JK Capital Management Ltd.

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Governance in Chinese boardrooms - China to overhaul the appointment of independent directors

On 14th April 2023, China's State Council released a document on reforming the independent director system of listed companies, with the ultimate goal of defining the role of independent directors and strengthening corporate governance practices.

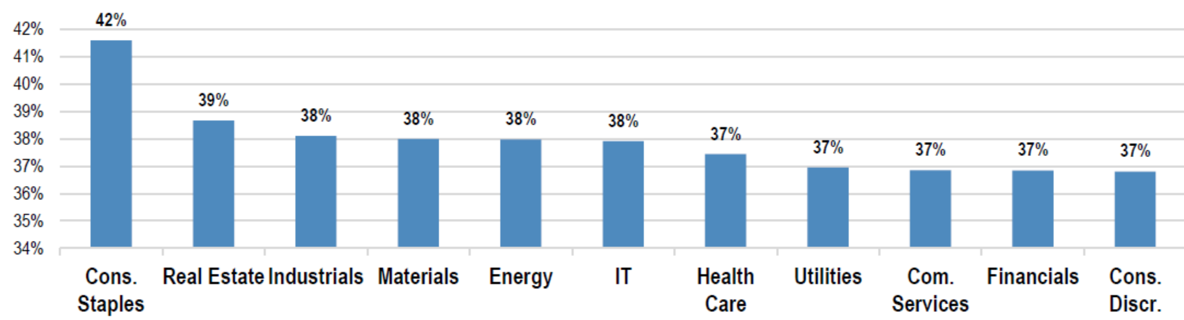
It has been more than two decades since China officially rolled out the independent director system in 2001. Despite the regulator subsequently introducing a number of guidance documents to plug loopholes, structural flaws within the system still persist. Issues such as the unclear legal role of independent directors, unequal and under-defined responsibilities and rights, and insufficient supervision methods have long been criticized by professional investors.

Among these, independent directors' negligence or their tendency of being silent partners have received the most criticism in recent years when accounting frauds were exposed and shareholders found independent directors have completely failed their duties. The most infamous incident occurred in 2021 when a company named Kangmei Pharmaceutical (600518.SH) was found engaged in intentional and systematic accounting fraud to the tune of RMB30 billion ($4.4 billion). Alongside the company itself and the auditor involved, its independent directors were ordered to pay back investors from their own pocket, each one of them being personally liable for amounts ranging from RMB123 million ($17.9 million) to RMB246 million ($35.8 million), the precise amount depending upon the number of signatures they put on fraudulent financial statements. The document recently released by the State Council not only attempts to tackle this particular problem, but all of the structural issues mentioned earlier.

Within the document, the regulator for the first time systematically and clearly defined the role, responsibilities and performance expected of independent directors. It stipulates that as a member of the board of directors, an independent director should play the role of participating in decision-making, supervising and offering professional consultation. In other words, the widely-held yet unspoken notion that independent directors are fulfilling a "silent partner" role within Chinese companies and could not be held accountable for companies' wrongdoings has officially been thrown out of the window and replaced by strictly-enforced accountability.

The document also specifies that companies should optimize the composition of the board of directors. According to the document, independent directors should account for more than one-third of the board of directors of listed companies, and they should account for the majority of the boards of state-owned enterprises (SOEs). While the one-third independent director requirement is merely a reiteration of previous regulations, the majority independent board requirement for SOEs is perhaps the biggest surprise to investors who follow the China market closely.

Board Independence Ratios of CSI 500 Companies by Sector



Source: JP Morgan

According to JP Morgan, the board independence ratios of companies in the CSI 500 index stands at 38% on average, with most sectors ranging between 37% to 39%. Virtually no sector or company has come even close to having a board dominated by independent directors, not to mention State-Owned Enterprises (SOEs) that are under the notoriously tight control of the State-owned Assets Supervision and Administration Commission (SASAC).

It may look like SASAC is giving up its control over the board of its SOEs, at least on paper. However, we believe that the most likely outcome remains that SASAC appoints executives of an SOE to another unrelated SOE's board as independent directors, as long as they qualify for the "independence" requirement. Nonetheless, this represents a significant progress in the opening-up reform of SOEs' corporate governance structure, in our view, by potentially allowing more competent external professionals to participate.

Furthermore, strengthening the selection and nomination process for independent directors is also highlighted by the document. It encourages shareholders as well as investor protection agencies to nominate independent directors through public solicitation, and therefore promoting the rights of minority shareholders.

Overall, the document serves as a promising pathway towards improving the corporate governance structure within Chinese listed companies, particularly with its emphasis on accountability, board composition, and zero-tolerance towards security frauds. How these regulations will actually be implemented remains highly uncertain at present, however we believe the fact that the State Council is willing to set up more stringent rules for SOEs is an encouraging start, one that could potentially strengthen the corporate governance norms of Chinese companies to a level that is more comparable with its western peers.