independence test for determining board independence. According to the Guidance Opinion, independent directors must be independent and a director is not independent if the director is:

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<sup>431</sup> Rule 3.3.4.

<sup>432</sup> Rule 3.3.5.

- 1) an employee or his/her immediate family member or major social relative in the listed company or a subsidiary thereof;
- 2) a personal shareholder or his/her immediate family member who directly or indirectly holds not less than 1% of the listed company's shares, or who is one of top ten shareholders of the listed company;
- 3) an employee or his/her immediate family member of an entity which directly or indirectly holds not less than 5% of the listed company's shares, or which is one of top five shareholders of the listed company;
- 4) one who is classified as one of the above three categories in the previous year;
- 5) one who provides financial, legal, consulting or other services to the listed company or a subsidiary thereof;
- 6) one who is specified in the listed company's articles of association; or
- 7) one who is determined by the CSRC.<sup>433</sup>

Apparently, the CSRC tries to impose a strict definition of the independence standard for testing the quality of an independent director who must be free of the conflict of interests between the largest or controlling shareholder and minority shareholders.<sup>434</sup> That is, the qualification as an independent director is not to subject him/her to the influence of the listed company's largest or controlling shareholder or other substantially interested party that might interfere with his/her independent judgment.<sup>435</sup>

### Comparison and Contrast

Both the US and China have the independence standard in place for testing the board independence of listed companies in their stock markets while there are different formal criteria in New Zealand. That is, the independence standard in the US and China is objective while the formal criteria in New Zealand is subjective. There are three main

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<sup>433</sup> Guidance Opinion, above n 350 art.3.

<sup>434</sup> Code of Corporate Governance for Chinese Listed Companies, art 49 (January 7, 2001) the CSRC & the SETC (Zhengjianfa No.1 2002) [http://www.eduzhai.net/yingyu/615/763/yingyu\\_247328.html](http://www.eduzhai.net/yingyu/615/763/yingyu_247328.html).

<sup>435</sup> Art 50.



similarities identified here as regards the independence standard between the US and China. First, both standards focus on defining a director's financial and familial relationships with the listed company to determine the director's qualification for independence. This relationship is between the director and the management of the listed company in the US while it is between the director and the largest or controlling shareholder or substantially interested party of the listed company in China. Second, both standards provide the threshold that the director or an immediate family member or main social relatives who may hold the listed company's shares to determine the director's qualification for independence, although there are a slightly difference as to the thresholds between both. Third, both standards provide a cooling off period where the director or an immediate family member is a former employee or executive officer of the listed company or the entity having a threshold financial interest in the listed company. The cooling off period is three years in the US while it is one year in China.

There are also two main distinctions identified here as to the independence standard between the US and China. First, there is a distinction regarding the authority to set down the independence standard, which is the NYSE or NASDAQ in the US but the CSRC in China. In nature, the former is but a private corporation, though with a regulatory function, and not a legislature in the US; while the latter is a government regulatory authority, a delegated legislative authority in China. Second, it is also distinguished by the independence standard's binding force and effect. The NYSE or NASDAQ's independence standard is in nature a corporation's by-law, a self-regulatory rule, while the CRSC's independence standard is in nature the government rule, a delegated legislation. In other words, the former *per se* is not law but the latter *per se* is. Either NYSE or NASDAQ's independence standard is only binding as the company's self-regulatory rules applicable in each individual stock market, which are "voluntary measures that might ward off federal legislation".<sup>436</sup> To be true, both federal acts and state laws generally avoid defining the independence standard, with the peculiar exception of the Investment Company Act

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<sup>436</sup> Roberta S. Karmel "The Independent Corporate Board: A Means to Want End?" (1984) 52 *Geo. Wash. L. Rev.* 534 at 564.

1940.<sup>437</sup> Certainly, the independence standard can be dictated by judicial decisions and courts may elevate it to the case law in the US. In contrast, The CSRC's independence standard is legally binding in force and effect as the delegated legislation applicable in Chinese stock markets because the CSRC is the central government's agency, which is delegated the power to make legal rules at the level of the central government's department in China.

### **6.3 Elements Impacting on Board Independence**

Board independence has become an ingrained part of the monitoring board model and the effective monitor theory suggests that the placement of independent directors on the board is crucial for board independence. "Independence is important because a director's willingness to monitor the CEO increases with his or her independence".<sup>438</sup> No one disputes that the board's primary role is to monitor top management under this model or that independent directors should be effective monitors over rather than beholden "lapdogs" or "puppets" of top management. The question is how to ensure that board independence is not just in form but also in substance so that board effectiveness can be actually achieved and independent directors can be truly "independent watchdogs". Board independence as an optimally chosen behavior, but not as a given trait, is determined by a director's status as an outsider of his/her character as an independent director and there are many elements in play with this character. As mentioned in Section 6.1, literature recognizes such important elements as independent of management, dependent on shareholder, access to information and incentive to monitor which may have substantial influence on board independence and align with the effectiveness of the role of independent directors in monitoring top management. This section discusses them in turn.

#### **6.3.1 Independent of Management**

The fundamental element that has substantial impact on board independence is the board

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<sup>437</sup> Investment Company Act, § 2(19), above n 36.

<sup>438</sup> Hermalin & Weisbach, above 126 at 97.

of directors of a listed company composed of a majority of independent directors who are independent of management. Board composition is closely related to board independence. When the proportion of independent directors increases board independence also increases, which suggests that boards composed of a higher proportion of independent directors have greater monitoring ability over management. Only where board composition reaches the threshold of a majority of independent directors can board independence become effectively to work in practice. In this setting, independent directors are provided a dynamic to potentially play their role as effective monitors. To play their roles effectively, independent directors need first to be independent of management, which means that they should not be subject to interference from management so that they are able to air their independent minds objectively on top management's performance.

Independent of management, as suggested by Robert M. Estes, refers to a position for an outside director “with a considerable history of direct professional and personal involvement in corporate decision-making processes, and with the maturity and perception that will enable him to safeguard the director/shareholder interests without alienating himself from the senior management team” but “with substantial independent means and a temperament to match”.<sup>439</sup> This means that such an outside (independent) director “should be able to take initiatives in aid of, but independent of, corporate management”.<sup>440</sup> As an independent director, he/she should have an independent mind to confront top management with a dissenting voice on the one hand but his/her confrontation may not result in discordant camaraderie in the corporate boardroom on the other hand.

This is really a tough nut for an independent director to crack because board culture upholds a friendly milieu of collective cohesion and top management are uncomfortable with a critical voice in the boardroom. Independent directors “are selected who are known as noncontroversial, friendly, sympathetic, congenial, and understanders of the system”.<sup>441</sup> Otherwise, they “would not be necessary—indeed, would be a detriment—in a world of

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<sup>439</sup> Estes, above n 337 at 114.

<sup>440</sup> Robert M. Estes “The Case for counsel to outside directors” (1976) 54 (4) *Harvard Business Review* 125 at 125.

<sup>441</sup> Mace, above n 157 at 196.

perfectly loyal managers”.<sup>442</sup> Board practice either in the US or in China has been in favour of this kind of board culture and feelings of cordiality and friendliness are the core of this culture. If a board is assumed to be generally independent from management and actively involved in overseeing the firm’s operations the board controlled by independent directors might be a sufficient constraint on management shirking and self-dealing.<sup>443</sup> In this scenario, board independence may be truly effective. Based on this assumption, corporate governance reformers bend themselves for decades to efforts of detaching the relationship between independent directors and top management that would impede such a director’s “substantial independent means and a temperament to match” in performing his/her oversight role over top management so as to enhance board independence effectively. From the “disinterested”<sup>444</sup> relationship in the Investment Company Act to the “significant”<sup>445</sup> relationship in the ALI’s Principles up to the “material”<sup>446</sup> relationship in the NYSE’s listing rules, consensus held by lawmakers and regulators is that this relationship is either financial or familial, which would substantially restrict a director’s independent mind.

Briefly, there is such a “material relationship” that constrains an independent director’s objective judgment. In the dispersed ownership structure like the US, this kind of material relationship happens between independent directors and top management. In the concentrated ownership structure, it is present between independent directors and the largest or controlling shareholder like China. Lawmakers and regulators expect that legal rules could restrain this relationship under which the corporate board would be independent of management and serve as an effective management accountability mechanism. They assume that “directors who are best-suited to monitor managers are those that do not have strong economic or familial ties to the company”.<sup>447</sup> For more than six decades, lawmakers and regulators in the US have tightened up on this kind of material relationship by refining the independence standard to ensure directors independent of management. Chinese

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<sup>442</sup> Stephen M. Bainbridge “Independent directors and the ALI Corporate Governance Project” (1993) 61 (4) *Geo. Wash. L. Rev.* 1034 at 1054.

<sup>443</sup> At 1035.

<sup>444</sup> Investment Company Act, above n 36, § 2(19).

<sup>445</sup> ALI Corp. Gov. Proj. § 3A.01 (a).

<sup>446</sup> NYSE, above n 97, § 303A.02 (a).

<sup>447</sup> Nicola Faith Sharpe “The Cosmetic Independence of Corporate Board” (2011) 34 *Seattle U. L. Rev.* 1435 at 1447.

regulators have also done the same thing when the independent director institution was imported into China.

As discussed in the previous section, law and regulation in the US and China try to tighten this kind of material relationship, either financial or familial, at some point that lawmakers and regulators would believe to be critical for a director to be independent of management. Undoubtedly, it is necessary for law and regulation to define what kind of relationship is the material relationship. The question is whether the material relationship includes only the financial and familial relationships that interfere with a director's ability to be independent of management. Empirical research so far reveals that independent directors who satisfied the independence standard stipulated by law and regulation are not truly independent of management because they have still been subject to the determinations of top management and have usually played little role as an effective management accountability mechanism. This seems a paradoxical dilemma: independent directors in boardrooms have generally passed the independence test required by law and regulation but they are usually not independent of management in reality. Actions speak louder than words and episodes of financial fiascoes in the recent decades provide evidence. Probably, three explanations identified here may account for this dilemma: social ties, structural bias and CEO resistance. They may be blamed for quashing independent directors' financial or familial independence of management.

Social ties mean that independent directors are usually either friends of or those familiar with top management. Friendship implies common interests that share things to the extent that trust is most important.<sup>448</sup> "Without trust, friendship does not exist."<sup>449</sup> Familiarity breeds understanding that trust is expected. Thus, the ties of friendship and familiarity between a director and top management might increase top management's confidence that such a director "will refrain from publicly challenging their position on strategic issues in board meetings or backing opponents".<sup>450</sup> It is true that "[t]he so-called outsiders moreover

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<sup>448</sup> Robert R. Bell *Words of Friendship* (Sage Publications, Beverly Hills, 1981) at 15, 16.

<sup>449</sup> David Krackhardt and Robert N. Stern "Informational Networks and Organizational Crises: An Experimental Simulation" (1988) 51 (2) *Social Psychology Quarterly* 123 at 126.

<sup>450</sup> Westphal, above n 410 at 516.

are often friends of the insiders”.<sup>451</sup> Obviously, such social ties could frustrate an independent director’s impartiality. Even though such a director may be of course independent of management from a financial or familial point of view according to the independence standard, they may not be truly independent of management because it is unlikely for him/her to bite the hand that does him/her a favour. Thus, he/she has been invited by top management to sit in the boardroom just for rubber-stamping the action of management and mollifying the outside stockholders.<sup>452</sup> Empirical research shows that social ties between an independent director and top management do compromise such a director as an effective monitor. Indeed, social ties may enhance top management’s trust on an independent director, which facilitates the board’s advisory function but weakens its monitoring function. Unsurprisingly, it is a common practice that independent directors come from this kind of social ties in the corporate world. The fact that law and regulation fail to exclude those socially associated with top management as independent directors strengthens this practice.

Structural bias refers to the phenomenon that independent directors are not actually biased in favour of inside directors but the former often are predisposed to the latter because independent directors tend to be corporate officers or retirees who share the same views and values as the insiders.<sup>453</sup> The phenomenon comes from the fact that independent directors generally nominated by the incumbent board members, especially CEOs, and passively elected by the stockholders of the company. The predisposition may lead to the deference to top management that these corporate officers or retirees “will view their roles as directors in the same way that they probably wish outside directors on the board of their own companies”.<sup>454</sup> Both phenomenon and predisposition create bias in structure that “the selection process towards directors on whose cooperation and support the incumbents can rely”.<sup>455</sup> Thus, it would place such independent outside directors “in the embarrassing and invidious position of having to pass upon, scrutinize and check the transactions and

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<sup>451</sup> *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987).

<sup>452</sup> Mace, above n 157 at 15.

<sup>453</sup> Bainbridge, above n 442 at 1059.

<sup>454</sup> William T. Allen “Independent Directors in MBO Transaction: Are They Fact or Fantasy?” (1990) 45 *Bus. Law.* 2055 at 2057.

<sup>455</sup> Bainbridge, above n 442 at 1058.

accounts of one of their own body”.<sup>456</sup> When they pass judgments on their fellow directors who designate them to serve the company, the question naturally arises whether a “there but for the grace of God go I” empathy might not play a role.<sup>457</sup> Even though such a judgment has been passed by a board committee overwhelmingly composed of independent outside directors, it is but “a tool of management self-perpetuation”.<sup>458</sup> Consequently, independent directors who are sensible “are at best advisory in character and at worst ornamental”.<sup>459</sup>

CEO resistance suggests that CEOs may develop a fundamental mechanism “to compensate for the loss of structural sources of power over their boards by initiating interpersonal influence attempts toward relatively independent board members”.<sup>460</sup> Reactance in psychology refers to the behavior effect that human beings’ motivation to attain something increases when the threat of losing control over it raises its perceived attractiveness. According to the psychological reactance theory, the reduction or the threat of reduction of a person’s behavioural freedom will arouse his/her motivation that would direct him/her against any further loss of freedom and toward the re-establishment of whatever freedom had already been lost or threatened.<sup>461</sup>

Psychological reactance can cause what is called “boomerang effect”, i.e., “[t]he more a person feels pushed in a given direction, the more reactance will move him in the opposite direction”.<sup>462</sup> In short, a threat to or loss of a freedom may motivate a person to restore that freedom. This theory holds that the structural adjustment of the board and the refining the independence standard has increased board independence to the extent that threatens CEOs’

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<sup>456</sup> *Cumberland Coal & Iron Co. v. Parish*, 42 Md. 598, 606 (1875).

<sup>457</sup> *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (del.1981).

<sup>458</sup> *Norlin Corp. v. Rooney Pace, Inc.*, 744 F.2d 255, 266 (2d Cir. 1984).

<sup>459</sup> Allen, above n 454 at 2056.

<sup>460</sup> Westphal, above n 410 at 514. The word of “reactance” originates from physics, meaning “electronic reaction and resistance”. Psychologists apply the concept of reactance in psychology, meaning to take opposite action in response to an action so as to reduce the influence of this action. Borrowed from psychology, the concept of reactance has also been used by corporate governance scholars. Therefore, “CEO resistance may also be called “CEO reactance”. In this thesis, both CEO resistance and CEO reactance are used interchangeably.

<sup>461</sup> Jack W. Brehm *A Theory of Psychological Reactance* (Academic Press, New York, 1966) at 2.

<sup>462</sup> Robert A. Wicklund *Freedom and Reactance* (John Wiley & Sons, New York, 1974) at 4.

discretion and thus motivates them to maintain this discretion by using such interpersonal influence tactics as persuasion and ingratiation. In other words, board independence threatens the CEO's control and this develops the CEO reactance, i.e., the threat of losing this control increases its attractiveness, which motivate the CEO to restore it. In taking advantage of their positions to face the structural disadvantage from greater board independence, CEOs may exploit their superior firm-specific expertise to persuade independent directors to support their existing projects; or they may increase their personal attractiveness to ingratiate independent directors by using what are called "impression management tactics" such as opinion conformity, other-enhancing communications or flattery, self-enhancing communications and favor doing.<sup>463</sup> Empirical findings indicate that "CEOs' interpersonal influence behaviors mediate the effects of increased structural board independence"<sup>464</sup> and lawmakers and regulators' efforts of refining the independence standard.

### 6.3.2 Dependent on Shareholders

Financial and familial independence of management may be necessary conditions for board independence to ensure the board's effective monitoring role. Unfortunately, either of them or both *per se* are hardly sufficient to guarantee the board truly independent from management so as to play its oversight role effectively. As analyzed in Section 6.3.1, social ties, structural bias and CEO reactance may be explained for this dilemma. If taking the analysis further, it can be observed that CEOs may be directly or indirectly accused of these ideological and social obstacles in the nomination process of independent directors. This suggests that independent directors nominated by CEOs either directly or indirectly still face the problem of conflict of interests between management and stockholders, which makes independent directors in fact independent of stockholders of whom they should be on behalf even though they are independent of management in compliance with the independence standard.

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<sup>463</sup> Westphal, above n 410 at 514.

<sup>464</sup> At 529.



Gilson and Kraakman in the early 1990s criticized that corporate governance reforms in the US are too often focused on merely making independent directors “independent of management, rather than *dependent* on shareholders”.<sup>465</sup> Davies in 1993 suggests that making independent directors independent of management is only half the task and independence of management can only be received in a reliable way by making independent directors dependent on another powerful group within the company.<sup>466</sup> Namely, independent directors should be linked up with “the shareholders, meaning in particular the institutional shareholders”.<sup>467</sup> Indeed, “[t]he independence of directors from the firm’s executives does not imply that the directors are dependent on shareholders or otherwise induced to focus solely on shareholder interests”.<sup>468</sup> They should be seen as “dependent” on shareholder choice and act accordingly.

Reasonably, the proposition of making independent directors dependent on shareholders is based on the shareholder theory, presumably aiming to activate the shareholder activism to cure the failure of making independent directors independent of management. Indeed, shareholder activism, especially institutional activism, has a real potential to boost this proposition and episodes of such activism are evident in the United States. Shareholders, especially institutional investors and independent directors, are two essentials in board independence. This is not only because independent directors are key players in board independence but also because shareholders, especially institutional investors, are potentially a powerful group which could be expected to exert its prevailing influence on board independence. In a sense of internal control, independent directors and shareholders are only two potential players who can play in board independence, bearing in mind the agency relationship between them. Only if independent directors can become actually dependent on shareholders can they be truly independent of management. Shareholder activism could play its role in this scenario. Accordingly, the key for independent directors to be dependent on shareholders is how to link up independent directors with shareholders

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<sup>465</sup> Gilson & Kraakman, above 170 at 881.

<sup>466</sup> Paul L. Davis “Institutional Investors in the United Kingdom” in D.D. Prentice and P.R.J. Holland (eds.) *Contemporary Issues in Corporate Governance* (Clarendon Press, Oxford, 1993) at 93.

<sup>467</sup> At 94.

<sup>468</sup> Lucian A. Bebchuk “The Case for Shareholder Access to the Ballot” (2003-2004) 59 *Bus. Law.* 43 at 49.

and thus hold independent directors accountable to shareholders. In reality, it is however a different story. “Independent of management, perhaps; but dependent on shareholders, hardly.”<sup>469</sup> Probing into the reasons that might be answerable for this reality, there may be mainly three, i.e., shareholder apathy, board disregard and regulatory barrier.

Shareholder apathy suggests that shareholders usually lack incentives of “*proactive* efforts to change firm behavior or governance rules” so as to enhance “the overall importance of shareholder monitoring as a constraint on corporate managers”.<sup>470</sup> In theory, shareholders as the residual claimants of the company’s assets are the ultimate owners of the company. They have the right to manage the company. In practice, they delegate the right to the board of directors of the company. This is owing to the nature of atomization of their ownerships which make them impractical to manage the company themselves. Even so, they still retain the oversight right to restrain management’s misbehaviours and exercise this right effectively by way of shareholder proposal. To exercise the oversight right, the most important task is to select or dismiss the board of directors by voting for or against via shareholder proposals the board members in the company’s annual shareholders meeting. In reality, they rarely do this and most proposals are “precatory”.<sup>471</sup> As an aggregation on behalf of individual investors, institutional investors are expected to play an important role in shareholder activism in view of their influential voting powers via their concentrated shareholdings. Regrettably, they usually act individually as “a lone wolf”<sup>472</sup> and at most “jawboning” management for some changes in companies that they are dissatisfied. Nonetheless, they rarely nominate their representatives to the board of their portfolio companies.

Shareholder activism requires coordinated actions through proxy fights but it is difficult to arrive at such coordinated shareholder activism. In addition to the problems of free rider and agency cost identified in literature, incentive to invest is probably the main concern for

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<sup>469</sup> Gilson & Kraakman, above 170 at 881.

<sup>470</sup> Black, above n 150 at 459.

<sup>471</sup> John C. Coffee, Jr. “The SEC and the Institutional Investor: A half-Time Report” (1993-1994) 15 *Cardozo L. Rev.* 837 at 883.

<sup>472</sup> Black, above n 150 at 461.

shareholder apathy. Profit is the incentive for an investor to invest in a company. In a stock market, profit maximization does not rest with corporate governance and firm performance but market manipulation, which can create a company but can destroy it as well. This is the two sides of a story. There is no stock market without market manipulation. Stock means speculation, which is characterized as a built-in nature of manipulation. Institutional investors are key players in market manipulation by controlling stock price fluctuation through buying and selling stocks. Law can regulate market manipulation but it cannot stop market manipulation. It is just like the situation in insider dealing. Law can regulate insider dealing but it cannot stop insider dealing. What law can do is to protect the victims of market manipulation or insider dealing. This is especially the case of vulnerable individual investors. Individual investors are usually following suit and thus become institutional investors' victims. Stock price difference rather than stock dividend is the biggest concern for profit and those greedy for the biggest profit will not hold such stocks any longer no matter how good corporate governance and firm performance of these companies is. This nature of the incentive to invest certainly runs counter to shareholder activism. Literature is rich in shareholder activism such as the derivative action and M&A but it is unusual in shareholder proposal regarding board independence especially the nomination of independent directors. Clearly, the former directly or indirectly connects with shareholders' incentive for profit while the latter does not.

Board disregard means that “[a] company’s board of directors can, and often does, ignore a majority shareholder vote for a proposal”.<sup>473</sup> This disregard keeps shareholders voting for managerial proposals and curbs their incentives to make proactive efforts to make changes, both of which foster shareholder apathy. The board of directors is a governance body delegated by shareholders based on the agency relationship and is bound to act on behalf of shareholders. From an agency angle, shareholders as principals have the right to supervise the board acting as their agents. In practice, they are reluctant to exercise their supervision right. This is because shareholders have no any means to supervise the board other than shareholder proposal, which is however at the mercy of the board. Otherwise, they can only either be subject to the market for corporate control or follow the Wall Street

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<sup>473</sup> At 460.

Rule (i.e., to sell stocks and leave the market).

It is true that the board should not be dictated by every wish of shareholders that has been put into a shareholder proposal. However, it would be disappointing if shareholders feel their rights to be ignored and their voices to be unheard. It may be argued that shareholders can just sell their stocks and leave the market if they are not happy with companies they invest. For individual investors, it is possible for them to sell stocks and leave the market. For institutional investors, this is not always the case in view of their large stockholding portfolios. In this situation, institutional investors may prefer their voices to be heard by way of shareholder activism, which is usually in the form of institutional investor activism. The feeling of their rights to be ignored and their voices to be unheard may definitely asphyxiate shareholders' incentives to make proactive efforts to effectuate their shareholder activism. Shareholder activism is the way that shareholders can express their voices in corporate governance.

Law provides protection to shareholder activism so that shareholders' voices can be heard. One way of this protection is by means of shareholder proposal. The issue is whether the board can pay attention to shareholder proposal and implement it when it comes to the board. If shareholder proposal is usually disregarded or unimplemented by the board shareholder activism will be discouraged. In reality, the actual number of shareholder proposals implemented falls on the lower end of the scale because shareholder proposals are generally negative and fail to gain management support.<sup>474</sup> This means that such shareholder proposals have usually been disregarded by the board of directors.

Shareholder activism is a double-edged sword which serves both "as a way to improve governance procedures and as a signal of investor displeasure with management".<sup>475</sup> In case of board independence, shareholders have the right to do both via shareholder proposals either by nominating candidates who are potential independent directors to the

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<sup>474</sup> Marc Weingarten, Schulte Roth & Zabel LLP "2012 Shareholder Activism Insight Report" November 26, 2012 at <http://blogs.law.harvard.edu/corpgov/2012/11/26/2012-shareholder-activism-insight-report/>

<sup>475</sup> Black, above n 150 at 460.

board or by removing those from the board who fail to carry out their duties as effective monitors. If shareholders' voices can be heard in nominating and removing independent directors by way of shareholder proposal independent directors can be really dependent on shareholders. Although shareholders' voices such as a precatory vote on say-on-pay on the corporate ballot become stronger and may attract the board's attention after the Dodd-Frank Act of 2010 their voices of nominating and removing independent directors are still weak and may not attract the board's attention in the corporate proxy fight. Board disregard, even if it does not stifle but it at least discourages both, can do no good to shareholder activism. Consensus is that majority voting to select independent directors is at the heart of today's shareholder activism. Without this double-edged sword, a CEO "believes that he is indeed only one man" and there is no monitoring management "to be gained by having the involvement of outside (independent) directors".<sup>476</sup>

Regulatory barriers suggest that legal rules create "obstacles to shareholder voice" and thus "obstruct individual and collective shareholder action".<sup>477</sup> To exercise shareholder voice and take collective shareholder action is by way of shareholder proposals and a proxy fight enables shareholder proposals to be included in company proxy materials for the shareholder voice to be heard. A proxy fight needs coordinated shareholder action due to the dispersed nature of the ownership structure of shareholders. To launch proxy fights, shareholders first need to qualify for proxy access, which is regulated by legal rules. Thus, proxy access is important for shareholders to be able to present their proposals into company proxy materials. Generally, legal rules endow shareholders with proxy access but they also set restrictions which become regulatory barriers to facilitate shareholder voice.

As regards board independence, "[l]egal obstacles are especially great for shareholder efforts to nominate and elect directors, even to a minority of board seats. The proxy rules, in particular, help shareholders in some ways, but mostly hinder shareholder efforts to nominate and elect directors."<sup>478</sup> Legal obstacles may disenable shareholders with small

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<sup>476</sup> Mace, above n 157 at 70.

<sup>477</sup> Bernard S. Black "Shareholder Passivity Reexamined" (1990) 89 (3) *Michigan Law Review* 520 at 525.

<sup>478</sup> At 523.

individual stakes to act collectively, which forecloses shareholders' ability to form an effective voting coalition. Thus, "[t]he modern proxy contest has become a grotesque travesty of an orderly machinery for corporate decision making".<sup>479</sup> Three legal obstacles are main concerns in the US, i.e., the Exchange Act 1934 section 13(d)(1), section 14(a)(1) and section 16(a)(1).

Section 13(d)(1) requires that any person as a beneficial owner owning more than 5% of a public company's stocks, directly or indirectly, needs to file a Schedule 13D disclosure form to the SEC.<sup>480</sup> When more than two persons act as a group for the purpose of acquiring, holding or disposing of securities of an issuer such a group shall be deemed a "person" under Section 13(d)(1).<sup>481</sup> The SEC stretches that so that a shareholder consortium formed to influence company policy through the voting process is such a group.<sup>482</sup> Section 14(a)(1) bars any person by any means or instrumentality for illegal solicitation for proxy fight.<sup>483</sup> This solicitation includes a nominee submitted by a shareholder to serve on the board of directors of the issuer.<sup>484</sup> Section 16(a)(1) requires every person, directly or indirectly, as a beneficial owner of more than 10% of any class of any equity security of an issuer need to file a Rule 16D statement to the SEC.<sup>485</sup> If such a person nominates and elects a member of the board, the SEC takes the view that this person not only has "expressly or impliedly 'deputized' an individual to serve as its representative on a company's board of directors"<sup>486</sup> but also has had the "directly or indirectly controlling"<sup>487</sup> power to direct the management and policies of the company through the ownership of voting securities. "The message that these legal rules convey to shareholders is: Be quiet, and no one will bother

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<sup>479</sup> Bayless Manning "The American Stockholder by J. A. Livingston" (1958) 67 (8) *Yale L. J.* 1477 at 1488.

<sup>480</sup> Securities Exchange Act 1934 (USA), §13(d) (1). Pub. L. 112-158, title II, 219(a), Aug. 10, 2012, 126 Stat. 1235.

<sup>481</sup> *Ibid.*, §13d (3).

<sup>482</sup> SEC Rule 13d-5(b) (1), 17 C.F.R. §240.13d-5(b) (1) (1990).

<sup>483</sup> Securities Exchange Act, above n 480, §14(a) (1). The SEC mended its proxy Rule 14a-8 and finalized its proxy access Rule 14a-11 on November 15, 2010, aiming to improve shareholders' nomination and selection of members of the board of directors of an issuer. However, Rule 14a-11 was vacated by the District Court of Appeals of the US on July 22, 2011(see *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011)).

<sup>484</sup> *Ibid.*, §14(a) (2) (A).

<sup>485</sup> *Ibid.*, §16(a) (1).

<sup>486</sup> Exchange Act Release No. 26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,343, at 89,602 (Dec. 2, 1988).

<sup>487</sup> Securities Exchange Act, above n 480, §12(b) (2).

you. Be too active, and you'll pay the price.”<sup>488</sup> That is, group solicitation, deputization and controlling power may cause shareholders to face legal risks.

### 6.3.3 Access to Information

The need for access to information derives from information asymmetry between management and independent directors. Information asymmetry means that at the time of decision-making, the *sine qua non* information is known to management but not to independent directors as management possesses the information available to independent directors. This may be explained by the fact that independent directors as outsiders of the company are disadvantaged in their access to the company information, compared with management who as insiders of the company enjoys superior informational advantage based on their full-time status and inside knowledge. Taking advantage of this, management controls information available to independent directors, who can only passively rely on management for information access. Information asymmetry gives rise to what is referred to as the “independence paradox”: in obtaining adequate information, independent directors are dependent on management they are expected to monitor and to be independent from.<sup>489</sup> “Voluntary disclosure theory hypothesizes that, given the risk of job loss accompanying poor stock and earnings performance, managers use corporate disclosures to reduce the likelihood of undervaluation and to explain away poor earnings performance.”<sup>490</sup> Management, thus, plays “end games” by cutting and running undisclosed strategic decisions before corrective measures can be taken and managers commonly disclose information selectively or distort data.<sup>491</sup>

Undoubtedly, this kind of concealment and distortion undermine independent directors’ objective judgments on the merits and demerits of managerial projects and should be

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<sup>488</sup> Black, above n 477 at 533.

<sup>489</sup> Reggy Hooghiemstra and Jaap van Manen “The Independence Paradox: (im)possibilities facing non-executive directors in The Netherlands” (2004) 12 (3) *Corporate Governance* 314 at 314.

<sup>490</sup> Paul M. Healy and Krishna G. Palepu “Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature” (2001) 31 *Journal of Accounting and Economics* 405 at 421.

<sup>491</sup> Oliver Williamson “Corporate Governance” (1984) 93 *Yale L. J.* 1197 at 1211.

checked. This is because “greater board independence [is expected] to be linked to more transparency, better monitoring, and increased voluntary disclosure”.<sup>492</sup> Information asymmetry between management and independent directors weakens board independence since concealed and distorted information disclosed by management to independent directors undercuts the board’s monitoring quality. Arguably, the board composed of a majority of independent directors is devised to promote the expectation of increased voluntary disclosure by management as a check against managerial concealment and distortion in information disclosure.

Board independence may be an indicator of the board’s monitoring quality, which is however dependent on the quality of information disclosed to the board. The quality of information that the board can access is important when considering the board’s abilities to reduce information asymmetry and to monitor management.<sup>493</sup> In order to effectively execute its monitoring function, the board needs access to quality information, especially unconcealed and undistorted information regarding the company’s strategic operation, so that the board can act on such information to objectively evaluate managerial discretion and make decisions on management projects. With poor information, the board cannot monitor effectively. By this token, information asymmetry plays an adverse role on board independence. That is, the strength of board monitoring may decrease with the presence of information asymmetry, even though the degree of board independence increases. Clearly, information asymmetry creates “independence paradox” and detains independent directors’ access to quality information. This shows that information access is critical for the board to function as an effective monitoring mechanism in checking the credibility of management’s self-serving voluntary disclosures, “while allowing management to retain the flexibility necessary to operate in a dynamic environment”.<sup>494</sup> Clearly, access to information needs to overcome information asymmetry.

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<sup>492</sup> Ray Donnelly and Mark Mulcahy “Board Structure, Ownership, and Voluntary Disclosure in Ireland” (2008) 16 (5) *Journal Compilation* 416 at 418.

<sup>493</sup> Matthew A. Rutherford and Ann K. Buchholtz “Investigating the Relationship Between Board Characteristics and Board Information” (2007) 15 (4) *Corporate Governance* 576 at 578.

<sup>494</sup> Jerilyn W. Coles and William S. Hesterly “Independence of the Chairman and Board Composition: Firm Choices and Shareholder Value” (2006) 26 (2) *Journal of Management* 195 at 201.



In theory, information asymmetry may be created by management's manipulation of information flow between management and independent directors. This manipulation of information flow creates what is called a "structural hole" in sociology, which can connect or disconnect separated non-redundant contacts in a social network.<sup>495</sup> To put it another way, when two contacts are distinct and lack ties to each other, the gap between them is a structural hole.<sup>496</sup> A structural hole can create either a chasm or a bridge between two separated contacts, which can serve two opposite purposes: connect or disconnect with two separated contacts. This provides an opportunity for a player in a social network to maneuver the structural hole for his/her own benefits. There are two kinds of network benefits that a structural hole can provide: information and control.<sup>497</sup> "The information benefits of structural holes might come to a passive player, but control benefits require an active hand in the distribution of information."<sup>498</sup>

Positioned in a structural hole, a player can control the flow of information between two separated contacts in a social network. A player who is good at taking advantage of information and control of a structural hole is called a network "entrepreneur",<sup>499</sup> who is thus "best positioned for the information and control that a network can provide".<sup>500</sup> As a network entrepreneur, a player can play on his/her position in a structural hole by either bridging or creating a chasm for the purpose of controlling the flow of information between two separated contacts. When a player bridges a chasm in a structural hole there is information access between two separated contacts. When a player creates a chasm in a structural hole there is no information access between both contacts. When a player controls information access he/she can allow information access at his/her own preference. In this case, a player creates information asymmetry because he/she holds and distributes information to his/her advantage but puts others at disadvantage.

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<sup>495</sup> Ronald S. Burt *Structural Holes: The Social Structure of Competition* (Harvard University Press, Cambridge, Massachusetts, 1992) at 18. Burt defines that "a structural hole is a relationship of nonredundancy between two contacts". Nonredundant contact means either direct disconnection with or indirect exclusion from one another in a social network.

<sup>496</sup> Lawrence E. Mitchell "Structural Holes, CEOs, and Informational Monopolies (2004-2005) 70 *Brook. L. Rev.* 1313 at 1321.

<sup>497</sup> Burt, above n 495 at 47.

<sup>498</sup> At 34

<sup>499</sup> Ibid.

<sup>500</sup> At 49.

Corporate governance scholars apply the structural holes theory to explain information asymmetry in corporate structures and the potential deformities that asymmetry causes. In the corporate world, a corporation is a social network, and so is a board of directors. The application of the structural holes theory in a social network such as the board of directors aims to provide an explanation for information asymmetry between management and independent directors that has impact on board independence. It reveals the power of the position that a corporate player has to play on information control. Management and independent directors are two separated contacts in a structural hole in the network of the board of directors. Both management and independent directors, seen individually or as a whole, are also two corporate players in such a structural hole. According to the structural holes theory, a player who can identify the chasm and bridge it in a structural hole is in a position not only to receive information but also to control the flow of information.

In a social network of the board of directors, the power of the position that management or independent directors has is significantly different. In contrast to independent directors, management is obviously in a position of a network entrepreneur who has the monopoly power of information control. This means that management has the preference to decide the quantity and quality of information disseminated to independent directors. In this scenario, management can actively enjoy both information and control benefits while independent directors can only passively obtain information at the behest of management. That is to say, management places themselves in an advantageous position to receive and distribute information as desired.

Collectively, management as an integration of inside directors is one contact in a structural hole in a social network of the board of directors and independent directors as a whole another contact. As a director, each inside director is also an individual contact in such a social network, which suggests that there may be potentially more than one structural hole in the same social network composed of more than one inside director. The same is true of an independent director. As suggested by the structural holes theory, the structural hole provides the opportunity. The more structural holes the more opportunities, which suggest

more potential for access to information. It is just the proliferation of structural holes by way of increasing more opportunities for independent directors to access information that diminishes information asymmetry and enriches the flow of information in a social network. This is the value of the theory, although it is also a theory of manipulation.<sup>501</sup> Although a cliché, the theory may arguably explain information asymmetry caused by access to information manipulated by management between management and independent directors.

In the context of the board of directors, to identify and bridge more structural holes mean to find more potential for access to information. In a supermajority-independent board, there is usually one or two inside directors, i.e. CEO or CEO and CFO, on the board. In this social network, there may be one or two structural holes. In a majority-independent board, there are usually more inside directors other than the CEO and CFO on the board. Potentially, there are more structural holes in such a social network. No matter of what kind of board model, the CEO as a network entrepreneur plays an important role in creating and bridging a structural hole, especially under the board leadership structure of CEO duality. In a social network of the supermajority-independent board, the CEO may be the only network entrepreneur, who occupies the power of the position to bridge the only structural hole and maneuver the flow of information to independent directors. In a social network of the majority-independent board, there are potentially more network entrepreneurs other than the CEO, whose position to manipulate the flow of information may be weakened by other network entrepreneurs. The implication is that more inside directors other than the CEO on the board may provide much more potentials for independent directors to access to information. In this way, “independent directors have sources of information independent of the CEO”.<sup>502</sup> It suggests that information asymmetry can only be reduced or eliminated if the structural opportunities, as suggested by the structural holes theory, for top management to control and manipulate information are reduced or eliminated.

#### 6.3.4 Incentive to Monitor

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<sup>501</sup> Mitchell, above n 496 at 1326.

<sup>502</sup> At 1347.

The quality of board independence may be dependent on the independent directors' incentive to monitor management. This can be explained by the conventional assumption that the board's ability to effectively monitor management is a function of board independence, whereas the desire of independent directors to effectively fulfil the board's monitoring responsibility is signaled by the extent to which independent directors are independent from management. Agency theory takes the view that incentive is a prerequisite to effective monitoring and the dependence of an independent director on management engenders disincentive to monitor management. Following this line of reasoning, the independent directors' incentive to monitor is also critical to board independence. From a psychological viewpoint, incentive is a kind of desire, motivation or expectation that drives one to do something. Specifically, incentive is the willingness of a person to contribute his/her individual effort to a cooperative system where his/her egotistical motives of self-preservation and self-satisfaction are satisfied.<sup>503</sup>

Obviously, willingness to contribute efforts is indispensable for a person to join in a cooperative system. However, people will not work for what they are not convinced is "worthwhile".<sup>504</sup> A person's choice to enter into a specific cooperative system is based on his/her desire or motive of the moment if alternatives external to the person recognized by him/her are available.<sup>505</sup> In other words, people are usually motivated to make contribution to a course of enterprise that they believe they are satisfied for their self-preservation and self-satisfaction. Human beings are selfish creatures driven by hungering for self-preservation and self-satisfaction. When recognition of something worthwhile is absent, the motivation to participate is missing; when awareness of something worthwhile exists, the desire to contribute emerges; when expectation of something worthwhile ceases, willingness to contribute disappears. The continuance of willingness is however dependent on the satisfaction that can be secured in the process of the contribution. "If the satisfactions do not exceed the sacrifices required, willingness disappears ... If the satisfactions exceed

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<sup>503</sup> Chester I. Barnard *The Functions of the Executive* (Harvard University Press, Cambridge, 1938) at 139.

<sup>504</sup> At 151.

<sup>505</sup> At 17.

the sacrifices, willingness persists”.<sup>506</sup> Hence, incentive to induce contribution is necessary for human beings to devote their efforts to a course of enterprise that they are satisfied for their hungering for something “worthwhile”.

Incentive is fundamental to conscious effort to contribute. “Organizations distribute incentives to individuals in order to induce them to contribute activity”.<sup>507</sup> The central incentive predicts contributors’ basic preoccupations: to create and state organizational purposes in such a way to maintain contribution of effort.<sup>508</sup> Self-preservation and self-satisfaction are two basic instincts in human beings that incentive can be induced, i.e., willingness to contribute. The former is to avoid exposing oneself to cost-taking like harm or risk, which is the negative side of incentive, and the latter is to enjoy oneself with benefit-gaining like reward or achievement, which is positive side of incentive. Incentive is also either positive or negative. When facing an incentive or incentives, people usually take both into account and make a balance or trade-off. This is especially true of the nature of an incentive offered to them.

Incentive is different in nature, material (money, things or physical condition) or non-material (distinction, prestige, personal power or dominant position).<sup>509</sup> Material incentive is offered for physical satisfaction while nonmaterial incentive is offered for psychological gratification. If material or nonmaterial incentives are unable to afford physical satisfaction or psychological gratification adequately, willingness to contribute will perish unless it can be changed by persuasion such as coercion, rationalization or inculcation that incentive to offer will be adequate.<sup>510</sup> In this sense, persuasion may be a kind of indirect incentive. However, a caveat should be noticed that persuasion, especially coercion, may work against a willingness to contribute.

A brief analysis of the theoretical implications of incentive above aims to explain the

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<sup>506</sup> At 82.

<sup>507</sup> Peter B. Clark & James Q. Wilson “Incentive Systems: A Theory of Organizations” (1961) 6 (2) *Administrative Science Quarterly* 129 at 129.

<sup>508</sup> At 146.

<sup>509</sup> Barnard, above n 503 at 142, 145.

<sup>510</sup> At 149.

psychological force behind desire or motive that affects human beings' behaviors in participating in a cooperative system and contributing to a course of enterprise. The board of directors is a cooperative system and monitoring management is a course of enterprise to which independent directors are required to contribute their efforts. All things being equal, incentive to monitor should be by no means ignored for independent directors to be willing to contribute their efforts, which ensures the quality of board independence. This suggests that independent directors' willingness to contribute may be the determinant to their incentive to monitor. Otherwise, board independence will still not be truly realized even though other elements such as independence of management, dependence on shareholders and access to information are all satisfied. So, incentive to monitor is also a must for board independence.

In connection with independent directors' efforts to contribute in monitoring management, the literature identifies three kinds of incentives: financial reward, reputational capital and legal obligation.<sup>511</sup> Financial reward is a material incentive and reputational capital is a nonmaterial incentive, both are direct incentives; while legal obligation is persuasion, a coercion that is an indirect incentive. Theories are rich in proposing the positive side of these incentives but empirical evidence is mixed in support of the theoretical propositions; more prevalent is the negative side of these incentives.

Financial reward is probably the main kind of incentive offered to independent directors in the form of salary and stocks. Psychological research shows that financial reward is an effective motivator of performance when it is important to people for their subsistence and it is tied to their performance.<sup>512</sup> For most people, there is no problem in using financial reward as a motivator. The critical inquiry is whether a relationship is perceived to exist between financial reward and performance for people when the bare physiological necessities for subsistence are satisfied, especially the quantity of financial reward is

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<sup>511</sup> Tod Perry "Incentive Compensation for Outside Directors and CEO turnover" (1999) (paper presented at Tuck-JFE Contemporary Corporate Governance Conference), available at SSRN: <http://ssrn.com.ezproxy.auckland.ac.nz/abstract=236033> at 3. Also see Lin, above n 172 at 940.

<sup>512</sup> Edward E. Lawler III "Pay for Performance: A Motivational Analysis" in Haig R. Nalbantian (ed.) *Incentives, Cooperation, and Risk Sharing: Economic and Psychological Perspectives on Employment Contracts* (Rowman & Littlefield, Totowa, 1987) at 69.

relatively very small. Barnard claims that, “unaided by other motives, they constitute weak incentives ... Hence, there has been a forced cultivation of the love of material things among those above the level of subsistence”.<sup>513</sup>

Independent directors are generally those who are well above the level of subsistence and the financial rewards for their contributions to companies they serve as monitors are indeed very small, either in salary or in salary and stocks, compared with their main financial rewards at their own organizations as full-timers. From a cost-benefit analysis aspect, financial reward has its most powerful effect when it is sufficiently valued, that is, benefit is larger enough than cost. However, there is anecdotal evidence showing that even the wealthiest persons appear to be motivated by relatively small financial rewards.<sup>514</sup> Some empirical research confirms that “corporate directors appear to perform for even very small financial rewards” based on “an incentive effect: directors seem to change their attendance behavior in response to changes in meeting fees”.<sup>515</sup> Indeed, meeting fees as a financial reward can motivate independent directors to attend board meetings, saying nothing of salary and stocks. Financial incentive does matter. Then, the question is how big the financial reward is “sufficiently adequate” for independent directors to contribute their efforts not in passive attendance but in active participation, i.e., linking financial reward to effective performance. The dilemma is what “sufficiently adequate” is reasonable, neither too low to motivate independent directors as effective monitors, nor too high to entrench them management-orientated.

Reputational capital is the psychological attainment of prestige and distinction that can be used as investments for opportunities of further achievements. People are usually motivated by opportunities for distinction, prestige, personal power and dominant position

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<sup>513</sup> Barnard, above n 503 at 143.

<sup>514</sup> Julius Lowenthal “Every man has his price; in Some Cases, 13 Cents” (July 1990) *Spy* 80-84. *Spy* Magazine conducted an experiment by sending checks of \$1.11 to 58 wealthiest Americans and ensured the checks actually reached them. 26 of 58 deposited the checks. Checks for \$0.64 were then sent to these 26 and 13 of them cashed the checks. Checks for \$0.13 were then sent to the final 13 and two people deposited the checks. This anecdote shows well that even the wealthiest people can be motivated by a tiny financial reward, no matter however trivial, to contribute their efforts, i.e., to cash or deposit checks.

<sup>515</sup> Renee B. Adam & Daniel Ferreira “Do directors perform for pay?” (2008) 46 *Journal of Accounting and Economics* 154 at 154.

and they think a lot about obtaining such opportunities. For them, these opportunities mean the high achievements that lead to high social standings and more opportunities for further accomplishments. The chance to obtain a reward such as prestige and distinction is an important ingredient in people's motivation to contribute their constructive efforts. So, a sense of accomplishment is essential in maintaining the force of incentive.<sup>516</sup> From people's point of view, a powerful incentive to their efforts is an associational condition for them to move up in the ladder of high social standing. Reputational capital is just such a powerful incentive. "Corporation officials are strongly motivated by personal prestige and by prestige of the firm."<sup>517</sup> A directorship of a board of directors is an opportunity for achieving distinction and prestige in a company, especially in a very big publicly held company. "The personal prestige which membership provides is often a strong incentive. Board members not only contribute prestige to such boards, but their own prestige is enhanced through association with other high-status community figures and with institutions themselves."<sup>518</sup>

Independent directors are such corporation officers who are influenced by their desire to maintain good reputation for their directorships as monitors. They are usually "professional referees"<sup>519</sup> of management actions who have invested greatly in developing their prestige and distinction as "experts in decision control".<sup>520</sup> Their directorships in well-performing companies may signal the value of their reputational capitals as effective monitors to the independent director market, which can attract the boards of other companies for additional directorships.<sup>521</sup> Indeed, independent directors who accept board memberships do so for the prestige value derived from an identification with other impressive names.<sup>522</sup> Unfortunately, this motivational force does not encourage them to "devote more than casual amounts of time to the fulfillment of any significant standards of performance".<sup>523</sup> The reason is simple: they are all busy persons who have their own primary responsibilities

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<sup>516</sup> Clark & Wilson, above n 507 at 148.

<sup>517</sup> At 166.

<sup>518</sup> At 141.

<sup>519</sup> Fama, above n 169 at 293.

<sup>520</sup> Fama & Jensen, above n 171 at 315.

<sup>521</sup> Lin, above n 172 at 917.

<sup>522</sup> Mace, above n 157 at 109.

<sup>523</sup> Ibid.



in their own organizations. Thus, even though high motivated, their willingness to contribute their efforts as monitors at other companies is limited. Monitoring management is a rigorous task that requires independent directors to put their constructive efforts into it. Clearly, limited willingness to contribute has a negative impact on independent directors' reputational capital and it can moderate their motivation to execute this rigorous task. This suggests that reputational capital can affect the willingness to contribute but it may not independently affect the magnitude of efforts to contribute. So, reputational capital by itself is not sufficient to be an effective incentive to monitor.

Legal obligation is a mechanism in law that exists to provide independent directors with incentives to act independently from management.<sup>524</sup> Law requires actions that should be taken or not be taken. Thus, it is an incentive offered by law, which is binding. As a legal incentive, legal obligation has two distinct characteristics: persuasion and discipline. Persuasion gives the direction that actions should follow and encourages action, which has the positive effect of a legal incentive. Discipline corrects actions that deviate from the direction and discourage action. The benefit of legal obligation is to offer legal reward and the cost of legal obligation is to incur legal risk. For an independent director, monitoring management is a legal obligation required by law. The benefit of the monitoring obligation is the directorship and the cost of this obligation is the effort put in. In law, directors have fiduciary duties when performing their responsibilities as directors. Failure to meet these fiduciary duties can result in liabilities, which impose legal risk such as litigation on directors. There is no difference in law as regards fiduciary duties between management (inside directors) and independent directors. Both have the same duties and face the same liabilities when executing their responsibilities. However, both have different responsibilities: management is responsible for decision-management, while independent directors are responsible for decision-control. For management, decision-management is their primary responsibilities; for independent directors, decision-control is their secondary responsibilities.

Two concerns may come to mind when independent directors exercise their responsibilities.

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<sup>524</sup> Perry, above n 511 at 3.

One is that decision-management is the business of management and interfering with it should be avoided. Another is that decision-control is to approve management projects and it is but a procedural routine. These concerns are probably connected with their financial reward measured by their inputs in time and energy. In addition, information asymmetry increases their inputs in time and energy if they seek to access to adequate information, which is not financially rewarded and also increases the difficulty of their jobs. This creates a dilemma: if they put in more time and energy the cost of their inputs increase but the benefits do not; if they do not they fail to perform their fiduciary duties and incur legal risk. Legal risk may be a threat even under the protection of the business judgment rule. Although this threat does not usually happen, it is realistic.<sup>525</sup> Therefore, a balance between benefit-gaining and risk-taking has to be considered when independent directors accept a directorship and discharge their fiduciary duties, even though legal obligation is mandatory. When risk-taking cannot be compensated by benefit-gaining, legal obligation may have a negative effect, i.e., discouraging independent directors from taking up the directorship or actively performing their fiduciary duties.

#### **6.4 Independent Directors as a Governance Mechanism in China**

Board independence aims to effectuate independent directors' oversight function in corporate governance. This function is carried out by independent directors via attending board meetings and airing independent opinions. As a corporate governance mechanism, independent directors should attend board meetings and air their independent opinions objectively on companies' affairs in order to accomplish their oversight function on management performance. This section investigates independent directors who attend board meetings and air their independent opinions in Chinese listed companies after the release of the Guidance Opinion by the CSRC in 2001 so as to examine the reality of independent directors as a governance mechanism as claimed by the Guidance Opinion.

##### **6.4.1 Attendance at Board Meeting**

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<sup>525</sup> For example, Enron's independent directors were sued for their failure of performing their monitoring duties on Enron's financial frauds of management.

Attending board meetings is the basic way that a director to execute his/her fiduciary duties as a director, which is particularly true of an independent director as a part-timer. Without attending board meetings, independent directors would not be able to discharge their fiduciary duties. Thus, attending board meetings is *prima facie* what independent directors should do in performing their monitoring role. For that reason, the Guidance Opinion specifies that the board should propose in the general meeting of shareholders to replace an independent director who has been absent personally from three consecutive board meetings.<sup>526</sup> This suggests that attending board meetings can be used to evaluate independent directors as a governance mechanism. Table 6.4.1(a) shows the distribution of independent directors who attend the board meetings in Chinese listed companies in the period of 2004-2012.

From Table 6.4.1(a), it can be seen that the number of independent directors who attend board meetings increased yearly from 2004 to 2011, except for that in 2012 when there was a sharp decrease of 79.09%, compared with the year before, and this is really an abnormal phenomenon. The mean of attending board meetings by each independent director also increases each year with an average of 7.72 in the period of 2004-2012. This indicates that an independent director attends roughly 8 board meetings in average each year in the period. Disappointingly, there are still some independent directors who do not attend any board meetings each year with an average of 1.49 times that each such independent director fails to attend board meetings each year in the period, although such independent directors who fail to attend board meetings decrease yearly. In contrast, the busiest independent directors attend board meetings as many as 72 times in a single year, with an average of 51.78 times that each such busiest independent director attend board meetings each year in the period, although such independent directors also decrease yearly. Noticeably, many independent directors attend board meetings by proxy. In this period, the trend that independent directors attend board meetings by proxy seems persistent, though there is a slightly decrease, with an average of 1.44 times that each such independent director attends board meetings by proxy each year.

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<sup>526</sup> Guidance Opinion, above n 369 art. 4(5).

Table 6.4.1(a) Distribution of Independent Directors Attending Board Meetings in Chinese Listed Companies

	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>Attendance:</b>									
N	4703	4827	5189	5815	6340	6418	7631	8574	1793
Mean	6.85	6.95	7.25	8.42	7.96	7.34	7.81	8.38	8.56
Minimum	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Maximum	43	72	62	62	52	41	56	47	31
<b>Proxy:</b>									
N	1607	1491	1484	1717	1449	1254	1500	1509	275
Mean	1.58	1.54	1.52	1.54	1.42	1.41	1.32	1.30	1.35
Minimum	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Maximum	10	8	9	11	12	12	11	16	5
<b>Absence:</b>									
N	597	394	369	392	239	153	127	115	16
Mean	1.84	1.55	1.62	1.56	1.46	1.26	1.37	1.37	1.38
Minimum	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Maximum	18	8	10	12	7	6	7	10	4

Source: Calculated on data from CSMAR.

Note: "N" means the number of independent directors who attend the board meetings. "Attendance" means the board meetings that independent directors should be present. "Proxy" means the board meetings that independent directors delegate their representatives to attend on their behalf. "Absence" means the board meetings that independent directors fail to appear.

Table 6.4.1(b) provides evidence on the frequency of independent directors who attend board meetings in Chinese listed companies in the same period. Of the total number of independent directors who should attend board meetings in 2004, only a little more than half of them attended in person, slightly more than one third by proxy and more than one tenth were absent. It has to be said that this kind of attendance rate of independent directors was not up to the expectation of the CSRC two years after the release of the Guidance Opinion. This situation has been improved yearly since then with an average of 70.79% of attendance rate by independent directors in person, an average of 24.14% of attendance rate by proxy and an average of 4.97% of attendance rate by absence in the period. In this period, the yearly average increase rate of independent directors who are present in person in board meetings is 3.83%, the yearly average decrease rate of those who are present by proxy is 2.35% and the yearly average decrease rate of those who are absent is 1.48%.

Compared with the year of 2004, there was a remarkable improvement in the year of 2012: 57.64% of increase in attendance in person, 55.11% of decrease in attendance by proxy and 92.99% of decrease in absence. Although remarkably improved as regards the attendance rate of independent directors, there were still 15.34% of independent directors who attend the board meeting by proxy in 2012. This seems to frustrate the CSRC's expectation on the utility of the independent director institution.

Table 6.4.1(b) Frequency of Independent Directors Attending Board Meetings in Chinese Listed Companies

	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>Attendance:</b>									
N	2499	2942	3336	3706	4652	5011	6004	6950	1502
%	53.14	60.95	64.29	63.73	73.38	78.08	78.68	81.06	83.77
<b>Proxy:</b>									
N	1607	1491	1484	1717	1449	1254	1500	1509	275
%	34.17	30.89	28.60	29.53	22.85	19.54	19.66	17.60	15.34
<b>Absence:</b>									
N	597	394	369	392	239	153	127	115	16
%	12.69	8.16	7.11	6.74	3.77	2.38	1.66	1.34	0.89
<b>Total</b>									
N	4703	4827	5189	5815	6340	6418	7631	8574	1793
%	100	100	100	100	100	100	100	100	100

Source: Calculated on date from Table 6.4.1(a).

Note: "Attendance" means the board meetings that independent directors are present personally. "%" means the percentage of independent directors who are present, absent or delegated by their representatives in the board meetings. "N", "Proxy" and "Absence" are defined as same as that in Table 6.4.1(a).

Table 6.4.1(c) presents the frequency of board meetings attended by independent directors of Chinese listed companies from 2004 to 2012. Generally speaking, the percentage of the number of board meetings that independent directors are present in person each year is very high, with an average of 94.19% in the period, an average of 1.17% yearly improvement. Correspondingly, the percentages of the numbers of board meetings that independent directors are present by proxy and absent are very low, with the averages of 4.71% and 1.09% in the period, respectively. The yearly decreases in averages for both are 0.69% and 0.41%, respectively. Still noticeably, the year of 2012 also sees a remarkable improvement

for the percentages of the numbers of board meetings that independent directors are present in person, present by proxy or absent. This can be seen from the ratios of the percentages of the numbers of board meetings that independent directors are present in person, present by proxy and absent in 2012 to the above relevant averages of the period. They are 1.0344, 0.5138 and 0.1284, respectively. This means that the percentage of the number of board meetings that independent directors are present in person in 2012 is 3.44% higher than the relevant average of the period of 2004-2012 and the percentages of the numbers of board meetings that independent directors are present by proxy and absent in the same year are 48.62% and 87.16% lower than the relevant averages of the same period, respectively. That is, by the end of 2012, most independent directors attend most board meetings in person, although there are still some independent directors are present by proxy or fail to attend. This suggests that, as a governance mechanism, independent directorship of Chinese listed companies has significantly improved their basic way of executing their fiduciary duties as monitors up to now, i.e., attending board meetings in person. However, attending board meetings by itself does not provide evidence that independent directors perform as a governance mechanism, which requires them actively to air their independent opinions.

Table 6.4.1(c) Frequency of board meeting attendance of independent directors of Chinese listed companies

	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>Attendance:</b>									
N	28554	30667	34774	45703	48050	45167	57461	69764	14961
%	88.68	91.36	92.40	93.36	95.24	95.83	96.38	97.06	97.43
<b>Proxy:</b>									
N	2545	2292	2260	2639	2051	1774	1986	1958	372
%	7.90	6.83	6.01	5.39	4.07	3.76	3.33	2.72	2.42
<b>Absence:</b>									
N	1100	609	599	611	350	193	174	158	22
%	3.42	1.81	1.59	1.25	0.69	0.41	0.29	0.22	0.14
<b>Grand Total:</b>									
N	32199	33568	37633	48953	50451	47134	59621	71878	15355
%	100	100	100	100	100	100	100	100	99.99

Source: Calculated on data from CSMAR.

Note: "Attendance", "Proxy" and "Absence" are defined as same as that in Table 6.4.1(b). "N" means the number of board meetings that independent directors are present in person or by proxy or absent. "%" means the percentage of board meetings that independent directors are present in person or by proxy or absent.

## 6.4.2 Independent Opinion

The primary way that independent directors execute their fiduciary duties is to air their independent opinions on companies' affairs so as to supervise management performance. This is because delivering independent opinions in board meetings is the duty of care and diligence that independent directors owe to shareholders to perform their monitoring role on management on behalf of shareholders. That is, "[p]roviding objective independent judgment is at the core of the board's oversight function".<sup>527</sup> According to the Guidance Opinion, independent directors should express their independent opinions on such material matters of listed companies as 1) nomination, appointment and removal of directors, 2) engagement or dismissal of senior managers, 3) remuneration of directors and senior managers, 4) loans or transactions with the value totaling more than Chinese RMB 3 million or more than 5% of the listed company's most recently audited net assets, 5) matters impairing the rights and interests of small and medium shareholders and 6) other matters specified in the company's articles of association.<sup>528</sup> Conspicuously, there are no matters concerning auditing. As regards the afore-mentioning matters, an independent director should express one of the following opinions: 1) agree, 2) reserve with the reason, 3) oppose with the reason and 4) unable to express an opinion and the obstacles to express.<sup>529</sup> These provisions provide criteria on which independent directors' performance can be evaluated. Thus, from the matters on which independent directors express their opinions and what kinds of opinions on which independent directors express, investigation can be conducted on whether independent directors work as monitors required by the Guidance Opinion.

Table 6.4.2(a) shows the subject matter<sup>530</sup> on which independent directors express their independent opinions in Chinese listed companies from 2002 to 2012. Of twelve subject

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<sup>527</sup> Business Roundtable "Principles of Corporate Governance" (2012) available at [http://businessroundtable.org/uploads/studies-reports/downloads/BRT\\_Principles\\_of\\_Corporate\\_Governance\\_-2012\\_Formatted\\_Final.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/BRT_Principles_of_Corporate_Governance_-2012_Formatted_Final.pdf) at 14.

<sup>528</sup> Guidance Opinion, above n 350, art. 6 (1).

<sup>529</sup> Art. 6 (2).

<sup>530</sup> The CSMAR classifies twelve subject matters based on the Guidance Opinion, art. 6 (1).

matters on Table 6.4.2(a), related transactions are the subject matter on which independent directors express most of their independent opinions, with an average of 38.18% of all independent opinions in the period of 2002-2012. Although there is a trend that independent opinions on this subject matter are relatively decreasing, related transactions still account for slightly more than a quarter of independent opinions expressed by independent directors in 2012. This is probably because related-party-transactions, as is well-known, are the most popular way of tunneling (misappropriating) by the majority shareholders of Chinese listed companies in China.

Nomination is the subject matter that independent directors air their second most independent opinions, with an average of 26.39% of all independent opinions in the period. The trend of independent opinions on nomination is generally increasing, though wavering upward. Like related transactions, the same was true of independent opinions on nomination in 2012. Other matters are the subject matter on which independent directors express their third most independent opinions, with an average of 14.41% of all independent opinions in the period. There is a sharp increase of independent opinions on this subject matter since 2008 and there were even about one third of independent opinions on other matters in 2010-2011. Compensation is the subject matter that is only responsible for 3.81% of independent opinions expressed by independent directors in the period. In 2012, there was slightly over one tenth of independent opinions concerned compensation. Auditing is one of subject matters amongst the least independent opinions, with an average of 1.12% of all independent opinions expressed by independent directors in the period. In some years, there were even no independent opinions on auditing.

This anomaly should be no surprise because, as discussed above, the Guidance Opinion provides no requirement for independent opinions on auditing. Conventional wisdom is that nomination, compensation and auditing are three subject matters on which independent directors should express their independent opinions in exercising their oversight function as a governance mechanism. Particularly, auditing is the central subject matter on which independent directors should air their independent opinions. Interestingly, independent opinions in total on nomination, compensation and auditing account for less than one third



Table 6.4.2 (a) Subject Matters of independent opinions of independent directors of Chinese listed companies (2002-2012)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Nomination: N	26	26	95	764	513	859	1081	1094	832	1	85
%	15.03	28.57	59.01	22.55	14.04	24.89	24.33	23.89	19.40	33.33	25.30
Compensation: N	1	2	2	38	72	107	286	298	405		34
%	0.58	2.20	1.24	1.12	1.20	3.10	6.44	6.51	9.44		10.12
Annual Report: N		3	11	182	219	192	225	317	332		2
%		3.30	6.83	5.37	5.99	5.56	5.06	6.92	7.74		0.60
Related Transaction: N	96	43	46	1201	1067	1475	2110	1845	1487	1	85
%	55.49	47.25	28.57	35.45	29.19	42.74	47.49	40.29	34.68	33.33	25.30
Guarantee: N	1		14	396	630	763	932	1305	1121		19
%	0.58		8.70	11.69	17.24	22.11	20.98	28.50	26.14		5.65
Merge & Acquisition: N	6	4	5	67	67	123	117	130	97		20
%	3.47	4.40	3.11	1.98	1.83	3.56	2.63	2.84	2.26		5.95
Auditing: N	3			30	117	117	22	58	60		
%	1.73			0.89	3.20	3.39	0.50	1.23	1.40		
Equity Transfer: N	2	6	8	576	60	53	29	61	47		16
%	1.16	6.59	4.50	17.00	1.64	1.54	0.65	1.33	1.10		4.76
Fund Collection: N	11	7	3	119	76	195	440	460	484		54
%	6.36	7.69	1.86	3.51	2.08	5.65	9.90	10.01	11.29		16.07
Asset Transfer: N	8	2	9	49	58	66	42	64	33		12
%	4.62	2.20	5.59	1.45	1.59	1.91	0.95	1.40	0.77		3.57
Others: N	22	7	10	136	78	104	529	915	1331	1	89
%	12.72	7.69	6.21	4.01	2.13	3.01	11.91	19.98	31.04	33.33	26.49
Share Structure Split: N											
%					1021	99	54	16	3		
					27.93	2.87	1.22	0.35	0.07		

Source: Calculated on data from CSMAR.

Note: "N" means the yearly number of independent opinions related to the subject matter concerned. "%" means the percentage of the yearly number of independent opinions related to the subject matter to the total yearly number of independent opinions in that year.

of all independent opinions in the period of 2002-2012. This seems to suggest that monitoring management is not the primary function of independent directors in Chinese listed companies.

Table 6.4.2(b) shows the classifications<sup>531</sup> of independent opinions that independent directors express in Chinese listed companies in the same period. It is crystal-clear that most independent opinions expressed by independent directors are to agree, with an average of 98.24% (excluding 2011) in this period. Other forms of independent opinions, including to express reservations, oppose, unable to express, abstain from expressing, dissent and others, only account for 1.76% (excluding 2011) in average in the same period. To oppose and to dissent are the two forms that independent directors actively express their independent opinions, the ability of independent directors to see things differently. There are no independent opinions in the form of opposition before 2005, with an average of 0.42% (excluding 2011) in the period of 2005-2012. There are also no independent opinions in the form of dissenting before 2006 and after 2010, with an average of 0.11% in the period of 2006-2009. Markedly, there are some independent directors who are unable to express or abstain from expressing their independent opinions, with an average of 0.17% or 0.36% in the period of 2005-2012 (excluding 2011), respectively.

Quite mysteriously, there were 8,574 independent directors in Chinese listed companies in 2011 but only three pieces of independent opinions were even aired by all of them in that year. That is even if these three independent opinions were expressed passively by way of abstaining from airing and others. These statistics indicate that almost all independent opinions aired by independent directors are passively in agreement with or at least not active in confronting management, which absurdly justifies their nick name as “vase directors”, an indication of the managerial hegemony dominating in Chinese listed companies. Therefore, it is difficult to say that independent directors of Chinese listed companies can function as a governance mechanism to perform a monitoring role over management. Probably, it can be said that they may primarily play an advisory role to the

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<sup>531</sup> The CSMAR classifies seven forms of independent opinions based on the Guidance Opinion, art. 6 (2).

management of Chinese listed companies in fact and their monitoring role is just complementary to that of the supervisory board.

Table 6.4.2 (b) Classification of independent opinions of independent directors of Chinese listed companies

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Agree: N	173	91	160	3350	3478	3190	4428	4563	4252		331
%	100	100	99.38	98.88	95.16	92.44	99.66	99.65	99.16		98.51
Reserve: N				9	21	2	1	1	2		
%				0.27	0.57	0.05	0.02	0.02	0.05		
Oppose: N				13	29	7	6	5	13		2
%				0.38	0.79	0.20	0.14	0.11	0.30		0.60
Unable: N				2	12	3	4	1	1		2
%				0.06	0.33	0.09	0.09	0.02	0.02		0.60
Abstain: N				12	42	10	1	5	14	2	1
%				0.35	1.15	0.29	0.02	0.11	0.33	66.67	0.30
Dissent: N					8	5	2	2			
%					0.22	0.14	0.05	0.04			
Others: N			1	2	65	234	1	2	6	1	
%			0.62	0.06	1.78	6.78	0.02	0.04	0.14	33.33	
Total: N*	173	91	161	3388	3655	3451	4443	4579	4288	3	336
%	100	100	100	100	100	99.99	100	99.99	100	100	100

Source: Calculated on data from CSMAR.

Note: "N" means the yearly number of independent opinions that independent directors air their stances on Chinese listed companies' affairs. "%" means the yearly number of independent opinions that independent directors air their individual stances to the total yearly number of independent opinions aired by independent directors in that year. "N\*" means the total yearly number of independent opinions aired by independent directors that year.

## 6.5 Efficiency and Effectiveness of Independent Directors

To make board independence become true is to make independent directors become efficient and effective. This means that board independence is just the means by which independent directors can function as monitors and the efficiency and effectiveness of independent directors is the end that board independence aims to achieve. Thus, board independence would be meaningless if independent directors were inefficient and ineffective. From the behaviourism viewpoint, efficiency and effectiveness are both in relation to personal or organizational action taken to pursue a perceived end sought. The action is usually taken by a person or an organization's desire or motive that results in the

attainment of the end sought and satisfaction of the tension.<sup>532</sup> When a specific desired end is attained, the action is “effective”; when the unsought consequences of the desired end are unimportant or trivial, the action is “efficient”.<sup>533</sup>

In the scenario of independent directors, the perceived end sought of board independence is to realize the desire or motive that independent directors work efficiently as effective monitors expected by legislators or regulators. That is, in performing their oversight function on management, independent directors should not only attend board meetings in person and air their independent opinions actively but also focus on airing their independent opinions on subject matters related to their monitoring role. Independent directors who attend board meeting by proxy defeat the utility of the independent director institution because independent directors are invited as directors for their own reputations and expertise and not that of others. Independent opinions on subject matters irrelevant to independent directors’ oversight function are the unsought consequences of the desired end of independent directors as effective monitors. If independent opinions are related to their monitoring role such as auditing, compensation and nomination, independent directors are efficient. Otherwise, independent opinions are unimportant and trivial in terms of their oversight function. If independent opinions are expressed actively on management performance such as confronting management on directors’ nomination, top management compensation package and auditing on financial statement, particularly CEO nominee directors, fabulous CEO remuneration packages and “cooked books”, independent directors are effective. If not, the specific desired end sought, i.e., monitoring management, has not been attained.<sup>534</sup>

Literature provides no convincing evidence regarding the efficiency and effectiveness of independent directors as monitors in corporate governance in view of equivocal empirical findings, doubtful theoretical assumptions and methodologies distant from governance

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<sup>532</sup> Barnard, above n 503 at 19.

<sup>533</sup> Ibid.

<sup>534</sup> As to the rest such as the correlation between independent directors and corporate performance, this line of reasoning may also apply if corporate performance can be seen as the desired end sought as per independent directors’ oversight function. Chapter Eight discusses this issue in detail.

phenomena. Thus, there are calls for more detailed attention to board processes and dynamics with the emphasis on independent directors' monitoring and control, i.e., the actual conduct of the independent director vis-à-vis the top management.<sup>535</sup> The rationale is that the effectiveness of board independence, other things being equal, lies in the degree to which independent directors, acting either individually or collectively, are able to create accountability within the board. Such accountability is in practice achieved through a wide variety of behaviour such as challenging, questioning, probing, discussing, testing, informing, debating, exploring and encouraging that are at the very heart of how independent directors seek to be effective.<sup>536</sup> That is, independent directors as effective monitors should actively ask questions and not passively listen to top management by merely ticking the box. This kind of accountability can be realized by independent directors attending board meetings and airing independent opinions.

Attending board meetings is the first action that independent directors can do to be diligent when overseeing management; exercising independent judgment the last one.<sup>537</sup> Concisely, independent directors should attend board meetings with an independent character and judgment, i.e., independence of mind. This independent judgment requires detachment and distance, which is both critical and independent and should not just be a matter of cheering or booing.<sup>538</sup> However, there are scant empirical findings to support this proposition.

Under the SEC Regulation S-K Item 407(b)(1), publically traded companies in the US are required to disclose in their annual proxy statements the name of each incumbent director who attended fewer than 75% of the aggregate of the total number of the board and committee meetings they were supposed to attend during the previous fiscal year.<sup>539</sup> In

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<sup>535</sup> John Roberts, Terry McNulty & Philip Stiles "Beyond Agency Conceptions of the Work of Non-Executive Director: Creating Accountability in the Boardroom" (2005) 16 *British Journal of Management* 5 at 6.

<sup>536</sup> Ibid.

<sup>537</sup> The Office of the Comptroller of the Currency of the US Department of the Treasury (OCC) "The Director's Book" (October 2010), available at [www.occ.treas.gov](http://www.occ.treas.gov) at 68, 73.

<sup>538</sup> Ada Demb & F.-Friedrich Neubauer "The Corporate Board: Confronting the Paradoxes" (1992) 25 (3) *Long Range Planning* 9 at 14, 15.

<sup>539</sup> The SEC "Standard Instructions for Filing Forms under the Securities Act of 1933, Securities Exchange Act of 1934, and Energy Policy and Conservation Act of 1975: Regulation S-K", § 229.407(Item 407) (last update on March 13, 2007) <http://www.law.cornell.edu/cfr/text/17/229.407>.

their study of regulatory pressure on bank directors' incentives to attend board meetings, Adams & Ferreira find that bank directors (excluding executive or inside directors) appear to have worse attendance records than their counterparts in nonfinancial firms.<sup>540</sup> Of their sample of 5,707 directorships (director-firm year observations) in 35 BHCs over the years 1986-1999, the proportion of directorships reported as having attendance problems, i.e., failed to meet the SEC's threshold of fewer than 75% of board meeting attendance, is relatively large: 9.4%.<sup>541</sup> A similar result can be seen in another recent study. Using annual director data of S&P500, S&P MidCaps and S&P SmallCaps firms from RiskMetrics database in the period of 2004-2006, Chou et al. find in their samples of 2,470 observations that there were approximately 7.8% of firms having at least one independent director who was absent more than 25% of board meetings.<sup>542</sup>

From these two studies, it seems to suggest that there is probably an attendance problem at board meetings with independent directors in the US publically traded companies. If taking into account of independent directors who attend fewer than 25% of board meetings, this attendance problem seems to be worse. The failure to meet the SEC's threshold of board meeting attendance is the unsought consequence of the desired end of the independent director institution and such independent directors thus probably cannot be seen to be efficient.

According to the SEC, independent directors cannot be passive by placing blind or exclusive reliance on management. They "have a responsibility affirmatively to keep themselves informed of developments within the company and to seek the nature of corporate disclosures to determine if adequate disclosures are being made."<sup>543</sup> This places them "in the position to provide a check on management's desire to avoid or prolong

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<sup>540</sup> Renée B. Adams & Daniel Ferreira "Regulatory Pressure and Bank Directors' Incentive to Attend Board Meetings" (working paper No. 203/2008, April 2008) [http://ssrn.com/abstract\\_id=936261](http://ssrn.com/abstract_id=936261) at 2, 7.

<sup>541</sup> At 8, 11.

<sup>542</sup> Hsin-I Chou, Hui Li & Xiangkang Yin "The effects of financial distress and capital structure on the work effort of outside directors" (2010) 17 *Journal of Empirical Finance* 300 at 305.

<sup>543</sup> The SEC "Report of Investigation in the matter of National Telephone Co. Inc., Relating Activities of the Independent Directors of National Telephone Co. Inc." (Jan. 16, 1978), available at: <http://international.westlaw.com.ezproxy.auckland.ac.nz/find/default.wl?cite=Exchange+Act+Release+No.+34-14380&rs=WLIN14.01&utid=7&vr=2.0&rp=%2ffind%2fdefault.wl&sp=003574757-4000&fn=top&findjuris=00001&mt=WLILawSchool&sv=Split> 1 at 4.

sharing bad information with investors”,<sup>544</sup> i.e., sufficiently engaged and active to question and correct inadequate disclosures.<sup>545</sup> The SEC disclosure method is also designed to urge independent directors to be active and engaged by vetting and questioning before corporate disclosures. The purpose is to encourage independent directors to exercise objective judgment, which is critical to board effectiveness. Thoughtful disagreement suggests that the board is independent and not operating under undue influence by management.<sup>546</sup>

Therefore, it is the independent directors’ fiduciary duties to question, discover and correct potential discrepancies or actual inaccuracies in corporate disclosures. Failing to do so, independent directors will fail to discharge their monitoring obligations with diligence and care, i.e., fail to attain the desired end sought by the SEC, and thus will be inefficient and ineffective. This was especially the case in Enron where its independent directors “routinely relied on Enron management and Anderson representations with little or no effort to verify the information provided”<sup>547</sup> and without “willingness to challenge management”<sup>548</sup> even “Enron’s high-risk accounting practices, for example, were not hidden from the board.”<sup>549</sup> Thus, the failure to ask tough questions on management indiscretion is the failure of independent directors as effective monitors. The same is true of Lehman Brothers and other financial catastrophes in the recent years.

## 6.6 Conclusion

This Chapter has examined board independence and its impact on independent directors of listed companies in the United States, New Zealand and China. First, it has explored the independence standard provided by law and regulation to test the qualification of a director as independent. Both the US and China have the independence standard in place for testing the board independence of listed companies in their stock markets, although there are some

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<sup>544</sup> Hillary A. Sale “Independent Directors as Securities Monitors” (2006) 61 (4) *The Business Lawyer* 1375 at 1383-1384.

<sup>545</sup> At 1382.

<sup>546</sup> The OCC, above n 537 at 73.

<sup>547</sup> The Committee on Governmental Affairs of United States Senate “The Role of The Board of Directors in Enron’s Collapse” (July 28, 2002) *Report 107-70*, available at [www.findlaw.com](http://www.findlaw.com) at 14.

<sup>548</sup> *Ibid.*

<sup>549</sup> At 13.

slight differences on the independence standard between the US and China. In New Zealand, there is a formal criterion to evaluate director independence, which is different from the independence standard in the US and China. Board independence can only be expected to be effective when the board is composed of at least a marginal majority of independent directors. Thus, it is difficult to imagine that the board consisted of a minority of independent directors would be independent.

Second, it has examined the elements such as independence of management, dependence on shareholders, access to information and incentive to monitor that are critical to the effectiveness of board independence. The examination of the impacts of these elements on board independence shows that there are some problems identified by this research, which have negative effects on the efficacy of these elements and need to be solved. These problems are social ties, structural bias and CEO reactance connected to independent of management, shareholder apathy, board disregard and regulatory barrier related to dependent on shareholders, structural hole manipulation linked to access to information, and financial reward, reputational capital and legal obligation associated with the incentive to monitor. Without getting these problems solved or at least getting their negative effects reduced, independent directors may not be able to be truly independent from management or controlling shareholders and board independence can probably be in name only.

Third, it has investigated the reality of board independence of Chinese listed companies and probed into the efficiency and effectiveness of independent directors in the US publicly traded companies. Based on an analysis of behaviors, the investigation finds that independent directors of Chinese listed companies seem to exercise their fiduciary duties better than their US counterparts in attending board meetings but pretty much the same thing in airing independent opinions (or independent judgments). Statistics in Section 6.4 provides little evidence that independent directors serve as a governance mechanism in monitoring top management in Chinese listed companies. Financial disasters in the recent years also provide doubtful evidence that independent directors are efficient and effective as monitors of top management in the US publicly traded companies.



## CHAPTER 7

### THE SUPERVISORY BOARD

#### 7.1 Introduction

Board independence aims to improve board effectiveness in discharging its oversight function. However, this function is maintained by different corporate governance institutions, depending on what kind of corporate governance model the board of directors has adopted. In the unitary board model, the board's oversight function is carried out by independent directors while in the two-tier board model, this function is exercised by the supervisory board; but in the hybrid board model, it is shared by independent directors and the supervisory board. This shared responsibility of oversight function is in the legislative design to interplay between independent directors and the supervisory board, aiming to remedy the dysfunction of the supervisory board's oversight function in the two-tier board model in corporate governance. The question arises as regards this kind of shared responsibility of the oversight role between these two corporate control devices. That is, whether they can work well together to achieve the statutory objective.

This chapter examines the interplay of the oversight function between independent directors and the supervisory board with focus on China's perspective. The rest of this chapter proceeds as follows. Section 7.2 discusses the distinctive characteristics of the supervisory board with focus on a comparison between Germany and China. Section 7.3 examines the interplay between the roles of independent directors and the supervisory board in the hybrid board model in China. Section 7.4 concludes the chapter.

#### 7.2 Characteristics of the Supervisory Boards of Chinese Listed Companies

As discussed in Section 1.2, the supervisory board can be tracked back to the Committee of Nine of the Dutch East India Company in 1623. The Committee of Nine was created to

supervise the Seventeen Directors (a board of governors), which fostered the two-tier board structure like Germany's two-tier board model and therefore was regarded as the precursor of the existing supervisory board of modern corporations. In the civil law countries, France is probably the first European country to adopt in legislation a stewardship mechanism (consuls)<sup>550</sup> performing the function of the supervisory board (*conseil de surveillance*) in a limited liability partnership (*société en commandite*) by Louis XIV in his Commercial Ordinance (*Pour le Commerce*) in March 1673. However, Germany is well recognized as the main country to take on the supervisory board (*Aufsichtsrat*) in the two-tier board model of corporate governance in publicly listed companies in the world.

Although closely related, there are three distinctive differences as regards the supervisory board between France and Germany. First, the relationship between the management board and the supervisory board. In France, the relationship is horizontal, i.e., the management board (*directoire*) is parallel to the supervisory board in the two-tier board model and both are responsible to the general shareholders meeting. In Germany, the relationship is vertical, i.e., the supervisory board controls the management board (*Vorstand*),<sup>551</sup> which is “just a recipient of orders”<sup>552</sup> from the supervisory board. Second, the authority of the supervision. In France, the management board is required to submit its quarterly reports to the supervisory board for “verifications and inspections” while the supervisory board however cannot take action but “presents its observations on the executive board's report and

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<sup>550</sup> The Commercial Ordinance (*Pour le Commerce*) 1673 (France), art. 3 of Title III. See also Stanley E. Howard “Public Rules for Private Accounting in France, 1673 and 1807” (1932) 7 (2) *The Accounting Review* 91 at 91. Article 3 requires that consuls should sign the books (*livres*) and journals (*Livre journals*) of joint-stock limited partnerships to authenticate the status of accounting records in suit with the bookkeeping rules of the Ordinance. In a joint-stock limited partnership (*société en commandite par actions*), there are two kinds of shareholders, general partnership (*societas*) and limited partnership (*société en commandite*). The former bears the responsibility for management with the unlimited liability on their investments while the latter is free of the responsibility for management with the limited liability not beyond their investments. Consuls come from the limited partners (*commanditaires*) who may be private investors and the government. See also Judson A. Crane “Are Limited Partnerships Necessary? The Return of the Commenda” (1933) 17 (4) *Minnesota Law Review* 351 at 351.

<sup>551</sup> Stock Corporation Act 2010 (Germany) (English version), §30(4). This subsection stipulates that the supervisory board shall appoint the first management board. See also §82(2), which provides that the management board is obliged in the relationship to comply with the restrictions, in respect of the authority to manage the company, imposed by the supervisory board.

<sup>552</sup> Klaus J. Hopt “The German Two-Tier Board: Experience, Theories, Reforms” in K. J. Hopt et al. (eds.) *Comparative Corporate Governance-The State of the Art and Emerging Research* (Oxford University Press, Oxford & New York, 1998) at 231.

accounts for the period to the general meeting”.<sup>553</sup> In Germany, the management board must submit its annual financial statement, annual report and proposal to the supervisory board for examination and approval<sup>554</sup> while the supervisory board has “the real say”.<sup>555</sup> Third, the adoption of the supervisory board. In France, publicly listed companies have the option in law to choose alternative governance structures—either the two-tier board or the unitary board.<sup>556</sup> In Germany, it is mandatory in law that publicly listed companies adopt the two-tier board.<sup>557</sup> These distinctions may have different impacts on the function of the supervisory board, although the laws in both countries all provide that the management board is under the supervision of the supervisory board.<sup>558</sup>

The supervisory board is a tradition of the civil law system in continental Europe. China has a legal system based to some extent on the civil law tradition and has followed Germany’s suit. In China, the supervisory board (or supervisors) is required by law not only in joint-stock companies but also in limited companies.<sup>559</sup> This is significantly different from the continental Europe, where the supervisory board is usually required by law in joint-stock companies adopting the two-tier board model.<sup>560</sup> In addition, Chinese listed companies have adopted the hybrid board model, i.e., combined the two-tier board model and the unitary board model into one board model. It is also considerably different from either France where joint-stock companies may opt for either the two-tier board model or the unitary board model but not both, or Germany where joint-stock companies must adopt the two-tier board model.

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<sup>553</sup> Commercial Code 2006 (France) (English version), art. L225-68.

<sup>554</sup> Stock Corporation Act, above n 551, §30(171).

<sup>555</sup> Hopt, above n 552. *See also* Stock Corporation Act, §30(172).

<sup>556</sup> Commercial Code, above n 553, art. L225-57. According to this article, any public limited company may choose to be governed either by art. L225-57 (management board and supervisory board) or by art.L225-17 (board of directors). *See also* Benedicte Millet-Reyes & Ronald Zhao “A Comparison between One-Tier and Two-Tier Board Structures in France” (2010) 21 (3) *Journal of International Management and Accounting* 279 at 279.

<sup>557</sup> Stock Corporation Act, above n 551, §30(1).

<sup>558</sup> Commercial Code, above n 553, art. L225-58, Stock Corporation Act, above n 551, §111(1).

<sup>559</sup> Company Law 2005, above n 327, arts. 52, 118.

<sup>560</sup> Commercial Code, above n 553, art. L225-57 and Stock Corporation Act, above n 551, §30(1).

Compared with the German model, the supervisory board in China has its own characteristics. First, the relationship between the board of directors and the supervisory board. The Company Law 2005 does not clearly provide the relationship between the two but specifies that the shareholders' meetings shall examine and approve reports of both the board of directors and the supervisory board.<sup>561</sup> From this provision, it seems to imply that this kind of relationship between the board of directors and the supervisory board is similar to the relationship between the management board and the supervisory board in France. Although the board of directors is in essence to perform the function of the management board like that of the German management board, it has the typical characteristic of America's board of directors, i.e., having independent directors in the boardroom. This is remarkably different from Germany's management board.

Second, the authority of the supervisory board. In China, the supervisory board has no right to approve annual financial reports and management proposals like that in Germany or to present its observations on such reports and proposals to the shareholders' general meetings like that in France, although it is obliged to examine the financial affairs of the company and demand the management to correct its misbehaviors.<sup>562</sup> Supervisors may attend the board of directors' meetings as non-voting attendees and make enquiry and suggestion on the board of directors' decision-making process.<sup>563</sup> This means that the supervisory board has no say on the resolutions of the board of directors but can provide advice at most. In legislative design, this may aim to improve the function of the supervisory board. It may probably be an advantage of the supervisory board of listed companies in China, compared with that in Germany where the supervisory board is required by law not to be involved in the decision-making process of the management board unless the articles of association and the supervisory board have to determine that "specific types of transactions may be entered into only with the consent of the supervisory board".<sup>564</sup> In practice, there seems no empirical evidence that this legislative design has impact on the supervisory board's supervising role over top management in China.

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<sup>561</sup> Company Law 2005, above n 327, art. 38(2), (3).

<sup>562</sup> Ibid, art. 54(1), (3).

<sup>563</sup> Ibid, art. 55.

<sup>564</sup> Stock Corporation Act, above n 551, §111(4).

Third, the independence of the supervisory board. Lack of board independence is a typical characteristic of the supervisory board of Chinese listed companies. According to the Company Law 2005, the supervisory board is composed of representatives of employees and shareholders,<sup>565</sup> which seems to be the same as that in the Germany Stock Corporation Act.<sup>566</sup> The difference is that the members of the supervisory board in China are the representatives of employees and shareholders of a listed company while in Germany they are employees and shareholders. This difference has significant impact on the lack of independence of the supervisory board in Chinese listed companies. The reasons are: a) employee representatives are generally the chairpersons of the trade unions<sup>567</sup> and worker models, both of whom are usually political appointees; b) shareholder representatives are normally the delegates of the government, who are the government' appointees;<sup>568</sup> and c) employee representatives shall be elected either by the general meeting of all employees/employee representatives or other democratic ways; the Company Law 2005 is silent on the election of representatives of shareholders. In practice, the election of the representatives of employees and shareholders is however completely under the control of the biggest or controlling shareholders. This means that the biggest or controlling shareholders can designate their representatives as both directors and supervisors and thus control not only the board of directors but also the supervisory board. In view of these reasons, it seems hardly realistic to talk about board independence as to the supervisory board of Chinese listed companies.

### **7.3 Interplay of Independent Directors and the Supervisory Board**

The distinctive characteristics of the supervisory board in China discussed above may be considered to contribute the dysfunction of the supervisory board of Chinese listed

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<sup>565</sup> Company Law 2005, above n 327, art. 52.

<sup>566</sup> Stock Corporation Act, above n 551, § 96.

<sup>567</sup> The trade union in China is fundamentally distinguished from its counterpart in western countries because it is not an autonomic organization but an organ of the country machine functioning as the political tool of the Communist Party.

<sup>568</sup> This is because of the Only-Big Shareholder problem that the government is usually the biggest or controlling shareholder, which is different from that in Germany where the bank is generally a shareholder of a listed company. The bank in China is generally a creditor but not a shareholder.

companies. Critics censure that the supervisory board is only nominally in place without real value in corporate governance. This is probably because the supervisory board was transformed from the trade union of SOEs in the movement for incorporation in the early 1990s in China. Simply speaking, the supervisory board is basically the reproduction of the trade union of SOEs to meet the requirements of corporate governance for listed companies.<sup>569</sup> In view of the fact that the memberships of the trade union are usually political trophies, there should be no surprise that the supervisory board fails to function as expected. Ironically, top management sees the supervisory board as “nonexistent” while the supervisory board seems to be never really aware of its own “existence”. A recent empirical study provides evidence to justify this sarcasm.<sup>570</sup>

The Company Law 2005 imports the independent director institution from corporate America to corporate China, aiming to make independent directors and the supervisory board interplay. This importation makes the corporate governance model of Chinese listed companies become the hybrid model, i.e., adding independent directors to the board of directors while still retaining the supervisory board. Although the original purpose of the transplantation of independent directors is to meet the listing rules of stock markets abroad for Chinese companies to list there, regulators later on expect that this transplantation will supplement the dysfunction of the supervisory board. Protagonists of this transplantation acclaim its perfect legislative design, proclaiming that independent directors can bring on the *ex-ante* and interim oversight function while the supervisory board can keep on the interim and *ex post* supervision function. Regulators thus rely on this assumed interplay of the two governance mechanisms to cure the dysfunction of the supervisory board.

Indeed, the real play of these two institutions may complement each other regarding their

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<sup>569</sup> Before the Company Law 1993, there were what called “Old Three Meetings” in Chinese SOEs (see note 78), which were transformed into what called “New Three Meetings” in Chinese listed companies after the Company Law 1993. Among them, the party committee became the board of directors, the trade union became the supervisory board and the assembly of workers was replaced by the shareholders’ meeting.

<sup>570</sup> Qianna Wu “An Empirical Study on the Effect of Implementing the Systems of the Independent Director and the Supervisory Board in Listed Companies” (in Chinese) (2010) 2 *Modern Accounting* 20 at 22. This study shows that there is no correlation between the proportion of independent directors and firm performance, and that there exists a negative correlation between the proportion of outside supervisors of the supervisory board and firm performance. This means that the hybrid board model seems to have little impact on improving firm performance in Chinese listed companies.

supervision functions and meet the purpose of this legislative design. However, the reality is that independent directors seem hardly to play their oversight role as expected, to say nothing of interplaying with the supervisory board.<sup>571</sup> Probing into the reasons behind this reality, one may have to say that there still are some lacunae and ambiguities in the legislation as regards the functions of both institutions.

First, there is no law to clarify the relationship between independent directors and the supervisory board. The Company Law 2005 recognizes a dual-supervision system<sup>572</sup> where independent directors and the supervisory board coexist, both of which perform the function of monitoring top management in Chinese listed companies. Unless the law makes clear the relationship between independent directors and the supervisory board, i.e., who takes the main responsibility of monitoring top management, the free-rider problem may occur. That is, buck-passing may occur if both of them have the same responsibility but one may shift it to the other. Buck-passing can result in not only the inefficiency and ineffectiveness of the dual-supervision system but also the waste of the limited supervision resources. In essence, independent directors as the internal governance mechanism are the members of the board of directors while the supervisory board is an independent supervisory organ parallel to the board of directors. Both are under different leadership. Independent directors are responsible to the board of directors while the supervisory board reports to the general shareholders' meeting. It seems that they just need to do their own business and there is no link between them. However, conflicts may arise when they perform the same responsibility under the individual leadership relationships. Conflicts may become intense and worse in view of the fact that the supervisory board is a standing body of the company while independent directors are only part-timers. Without clearly provided law on the relationship between them, the buck-passing may be inevitable when conflicts arise in performing the same responsibility. This suggests that it is important that law and regulation should clarify and coordinate the relationship between independent directors and the supervisory board in the current hybrid board model.

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<sup>571</sup> Ibid. This study provides no empirical evidence on the interplay effect between independent directors and the supervisory board in Chinese listed companies.

<sup>572</sup> Company Law 2005, above n 327, arts. 123, 118.

Second, the overlap of the responsibilities and powers between independent directors and the supervisory board. According to the Company Law 2005, the supervisory board has the following responsibilities and powers: a) examine the company's financial affairs, b) supervise the performances of directors and senior executives, c) demand directors and senior executives to correct their acts that damage the company's interests, d) propose the convening of interim shareholders' meetings, and convene and preside over the shareholders' meetings when the board of directors fails to do so, e) put forward proposals to the shareholders' meetings, f) bring lawsuits against directors and senior executives in accordance with Article 152, and g) exercise other responsibilities and powers in the articles of association of the company.<sup>573</sup> Correspondingly, in addition to the responsibilities and powers as directors provided by the Company Law 2005, independent directors have been given by the Guidance Opinion the following special rights and duties: a) recognize the important related-party transactions, b) propose to hire or dismiss accountant firms, c) propose to convene interim shareholders' meetings, d) propose to hold the board of directors' meetings, e) independently employ external audit and consultant firms, and f) launch proxy fights before the shareholders' meetings.<sup>574</sup> Furthermore, the Code of Corporate Governance also provides that the main responsibilities and powers of the audit committee are: a) propose to employ or replace external auditors, b) supervise the company's internal auditing system and its implementation, c) communicate between internal and external auditors, d) checkup the company's financial statements and information disclosure, and e) examine the company's internal control system.<sup>575</sup>

From the above comparison of law and regulation, it can be seen that there exists at least two overlaps of the responsibilities and powers between independent directors and the supervisory board, i.e., the supervision of financial affairs and the oversight of management performance. Interestingly, the Company Law 2005 clearly specifies that the supervisory board has the responsibilities and powers of supervising the legitimacy of directors and

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<sup>573</sup> Ibid, art. 54.

<sup>574</sup> Guidance Opinion, above n 350 art. 5(1).

<sup>575</sup> Code of Corporate Governance, above n 434, art. 54.



senior executives' acts but there are no such provisions on independent directors in this law and the relevant regulations. The supervision of the company's financial affairs is primarily the duty of the audit committee, which is composed of at least 50% of independent directors<sup>576</sup> and one of them must be an accountant.<sup>577</sup> Thus, it seems to wrongly place this duty on the supervisory board because the members of the supervisory board have no special expertise in financial matters but are politically sensitive. In addition, independent directors are required to provide independent opinions and the supervisory board is also required to demand directors and senior executives to correct their misbehavior. These overlaps of the responsibilities and powers between them certainly interfere with the interplay of their shared function of supervising top management in Chinese listed companies.

#### **7.4 Conclusion**

The supervisory board is a civil law tradition of the two-tier board model of corporate governance in continental Europe. China has this legal tradition to some extent but has mixed it with the characteristics of the common law tradition of the unitary board model, owing to the dysfunction of the supervisory board. In practice, this hybrid model does not seem to work well or achieve the effect of this legislative design. The problem is that there may exist lacunae and ambiguities in the law and regulation, which probably hinder the shared responsibility of supervising top management between independent directors and the supervisory board in Chinese listed companies. Unless law and regulation deal with these lacunae and ambiguities the real interplay of the supervision function between independent directors and the supervisory board may not work effectively.

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<sup>576</sup> Guidance Opinion, above n 350 art. 5(4).

<sup>577</sup> Code of Corporate Governance, above n 434, art. 52.

## CHAPTER 8

# INDEPENDENT DIRECTORS AND CORPORATE PERFORMANCE IN CHINA: A META-EMPIRICAL STUDY

### 8.1 Introduction

From a viewpoint of economic efficiency, independent directors as an internal control mechanism are concerned with the improvement of corporate governance, which thus increases firm value and maximizes shareholder wealth in a corporation. Applying a comparative law method, the preceding chapters have explored the evolution and development of independent directors and corporate governance in China, compared with the United States and New Zealand, and examined the key elements that have impact on the efficacy of independent directors in corporate governance. No matter how controversial their effectiveness in corporate governance is, independent directors exist as a given. However, their existence is not only for the improvement of corporate governance but also for the enhancement of corporate performance. This is because good corporate governance is but a means of bringing about better corporate performance. Therefore, it would be foolish to study the effectiveness of independent directors in corporate governance without a further investigation of the relation between independent directors and firm performance. For the purpose of this further investigation, this chapter reviews the current empirical evidence regarding the impact of independent directors on firm performance by way of a meta-empirical study on independent directors and corporate performance in Chinese listed companies.

Based on this understanding, the focus of this meta-empirical study is to review the existing empirical studies on independent directors and corporate performance in Chinese listed companies so as to identify the existing empirical evidence on the efficacy of independent directors in corporate governance in China. Section 8.2 contains a literature review of the

existing empirical studies on independent directors and firm performance from an international perspective. Section 8.3 describes the collection of sample articles of empirical studies on independent directors and firm performance in China. Section 8.4 contains an analysis and discussion of the empirical evidence on independent directors and firm performance from the selected sample articles. Section 8.5 concludes the chapter.

## **8.2 International Literature Review**

Jensen and Meckling (1976) postulated that “a manager who invests all of his wealth in a single firm (his own) ..... will suffer a wealth loss as he reduces his fractional ownership because prospective shareholders and bondholders will take into account the agency costs”.<sup>578</sup> This suggests that the dispersion of stockholders can decrease a firm’s value because it will inevitably increase agency costs. Beneficially, this may also “tend to increase the optional level of monitoring”,<sup>579</sup> which can be expected to moderate the decrease of firm value and augment shareholder wealth. As pointed out by Fama & Jensen (1983), corporate boards generally include outside board members who “carry out tasks that involve serious agency problems between internal managers and residual claimants”<sup>580</sup> because they “have incentives to carry out their tasks and do not collude with managers to expropriate residual claimants”.<sup>581</sup> Accordingly, the presence of outsiders on corporate boards can reduce the possibility of the collusion between managers and internal board members, which can activate the board’s monitoring function and thus decrease managers’ expropriation of residual claimants’ wealth. In this way, firm value may be minimally decreased and stockholder wealth may be maximally increased. Following this line of reasoning, the corollary is that independent directors can improve corporate performance.

True, theoretical reasoning that the presence of independent directors on corporate boards can improve corporate governance and firm performance is sound. Since the monitoring board model has been adopted as the typical internal corporate control mechanism in the

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<sup>578</sup> Jensen & Meckling, above n 1 at 349.

<sup>579</sup> At 346.

<sup>580</sup> Fama & Jensen, above n 130 at 315.

<sup>581</sup> Ibid.

United States in the 1970s, the relationship between independent directors and corporate performance has been a more controversial theme of academic research in corporate governance. Empirical studies that examine this relationship look at the impact of different perspectives of independent directors such as number, proportion, characteristic and background on firm performance. Internationally, there is no given answer to this controversy because empirical evidence on whether independent directors can improve corporate performance is mixed. Generally speaking, there are mainly three kinds of empirical findings as regards the correlation between independent directors and corporate performance. That is, there may exist either a positive or a negative correlation, or no correlation between independent directors and corporate performance.

### Positive Correlation

In the earlier empirical literature, Vance (1964) and Pfeffer (1972) examined the impact of the outsider orientation of corporate boards on firm value and find there is a positive association between outside board members and corporate performance.<sup>582</sup> Following Vance and Pfeffer's work, a stream of empirical research has confirmed this finding. In an examination of 266 U.S. corporations, Baysinger and Butler (1985) provide evidence that more independent directors on firms' boards improve corporate performance by having realized higher relative financial performance (RFP),<sup>583</sup> although this effect is mild and lagged.<sup>584</sup> In a similar vein, Rosenstein and Wyatt (1990) indicate that the clearly identifiable announcements of appointing independent directors are associated with increases in shareholder wealth.<sup>585</sup> This is by reporting significant positive excess returns accompanying the announcements of the appointment of additional independent directors

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<sup>582</sup> Stanley C. Vance *Boards of Directors: Structure and Performance* (University of Oregon Press, Eugene, 1964) at 46. Jeffrey Pfeffer "Size and composition of corporate boards of directors: the organization and its environment" (1972) 17 *Administrative Science Quarterly* 218 at 224.

<sup>583</sup> Baysinger & Butler, above n 207 at 117. RFP is calculated by dividing the firm's return on equity by the average return on equity for all the firms in its primary industry.

<sup>584</sup> At 104. According the authors, "laggard" means that "firms that had invited relatively more independent directors onto these boards in the early 1970s enjoyed relatively better records of financial performance in the late 1970s" (at 117).

<sup>585</sup> Rosenstein & Wyatt, above n 210 at 186.

on firms' boards, even if the numbers of independent directors were dominant before the announcements.<sup>586</sup>

In a related study, Hermalin and Weisbach (1988) find that poor performance leads to changes in board composition and a poorly performing firm is more likely to invite independent directors to join its board, although perhaps with a time lag.<sup>587</sup> A number of other empirical studies have also reported a positive relationship between independent directors and firm performance (Schellenger, Wood, and Tashakori, 1989; Pearce and Zahra, 1992; Ezzamel and Watson, 1993; Rosenstein and Wyatt, 1997, Millstein and MacAvoy, 1998).<sup>588</sup> Wagner et al. (1998) conduct a meta-analysis of 63 empirical studies on the correlation between board composition and organizational performance and the result of their work indicates that the greater presence of independent directors is associated with higher organizational performance.<sup>589</sup> Subsequent research is supportive of their result (Lee et al., 1999; Ferris et al., 2003; Hillman, 2005; Honeine and Swan, 2010; Masulis et al., 2012).<sup>590</sup>

### Negative Correlation

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<sup>586</sup> At 176.

<sup>587</sup> Hermalin and Weisbach, above n 388 at 602.

<sup>588</sup> See Michael H. Schellenger, David, D. Wood and Ahmad Tashakori "Board of directors composition, shareholder wealth, and dividend policy" (1989) 15 *Journal of Management* 457-467. John A. Pearce and Shaker A. Zahra "Board compensation from a strategic contingency perspective" (1992) 29 *Journal of Management Studies* 411-438. Mahmoud Ezzamel and Robert Watson "Organizational form, ownership structure, and corporate performance: A contextual empirical analysis of UK companies" (1993) 4(3) *British Journal of Management* 161-176. Stuart Rosenstein and Jeffrey G. Wyatt "Inside Directors, Board Effectiveness, and Shareholder Wealth" (1997) 44 *Journal of Financial Economics* 229-250. Millstein & MacAvoy, above n 207.

<sup>589</sup> John A. Wagner III, J. L. Stimpert & Edward I. Fubara "Board Composition and Organizational Performance: Two Studies of Insider/Outsider Effects" (1998) 35 (5) *Journal of Management Studies* 656 at 664.

<sup>590</sup> See Yung Sheng Lee, Stuart Rosenstein & Jeffrey G. Wyatt "The Value of Financial Outside Directors on Corporate Boards" (1999) 8 *International Review of Economics and Finance* 421-431. Stephen P. Ferris, Murali Jagannathan & Adam C. Pritchard "Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments" (2003) 3 *The Journal of Finance* 1087-1111. Amy J. Hillman "Politicians on the board of directors: Do connections affect the bottom line?" (2005) 31 *Journal of Management* 464-481. Serkan Honeine & Peter L. Swan "Is Company Performance Dependent on Outside Director 'Skin in the Game'?" (26 November, 2010) available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1746536](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1746536). Ronald W. Masulis, Christian Ruzzier, Sheng Xiao & San Zhao "Do Independent Directors Matter?" (March 14, 2012) available at: <http://ssrn.com/abstract=2022831>.

Contrary to the above empirical findings, another stream of empirical research has found that there is a negative relationship between independent directors and firm performance. Zahra and Stanton (1988) conduct an examination on 100 randomly selected companies from the 1980 Fortune 500 List and observe that the ratio of independent directors has a significant negative effect on the firm's financial performance.<sup>591</sup> In a test on the managerial monitoring hypothesis, Fosberg (1989) investigates the impacts of various proportions of independent directors on the level of management performance. By using an extensive accounting means to measure firm performance, he provides the evidence that the relationship between the proportion of independent directors and firm performance is negative in general.<sup>592</sup> Using panel data of 142 NYSE firms to control for the possible bias due to the joint endogeneity of variables, Hermalin and Weisbach (1991) also find that the different proportions of independent directors on the board makes no noticeable difference but has a negative effect on the firm's profitability measured by Tobin's Q.<sup>593</sup> Consistent with this finding, Agrawal and Knoeber (1996) report a consistently negative and significant correlation between the proportion of independent directors and Tobin's Q, suggesting that firms having more independent directors add little to firm value.<sup>594</sup> The same is true of Yermack (1996), whose empirical work on the association between the fraction of independent directors and firm performance concurs with the same finding.<sup>595</sup>

There is influential empirical research by Bhagat and Black (1996), who conducted the first large sample, long-horizon study of whether the proportion of independent directors affects firm performance. Using a wide variety of market and accounting measures, they find that there is a strikingly significant negative correlation between the proportion of independent

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<sup>591</sup> Shaker A. Zahra and Wilbur W. Stanton "The Implications of Board of Directors' Composition for Corporate Strategy and Performance" (1988) 5 (2) *International Journal of Management* 229 at 232.

<sup>592</sup> Richard H. Fosberg "Outside Directors and Managerial Monitoring" (1989) 20 (2) *Akron Business and Economic Review* 24 at 29-31.

<sup>593</sup> Hermalin and Weisbach, above n 207 at 108, 110.

<sup>594</sup> Anup Agrawal and Charles R. Knoeber "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders" (1996) 31 (3) *Journal of Financial and Quantitative Analysis* 377 at 392.

<sup>595</sup> David Yermack "Higher Market Valuation of Companies with A Small Board of Directors" (1996) 40 *Journal of Financial Economics* 185 at 195.

directors and firm performance measured by a large variety of accounting measures.<sup>596</sup> In their follow-up studies, this finding has been confirmed again.<sup>597</sup> The finding is also in alignment with a stream of other empirical works (Daily and Dalton, 1993; Klein, 1998; Anderson et al., 2000; Beiner et al., 2004; Boone et al., 2007; Bhagat and Bolton, 2008).<sup>598</sup>

### No Correlation

Notably, the empirical literature also includes the evidence that no association exists between independent directors and firm performance. The earliest evidence is perhaps provided by Baysinger and Butler (1985), who find that there is no relationship between the proportion of independent directors on the board and the firm's profitability in the same year in 1970s, although there is a mild and lag effect on the positive relationship between the proportion of independent directors on the board in 1970s and firm performance in 1980s.<sup>599</sup> Rechner and Dalton (1986) document this no-relationship finding in their examination on the extent to which board composition measured by the percentage of independent directors on the board is associated with shareholder wealth.<sup>600</sup> Chagati et al. (1985), Kesner (1987) and Dalton et al. (1998) provide support for the no-relationship proposition.<sup>601</sup> Some researchers also find similar controversial evidence. For example,

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<sup>596</sup> Sanjai Bhagat and Bernard S. Black "Do Independent Directors Matter?" (March, 1996) Working paper # 112, Center for Law and Economics, Columbia University School of Law 1 at 37, 38, 40, 42, 43 and 44. This study has perhaps provided a more persuasive empirical evidence on the negative correlation between independent directors and firm performance.

<sup>597</sup> Bhagat and Black, above n 207 at 247, 250, 258. This is also consistent with their 1999 work.

<sup>598</sup> See Catherine M. Daily and Dan R. Dalton "Board of Directors Leadership and Structure: Control and Performance Implications" (1993) *Entrepreneurship Theory and Practice* 65-81. April Klein "Firm Performance and Board Committee Structure" (1998) 41 *Journal of Law and Economics* 275-303. Ronald C. Anderson, Thomas W. Bates, John M Bizjak and Michael L. Lemmon "Corporate Governance and Firm Diversification" (2000) 29 (1) 5 at 20. Stefan Beiner, Wolfgang Drobetz, Frank Schmid and Heinz Zimmermann "Is Board Size An Independent Corporate Governance Mechanism?" (2004) 57 (3) *KYKLOS* 327-356. Audra L. Boone, Laura Casares Field, Jonathan M. Karpoff and Charu G. Raheja "The Determinants of Corporate Board Size and Composition: An Empirical Analysis" (2007) 85 *Journal of Financial Economics* 66-101. Sanjai Bhagat and Brian Bolton "Corporate Governance and Firm Performance" (2008) 14 *Journal of Corporate Finance* 257-258.

<sup>599</sup> Baysinger & Butler, above n 207 at 117.

<sup>600</sup> Paula Rechner and Dan R. Dalton "Board Composition and Shareholder Wealth: An Empirical Assessment" (1986) 3 (2) *International Journal of Management* 86 at 89.

<sup>601</sup> Rajeswararao S. Chaganti, Viay Manajan and Subhash Sharma "Corporate Board Size, Composition and Corporate Failures in Retailing Industry" (1985) 22 *Journal of Management Studies* 400 at 412. Dan R. Dalto, Catherine M. Daily, Alan E. Ellstrand & Jonathan L. Johnson "Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance" (1998) 19 *Strategic Management Journal* 269 at 279.

except for a negative relation between the proportion of independent directors and firm performance measured by Tobin's Q, Hermalin and Weisbach (1991) find that "there appears to be no relation"<sup>602</sup> between board composition measured by the percentage of independent directors and firm performance.

In a recent empirical work, Duchin et al. (2010) observe an interesting finding.<sup>603</sup> In addressing the exogenous regulation changes in board composition that are presumably explainable for firm performance changes over the period of 2000-2005 while controlling the endogeneity issue at the same time, they find that the relationship between independent directors and firm performance is conditional on information cost: independent directors significantly improve firm performance, measured not only by accounting measures such as return on assets (ROA) and Tobin's Q but also by market measure such as stock return, when information cost is low but hurt firm performance significantly when information cost is high, using the same performance measures.<sup>604</sup> They provide an explanation for these dichotomy phenomena as - "the positive and negative effects cancel out on average"<sup>605</sup> - and claim that "the unconditional effect of outsiders, which in our sample is close to zero".<sup>606</sup>

Compared with international studies, empirical research on the association between independent directors and firm performance in China seems to be abundant in scope but not plentiful in depth. The empirical evidence provided by Chinese studies is similar to that of international studies. The following sections examine this issue in detail by way of reviewing 30 selected sample empirical studies.

### **8.3 Sample Collection of Chinese Research**

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<sup>602</sup> Hermalin and Weisbach, above n 207 at 111. They explain that "this could simply be due to insufficiently powerful tests".

<sup>603</sup> Ran Duchin, John G. Matsusaka and Oguzhan Ozbas "When Are Outside Directors Effective?" (2010) 96 *Journal of Financial Economics* 195-214.

<sup>604</sup> At 203.

<sup>605</sup> At 204.

<sup>606</sup> Ibid.



To review empirical research on the relationship between independent directors and firm performance in China, this research selects 30 empirical works to conduct the review. The selection procedure of sample articles, including sample sources and selection criteria, is described as follows.

### 8.3.1 Sample Sources

The aim of the review is to generalize the empirical research on the relationship between independent directors and firm performance in Chinese listed companies, which directs this research to search for any empirical study on this relationship. Searching is divided into two stages: to set selection criteria and to conduct searching.

The first stage is to set the criteria for searching. In addition to three mandatory criteria set for sample article selection in Section 3.6, three additional criteria are also set for sample article selection: endogeneity control, multi-performance measure and robustness check. Endogeneity control means that the sample article takes into account the endogeneity problem connected with board composition albeit it just runs a simple linear regression without taking into consideration either multi-performance measure or robustness check or both. The same logic applies to the multi-performance measure and robustness check criteria, respectively. Multi-performance measure means that the sample article applies at least two performance measures while robustness check means that the sample article conducts at least one robustness test. These three criteria are not all mandatory but are alternatives for each selected sample article. This means that each sample article, in addition to meeting the three mandatory selection criteria set in Section 3.6, also needs to meet at least one of three alternative criteria to be selected. The rationale behind three additional criteria is to identify those sample articles with some detailed and in-depth empirical evidence for the purpose of this review study.

The second stage is to conduct the search, which is also conducted in two stages: international and domestic. In the case of some sample articles that are not available via either international or domestic source, the searching was conducted through the

universities' interlibrary loan system. The international search was conducted by way of international scholarly websites such as Google Scholar, ProQuest, Scopus, Heinonline and SSRN, which showed that there are few sample articles on this subject. The searching effort then shifted in the domestic direction through the CNKI website, administered by China Academic Journal Electronic Publishing House. The initial searching identifies 52 sample articles. After the screening procedure according to the six selection criteria set by this research, 30 sample articles have been selected for reviewing in the rest of this meta-empirical study.

### 8.3.2 Sample Description

A description of 30 selected sample articles is presented in Table 8.3.2.1. Some observations can be made from Table 8.3.2.1. First, the empirical research on the relationship between independent directors and firm performance in Chinese listed companies began in 2001 (Li & Li), which was concurrent with the formal introduction of independent directors from the United States to China by Chinese regulators the same year. The relatively recent study was conducted in 2013 (Zhang & Wang). Even as a late starter in this field of research, Chinese scholars produce abundant empirical works in a short period of thirteen years from 2001 to 2013, compared with international studies at least since the 1970s (see discussions in Section 8.2). Second, the sample size used by all researchers varied greatly, from the smallest one of 31 (Shen et al., 2007) to the biggest one of 3,474 (Wang et al., 2006).

Third, the sample period covered in the Chinese studies spans from 1998 to 2010, which reflects the fact that the empirical study of the relationship between independent directors and firm performance is a hot topic in the corporate governance literature in China. For example, the sample periods of three recent studies (Hui & Lu, 2013; Lan & Zhang, 2013 and Zhang & Wang, 2013) range from 2005 to 2010, which shows the authors' interests in changes of law and policy such as the Company Law 2005 and the share structure split reform 2005 on the relationship between independent directors and firm performance in Chinese listed companies.

**Table 8.3.2.1 Description of 30 Selected Empirical studies on the Correlation between Independent Directors and Firm Performance**

Author	Sample Size	Sample Period	Methodology	Stock Exchange	Industry	Finding
Yougen Li, Xiping Zhao & Huaizu Li (2001)	91	1998-1999	Linear & Quadratic	SHSE & SZSE	All	Weakly Positive
Minghua Gao & Shouli Ma (2002)	1018	2001	Linear & Quadratic	SHSE & SZSE	All	Weakly Positive
Qinqin Hu & Yifeng Shen (2002)	41	2000	OLS	SHSE & SZSE	All	Weakly Positive
Qisheng Lü & Yue Lü (2003)	152	2001	Linear	SHSE & SZSE	All	Weakly Positive
Dongzhi Yu (2003)	1088	1997-2000	OLS	SHSE & SZSE	Non-Financial	No Correlation
Jingshui Sun (2003)	58	2002-2003	OLS & Quadratic	SHSE & SZSE	All	Weakly Positive
Chaojin Xiang & Ming Xie (2003)	110	2001	OLS	SHSE & SZSE	All	Weakly Positive
Pinliang Luo, Yong Zhou & Hui Guo (2004)	673	1999-2002	Linear	SHSE	All	No Correlation
Shuoli Ma (2004)	1244	2003	Linear & Quadratic	SHSE & SZSE	All	Weakly Positive
Jie Yang, Jun Zheng & Long Cheng (2004)	59	2002	Linear	SHSE & SZSE	Medicine	Weakly Positive
Qingquan Tang, donglun Luo & Xueqin Zhang (2005)	297	2002	OLS	SHSE & SZSE	All	Negative **
Jianguo Gu & Jiancheng Long (2006)	215	2001-2003	OLS	SHSE & SZSE	Non-Financial	Negative
Yaotang Wang, Ziyi Zhao & Xiaoyan Wei (2006)	3476	2002-2004	SEM (OLS, 2SLS)	SHSE & SZSE	Non-Financial	Positive***
Xiaodong Chen & Danfeng Chi (2007)	866	2003-2005	OLS & WLS	SHSE & SZSE	Non-Financial	Negative**
Fuping Shen, Qiaoyan Han & Hongmei Zhao (2007)	31	2005	OLS	SHSE & SZSE	All	Weakly Positive
Gang Wei, Zezhong Xiao, Nick Travlos & Hong Zou (2007)	291	1999-2002	SEM (OLS, 3SLS)	SHSE & SZSE	Non-Financial	Positive
Jin Zou (2007)	1599	2003-2005	Linear & Quadratic	SHSE	All	Weakly Positive
Kai Hu & Zegang Zhu (2008)	89	2004	Linear & Quadratic	SHSE	All	Negative

**Table 8.3.2.1** Cont'd

Author	Sample Size	Sample Period	Methodology	Stock Exchange	Industry	Finding
Dewu Zhao, li Zeng & Lichuan Tan (2008)	993	2002-2004	OLS (Component & Path Analyses)	SHSE & SZSE	Non-Financial	Positive***
Jie Wu & Faqin Lan (2009)	462	2005-2007	OLS	SHSE	Industrial	Positive**
Zhigang Zheng & Xiuhua Lü (2009)	4148	2001-2004	OLS	SHSE & SZSE	All	Negative***
Yihong Lu (2009)	1395	2003-2006	SEM (OLS, 3SLS)	SHSE & SZSE	Non-Financial	Weakly Positive
Yuchao Ma (2009)	100	2007	Multiple linear	SHSE & SZSE	All	Positive***
Yingzi Bian (2010)	873	2006	OLS	SHSE & SZSE	All	Weakly positive
Helen Wei Hu, On Kit Tam & Monica Guosze Tan (2010)	304	2003-2005	SEM	SHSE & SZSE	All	Negative
Luhang Zheng (2010)	1548	2006-2007	OLS	SHSE & SZSE	All	Positive ***
Tiaoyan Hui & Feilan Lu (2013)	305	2005-2010	Linear	Not Reported	Financial	Negative
Xiaochun Lan & Tienan Zhang (2013)	1721	2002-2004	SEM (OLS, 2SLS)	SHSE & SZSE	Non-Financial	Negative***
Ming Li & Hui He (2013)	285	2005-2009	SEM (AMOS)	SZSE	Non-Financial	Weakly Positive
Zhiping Zhang & Zhiqiang Wang (2013)	1515	2010	OLS	SHSE & SZSE	All	Weakly Negative

Note: SHSE means Shanghai Stock Exchange and SZSE means Shenzhen Stock Exchange. OLS means Ordinary Least Square. WLS means Weighted Ordinary Least Square. 2SLS means Two Stage Least Squares and 3SLS means Three Stage Least Squares. SEM means Simultaneous/Structural Equation Model. Linear means simple linear regression. Quadratic means quadratic curve regression. Multiple Linear means multiple linear regression. AMOS means AMOS path analysis. \*\*, \*\*\* denote statistically significant at the 5%, 1% levels, respectively.

Fourth, most studies cover Chinese companies from all industries, or all industries excluding financial industry, listed in both Shanghai and Shenzhen stock exchanges. Some studies are only cover Shanghai or Shenzhen stock exchange (Luo et al., 2004; Zou, 2007; Hu & Zhu, 2008; Wu & Lan, 2009 and Li & He, 2013) or a single industry (Yang et al., 2004; Wu & Lan, 2009 and Hui & Lu, 2013). Fifth, the results of researchers are similar to those of international studies, i.e., they have identified three kinds of relationships between independent directors and firm performance: positive, negative and no relation.

Table 8.3.2.2 describes the distribution of the three relationships in China studies. Table 8.3.2.2 shows that 63.33% of 30 selected empirical studies report a positive relationship between independent directors and firm performance in Chinese listed companies. 5 studies document a significant positive relationship. 9 studies find that independent directors have a negative effect on firm performance. 44.44% of them are significantly negative. Only 2 selected studies find no relationship between independent directors and firm performance, which is 6.67% of 30 selected sample articles. Of 30 selected sample articles, studies reporting a statistically positive significance comprise 16.67%, while studies reporting a statistically negative significance comprise 13.33%. This means that only less than one third of 30 selected sample articles report a meaningful finding from a statistical perspective.

From Table 8.3.2.2, it appears that less than two thirds of 30 selected studies report a positive relation between independent directors and firm performance in Chinese listed companies. The ratio of studies reporting a positive relationship between independent directors and firm performance to studies reporting a negative and no relationship between independent directors and firm performance is 19 to 11, i.e., approximately 2 to 1. So, it seems that, generally speaking, independent directors positively affect firm performance in Chinese listed companies. This is confounding and misleading because it cannot tell us which role, monitoring or advising, played by independent directors, affects firm performance. It is confounding because it is not consistent with the received wisdom that independent directors are just “vase directors” in China. It is misleading because it gives a false impression that independent directors perform their monitoring role well in China.

One possible explanation is that independent directors may perform their advising role better than their monitoring role and thus add value to firm performance. A number of selected sample articles may provide evidence for this explanation.<sup>607</sup>

**Table 8.3.2.2 Results of 30 Selected Empirical Studies on the Relationship between Independent Directors and Firm Performance**

Result	Number	Percentage	Significance		
			Number	Percentage <sup>1</sup>	Percentage <sup>2</sup>
Positive	19	63.33	5	26.32	16.67
Negative	9	30.00	4	44.44	13.33
No Correlation	2	6.67			
Total	30	100	9	32.14	30.00

Note: Percentage<sup>1</sup> is the ratio of significance number to positive/negative number. Percentage<sup>2</sup> is the ratio of significance number to total number. Number means the number of sample articles. Percentage is the ratio of positive/negative number to total number. Significance means statistical significance.

## 8.4 Discussion and Analyses

A review of 30 selected sample articles identifies that the authors of these sample articles examine the relationship between independent directors and firm performance from four categories: board independence, independent directors' background, characteristic and compensation. Table 8.4 describes the classification of the four categories and this section discusses and analyzes them in detail.

**Table 8.4 Classification of 30 Selected Empirical Studies on the Relationship between Independent Directors and Firm Performance**

<b>Panel A: Four Categories</b>				
	Independence	Background	Characteristic	Compensation
Number	28	7	8	5
Percentage	93.33	23.33	26.67	16.67
<b>Panel B: Sub-categories of Board Independence</b>				
	Proportion	Number*	Adoption	
Number	22	2	4	
Percentage	78.57	7.14	14.29	

Note: Number is the number of sample articles. Percentage is the percentage of sample articles in each category. Independence means board independence. Background, characteristic and compensation mean independent directors' background, characteristic and compensation, respectively. Proportion and number\* mean the proportion

<sup>607</sup> Further analysis is discussed in Section 8.4.2.

and the number of independent directors, respectively. Adoption means whether or not a firm has independent directors on its board of directors.

#### 8.4.1 Board Independence and Firm Performance

From Panel A of Table 8.4, it can be seen that 28 selected sample articles, 93.33% of 30 selected sample articles, examine the impact of board independence on firm performance. Undoubtedly, board independence is the focus that most authors of the selected sample articles are interested in testing the relationship between independent directors and firm performance. To test this relationship, these authors pay attention to three subcategories of board independence. Panel B of Table 8.4 further classifies these three sub-categories that may affect firm performance, i.e., the proportion of independent directors, the number of independent directors and the adoption of the independent director institution. Table 8.4.1 reports the relevant test statistics of 28 selected sample articles regarding the relationship between the three sub-categories of board independence and firm performance.

##### The Proportion of Independent Directors

As shown in Panel B of Table 8.4, 22 selected sample articles, 78.57% of 28 selected sample articles that test the effect of board independence on firm performance, scrutinize the relationship between the proportion of independent directors and firm performance. Panel A of Table 8.4.1 provides the detailed test results of 22 selected sample articles. Of them, 5 studies identify a statistically significant relationship between the proportion of independent directors and firm performance: two are negative and three are positive, accountable for 9.09% and 13.64% of 22 selected sample articles examining the relationship between board independence and firm performance, respectively. Wang et al. (2006) probably conducted the first empirical research that found such a significant relationship. The authors use the SEM model to control the endogeneity problem connected with board composition based on 3,476 observations from Chinese listed companies of non-financial industries in the period of 2002-2004 and find a positive correlation between the proportion of independent directors and firm performance measured by the PER (adjusted ROA), statistically significant at the 1% level (p-Values for both OLS and 2SLS

are 0.010 and 0.0102, respectively).<sup>608</sup>

This finding is consistent with that of Rosenstein and Wyatt (1990) and provides the Chinese evidence. To avoid the multicollinearity problem caused by multivariate interaction, Zhao et al. (2008) apply the factor analysis method by way of component analysis and path analysis on 993 companies in non-financial industries, listed before 2002 in two Chinese stock exchanges that survived in the period of 2002-2004. They ran an OLS regression on the correlation between the percentage of independent directors and the firm's profit stability measured by E/P (initial stock price per share). They found that the percentage of independent directors has a positive effect on the stability of firm profitability, statistically significant at 1% level (p-Value for all estimated components is 0.000).<sup>609</sup>

In another selected sample article, Wu and Lan (2009) provided the evidence to support their findings. The two authors collected the data of 462 Chinese listed companies from the industrial sector in the period of 2005-2007 as their samples to establish a panel regression model to test the correlation between the percentage of independent directors and firm performance measured by ROE and Tobin's Q. Their test result supports the findings of Zhao et al. (2008) and Wu and Lan (2009). The difference is that Wu and Lan (2009) report a positive correlation between the percentage of independent directors and firm performance measured by ROE, statistically significant at the 1% level (p-Value is 0.003).<sup>610</sup> In Contrast, Chen & Chi (2007) and Zheng & Lü (2009) discover a negative relationship between the proportion of independent directors and firm performance measured by Tobin's Q, statistically significant at the 5% and 1% levels, respectively.<sup>611</sup>

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<sup>608</sup> Yaotang Wang, Ziye Zhao & Xiaoyan Wei "Does Independence of the Board affect Firm Performance?" (2006) 5 *Economic Research* (Chinese version) 62 at 70.

<sup>609</sup> Dewu Zhao, li Zeng & Lichuan Tan "Supervision of Independent Directors and Earnings Conservatism: An Empirical Study Based on Chinese Listed Companies" (2008) 9 *Accounting Research* (Chinese version) 55 at 62.

<sup>610</sup> Jie Wu & Faqin Lan "Study on the Correlation between Independent Director System and Firm Performance: An Empirical Study based on Chinese Listed Companies" (2009) 462 (14) *Economic Forum* (Chinese version) 117 at 120.

<sup>611</sup> Xiaodong Chen & Danfeng Chi "Empirical Study on the Relevance of Independent Directors and Firm Performance in Listed Companies" (2007) 8 *Communication of Finance and Accounting* (Chinese version) 8 at 12. Zhigang Zheng and Xiuhua Lü "The Interactive Effects of the Independence of the Board of Directors, and Evaluation of the effectiveness of the Policies for the System of Independent Directors in Chinese Capital Markets" (2009) 7 *Management World (Monthly)* (Chinese version) 133 at 136.



Chen & Chi (2007) use the data of 886 companies listed before 2002 and existed in the period of 2003-2005 to run both OLS and WLS regressions. Their study aims to investigate whether independent directors add value to their firms from the official introduction of the independent director system in 2001 to the share structure split reform in 2005. The result is consistent with their hypothesis that the percentage of independent directors is negatively associated with firm performance (t-value is -2.338, which is statistically significant at the 5% level). Zheng & Lü (2009) take into consideration of the lag effect of corporate governance. Their samples included 4,148 observations from 2001 to 2004 but their data of firm performance and control variables range from 2002 to 2005. The finding is that the coefficient (r-value) between the percentage of independent directors and Tobin's Q is -0.314, statistically significant at the 1% level. From the perspective of Chinese practice, the findings of Chen & Chi (2007) and Zheng & Lü (2009) support that of Bhagat and Black (1996).

Except for the above 5 studies, 17 selected sample articles identify that there is a correlation, either positive or negative, between the proportion of independent directors and firm performance although the correlation is not statistically significant. Among them, twelve (Li et al., 2001; Gao & Ma, 2002; Hu & Shen, 2002; Lü & Lü, 2003; Sun, 2003; Xiang & Xie, 2003; Ma, 2004; Shen et al, 2007; Zou, 2007; Lu, 2009; Bian, 2010 and Li & He, 2013) are positive<sup>612</sup> and five (Yu, 2003; Luo et al., 2004; Hu & Zhu, 2008; Hu et al., 2010 and

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<sup>612</sup> Yougen Li, Xiping Zhao & Huaizu Li "Study on Board Composition and Firm Performance in Listed Companies" (2001) 5 *China Industrial Economics* (Chinese version) 48-53. Minghua Gao & Shouli Ma "An Empirical Analysis on the Relationship between the Independent Director System and Firm Performance—the Institutional Environment of Effectuating Independent Directors' Rights in China" (2002) 2 *Nankai Economic Studies* (Chinese version) 64-68. Qinqin Hu & Yifeng Shen "Can Independent Directors Improve the Listed Companies' Performance" (2002) 7 *World Economy* (Chinese version) 55-62. Qisheng Lü & Yue Lü "An Empirical Analysis on the Effectiveness of the Independent Director System of Chinese Listed Companies" (2003) 167 (11) *Statistics & Decision* (Chinese version) 30-32. Jingshui Sun "Positive Analysis on the Institution of Independent Director System and Firm Performance in China's Listed Companies—A Case Study of Zhejiang Listed Companies" (A partial report of 2003 Zhejiang province's research project on philosophy and social science, approval No. Z03YJ18) (Chinese version) 1-28. Chaojin Xiang & Ming Xie "An Empirical Analysis on the Relation between Corporate Governance and Firm Performance in Chinese Listed Companies" (2003) 5 *Management World (Quarterly)* (Chinese version) 117-124. Shuoli Ma "An Empirical Analysis on 2003 Chinese Independent Director System and Operation Performance of Listed Companies" (2004) 19 (5) *Journal of Pindingshan Teachers College* (Chinese version) 52-54. Fuping Shen, Qiaoyan Han & Hongmei Zhao "An Empirical Analysis on the Independent Director System and Operation Performance: An Example of Hebei Listed Companies" (2007) *Special Zone Economy* (Chinese version) 59-60. Jin Zou "An Empirical Analysis on Independent Directors and Firm Performance in Chinese Listed Companies" (2007) *Special Zone Economy* (Chinese version) 118-120. Yihong Lu "Study on Integrating Function of Independent Director" (2009) (A PhD thesis of College of Economics and Business

Zhang & Wang, 2013) are negative.<sup>613</sup> Among 12 selected sample articles that identify a positive relation between the proportion of independent directors and firm performance, 5 studies ran a simple linear regression. The difference is that Li et al. (2001), Gao & Ma (2002) and Ma (2004) used two measures to measure firm performance, compared with Lü & Lü (2003), who used four measures, and Zou (2007), who uses an integrated financial indices consisted of 20 financial indices under 5 categories of abilities in payment, debt, profit, growth and cash flow.

Another seven studies ran an OLS regression, of which two studies also ran a SEM regression. Bian (2010) used one measure to measure firm performance while Hu & Shen (2002), Xiang & Xie (2003), Lu (2009) and Li & He (2013) used two measures. Hu & Shen identified a weak positive effect (r-coefficients are 0.055 and 0.099 for CAR and Tobin's Q, respectively). In comparison, Sun (2003) used four measures and Shen et al (2007) use five measures. By using various measures to measure firm performance, the authors' reasoning is perhaps to strengthen the robustness of their models' predictability.<sup>614</sup> Among 6 selected sample articles that identify a negative relation between independent directors and firm performance, two studies regress a simple linear model. While Luo et al (2004) utilize two measures to measure firm performance, Hu & Zhu (2008) apply an integrated performance index comprised of 11 firm performance indices.<sup>615</sup> Four other studies regress an OLS model, of which one study also runs a SEM regression. Yu (2003) employs two measures to measure firm performance but Hu et al (2010) and Zhang & Wang (2013) use

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Administration of Chongqing University) (Chinese version) 1-108. Yingzi Bian "The Relationship between Independent Directors and Firm Performance in Listed Companies" (2010) 3 *Communication of Finance & Accounting* (Chinese version) 17-19. Ming Li & Hui He "A Study on the Role Path of Independent Directors in Listed Companies" (2013) 123 (1) *Journal of Shandong University of Finance* (Chinese version) 100-107.  
<sup>613</sup> Dongzhi Yu "Board of Directors, Corporation Governance and Performance: An Empirical Analysis of Listed Companies in China" (2003) 3 *Social Sciences in China (Bimonthly)* (Chinese version) 29-41. Pinliang Luo, Yong Zhou & Hui Guo "The Co-relation Analysis on Independent Directors and Corporate Performance: A Empirical Study of a Share Index of Shanghai" (2004) 2 *Shanghai Management Science* (Chinese version) 20-23. Kai Hu & Zegang Zhu "An Empirical Study on the Relationship between the Independent Director System under Various Controlling Shareholders and Firm Performance" (2008) 12 *Communication of Finance & Accounting* (Chinese version) 36-38. Helen Wei Hu, On Kit Tam & Monica Guosze Tan "Internal governance mechanism and firm performance in China" (2010) *Asia Pac. J. Manag.* 727-749. Zhiping Zhang & Zhiqiang Wang "Can Independent Director System in China Improve the Performance of Listed Firms in Shenzhen and Shanghai in 2010" (2013) 36 (3) *Journal of Shijiazhuang University of Economics* (Chinese version) 73-77.

<sup>614</sup> Details see Section 8.4.5.

<sup>615</sup> Hu & Zhu, above n 613 at 37.

one measure. As seen from Table 8.4.1, Lü & Lü (2003) and Zou (2007) report a weak correlation between independent directors and firm performance, r- coefficients for both are 0.067 and 0.076, respectively.

Noticeably, two studies report a no-correlation finding between the proportion of independent directors and firm performance. Although no regression coefficients reported, Yu (2003) and Luo et al. (2004) identify that there is no correlation between the percentage of independent directors and firm performance.<sup>616</sup> Just as Duchin et al. (2010), Yu (2003) notices that, in running an OLS model, t-Value is 0.669 when firm performance is measured by average sales on assets (ACPM) but it is -0.571 when measured by average return on equity (AROE). Therefore, he comes to a conclusion like Duchin et al. (2010). In running a simple linear model, Luo et al. (2004) find that the absolute value of both Pearson and Spearman correlation coefficients is lower than 0.18 when firm performance is measured by EPS (earning per share) and ROE, and that  $R^2$  is 0.0184 for EPS and 0.0260 for ROE, respectively.<sup>617</sup> These figures are much lower than 1 but close to zero and thus they reach the same conclusion.

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<sup>616</sup> Yu, above n 773 at 39. Luo et al, above n 613 at 22.

<sup>617</sup> Ibid.

**Table 8.4.1 Board Independence and Firm Performance**

Author	Model	Measure	r-Coefficient	t-Test	F-Test	p-Value
<b>Panel A: Proportion</b>						
Li et al (2001)	Linear	ROE ROA			1.00 1.83	0.320 0.179
Gao & Ma (2002)	Linear	ROE EPS	0.55 0.22			0.0687 0.3517
Hu & Shen (2002)	OLS	CAR Tobin's Q	0.053 0.099	-0.329 -0.624		
Lü & Lü (2003)	Linear	ROE EPS SOA ROA	0.197 0.067 -0.069 0.215			0.185 0.656 0.645 0.146
Sun (2003)	OLS	EPS ROE ROA Tobin's Q	0.007 0.019 0.002 0.003			0.158 0.881 0.973 0.956
Xiang & Xie (2003)	OLS	ROE Tobin's Q	0.001987 0.004719	0.040 1.279		0.968 0.204
Yu (2003)	OLS	AROE ACPM	-0.370 -0.0835	-0.571 0.669		0.57 0.51
Luo et al (2004)	Linear	EPS ROE	-0.27521 -17.0986	-0.76 -0.91		0.4511 0.3696
Ma (2004)	Linear	ROE EPS	16.9888 0.8012		1.50 1.49	0.221 0.223
Wang et al (2006)	SEM	PER	016145			0102***
Chen & Chi (2007)	OLS	Tobin's Q	-0.011	-2.338		**
Shen et al (2007)	OLS	EPS ROE SOA SE RP				0.3959 0.8710 0.8005 0.9830 0.7305
Zou (2007)	Linear	CWZP	0.076			
Hu & Zhu (2008)	Linear	CPI	-11.527	-0.658		0.513
Zhao et al (2008)	OLS	E/P	0.191	8.756		0.00***
Lu (2009)	SEM	ROA MBV	0.021 0.052	0.337 0.417		
Wu & Lan (2009)	OLS	ROE Tobin's Q	0.2789 3.6366			0.003** 0.056
Zheng & Lü (2009)	OLS	ROA Tobin's Q	0.009 -0.314			***
Bian (2010)	OLS	Tobin's Q	-			0.99
Hu et al (2010)	SEM	Tobin's Q	-0.035	-0.109		
Li & He (2013)	SEM	Tobin's Q ROA	0.7192 0.054	1.21 1.59		
Zhang & Wang (2013)	OLS	ROE	-0.02	-0.30		
<b>Panel B: Number*</b>						
Yang et al (2004)	Linear	EPS	0.87			0.512
Gu & Long (2006)	OLS	EPS NAS RNAS MB	-0.004 0.029 -0.072 -0.065	-0.092 0.817 -1.73 -1.84		

**Table 8.4.1** Cont'd

Author	Model	Measure	r-coefficient	t-Test	F-Test	p-Value
<b>Panel C: Adoption</b>						
Gao & Ma (2002)	Linear	ROE		1.481		0.139
		EPS		0.370		0.712
Lü & Lü (2003)	Linear	ROE		1.232		0.220
		EPS		0.112		0.911
		SOA	+	-0.586		0.559
		ROA		1.053		0.294
Ma (2004)	Linear	ROE		1.061		0.289
		EPS		0.327		0.744
Luo et al (2004)	Linear	EPS	-	-3.20		0.0031***
		ROE	-	-2.29		0.0286**

Note: Measure means the method used to measure firm performance. ROE means return on equity. ROA means return on assets. EPS means earnings per share. SOA means sales on assets. Tobin's Q means the ratio of equity market value to assets replacement costs. AROE means average ROE. ACPM means average SOA. RP means retained profits. E/P means initial price per share. SE means shareholders' equity. CAR means cumulative abnormal return. CPI means integrated performance index. MB means market value. MBV means net market value. NAS means net assets per share. RNAS means ROE. PER means adjusted ROA. CWZP means integrated financial indices. \*\*, \*\*\* denotes the statistical significance at the 5%, 1% levels, respectively.

### The Number of Independent Directors

In Panel B of Table 8.4, 2 selected sample articles, 7.14% of 28 selected sample articles that test the effect of board independence on firm performance, look into the relationship of the number of independent directors and firm performance. Panel B of Table 8.4.1 describes the relevant test details of these 2 studies. There is no significant relationship identified between the number of independent directors and firm performance. Yang et al. (2004) use a single linear model and find a positive effect, i.e., the higher the number of independent directors the better the firm performance measured by EPS (r-coefficient is 0.87) and ROE (r-coefficient is 0.045), respectively.<sup>618</sup> Their results come from an investigation of 59 listed companies in the medical industry in 2002. In contrast, Gu & Long (2006) identify a negative effect that the number of independent directors has on firm performance. They use four measures to measure firm performance and find that four relevant regression coefficients are -0.004 for EPS, 0.029 for NAS (net assets per share), -0.072 for RNAS (ROE) and -0.065 for MB (market value), respectively.<sup>619</sup> The samples chosen by the authors are 215 listed companies from non-financial industries in the period

<sup>618</sup> Jie Yang, Jun Zheng & Long Cheng "Independent Director System and Firm Performance" (2004) 12 *Economic Perspectives* (Chinese version) 57 at 58, 59.

<sup>619</sup> Jianguo Gu & Jiancheng Long "Corporate Governance, Board Independence and Firm Performance" (2006) General No. 125, No. 5 *Collected Essays on Finance and Economics* (Chinese version) 86 at 88.

of 2001-2003. The findings based on these figures reject their hypothesis that the number of independent directors has a positive impact on firm performance.

### The Adoption of the Independent Director Institution

Panel B of Table 8.4 also shows that 4 selected sample articles, 14.29% of 28 selected sample articles that test the effect of board independence on firm performance, explore whether or not the adoption of the independent director institution has impact on firm performance. Panel B of Table 8.4.1 reports the relevant test statistics. The four studies all run a simple linear regression to test whether or not firms adopting the independent director practice have an influence on their financial performance, compared with firms that do not adopt the independent director practice. Although Luo et al. (2004) conclude that there is no correlation between the proportion of independent directors and firm performance, they do document a significant negative effect on firms adopting the independent director institution, measured by the same measures EPS (t-Value is -3.20, significant at the 1% level) and ROE (t-Value is -2.29, significant at the 5% level). They further find that the average EPS drops RMB¥0.103 and the average ROE goes down 3.768% for firms adopting the independent director institution.<sup>620</sup> They conclude that firm performance is even worse after the adoption of the independent director institution than before.

Contrary to their findings, the other 3 studies all report a positive effect, albeit not statistically significant, that the adoption of the independent director practice has on firm performance. Gao & Ma (2002) and Ma (2004) both use the same two measures to measure firm performance. The latter is in essence a follow-up study of the former, though samples in the former are 1,018 in 2001 while samples in the latter are 1,244 in 2003, and there is no big difference between the results of both studies. Lü & Lü (2003) utilize four measures to measure firm performance and report a positive correlation between the adoption of independent director institution and firm performance measured by ROE, EPS and ROA (t-Value is 1.232, 0.112 or 1.053, respectively) but a negative correlation measured by SOA

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<sup>620</sup> Luo et al., above n 613 at 22.

(t-Value is -0.586).<sup>621</sup> From a viewpoint of generalizing the relationship in whole between the adoption of the independent director institution and firm performance, they conclude that there is no significant difference between firms with independent directors and those without, because the establishment of the independent director institution has no significant influence on the improvement of firm performance.

#### 8.4.2 Independent Directors' Background and Firm Performance

Panel A of Table 8.4 shows that 7 selected sample articles, 23.33% of 30 selected sample articles, examine the impact of independent directors' background on firm performance. Table 8.4.2 provides the detailed test statistics of these 7 studies on the relationship between independent directors' background and firm performance. Most remarkably, 5 studies (Chen & Chi, 2007; Wei et al., 2007; Zhao et al., 2008; Lu, 2009 and Zheng, 2010) find a strong effect, either positive or negative, that independent directors' background has on firm performance measured by several different performance measures. To find what kind of background that influences firm performance, the authors test a variety of independent directors' backgrounds in connection with different performance measures. Four studies provide evidence that independent directors' background has a positive effect on firm performance. Among them, Tang et al. (2005) classify independent directors as two groups according to their academic and industrial experiences, respectively, and use ROA, ROE and Tobin's Q to measure firm performance. They find that no single group, either academic or industrial, has a significant impact on three performance measures but there is when both groups mix together equally, measured by ROA (t-Value is -2.00) and Tobin's Q (t-Value is -1.93) but not by ROE (t-Value is -0.92).<sup>622</sup> Based on this finding, the authors comment that listed companies invite academic independent directors just for the "vase director" effect so as to enhance their companies' reputations. Interestingly, the authors do not comment on independent directors invited from industry even though they have the same effect as those from academics.

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<sup>621</sup> Lü & Lü, above n 612 at 31.

<sup>622</sup> Qingquan Tang, Danglun Luo & Xueqin Zhang "Empirical Evidence of Relationship between Professional Backgrounds of Independent Directors and Corporate Performance" (2005) 27 (1) *Contemporary Economic Management* (Chinese version) 97 at 100.

Compared with Tang et al. (2005), Zhao et al. (2008), Lu (2009) and Zheng (2010) document a strong significant relationship between independent directors' background and firm performance. Like the finding on the percentage of independent directors, Zhao et al. (2008) also find that independent directors who are professional accountants positively affect the stability of the firm profitability measured by E/P (initial stock price per share), statistically significant at the 1% level (p-Value for independent directors with the professional accountant background as the estimated component is 0.000).<sup>623</sup> Lu (2009) classifies independent directors' backgrounds in six categories, i.e., academic, banking, education, finance, government and neutral (other backgrounds), and uses ROA and MBV (net market value) to measure the effect of independent directors' different backgrounds on firm performance. He finds that independent directors from any background have a positive influence on firm performance, although the influence of each category is different. The influences of independent directors from academic institutions and other backgrounds to firm performance are not statistically significant, though positive (r-coefficients for ROA<sub>a</sub>, ROA<sub>n</sub>, MBV<sub>a</sub> and MBV<sub>n</sub> are 0.40, 0.133, 0.016 and 0.532, respectively).<sup>624</sup>

However, independent directors with backgrounds in banking, education, finance and government all have a positive impact on firm performance, statistically significant either at the 1% level (t-Values for ROA<sub>b</sub>, ROA<sub>e</sub>, MBV<sub>b</sub> and MBV<sub>e</sub> are 3.658, 2.321, 2.849 and 2.732, respectively) or at the 5% level (ROA<sub>f</sub>, ROA<sub>g</sub>, MBV<sub>f</sub> and MBV<sub>g</sub> are 2.024, 2.189, 1.915 and 2.044, respectively).<sup>625</sup> He explains that social relationships, especially the relationships with government officials or those in connection with government officials (banks are owned or controlled by the government in China), can provide resources to companies because government officials control the distribution of social resources in China. This explanation suggests that independent directors' resource role rather than their supervision role is most important to listed companies for their survival and growth in China. This nature of the relation business is endogenous in Chinese commercial practice

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<sup>623</sup> Zhao et al., above n 609 at 62.

<sup>624</sup> Lu (2009), above n 612 at 79.

<sup>625</sup> Ibid.



inherited at least from the late Qing Dynasty's commerce policy of "government supervision and merchant management" (*guandu shangban*).

Zheng (2010) provides evidence to support Lu (2009)'s explanation. Using the data of 1,548 Chinese listed companies in the period of 2006-2007, she investigates the political connection of independent directors and firm performance, measured by independent directors' background in connection with the government on Tobin's Q, which is calculated on either the stock price of negotiable shares (Tobin's  $Q_1$ ) or the value of net assets (Tobin's  $Q_2$ ). The finding is that the political background of independent directors has a strong positive impact on firm performance measured either by Tobin's  $Q_{1g}$  (t-Value is 2.79) or by Tobin's  $Q_{2g}$  (t-Value is 1.78), statistically significant at the 1% level or at the 10% level, respectively.<sup>626</sup> This suggests that the political background of independent directors is beneficial to companies in a country like China where politics is an important determinant factor to influence the firm's profitability. Independent directors with the political background can play an important advisory role by moving in government officials and garnering business opportunities, which may send a positive signal of the firm's prospective to stock investors. In addition to the political background of independent directors, Zheng (2010) also finds the same strong positive correlation between the educational background of independent directors and firm performance (t-Values for Tobin's  $Q_{1e}$  and Tobin's  $Q_{2e}$  are 2.97 and 1.91, respectively), statistically significant at the 1% level and at the 10% level, respectively.<sup>627</sup>

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<sup>626</sup> Luhang Zheng (2010) "Political Connection of Independent Directors and Firm Performance" (2010) 32 (11) *Contemporary Economy & Management* (Chinese version) 20 at 23.

<sup>627</sup> Ibid.

**Table 8.4.2 Independent Directors' Background and Firm Performance**

Author	Model	Measure	r-Coefficient	t-Test	p-Value
Tang et al (2005)	OLS	ROE ROA Tobin's Q	+	0.58 -0.23 1.41	
Wang et al. (2006)	SEM	PER <sub>a</sub> PER <sub>i</sub> PER <sub>p</sub>	010003 -010058 -010043		0190 0122 0128
Chen & Chi (2007)	OLS	Tobin's Q <sub>a</sub> Tobin's Q <sub>b</sub> Tobin's Q <sub>f</sub> Tobin's Q <sub>i</sub> Tobin's Q <sub>l</sub> Tobin's Q <sub>m</sub> Tobin's Q <sub>p</sub>	0.007 0.007 -0.019 -0.014 -0.006 0.002 -0.003	1.364 1.934 -4.447 -3.222 -1.487 0.385 -0.745	* *** ***
Wei et al (2007)	SEM	MBV <sub>a</sub> MBV <sub>b</sub> MBV <sub>c</sub> MBV <sub>cpa</sub> MBV <sub>e</sub> MBV <sub>g</sub> MBV <sub>l</sub> MBV <sub>n</sub> CFO <sub>a</sub> CFO <sub>b</sub> CFO <sub>c</sub> CFO <sub>cpa</sub> CFO <sub>e</sub> CFO <sub>g</sub> CFO <sub>l</sub> CFO <sub>n</sub> EBIT <sub>a</sub> EBIT <sub>b</sub> EBIT <sub>c</sub> EBIT <sub>cpa</sub> EBIT <sub>e</sub> EBIT <sub>g</sub> EBIT <sub>l</sub> EBIT <sub>n</sub>	-0.023 0.121 -0.142 -0.029 -0.017 0.134 0.015 -0.078 0.056 0.101 -0.002 -0.012 -0.049 0.157 0.038 0.029 -0.144 0.140 -0.11 0.004 0.009 0.199 -0.096 -0.124		** *   **    *       *       ***
Zhao et al (2008)	OLS	E/P	0.191	8.756	0.00***
Lu (2009)	SEM	ROA <sub>a</sub> ROA <sub>b</sub> ROA <sub>e</sub> ROA <sub>f</sub> ROA <sub>g</sub> ROA <sub>n</sub> MBV <sub>a</sub> MBV <sub>b</sub> MBV <sub>e</sub> MBV <sub>f</sub> MBV <sub>g</sub> MBV <sub>n</sub>	0.040 0.844 0.032 1.746 0.008 0.133 0.016 1.392 0.012 0.902 0.013 0.532	0.560 3.658 2.321 2.024 2.189 0.287 0.623 2.849 2.732 1.915 2.044 0.647	*** *** ** **   *** *** ** **

**Table 8.4.2 Cont'd**

Author	Model	Measure	r-Coefficient	t-Test	p-Value
Zheng (2010)	OLS	Tobin's Q <sub>1e</sub>	0.464	2.97	***
		Tobin's Q <sub>1g</sub>	0.761	2.79	***
		Tobin's Q <sub>2e</sub>	0.206	1.91	*
		Tobin's Q <sub>2g</sub>	0.335	1.78	*

Note: a, b, c, e, f, g, i, l, n, m and p denote academic, bank, corporate, education, finance, government, industrial, law, neutral (others), management and political, respectively, while cpa represents certified public accountant. CFO means net cash flow. EBIT means profits before tax. Others are the same as those in Table 8.4.1.

Three studies (Wang et al., 2006; Chen & Chi, 2007 and Wei et al., 2007) identify some controversial findings on the impact of independent directors' different backgrounds on firm performance. They find that some backgrounds of independent directors are positive on firm performance, while some are negative. Wang et al. (2006) investigate the influences of independent directors' academic, industrial and political backgrounds to firm performance measured by PER (adjusted ROA). They find that independent directors' academic background in terms of business school education has a positive effect (r-Coefficient is 0.1003) on firm performance but independent directors' industrial and political backgrounds have a negative influence (r-Coefficients are -0.10058 and -0.10043, respectively) on firm performance, though they are all not statistically significant.<sup>628</sup> Wang et al. (2006)'s findings are consistent with Zheng (2010)'s findings in the independent directors' education background but not in their industrial and political backgrounds.

Chen & Chi (2007) classify independent directors' backgrounds into seven categories: academic, banking, finance, industry, law, management and political. They find that independent directors with academic, banking and management backgrounds play a positive role on firm performance measured by Tobin's Q (r-Coefficients are 0.007, 0.007 and 0.002, respectively) and independent directors' banking ground is statistically significant at the 10% level (t-Value is 1.934).<sup>629</sup> However, independent directors with backgrounds in finance, industry, law and political are all negative (r-coefficients are -0.019, -0.014, -0.006 and -0.003, respectively) and independent directors' finance and

<sup>628</sup> Wang et al., above n 608 at 70.

<sup>629</sup> Xiaodong Chen & Danfeng Chi "Empirical Study on the Relevance of Independent Directors and Firm Performance in Listed Companies" (2007) 8 *Communication of Finance and Accounting* (Chinese version) 8 at 12.

industry backgrounds are both statistically significant at the 1% level (t-Values are -4.447 and -3.222, respectively).<sup>630</sup> These two findings are very interesting because they are obviously against the conventional wisdom that independent directors with financial expertise and industrial experience can effectively play not only their monitoring role but also their advisory role and thus improve firm performance. They may also suggest that independent directors' expertise and experience may not be important for their role-play in China, which is perhaps consistent with the "vase director" effect of independent directors commented on by Tang et al. (2005).

These two findings are also documented by Wei et al. (2007) in their studies. Wei et al. (2007) classify independent directors' backgrounds into eight categories: academic, banking, corporate, certified public accountant, education, government, law and neutral (others) and find that independent directors with corporate experience and certified public accountant qualification are negatively associated with firm performance measured by MBV (net market value), CFO (cash flow) and EBIT (profits before tax). The regression coefficients are -0.142, -0.002 and -0.11 for  $MBV_c$ ,  $CFO_c$  and  $EBIT_c$ , respectively; while they are -0.029 and -0.012 for  $MBV_{cpa}$  and  $CFO_{cpa}$ , respectively, but 0.004 for  $TBIT_{cpa}$ .<sup>631</sup> Among them, only independent directors with corporate experience measured by MBV is statistically significant at the 10% level. This finding further questions the conventional wisdom, in view of the negative effect of independent directors' background with the certified public accountant qualification, on firm performance.

Wei et al. (2007) also identify that independent directors with backgrounds in academic, education and others in general have a negative effect on firm performance measured by these three performance measures, though they are not statistically significant. However, they do find that independent directors with backgrounds in banking, government and law play a positive role on firm performance (r-coefficients are: 0.121, 0.101 and 0.140 for  $MBV_b$ ,  $CFO_b$  and  $EBIT_b$ ; 0.134, 0.157 and 0.199 for  $MBV_g$ ,  $CFO_g$  and  $EBIT_g$ ; and 0.015,

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<sup>630</sup> Ibid.

<sup>631</sup> Gang Wei, Zezhong Xiao, Nick Travlos & Hong Zou "Background of Independent Directors and Corporate Performance" (2007) 3 *Economic Research* (Chinese version) 92 at 100.

0.038 and -0.096 for  $MBV_1$ ,  $CFO_1$  and  $EBIT_1$ ; respectively).<sup>632</sup> Among them, independent directors with backgrounds in banking and government measured by three performance measures are all statistically significant at the 5% level. These findings confirm Wang et al. (2006) and Chen et al. (2007)'s findings that independent directors' political background can play a positive role on firm performance in terms of the relation business thesis, which may be the virtue of independent directors' advisory role but may also be the Achillean's heel of independent directors' monitoring role. Thus, it may provide evidence why independent directors fail to perform their monitoring role and why they may only perform their advisory role in China.

#### 8.4.3 Independent Director's Characteristics and Firm Performance

Panel A of Table 8.4 also shows that another 8 selected sample articles, 26.67% of 30 selected sample articles, investigate whether or not independent directors' characteristics affect firm performance. Table 8.4.3 delineates the test statistics of these 8 studies on the relationship between independent directors' characteristics and firm performance. These studies investigate if independent directors' characteristics such as age, multi-directorship, gender, location, board meeting attendance, independent opinion, overseas experience and reputation influence firm performance. Of them, 4 studies (Shen et al., 2007; Zhao et al., 2008; Zheng, 2010 and Zhang & Wang, 2013) find a positive relationship between independent directors' characteristics and firm performance and two studies (Lu, 2009 and Bian, 2010) find a negative relationship while two studies (Chen & Chi, 2007 and Wei et al., 2007) find a controversial relationship among independent directors' different characteristics. Chen & Chi (2007) report that independent directors' location, board meeting attendance and reputation all have a strong positive influence on firm performance measured by Tobin's Q (t-Values are 2.800, 2.375 and 2.356, respectively), statistically significant at least at the 5% level.<sup>633</sup>

The finding of Zhao et al. (2008) supports that independent directors' reputations have a

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<sup>632</sup> Ibid.

<sup>633</sup> Chen & Chi, above n 629 at 12.

significant positive effect on firm performance.<sup>634</sup> These findings indicate that independent directors coming from the same location as firms they serve, attending more board meetings per se and having a good reputation measured by multi-directorship, all add value to firms. However, Chen & Chi (2007) also find that independent directors who deliver dissenting independent opinions have a negative impact on firm performance (r-coefficient is -0.007), statistically significant at 5% level (t-Value is -2.031).<sup>635</sup> This finding is obviously against the utility of independent directors' role as effective monitors by way of actively delivering independent opinions. The inconsistency is probably because independent directors' dissenting opinions may send a signal to stock markets problems may exist in the listed companies concerned, and thus reduce firm value and shareholder wealth.

Zhang & Wang (2013) also document a strong positive effect that independent directors' location (r-coefficient is 1.11) and board meeting attendance (r-coefficient is 0.09) have on firm performance measured by ROE, statistically significant at the 5% level (t-Values are 2.03 for ROE<sub>l</sub> and 2.04 for ROE<sub>m</sub>, respectively).<sup>636</sup> Their findings are aligned with those of Chen & Chi (2007). From these findings, it may be inferred that independent directors coming from the same location as firms they serve can make it convenient for independent directors to provide their services, and that independent directors' meeting attendance can reflect the frequency of independent directors who attend board meetings in time. Both may improve a firm's corporate governance and therefore influence the firm's performance.

Shen et al (2007) provide further evidence on the frequency of independent directors' board meeting attendance on firm performance. They employ five performance measures to evaluate if independent directors' meeting attendance frequency affects firm performance and also report a positive effect, though not statistically significant (p-Values for EPS<sub>m</sub>, ROE<sub>m</sub>, SOA<sub>m</sub>, SE<sub>m</sub> and RP<sub>m</sub> are 0.6547, 0.9091, 0.4167, 0.8907 and 0.3353, respectively).<sup>637</sup> However, Bian (2010) identify a negative correlation between

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<sup>634</sup> Zhao et al., above n 609 at 62.

<sup>635</sup> Chen & Chi, above n 629 at 12.

<sup>636</sup> Zhang & Wang, above n 613 at 76.

<sup>637</sup> Shen et al., above n 612 at 60.

independent directors coming from the same location as the firms they serve and firm performance measured by Tobin's Q, though also not statistically significant (p-Value is 0.72).<sup>638</sup> Yet, this is not in accordance with the finding of Chen & Chi (2007) that there is a strong positive correlation between independent directors coming from the same location as firms they serve and firm performance.

**Table 8.4.3 Independent Directors' Characteristics and Firm Performance**

Author	Model	Measure	r-Coefficient	t-Test	p-Value
Chen & Chi (2007)	OLS	Tobin's Q <sub>l</sub>	0.008	2.800	***
		Tobin's Q <sub>m</sub>	0.007	2.375	**
		Tobin's Q <sub>o</sub>	-0.007	-2.031	**
		Tobin's Q <sub>r</sub>	0.008	2.356	***
Shen et al (2007)	OLS	EPS <sub>m</sub>			0.6547
		ROE <sub>m</sub>			0.9091
		SOA <sub>m</sub>			0.4167
		SE <sub>m</sub>			0.8907
		RP <sub>m</sub>			0.3353
Wei et al (2007)	SEM	MBV <sub>a</sub>	-0.025		
		MBV <sub>d</sub>	-0.096		***
		MBV <sub>g</sub>	-0.055		*
		MBV <sub>oe</sub>	0.236		***
		CFO <sub>a</sub>	-0.034		
		CFO <sub>d</sub>	-0.093		***
		CFO <sub>g</sub>	-0.074		***
		CFO <sub>oe</sub>	0.219		***
		EBIT <sub>a</sub>	0.017		
		EBIT <sub>d</sub>	-0.080		**
		EBIT <sub>g</sub>	-0.104		***
EBIT <sub>oe</sub>	0.189		**		
Zhao et al (2008)	OLS	E/P <sub>r</sub>	0.191	8.756	0.00***
Lu (2009)	SEM	ROA <sub>d</sub>	-0.012	-0.142	
		MBV <sub>d</sub>	-0.455	-0.236	
Bian (2010)	OLS	Tobin's Q <sub>l</sub>	-		0.72
Zheng (2010)	OLS	Tobin's Q <sub>1a</sub>	0.865	3.55	***
		Tobin's Q <sub>2a</sub>	0.649	3.87	***
Zhang & Wang (2013)	OLS	ROE <sub>l</sub>	1.11	2.03	**
		ROE <sub>m</sub>	0.09	2.04	**

Note: a, d, g, l, m, o, oe and r represent an independent director's age, multi-directorship, gender, location, meeting attendance, independent opinion, overseas experience and reputation, respectively. Others are the same as those in Table 8.4.2.

Lu (2009) investigates how independent directors' multi-directorship influences firm performance measured by ROA and MBV. He observes a negative effect (r-Coefficients are -0.012 for ROA<sub>d</sub> and -0.455 for MBV<sub>d</sub>, respectively) that independent directors' multi-directorship has on firm performance, although the effect is not statistically significant (t-Values are -0.142 for ROA<sub>d</sub> and -0.236 for MBV<sub>d</sub>, respectively). His finding is a counter

<sup>638</sup> Bian (2010), above n 612 at 19.

to the observation of Chen & Chi (2007) that independent directors' reputation measured by multi-directorship has a strong significant positive effect on firm performance. It is probably because independent directors with multi-directorships are usually acting on behalf of their host companies, which may be in conflict with the interests of companies they serve if their host companies have business interests in companies they serve. Lu (2009)'s finding is in support of the same finding by Wei et al. (2007) who report a strong negative effect of independent directors' multi-directorships on firm performance measured by  $MBV_d$ ,  $CFO_d$  and  $EBIT_d$  (r-coefficients are -0.096, -0.093 and -0.080, respectively), statistically significant at the 1% level ( $MBV_d$  and  $CFO_d$ ) and at the 5% level ( $EBIT_d$ ), respectively.

Along with independent directors' multi-directorships, Wei et al. (2007) also investigate the impact of independent directors' age, gender and overseas experience on firm performance. They observe that independent directors' age and gender have a negative impact on firm performance. Except for r-coefficient for  $EBIT_a$ , which is 0.017 (positive), r-coefficients for  $MBV_a$ ,  $MBV_g$ ,  $CFO_a$ ,  $CFO_g$  and  $EBIT_g$  are -0.025, -0.055, -0.034, -0.074 and -0.104, which are all negative.<sup>639</sup> Of them, independent directors' gender in terms of female directors is statistically significant at the 1% level, measured by CFO and EBIT, and at the 10% level, measured by MBV, and even though independent directors' age is not statistically significant, measured by all three performance measures.<sup>640</sup> Wei et al. (2007)'s observations seem to suggest that the greater the age of independent directors, the worse the impact of their age on firm performance. However, this observation is challenged by the finding of Zheng (2010), who observes that independent directors' age does have a strong positive effect on firm performance measured by Tobin's Q (r-coefficients are 0.865 and 0.649 for Tobin's  $Q_{1a}$  and Tobin's  $Q_{2a}$ , respectively), statistically significant at the 1% level (t-Values are 3.55 for Tobin's  $Q_{1a}$  and 3.87 for Tobin's  $Q_{2a}$ ). The controversial findings between these two studies as regards the impact of independent directors' age on firm performance may be owing to different performance measures used by the authors of two studies. Zheng (2010)'s finding seems to show that the greater the independent

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<sup>639</sup> Wei et al., above n 631 at 100.

<sup>640</sup> Ibid.



directors' age, the more experience they have, which may enable them to provide the valuable advice to the companies they serve. It is perhaps just like an old Chinese saying, which goes: "the older a man the higher his value".

Other than independent directors' age, gender and multi-directorship, Wei et al. (2007) further investigate if independent directors' overseas experience in terms of either education or work or both has an influence on firm performance. They identify a strong correlation between independent directors' overseas experience and firm performance measured by all three performance measures. The r-coefficients for  $MBV_{oe}$ ,  $CFO_{oe}$  and  $EBIT_{oe}$  are 0.236, 0.219 and 0.189, which are statistically significant at the 1% level for  $MBV_{oe}$  and  $CFO_{oe}$ , and at the 5% level for  $EBIT_{oe}$ .<sup>641</sup> This finding may be no surprise because independent directors with overseas experience may bring international experience to the firms they serve, which can add value to firms and thus improve the firms' performance.

#### 8.4.4 Independent Directors' Compensation and Firm Performance

In Panel A of Table 8.4, 5 remaining selected sample articles, 16.67% of the 30 selected sample articles, inquire into the relationship of independent directors' compensation and firm performance. Table 8.4.4 reports the test statistics of these 5 studies on the relationship between independent directors' compensation and firm performance. Noticeably, all 5 studies (Sun, 2003; Shen et al., 2007; Zhao et al., 2008; Lu, 2009 and Wu & Lan, 2009) observe a positive effect that independent directors' compensation has on firm performance, although only one study (Zhao et al., 2008) reports a strong positive effect (r-coefficient is 0.191), which is statistically significant at the 1% level (t-Value is 8.756).<sup>642</sup> This finding seems to indicate that economic incentive may play an important role in encouraging independent directors' role-play, which can add firm value. Two studies use one measure to evaluate if independent directors' compensation affects firm performance. Sun (2003) uses EPS (earning per share) while Zhao et al. (2008) use E/P (initial stock price per share).

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<sup>641</sup> Ibid.

<sup>642</sup> Zhao et al., above n 609 at 62.

Lu (2009) and Wu & Lan (2009) employ two performance measures to evaluate the influence of independent directors' compensation to firm performance. The former uses ROA and MBV and the latter uses ROE and Tobin's Q. Although they identify a positive effect that independent directors' compensation has on firm performance the effect is not statistically significant (t-Values are 0.247 for ROA and 0.830 for MBV<sup>643</sup> while p-Values are 0.1201 for ROE and 0.6483 for Tobin's Q<sup>644</sup>).

**Table 8.4.4 Independent Directors' Compensation and Firm Performance**

Author	Model	Measure	r-Coefficient	t-Test	p-Value
Sun (2003)	OLS	EPS	0.067		0.203
Shen et al (2007)	OLS	EPS			0.2032
		ROE			0.097
		SOA			0.3330
		SE			0.1294
		RP			0.3484
Zhao et al (2008)	OLS	E/P	0.191	8.756	0.00***
Lu (2009)	SEM	ROA	0.043	0.247	
		MBV	0.014	0.830	
Wu & Lan (2009)	OLS	ROE	0.003037		0.1201
		Tobin's Q	0.091217		0.6483

Note: All abbreviations are the same as those in Table 8.4.1.

Compared with the authors of four studies above, Shen et al. (2007) use five performance measures to estimate the impact of independent directors' compensation on firm performance. They find that only independent directors' compensation is positively linked with firm performance measured by ROE, significant at the 10% level (p-Value is 0.097).<sup>645</sup> Measured by the other four performance measures, the correlation between independent directors' compensation and firm performance is not statistically significant (p-Values are 0.2032 for EPS, 0.3330 for SOA, 0.1294 for SE and 0.3484 for RP, respectively), although it is positive.<sup>646</sup> These observations provide further evidence that the positive effect of independent directors' compensation has on firm performance, which may reflect the nature of human beings scrambling for material benefits even in the case of independent directors. Clearly, economic incentives in terms of monetary award do matter.

<sup>643</sup> Lu (2009), above n 612 at 79.

<sup>644</sup> Wu & Lan, above n 610 at 120.

<sup>645</sup> Shen et al., above n 612 at 60.

<sup>646</sup> Ibid.

## 8.5 Conclusion

This chapter reviews 30 selected empirical studies on independent directors and corporate performance in Chinese listed companies. The authors of these studies investigate the relationship of independent directors and corporate performance mainly from the perspectives of independent directors' proportion, background, characteristic and compensation. In general, the findings of these studies are similar to those of the international studies. That is, the empirical evidence on the relationship between independent directors and corporate performance is mixed, either positive or negative or no correlation. As to the impacts of independent directors' various perspectives on firm performance, there seems to be some differences.

A prevailing majority of 30 studies report that board independence in terms of the proportion and number of independent directors on the board of directors and the adoption of the independent director institution has no significant impact on firm performance. This may explain why independent directors fail to play their monitoring role in China. Although it is somewhat controversial, independent directors' backgrounds on the whole show a significant positive effect on firm performance. Most remarkable is independent directors' political background. This may explain why independent directors primarily play an advisory role in China. Independent directors' characteristics also have a controversial effect on firm performance. Some of independent directors' characteristics such as age, meeting attendance, overseas experience and location are positive while some such as multi-directorships and gender are negative. However, independent directors' compensation has a positive effect on firm performance, which shows that economic incentive may be important in influencing the correlation between independent directors and firm performance.

## **CHAPTER 9**

### **CONCLUSION**

#### **9.1 Introduction**

The foregoing chapters have examined the role of independent directors in corporate governance in the United States, New Zealand and China. This examination has been carried out by means of a comparative law study in corporate law combined with a meta-empirical study in corporate governance. The former investigates not only the evolution and development of corporate governance and independent directors but also ownership structure, the board of directors, board independence and the supervisory board in connection with the role of independent directors in corporate governance in the targeted jurisdictions. The latter reviews the existing empirical evidence on the relationship between independent directors and corporate performance in Chinese listed companies. By applying this combined research methodology, this research identifies many problems both in theory and in practice in support of the author's argument that independent directors may play an important role in improving corporate governance in theory but not in reality.

Compared with those in the United States and New Zealand, the problems in China include but are not limited to (1) the concentrated corporate ownership structure by way of combined absolute with relative corporate control by the state, (2) the ineffectiveness of the hybrid board model characterized by a controversial dual supervision system housing both independent directors and the supervisory board, (3) the “vase director” effect of independent directors in view of the lower degree of board independence in legislative design that does not support independent directors' monitoring role even in procedure, and (4) the lacunae and ambiguity in legislation regarding the demarcation on the responsibilities and liabilities between independent directors and the supervisory board. The meta-empirical study generalizes statistical insights on these problems that have

impact on corporate performance in Chinese listed companies, which provides a whole picture of empirical evidence on the failure of independent directors' monitoring role in corporate governance in China.

Many findings by this research as presented in the following sections reveal that the transplantation of independent directors from the unitary board model in corporate America into the two-tier board model in corporate China is a misfit in the form of the hybrid board model in China. This suggests that there is a need to improve the efficiency and effectiveness of the monitoring role of independent directors in corporate governance in Chinese listed companies, bearing in mind the fact that independent directors are a given in the current corporate governance system in China. Based on these understandings, Section 9.2 answers the research questions set at Section 1.4; Section 9.3 discusses the findings of this research and their implications for policy making; Section 9.4 explains the limitations of this research; Section 9.5 provides suggestions for future research.

## **9.2 Answers to Research Questions**

The research questions set in Section 1.4 are: (1) what are the relative advantages and disadvantages of the role of independent directors in China compared with that of the US and New Zealand; (2) which corporate governance model upholds the role of independent directors in either the US, New Zealand or China; (3) what factors affect the role of independent directors in corporate governance in either the US, New Zealand or China; (4) to what extent Chinese listed companies may experience a positive transition to good corporate governance.

Chapter 5 addresses Question (1). To identify the relative advantages and disadvantages of the role of independent directors in China compared with that of the US and New Zealand, Chapter 5 investigates the function of the board of directors as an internal corporate control device to monitor management, performed by independent directors in connection with board size, board composition, board leadership structure and board committee. This is to find out not only the way through which independent directors can carry out their role as

effective monitors but also the way that can influence independent directors to perform their monitoring role. Thus, the investigation can be conducted to identify the relative advantages and disadvantages of the role of independent directors in the targeted jurisdictions. The result of this investigation shows that the board of directors does not seem to work well in upholding independent directors' monitoring role in the listed companies in China than it does in the US. There is a similar story in New Zealand.

In the US, the board model is in the form of the majority or supermajority independence model, which can provide the strong support to the execution of independent directors' monitoring role. Although it is in procedure that independent directors compose of the majority of the board of directors, this procedure is indispensable for independent directors to perform their role as effective monitors at least in theory. This is an advantage in comparison with independent directors in China. In China, the board model is in the form of the minority independence model, which does not provide the procedural support for the role-play of independent directors in performing their monitoring role. The statistical evidence from the investigation on the structural adjustment of the board of directors of Chinese listed companies from 2002 to 2011 shows that, by the end of 2011, 94.46% of Chinese listed companies have a minority independent-board (i.e., independent directors composes of less than 50% of all directors of the board of directors). This means that the board of directors in Chinese listed companies usually has the much lower degree of board independence, compared with the board of directors in the US publicly held corporations. Technically, it seems that this minority independence board model cannot effectuate independent directors' monitoring role even in procedure.

Chapter 4 addresses Question (2). Chapter 4 investigates ownership structure and corporate control in publicly traded corporations in the targeted jurisdictions with focus on China. This is because ownership structure has fundamental impact on corporate control, which is a determinant of the board model in corporate governance. Corporate control is usually in the form of management control in the dispersed ownership structure while it is usually majority control in the concentrated ownership structure. Dispersed corporate ownership structure is crucial to the unitary board model while concentrated ownership structure is

essential to the two-tier board model. The former houses independent directors in the board of directors while the latter has the supervisory board along with the board of directors. In practice, there also exists the hybrid board model mixing the elements of the unitary board model and the two-tier board model. This is the case in China where listed companies not only have the board of directors housing independent directors but also have the supervisory board parallel to the board of directors.

Chapter 4 shows that independent directors are native to the unitary board of the corporate governance model and they are exotic foreigners to the two-tier board of the corporate governance model. The dispersed corporate ownership structure gives rise to independent directors and nurtures their growth while the concentrated corporate ownership structure does not. The experience of corporate America is that it is evident that independent directors do work to some extent in the dispersed corporate ownership structure. This means that the unitary board model in the US does uphold the role of independent directors at least in procedure, which provides the procedural protection for independent directors to perform their role as effective monitors to some extent. The hybrid board of the corporate governance model in China based on the concentrated corporate ownership structure seems to miss the nurturing foundation on which independent directors can survive and thrive.

The experience of corporate China suggests that independent directors appear to be a misfit to the hybrid board of the corporate governance model in China, which exhibits the impact of path dependency on the Chinese legal transplant. This is supported by an examination on the share structure split reform in 2005. By lifting the veil of state shares under the standard types of shares and A-shares, this examination provides evidence that the ownership concentration and corporate control in Chinese listed companies still remain as two big obstacles to independent directors' monitoring role even after the share-split structure reform in 2005. This is because the state still has a big hand by way of the "only big shareholder" in the corporate ownership structure in Chinese listed companies and the state is still in the form of the relative control combined with the absolute control in the corporate control pattern of Chinese listed companies.

Chapter 6 addresses Question (3). Chapter 6 examines board independence and identifies what elements have substantial impact on board independence, which may determine independent directors to be truly independent. The examination identifies four elements that have substantial impact on the monitoring role of independent directors in view of their influences on board independence either in form or in substance, no matter what kind of the corporate ownership structure is, dispersed or concentrated, from which independent directors come. These elements are independent of management, dependent on shareholders, access to information and incentive to monitor. To make board independence come true, independent directors need to perform their monitoring role efficiently and effectively provided these four elements are present. Without having had these elements dealt with properly, board independence can only exist in name but not in fact and independent directors are not able to be effective monitors.

An investigation conducted in this chapter on the behaviour of independent directors of Chinese listed companies provides the statistical evidence to support this reflection. This can be seen from the type of independent opinions expressed by independent directors in the period of the examination, i.e., an average of 98.24% independent opinions expressed by independent directors is in the form of agreeing with management in the period of 2002-2012 (excluding 2011). According to the data collected from CSMAR database, there are seven types of independent opinions that independent directors can express and agreeing with management is only one of them. However, other six types of independent opinions expressed by independent directors are only accountable for 1.76% in average in the same period (excluding 2011). This means that independent directors usually passively perform their monitoring role by rubber-stamping management project.

This may suggest that independent directors of Chinese listed companies are not able to be truly independent from management because of the “only big shareholder” problem in China, which makes the four elements of board independence missing. The most important difference is that the mainstream of Chinese listed companies needs to follow the economic policy of the state capitalism that directs the operation and governance of these listed companies. When expressing independent opinions, independent directors need to take into



consideration this policy. Thus, independent directors may prefer to agree with rather than dissent from management projects. This temperament is of course not conducive to cultivating the presence of the four elements of board independence. Therefore, independent directors may only perform their advisory role but not their monitoring role in corporate China owing to the absence of all of the four elements that are crucial to board independence.

Chapter 8 addresses Question (4). To investigate to what extent Chinese listed companies may experience a positive transition to good corporate governance, Chapter 8 analyses and evaluates the role of independent directors in corporate performance in Chinese practice by way of a meta-empirical study so as to identify whether or not independent directors improve corporate governance demonstrated by good corporate performance in Chinese listed companies. The rationale is that good corporate governance can improve corporate performance and the improvement of corporate performance may be the reflection of good corporate governance. This suggests that if independent directors can bring about good corporate governance they can also improve corporate performance.

A meta-empirical study, by collecting existing empirical studies, can serve this purpose by reviewing and generalizing an integrated empirical evidence that can demonstrate if independent directors can improve corporate performance in a given period. In this way, it can investigate to what extent Chinese listed companies may experience a positive transition to good corporate governance by examining the relationship between independent directors and corporate performance in Chinese listed companies. From the investigation, this review identifies four categories under which existing empirical research examines the relationship between independent directors and corporate performance. The four categories are board independence, independent directors' characteristics, background and compensation.

The meta-empirical study, conducted by this research, shows that the generalized empirical evidence from 30 selected sample articles of the existing empirical studies on the association between independent directors and firm performance supports the independent

directors' advisory role but not their monitoring role in Chinese listed companies. For example, of 28 selected sample articles that examine the correlation between board independence and firm performance, only 6 studies, 21.43% of these 28 selected sample articles, report a statistically significant correlation between board independence and firm performance in Chinese listed companies. This may not provide evidence that Chinese listed companies may experience a positive transition to good corporate governance from the viewpoint of the monitoring role performed by independent directors. In contrast, 5 studies, 71.43% of 7 selected sample articles that examine the correlation between independent directors' background and firm performance, find a strong effect, either positive or negative, that independent directors' background has on firm performance. This may provide evidence that Chinese listed companies may experience a positive transition to good corporate governance from the viewpoint of the advisory role performed by independent directors. Generally speaking, it may be considered to the extent that Chinese listed companies experience a positive transition to good corporate governance from the standpoint of the stakeholder theory but not shareholder theory. This has been evidenced by the selected sample articles that by and large report a positive correlation between independent directors' background and firm performance but a negative correlation between board independence and firm performance in Chinese listed companies on the whole.

### **9.3 Findings and Policy Implications**

The main findings of this research are summarized as follows:

First, the origin of independent directors may be arguably tracked back to the origin of the British East India Company in 1660, when there was the need of the absentee authority to control the on-scene authority and deal with the conflict of interests between managers and residual stockholders caused by the separation of ownership from control in the dispersed corporate ownership structure along with the birth of joint stock companies. This finding may suggest that independent directors may arguably originate from the need by stockholders in joint stock companies with the dispersed ownership structure to supervise

management.

Second, although independent directors were developed as an internal control mechanism in joint stock companies since 1660s in England, their utility as an internal corporate control mechanism to perform the monitoring function of the board of directors had been ignored until the monitoring board model came into attention in the 1970s in the US. This finding may suggest that although independent directors may arguably originate in the need of supervising management in joint stock companies they have played little role in monitoring management since they come into existence in history.

Third, the rise of institutional investors in the 1920s has significantly changed the ownership structure in corporate America since then. However, the nature of the dispersed shareholding structure has not substantially changed in US corporations because institutional investors manage other people's money. Thus, this ownership reconcentration in corporate America is fundamentally different from the ownership concentration in corporate China. This finding suggests that the ownership reconcentration in corporate America may not experience the convergence between the dispersed corporate ownership structure and the concentrated corporate ownership structure.

Fourth, the share-split structure reform in 2005 greatly reduced the state shares of Chinese listed companies to the extent that the concentrated corporate ownership structure in China has changed from highly concentrated to moderately concentrated and to the degree that the corporate control pattern has changed from completely absolute control to relative control combined with absolute control in Chinese listed companies, both of which clearly demonstrate that state shares have no sign to be further reduced. This finding may suggest that it remains to be seen if the corporate ownership structure of Chinese listed companies is converging to the US corporate ownership structure model.

Fifth, the managerial hegemony in the form of the CEO duality, the absolutely dominant board leadership structure, is fundamentally the cause that frustrates the effectiveness of the monitoring board model in corporate America. The same is true in corporate China, no

matter if the board leadership structure is in the form of either CEO duality or chairperson duality because both are in reality under the dominance of the chairperson of the board of directors, which is essentially in the form of the advisory board model. This finding may suggest that the board leadership structure may be influential in supporting independent directors' monitoring role.

Sixth, there are some elements that have substantial impact on whether or not board independence is in name or in fact, which is the ultimate determinant of the efficacy of the monitoring role of independent directors no matter what kind of the board model, unitary or hybrid, and what kind of the corporate ownership structure, dispersed or concentrated, under which independent directors work. These elements are independent of management, dependent on shareholders, access to information and incentive to monitor. This finding may suggest that board independence can only exist in substance but not just in form provided these four elements are present for independent directors to perform their monitoring role.

Seventh, there are lacunae and ambiguities in legislation as regards the demarcation on the responsibilities and liabilities between independent directors and the supervisory board, which undermines the current hybrid board model concerning the monitoring role of the dual supervision system between independent directors and the supervisory board in Chinese listed companies. This finding may suggest that there may be a need to differentiate the responsibilities and liabilities between independent directors and the supervisory board, when they perform the same monitoring role, in order to make the current dual supervision system work in Chinese listed companies in the manner expected.

Eighth, the meta-empirical study conducted by this research on the relationship between independent directors and firm performance shows that independent directors primarily perform the advisory role, evaluated from the impact of independent directors' background, characteristics and compensation on firm performance, but not the monitoring role, evaluated from the impact of board independence in terms of the proportion and number of independent directors in the boardroom and the adoption of the independent director

institution on firm performance, in the corporate governance of Chinese listed companies. This finding may suggest that the current empirical studies have not provided evidence to support independent directors who have influence on firm performance through their monitoring role over management in Chinese listed companies.

These findings may have the following implications for policy-making under the current legal framework in China.

- (1) The reduction of the state shares in substance but not just in form. This may mean that state shares should be reduced to the extent that the stability and liquidation of stock markets in China can be manageable and controllable.
- (2) The fostering of institutional activism in corporate governance. This may mean a need to encourage institutional investors to participate in the corporate governance of Chinese listed companies.
- (3) The reduction of the abuse of management control by the majority shareholders. This may mean a need to curb majority shareholders' exploitation of minority shareholders' interests in Chinese listed companies.
- (4) The increase of board independence to the extent that independent directors work. This may mean a need to make the structural adjustment for independent directors to be able to perform their monitoring role.
- (5) The nurturing of the elements that have substantial impact on board independence. This may mean a need to provide adequate environments for independent directors to be truly independent in performing their monitoring role.
- (6) The clarification in legislation of the distinction on the monitoring role between independent directors and the supervisory board. This may mean a need in law and regulation to differentiate the responsibilities and liabilities on the monitoring role between independent directors and the supervisory board in the current dual supervision system in Chinese listed companies.

#### **9.4 Limitations of the Research**

There are three main limitations that restrict the ability of this research to make a more detailed comparative study on the role of independent directors in corporate governance between the US, New Zealand and China.

First, the relevant data available of listed companies in the US and New Zealand. This research provides the completed and detailed data on the role of independent directors in the corporate governance of Chinese listed companies in the period of 2002-2013 but not the relevant data of the US and New Zealand. Some reasons are accountable for the unavailability of the relevant US and New Zealand data such as the university having not subscribed to the relevant databases, the cost-prohibited data-buying owing to the limit of the author's research fund, the unavailability of the relevant data such as New Zealand's data and the unrealistic data-collection by hand for so huge data in the period of this research. For these reasons, the comparative study conducted by this research would be much more convincing and powerful if the relevant data would be available.

Second, the enforcement of law on the role of independent directors in corporate governance. This research leaves a loophole on the law enforcement on the role of independent directors in corporate governance as originally planned because of the word limit requirement for a PhD thesis set by this university. The research on this issue can provide a better understanding of law and regulation on the role of independent directors in corporate governance because, other things being equal, a working system of law enforcement is crucial for the efficiency and effectiveness of independent directors in corporate governance in a legal system.

Third, the meta-empirical study on the relationship between independent directors and corporate performance in Chinese listed companies. A meta-empirical study is a review study that reviews and generalizes the empirical evidence reported by the existing empirical studies collected by the incumbent meta-empirical study. However, it cannot correct statistical bias in individual empirical studies for failing to correct such statistical bias by employing the relevant statistical tools. Thus, a review study by way of a meta-empirical study may not be able to provide a more accurate picture on the existing empirical

studies collected by the meta-empirical study of the whole.

### **9.5 Suggestions for Further Research**

Based on the findings by and the limitations in this research, suggestions for further research on independent directors in corporate governance identified by this research may be conducted on, but not limited to, the following issues.

- (1) The CEO duality and independent directors. As suggested by this research, the CEO duality may be accountable for the failure of the monitoring role of independent directors. Thus, more attention should be paid to this topic concerning the impact of the CEO duality on the monitoring role of independent directors.
- (2) The effect of institutional activism in board independence. The received wisdom that institutional activism should play an important role in board independence by way of nominating and removing independent directors on the board of directors. Research so far provides little support for this wisdom. Thus, it is still a hot topic in the corporate governance literature.
- (3) The efficacy of lead/presiding directors in the monitoring board model of publicly traded corporations in the US. This is a topic that there is little research on so far. This topic can explore either theoretically or empirically or both so as to provide evidence on the efficacy of the leading independent director institution under the CEO duality.
- (4) The role of inside directors in independent directors' access to information. This is perhaps a controversial topic that needs to be verified by research because inside directors may feel the need to be loyal to CEOs. Conversely, inside directors may consider the possibility of becoming a CEO and thus cooperate with independent directors. These hypotheses need to be tested.
- (5) Independent directors' incentives and their performance. There are some research done on this topic but consensus has still not reached to the extent how to connect independent directors and their performance.
- (6) Law enforcement on the role of independent directors. There is perhaps no research

- on this topic so far. So, research on this topic would be valuable to better understand the function of law on the independent director institution.
- (7) The interplay of the monitoring role between independent directors and the supervisory board in Chinese listed companies. This is particularly a topic of research on Chinese dual supervision system which needs to be undertaken so as to provide suggestions to Chinese regulators.
  - (8) A meta-analysis on independent directors and corporate performance in Chinese listed companies. A meta-analysis is significantly different from a meta-empirical study. The former is an empirical study by means of the effect size analysis and the multiple meta-regression (or meta-SEM) model to integrate empirical evidence while the latter is a narrative review by means of the vote-counting method on the statistical significance test analysis to generalize empirical evidence. Thus, a meta-analysis has a much stronger statistical power than a meta-empirical study on the relationship between independent directors and firm performance in Chinese listed companies. Currently, there is no research by way of a meta-analysis on this topic.





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