

# Legal vs. Reputational Bonding: Board Independence of Chinese Companies Listed in Hong Kong

(Frank) Meng Fangpeng\*

“Like a man’s word, a provider’s reputation is its bond.”<sup>1</sup> --- Ted Schneyer

## ABSTRACT

The bonding hypothesis posits that a firm may improve governance practices by listing in a developed foreign market. Research has shown that the bonding effect may flow at both legal and reputational levels. While at the former, the firm “ties its hands” to better legal and regulatory rules of the host market, at the latter, such a listing bonds the firm by building its reputation, and the prospect of creating reputational capital induces the firm to observe rules that it is not forced to follow. Chinese companies listed in Hong Kong are known as H-share companies for the first letter of the listing locality. This article tests the bonding effect on H-share companies in respect of board independence. It argues that, since the agency problem of both China and Hong Kong arises between the major shareholder and minority shareholders rather than between managers and shareholders, independent directorship is a wrong prescription for their governance disease. Thus, the bonding effect at the legal level is conspicuous by its absence. Further, it examines the changes in governance practices in an effective sample of 81 H-share companies, which shows that these companies have voluntarily observed additional rules that they are not strictly required to follow. This may suggest that reputational bonding better explains the case of H-share companies. In addition, it finds that H-share companies tend to hire high-profile figures in Hong Kong, which may shed light on their motive for listing in Hong Kong, namely to enhance reputation.

---

\* Ph.D Candidate, Faculty of Law, the Chinese University of Hong Kong. A major part of this article was written while I was a visiting scholar at UC Berkeley’s Boalt Hall School of Law from April to July 2011. I deeply appreciate Boalt Hall for providing me with such a valuable opportunity. Meanwhile, helpful comments on this research were received from David C. Donald, Richard M. Buxbaum, Xuanming (Steven) Pan, Bei (Rebecca) Yin, Yaling Zhang.

<sup>1</sup> Ted Schneyer, Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Storyteller, 84 Va. L. Rev. 1777, 1779 (1998).

## INTRODUCTION<sup>3</sup>

Cross-listing refers to the phenomenon of a firm listing its securities on a stock exchange located in a foreign jurisdiction. In the global market, cross-listing did not become a common practice until the early 1990s, when a large number of enterprises from transition economies following the privatization trend started to float on exchanges in the US and UK.<sup>2</sup> In the late 1990s, finance and legal scholars proffered the idea that cross-listing on a developed stock market functions as a “bonding” mechanism by which a firm may improve its governance practices despite the home market’s weak legal infrastructure.<sup>3</sup>

It is now established that the bonding mechanism may work at both legal and reputational levels. At the legal level, by cross-listing in a developed stock market, the firm “ties its own hands” to the better legal and regulatory rules of the host market.<sup>4</sup> At the reputational level, such a listing bonds the firm by building its reputation; in turn, the prospect of gaining reputation capital incentives the firm to voluntarily observe rules that it is not obligated to follow.<sup>5</sup>

Literature has identified board independence as an important element of the bonding mechanism, which is alleged to indicate that the firm has better governance.<sup>6</sup> Since the 1950s, the institution of the independent director has been developed as a solution to the managerial agency problem associated with Berle-Means corporations characterized by separation of ownership and control in the US.<sup>7</sup> In the 1990s, it was recognized that sound corporate governance plays a crucial role in economic development.<sup>8</sup> Shortly, other jurisdictions borrowed the institution in expectation of solving their own governance problem without seriously questioning whether logically it is the proper solution for that unique problem.<sup>9</sup>

---

<sup>2</sup> See, eg. James L. Cochrane, James E. Shapiro & Jean E. Tobin, Foreign Equities and US Investors: Breaking Down the Barriers Separating Supply and Demand, 2 *Stan. J. L. Bus. & Fin.* 241 (1996) (detailing the driving forces of cross-border listings in the 1990s).

<sup>3</sup> See *infra* note 29-30 and accompanying text.

<sup>4</sup> See *infra* note 31 and accompanying text.

<sup>5</sup> See *infra* note 36 and accompanying text.

<sup>6</sup> See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 *UCLA L. Rev.* 781, 824-26 (2001). Dariusz Wójcik, Gordon L. Clark & Rob Bauer, Corporate Governance and Cross-listing: Evidence from European Companies, 4 (May 2005), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=593364](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593364). Lixian Liu, Vikash Ramiah and Tony Naughton, Do Corporate Governance Mechanism Affect the Value of Cross-listed Firms (2011), Paper Presented at the Annual Conference on Pacific Basin Finance, Economics, Accounting and Management, Taipei, Taiwan (on file with the author). Also see Hua Cai, Bonding, Law Enforcement and Corporate Governance in China, 13 *Stan. J. L. Bus. & Fin.* 82 (2007) (arguing that the introduction of the independent director system in China is a bonding measure itself).

<sup>7</sup> See, eg. Barry D. Baysinger & Henry N. Butler, Revolution Versus Evolution in Corporation Law: The ALI’s Project and the Independent Director, 52 *Geo. Wash. L. Rev.* 557, 563-64 (1984) (discussing the managerial dominance of the board and the need of board independence). Jeffrey N. Gordon, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices 59 *Stan. L. Rev.* 1465 (2007) (tracing the rise of independent directors in the US over the period between 1950 and 2005). Robert W. Hamilton, Corporate Governance in American 1950-2000: Major Changes But Uncertain Benefits 25 *J. Corp. L.* 349 (2000) (outlining the major changes in board independence in the US between 1950 and 2000).

<sup>8</sup> See Stephen M. Davis, *The Race for Global Corporate Governance*, in *Corporate Governance Reform: China and the World* 10 (Tong Lu ed., 2002).

<sup>9</sup> *Id.*

The concept of independent director was first introduced to the Chinese legal system in 1997.<sup>10</sup> To date, theoretical and empirical studies have provided robust evidence that independent directors have induced little improvement in the governance of Chinese listed companies.<sup>11</sup> In China, the agency problem lies in assuring that the state as the major shareholder is prevented from exploiting the interests of minority shareholders.<sup>12</sup> Nevertheless, independent directors functions as an external protection for shareholders from the abuse of power by corporate managers.<sup>13</sup> Thus, the Chinese policymakers have adopted the wrong solution for the governance problem.<sup>14</sup>

In Hong Kong, the Stock Exchange of Hong Kong (SEHK) introduced the concept of independent non-executive directors (INEDs) to its Listing Rules in 1993.<sup>15</sup> Indeed, Hong Kong suffers from a similar problem to that of China. Since a large majority of companies listed on the SEHK are family-owned enterprises (FOEs),<sup>16</sup> the agency problem arises between the major shareholder and minority shareholders too, despite that the major shareholder becomes a family and no longer the state.<sup>17</sup> Unsurprisingly, independent directorship is regarded as a wrong solution in Hong Kong as well.<sup>18</sup>

That said, initially developed in the context of foreign companies listing in the US market, the bonding mechanism has been applied to test the level of governance practices in other places of the global market.<sup>19</sup> Critical to this scenario is the “quality gap” between the home and the host markets, which has to be there for generating the bonding effect.<sup>20</sup> Since the early 1990s, the SEHK has been a prime venue for Chinese companies listed overseas.<sup>21</sup> These are known as H-share companies for the first letter of their listing locality. At the end of 2011, there were 139 H-share companies on the Main Board (MB) and 29 on the Growth Enterprise Market (GEM) of the SEHK.<sup>22</sup> Together, they constitute about 25 percent of the market capitalization of the SEHK.<sup>23</sup> Previous research has generally agreed on the existence of the bonding effect on H-share

---

<sup>10</sup> See *infra* note 65 and accompanying text.

<sup>11</sup> See *infra* III. C, D.

<sup>12</sup> There is a rich body of literature in this area, for a recent study, see, eg. Michael Firth, Peter M. Y. Fung & Oliver M. Rui, Ownership, Governance Mechanisms, and Agency Costs in China’s Listed Firms, 9 J. A. M. 90 (2008).

<sup>13</sup> See *infra* note 42-43 and accompanying text.

<sup>14</sup> I thank Prof. David C Donald for raising the idea that shareholder power rather than managerial agency cost should be the correct answer to the governance issue in China. This perspective has been a great influence on this article. For a consideration of Prof. Donald’s work in this regard, see Donald C. Donald, Shareholder Voice and its Opponents 5 J.C.L.S 305 (2005).

<sup>15</sup> See *infra* note 126 and accompanying text.

<sup>16</sup> See *infra* note 153-156 and accompanying text.

<sup>17</sup> See *id.*

<sup>18</sup> See *infra* IV. B.

<sup>19</sup> See Qian Sun, Wilson H. S. Tong & Yujun Wu, Bonding Premium as a General Phenomenon (March 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=890962](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890962).

<sup>20</sup> *Id.* 3.

<sup>21</sup> See Fanpeng (Frank) Meng, A History of Chinese Companies Listing in Hong Kong and its Implications for the Future, 11 J.C.L.S. 243 (2011) (presenting a history of Chinese companies listing in Hong Kong).

<sup>22</sup> HKEx, *List of H Share Companies (MB)*, [http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd\\_hmb.htm](http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd_hmb.htm) (last updated March 1, 2012). HKEx, *List of H Share Companies (GEM)*, [http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd\\_hg.htm](http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd_hg.htm) (last updated March 1, 2012).

<sup>23</sup> HKEx, *Market Capitalization of China-Related Stocks (Main Board and GEM)*, [http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd\\_mc.htm](http://www.hkex.com.hk/eng/stat/smstat/chidimen/cd_mc.htm) (last updated March 1, 2012).

companies as Hong Kong's legal and regulatory rules are perceived to be better than China's.<sup>24</sup>

This article tests the alleged bonding effect on H-share companies in respect of board independence. It demonstrates that, since the prevailing agency problem of China and Hong Kong is between the major shareholder and minority shareholders rather than between corporate managers and shareholders as a whole, both jurisdictions have used the wrong prescription of independent directorship to cure their governance disease. Thus, at the legal level, the bonding effect on H-share companies is conspicuous only by its absence. At the same time, by examining the changes in governance practices of these companies, it shows that they have voluntarily observed rules that they are not strictly required to follow, which may suggest that reputational bonding better explains the case of Chinese companies listing in Hong Kong. In addition, this article finds that H-share companies tend to hire high-profile figures of the Hong Kong market, which may indicate that their true motive for listing in Hong Kong is to enhance reputation, though further empirical evidence is needed.

The remainder of this article is organized as follows. Part I explicates the bonding effect at both the legal and reputational levels. Part II discusses the concept of independent director and the function it is expected to perform. Part III examines the defects of the independent director system in China. Part IV analyzes the flaws of the INED system in the context of Hong Kong FOEs. Part V reviews the regulatory requirements on board independence applicable to H-share companies and examines the changes in governance practices in an effective sample of 81 H-share companies listed on the MB of the SEHK. Last, it offers a conclusion.

## I. LEGAL VS. REPUTATIONAL BONDING

The Oxford Dictionary of Law defines the term, bond, as “a deed by which one person (the obligor) commits himself to another (the obligee) to do something or refrain from doing something.”<sup>25</sup> The term was adopted to corporate law through Jensen and Meckling's seminal work on agency cost in modern corporations, which explained the cost as a sum of three things: the “monitoring cost” by the principal, the “bonding cost” by the agent, and the residual loss.<sup>26</sup> In a regulatory perspective, Gordon presented the idea of bonding through listing in a US domestic context:

---

<sup>24</sup> See Sun et al. *supra* note 19. Laixiang Sun & Damian Tobin, International Listing as a Mechanism of Commitment to More Credible Corporate Governance Practices: The Case of the Bank of China (Hong Kong), 13 Corp. Gov. 81 (2005) (finding that Hong Kong listings function as a mechanism of commitment to credible governance practices as it mitigates the consequence of discretionary policies and managerial opportunism in China). Damian Tobin & Laixiang Sun, International Listing as a Means to Mobilize the Benefits of Financial Globalization: Micro-level Evidence from China, 37 World Dev. 825 (2009) (proposing that cross-listing in developed markets enables Chinese companies to overcome institutional constraints, thereby enhancing corporate governance). Also see Iain MacNeil & Alex Lau, International Corporate Regulation: Listing Rules and Overseas Companies, 50 Int'l & Comp. L.Q. 788 (2001) (pointing out that the SEHK tends to put overseas listed companies in the same position as locally incorporated ones by offering fewer concessions to them than its UK counterpart, which provides evidence for the validity of the bonding hypothesis).

<sup>25</sup> Jonathan Law & Elizabeth A Martin (ed), A Dictionary of Law 64 (2009).

<sup>26</sup> Michael J. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, 3 J. Finan. Econ. 305 (1976).

“insiders who seek to lower the cost of capital will find it valuable to bond a promise that the firm’s single class capital structure will not be renegotiated ... The NYSE [New York Stock Exchange] rule is the only secure bond available for such a promise.”<sup>27</sup>

In the early 1990s, empirical studies found that the benefits of cross-listing on developed exchanges outweigh its costs.<sup>28</sup> Following that, Doidge, Karolyi and Stulz argued that US listings represent a bonding mechanism by which cross-listed firms are more highly valued than those not listed there both because controlling shareholders bond themselves to limit their consumption of private benefits and because these firms are better able to take advantage of growth opportunities.<sup>29</sup> In a legal perspective, Coffee further developed the hypothesis, alleging that cross-listing in the US can be used as a strategy for governance enhancement.<sup>30</sup> He summarized the strategy in the following terms:

“The simplest explanation for the migration of foreign issuers to US exchanges and NASDAQ [National Association of Securities Dealers Automated Quotations] is that such a listing is a form of bonding – a credible and binding commitment by the issuer not to exploit whatever discretion it enjoys under foreign law to overreach the minority investor. That is, the issuer ties its own hands by subjecting itself to the mandatory requirements of U.S. law in order to induce minority shareholders to invest in it.”<sup>31</sup>

Coffee was of opinion that a strong legal standard attracts rather than repels issuers for it is a signal that the firm has high growth prospect in part as a bonding mechanism to assure public investors that they will not be exploited and in part as a means of attaining greater analyst attention and reducing informational asymmetry.<sup>32</sup>

---

<sup>27</sup> Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Cal. L. Rev. 3, 9 (1988).

<sup>28</sup> Usha R. Mittoo, *Managerial Perceptions of the Net Benefits of Foreign Listing: Canadian Evidence*, 4 J. INT. FIN. MANAG. ACC. 40 (1992) (finding that access to foreign capital and increased liquidity are the major benefits of cross-listing in the US, which outweigh the increased costs associated with SEC reporting and compliance requirements). Sherman C. Cheung & Jason Lee, *Disclosure Environment and Listing on Foreign Stock Exchanges*, 19 J. of Bank. Finance. 347 (1995) (showing that listing on a foreign exchange such as the NYSE with a strict disclosure environment has a credible signaling effect of the firm’s future prospect, albeit increased costs in compliance). Oren Fürst, *A Theoretical Analysis of the Investor Protection Regulations Argument for Global Listing of Stocks*, Yale School of Management Working Paper, (Sep 1998), *available at* <http://ssrn.com/abstract=139599> (reporting that cross-listing in a more rigorous regulatory regime and assuming additional regulatory exposure can be viewed as a significant step of separating their firms from those with lower future profitability, and, in return, they are compensated by higher market values).

<sup>29</sup> Craig Doidge, George A. Karolyi & René M. Stulz, *Why are Foreign Firms Listed in the US Worth More?*, Dice Center Working Paper No. 2001-16, (Sep 2001), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=285337](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=285337).

<sup>30</sup> John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 Nw. U. L. Rev. 641 (1999).

<sup>31</sup> *Id.*, 691.

<sup>32</sup> John C. Coffee, Jr., *Racing Towards the Top? The Impact of Cross-listing and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757 (2002).

In a similar vein, Rock argued that the disclosure regime of the Securities and Exchange Commission (SEC) has a characteristic of a “lobster trap,” easy to enter voluntarily, hard to exit.<sup>33</sup> Due to its monopoly over criminal sanctions for securities violations and a history of enforcing high disclosure requirements, the SEC has been able to provide issuers with a device for making a credible commitment to “high quality, comprehensive disclosure for an indefinite period into the future,” which is particularly useful for firms seeking to tap the US capital market.<sup>34</sup>

While previous studies on the bonding effect are primarily conducted in a legal perspective, it is recently proposed that the effect may be accrued from a reputational level as well. Initially, Diamond alleged that a firm may show over time through good behavior that it deserves reputation capital.<sup>35</sup> Built upon Diamond’s allegations, Siegel argued that listing in a developed market bonds the firm by building its reputation and the prospect of creating reputation capital may lead the firm to voluntarily observe rules that it is not obligated to follow.<sup>36</sup> According to Siegel, reputational bonding may occur even without effective legal and regulatory enforcement.<sup>37</sup> Summarily, the major difference between legal and reputational bonding is that, while the former relies on the enforcement power of the host market, the latter incentivizes listed companies to follow rules for reputational purposes.<sup>38</sup>

## II. AGENCY COST, BOARD INDEPENDENCE, AND CORPORATE PERFORMANCE

In the 1930s, Adolf Berle and Gardiner Means asserted that there was a separation of ownership and control in US public companies, which creates a free-riding problem: no individual shareholders were willing to invest necessary and efforts monitoring management.<sup>39</sup> In consequence,

“...managers have an incentive to consume excess leisure, perquisites and in general be less dedicated to the goal of wealth maximization than they would be if they were not simply agents.”<sup>40</sup>

To minimize the agency cost, independent directors were employed to perform two essential functions: to goad managers to perform adequately their goal of wealth maximization, and to ensure managers’ integrity in dividing corporate assets between themselves and shareholders.<sup>41</sup> While these two functions are supposed to be undertaken by the entire board, independent

---

<sup>33</sup> Edward B. Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 *Cardozo L. Rev.* 675 (2002).

<sup>34</sup> *Id.*, 675, 703.

<sup>35</sup> Douglas W. Diamond, *Monitoring and Reputation: The Choice Between Bank Loans and Direct Placed Debt*, 99 *J. Pol. Econ.* 689 (1991).

<sup>36</sup> Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting US Securities Laws*, 75 *J. Fin. Econ.* 319 (2005).

<sup>37</sup> *Id.*, 321.

<sup>38</sup> Amir N. Licht, Christopher Poliquin, Jordan I. Siegel & Xi Li, *What Makes the Bonding Stick? A Natural Experiment Involving the US Supreme Court and Cross-Listed Firms*, Harvard Business School Strategy Unit Working Paper No. 11-072, 2 (Dec 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1744905](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1744905).

<sup>39</sup> Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (1932).

<sup>40</sup> Daniel R. Fischel, *The Corporate Governance Movement*, 35 *Vand. L. Rev.* 1259, 1262-1263 (1982).

<sup>41</sup> Victor Brudney, *The Independent Director – Heavenly City of Potemkin Village?*, 95 *Harv. L. Rev.* 597, 602 (1982).

directors are expected to be effective monitors.<sup>42</sup>

Beginning as a “good governance exhortation,” board independence has become an essential element of corporate law in some respects.<sup>43</sup> Under the Sarbanes-Oxley Act of 2002 (SOA), all US listed companies must have an audit committee composed entirely of independent directors.<sup>44</sup> To be deemed independent, a member of the audit committee must not receive “any consulting, advisory, or other compensatory fee” from the company, affiliate to the company, or any of its subsidiaries.”<sup>45</sup> The rationale for this provision is that independent directors can monitor management, and therefore reduce the possibility of audit failure, because their financial dependence on the company is only limited to the fees paid to them.<sup>46</sup>

Following the spirit of the SOA, the NYSE requires listed companies not only to be installed with an audit committee<sup>47</sup> but also a nominating committee<sup>48</sup> and a compensation committee.<sup>49</sup> Each of these specialized committees must be composed entirely of independent directors.<sup>50</sup> Meanwhile, NASDAQ has also adopted this independence criterion for audit committee,<sup>51</sup> but has not made it mandatory to have a nominating committee<sup>52</sup> or a compensation committee.<sup>53</sup> Further, both the NYSE and NASDAQ provide that independent directors must constitute a majority of the board unless the company is a “controlled company,”<sup>54</sup> which means that an individual, group, or company controls more than 50 percent of the voting power.<sup>55</sup> In other words, both exchanges view independent directors as a safeguard for shareholders specifically against management but not against other shareholders.<sup>56</sup> The consideration seems to be that a shareholder who controls a company does not need an external protection for it from management who the shareholder has the power to appoint.<sup>57</sup>

By far, empirical research has seriously examined whether board independence improves corporate performance by various analytical approaches. While a handful of studies found a positive correlation between these two factors,<sup>58</sup> the generally accepted notion appears to be that

---

<sup>42</sup> Id. Also see Sanjai Bhagat & Bernard S. Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 *J. Corp. L.* 231, 232 (2002).

<sup>43</sup> Gordon, *supra* note 27, 1468.

<sup>44</sup> S.301(m)(3)(A).

<sup>45</sup> S.301(m)(3)(B).

<sup>46</sup> Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *Yale L.J.* 1521, 1529-30 (2005).

<sup>47</sup> NYSE Listed Company Manual (2009), S.303A.06.

<sup>48</sup> NYSE Listed Company Manual (2009), S.303A.04.

<sup>49</sup> NYSE Listed Company Manual (2009), S.303A.05.

<sup>50</sup> NYSE Listed Company Manual, S.303A.07(a)(audit committee); S.303A.04(a)(nominating/corporate governance committee), S.303A.05(a)(compensation committee).

<sup>51</sup> NASDAQ Listing Rules, Rule 5605(a)(2).

<sup>52</sup> NASDAQ Listing Rules, Rule 5605(e)(1).

<sup>53</sup> NASDAQ Listing Rules, Rule 5605(d)(1)(B).

<sup>54</sup> NYSE Listed Company Manual, S.303A.00; NASDAQ Listing Rules, Rule 5605(c)(2).

<sup>55</sup> NYSE Listing Company Manual, S.303A.00; NASDAQ Listing Rules, Rule 5615(c)(1).

<sup>56</sup> Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 *Del. J. Corp. L.* 125, 159 (2006).

<sup>57</sup> Id.

<sup>58</sup> See, eg. Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 *J.L. Econ. & Org.* 101 (1985) (showing a positive correlation between board composition in 1970 and firm performance in 1980). Ira M. Millstein & Paul W. MacAvoy, *The Active Board*

there is no solid evidence suggests that board independence improves corporate performance, and greater board independence may even have a negative impact on performance.<sup>59</sup>

### III. INDEPENDENT DIRECTORS IN CHINA

In China, independent directorship is considered one of the most valuable institutional borrowings in the country's corporate law development.<sup>60</sup> Chinese policymakers appeared to have deeply believed that independent directors would provide effective protection for minority shareholders.<sup>61</sup> As former Vice Chairman of the China Securities Regulatory Commission (CSRC), Gao Xiqing, stated: "the higher the ratio of independent directors, the better the protection afforded to investors."<sup>62</sup>

#### A. *Regulatory Rules on Board Independence*

When China's first corporate law, the Chinese Company Law, was promulgated in 1993, there was no mention of independent directorship at all. Although the Law was amended in 2005 to call for listed companies to employ independent directors,<sup>63</sup> specific provisions have mainly been set out by the CSRC. In 1997, the CSRC issued the Guidelines for the Articles of Association of Listed Companies, which were the first official document to embrace the term of independent director in China.<sup>64</sup>

**1. Guidelines for the Articles of Association of Listed Companies** – The Guidelines provide that listed companies may elect independent directors according to their actual needs, and certain persons are not allowed to act as independent directors including: shareholders and those employed by shareholding entities, internal personnel of the company such as managers, employees, and persons who have a relationship of interest with affiliates or management of the company.<sup>65</sup> However, the Guidelines failed to specify qualifications, responsibilities, or proportion of independent directors on the board of directors.

In 2006, the Guidelines were revised to grant more powers and responsibilities to independent directors. First, at the annual shareholders' meeting, all independent directors must deliver a performance report.<sup>66</sup> Second, where matters to be discussed require independent directors' opinions, the opinions tendered must be disclosed upon the issuance of a notice of shareholders'

---

of Directors and Performance of the Large Publicly Traded Corporation, 98 Colum. L. Rev. 1283 (1998) (reporting that active and independent boards generate higher returns).

<sup>59</sup> Sanjai Bhagat & Bernard S. Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921 (1999). Bhagat & Black, *supra* note 42. Benjamin E. Hermalin & Michael S. Weisbach, Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature, 9 FRBNY Eco. Pol. Rev. 7 (2003) (reaching a similar conclusion).

<sup>60</sup> Donald C. Clarke, Lost in Translation? Corporate Legal Transplants in China, George Washington University Law School Public Law Research Paper No. 213, 8-14, (July 2006), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=913784](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913784).

<sup>61</sup> See Chao Xi, In Search of an Effective Monitoring Board Model: Board Reforms and the Political Economy of Corporate Law in China, 22 Conn. J. Int'l L. 1, 12-15 (2006).

<sup>62</sup> *Id.*, 12.

<sup>63</sup> Art. 123.

<sup>64</sup> No.16 [1997] CSRC.

<sup>65</sup> Art. 112.

<sup>66</sup> Art. 69.



meeting or a supplementary notice.<sup>67</sup> Third, independent directors may propose to the board of directors to convene an interim shareholders' meeting.<sup>68</sup> In addition, the Guidelines provide that independent directors must perform their duties according to relevant laws, administrative regulations, and departmental rules.<sup>69</sup> Here comes the milestone document regarding board independence for Chinese listed companies.

**2. Guiding Opinions on the Establishment of Independent Director System for Listed Companies** – In 2001, the CSRC issued the Guiding Opinions on the Establishment of Independent Director System for Listed Companies.<sup>70</sup> According to the Guiding Opinions, listed companies are required to have at least two independent directors by 30 June 2002, at least one third of the board must be comprised of independent directors by 30 June 2003,<sup>71</sup> and at least one of the independent directors must be an accounting professional.<sup>72</sup> In addition, it is stated that at least half of the members of the specialized committees established on the board of directors must be independent directors,<sup>73</sup> but the Guiding Opinions did not make it mandatory to have these committees.

The Guiding Opinions define an independent director as a person that holds no position in the company other than that of independent director, and that has no relationship with the company and its major shareholder, which is likely to prevent him or her from making objective judgment independently.<sup>74</sup> The circumstances and relationships that are deemed to be inconsistent with independence include:

- (1) a person who holds a position in the listed company or its subordinate affiliates, or this person's direct relative (including spouse, parent, or child), or this person's major social relative (including sibling, parent-in-law, daughter-in-law, son-in-law),
- (2) a person directly or indirectly holding at least one percent of the listed company's shares or being among one of the top ten shareholders of the listed company,
- (3) a person, or the direct relative of a person, employed by a shareholder holding at least five percent of the listed company's shares or among one of the top five shareholders of the listed company,
- (4) a person who has fulfilled one of the above conditions in the preceding year,
- (5) a person who provides financial, legal, consulting, or other similar services to the listed company or its subordinate affiliates, or
- (6) any other person specified in the listed company's articles of association; or specified by the CSRC.<sup>75</sup>

---

<sup>67</sup> Art. 55(3).

<sup>68</sup> Art. 46 (upon receiving the proposal, the board of directors must, in accordance with relevant laws, administrative regulations, and articles of association of the listed company, issue a written response on whether it agrees that the meeting must be convened within ten days).

<sup>69</sup> Art. 104.

<sup>70</sup> No.102 [2001] CSRC.

<sup>71</sup> Art.1(3).

<sup>72</sup> Id.

<sup>73</sup> Art. 5(4).

<sup>74</sup> Art. 1(1).

<sup>75</sup> Art. 3.

Under the Guiding Opinions, independent directors owe a duty of good faith and diligence to the company and to the shareholders as a whole.<sup>76</sup> They must pay particular attention to the interests of minority shareholders, and must not be influenced by the major shareholder, de facto controller, or others who have a relationship of interest with the listed company.<sup>77</sup> Proceeding from this provision, it can be assumed that independent directors of Chinese listed companies are not only expected to prevent the abuse of power by management but also to protect minority shareholders from the exploitation by major shareholders.<sup>78</sup>

**3. Principles of Corporate Governance for Listed Companies** – In 2002, the CSRC and the State Economic and Trade Commission (SETC) jointly issued the Principles of Corporate Governance for Listed Companies.<sup>79</sup> The Principles are adopted from the OECD Principles of Corporate Governance, while taking into account of China’s own circumstances.<sup>80</sup> Strictly speaking, these Principles are not legally binding.<sup>81</sup> The Preamble provides that “listed companies should follow the spirit of the Principles when trying to improve corporate governance[,]” and “reflect the contents of the Principles when formulating or amending articles of associations.”

The Principles require listed companies to have independent directors in accordance with relevant provisions.<sup>82</sup> Presumably, this refers to the Guiding Opinions as just discussed. The Principles further emphasized two points. First, independent directors must hold no other position in the listed company or its major shareholder.<sup>83</sup> Second, independent directors must pay particular attention to the interests of minority shareholders and not be influenced by the major shareholder, de facto controller, or others who have a relationship of interest with the listed company.<sup>84</sup> Thus, it provides further evidence that independent directors are expected to be a guardian for minority shareholders in China.

Besides, the Principles supplement the Guiding Opinions with more detailed provisions concerning specialized committees on the board of directors. Under the Principles, listed companies may establish an audit committee,<sup>85</sup> a nominating committee,<sup>86</sup> a remuneration committee,<sup>87</sup> a corporate strategy committee,<sup>88</sup> and other committees according to the resolution of the shareholders’ meeting.<sup>89</sup> All committees must be chaired by an independent director, and independent directors must constitute at least half of the committees, and at least one independent

---

<sup>76</sup> Art. 1(2).

<sup>77</sup> Id.

<sup>78</sup> Sibao Shen & Jing Jia, Will the Independent Director Institution Work in China, 27 *Loy. L.A. Int'l & Comp. L. Rev.* 223-35 (2005).

<sup>79</sup> No.1 [2002] CSRC & SETC.

<sup>80</sup> Xin Tang, *Zhongguo Shangshi Gongsì Zhili Huanjing de Xinfazhan* [New Development in the Governance Environment for Listed Companies in China], *Nanjing University Law Review* 187, 188 (2001).

<sup>81</sup> Clarke argued that the CSRC will presumably bring various kinds of pressure on companies that do not amend their articles of association to conform with the Principles. See Clarke, *supra*, note 56, 189.

<sup>82</sup> Art. 49.

<sup>83</sup> Id.

<sup>84</sup> Art. 50.

<sup>85</sup> Art. 54.

<sup>86</sup> Art. 55.

<sup>87</sup> Art. 56.

<sup>88</sup> Art. 53.

<sup>89</sup> Art. 52.

director from the audit committee must be an accounting professional.<sup>90</sup>

## **B. Implementation of the Independent Director System**

Overall, listed companies have well met the requirements prescribed by the Guiding Opinions. It is reported that, at the deadline as of 30 June 2002, 1124 out of 1187 companies appointed a total of 2412 independent directors, and 80 percent of them had two independent directors.<sup>91</sup> At the deadline as of 30 June 2003, 1244 out of 1250 companies had a total of 3839 independent directors, and, in 800 companies, independent directors constituted more than one third of their board.<sup>92</sup> At the end of 2005, of all 1377 listed companies, 4640 independent directors were employed, producing an average of three per company.<sup>93</sup> The requirement that at least one of the independent directors must be an accounting professional was generally satisfied.<sup>94</sup>

However, considering that it is not mandatory to have specialized committees, they have not gained wide popularity among listed companies. According to one study conducted in 2004, only 25.39 percent of listed companies were installed with one or more committee, whether audit, remuneration, or nominating committee, on the board of directors. Of these companies, 80.41 percent had remuneration committees, 74.23 percent had audit committees, and 57.73 percent had nominating committees.<sup>95</sup>

## **C. Empirical Results**

Notwithstanding a few exceptions, empirical studies have concurred that the independent director system has not improved the governance of Chinese listed companies.<sup>96</sup> For example,

---

<sup>90</sup> Id.

<sup>91</sup> Jianhua Liu, Qianyi Woguo de Duli Dongshi Zhidu [A Brief Discussion of the Chinese System of Independent Director], 1 *Statistics & Decision* 107, 107 (2004). Also see Wanyuan Zhu, Lun Woguo Duli Dongshi Zhidu de Xianzhuang yu Wanshan [A Discussion on the Status Quo and the Improvement of the Chinese Independent Director System], 18 *Journal of Hefei University of Technology (Social Science)* 63, 64 (2004) (finding that, by the end of 2002, 1173 listed companies had independent directors, the average number of independent directors was 2.31 per company, and independent directors constituted 23.30% of the board members).

<sup>92</sup> Quan Lou, Duli Dongshi Shifou Tigao Kuaiji Yingyu de Wenjianxing [Have Independent Directors Improved the Conservatism of Accounting Earnings], 9 *Communication of Finance & Accounting* 3, 3 (2004).

<sup>93</sup> Xiaohong Wang, Qiantan Woguo de Duli Dongshi Zhidu [A Discussion of China's Independent Director System], 155 *Journal of Nanjing University of Finance & Economics* 83, 84 (2009).

<sup>94</sup> Yang Yu & Xiaobo Zheng, 31.7% de Duli Dongshi Wei Kuaiji Zhuanye Renshi [31.7% of Independent Directors Being Accounting Professionals], *Securities Times* (June 8, 2006) (reporting that, by the end of 2004, 31.7% of independent directors were accounting professionals, and the requirement of having at least one accounting professional was generally met by all listed companies), <http://www.chinaacc.com/new/184%2F185%2F2006%2F6%2Fma01984113418660027910-0.htm>.

<sup>95</sup> Weian Li, Guoping Zhang, Yongzhen Xie & Yuejun Tang, Pandian Sannian Dudong Zhidu de Gongsi Zhili Jiazhi [Measuring the Corporate Governance Value of the Three Years' Old Independent Director System], 9 *Sino-foreign Management* 29, 30 (2004).

<sup>96</sup> See, eg. Lei Gao, Yang Luo & Jie Zhang, Duli Dongshi Zhidu yu Gongsi Jixiao [The Characteristics of the Independent Director System and Corporate Performance], 3 *Research on Economics & Management* 60 (2007) (finding a positive correlation between board independence and corporate performance in a sample of 1220 A-share companies). You Luan & Jun Shi, Zhongguo Shangshi Gongsi Duli Dongshi Zhidu yu Gongsi Jiazhi Guanxi de Shizheng Yanjiu [An Empirical Study of the Relationship Between the Chinese Independent Director System and Firm Value], 2 *Journal of Shangdong University (Philosophy & Social Science)* 97 (2009) (reaching a similar result by examining 483 A-share companies).

Liang, Yu and Hao examined 289 listed companies on the Shenzhen Stock Exchange that appointed independent directors between August 2001 and July 2002, and found that the implementation of the Guiding Opinions had only caused extra operation costs, but had not increased governance efficiency or firm value.<sup>97</sup> Recently, Wu looked at 702 A-share companies listed on the Shanghai Stock Exchange as of the end of 2007, and showed that independent directors had little influence in decision making on the board of directors, thereby hardly improving corporate governance.<sup>98</sup>

#### ***D. A Wrong Prescription for the Governance Problem***

In the US, as discussed above, independent directors are appointed to monitor managers' behavior, thereby minimizing the agency cost between managers and shareholders. Nonetheless, the mere presence of independent directors on the board does not fulfill this goal. Tan noted:

“Unless independent directors are truly independent and have the strength and ability to perform effective monitoring function, the presence of independent directors acts as a smokescreen and a snare for the unwary investor who may pay a higher price for equity on the basis of a supposedly better corporate governance structure.”<sup>99</sup>

Indeed, research has indicated that true independence is virtually unobtainable because corporate managers maintain significant control over the selection of independent directors.<sup>100</sup> As Brudney observed, no definition of independence precludes an independent director from being a social friend of, or a member of the same clubs, associations, or charitable efforts as, the managing directors.<sup>101</sup> Assuredly, managers can easily find independent directors who are neither relatives nor business partners, and yet may well support anything they propose, and resign in extreme cases rather than oppose those who have invited them to the board.<sup>102</sup>

By the same token, since Chinese independent directors are expected to protect minority shareholders against the exploitation of major shareholders, the selection process is supposed to be immune from the influence of major shareholders. In practice, nevertheless, independent directors are mostly nominated and elected by the board of directors, which is further controlled by the

---

<sup>97</sup> Qi Liang, Fengyan Yu & Xiangchao Hao, Duli Dongshi Zhidu Yinru de Shichang Xiaoying Yanjiu [A Market Efficiency Analysis of the Introduction of the Independent Director System], 11 China Industrial Economics 151 (2009).

<sup>98</sup> Jingna Wu, Shangshi Gongsi Duli Dongshi yu Jianshahui Zhidu Shishi Xiaoguo Shizheng Yanjiu [An Empirical Study of the Implementation of the Independent Director System and the Supervisory Board in Listed Companies], 2 Modern Accounting 20 (2010). Also see Zhen Wang & Xin Yang, Duli Dongshi Tezheng yu Shangshi Gongsi Xinxi Pulu Zhiliang de Guanxi [The Characteristics of Independent Director and its Relationship with the Quality of Information Disclosure], 5 Shanghai Journal of Economics 54 (2010) (finding that, in a sample of 1349 listed companies that appointed independent directors from 2005 to 2007, although the independent director system induces better information disclosure, because of certain serious mismatches that exist in appointment, board structure, and responsibilities, independent directors cannot fulfill their monitoring role as expected).

<sup>99</sup> Cheng H. Tan, Corporate Governance and Independent Directors, 15 Sing. Ac. L.J. 355, 378 (2003).

<sup>100</sup> See, eg. Lewis D. Soloman, Restructuring the Corporate Board of Directors: Fond Hope – Faint Promise?, 76 Mich. L. Rev. 581 (1978). Roberta S. Karmel, The Independent Corporate Board: A Means to What End, 52 Geo. Wash. L. Rev. 534 (1984).

<sup>101</sup> Brudney, supra note 41, 613.

<sup>102</sup> Brent A. Olson, Publicly Traded Corporations: Governance & Regulation S. 2.26 (2<sup>nd</sup> ed, 2004).

major shareholder.<sup>103</sup> Under these circumstances, it is unrealistic to count independent directors to faithfully act for minority shareholders.<sup>104</sup>

According to the Guiding Opinions, independent directors are to be nominated by the board of directors, the supervisory board,<sup>105</sup> or the shareholders individually or aggregately owning not less than one percent of total shares.<sup>106</sup> The nominee, prior to the election in the shareholders' general meeting, must issue a public statement that he or she has no relationship with the company which may impair his independent and objective judgment.<sup>107</sup> However, all nominations must be approved by the shareholders' general meeting.<sup>108</sup> This suggests that, in the absence of support from the major shareholder, shareholders with a smaller stake can hardly have their nominees successfully appointed.<sup>109</sup> In turn, the major shareholder is free to nominate and elect those willing to subordinate to their orders.<sup>110</sup> Thus, the putative effect of the public statement remains largely spurious.

In theory, the CSRC is authorized to examine and approve all appointments of independent directors,<sup>111</sup> and it would reject a certain number of appointments each year because of various "under the table" linkages with major shareholders.<sup>112</sup> However, the Commission admitted that many independent directors are actually nominated by the major shareholders, and therefore this mechanism cannot guarantee the full independence of the appointees.<sup>113</sup> In short, most independent directors of Chinese listed companies are handpicked by the major shareholders.

This proposition is supported by empirical evidence. The Research Centre of Corporate Governance of Nankai University found that, of all independent directors in 2001, 87.36 percent were nominated by the board of directors, 15.06 percent were directly nominated by the major

---

<sup>103</sup> Jipeng Liu, *Independent Directors System in Modern Corporate Governance Structure*, in Lu, *supra* note 8, 176-177.

<sup>104</sup> *Id.*

<sup>105</sup> The Chinese corporate law adopts a two-tier board structure for listed companies. While the board of directors performs a managerial function, the supervisory board is expected to monitor the performance of the former. Research has shown that the board of supervisors is an impotent monitoring organ, but in practice plays no meaningful role in corporate governance in China. For a discussion on the role of supervisory board in China, see Xi, *supra* note 61. Jason Z. Xiao, Jay Dahya & Z Jun Lin, A Grounded Theory Exposition of the Role of the Supervisory Board in China, 15 *Brit. J. Manage.* 39 (2004). Jay Dahya, Yusuf Karbhari & Jason Z. Xiao, The Supervisory Board in Chinese Listed Companies: Problems, Causes, Consequences and Remedies, 9 *Asia Pacific Bus. Rev.* 118 (2002). S.H. Goo & Fidy Xiangxing Hong, The Curious Model of Internal Monitoring Mechanism of Listing Corporations in China: the Sinonisation Process, 12 *E.B.O.R.* 469 (2011).

<sup>106</sup> Art. 4(1).

<sup>107</sup> Art. 4(2).

<sup>108</sup> *Id.*

<sup>109</sup> See Xi, *supra* note 61, 17.

<sup>110</sup> Liu, *supra* note 103.

<sup>111</sup> Art. 4(3) (if the CSRC objects the appointment, the nominee can still serve as a candidate for non-independent director).

<sup>112</sup> Zhiqiang Peng, Zhangjizhong Jiapingwa Kechuan Duli Dongshi Jingjixuejie Shangshu Shouci [Zhangjizhong and Jiapingwa are to be Independent Directors, the First Time in the Circle of Economics], *Chengdu Business News* (May 15, 2003), <http://ent.sina.com.cn/s/m/2003-05-13/1530149376.html>.

<sup>113</sup> Bei Hu, Independence Shunned by China Firms, *South China Morning Post*, 1 (Feb 7, 2004).

shareholders.<sup>114</sup> A 2003 survey of 69 listed companies jointly conducted by the Association of Board Secretaries of Shanghai Listed Companies and Golden Trust Institute of Securities found that nearly 90 percent of independent directors were nominated by the major shareholders or senior managers and 55 percent were recommended by the major shareholders for nomination.<sup>115</sup> In 2004, Tang and Xiao examined 397 listed companies, and showed that 91.94 percent of directors in these companies had direct or indirect relationship with the major shareholders and 72.29 percent of them were directly appointed by them.<sup>116</sup>

In terms of occupational background, the CSRC found that 50 percent of Chinese independent directors are university professors and technical experts, 30 percent are accountants, lawyers, or investment consultants, 10 percent are executives of other companies, and others (including retired government officials) take up five percent.<sup>117</sup> Similarly, in a random sample of 500 listed companies, Yue found that 39 percent of the independent directors are university professors, six percent are from other research institutions, 28 percent are from other companies, 14 percent are accountants, lawyers, or other intermediaries, and 13 percent are from governmental agencies, who are mostly retired officials.<sup>118</sup>

Arguably, these individuals are appointed because listed companies have to fulfill the regulatory requirements rather than sincerely seek out independent souls for governance enhancement.<sup>119</sup> The prevailing practice has been that major shareholders appoint their social friends to the position.<sup>120</sup> Despite their personal strength of monitoring the behavior of the major shareholders, they lack incentives to do so and have no good reason to counter the will of those who appointed them.<sup>121</sup> Thus, both in theory and practice, the institution of independent directors is not the logical answer to the governance problem of Chinese listed companies. Naturally, they have widely been labeled as a “vase” on the corporate board.<sup>122</sup>

---

<sup>114</sup> Dongping Li, Sanda Wenti Kunrao Dudong Zhidu Shijian [Three Problems Puzzled the Practice of the Independent Director System], *China Securities Journal* (March 23, 2007), [http://www.lhq.com/index.jsp?pageAlias=news\\_cont&newsid=399593](http://www.lhq.com/index.jsp?pageAlias=news_cont&newsid=399593).

<sup>115</sup> The Association of Board Secretaries of Shanghai Listed Companies & Golden Trust Institute of Securities, Duli Dongshi Zhenmeyang Le? [How are the Independent Directors?], *Sina* (Aug 7, 2003), <http://finance.sina.com.cn/roll/20030807/0301396708.shtml>.

<sup>116</sup> Yuejun Tang & Guozhong Xiao, Duli Dongshi Zhidu de Yizhi Jiqi Bentuhua – Jiyu dui 500 Jia Zhongguo Shangshi Gongsi de Wenjuan Diaocha [Independent Director Mechanism and its Localization – Based on a Questionnaire Survey on 500 Chinese Listed Corporations], 30 *Journal of Finance & Economics* 117, 125 (2004).

<sup>117</sup> Dudong Duiwu Jisu Kuorong [Ranks of Independent Directors Quickly Enlarged], *Securities Times* (March 24, 2003), <http://www.jrj.com.cn/NewsRead/Detail.asp?NewsID=184394>.

<sup>118</sup> Qingtang Yue, Dui 500 Jia Shangshi Gongsi Duli Dongshi Nianling Zhuanye deng Goucheng de Shizheng Yanjiu [An Empirical Study of the Age and Occupational Composition of the Independent Directors in 500 Listed Companies], 2 *Economic Affairs* 86 (2003).

<sup>119</sup> Liang et al., *supra* note 97, 152.

<sup>120</sup> Haifeng Wu, Yili Dudong Weishenme Nao Duli [Why did Independent Directors of the Yili Group Struggle for Independence], *China Industry & Business Times* (June 23, 2004), <http://www.stockstar.com/info/darticle.aspx?id=ZH,20040623,01113925&columnid=63&pageno=1>.

<sup>121</sup> *Id.*

<sup>122</sup> See, eg. Yi Xiong, Duli Dongshi Huaping Zuole Hendo Nian [Independent Directorship has been a Vase for Years], *China Times* (June 28, 2008), <http://finance.sina.com.cn/stock/stocktalk/20080628/21475034364.shtml>.

## IV. INDEPENDENT DIRECTORS IN HONG KONG

If independent directors in China are merely a vase, are INEDs in Hong Kong anything much better than that? In effect, a similar defect exists in Hong Kong's board governance regime, and the only variation seems to be that major shareholder is now a family rather than the state.

### A. *Regulatory Rules*

In Hong Kong, specific requirements on board independence are made in the SEHK Listing Rules. These requirements can be further classified into two levels. The first is the Listing Rules themselves, which normally have binding effect on listed companies.<sup>123</sup> The second is the Code on Corporate Governance Practices, which, though contained in the Listing Rules, was implemented by the SEHK as good corporate governance recommendations.<sup>124</sup>

1. **Listing Rules** – In 1993, the SEHK introduced a new provision in its Listing Rules, requiring listed companies to have at least two INEDs on their boards of directors.<sup>125</sup> In 2004, the SEHK increased the minimum number to three,<sup>126</sup> and one must have “appropriate professional qualifications or accounting or related financial management expertise (APQs).”<sup>127</sup> The Listing Rules also provide that listed companies must establish an audit committee comprised solely of non-executive directors (NEDs), and the audit committee must have a minimum of three members, at least one of whom is an INED with APQs.<sup>128</sup>

In assessing the independence of a NED, the SEHK takes account of a range of factors, and independence is most likely to be questioned if the director:

- (1) holds more than one percent of the total issued share capital of the company,<sup>129</sup>
- (2) has received an interest in any securities of the company as a gift, or by means of financial assistance, from a connected person or the company itself,<sup>130</sup>
- (3) is a director, partner, or principal of a professional advisor which currently or previously provides services, or is an employee of such professional adviser involved in providing such services to

---

<sup>123</sup> The SEHK Listing Rules have the status of a contract between the SEHK and listed companies. See Say H. Goo & Anne Carver, *Corporate Governance: The Hong Kong Debate* 170 (2003).

<sup>124</sup> MB Listing Rules, Appendix 14; GEM Listing Rules, Appendix 15. For an overview of the Code of Best Practice, see HKEx, *Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report* (Jan 2004), available at <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/edc-e.PDF>.

<sup>125</sup> Betty M. Ho, *Restructuring the Boards of Directors of Public Companies in Hong Kong: Barking up the Wrong Tree*, 1 *Sing. J.I.C.L.* 507, 507 (1997).

<sup>126</sup> MB Listing Rules, Cap 3.10(1), 3.19(1); GEM Listing Rules, Cap 5.05(1), 5.08(2).

<sup>127</sup> MB Listing Rules, Cap 3.10(2); GEM Listing Rules, Cap 5.05(2) (with regard to APQs, the SEHK would expect the person to have, through experience as a public accountant or auditor or as a chief financial officer, controller or principal accounting officer of a public company or through performance of similar functions, experience with internal controls and in preparing or auditing comparable financial statements or experience reviewing or analyzing audited financial statements of public companies).

<sup>128</sup> MB Listing Rules, Cap 3.21, GEM Listing Rules, Cap 5.28.

<sup>129</sup> MB Listing Rules, Cap 3.13(1); GEM Listing Rules, Cap 5.09(1).

<sup>130</sup> MB Listing Rules, Cap 3.13(2); GEM Listing Rules, Cap 5.09(2).

- (a) the company, its holding company, subsidiaries, or connected persons, or
  - (b) a controlling shareholder, or, where there is no controlling shareholder, or previously the chief executive or a director (other than an INED), of the company, or its associates,<sup>131</sup>
- (4) has a material interest in the principal business activities of the company, its holding company, subsidiaries, or connected persons,<sup>132</sup>
  - (5) has present or past connection with a director, the chief executive, or a substantial shareholder of the company,<sup>133</sup>
  - (6) is currently or previously an executive or director (other than an INED) of the company, its holding company, subsidiaries, or connected persons,<sup>134</sup> or
  - (7) is financially dependent on the listed issuer, its holding company or any their respective subsidiaries or connected persons of the listed issuer.<sup>135</sup>

**2. Code on Corporate Governance Practices** – The SEHK implemented the Code on Corporate Governance Practices in its Listing Rules in 2004.<sup>136</sup> Like the Principle of Corporate Governance for Listed Companies issued in China, the Code is not strictly binding either. The Code sets out two levels of recommendations: the Code Provisions (CPs) and the Recommended Best Practices (RBPs).<sup>137</sup> Listed companies are expected to comply with, but may choose to deviate from, the CPs.<sup>138</sup> Meanwhile, they are encouraged to comply with the RBPs, which serve as a guidance.<sup>139</sup>

Both levels of recommendations consist of specific provisions in relation to board independence. The CPs state that listed companies should disclose board composition by category of directors including names of the chairman, executive directors, NEDs, and INEDs in its annual report.<sup>140</sup> The RBPs further encourage listed companies to appoint INEDs representing at least one third of the board.<sup>141</sup> At the same time, the CPs state that listed companies should establish a remuneration committee with a majority of INEDs.<sup>142</sup> RBPs recommend issuers to establish a nomination committee with a majority of INEDs.<sup>143</sup>

<sup>131</sup> MB Listing Rules, Cap 3.13(3); GEM Listing Rules, Cap 5.09 (3).

<sup>132</sup> MB Listing Rules, Cap 3.13(4); GEM Listing Rules, Cap 5.09 (4).

<sup>133</sup> MB Listing Rules, Cap 3.13(6); GEM Listing Rules, Cap 5.09 (6).

<sup>134</sup> MB Listing Rules, Cap 3.13(7); GEM Listing Rules, Cap 5.09 (7).

<sup>135</sup> MB Listing Rules, Cap 3.13(8); GEM Listing Rules, Cap 5.09 (8).

<sup>136</sup> MB Listing Rules, Appendix 14; GEM Listing Rules, Appendix 15. For an overview of the Code of Best Practice, see HKEx, Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report (Jan 2004), available at <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/edc-e.PDF>.

<sup>137</sup> Id. For a discussion on these two levels of recommendations, see Alex Lau, *The New Hong Kong Code on Corporate Governance Practice*, 26 Co. Law. 317 (2006).

<sup>138</sup> Id.

<sup>139</sup> Id.

<sup>140</sup> MB Listing Rules, Appendix 23, Para. 2(a)(i); GEM Listing Rules, Appendix 16, Para. 2(c)(i).

<sup>141</sup> MB Listing Rules, Appendix 14, Para. A.3.2; GEM Listing Rules, Appendix 15, Para. A.3.2.

<sup>142</sup> MB Listing Rules, Appendix 14, Para. B.1.1; GEM Listing Rules, Appendix 15, Para. B.1.1.

<sup>143</sup> MB Listing Rules, Appendix 14, Para. A 4.4; GEM Listing Rules, Appendix 15, Para. A. 4.4.



In December 2010, the HKEx published a consultation paper,<sup>144</sup> which, among other things, considered that the increase in the number of INEDs will promote better governance practices and proposed to introduce one rule in the Listing Rules, which requires INEDs to constitute at least one third of the board,<sup>145</sup> and another rule that requires listed companies to establish a remuneration committee with a majority of INEDs and chaired by an INED.<sup>146</sup> In addition, it proposed to upgrade the establishment of a nomination committee with a majority of INEDs from RBPs to CPs and further proposed that the nomination committee should be chaired by an INED.<sup>147</sup> Respondents to the consultation largely supported these proposals.<sup>148</sup> In October 2011, the HKEx released conclusions to the consultation paper and decided to adopt them.<sup>149</sup> Specifically, the proposed rule that INEDs must form at least one third of the board will take effect on 31 December 2012.<sup>150</sup> And the proposals made regarding remuneration committee and nomination committee will be effective on 1 April 2012.<sup>151</sup>

### **B. *The Same Wrong Prescription***

In the Hong Kong market, a significant proportion of listed companies started as a family concern, and steadily grew into large public corporations.<sup>152</sup> An early study found that 54 percent of the market capitalization was made by FOEs in the 1980s.<sup>153</sup> In 1997, the Hong Kong Society of Accounts reported that nine out of ten of listed companies in Hong Kong have one family group holding 25 percent or more of the issued shares.<sup>154</sup> In 2000, Claessens, Djankow and Lang found that around 65 percent of listed companies on the SEHK are FOEs.<sup>155</sup>

In the Chinese culture, family is the basic social unit as well as the basic economic unit.<sup>156</sup> Family members gather together not only out of affection for their kinfolk but also to pursue profit and accumulate wealth more effectively.<sup>157</sup> According to one commentator, perhaps with a few

---

<sup>144</sup> HKEx, Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules [Consultation on Review of Code] (Dec 2010), available at <http://www.hkex.com.hk/eng/newsconsul/mktconsul/documents/corporate%20governance%20issues.pdf>.

<sup>145</sup> Id, Para. 7.

<sup>146</sup> Id, Para. 113.

<sup>147</sup> Id, Para. 131.

<sup>148</sup> HKEx, Consultation Conclusions on Review of the Corporate Governance Code and Associated Listing Rules (Oct 2011), available at <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp2010124cc.pdf>, Para. 87, 108, 128.

<sup>149</sup> Id, Para. 94, 126, 144.

<sup>150</sup> Id, Para. 20(4).

<sup>151</sup> Id, Para. 20(6)A, B.

<sup>152</sup> See, eg. Siu-Lun Wong, *The Chinese Family Firm: A Model*, 36 *Brit. J. Sociol.* 58 (1985) (arguing that because these companies tend to behave differently at various stages of their development circle, these firms are not necessarily small, impermanent and conservative). Also see Philip Lawton, *Modeling the Chinese Family Firm and Minority Shareholder Protection: The Hong Kong Experience 1980-1995*, 49 *Man. L.* 249 (2007) (relating minority shareholder protection to the family model of listed companies in Hong Kong in a sociological perspective).

<sup>153</sup> Gordon S. Redding, *The Spirit of Chinese Capitalism* (New York, de Gruyter, 1990), 151.

<sup>154</sup> The Hong Kong Society of Accountants, *Second Report of the Corporate Governance Working Group*, (Jan 1997) (On file with the author).

<sup>155</sup> Stijn Claessens, Simeon Djankow & Larry H. P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 *J. Fin. Econ.* 81 (2000).

<sup>156</sup> See, eg. William J. Duiker & Jackson J. Spielvogel, *The Essential World History* 66-67 (2005).

<sup>157</sup> Hill Gates, *China's Motor: A Thousand Years of Petty Capitalism* 84-120 (1996) (discussing that family clans can also be commercially oriented).

exceptions,<sup>158</sup> the internal governance of Hong Kong listed FOEs continues to be strongly influenced by the hierarchical structure of the family rather than unreservedly entrusts professional management.<sup>159</sup> Far too often, family owners tend to treat the entire company as their domestic property, consume private benefits of control, and resent outsider monitoring or meddling in the company's affairs.<sup>160</sup>

In theory, INEDs are supposed to provide a counterweight to controlling shareholders for the interests of minority shareholders.<sup>161</sup> In practice, rational INEDs would most likely bow to the judgment of the family entrepreneur who has built a multi-billion empire from nothing and put his own hand-earned wealth at risk.<sup>162</sup> This is especially true when considering that these INEDs are appointed by the board of directors, which in turn is appointed by the controlling shareholders.<sup>163</sup> From another angle, being able to dominate the selection of the INEDs, controlling shareholders would be surely keen to take individuals loyal to them and willing to yield to their wishes so that their consumption of private benefits of control is not challenged.<sup>164</sup> The SEHK is well aware of the problem. As stated in a 2002 consultation paper: "we also note comments that INEDs should be appointed or removed by minority shareholders so as to ensure that INEDs are not influenced by controlling shareholders."<sup>165</sup>

In Hong Kong, traditional Confucian values that place great emphasis on harmony and connection are deeply rooted in people's daily life.<sup>166</sup> As well, it is reflected in the SEHK's regulatory style.<sup>167</sup> In the present scenario, the SEHK rejected the above argument, leaning

---

<sup>158</sup> See, eg. Philip Lawton, Berle and Means, Corporate Governance and the Chinese Family Firm, 6 *Austl. J. Asian L.* 348, 361 (1996) (pointing out that Li Ka Shing is one of the few Hong Kong entrepreneurs recognized for an ability to trust and delegate to professional management).

<sup>159</sup> See Teemu Ruskola, Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective, 52 *Stan. L. Rev.* 1599, 1649-1651 (2000) (describing that management of these family firms is centralized and based on the ritual structure of kinship).

<sup>160</sup> Alex Lau, John Nowland & Angus Young, In Search of Good Governance for Asian Family Listed Companies: A Case Study on Hong Kong, 28 *Co. Law.* 306, 306 (2007). Also see Suzanne Lane, Joseph Astrachan, Andrew Keyt, Kristi McMillan, Guidelines for Family Business Boards of Directors, 19 *Fam. Bus. Rev.* 147 (2006) (discussing the general characteristics of family-owned companies). Also see Lung-Sheng Sung, Property and Family Division, in Emily Martin Ahern & Hill Gates, *The Anthropology of Taiwanese Society* 361, 367-368 (1981) (showing that family members who do not live together can still constitute a family if their property is undivided).

<sup>161</sup> See, eg. HKEx, Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues [Consultation on Corporate Governance Issues] (Jan 2002) Para. 22.2., available at <http://www.hkex.com.hk/eng/newsconsul/mktconsul/documents/corporate%20governance%20issues.pdf>.

<sup>162</sup> Ho, supra note 125.

<sup>163</sup> David Webb, Listing Rules Review Part 2: Board Games (Feb 2002), available at <http://www.webb-site.com/articles/boardgames.asp> (proposing that INEDs should be elected by independent directors, and any shareholder or concert party holding 20%, and, of more of the votes, should be prohibited from voting on such elections unless they have no existing board representation).

<sup>164</sup> See, eg. Lau et al., supra note 160. Ho, supra note 125, 531. Also see Deborah A. DeMott, Guest at the Table?: Independent Directors in Family – Influenced Public Companies, 33 *J. Corp. L.* 819 (2008) (discussing board governance of family firms in the US).

<sup>165</sup> HKEx, Consultation on Corporate Governance Issues, supra note 161.

<sup>166</sup> See Aimee Wheaton, The Generation of Organizational Commitment in a Cross-Cultural Context, in Chris Rowley & Robert Fitzgerald(ed), *Managed in Hong Kong: Adaptive Systems, Entrepreneurship and Human Resources* 73 (2000).

<sup>167</sup> See, eg. Paul Chow, Implementing Corporate Governance Reforms in Hong Kong, Exchange (Jan 2005), available at <http://www.hkex.com.hk/eng/newsconsul/newsltr/2005/documents/2005-01-02-e.pdf> (stating: "[t]he final outcomes the investing public desires are that companies make decisions that are fair and add value for all shareholders that is,

towards the view that, with respect to the manner of appointment, “a harmonized board is an essential element for an effective board,”<sup>168</sup> and reached the conclusion that “[w]e do not consider that it is necessary to require appointment or reappointment of INEDs to be subject to independent shareholders’ approval.”<sup>169</sup>

In short, the introduction of the INED system fails to realize the significance of the cultural milieu of listed companies in Hong Kong.<sup>170</sup> Simply put, it is unreasonable to expect INEDs chosen by the controlling shareholders to have a truly independent mind and act for the interests of minority shareholders. This reality is vividly portrayed by an independent investor and governance advocate of the Hong Kong capital market, David Webb, as: “[a]s long as controlling shareholders dominate, then their directors serve on the board at the pleasure of the king ...”<sup>171</sup>

Empirically, the study conducted by Dahya, Dimitrov and McConnell on Asian family firms suggests that there is a gap between the overall board governance of FOEs and non family-owned enterprises (NFOEs), and FOEs tend to not improve their board governance to the level of NFOEs in order to retain private benefits of control.<sup>172</sup> Specifically focusing on the Hong Kong market, Chen and Jaggi found that there is a positive association between the proportion of INEDs on corporate boards and comprehensiveness of financial disclosure, but the association is weaker for FOEs compared with NFOEs, which suggests that the effectiveness of INEDs on FOEs is reduced by their ties to the controlling family.<sup>173</sup> In summary, the introduction of the INED system is just not the right solution for the agency problem between controlling and minority shareholders, no matter whether the controlling shareholder is the state or a family.

## V. INEDS OF H-SHARE COMPANIES

By travelling to Hong Kong, H-share companies have successfully obtained a new prescription for their governance disease. Ironically, this new prescription has turned out to be virtually the same as the domestic one, and equally wrong. Leaving that aside, this section examines the changes in governance practices of these corporate citizens after living in this new environment that is perceived to be better to the domestic one.

---

the public is looking for honesty in business dealing. However, honesty is a matter of culture and morals: one cannot legislate for morals and therefore the regulator cannot mandate final outcomes. What the regulator can do instead is to insist that the outcomes the business decisions are arrived at after due process”).

<sup>168</sup> HKEx, Consultation on Corporate Governance Issues, *supra* note 161, Para. 22.3.

<sup>169</sup> *Id.*

<sup>170</sup> See, eg. Ho, *supra* note 125. Lawton, *supra* note 158. Lau et al., *supra* note 160.

<sup>171</sup> David Webb, Not Serving on the Board at the Pleasure of the King, *available at* <http://web.ifac.org/download/3.2-David-Webb-Not-Serving-on-Board-at-Pleasure-of-King-FINAL.pdf> .

<sup>172</sup> See, eg. Jay Dahya, Orlin Dimitrov & John J. McConnell, Dominant Shareholders, Corporate Boards and Corporate Value: A Cross-Country Analysis (Sep 2006), ECGI – Finance Working Paper No. 99/2005, *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=887383](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=887383). John Nowland, Are East Asian Companies Benefiting from Western Board Practices?, 79 J. Bus. Ethics. 133 (2008).

<sup>173</sup> Charles J. P. Chen & Bikki Jaggi, Association Between Independent Non-Executive Directors, Family Control and Financial Disclosures in Hong Kong, 19 J. Account. Public. Pol. 285 (2000).

## **A. Regulatory Rules**

H-share companies are subject to legal and regulatory rules from both the Chinese and the Hong Kong sides. On the Chinese side, in 1999, the CSRC and the SETC jointly issued the first and by far the only set of rules on board independence for Chinese companies listed overseas, the Opinions on Further Promoting the Standard Operation and Reform of Companies Listed Overseas.<sup>174</sup> The Opinions provide that “outside directors” must constitute at least half of the board of directors, but make no attempt to define the term.<sup>175</sup> Meanwhile, at least two board members must be independent directors<sup>176</sup> who are meant to be independent from the shareholders and not holding any other position within the company.<sup>177</sup>

Labeled as “opinions,” the document is surely intended to have some effect, though not legally binding.<sup>178</sup> Yet, in practice, H-share companies have not substantially complied with the Opinions. As discussed below, only a small number of H-share companies have INEDs representing half of the board or more.<sup>179</sup> Even if “outside directors” are taken to include both INEDs and NEDs, there are still companies that do not meet the requirement.<sup>180</sup>

On the Hong Kong side, to the extent that an H-share company has fully complied with the current SEHK Listing Rules, it should have at least three INEDs and one of whom should have APQs. Also, it should have an audit committee comprised solely of NEDs. The committee should have a minimum of three members and at least one of whom is an INED with APQs. In addition, the company is encouraged to have INEDs representing at least one-third of the board under the RBPs.

## **B. Comparison of the Minimum Mandatory Requirements**

Table 1 compares the minimum mandatory requirements on independent directorship for H-share companies with those for companies listed domestically.

---

<sup>174</sup> [1999] CSRC & SETC.

<sup>175</sup> Art. 6.

<sup>176</sup> Id.

<sup>177</sup> Id.

<sup>178</sup> See Clarke, *supra* note 56, 184-185.

<sup>179</sup> See *infra* V. C (in a sample of 81 H-share companies, only 13 of them have INEDs representing at least half of the board).

<sup>180</sup> See *id* (in a sample 81 H-share companies, five companies do not have NEDs and INEDs representing at least half of the board, and 18 companies that either do not have NEDs or do not keep a separate category of NEDs in their financial reports).

**Table 1. Minimum Mandatory Requirements**<sup>181</sup>

<b>Min Requirements</b>	<b>H-share Companies</b>	<b>Companies Listed in China</b>
<b>No. of Independent Directors</b>	3	2
<b>Percentage of Independent Directors on the Board</b>	N/A	1/3
<b>Professional Qualification</b>	1(APQs)	1(Accounting Professional)
<b>Specialized Committee</b>	Audit	N/A

Loosely speaking, these two sets of rules are similar. Although one more independent director is required on the board of H-share companies, listed companies in China should have independent directors representing at least one third of the board, which is not required under the SEHK Listing Rules at present. Nevertheless, this will be made mandatory in Hong Kong too, when the amendment of the Listing Rules takes effect on 31 December 2012.<sup>182</sup> At the same time, a difference exists between them in that, while the SEHK Listing Rules require listed companies to set up at least one specialized committee, namely the audit committee, there is no such a rule made for companies listed in China. This difference will be enlarged from 1 April 2012, when the amendment of the Listing Rules takes effect to demand the establishment of a remuneration committee.<sup>183</sup>

### **C. Sample Study**

In an effective sample of 81 H-share companies listed on the Main Board of the SEHK,<sup>184</sup> the following part examines board composition of these companies in three respects based on their financial reports ended 31 December 2010: the employment of INEDs, installment of specialized committees, and occupational background of INEDs.

**1. Employment of INEDs** - All 81 companies have not only met the requirement of having three INEDs, and at least one of whom has the requisite APQs, but also a majority of these companies have voluntarily appointed more INEDs than they are required to do under the SEHK Listing Rules. In total, 339 INEDs are appointed, yielding an average of four INEDs per company. Specifically, a total of 55 companies have appointed four INEDs or more, 26 companies have appointed five INEDs or more, and the maximum number of INEDs appointed is eight. As discussed, the Code of Corporate Governance Practices in its current form encourages listed

<sup>181</sup> Table 1 takes no consideration of the effect of the Opinions on Further Promoting the Standard Operation and Reform of Companies Listed Overseas and the Principles of Corporate Governance for Listed Companies issued by the Chinese government, and the Code on Corporate Governance Practices issued by the SEHK.

<sup>182</sup> See supra note 150 and accompanying text.

<sup>183</sup> See supra note 151 and accompanying text.

<sup>184</sup> At the end of 2010, there were 135 H-share companies listed on the MB of the SEHK. The data of this sample is obtained from a database known as Mergent Online. For those companies that are not included in the sample, it is either because they are not available in the database or because the information provided in the English version of the financial reports is not complete for the purpose of this study.

companies to have INEDs representing at least one third of the board, 67 companies have met this standard. A total of 43 companies have appointed INEDs representing over one third of the board, and 13 companies have appointed INEDs representing half of the board or even higher.

**2. Specialized Committee** - In accordance with the SEHK Listing Rules, all companies in the sample have established an audit committee comprised of at least three members, who are either NEDs or INEDs, and at least one is an INED with APQs. A total of 80 companies have other specialized committees alongside the audit committee, 80 have remuneration committees,<sup>185</sup> 59 have nomination committees,<sup>186</sup> 47 have strategy committees,<sup>187</sup> and 18 have other committees such as risk management committees, connected transaction committees, and social responsibility committees. In this connection, H-share companies have taken an active step in signaling that they are committed to better governance practices by voluntarily setting up other specialized committees.

**3. Occupational Background of INEDs** - Of these 339 INEDs, four categories can be broadly made according to their occupational background. First, 130 INEDs are college professors, researchers, or technical experts from academic or scientific institutions. Second, 84 (25 percent) are executives or former executives of other private or public companies. Third, 69 (20 percent) are lawyers, accountants, or professionals from the banking and investment sector. Fourth, 56 (17 percent) are mostly retired government officials who hold no other active position except being INEDs of other listed companies, and yet include a small number of current officials. In plain terms, most INEDs of H-share companies are universities professors, researchers, technical experts, accountants, lawyers, and executives of other companies, and retired government officials.

It is worth noting that most companies in the sample have appointed INEDs from the Hong Kong market.<sup>188</sup> Although these Hong Kong-based INEDs are mainly lawyers, accountants, professionals from the banking and investment industry, they include high-profile figures such as Laura Cha, former Vice Chairman of the CSRC and former Deputy Chairman of the Securities Future Commission (SFC), Paul Chow, former Chief Executive of Hong Kong Exchange and Clearing Ltd, Rita Fan, former Chief Executive of the Legislative Council of Hong Kong, Antony Leung, former Financial Secretary of Hong Kong, Anthony Neoh, former Chairman of the SFC, Frank Wong, former Chairman of Hong Kong Futures Exchange Ltd, and Joseph Yam, former Chief Executive of Hong Kong Monetary Authority. While these well-respected figures may bring valuable experience and expertise to the company, they are likely to be selected for enhancing the reputation of the company too.

---

<sup>185</sup> Certain companies have used other names such as compensation committee or emolument committee rather than remuneration committee.

<sup>186</sup> Certain companies have established one single committee that deals with both remuneration and nomination affairs. These committees are calculated separately.

<sup>187</sup> Certain companies have used other names such as strategic development committee.

<sup>188</sup> For H-share companies listed on the MB, the SEHK Listing Rules provide that at least one of the INEDs must be ordinarily resident in Hong Kong. See MB Listing Rules, Cap 19A.18(1). But it is insufficient to judge whether this requirement was fully complied based on the information disclosed in the financial reports.

## CONCLUSION

This article has shown that, since the agency problem in China and Hong Kong is between the major shareholder and minority shareholders rather than a managerial type, both jurisdictions have adopted the wrong prescription of independent directorship to solve their problem. Thus, the bonding effect on H-share companies is absent at the legal level. At the same time, however, this article has revealed that H-share companies have managed to show that they have better governance in three aspects. First, they have generally maintained a high degree of board independence by appointing more INEDs than they are required to do under the SEHK Listing Rules. Second, they have voluntarily installed specialized committees to assist the performance of the board of directors. Third, they tend to hire experienced local professionals to bring their expertise as well as reputation to the company. Put together, H-share companies have voluntarily observed rules that they are not obligated to follow, which may indicate that reputational bonding better explains the case of Chinese companies listing in Hong Kong. In addition, the fact that certain H-share companies tend to hire high-profile individuals in Hong Kong may shed some light on their true motive for listing in Hong Kong, namely to create reputational capital, though this requires further empirical evidence.