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# On the Legal Status of the Independence of Supervisors in Chinese Companies: Problems and Reconstruction

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According to corporate governance institutions in China, the supervisors' independence is weak and their practical performance is unsatisfying. The failure of supervisor's supervision mechanism is mainly caused by the erosion of the independence guarantee mechanism of supervisors due to the following two factors. First, the shareholding structure of listed companies is highly centralized, resulting in the nomination, remuneration, and dismissal of supervisors controlled by major shareholders or actual controllers, leading to the collusion among supervisors, major shareholders, actual controllers, directors, or executives. Second, the lack of civil compensation liability of supervisors leads to the dereliction of duty. The way to guarantee the independence of supervisors is to reconstruct the legal status of the board of supervisors and supervisors.

*Keywords:* corporate governance, board of supervisors, independence of supervisors, external supervisor

## Introduction

Investors' confidence that the capital they provide will be protected from misuse or misappropriation by corporate managers, board members, or controlling shareholders is an important factor in the development and proper functioning of capital markets. Corporate boards, managers, and controlling shareholders may have the opportunity to engage in activities that advance their own interests at the expense of non-controlling shareholders (OECD, 2016, p. 19). Therefore, despite of the differences among corporate governance models in countries, they all strengthen the supervisory authority in corporate governance, so as to protect investors' stock rights.

In terms of power distribution of corporate governance in China's legislation, the excessively general right establishing makes it hard for supervision authority to come into play, and the lack of independence guarantee of supervisors leads to the failure to fulfil their duties. Meanwhile, some scholars believe that the board of supervisors occupies the space of corporate supervision mechanism, so the solution for Chinese corporate supervision mechanism is to learn from Anglo-American law system to build a one-tier board system with non-executive directors in the majority. In December 2021, Company Law of the People's Republic of China (Revised Edition) (hereinafter referred to as "Revised Edition") was deliberated during the 32nd Session of the Standing Committee of the 13th National People's Congress. The major content of the board of supervisors involved in the Revised Edition is as follows: (1) The board of supervisors can be canceled under certain conditions.

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> A limited liability company with an audit committee in its board of directors may not have a board of supervisors or any supervisor. (Article 64 of the Revised Edition)
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> A joint stock limited company with an audit committee, of which over half of the members are non-executive directors who shall not serve as managers or financial officers, may not have a board of supervisors or any supervisor. (Paragraph 2, Article 125 of the Revised Edition)
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> A wholly state-owned company shall not have a board of supervisors or any supervisor in accordance with the provision, but shall establish an audit committee and other special committees composed of directors in the board of directors. Over half of the members in the audit committee shall be outside directors and the committee is responsible for the supervision on financial affairs and accounting of the company, and shall exercise functions and powers specified in the company's bylaw. (Article 153 of the Revised Edition)

(2) The functions and powers of supervisors have been expanded. "The board of supervisors may require directors and senior managers to submit reports on the performance of their duties" (Article 81 of the Revised Edition). (3) The number of the supervisors with voting rights to approve a resolution has been increased. "The resolution of the board of supervisors shall be approved by over half of the supervisors" (Articles 82 and 126 of the Revised Edition).

However, by investigating the corporate governance practices in China, it is easy to find that in most cases, the supervisors are involved in a collusion between the company's major shareholders or actual controllers, to "steal" and "hide" the company's property.[1] Besides, when problems occur in a listed company, few independent directors issue a report with different opinions from the board of directors or managers. The scandal of Furen Medicines Group gives legislators a warning: Where the corporate's control right and management right overlap with each other, how can supervisors avoid intervention from the major shareholders to exercise their power of supervision over the performance of directors and managers, as well as the company's financial status? The corruption case of Lai, former Secretary of the CPC China Huarong Committee and Chairman of China Huarong Asset Management Co., Ltd., and the corruption case of Cai, former Chairman of the Evergrowing Bank Co., Ltd. warn China that the five defense lines of supervision (corporate primary party organization, discipline inspection team, independent directors, the board of supervisors, and SASAC) in the prior and interim administration of state-funded companies exist in name only.

Hence, the failure of the internal supervision mechanism of Chinese companies does not lie in the choice of the board of supervisors or audit committee for internal governance, but in how the legislature ensures the independence of internal supervisory bodies, especially the supervisors, by establishing regulations, term of reference, and operation specifications. The above Paragraphs 1 and 3 of the "Exposure Draft" deviate from the requirement for the supervisors' independence. At present, it is especially urgent to make an in-depth analysis of the reasons for the lack of independence of supervisors in Chinese companies, taking the independence of the legal status of supervisors as the research object, and to explore and strengthen regulations and guarantees of the independence of the legal status of supervisors in China through the study of comparative law.

[1] See the official website of CSRC: Lina Lu, an employee of the Chengdu Huaze Cobalt & Nickel Material Co., Ltd. (Stock Code: 000693), who was responsible for financing in the Shanxi Xingwang Group Co., Ltd. (an affiliated party), provided illegal financing assurance for the Xingwang Group several times, illegally approved the contract of pledge of relevant acceptance bill, and endorsed the resolution by the board of supervisors, more than once, on the regular report involved in the case of the Chengdu Huaze Cobalt & Nickel Material Co., Ltd.

## The Independence of Members of Supervisory Bodies Is the Basis for the Exercise of Supervisory Function and Power

The independent performance of duties by the members of the supervisory bodies is a commonality of multiple supervision modes. "The self-interest nature of individuals is the humanity basis for the formation and development of all social relations" (Cai, 2017). As an agent for the corporate, the executive body may inevitably rely on its power to break the rules and even infringe on the interests of the corporate and shareholders for their own interests. To ensure that the executive body fulfills its duties and avoids high agency cost, modern companies have set up internal bodies to supervise business activities, so as to achieve checks and balances on the executive body. "Compared with shareholders' supervision, a third party has irreplaceable advantages in performing its supervisory functions: preventing major shareholders from excessively interfering with the management in the name of undertaking supervisory responsibilities" (Strausz, 1997). The various business of modern companies makes the requirement for permanent and professional supervisory bodies prominent. In the face of a high price for supervision, it has become the most rational and economical option for all parties to appoint professional supervisors as a third party to restrain the business executions of directors and managers. The board of supervisors set up in 1602 by the Dutch East India Company is the origin of the establishment of a special supervisory body in a modern corporate governance structure.[2]

### The Candidates Exercising the Power of Supervision Are Independent

The United States is a representative of the implementation of the one-tier board system. The most distinctive feature of the American corporate structure is the audit committee composed of independent directors under the board of directors, exercising the power of supervision on the operational organ. An independent director refers to an organ with independent will and without any economic intercourse or interest connection with the company that may interfere with its independent judgment. The board of directors is entitled to the right to operate and supervise the company at the same time. In order to avoid the possible moral risks and effectively supervise the board chairman in power (as well as the general manager), members of shareholders' meeting prefer candidates with independence when selecting members of the board of directors, and expect them to become "objective critics" for the senior management of the company. "Independence" is the most primary characteristics of independent directors. In terms of the election and appointment of independent directors, the decentralized stock rights of the listed companies in the United States help to avoid the major shareholders' intervention in the selection of independent directors by abusing the nomination rights. Meanwhile, in view of that "close relationship" impairs the objective judgment of independent directors, anyone who is under any of the following circumstances is prohibited from acting as independent directors in listed companies by the US Securities and Exchange Commission (SEC): (1) related by blood or marriage to a senior manager or other directors in the company; (2) a former employee of the company within the past five years; (3) having been involved in partnership with the company as a banking provider or creditor within the past two years; (4) the "corporate

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[2] Zhiwei Xu, the scholar from Taiwan, China believes: "The supervisory mechanism of modern corporate can date back to the Dutch East India Company in 1602, of which the major shareholders are entrusted to be directors and supervisors. To select the supervisors, countries have taken the essence and structure of the modern political idea—Separation of Powers, to establish three separate organizations, the shareholders' meeting, the board of directors and supervisors, through legislation". See K. Osumi, *Study on the Changes of Stock Corporation* (Tokyo: Yuhikaku, 1987), pp. 18-19.

controller" defined by the SEC due to the amount of shares owned by the person. Passive qualifications help independent directors establish a legal status beyond the shareholders and managers. In a market environment with a relatively thorough credit constraint and incentive mechanism, as an economic man, independent directors value their own reputation, which ensures their diligent supervision on the corporate management. In the corporate governance structure, independent directors ensure the independence of members of the supervisory bodies, so as to realize the independence of the audit and supervisory bodies from the policy-making and executive bodies and achieve function separation between them. To make sure that independent directors can perform their supervisory function, listed companies shall establish special committees with independent director in majority for auditing, nomination, and remuneration as prescribed by the law, for the purpose that independent directors may nominate, appoint and dismiss, and assess board directors and senior managers, as well as check the corporate financial statements, etc.

Germany is a representative of the implementation of the two-tier board system. The passive qualifications of directors prescribed in AktG prohibit the legal representative (including the agent and the plenipotentiary delegate) of the company's management body and associated companies from acting as the company's supervisors. Board directors of associated companies and affiliated companies are prohibited from acting as supervisors at the same time, so as to prevent conflicts between self-censorship and self-interests. In addition, in order to further prevent the conflict of interests, the retention and loss of supervisors' independence during the process of performing their duties is closely watched by the law and it specifies that the company must obtain the approval of the board of directors before providing a loan to supervisors, their spouses, same-sex partners, and minor children. Without the consent of the board of supervisors, supervisors shall not be obligated to engage in higher-level activities through a labor contract that does not construct labor relations or a contract of hired work. Japan is a representative of the hybrid of the one-tier and two-tier board systems. This country has learned from the success of the German stock corporation act and found a development pattern for the indigenization of Japanese companies.

The Japan Companies Act stipulates that under the shareholders' meeting, the board of directors responsible for the business execution and the board of supervisors responsible for the business supervision shall be established separately. As the sub-committees of the shareholders' meeting, the board of directors and the board of supervisors are independent from each other and members of the two boards are elected by and accountable to the shareholders' meeting. In order to prevent major shareholders from abusing the nomination rights and the power of appointment to interfere with supervisors' independence in the process of the election and appointment of supervisors, Japan took the lead in establishing the system of external supervisors in The Japan Companies Act and formulated strict provisions of the qualifications of external supervisors. In view of the fact that the board of directors may exert pressure on supervisors through remunerations and evaluations, the remunerations for supervisors are regarded as a special resolution of the company's bylaw and the shareholders' meeting, where the supervisors may state their opinions on their remunerations and benefits.

**Distribution of Supervisory Power Ensures the Independence of Supervisors**

The prerequisite for the board of supervisors to fulfill their duties is a clear distribution of powers. Different from the work pattern of "supervision through review", the German board of supervisors has gradually turned from a previously pure supervisory body into a body that cooperates with the board of directors to run and manage the company and provide advisory opinions and decision reference for the board of directors. First of all, as the superior organ of the board of directors, the German board of supervisors is entitled to the company's basic right of personnel administration to appoint and dismiss directors and decide on remunerations. Furthermore, Paragraph 4 of Section 111 in AktG empowers the board of supervisors to reserve their consent, so as to avoid ethical risks arising from the abuse of directors' rights. In accordance with this provision, although the German board of supervisors is not entitled to the right to execute daily business, it is to be determined in the bylaw or by the board of supervisors that certain types of business activities may only be implemented with the board's consent. However, the board of supervisors does not have absolute power. Where the board of directors believes that its management rights and proxy rights are unduly restricted, it may request the shareholders' meeting to amend the resolution of the board of supervisors. Such a resolution shall be adopted provided that over 3/4 of the shareholders give consent to it. Moreover, the German board of supervisors is entitled to the right to audit corporate finance in an attempt to protect shareholders' interests. AktG not only empowers the board of supervisors to reserve their consent, but provides that the board of directors shall regularly report to the board of supervisors on the fundamental matters of corporate planning. For example, where actual developments deviate from the targets previously reported, the board of directors shall provide the reasons therefore; the board of supervisors may demand at any point in time that the board of directors submits a report to it concerning the corporate matters, its legal and business relations with affiliated enterprises, as well as business processes ongoing at these enterprises that are suited to significantly influence the economic situation of the company. In terms of work patterns of the board of supervisors, AktG stipulates principles such as the corporate committee and the adoption of resolutions. Meanwhile, it provides exceptions in which supervisors may employ experts, in their own name, with work experience in finance to exercise the right to inspect and audit the books and records of the company or the company's inventory of goods. The original intention of the establishment of the board of supervisors is to improve the corporate capability in governance and supervision; therefore, for the purpose of maintaining professionalism and efficiency of the supervisory body, German legislators require that companies that are publicly traded in the sense of Section 264d of the Commercial Code (HGB) shall at least have one member of the board of supervisors that must have expertise in the fields of accounting or auditing.

In the face of the continuous expansion of power of the company's executive body, the Japan Companies Act empowers supervisors to provide checks and balances on the board of directors through a special section of provisions: (1) The right of statement: Supervisors may state their opinions at the regular shareholders' meeting, or even state their opinions on the resignation at the first shareholders' meeting after the resignation. (2) The right of supervision and review: Supervisors are entitled to supervise and review the performance of duties of directors and managers, as well as the company's accounting books. (3) The investigative power: Supervisors may at any time request reports on the business from the directors, accounting advisors, managers, and other employees, or investigate the status of the operations and financial status of the company; if it is necessary, supervisors may request reports on the business from subsidiary companies. (4) The right to know: Supervisors are entitled to attend board meetings and state their opinions at the meeting for the purpose of protecting supervisors' right to know the corporate business. If supervisors find that directors engage in misconduct, or are likely to engage in such conduct, they must report the same to the directors without delay. (5) Independent exercise of powers: In terms of the organizational form, Japan's board of supervisors only serves as a platform to share information, expertise, and experience, where each supervisor exercises all the rights under relevant laws and the company's bylaw through a "system of sole-judge proceedings". Any one of the supervisors may inspect the conduct of directors and managers without the consent of the board of supervisors, and may even file a petition for the court to stop their misconduct.

### Rigid Civil Liability for Compensation Urges Supervisors to Perform Their Duties

Both the German board of supervisors with decision-making and advisory functions and the Japan's supervisors with supervisory function only apply directors' duty of care and responsibilities. To prevent supervisors from attaching to major shareholders or actual controllers and urge them to get rid of the improper restraint of resolutions made by the board of supervisors, so as to make rational judgements, AktG has made a deliberate system design in terms of the supervisors' civil liability for compensation, which is worth drawing lessons from for China's Revised Edition: (1) Section 116 of AktG provides that Section 93 shall apply mutatis mutandis to the duty of care of the supervisors; where any violation of the duty causes losses as a result, the supervisor shall undertake joint and several liability for compensation. (2) Where an influential person in the company instructs the supervisor to impair interests of the company or other shareholders, the supervisor shall undertake joint and several liability for compensation for the losses suffered by the company and the shareholders. (3) Where a supervisor acts in accordance with a lawful resolution of the shareholders' meeting, the supervisor shall not be liable for compensation to the company or shareholders. (4) The fact that the board of supervisors has endorsed the action does not preclude the obligation to provide compensation. (5) To prevent supervisors from avoiding the compensation through the Employment Practice Liability Insurance, Section 93 of AktG provides that the insurance policy is to provide for a deductible of at least 10 percent of the damage, up to a minimum of 150 percent of the annual fixed remuneration of the supervisors. The supervisors shall not disperse the deductible, but shall provide the compensation with their own property, which greatly increases the rigidity of supervisors' civil liability for compensation.

## Reasons for the Decline of Supervisors' Independence in China

The functions and powers of China's board of supervisors are provided in pursuance of Articles 39, 53, 54, and 56 of the Company Law of the People's Republic of China and the Revised Edition. The board of supervisors is entitled to inspect the corporate directors and senior managers; where an audit committee is established in a listed company, the independent directors of the company are empowered to give prior approval and independent reports on substantive connected transactions. The board of supervisors may request reports on the performance of duties from directors and senior managers in pursuance of Article 81 of the Revised Edition. Nonetheless, the role of the board of supervisors and independent directors has been questioned by Chinese academic circles. Some scholars believe that the board of supervisors is "the ears of the deaf" and a body acts as "the home for the aged", and they even criticize independent directors for being the "eye candy". In the face of violation of laws, the supervisory mechanism of listed companies has hardly performed well in giving warnings and precautions, for which the fundamental reasons are as follows.

**The Dependence of the Legal Status of Supervisors**

In the modern corporate governance structure, the shareholder democracy is represented as a kind of "capital democracy". The prominent features of China's listed companies include "dominant shareholders" and "the lack of ownership", and where the Company Law firmly safeguards the functions and powers of the shareholders' meeting and the legal representative being the agent of controlling shareholders, the supervisors, derived from the shareholders' meeting, act more for ornament than for actual effects.

Major shareholders and actual controllers have influenced on the election and appointment of supervisors. In the operation practice of China's company, the controlling shareholders dominate the company business, which is different from companies in other countries where stock rights are decentralized and the corporate management controls the company affairs. Due to the equity structure of the "dominant shareholders", the decision-making power is mainly distributed in the shareholders' meeting and legal representatives. The people who are truly entitled to the rights of external representation and internal management are the legal representatives (usually the chairman and the general manager), and legal representatives (usually the actual controllers of private enterprises) who implement the will of controlling shareholders are playing a leading role in the corporate governance. In state-owned companies, in the face of power vacuum caused by the lack of ownership, the "Three Importance and One Greatness" decision-making system establishes the status of the corporate primary party organization (especially the Party Secretary of the Company, who usually serves concurrently as the Chairman and the legal representative of the company) in the centralized management of the company affairs. The centralized management of the company based on controlling shareholders or legal representatives makes the board of supervisors act as a parliamentary organization, excluded from the power center of the company. In this case, the three generic conflicts in Chinese companies (Kraakman et al., 2017, p. 2)[3] change into the appropriation of public assets by controlling shareholders, through illegal guarantee and the appropriation of non-productive funds; the impairing of the interests of other stakeholders (usually creditors and consumers) through the expansion of borrowing. Therefore, it is hard for the supervisors derived from the shareholders' meeting or controlling shareholders to effectively supervise the conduct of controlling shareholders and their representatives (usually the legal representatives), which hinders the implementation effect of the legal norm—"State-funded companies shall establish and improve internal mechanism for supervision, management and risk-control in accordance with the law, and strengthen compliance management within the company" (Article 154 of the Revised Edition).

The staff supervisors are deficient in the foundation of independence. In China, as one of the "Old three-meeting"—a traditional form of corporate organization, the assembly of the employees' representatives is a way of democratic management for workers to participate in corporate management and supervision on corporate leaders through the representatives of employees. Article 51 of the Company Law provides that the employees' representatives who are to serve as members of the board of supervisors shall be democratically elected by the employees of the company through the assembly of the employees' representatives, or employees' assembly or by any other means. In the "Opinions on Further Implementing the System of Staff Directors and Staff Supervisors", All-China Federation of Trade Unions requires staff supervisors to fully express their views and

[3] The three generic conflicts refer to conflicts between managers and shareholders, conflicts between controlling and non-controlling shareholders, and conflicts between shareholders and the corporation's other contractual counterparties, including particularly creditors and employees.

exercise the rights on behalf of employees in the process of the research on significant problems by the board of supervisors. However, since the 1990s, during the establishment of modern corporate system, the role of assets has been highlighted while the value of human capital has been downplayed, causing the assembly of the employees' representatives to exist in name only. Due to the lack of theories and the basis for actual operation, trade unions gradually become formalistic organizations and they lack channels to participate in corporate management and supervision. First, candidates for the staff supervisors can hardly represent the employees' interests. In Germany, staff supervisors are provided to be composed of a certain number of senior and ordinary staff, as well as union representatives. Although the Company Law of China provides the way of electing supervisors, there is no law on the composition and qualifications of staff supervisors; the rules of procedure and the rules of establishment of internal organization of the assembly of the employees' representatives still need to be improved. Second, the supervision by staff supervisors faces the problem of "conflict of interest". The Company Law only prohibits directors and managers in the company from serving as the supervisors, but it is nothing new that some staff supervisors hold several posts concurrently (usually supervisors of the subsidiary company or directors and managers of the parent company) during their term of office. Therefore, it is usually difficult for staff supervisors to express their opinions independently when dealing with directors and managers who have worked or are working with their, and diligent supervision may cause them to lose the qualifications of supervisors. Furthermore, staff supervisors also lack independence in the organization. In the board of supervisors, staff supervisors shall account for no less than 1/3 in pursuant of the Company Law, and other supervisors may be elected by shareholders. However, in practice, it is rare that staff supervisors account for more than 1/2 of the company's supervisors, which makes it hard for them to win support for their claims through voting rights and the actual effect of staff supervisors is limited. In most cases, staff supervisors perform their duties in the form of a concurrent post, without a permanent office or necessary economic incentives, which limits their fulfillment of the supervisory function.

**The Lack of Guarantee for Supervisors' Performance of Duties**

In the face of the complex, specialized, and elaborate modern enterprise, the supervisory body must have the same specialized knowledge and management experience to the executive body, as well as specialized supervision capability, so as to achieve checks and balances on the executive body that abuses its powers. To solve the problem of low efficiency, the German legislative body encourages the board of supervisors to set up special committees for audit, renumeration, nomination, etc. During the reform of corporate governance in the US, problems of the supervisory body such as information acquisition, executive ability, and energy input have been solved by establishing the systems of independent supervisors and collective discussion on special affairs.

Chinese supervisors lack the ability to perform their duties. The primary function of the supervisory body is to ensure a true and complete picture of the company's financial situation, which requires members of the supervisory body to have professional supervision capability. The German Corporate Governance Code provides that the candidates for supervisors must possess the knowledge, ability, and expert experience required to properly complete their tasks, and at least one member of the board of supervisors must have expertise in the fields of accounting or auditing. In the US, the independent supervisors of listed companies must have expertise in law, accounting, economics, etc. In the practice of Chinese corporate governance, the post of supervisor has been held by cadres of the party and government, who have difficulty in assessing professional financial problems such as assets appraisal and equity options, and even do not possess the basic financial knowledge. The lack of expertise and management experience leads to their poor ability to have a dialogue with the members of the corporate management.

The rules of procedure in Chinese board of supervisors become formalistic. The Chinese Company Law provides for, in principle only, the rules of resolution, without detailed provisions of procedural rules for directors' decision-making, and the Revised Edition does not elaborate on regulations of establishment, function and power, and operation for the audit committee. Under the election mechanism where supervisors are nominated by some shareholders and elected by votes of all shareholders, the interest relationship between some directors, supervisors, and specific shareholders makes them follow the instructions of specific shareholders and become representatives of these shareholders' interests, causing the resolution procedure of the supervisory body to be formalistic. The lack of rules of agency by agreement and decision-making process, in particular, makes it easy for different opinions in the supervisory body to be suppressed and gradually causes specific directors and supervisors (usually recommended by major shareholders) to replace the organization to adopt a resolution, thus giving rise to the phenomenon where supervisors echo the will of controlling shareholders. Due to the lack of written meeting minutes of the resolution process of the board of supervisors, the law enforcement agency fails to differentiate the supervisors' individual responsibility, causing the behavior responsibility to be blurred by the liability via status in practice. Moreover, where the board of supervisors is established, the Company Law does not empower supervisors to perform their duties independently, but requires the board of supervisors to be the subject of supervision, which greatly limits or even deprives supervisors of the power to perform duties independently.

Chinese supervisors are forced to depend on information supplies from the corporate management. With the development of financial market, the financing capacity of listed companies continues to grow. While financial leverage generates rich profits, it also magnifies operation risks invisibly in the company. Legislators in different countries gradually realized that "It makes no contribution to avoid mistakes and recoup the corporate loss if the corporate operation and management can only be supervised after the event". As a result, developed countries with market economy have strengthened the information transparency of corporate operation by empowering the supervisory body to the right of financial inspection, adding the right of consent reservation to the board of supervisors, and specifying the obligation of giving a comprehensive report by the operating agency, in an attempt to let the supervisory body play its role through "prevention with foresight" of the company's operation risks. In the practice of Chinese corporate governance, supervisors are faced with the problem of insufficient supply of supervisory information. Frist, the content of supervision and inspection is not specific. The right of financial inspection is at the core of supervisors' power. AktG provides that supervisors may refer to and investigate the company's books, documents, and subject property, especially cash, securities, and the inventory of goods. The Japan Companies Act has similar provisions. The board of supervisors in China is entitled to the right of financial inspection by the Company Law, but there is no specific provision for the content and procedure of the inspection. Although corporate bylaws may further explain the content of the right of inspection and the way to exercise this right, under the capital market structure controlled by dominant shareholders, controlling shareholders are not interested in proposals that may limit their voting advantages; instead, they tend to manipulate the content and procedure of financial inspection in the company and cause the supervisory body to virtually lose its power. Furthermore, supervisors lack the channels to participate in the major decision-making process of the company. Sufficient information supply is the fundamental guarantee for the supervisory body to exercise the right of supervision, which, however, has been ignored by Chinese legislators for a long time. In the company, supervisory bodies working by convening meetings such as the board of supervisors and the audit committee are not permanent organizations, causing that the implementation of supervision greatly relies on the information provided by the supervisory objects (executive directors and managers), and the operating agency with the corporate legal representative at its core fails to give overall reports on the operation. This type of supervision through "Q&A" not only makes it difficult for supervisors to grasp a whole picture of the corporate state of operation, but also increases antagonism between the board of supervisors and the board of directors. In accordance with Articles 64 and 125 of the Revised Edition, the company is allowed not to establish the board of supervisors, which seriously undermines the internal supervisory mechanism of the company. Because the legal rights of the audit committee only include supervision and inspection on corporate finance and accounting, Articles 53 and 56 of the Company Law entitle the board of supervisors to extensive function and power in financial inspection, supervisory proposals, and proposals to remove company director and senior managers. However, the abolishment of the board of supervisors leads to the vanishment of the above supervisory power.

**The Faultiness of the Incentive and Restraint Mechanism**

The Company Law shall provide the guarantee for the supervisory body and supervisors to exercise their right of supervision, and implement the principle of the consistency of "responsibility, power and benefits", so as to encourage supervisors to exercise the right of supervision independently within the range of their legal rights, free from the intervention of controlling shareholders, actual controllers, legal representatives and directors.

The operating funds of Chinese supervisory body depend on the appropriation from the operating agency. Although the Company Law clearly specifies that the expenses incurred from the performance of duties by the board of supervisors shall be borne by the company, it does not allocate special funds for the board of supervisors to perform their duties. Article 35 of the Company Law provides that supervisors' remuneration shall be decided by the shareholders' meeting, but in fact, not only the board of supervisors lacks funds that they can manage independently, but the remuneration and benefits of independent supervisors and supervisors themselves are usually controlled by the board of directors or the remuneration and appraisal committee. The practice that the supervisory objects decide the remuneration and benefits of supervisors hinders the supervisors' performance of duties. In addition, the necessary conditions (including the office and personnel) for the board of supervisors and the audit committee working by convening meetings to perform their duties all depend on the coordination of supervisory objects, who hold the corporate resources for operation. Where the supervisors find that the corporate operation is in an abnormal state, and intend to hire an external accounting firm to assist them in performing their duties, the board of supervisors not only has to justify the necessity of the appointment, but may be faced with intervention from the supervisory objects (usually the executive directors and managers) in terms of financial resources, etc.

The effect of legal liability has been undermined. Moral restraint and economic incentive alone is not enough to urge corporate supervisors to commit to their duties. Prof. Raiser pointed out the prerequisite for implementing co-management in the company: Supervisors must be, first and foremost, the body of the company, without compulsory commission and may perform their duties freely and independently and undertake any responsibility arising therefrom. The imperfect supervisory responsibility system is an important cause for the dereliction of duty of Chinese supervisors. Frist, the cost of supervisors' dereliction of duty is low. Articles 54 and 55 of the Company Law provides the duty of care for supervisors, and Article 149 provides the liability for compensation where any supervisor violates any law, administrative regulation, or the bylaw during the course of performing his duties. The Securities Law of the People's Republic of China (hereinafter referred to as "Securities Law") provides that where the persons with information disclosure obligations fail to disclose information in accordance with the law, the issuers and their supervisors shall undertake joint and several liability for compensation. In terms of administrative responsibility, where any person conceals material facts or fabricates false content, persons who are directly in charge and other persons with direct responsibility shall be fined up to 10 million yuan in pursuance of Article 182 of the Securities Law. In terms of criminal responsibility, to punish criminal acts (Article 161 of Criminal Law of the People's Republic of China) that impair the interests of listed companies and disclose important information in violation of regulations, the Criminal Law of the People's Republic of China provides that the persons with major responsibility may be sentenced to a set term of imprisonment up to 10 years. China has built the system of civil, administrative, and criminal responsibility to urge supervisors to perform their duties, but it is hard to put the legal liability into practice. Taking the financial scandal of Kangmei Pharmaceutical as an example, the first judgement provides that supervisors shall undertake the joint and several liability for compensation within 20 percent of the investors' loss.[4] However, during the judicial enforcement period, the supervisors may be exempted from the compensation liability due to the supervisors' liability insurance and the settlement of debt by intermediary institutions. Even if the company involved has gone into bankruptcy liquidation, the investors still only hold the issuers responsible for false statement,[5] not to mention that corporate supervisors hardly undertake any criminal responsibility due to the failure of perform the duty of care. Second, the confirmation of supervisors' responsibility is deficient in certainty. In some companies, the disclosure of periodic report is delayed due to a supervisor's absence from the shareholders meeting, but the supervisor does not hold responsible for the delay;[6] under the same circumstances, only some of the supervisors in the company are penalized by China Securities Regulatory Commission (CSRC) without giving any reason.[7] Moreover, the supervisory body lacks standards in judging whether the supervisor is committed to the duty of care or not: Securities regulatory institutions pointed out in some cases that "where the directors, supervisors and senior managers of listed companies exercise the right of dissent to object the content of annual reports, they are not exempted automatically from the duty of care";[8] but in some similar cases, the supervisors are exempted

[4] Guangzhou Intermediate People's Court, 2171 *The Case of the Securities False Statement of Kangmei Pharmaceutical* (2020).
[5] Changsha Intermediate People's Court, 594 *Responsibility Disputes Between Junjie Liu and Hunan CHINASUN Pharmaceutical Machinery Co., Ltd. for Securities False Statement* (2021).
[6] CSRC, 57 *Written Decision of Administrative Penalty on Dang and Yang in Shanghai Zhongyida Co., Ltd.* (2019).
[7] CSRC, 58 *Written Decision of Administrative Penalty on Fourteen People With Responsibility and Shandong Minerals Co., Ltd.* (2019); CSRC, 69 *Written Decision of Administrative Penalty on Eighteen People With Responsibility, Shenzhen ECO Beauty Co., Ltd. and Jiangsu Bada Garden Co., Ltd.* (2019).
[8] CSRC and Anhui Securities Regulatory Bureau, 8 *Written Decision of Administrative Penalty* (2020).

from the legal responsibility by the securities regulatory institution, due to the supervisors' abstention in deliberating the report.[9]

## The Reconstruction of Supervisor's Independent Legal Status

The purpose of the establishment of the board of supervisors is to supervise on the corporate management right, prevent the abuse and corruption of the management right, and solve the agency cost arising from the division of ownership and management right. The corporate supervisors in Chinese companies are not able to perform their duties in accordance with the law and corporate bylaws for the reasons given above. Therefore, to reconstruct the supervisors' independent legal status through legislation is the only way to improve the corporate governance level in modern Chinese companies.

### The Guarantee of Members—Bringing External Supervisors Into Listed Companies

Aggressive operating strategies may bring excess earnings to the company, but may also lead to financial risks and social instability. In the face of the controlling shareholders with dominant power, medium and small investors who are rational and indifferent and other stakeholders with various opinions, the implementation of external correction of the corporate conduct and recommendations for external personnel to enter the company's internal governance mechanism helps to reach a social consensus. Under the capital structure of the dominant shareholders, controlling shareholders may not able to change the rules of power distribution in the company prescribed by the Company Law, but they may influence or even control supervisors through the nomination and election of shareholders, for the purpose of forcing supervisors to serve for the specific objectives of controlling shareholders. In accordance with the law, supervisors are selected or elected by the majority at the shareholders' meeting; in fact, they are bound up with shareholders' exercise of nomination rights and shareholding ratio. The supervisors are nominally the representatives of the corporate interests, but the substantial impact on the supervisors from the shareholders who have nominated them makes it hard for the nominees to be represent the corporate interests with independence from the shareholders. In practice, controlling shareholders abuse their rights to impair the interests of listed companies, but supervisors keep their mouth firmly closed, for which one of the significant reasons is their adherence to the will of specific shareholders. The failure of the system of independent directors in Chinese companies lies in the fact that while the legislators require independent directors to pay attention to the interests of medium and small shareholders, they entitle the controlling shareholders to the power of nominating and electing independent directors.

**The election of external supervisors.** Corporate democracy is an operation rule of the company with multiple dimensions. Through the combination of rules of "one share—one vote" and "one man—one vote", the governance system of modern corporate presents the internal democracy mechanism with "capital majority" rule at its core. However, the corporate democracy takes the homogeneity of participating members as the applicable condition; it is unable to solve the problem of interest distribution among heterogeneous members (stakeholders). When the legislators try to balance the relationship among heterogeneous members, they usually suggest or force the parties to settle disputes through consultation on the basis of equality. Where the existing consultation mechanism fails to strike a balance in the differential advantage among members of the society, a certain type of

[9] CSRC, 114 *Written Decision of Administrative Penalty* (F. W. Ying et al., were held responsible) (2019).

members may be allowed to intervene in affairs of other members. In the design of the system of external supervisors, the top priority is the nomination and election of external supervisors. In the corporate relationship, the shareholders, mangers, creditors, suppliers, consumers, community, and the government are heterogeneous members, among which the relationship of rights and obligations depends on the basic functions of consultation and contracts. However, given that the appeals of various parties are different and the consultation objects are not stable, it is difficult for the parties to determine the outsider to enter the corporate governance body through consultation on the basis of equality. The law shall replace the freedom of contract with obligatory regulations, and increase the intervention of public rights in the corporate election of external supervisors. Here are the specific approaches: (1) In accordance with the applications of experts, securities regulatory institutions shall build an expert base for candidates of external supervisors by distinguishing and selecting the applicants. Candidates of the external supervisors to enter the expert base shall have the following qualifications: the possession of corresponding supervision capability. As a measure to regulate the operation of listed companies and improve the transparency of listed companies, external supervisors shall possess professional capability and practical experience. (2) In accordance with the business scope of the company, the chairman or vice-chairman of the board of supervisors selects the external supervisors with the required qualifications by drawing lots from the expert base. The candidates for external supervisors shall not be involved in any conflict of interest with the company that they are to serve. With reference to the relevant provisions for the qualifications of independent directors, the external supervisors shall not be involved in any business and affiliated relation with the listed company, major shareholders, actual controllers and directors within the past five years, so as to guarantee the independence of external supervisors. (3) The candidates shall be approved by over half of the members of the board of supervisors to serve as the external supervisors of the listed company, which helps to eliminate the risks arising from controlling shareholders' abuse of the control right to appropriate and impair corporate interests.

**The purview and exercise of supervisors' rights.** The Chinese Company Law provides that in addition to attend the board meeting and state query opinions, supervisors shall, in the name of the board of supervisors, exercise the right of supervision through resolutions at meetings. However, in the current situation where the rules of procedure of the board of supervisors are not clear, the board of supervisors lacks permanent working organizations and controlling shareholders may influence or even decide on the majority of the board of supervisors, insisting on that limiting the supervisors' exercise of rights within group decisions will certainly lead to the suppression of heterogeneous opinions in the company. To ensure the convenience for supervisors to exercise the right of supervision, the Japan Companies Act provides that supervisors perform their duties independently, while the supervisors' meeting, as a coordinative organization, is not binding on supervisors' activities. Where supervisors believe that their exercise of the right of supervision is impeded by the resolutions adopted at the meeting, they may act independently regardless of the resolutions. The supervision system with the sole-judge proceedings effectively solves the problem of ineffective supervision caused by the rigged supervisory body. As the industry experts, external supervisors possess the necessary supervision capability to perform their duties. Therefore, the approval for supervisors' independence for implementing supervision not only can bring their initiative into play, but also avoid limitations of the board of supervisors due to the lack of permanent organizations. The external supervisors' independence in the exercise of rights helps to solve the problem of controlling shareholders' manipulation of the board of supervisors and improve the governance effect in the company.

**The Guarantee of Power—Strengthening Professional Supervision Capability**

Financial operation shall be a priority for the company's internal supervisory body, and specialized supervision on finance is a necessity for maintaining corporate interests. In terms of supervisors' qualifications, they shall possess professional knowledge in areas like finance, securities, or law, and shall be capable of making a basic judgement on the corporate operation and risks. The Company Law shall detail the institutional arrangement for the right of financial inspection, and clearly specify supervisors' rights by learning from The Japan Companies Act. Chinese supervisors shall be entitled to consult and check the corporate accounting books, inventory, cash, and other important assets, and may bring it to court for mandatory inspection if the company refuses to cooperate. The Company Law shall improve the rules of procedure for the board of supervisors and the audit committee. First, the content of meetings and resolutions, as well as supporting evidence, must be kept intact, so as to provide evidence to restore the decision-making process and to investigate and affix responsibility. Second, to ensure that supervisors participate equally in the corporate operation and supervision, the attendance of over half of the supervisors shall be a necessity for the convening of regular meetings. In addition, the corporate bylaw must provide for the way and the time of meeting notification, to prevent controlling shareholders from depriving specific supervisors (usually staff and external supervisors of the board of supervisors) of their rights to attend the meeting, by taking advantage of the meeting time. And finally, as the supervisory body performing duties through council or committees, the board of supervisors, of which most members hold the post concurrently, is faced with problems of inefficient supervision and irregular convening of meetings. By hiring full-time supervisors to normalize and streamline the supervisory work and to pay constant attention to specific business risks, the persistence in performing duties of supervisors can be improved effectively.

The supervisors shall be entitled to the right of supervision with foresight. Supervision with foresight refers to that the supervisory body for corporate operation takes the initiative to prevent any business decisions and performance of duties that may impair the corporate interests, by controlling the key information and material decisions of the company. This type of supervision not only can prevent decisions that may impair the corporate interests, but also attaches great importance to improve the company performance. AktG establishes the right of consent reservation for the board of supervisors and the obligation to give a comprehensive report by the board of directors, enabling the board of supervisors to participate in the strategic decision-making process of the company actively. The above provisions provide great reference for the transformation of supervisors' functions and duties in Chinese companies. Frist of all, the operational body shall undertake the obligation to disclose information. In order to prevent risks prior to any incurred loss through supervision, supervisors shall have the guarantee to get needed information to perform their duties and solve the problem of information asymmetry between operators and supervisors. In accordance with the Company Law, the prerequisite for the board of supervisors to conduct an investigation is the findings of abnormal operation of the company. In other words, the operators may have already made the mistake and impaired the corporate interests at the moment, so supervisors can hardly take preventive measures. If the board of directors and managers are required to regularly submit necessary operation information to the board of supervisors or the audit committee, supervisors can learn the progress of corporate operation and take preventive measures prior to any wrong decision made by the operational body. Second, the supervisors shall be entitled to the right of consent reservation. The modern corporate governance mechanism shall support material decisions of the board of supervisors that to some degree, have impacts on the operators and managers of the company, and prevent, in effect, any decision behavior that may impair the corporate interests. The core of the implementation of the right of consent reservation in German is that the board of supervisors can exercise the right of veto over the board of directors in terms of corporate matters connected with substantial transactions, funds, financing, personnel arrangement, etc. In this way, the limited intervention in corporate operation from the board of supervisors can be achieved on the basis of respecting the management and decision-making power of the board of directors, and the preventive effect of farsighted supervision of the supervisory body can be fully played.

**The Guarantee of Responsibility—Reconstructing the Restraint and Incentive Mechanism**

The legal responsibility of supervisors shall be specified. In legislative design, Chinese legislators expect to urge supervisors to perform duties through joint and several liability. However, in the face of the difficulty in conducting investigation of individual responsibility in reality and the selectivity and uncertainty in administrative punishment, legislators need to further specify the legal responsibility of corporate supervisors when they fail to perform duties, especially civil liability for compensation. First of all, the shared responsibility model shall be established between supervisors and the board of directors. Based on the obligation of information disclosure of the board of directors prescribed by the Company Law, the supervisors shall undertake the shared responsibility for decision-making, if the board of supervisors has got important information in operation and decision-making and has discussed it with the board of directors. Assuming that the Company Law fully ensures the right of the board of supervisors to gain operation information from the company, the supervisors shall undertake joint and several liability to the company and shareholders, if the board of supervisors fails to get key information due to their dereliction of duty, which further leads to wrong decisions during the decision-making process or the consultation with the corporate management. Even if the supervisors have the liability insurance, the deductible shall be no less than 10 percent, up to a minimum of 150 percent of the annual fixed remuneration of the supervisors, which means this part of responsibility shall be taken by supervisors themselves. Second, securities regulatory institutions shall specify the standards of law enforcement. In the face of the problems of excessive discretionary power and the standards of law enforcement in local securities regulatory bureau, the CSRC may learn from the work experience of the Supreme People’s Court, to issue guiding cases of administrative punishment and specify legal responsibility under similar conditions, so as to unify the standards of law enforcement. With the introduction of the right of consent reservation, the board of supervisors shall transform from a bystander into a participant. In the face of the corrupt practice related to major operation and decisions of the company, the supervisors’ legal responsibility shall gradually transform from “other persons with direct responsibility” into “the person directly responsible”.

The guarantee of special fund embodies the principle of responsibility, power, and benefits. Supervisors need the independent funds to support both their daily life and their independence. In the corporate governance, supervisors’ performance of duties is an essential part of the corporate operation. The lack of necessary funds may not only cause moral risks of individuals, but make the board of supervisors excessively depend on the financial resources of the operational body. Given that Chinese companies are controlled by dominant shareholders, the Company Law shall provide for the proportion of special funds in the corporate annual budget, which will be used to pay the supervisors' remuneration and allowances, as well as maintain the daily operation of the board of supervisors. Where the special funds cannot sustain the two demands, the company shall urgently grant the short amount of money and the shareholders' meeting shall give the ratification afterwards. Furthermore, the supervisors are equally important to the directors, so the Revised Edition shall learn from Section 113 of the AktG to entitle supervisors to the right of equity incentive, so as to stimulate supervisors' enthusiasm in supervision.

## Conclusion

Independence is a necessary condition for supervisors to perform their duties. The core problem of the failure of the internal supervision mechanism in Chinese companies does not lie in the choice of corporate governance models, but in that corporate supervisors attach themselves to major shareholders, directors, or managers due to organizational and interest relations, causing supervisors to lose the independence of performing duties. To solve the problem of supervisors' independence, first, China shall focus on the need of indigenization of the corporate governance mechanism, take the stakeholders' say in the candidates of supervisors into account, and bring the external supervisors into the company to solve supervisors' problems of independence and representativeness. Second, China shall solve the problem of supervisors' degree of specialization, and realize the specialization of candidates for supervisors, supervisory ideas, supervisory function and power as well as supervisory information. Again, the rules for supervisors' independent performance of duties shall be provided, since the board of supervisors is only a platform for supervisors to perform their duties. In the end, the principle of the consistency of right, responsibility, and benefits shall be fully implemented. The company's special funds approved at the shareholders' meeting shall be used to pay supervisors' remuneration and cover the operation costs of the board of supervisors; securities regulatory institutions shall unify the standards for law enforcement and reduce the rent-seeking behaviors; the civil liability for compensation caused by supervisor' failure to perform duties shall be promoted through juridical practice and the negative externality benefits shall be reduced.

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