

# The Perfection of External Corporate Governance Mode of Independent Director System in China

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**Abstract.** As a complicated organic system, the effective development of the independent director function is influenced by many factors. The difficult problem in our public company results in, not only the insider control problem, but also unreasonable structure of shareholders, immature capital market, short of market mechanism and so on. Those problems are all the drawbacks exists in the external corporate governance mode which is the institutional roots. Based on the discussion of the defect of external corporate governance mode, this article provides a serious of Suggestion for Perfection.

**Keyword:** the external corporate governance mode; independent director system; analysis

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## 1. The Defect Existing In External Corporate Governance Mode

### 1.1 The Defect of Large Shareholder Control and Insider Control

Different from the wider diversion of stock ownership in American, the stock ownership in our country is extremely focused. By the end of 2009, 662 companies, 79.3% of all the 835 listed companies exists state-owned shares .There are 533 companies where the state-owned shares appear in more than 30%, 370 companies where the state-owned shares appear in more than 50%, separately 63.9% and 44.35% of all companies. From the above, almost the stock of two-thirds is held by state, almost the stock of half of all the listed companies is held relatively by state. Therefore , the defect of large shareholder control exists badly. The Particularity of state controlling shareholder decides the Big Shareholder primary pattern under government administration. The state shareholder is weak domination economically, and is strong domination administratively. Because of the equity division of listed companies, the concern of large shareholder----state shareholders is the remaining assets, they pay attention to arbitrate by the Cash Dividends、the affiliated transaction and so on, therefore the serious insider control exists.

The lack of appointment standardization leads to the natural extension of government administration. The corporate management is short of enterpriser's qualities, who is not brought up in the market environment. Then the inefficient governance structure and model are translated into the listed companies, the managerial effectiveness is badly affected.

### 1.2 The Lack of Mature Capital Market

The capital market in our country, especially stock exchange was constructed to finance to resolve the faculty shortage of nationalized business, not to urge limited resource to flow to the businesses at the full blast. The equity division exists in listed companies, the state-owned shares control relatively. And the state-owned shares and corporate shares could not listing, which stunted the market development. Merger and Acquisition are the timeless theme in capital market, because of the equity division, M&A could not

exert a lot of pressure on the corporate governance. Although the reform of the shareholder structure of listed companies has been completed currently, the total value in Shanghai and Shenzhen Stock has been in excess of 23 trillion yuan, increased seven times. Total value of trade has reached 80295 billion yuan, cut the total value by more than a third. But the capital market in China is relatively closed, different from open market.

### **1.3 The Lack of Market Mechanism**

The state controls the shares and play a leading role, the corporate management can be only appointed by the administration. The irregular appointment results in the natural extension of the government administration. Which influenced immediately the development of professional manager market.

In china, the most genuine market of professional manager and independent director do not exist, which leads to Non-professional Trend, reputation incentive mechanism could not develop fully. Independent directors come from scientific research institutions mostly, lack of management experience. According to statistics, in 2009 43.5% of independent directors came from scientific research institutions or colleges and universities, 26.1% came from social intermediary such as accounting firm and law office, 26.1% came from enterprise management. The intellectual type of independent directors are short of the knowkedge and experience acquired form the pratice to provide valuable decision. Professional manager market is the sizer of independent director. The value of independent director in China lies on their management action, so market pricing mechanism don't exist. Many listed companies are interesting in hiring celebrity as independent director, whose reputation isn't influenced by the corporate benefit. Therefore the role of reputation mechanism is limited.

### **1.4 The Lack of Legal Constraints**

By now, there is mandatory provision about the construction and implementation of independent director. Therefore, institution of law couldn't support the implementation effectively. In China, we can find the relevant regulation in several laws, such as "Guide of Listed Companies Regulations", "Governance code of listed companies"and so on, which are not-binding and without coercive power. In practice, the managerial lacks of good faith and ignores regulation generally, the performance of independent director duty was obstructed, and then the weak of accountability system and punishment to the managerial unlawful practice come into light. Although which, regulator mostly censures publicly, forbid to Join and economic sanctions against listed company and responsible person concerned. Compared with the huge economic benefit, Violation Cost is too low which is not enough to frighten.

## **2. Suggestions for Improvement**

First half of 2009, the independent director of some listed companies wielded the sceptre actively, but the exercise failed finally because of stubborn resistance from the corporate insider. The independent director is weak in independence, weakly professional and enthusiasm; on the other hand, due to the disadvantaged Information and weak procedure of supervision, the performance of independent director duty was obstructed hardly. The author believes that the effective implementation of independent director system lies on the equity structure、 law environment and marketization of independent director .

### **2.1 To Optimize Stock Structure of Listed Companies**

Under the environment of the reform of the shareholder structure, all kinds of shareholders enjoy the same criterion of value, that is exterior supervision at many levels and restraining mechanism to protect the benefit of circulation share holders. But the full circulation has realized, which constructs the base to protect the Investor's profit

on circulation system. The state-owned stocks obtain circulation right, reduce to hold national stock in order to introduce other large shareholders. The other large shareholders pay more attention to the corporate management because of the rises of their proportionate share. Which resolves the owner absence problems partially resulted from the phantom of the state-owned stocks. And then Check-and-Balance in the corporate governance comes into being. Furthermore to play the role of capital market and improve the effectiveness of corporate governance, we could propel the reform of property rights system in listed companies, construct reasonable stock structure, reduce the administrative interpose. Furthermore we can impel reciprocal

shareholdings among state-owned businesses and between state-owned businesses and non-state-owned enterprise to realize diversity of equities, decentralization and corporation, and then rationalize equity structure to improve the effectiveness of corporate governance.

## **2.2 To Complete Relevant Legal Systems**

During the procedure of constructing independent director system, we should combine the system with the internal and external law environment. Because of incompleteness of many regulations, the self-discipline conduct of businesses is far from enough. The construction of independent director legal system is an important step to complete the independent director system. External law environment of corporate governance includes legislation, law enforcement, justice, independent management of the trades and so on. Learned from the foreign experiences, the position and function of independent directors has been specified in company law and securities exchanges Act. In term of the independent director system in China, the system should be designed into the company law. Company law shall clearly set out the definition and requirement of independent director, which could be a clear institution of law. The role, responsibility, duty, job requirements, appointment and the connection with the board should be specified and added to company law, which will be the legal ground of the exercise of independent director power. And some material operation provision could be formulated in the listing regulations of stock exchange.

## **2.3 To Establish The Market Mechanisms of Independent Director**

To complete the independent director system, we should establish the market mechanisms of handlers and independent director, and realize the professionalization and marketization. Furthermore, independent director office could be established, by which independent director can independently have private right and private obligations to compensate for lack of ability. Because of the team support involved of professional person such as professional manager, investment expert, accountant and so on. Therefore, after obtaining prediction scheme, independent directors could hold discussions among independent directors firm at first, and then vote in board as coming to an agreement to improve the science of decision. In China, the independent director system is still new institution, the talent person is in high demand. Corporate management could try to give full play to the role of social intermediary organizations, establish talent bank, choose and train reserve.

Simultaneously, we could establish self-regulatory organization such as the independent director institution and independent director office, draw up the self-disciplines of transactors to improve vocational training and self-disciplines education. Finally, form a professionalized crowd of independent director. At the same time of protecting independent directors' legitimate rights, we should draw up internal punitive measure to standard career behavior; construct independent director office to transfer natural person liability to international criminal tribunals, and then independent director office will become the carrier to regulate independent director and assume responsibility of independent directors. By means of system installation, the independent judgment and management by supervision give play to the function. Independent directors discharge their function and bear severe incentive and control and joint liabilities in accordance with their action; at the other hand, to construct reasonable salary system, carry out violation cost measures simultaneously, play the role of incentive and control system.

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