

Case study

Based on the US Independent Director System—Problems of China's Independent Director System and Countermeasures

Abstract: The independent director system first appeared in the Investment Company Act of the United States in 1940, and the main purpose of the system is to check and supervise the major shareholders and executives of enterprises, while playing a positive role in the normal operation and higher profits of the company. In 2001, the Securities Regulatory Commission of China officially issued the Guidance on the Establishment of Independent Director System in Listed Companies, which also explored the way of independent directors' the system. China's independent director system was implemented late and it is not mature enough. For example, there are still problems such as lack of independence professionalism of independent directors. Although China belongs to the socialist legal system, which is essentially different from the common law system, the independent director system in China is essentially an imported product, so the independent director system in the United Kingdom and the United States has a strong significance to learn from. This paper compares the current independent directorship in China with that in the U.S. through a controlled variables approach in the hope of drawing substantive suggestions and inspiration. Our proposal is divided into two parts firstly, from the perspective of addressing the independence of independent directors themselves, and then analyzing the possible upgrading of the operating environment of independent directors. In particular, we emphasize the advantages of the U.S. independent director system in terms of comprehensive talent training ,selection and recruitment mechanisms, so as to provide implications and solution strategies for Chinese independent director system, in order to improve the role of the Chinese independent director system in corporate governance.

[Keywords] Independent Directorship; Independence; Incentive Mechanism; Integrated Talent

Introduction

The independent directorship was first established in the United States in 1940 with the Investment Company Act, which established the independent directorship system to reduce the serious phenomenon of absolute control within enterprises, and the independent directorship system has been in place in China for 20 years since 2001 and has become the most basic and common system of corporate governance. However, today, the system of independent directors in China has been criticized by the world, and its independence and incentive have been questioned in many ways, with most believing that independent directors are mere "labels" and "titles". 17 November 2021, the well-known Chinese pharmaceutical company Kangmei Pharmaceuticals The five independent directors, all of whom were part-time independent directors, four of whom were university professors, were not involved in the day-to-day management of Kangmei Pharmaceuticals and did not exercise due diligence, and were thus jointly and severally liable for the financial fraud. This incident became the first incident in China in which an independent director was punished by more than RMB100 million, sounding a warning bell for independent directors to perform their duties. Therefore, based on the fact that the independent directors of Kangmei Pharmaceuticals were punished with huge sums of money, this paper will collect and collate the existing literature on the study of independent directors by using the literature research method, analyze and summarise their research methods and findings to have a certain understanding of the research results at this stage, and also lay a solid literature foundation for the subsequent research of this paper. At the same time, we adopt the case study method to analyze the problems of independent directors in Chinese enterprises in terms of independence and comprehensiveness and propose corresponding suggestions and countermeasures for the shortcomings of the independent director system in China by benchmarking the advantages of independent directors in American enterprises.

1 Status of China's independent director system

At the level of corporate governance, the independent director system plays a catalytic role in promoting listed companies to safeguard the rights and interests of small and medium shareholders, establish a modern enterprise system and formulate development strategies. At present, there are more than 3,600 listed companies in China, and the system of independent directors is mandated in the Company Law, and the number of independent directors is currently more than 10,000. The relevant provisions of China's independent director system impose restrictions on the number of shares held and the number of independent directors, as well as requirements on the length of service, the number of part-time positions, and due diligence requirements. However, the lack of independence, nepotism, and the incentive and accountability mechanisms of independent directors in China have been criticized and loopholes in the system continue to exist.

2 Review of the literature

2.1 Among domestic scholars' studies

By building an evolutionary game model of violation cases which listed companies announced by the SEC during 2012-2018, Wang Qi (2020) found that in practice the function of independent directors is often weakened due to the constraints of human relationships [1]. Liu Ping (2020) argues that plentiful intimate relationships are still included in the current appointment of independent directors, leading to a negative impact on the independence of independent directors by analyzing the current relevant laws in China [2]. Fang Chong (2021) analyzed the appointment of independent directors in listed companies from 2001 to 2020 and concluded that independent directors are often unable to exercise their independence due to various constraints [3]. Li Yi (2021) analyzed that the performance of independent directors is not widely recognized in practice based on the Questionnaire on the Performance of Independent Directors by the Association of Listed Companies in China in 2013 [4]. Tan, Xue, Li, Jingxuan, and Wu, Haozhou (2020) found that independent directors tend to vote in agreement, and those who raised objection only accounted for less than 5 percent of the total votes, by using 3749 independent directors of A-share listed companies in China from 2001 to

2019 as the research object [5]. Using non-financial listed companies in Shanghai and Shenzhen A-shares from 2006-2017 as a sample and the Guidelines on the Selection and Conduct of Directors of Listed Companies on the Shanghai Stock Exchange (hereinafter: the Guidelines) issued as an exogenous shock, Song Leilei (2020) used a double-difference model to find that external regulation plays a positive role in the performance of independent directors' duties [6]. Ning, Na, and He, Baocheng (2021) argued through literature research method that -establishment of an association of independent directors, professionalization of independent directors, and formation of a professional team of licensed independent directors play an active role in the position [7]. Wang Qi (2020) found that the establishment of an external reputation system has a positive impact on the diligence of independent directors through literature analysis [11]. Liu Ping (2020) compared the systems of independent directors in China, the United States, and Japan, and concluded that the establishment of a trinity of criminal, civil, and administrative penalties for independent directors could help maintain the purity of the position [2]. Fan, Hejun, and Wang, Siyu (2020) found that the current regulatory system of inquiries in China positively influences the voice of independent directors by comparing the volume and content of inquiry functions sent by the Chinese stock exchange from 2013 to 2019 [8]. He Xuan (2020) developed an evaluation model for independent directors through a qualitative and quantitative analysis, which drew a positive conclusion on the establishment of assessment criteria for independent directors [9]. By analyzing the existing regulatory associations, Lin Ke (2021) concluded that a third-party organization, like the China Association of Listed Companies, which evaluates and conducts the nomination of independent directors can positively influence the independence of independent directors [10].

2.2 Among foreign scholars' studies

Tran Thi Hoang Ha, Nguyen Bach Khoa, Dinh Tran Ngoc Huy (2019) by comparing the principles of corporate governance in Belgium and the Netherlands argued that independent directors need to disclose their tenure reports to the society on a regular basis, making a positive external public monitoring. [11]. Pham Minh Dat ,

Nguyen Duy Mau , Bui Thi Thu Loan , Dinh Tran Ngoc Huy (2020) by comparing empirical methods found that the main reason for the restricted rights of independent directors is to avoid conflict of interest with major shareholders and the difficulty of giving direct critical evidence for dissenting issues [12]. DINH TRAN NGOC HUY, DINH TRAN NGOC HIEN (2015) concluded by qualitative analysis method from the perspective of UK corporate governance that the current UK independent directorship has not been improved by mandatory acts, but the situation where the majority shareholder adversely affects the appointment of independent directors is indeed widespread. [13] Pham Minh Dat , Nguyen Duy Mau , Bui Thi Thu Loan , Dinh Tran Ngoc Huy (2020) concluded through empirical method that the appointment and removal of independent directors and the vote of participation should be made overt, and the reasons for proposing for or against should be elaborated to ensure the transparency [12]. DINH TRAN NGOC HUY, DINH TRAN NGOC HIEN (2015) by comparing corporate governance data in Malaysia and India, a comparative analysis concluded that the degree of expertise of an independent director in a particular aspect is more important than holding the position of independent director in multiple listed companies, therefore they believe that the examination of the professionalism of independent directors should be included in their performance appraisal [13].

3 Problems of China's independent director system

3.1 Lack of independence and enthusiasm of independent directors

The lack of independence of the independent director system in China is mainly reflected in two aspects, namely the remuneration mechanism and the selection and appointment mechanism.

3.1.1 With regard to the remuneration mechanism.

3.1.1.1 The remuneration of independent directors in most companies is mainly in the form of a fixed salary. The lack of incentive in the salary structure of these companies and the generally low salaries of these companies have led to the fact that independent directors usually do not participate in corporate operations and board meetings, making it difficult for them to provide effective operational advice to the companies diligently.

3.1.1.2 In a small number of enterprises, the current year's remuneration of independent directors is positively correlated with the current year's performance of the listed company. Independent directors of such enterprises usually choose to conceal or refrain from expressing their opinions on the financial statements of the enterprise, etc. to obtain higher salary remuneration.

3.1.1.3 Independent directors lack a sound remuneration incentive system. From the average salary level of independent directors in China in 2020 as shown in WIND, it is found that the main salary range of independent directors is concentrated in the range of RMB 40,000 to RMB 100,000 per year, while only 8.11% are paid above RMB 150,000 per year. Independent directors, therefore, present the problem of low remuneration but high responsibilities, with lower annual salary allowances failing to effectively motivate and weakening independent directors' motivation to work.

3.1.2 In terms of selection and recruitment mechanisms.

3.1.2.1 Most of the independent directors in China are nominated and appointed by the shareholders or management of listed companies, and the major shareholders or management usually use their power to appoint relatives and friends as independent directors, creating a corporate culture of nepotism. The majority shareholders use their acquaintance relationship with the independent directors to make decisions on important corporate matters, and the independent directors often follow the majority shareholders in voting and voting. Some of the independent directors who are not directly related to the shareholders and executives of the company find it difficult to hold on to their views and opinions in an atmosphere where "independent directors are not independent", forcing them to choose to be silent when voting or to leave the company on their initiative, or even to cater to the ideas of the major shareholders, which seriously affects the independence of independent directors.

3.1.2.2 It is difficult for independent directors to be diligent in their duties as independent directors when they are serving in more than one company at the same time. China's independent director system stipulates that one person can serve as an independent director of up to five enterprises at the same time, while according to the network data, 53% of independent directors serve in 1-2 enterprises and up to 30% in

3-4 enterprises, while most of the independent directors appointed in China serve on a part-time basis, and most of their time is spent in full-time work outside of independent directorship, while part-time work and simultaneous Working part-time and as an independent director of several companies at the same time makes it difficult to ensure that he or she is able to exercise due diligence, participate fully in the operations of the company and understand the current situation of the company, thus affecting the decisions he or she makes and the quality of his or her work.

3.2 Lack of comprehensive quality of independent directors

In addition to fulfilling their duties, independent directors in China also play a role in endorsing corporate brands, enhancing corporate reputation, and expanding resources. Therefore, most listed companies will focus on selecting independent directors who are highly reputable in the community, mainly technical and academic experts. Firstly, technical experts have the strong core technical ability in the characteristic technical industry and can drive the development of the technical level of the enterprise, but they lack the overall comprehensive ability and can hardly put forward constructive opinions from the financial, management, and human resources dimensions. Secondly, academic experts are mainly recruited from well-known universities. The main feature is that university professors have a high social status and industry reputation in the industry, master a large number of contacts and resources, and can provide theoretical advice to enterprises, but most professors lack corporate work experience and practical ability. As a result, the independent directors recruited by companies are not fully qualified for the position, but merely hold the title and are unable to provide comprehensive corporate governance advice to the company. There is still a large number of vacancies in the Chinese market for people with a combination of theoretical and practical skills.

3.3 Lack of voice of independent directors

The "Guiding Opinions on the Establishment of an Independent Director System in Listed Companies" promulgated by the CSRC stipulates that "at least 1/3 of the members of the board of directors shall be independent directors" and the number of independent directors is set to restrain the major shareholders' "one share

the governance problem of "one share alone" and to protect the interests of small and medium shareholders. The number of independent directors is set to constrain the governance problem of "one share dominating" by the major shareholder and to protect the interests of small and medium shareholders. Most listed companies in China have chosen to have at least 1/3 independent directors, which is much lower than the average of 2/3 in the UK and US, and most of the independent directors are appointed by the majority shareholders themselves. The low number of familiar independent directors makes it difficult for independent directors to play a role in restraining the absolute voice of major shareholders and for the board of directors to make fair and reasonable decisions, as their voice in decision-making is greatly weakened.

4 Advantages of the US Independent Director System

4.1 Strong independence of independent directors

The US independent director system is more substantive than formal. Its independent director system has formulated more binding policies in terms of independence, especially in the selection and appointment process, which places more emphasis on the independence of independent directors in the process of performing their duties, for example, "independent directors shall not serve in listed companies and their controlling shareholders and subsidiaries, and shall not be partners or employees of external auditors " and other requirements. The advantage of substantive independence is that independent directors in the US do not have "close relationships" with major shareholders or top management, and are not easily constrained by major shareholders in decision-making, and are able to check and balance with them, effectively avoiding the corporate governance problem of "one share dominating". This effectively avoids the problem of "one share dominating" corporate governance.

4.2 Strongly integrated independent directors

The independent directors recruited by US-listed companies are mainly CEOs, executives, and professional managers of other companies, who have many years of experience in business governance, professional quality, and practical ability. More than 50% of the independent directors are retired executives of listed companies, who are not working part-time and can spend more time understanding the overall situation

of corporate operations. As a result, the US has developed a more sophisticated and comprehensive market for independent director talent.

4.3 Mandatory performance of duties by independent directors

For example, independent directors are required to hold at least one to two management meetings a year, and management is required to recuse themselves during these meetings, making it possible for independent directors in the US to become more involved in the operations of the company without being constrained by management as much as possible. In addition, most companies in the US have an independent director as the presiding officer or convener of board meetings, and some listed companies have an independent director as chairman. As a result, independent directors in the US are far more involved in understanding corporate operations and have more voice and influence than independent directors, who are a "disadvantaged group" in China.

4.4 Stringent disciplinary system for independent directors

The US system of holding independent directors civilly and criminally liable is equipped with strict legal penalties. For example, the US law provides that an independent director who signs a fraudulent financial report will face up to 20 years in prison and a fine of US\$5 million[3]. In addition to this, there are severe penalties in the form of criminal penalties, fines, and forfeiture of related property. Based on the severe penalties imposed by the law, independent directors in the US are able to exercise more diligence, reflect more carefully on corporate financial reports and actual operations, and be more responsible for their authority. As a result, independent directors in the United States do not appear to be "titular" or other common phenomena.

5 Measures to improve the system of independent directors in China

5.1 Establishment of a third-party independent director body

5.1.1 Strengthen the independence of independent directors

In response to the serious lack of independence of independent directors in China, we can learn from the experience of the US independent director system which does not allow the existence of affiliation between independent directors and enterprises, and the State Securities Regulatory Commission takes the lead in setting up an external

third-party independent director body, the practitioners of the third-party body are composed of relevant personnel of the state government, rather than by the personnel of enterprises, to ensure the effectiveness and authority of the exercise of their powers, the body will be independent by the independent The appointment of directors is transformed into a system of appointing independent directors. The third-party body incorporates candidates into the independent director talent pool and must thoroughly endorse a full range of information on the independent director's connections, education, work experience, companies in which he or she works, work achievements, and credit assessment. Companies such as listed companies that need to select corporate independent directors can do so from the talent pool. After selection by the client company, the third party independent director body will investigate and review the candidate's information again to assess whether the candidate has an "interest" or "close relationship" with the client company. If a relationship exists, the candidate will be rejected from the client company to become an independent director, and if approved, the candidate will continue to be interviewed and recruited. Therefore, the independent director provided by a third party can avoid as far as possible the existence of close ties with the shareholders or management of the company, effectively preventing and avoiding the concerns of decision making due to "favors", and can better make scientific and effective decisions for the client company.

5.1.2 Strengthen the remuneration incentive system

When the salary of independent directors in our enterprises is a fixed allowance, it will significantly reduce the incentive of independent directors to work, and once the salary is linked to the performance of the enterprise, there may be a series of problems such as independent directors choosing to conceal or not expressing opinions on the financial statements of the enterprise, etc. to obtain a higher amount of allowance. Therefore, we propose that instead of independent directors' remuneration being paid by the company, the company should pay an annual fee to a third party independent director body, which will pay the appointed independent directors a stipend, following the actual budget. The independent director's salary will also no longer be presented in the form of a fixed salary or linked to the performance of the enterprise but will be

determined by the third-party independent director body's professional staff assessing the work of the appointed independent directors, the results of their decision-making and the actual due diligence of the independent directors as reflected by the client enterprise in a multi-dimensional manner to determine the salary to be paid to the independent directors for the year. The payment of salary by the third-party body can avoid negative decisions by the independent directors due to "taking advantage of the weaknesses of others", and the multi-dimensional assessment of salary can, to a certain extent, provide positive incentives for the independent directors to work.

5.2 Strengthening the comprehensive training of independent directors

In response to the problems of "titular" and "vase" independent directors in China, we suggest that third-party independent director bodies set up a professional examination for independent directors, consisting of a written test and an interview. Two national examinations will be set up each year, one in the spring and one in the autumn. The written examination will be conducted by the independent director body's "Independent Director Professional Examination Panel" under the leadership of the SFC, ensuring that the questions in each written examination can examine all aspects of the candidate's ability and that the questions are kept in accordance with state secrecy standards to prevent leakage. The interview will be conducted by an interview panel consisting of senior management of the company and professionals from the institution to assess and strengthen the professional and practical abilities of independent directors through qualitative and quantitative assessments, to avoid serious theoretical or technical "bias" in the abilities of independent directors. The SFC is also required to form an "Interview Assessment Supervisory Panel" to monitor and videotape each interview, monitor the assessment process in real-time, and review the situation at the end of the assessment, to strictly control any bias in standards caused by subjective factors. Only those who have passed the professional qualification examination are qualified to serve as independent directors and are allowed to enter the independent director talent pool. The professional assessment of independent directors is conducive to the cultivation of a comprehensive range of talents who are capable of independent and innovative thinking and who can offer constructive advice to the company, in line

with the requirements of contemporary corporate development.

After the appointment of an independent director, he or she will still be subject to the scrutiny of a third-party independent director body. In addition to the salary assessment, the independent director must also be assessed as to whether he or she has fulfilled his or her duties and responsibilities, and whether he or she has been able to protect the interests of the company and the interests of the shareholders. If the person concerned fails to pass the assessment repeatedly or fulfill the due diligence obligations, or if the enterprise reflects that the independent director has failed to exercise due diligence, the third-party independent director body will conduct verification and record the facts, and in serious cases, the independent director will be recalled from the position and restricted from holding office, or even impose punitive measures and so on.

5.3 Increasing the proportion of independent directors on the board of directors

China requires the number of independent directors to be 1/3 of the board of directors, and the majority of companies in China have exactly 1/3 of independent directors. In the enterprise to make decisions, if the independent directors deny the feasibility of decision-making, but because of their relatively small percentage, the majority shareholders may use their greater decision-making power and voice through decision-making, which will not be conducive to independent directors to effectively play its decision-making role, but also not conducive to the sustainable development of enterprises. To address this issue, we should learn from the US approach and increase the number of independent directors. The average number of independent directors in the US is more than 2/3, which effectively checks and balances the decision-making power of the majority shareholder, but based on the actual situation in China, a larger number of independent directors may reduce the enthusiasm of shareholders' investment. "This will not only effectively restrain the decision-making power of shareholders, but also maintain a certain degree of enthusiasm of shareholders, and help to enhance the enthusiasm of independent directors in decision-making, which is conducive to the healthy development of enterprises.

4.4 Strengthening the accountability mechanism for independent directors

The relevant laws in China have not established an accountability mechanism for independent directors, and most independent directors are not severely held accountable when they fail to exercise due diligence or commit illegal acts, and are less likely to be subject to criminal penalties and civil penalties, so that independent directors are not subject to strong constraints in performing their duties and are less likely to exercise due diligence and prudent decision-making. To address this situation, we suggest that strict criminal penalties should be used to discipline the behavior of independent directors, and that civil and administrative sanctions against independent directors should be strengthened, to increase the penalties and discipline the behavior of independent directors and force them to be more diligent and prudent in their decision-making.

6 Conclusion

The Chinese independent director system is originally under the common law system, but by studying the literature in the past decade, we find that the Chinese independent director system is gradually being improved and rooted in the legal system with Chinese characteristics, and it is making progress in ensuring its independence, stricter performance evaluation and other substantive issues. However, a review of the literature in the last decade shows that the Chinese independent director system are progressing in substantive issues such as ensuring the independence of their functions and strict performance evaluation of independent directors. At the same time, we have made more accurate and reliable recommendations, emphasizing the active role of third-party institutions and the public in the appointment and performance evaluation of independent directors, such as expanding the scope of independent directors, placing their behavior in a broader public perspective, and conducting multi-stage and multi-dimensional assessments of its performance. The lack of a broader scope of authority leads to the absence of some specific theoretical data in this paper, and although the concrete implementation of the findings has some limitations, it has some insights for further research.

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