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What's on our mind this week?

A wake-up call inside Chinese boardrooms

The rules of corporate governance are not exactly the same in emerging markets as they are in developed markets, at least not in practice. In fact, suboptimal governance practices in these markets have partially led to the so-called "emerging market risk premium" demanded by international investors, and China is no exception. A recent governance event related to an A-share company named Kangmei Pharmaceutical (600518.SH) was an earthquake that signaled a change towards a more robust corporate governance system in the Chinese equity market.

After a series of investigations, the China Securities Regulatory Commission (CSRC) has found Kangmei Pharmaceutical engaged in intentional and systematic accounting fraud to the tone of RMB30 billion ($4.7 billion) between 2016 and 2018. The investigation was recently followed by a court ruling in which the company was ordered to pay 55,326 investors a total of RMB2.46 billion ($384.8 million) to compensate their losses. In addition, market participants were astonished to learn that in addition to executive directors and internal accountants being held legally responsible and sentenced, external auditors as well as independent directors have also been held directly liable for the losses of investors.

Five independent directors who were serving on the company's board of directors are now responsible for paying back investors from their own pocket, each one of them being personally liable for amounts ranging from RMB123 million ($19.2 million) to RMB246 million ($38.5 million), the precise amount depending upon the number of signatures they put on fraudulent financial statements. This court ruling was an earthquake as it broke the market's widely-held yet unspoken understanding that independent directors are fulfilling a "silent partner" role within Chinese companies and could not be held accountable for companies' wrongdoings.

Admittedly, the "silent director" situation has been in place for the last 20 years, ever since the CSRC first mandated listed companies to appoint independent directors to their board of directors in 2001 with the intention of protecting shareholders' interests. Unfortunately, as independent directors are often nominated by majority shareholders (who are in many instances the founders), these majority shareholders continued to play a dominant role in board meetings, leaving independent directors' responsibility largely unfulfilled. The absence of checks and balances persists as companies typically hire college professors, economists and other professionals to fill

their board seats while keeping them unaware of companies' key agendas, including fraudulent ones. In addition to majority shareholders' absolute control in the boardroom, the relatively low level of compensation also contributes to their negligence.

Compared to their U.S. counterparts who receive a total average annual compensation of $304,856 (for S&P 500 non-employee directors from May 16, 2018 through May 15, 2019 according to this study), 80% of independent directors in China receive an annual compensation under 100,000 yuan, or $15,640, according to the following report: A 股独董图谱：80%薪酬低于 10 万，2021 年超 460 家上市公司独董辞职. Under-compensation discourages independent directors from exercising their duties with vigilance, and instead entices them to simply sign every document on the table without asking questions. More importantly, the non-intervention and lax regulation historically have created a hotbed for being a silent director. In the aftermath of the Kangmei Pharmaceutical scandal, the enormous difference between compensation package ($15,640) and potential liability ($38.5 million) have compelled Chinese independent directors to reconsider and re-examine their roles and responsibilities. We observed a significant spike in the number of resignations from independent directors following the court ruling.

During the past few years, Chinese market regulators have been playing a more active role in strengthening governance practices, probing issues such as connected transactions, unreasonable share-issuances, unchallenging stock option plans and fraudulent accounting. This recent milestone event further serves as a wake-up call for independent directors and financial market intermediaries, reminding them of their roles and responsibilities in protecting shareholders' interests. Although loopholes and suboptimal governance practices may still exist among the country's 4,000+ listed companies, we believe that supervising the duties to be fulfilled by independent directors will gradually improve the market's integrity in a meaningful way.

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