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REGULATING EXECUTIVE COMPENSATION IN CHINA: PROBLEMS AND SOLUTIONS

Dr. Lin Lin



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*Dr. Lin Lin**

ABSTRACT

Executive compensation is an essential element of a corporate governance system and an issue of public concern and academic debate. However, the existing literature on executive compensation has primarily focused on the United States, United Kingdom and continental European jurisdictions. This paper presents a comprehensive comparative study of the law and practices of executive pay in China. It critically examines the processes that produce compensation arrangements, as well as the various legal strategies and market forces that act on these processes in the context of China.

Based on extensive empirical evidence, it finds that excessive pay in China is less prevalent than that in the United States. Nevertheless, Chinese executive compensation is not optimal in that there are both excessive executive pay and low levels of equity incentives for executives in Chinese listed companies. Meanwhile, executives of state-owned enterprises are largely compensated by on-duty consumption, grey income and political reward.

The article argues that the fundamental problem of executive pay in Chinese listed companies lies in the internal defects of its unique governance institutions, as well as the prevalence of concentrated state ownership in listed companies. It concludes that the primary role of Chinese

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law in regulating executive compensation should not simply be to curb excessive executive pay, but it should be to improve the regulatory structure for setting executive pay in a fairer and more transparent way. To achieve this, regulatory strategies, especially heightened disclosure and strengthening the independence of the compensation committee, must be taken.

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I. INTRODUCTION

Executive compensation¹ is an essential element of a corporate governance system.² It is widely acknowledged that optimal pay packages can align the interests of managers with those of shareholders as a class.³ Executive pay is also an issue of public concern and academic debate in many jurisdictions, such as the United States (U.S.),⁴ the United Kingdom (U.K.), and other continental European countries.⁵ There are claims that inappropriate compensation practices have contributed to the economic crises in recent decades.⁶ In legal literature, there are two major schools of thought on executive compensation: the Board Capture theory and the Optimal Contracting theory.⁷ Advocates of the Board Capture theory claim that executives, particularly CEOs in most public corporations have been able to “capture” their boards of directors and thus they are able to set their own compensation.⁸ However, Optimal Contracting theorists argue that the system of executive compensation is largely working fine because most

¹ In this article, the terms “compensation” and “remuneration” are used interchangeably.

² ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 222 (2d ed. 2001).

³ See, e.g., REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 75 (2009).

⁴ New executive compensation regulations have been inserted into the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act in recent years.

⁵ See, e.g., Guido Ferrarini et al., *Executive Pay: Convergence in Law and Practice Across the EU Corporate Government Faultline*, 4 J. CORP. L. STUD. 243 (2004); Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 64 VAND. L. REV. 431 (2011); Guido Ferrarini et al., *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis*, ECGI Law Working Paper No. 126/2009; Guido Ferrarini et al., *Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe*, 10 J. CORP. L. STUDIES 73 (2010).

⁶ See, e.g., Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, FIN. MKT. TRENDS 2 (2009).

⁷ Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95(1) MINN. L. REV. 846, 901 (2011); STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 113 (2012) (discussing the two camps of scholarships are also termed as “the Managerial Power Model” and “the Arm’s-length Bargaining Model”).

⁸ LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 61–79 (2004).

boards are able to negotiate the best possible compensation arrangements in order to maximize shareholder value.⁹

In China, with the dramatic rise in executive compensation in the last decade, there has been a considerable concern as to whether the executive compensation arrangements are consistent with shareholder and social interests. One particular concern is that executives are rewarded excessively despite poor firm performance. For example, the aggregate net profit of 2,469 A-share companies listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) (A-share Companies¹⁰) was increased by only 0.85% in 2012.¹¹ However, the aggregate executive compensation was increased by 12.4% year on year, amounting to 11.953 billion RMB yuan.¹² Meanwhile, perceived abuses relating to the hidden payments for senior executives (e.g. on-duty consumption and excessive housing allowance), as well as the vast pay gap between senior management and ordinary employees have been the subjects of much public criticism.¹³

Although there are various public concerns on executive compensation, only a few legislative reforms have been done in China to curb the alleged problems among listed companies. In particular, legislative attention has not been sufficiently made to the role and the functions of the various institutions in setting executive pay, such as the board¹⁴ and the compensation committee. Also, the existing literature on executive compensation has primarily focused on the U.S., the U.K. and continental European jurisdictions; but answers to executive pay concerns in China are

⁹ See, e.g., John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160 (2005); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959 (1980).

¹⁰ "A Shares" refer to the specialized shares that are traded on Chinese stock exchanges. They are quoted in Chinese Renminbi.

¹¹ Wang Jie, *Listed Companies Buck the Trend and Increased Executive Pay*, BEIJING MORNING POST, May 6, 2013, at B01-08.

¹² *Id.*

¹³ See Yang Rong, *Research on Executive Compensation of Listed Companies of Monopolistic Industries—Based on Perquisite Consumption*, 5 FUDAN J. (SOCIAL SCIENCES ED.) 133, 133 (2011).

¹⁴ In this article, "the board" and "the board of directors" are used interchangeably.

limited.¹⁵ The article thus seeks to fill the literature gap by examining the law and practices of executive compensation in the context of China. It addresses the special features of executive compensation in China, in comparison to the U.S., the U.K., European Commission, Germany and Japan. Although this Article focuses largely on China, the comparative analysis on the regulations of executive pay would prove useful in assessing similar issues in other jurisdictions. The efforts to find a feasible way from the recent developments in corporate law to solve the problems of executive compensation would also be helpful in future law reforms.

Under the Company Law of People's Republic of China 2006 (PRC Company Law), the term "executive" or "senior management" (*gaoguan*) refers to "the general manager (*zongjingli*), the deputy general manager (*fuzongjingli*), the financial officer (*caiwufuzeren*), the company secretary in listed companies and other people as described in its articles of association."¹⁶ The "other people as described in its articles of association" usually refer to the officers who fall within the first layer of management below board level, such as the chief executive officer (CEO), the chief financial officer, the chief operation officer, the chief accountant, the chief technology officer and the chief legal officer.¹⁷ Worth mentioning, the same individual may simultaneously hold more than one office in a Chinese company.¹⁸ Especially, it is very common for a director to participate in the day-to-day operation of the firm and serve as the general managers¹⁹ or the CEO.²⁰ It is also a general practice for a chairman of the board to serve as the general manager.²¹ Thus, the term "executives" also includes the chairman of the board and executive directors in the Chinese context. This Article examines the executives that fall within the above categories and

¹⁵ Previous work in this field has examined the policies on executive compensation from economic perspective. However, there is limited legal scholarship examining the executive compensation in China from legal and comparative perspectives.

¹⁶ P.R.C. Company Law 2006, art. 217.

¹⁷ See Ge Wei & Gao Minghua, *Position Compensation, Comparison Effect and Executive Pay Gap*, 1 ECON. SURVEY 94 (2013); LIU JUNHAI, *COMPANY LAW 156* (China Law Press 2008).

¹⁸ The situation is similar in the U.S. Model Business Corporation Act. Section 8.40(d) provides that "The same individual may simultaneously hold more than one office in a corporation."

¹⁹ For example, the general manager of PetroChina Company Limited is also a director of the company.

²⁰ For example, the CEO of Haier Group is also a director of the group.

²¹ Wei & Minghua, *supra* note 17, at 94.

mainly deals with companies whose shares are publicly traded on the two stock exchanges in China, i.e. the SSE and the SZSE.

The structure of the remainder part is as follows. Part II introduces the law and practices of executive compensation in China from a comparative perspective. This part provides historical insights on the evolution of executive pay and the regulatory framework governing executive compensation in China. It also identifies special features and problems of Chinese compensation practice, based on extensive empirical evidence. Part III identifies the underlying institutional, political and social reasons for these problems. It specifically discusses the role and functions of the board of directors, compensation committee, supervisory board and independent directors in the setting of executive pay. Part IV critically examines the role of law in regulating the executive compensation as well as the common legal strategies that the law employs to address the executive pay problems. It then puts forward a set of proposals for improving executive compensation in the context of China. Part V draws conclusions.

II. THE LAW AND PRACTICES OF EXECUTIVE COMPENSATION IN CHINA

A. A Historical Overview on Executive Compensation in China

Executive compensation cannot be understood without a full picture of the political and economic development in China. From the founding of the People's Republic of China (PRC) in 1949 until late 1978 when the Reform and Opening-up policy (*gaigekaiifang*) was launched, China exercised a Soviet-style centrally planned economy. There was a traditional weak link between compensation and managerial performance during this period. In 1953, the Chinese Communist Party (CCP, or the Party) launched the socialist reforms (*shehuizhuyigaizao*) in order to establish a socialist public ownership system. When the reforms were completed in 1956, most private enterprises were transformed into the so-called "enterprises owned by the whole people" (*quanminsuoyouzhiquye*).²² Under the public ownership system, there was no private business or private capitalism. Managers were appointed by the government and their compensation was designed and

²² Wang Zhongming, *State-owned Enterprise Reform over the Past Sixty Years*, ECONOMIC INFORMATION DAILY (Sept. 1, 2009), <http://finance.ifeng.com/opinion/jjsh/20090901/1181429.shtml>.

paid by the government. Salary was the basic component of remuneration²³ and equity incentives did not exist. During the economic and social campaign—the “Great Leap Forward” (*dayuejin*) period (1958–1961), and the Cultural Revolution (1966–1976), performance-based distribution system was seriously affected²⁴ and compensation of managers was virtually independent of performance at that time. These social and political campaigns caused a disastrous impact on the country’s economy, leading to a low level of employee compensation. Evidence also shows that there was no significant difference between executive remuneration and the wages of ordinary employees from 1950 to 1978.²⁵

Since 1978, a series of positive regulatory reforms have been taken by the CCP to develop the economy of the nation, including, *inter alia*, privatization and modernization of state-owned enterprises (SOEs),²⁶ development of private businesses, and improvement of the distribution system. Laws and administrative regulations were also enacted to incentivize executives and encourage the usage of bonus and other pay incentives. For example, in 1979, the State Council issued a new regulation which required that bonuses must be allocated from retained profits.²⁷ Enterprises were required to establish the so-called “collective welfare fund” (*jitifulijjin*) and “employee incentive fund” (*zhigongjianglijjin*).²⁸ From 1986 to 1988, further regulations were issued to increase the pay gap between senior managers and ordinary employees.²⁹ For instance, managers were permitted to enjoy one to three times the average wage of

²³ On June 16, 1956, the State Council issued the *Decision on Salary Reform* and set up a system for monetary wage.

²⁴ EMPLOYEE WAGES, BENEFITS AND SOCIAL INSURANCE IN CONTEMPORARY CHINA 75–79, 91–93 (Yan Zhongqin ed., 1987), cited in Yu Guanghua, *The Regulation of Executive Compensation in China* (Jan. 15, 2005), at 2, available at <http://ssrn.com/abstract=1535660>.

²⁵ Yu, *supra* note 24, at 2 (noting that the difference between the remuneration of executives and the wages of other employees was not significant from 1950 to 1978).

²⁶ According to the supervisory authority, State-owned Enterprises (SOEs) can be divided into two types in China. Those SOEs that are governed by the central government through the national State-owned Assets Supervision and Administration Commission are considered “Central SOEs”; while the SOEs governed by local governments are considered “Local SOEs.”

²⁷ State Council, Several Regulations on Expanding Management Anatomy for State-owned Industrial Enterprise 1979, art. 2.

²⁸ *Id.*

²⁹ Yu, *supra* note 24, at 3.

employees.³⁰ Operators of local enterprises (*chengzujingyingzhe*) were entitled to have one to five times the average wage (including bonus) of employees.³¹

In contrast to the U.S. where equity incentives have long been widely used, the earliest practices of equity incentives in modern China started in the early 1980s. In 1984, the Beijing Tianqiao Department Store Company was incorporated. It was the first company that converted from an SOE to a company limited by shares (*youxianzerengongsi*), as well as the first company that allowed individual employees to purchase company shares after the 1978 economic reform.³² In 1994, the Shanghai government issued a local regulation which allowed managers to purchase company shares through an Employee Shareholding Committee called “*zhigongchiguhui*.”³³ Since 1994, national guidelines have been relaxed to allow companies to issue shares to employees.³⁴

In addition, in conjunction with the 1978 SOE reform, modern executive compensation mechanisms were progressively established and the level of executive pay of SOEs was gradually increased. In 1997, the Shenzhen government issued the first provisional measure to link pay to performance in SOEs.³⁵ In March 2003, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was established to regulate the central state-owned enterprises (Central SOEs). Executive compensation of Central SOEs was also reformed to delink it from civil servants’ pay.

With the above reforms on executive pay, China saw the fastest growth of senior management salaries in emerging markets between 2001 and 2011, rising by 3.5 times; compared to 2.8 times in Brazil, 1.4 times in

³⁰ State Council, Regulations on Further Enterprise Reform 1986, art. 33.

³¹ Temporary Regulations on Small-sized Industrial Enterprises Wholly-owned by People 1988, art. 33.

³² Tian Junrong, *The First Enterprise Limited by Share in China—Beijing Tianqiao Baihuo Limited Company by Share*, 9 RENMIN FORUM 27 (1998).

³³ Shanghai Temporary Rules on Employees Ownership Committee in Companies 1994.

³⁴ See, e.g., Commission for Economic Restructuring and the Securities Commission of the State Council, Supplementary Regulations on Rights Issue to Employees by Stock Limited Companies 1994; Commission for Economic Restructuring, Guidance on Development of City Share-holding Cooperative System 1997.

³⁵ Shenzhen Temporary Regulations on Annual Remuneration of Managers in State-owned Enterprises 1997, art. 1.

the U.S., 1.7 times in the U.K., and 2.0 times across Western Europe over the same period (Table 1).³⁶ Significantly, executive pay in China soared to unprecedented levels in 2006. The year of 2006 also saw the first time that the level of executive compensation in the state-controlled listed companies (*guoyoukonggu shangshigongsi*)³⁷ exceeded that in private-controlled listed companies.³⁸ In 2007, as a beneficial result of the adoption of the stock option schemes and other long-term incentive plans by listed companies, the average executive pay increased dramatically by 57.15% (Table 2).³⁹ In 2012, directors' compensation of the largest 100 Chinese listed companies increased by 82.3%.⁴⁰

Arguably, the increase of executive pay in China is largely accompanied with the rapid growth of GDP of the nation. During China's eleventh five-year plan period (2006–2010),⁴¹ the average growth rate of

³⁶ News Release, Hay Group, Management Salaries in Emerging Markets Now Match European Pay, at 1, available at <http://www.haygroup.com/downloads/ww/Hay%20Group%20emerging%20markets%20press%20release.pdf>.

³⁷ There is no legal definition of the "State-controlled Listed Company." In practice, the State-controlled Listed Company usually refers to the Chinese listed companies of which the government or state-owned companies own more than 50% of shares, or the resolution of whose shareholder meeting can be substantially influenced by the government or state-owned companies, despite the fact that the shares held by them account for less than half of the shares of the listed company.

³⁸ See Yang Zhigang, *Research Report: The Level of Executive Pay in State-owned Enterprise Exceeded That in Private Enterprises for the First Time in 2006*, CHINA SEC. J. (May 29, 2007), <http://manage.org.cn/observe/200705/47159.html>.

³⁹ Several measures were issued to regulate the equity incentive plans, including the Measures for the Administration of Equity Incentive Plans of Listed Companies 2005, the Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic) 2006, Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation), Notice of the State-Owned Assets Supervision and Administration Commission of the State Council and the Ministry of Finance on Issuing the Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic) 2006. See also Du Jing, *Theories and Practice of the Legal System of Executive Compensation in Listed Companies*, 3 TSHINGHUA L. REV. 131, 133 (2009).

⁴⁰ PROTIVITI, CORPORATE GOVERNANCE ASSESSMENT SUMMARY REPORT ON THE TOP 100 CHINESE LISTED COMPANIES FOR 2012, at 22, available at <http://www.protiviti.com/China-en/Documents/CN-en-2012-Corporate-Governance-Survey-Report.pdf> (stating that "[i]n terms of the level of remuneration per capita, the average remuneration of senior executives per capita was CNY627,900 this year, with an increase of 14.7% from the previous year. Remuneration of directors per capita was CNY682,000, which increased by 92.7% from last year; remuneration of supervisors per capita was CNY411,900, which increased by 29.2% from last year.>").

⁴¹ China's five-year plans are a series of social and economic development initiatives. The goals of the eleventh five-year plan were set by the 2006 National People's Congress session.

executive pay in listed companies was 18.1%⁴² and the GDP growth rate during this period was 11.2%⁴³ (Table 2). The increase in executive pay is partly due to the influx of foreign investment since China's entry into WTO in 2001, the rapid development of the capital market in 1990s and 2000s, as well as the pressure from severe global competition in the human resources market.

Table 1: A Comparison of Total Cash Levels in U.S. Dollars for Senior Management Positions in 2001 and 2011⁴⁴

Country	2001	2011	% change
China	35,636	123,477	+247
South Africa	44,405	151,273	+241
Indonesia	25,250	74,353	+195
Turkey	65,183	189,170	+190
Brazil	57,809	162,651	+181
U.A.E	90,341	204,421	+126
France	78,929	169,719	+115
Poland	65,961	136,602	+107
Netherlands	85,894	175,401	+104
Italy	87,462	165,168	+89
Germany	104,155	193,594	+86
Russia	86,576	153,229	+77
U.K.	83,246	138,287	+66
U.S.	112,433	154,847	+38
Mexico	116,882	145,509	+25

⁴² *Executive Pay Achieved Historical High*, ECONOMIC INFORMATION DAILY (Apr. 10, 2013), http://news.xinhuanet.com/local/2013-04/10/c_124559957.htm.

⁴³ National Bureau of Statistics of People's Republic of China.

⁴⁴ Hay Group, *supra* note 36, at 3.

Table 2: GDP Increase Compared with Year-Over-Year Average Increase (%) in Executive and Employee Pay in China⁴⁵

Year	Average Senior Management Pay in A-share Companies %	Average National Worker Pay %	GDP %
2007	57.15	9.7	13.0
2008	-4	11.7	8.9
2009	10.34	7.8	9.1
2010	8.87	12.3	10.3
2011	8	13.1	9.2

B. The Regulatory Framework and the Setting of Executive Compensation

China's legal framework for executive compensation is comprised of three major levels. The first level contains fundamental laws formulated either by the National People's Congress or its Standing Committee. The basic provisions regulating the setting of executive compensation are contained in the PRC Company Law.⁴⁶ Under this law, the board of directors has the right to determine the recruitment, termination and "compensation issues" of managers.⁴⁷ Directors' compensation must be proposed by the board⁴⁸ and approved by shareholders in the shareholders' general meeting.⁴⁹ Nevertheless, shareholders have no votes on individual director or manager's remuneration package, thus directors and managers'

⁴⁵ CHINA ADFAITH MANAGEMENT CONSULTING LIMITED COMPANY, CENTER OF BUSINESS DATA, CHINA COMPENSATION WHITE PAPER 2012, at 7; *Research Report on Executive Compensation in Listed Companies 2007*, SECURITIES TIMES (May 29, 2008), http://news.xinhuanet.com/fortune/2008-05/29/content_8273288.htm; *Towers Perrin Report on Executive Compensation in Chinese Listed Companies 2008*, 21 CEIBS BUS. REV. (2010), <http://www.ceibsonline.com/commentary/show/index/classid/2/id/871>; *Executive Pay Increased Rapidly in 2009*, FIRST FINANCIAL DAILY (May 10, 2010), <http://finance.people.com.cn/GB/1040/59941/11553445.html>; *Average Executive Compensation in Listed Companies in 2010*, NANFANG DAILY (May 11, 2011), http://news.xinhuanet.com/fortune/2011-05/11/c_121403506.htm.

⁴⁶ The PRC Personal Income Tax Law 2011 also contains certain regulations on executive compensation. However, the PRC Income Tax Law lacks comprehensive regulations on equity incentives. See Lou He-tong et al., *The Conflicts Between Income Tax Regulations of Executive Equity Incentives and Incentive Effect*, 9 J. FIN. & ECON. 37 (2010).

⁴⁷ P.R.C. Company Law 2006, art. 47(9).

⁴⁸ P.R.C. Corporate Governance Code 2002, art. 71.

⁴⁹ P.R.C. Company Law 2006, arts. 38(2) & 47(9).

compensation is in the hands of the board as a whole. Moreover, unlike the U.K. where there is a shareholder say-on-pay mechanism mandating a shareholder advisory vote on all executive directors' compensation for listed companies, there is no such mechanism in China.⁵⁰

The second level mainly involves administrative regulations enacted by the State Council, as well as departmental measures formulated by the China Securities Regulatory Commission (CSRC), the SASAC and other government agencies with administrative jurisdiction directly under the State Council, such as *the Administrative Measures for the Issuance of Securities by Listed Companies* and *the Code of Corporate Governance of Listed Companies 2002* (the PRC Corporate Governance Code)⁵¹ issued by the CSRC. The third level includes self-disciplinary rules set by stock exchanges, such as *the Listing Rules of Shanghai Stock Exchange* and *the Listing Rules of Shenzhen Stock Exchange*. Especially, in contrast to the U.S. and the U.K. where it is mandatory for publicly traded companies to have compensation committees, Chinese listed companies are not obliged to do so.⁵² The PRC Corporate Governance Code merely provides that the board of directors of a listed company may establish a remuneration and appraisal committee according to the resolution passed by the shareholders' general meetings.⁵³ The remuneration and appraisal committee is responsible for the performance evaluation of directors and managers.⁵⁴

It is worth noting that executive compensation of SOEs is subject to supervision and heavily regulated by the government. The reform on executive compensation in SOEs was also directed and driven by the state, not the market solely. After the global financial crisis of 2008, more restrictions were imposed on financial institutions and SOEs in order to curb the alleged overcompensation to executives in these institutions.⁵⁵ For

⁵⁰ See *infra* text accompanying notes 214–32.

⁵¹ Article 72 of the P.R.C. Corporate Governance Code 2002 provides that executive compensation shall be approved by the board, explained at the shareholders' meetings and disclosed to the public. Articles 77 and 78 of the P.R.C. Corporate Governance Code 2002 state that executive compensation must be linked to the firm's performance and the individual manager's performance.

⁵² P.R.C. Corporate Governance Code 2002, art. 52.

⁵³ *Id.*

⁵⁴ *Id.* at art. 70.

⁵⁵ See, e.g., Notice of the Ministry of Finance on the Issues in Relating to the Remunerations Paid to the Senior Management of the State-owned Financial Institutions for the Year of 2008, CAIJIN 2009,

instance, six governmental departments jointly issued a guideline in 2009, requiring that executive compensation in Central SOEs must not exceed 30 times its average worker's salary of the last financial year.⁵⁶ In 2013, the State Council issued a further notice stating that the growth rate of executive pay in SOEs must be lower than that in compensation to ordinary employees.⁵⁷ Nevertheless, these "one-size-fits-all" rules may not be effective in regulating executive pay. On the one hand, it may become a disincentive for talented executives. On the other hand, a mere cap on executive pay does not maximize shareholders' interests fundamentally. Compliance with these guidelines and measures is also an issue in practice.⁵⁸

C. Features and Problems of Executive Compensation in China

1. Pay Without Performance?

Executive compensation is a contentious area. While it is difficult to deploy an objective benchmark in estimating the level of executive compensation, the public generally believes that there is a wide range of problems regarding executive pay. A major concern in the U.S., the U.K. and other continental jurisdictions is that executive compensation is not aligned to firm performance and executives are paid excessively.⁵⁹

Excessive executive compensation seems less pervasive in China than in the U.S. Empirical evidence shows the average pay to executives in Chinese companies listed on SSE and SZSE (A-share Companies) is lower than that in Chinese companies listed on the Hong Kong Stock Exchange

No. 23; and the Standardized Guidelines for the Management of Compensation of Insurance Companies (For Trial Implementation), BAOJIANFA 2012, No. 63.

⁵⁶ Guidance on Regulating the Compensation of Managers in Key State-owned Enterprises, RENSHEBUFA 2009, No. 105.

⁵⁷ State Council Notice on Furthering Distribution System Reform, GUOBANHAN 2013, No. 36.

⁵⁸ *Ignorance of SASAC Rules*, NETEASE FINANCE (Feb. 26, 2013), <http://money.163.com/13/0226/21/8OM14GPG00252G50.html> (noting that some SOEs did not follow these guidelines and managed to pay their senior management compensation above the threshold).

⁵⁹ Andrew Morse, *Credit Suisse Chief Gets 34% Raise*, WALL ST. J. (Mar. 22, 2013), <http://online.wsj.com/article/SB10001424127887324103504578375680999693380.html> (noting that Credit Suisse Group AG rewarded their CEO with a 34% pay rise, despite a fall in net profit for the year 2012).

(H-share Companies⁶⁰).⁶¹ Also, it is contended that executives in Central SOEs earned much less than their counterparts in the same industries, as executive pay in these enterprises is heavily regulated by the government⁶² and is subject to a ceiling set by the SASAC.⁶³ The pay to general managers in state-controlled listed companies is lower than that in non-state-controlled listed companies.⁶⁴

Nonetheless, there is a greater pay increase than net profit growth among Chinese listed companies. A 2012 survey shows 239 companies listed on SSE and SZSE increased executive compensation despite a fall in net profit.⁶⁵ 151 Central SOEs increased their executive pay by 7.25%, although they experienced a decline in profitability by 13.89%.⁶⁶ In the case of Liaoning Huajin Tongda Chemicals Company Limited, the net profit decreased significantly by 97.67% and the stock price dropped by 10.39% in 2012, while the executive pay was increased by 23.60% and the aggregate executive pay accounted for 51.93% of the net profit of the firm.⁶⁷ In the case of Fangda Special Steel Technology Company Limited, the pay of the chairman of the board increased significantly by 658% year-over-year while the net profit declined by 27.61%.⁶⁸ Table 3 displays the top-ten payers for executive compensation among A-share Companies in

⁶⁰ “H shares” refers to the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange.

⁶¹ *The List of Top Executive Pay in Chinese Listed Companies 2011*, FORBES (Chinese Net) (June 27, 2012), http://www.forbeschina.com/review/201206/0017913_all.shtml.

⁶² *Lower Pay for Executives in Central SOEs*, CHINANEWS (Feb. 22, 2011), <http://finance.ifeng.com/news/20110222/3450412.shtml>.

⁶³ Guidance on Regulating the Compensation of Managers in Key State-owned Enterprises, *supra* note 56.

⁶⁴ *The Growth Rate of Executive Compensation in Listed Companies Declined*, MERCER (Oct. 11, 2012), available at <http://cn.mercer.com/press-releases/2011-China-ER-and-LTI-Trends>.

⁶⁵ Yu Ping, *239 Listed Companies Increased Executive Compensation Despite Declining Profits*, CHINA SEC. J. (Mar. 29, 2013), http://www.cs.com.cn/ssgs/gsyj/201303/t20130329_3926260.html.

⁶⁶ *Id.*

⁶⁷ *The List of Top Executive Compensation in Listed Companies 2012*, GUANGZHOU DAILY (Mar. 13, 2013), http://news.xinhuanet.com/fortune/2013-03/09/c_124435943.htm.

⁶⁸ Yu Yaofeng, *The Annual Compensation of the Chairman of the Board of the Fangda Special Steel Technology Achieved 15.16 Million*, NAT'L BUS. DAILY (Feb. 2, 2013), <http://finance.sina.com.cn/money/cfsgs/20130207/030414525135.shtml>.

2012 and shows that there is a greater pay increase than the profit increase in a number of companies.⁶⁹

Indeed, a publicly traded firm's profitability is affected by various factors, such as the overall performance of the economy and industry. Therefore, it is hard to estimate the optimal scale of excessive executive pay or to draw a correlation between pay and performance. Nonetheless, increasing executive pay despite the decline in profit deserves a certain level of regulatory scrutiny, as it would inevitably increase public concern on effective corporate governance of a company and dent public confidence in the company.

Table 3: Aggregate Top-Ten Compensation Firms in A-share Companies 2012⁷⁰

Rankings	Name of the securities	Increased compensation (%)	Increased annual net profit (%)
1	Vanke-A	-3.93	30.40
2	Ping An Bank	59.3	30.39
3	Fangda Special Steel	72.73	-27.61
4	TCL Group	-7.28	-21.43
5	Xingye Securities	39.33	9.42
6	AVIC Real Estate	28.66	28.66
7	Sanyou Chemical	-13.67	-13.67
8	Metersbonwe	-23.72	-29.55
9	Tianhong Shopping	-4.12	2.4
10	Huawen Media	-14.67	5.35

⁶⁹ For example, the companies ranked No. 2, 3 and 5 in Table 3 show a greater pay increase than profit increase.

⁷⁰ This table is drafted based on the *List of Top Executive Compensation in Listed Companies 2012*, *supra* note 67. It is worth noting the aggregate compensation reflects only those amounts reported in the firms' annual summary compensation. It omits some significant compensation, such as pension schemes and on-duty consumption. This table displays the figure for A-share Companies listed on the SSE and the SZSE.

2. *The Prevalence of Non-Equity and Short-term Compensation*

A well-designed compensation package with adequate incentives is considered a way to reduce agency costs and to align the interests of executives with those of shareholders.⁷¹ In modern corporations, executive compensation is typically a mixture of various components.⁷² It is grouped into three basic categories: (1) salary and benefits that do not depend on the firm's performance; (2) stock options and other incentive compensation that is based on the performance of the firm's stock price; and (3) bonuses and other incentive compensation that is based on the firm's performance according to specified accounting metrics.⁷³ The most important reward for managers of publicly traded companies today is equity compensation, e.g., stock options, restricted stock and stock appreciation rights.⁷⁴ In theory, equity compensation is considered the most effective tool for aligning the interests of executives and shareholders⁷⁵ as "the market value of the stock reflects the present value of the entire future stream of expected cash flows."⁷⁶ If CEOs own a large percentage of corporate equity, the generally weak link between cash compensation and corporate performance would be less troubling.⁷⁷ Evidence from Chinese listed companies also proves that there is a positive correlation between firm performance and the number of stock options held by the managers.⁷⁸ Nonetheless, salary and other non-performance-based compensation schemes lack incentives that align the interests of managers and shareholders and they can cause those interests to further diverge.⁷⁹

⁷¹ See David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 618 (2011).

⁷² BRUCE R. ELLIG, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* (New York 2002), at ch. 1 (noting that the five basic compensation elements are: salary, employee benefits, short-term incentives, long-term incentives, and perquisites).

⁷³ BAINBRIDGE, *supra* note 7, at 113.

⁷⁴ KRAAKMAN ET AL., *supra* note 3, at 75.

⁷⁵ See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, 68 HARV. BUS. REV., no. 3, 1990, at 138, 153.

⁷⁶ MICHAEL C. JENSEN, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* 146 (2000).

⁷⁷ *Id.*

⁷⁸ Zhou Jianbo & Sun Jusheng, *The Research on Governance Effect of Top-management Stock Incentive-Empirical Evidence from Chinese Listed Companies*, 5 ECON. RES. J. 74, 81-82 (2003).

⁷⁹ BAINBRIDGE, *supra* note 7, at 113.

A 2011 study finds the long-term performance plan was the most heavily-weighted element in the CEO pay package in 300 of the largest U.S. companies, making up 27.7% of the average CEO's total compensation.⁸⁰ A 2012 survey shows 76% of a sample of 233 companies in the Standard & Poor's 500 (S&P 500) Index adopted the stock options scheme; 81% adopted the performance long-term incentive plan and 58% had the restricted stock scheme.⁸¹

In contrast to its U.S. counterpart, there is much less usage of equity-based compensation in China.⁸² At present, the primary source of remuneration of executives in listed companies is non-equity compensation—salary and annual bonus. Among the largest 100 companies listed on SSE and SZSE, only 26 companies employed equity incentives for senior management and merely 13 had stock ownership plan for employees.⁸³ In particular, as executives in SOEs are generally appointed by the government and frequently reappointed to other government bodies after a short term, SOEs tend not to grant long-term equity incentives but short-term incentives for executives. From 2008 to April 2011, the listed companies that employed equity incentives (including stock options and restricted stock) were mainly private-controlled companies, but not state-controlled companies.⁸⁴ In 2011, only 18 state-controlled listed companies disclosed the adoption of equity incentives.⁸⁵

There are several contributing factors that led to the prevalence of non-equity compensation in China. As discussed,⁸⁶ China took a long time to embrace equity compensation. Equity compensation was not widely adopted by Chinese companies until 2006. At present, a listed company must inform and file the equity incentive schemes to the CSRC, the stock

⁸⁰ *The Wall Street Journal/Hay Group 2011 CEO Compensation Study*, HAY GROUP, available at <http://www.haygroup.com/ww/downloads/details.aspx?id=33830>.

⁸¹ See *Executive Rewards 2012: Global Trends*, MERCER, available at http://www.mercer.com/wbdownload.dyn?wcSession=14580550&nmeDownloadPath=/attachments/English/120523_Mercer_Global_ER_trends_webcast_final.pdf, at 6 (This study is based on a sample of 233 companies in the S&P 500 Index.).

⁸² Rong, *supra* note 13, at 136.

⁸³ PROTIVITI, *supra* note 40, at 10.

⁸⁴ *The Growth Rate of Executive Compensation in Listed Companies Declined*, *supra* note 64.

⁸⁵ *Id.*

⁸⁶ See *supra* text accompanying notes 32–35.

exchange and local securities regulatory authority.⁸⁷ Especially, the state-controlled listed companies need to obtain consent from relevant regulatory authorities on the proposed equity incentive before the proposal is submitted to the shareholders' general meeting for approval.⁸⁸ These companies also need to fulfill special corporate governance requirements in order to adopt equity incentives.⁸⁹

Moreover, Chinese law takes a conservative view towards equity incentives. Under PRC Company Law,⁹⁰ companies are only allowed to repurchase shares from employees for up to 5% of the issued shares in order to underwrite equity incentives for employees.⁹¹ For state-controlled listed companies that grant equity incentives to executives for the first time, only 1% of the total shares are permitted to issue stock option.⁹² This figure is even lower than that in Germany, where up to 10% of the issued shares is allowed to underwrite employee equity incentive plans.⁹³

3. Grey Income, On-duty Consumption and Political Reward

Grey income (*huisheshouru*) for executives has long attracted a great deal of attention in China. There is a concern that the disclosed aggregate executive compensation in annual reports does not reflect the actual income

⁸⁷ China Securities Regulatory Commission, Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation), ZHENGJIANGONGSIZI 2005, No. 151, art. 33.

⁸⁸ Notice of the State-Owned Assets Supervision and Administration Commission of the State Council and the Ministry of Finance on Issuing the Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic), GUOZIFAFENPEI 2006, No. 175; The Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic), art. 25.

⁸⁹ For example, Article 5 of the Trial Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic) provides that, in order to adopt the equity incentives, the compensation committee of state-controlled listed companies must consist of outside directors only and the board of directors must consist of at least half of outside directors.

⁹⁰ P.R.C. Company Law 2006, art. 143.

⁹¹ Before the revision of the P.R.C. Company Law in 2006, a company was permitted to repurchase shares only if the registered capital was reduced or when the company merged with another company holding shares in this company.

⁹² See *supra* note 87, at art. 14.

⁹³ KRAAKMAN ET AL., *supra* note 3, at 76 (noting that Germany only recently allowed publicly traded companies to repurchase up to 10% of their outstanding shares in order to underwrite stock option compensation plans).

of executives, as it omits grey income, such as hidden payments, subsidies and extra bonuses. As far as SOEs in monopolized industries are concerned, a major source of grey income is various kinds of subsidies,⁹⁴ such as housing allowance and shopping vouchers. The average take-home income of employees in these monopolized industries is much higher than that in other industries as well.⁹⁵

On-duty consumption (*zaizhixiaofei*) in the form of travel expenses, entertainment fees, overseas conference fees and communication expenses also constitutes a substantial component of executive income, especially those in SOEs.⁹⁶ A study of 1,320 Chinese listed companies found that the aggregate amount of on-duty consumption spent by executives was 2 to 50 times their average compensation between 2002 and 2009.⁹⁷ The ratio has been increasing in recent years.⁹⁸ Also, evidence shows a negative correlation between on-duty consumption and firm performance in companies listed on the SSE and SZSE. In other words, as on duty consumption increases, company performance decreases and vice versa.⁹⁹

The prevalence of on-duty consumption has its origins in China's distinct legal and political institutions and the lack of transparency. First of all, listed companies are not required to disclose executives' on-duty consumption by law. Also, the corporate leadership appointments in SOEs are made in a highly institutionalized sharing arrangement between the Party and SASAC.¹⁰⁰ The appointment of senior executives in SOEs is usually made by the Organization Department of the Communist Party of China Central Committee (*zhonggongzhongyangzuzhibu*) as well as the

⁹⁴ See Ding Shuo, *Preliminary Studies of Grey Income in China*, 10 SPECIAL ZONE ECONOMY 268, 268 (2007).

⁹⁵ *Id.*

⁹⁶ See Liang Tong-Ying, Feng Li & Chen Xiude, *Pyramid Structure, Executive Perks and Corporate Value: Empirical Evidence from Chinese Listed Companies*, 11 J. SHANXI FIN. & ECON. UNIV. 75, 76 (2012) (noting that on-duty consumption constitutes a significant part of the executive's pay). Qie Jianrong, *National Audit Office Disclosed Illegal Distribution of Welfare by Central SOEs*, LEGAL DAILY (May 21, 2011), http://www.legaldaily.com.cn/index_article/content/2011-05/21/content_2669997.htm?node=5955.

⁹⁷ Rong, *supra* note 13, at 133.

⁹⁸ *Id.*

⁹⁹ Feng Genfu & Zhao Yuhang, *Manager Compensation, On-duty Consumption and Firm Performance*, 6 CHINA INDUS. ECON. 147, 156 (2012).

¹⁰⁰ Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 737–38 (2013).

SASAC. These executives are paid like bureaucrats and their pay is considered a highly sensitive issue to the Party. Thus, SASAC generally does not disclose executive pay of SOEs, not to mention the grey income.¹⁰¹ Arguably, the lack of transparency makes it possible for executives to seek grey income by way of corruption, accounting fraud or abuse of powers.

Moreover, as executive pay of SOEs is subject to a cap set by the SASAC, it is not surprising that executives rely on political rewards as their incentives. In fact, it is very common for top executives in Central SOEs to hold vice ministerial rank.¹⁰² It is also a general practice that these executives serve as senior government officials such as provincial governors and members of the State Council after their term of office in the SOEs.¹⁰³

4. *The Pay Gap Between Executives and Employees*

The disparity in compensation between executives and employees is another typical concern on executive pay. In the U.S., executives are frequently accused of getting vastly more than other employees in the company. CEOs of S&P 500 Index Companies earned on average 354 times the average wages of workers in 2012.¹⁰⁴ It is worth noting that the pay gap between executives and ordinary workers in China seems more reasonable than its American counterpart. Empirical evidence from 1,672 Chinese listed companies finds the aggregate executive pay was 12.83 times the average pay to ordinary employees in 2010.¹⁰⁵ Companies which had 4 to 5 times pay gap accounted for 55.02% in the dataset.¹⁰⁶

¹⁰¹ Jiang Yunzhang, *Ineffective Rules to Cap Executive Pay of Central SOEs*, ECON. OBSERVER (July 27, 2013), <http://finance.sina.com.cn/china/20130727/002616258459.shtml>.

¹⁰² *The Appointment and Selection of Top Executives in Central SOEs*, CHINA NEWS WEEK (June 3, 2013), <http://news.163.com/13/0603/12/90ENTMCN0001124J.html>.

¹⁰³ Jiang Chao & Wang Chen, *Ex-Executives in SOEs Serve in the State*, CAIXIN (Mar. 20, 2013), <http://special.caixin.com/2013-03-20/100503822.html>.

¹⁰⁴ *CEO-to-Worker Pay Ratios Around the World*, AFL-CIO, http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/CEO-to-Worker-Pay-Gap-in-the-United-States/Pay-Gaps-in-the-World#_ftn1 (last visited May 14, 2014).

¹⁰⁵ Gao Minghua, *Expanded Pay Gap Between Executives and Ordinary Employees*, 11 DIRECTORS & BOARD 109 (2011).

¹⁰⁶ *Id.*

Nonetheless, there is still public perception that the pay gap is too big in China, given that the overall wage level of Chinese workers is relatively low. One extreme example is that the pay of the general manager of the Ping An Insurance Group was 2,751 times the average national worker pay of Chinese enterprises in 2007.¹⁰⁷ Moreover, the pay gap has increased considerably over time, especially in state-controlled listed companies. The gap between executive pay of the state-controlled listed companies and the average worker pay of Chinese enterprises increased from 12.7 times in 2002 to 24.3 times in 2006.¹⁰⁸ In 2011, the average CEO pay of state-controlled listed companies was 15.9 times the average worker salaries in public sector.¹⁰⁹ The increasing pay gap within these companies inevitably increases public concern, since their profitability is not mainly contributed by executives, but largely by the fact that they are in monopolized sectors, such as electricity, telecommunication, and petroleum.

III. WHY ARE THERE PROBLEMATIC PAY PRACTICES?

A. Agency Problems in Setting Executive Pay

Agency costs arise from separation of ownership and control.¹¹⁰ In modern corporations, agency costs typically reflect the divergence between employees and shareholders, as well as the monitoring and bonding expenditures undertaken to reduce that divergence. Leading managerial power theorists Lucian Bebchuk and Jesse Fried argue that director behavior in deciding executive pay is subject to an obvious agency problem.¹¹¹ Specifically, directors would not automatically seek to maximize shareholder value in setting executive compensation and there is potential divergence between executives and shareholders. They listed ten

¹⁰⁷ Zhao Peng, *Report Finds Executive Pay Was Increased by 370 Thousands While Employee Pay Was Increased by 30 Thousands Only*, BEIJING TIMES (Oct. 17, 2012), <http://finance.sina.com.cn/china/20121017/014913387940.shtml>.

¹⁰⁸ Ju Jinwen, *SOE Executive Pay System Need Top-Down Design*, 9 DIRECTORS & BOARDS 96, 97 (2012).

¹⁰⁹ *Id.*

¹¹⁰ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹¹¹ Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 17(4) J. APPLIED CORP. FIN. 8, 12 (2005).

possible incentives that make directors favor the company's executives, including, incentives to be re-elected, CEOs' power to benefit directors, friendship and loyalty, collegiality and authority, cognitive dissonance and solidarity, the small cost of favoring executives, ratcheting, limits of market forces, new CEOs and firing of executives.¹¹²

In Chinese context, the distinct pattern of ownership and control has implications for the agency problem and the determination of executive compensation.¹¹³ Since 1990s, the economic growth and the development of capital market have been state-led.¹¹⁴ The current legal mechanisms and corporate governance institutions are, to a certain extent, designed and set up for the purpose of maintaining the control of the government.¹¹⁵ Thus, the Chinese government retained firm control over SOEs, especially those in national security-related industries, natural monopolies sector providing important public goods and services, and pillar industries.¹¹⁶ As most listed companies are transformed from former SOEs, companies controlled by a single state shareholder (the "one-dominant controlling shareholder phenomenon") are very common at present (the so-called "yigududa"). To illustrate, the largest controlling shareholder, who is usually the state shareholder, owns the majority of shares in a company.¹¹⁷

In contrast to the U.S. which features a stock market-centered capital market, or Germany and Japan that rest on a bank-centered capital market,¹¹⁸ China is characterized by a capital market dominated by

¹¹² *Id.*

¹¹³ M. Conyon & L. He, *Executive Compensation and Corporate Governance in China*, CORNELL INST. COMPENSATION STUDIES 2011-003, at 8 (2011), <http://digitalcommons.ilr.cornell.edu/ics/6>.

¹¹⁴ Since late 2005, China has been implementing a nation-wide reform for listed companies in an effort to reduce the ratio of state-owned shares. See China Securities Regulatory Commission, *Governing Measures for Reforming the Ownership Structure of Listed Companies*, ZHENGJIANFA 2005, No. 86.

¹¹⁵ Ronald J. Gilson & Curtis J. Milhaupt, *Economically Benevolent Dictators: Lessons for Developing Democracies*, 59 AM. J. COMP. L. 227, 260-61 (2011) (noting that the laws were enacted or revised for the purpose of the SOE reform).

¹¹⁶ For corporatization of SOEs in China, see, e.g., Donald C. Clarke & Nicholas C. Howson, *Pathway to Minority Shareholder Protection: Derivative Actions in the People's Republic of China*, in THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 245-49 (Dan Puchniak et al. eds., 2012).

¹¹⁷ Helen Hu et al., *Internal Governance Mechanisms and Firm Performance in China* (Jan. 15, 2009), ASIA PACIFIC J. MGMT. (forthcoming), available at <http://ssrn.com/abstract=1328684>.

¹¹⁸ Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 1329 (2001).

controlling state shareholders.¹¹⁹ Empirical evidence from the largest 100 A-share Companies shows the highest shareholding ratio of the largest five shareholders reached 86%, and the average shareholding ratio was 43% in 2012 (Table 4).¹²⁰ Significantly, SOEs were the largest shareholders in more than 80% of the largest 100 companies in the past five years (Table 5).¹²¹ Although the average shareholding ratio of the largest shareholders declined slightly year by year, it remained at an average of around 40% in the past three years.¹²² This reveals a very high concentration level of state shareholdings of Chinese listed companies.

In theory, the dispersed or concentrated nature of the shareholder body may influence the role of the board in public companies.¹²³ It may affect what the board does and to whom it is accountable.¹²⁴ In dispersed shareholding companies, the most pressing agency problem exists between management and shareholders as a class; while in concentrated shareholding companies, the agency relationship is more problematic between majority and minority shareholders.¹²⁵ As China has a high concentrated ownership structure, the agency relationship between controlling shareholders and non-controlling shareholders is problematic. In the realm of executive compensation, the key concern for minority shareholders is whether controlling shareholders exercise their corporate rights to promote only their own interests or those of the shareholders as a whole in the negotiation or setting of executive compensation.

¹¹⁹ Helen Hu et al., *supra* note 117.

¹²⁰ PROTIVITI, *supra* note 40; *see also* Jiang Jianxiang, *The Ownership Structure of Chinese SOEs and Their Legal Reforms*, 6 SCI. L. 131, 133 (2012).

¹²¹ PROTIVITI, *supra* note 40.

¹²² *Id.*

¹²³ Paul L. Davies & Klaus J. Hopt, *Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 303 (2013).

¹²⁴ *Id.*

¹²⁵ *Id.* at 304.

Table 4: The Largest Shareholder Blocks in the Top 100 Chinese Listed Companies 2010–2012¹²⁶

	2010	2011	2012
Average %	46	45	43
Maximum %	86	86	86
Minimum %	20	19	20

Table 5: The State Ownership of the Top 100 Chinese Listed Companies 2008–2012¹²⁷

	2008	2009	2010	2011	2012
State shareholder being the largest shareholder %	85	86	88	86	84
State shareholder being the 2nd largest shareholder %	42	32	34	48	49
State shareholder being the 3rd largest shareholder %	29	23	24	37	39

B. Arm's Length Dealing by the Board?

As discussed, there are two major camps in scholarship on executive compensation: the Board Capture theory which claims that CEOs have effectively “captured” the boards of directors who nominally set their pay; and the Optimal Contracting theory which argues that the system of executive compensation is largely working fine because most boards are able to negotiate the best possible compensation arrangements.¹²⁸ The Chinese story seems not to support the Optimal Contracting theory, but

¹²⁶ PROTIVITI, *supra* note 40.

¹²⁷ The table is drafted based on the Protiviti's *Corporate Governance Assessment Summary Reports on the Top 100 Chinese Listed Companies* from 2006 to 2012 (The dataset is the top 100 Chinese listed companies based on market value. The aggregate market value of the selected top 100 listed companies in the 2012 report accounted for 60% of the total market value in China's A-share market; the assets accounted for 90% of the total asset value of A-share Companies and the profits accounted for 80% of the total profit of A-share Companies.). For the Assessment Methodology, see PROTIVITI, *supra* note 40.

¹²⁸ See *supra* text accompanying notes 7–9.

supports the Board Capture theory. As a practical matter, the setting of executive compensation in Chinese companies does not seem to be guided by shareholder interests and does not operate at arm's length from the executives whose pay they set.

First, under PRC Company Law, the right to appoint directors is vested with the shareholders' general meeting,¹²⁹ but the law does not specify the ways on how directors are nominated. Procedure of nomination and appointment of directors are left to be determined by the company articles of association. Under the CSRC Opinion, the board of directors, the supervisory board, or shareholders who separately or collectively have more than 1% of shareholdings of the company are eligible to nominate independent directors.¹³⁰ The PRC Company Law provides that shareholders with more than 3% of shareholdings (separately or collectively) of the companies have the right to nominate directors.¹³¹ The appointment of directors is determined by ordinary resolution at a shareholder general meeting, which requires the support of more than half of the shares with voting rights of the shareholders or their agents present at the meeting.¹³² Therefore, even if one shareholder who holds more than half of the voting rights, votes in favor of the board proposal, the resolution so passed will be effective.¹³³ These articles enable controlling shareholders to control the appointment of directors.

In practice, it is customary for shareholders to nominate directors. The board would generally have an internal discussion with controlling shareholders and large shareholders on the nomination of directors.¹³⁴ However, as there is no disclosure requirement on how directors are nominated, it is not clear how shareholders and the board bargain over the nomination of directors. While the factors for consideration vary from firm to firm, arguably, the shareholding of the nominators would be an

¹²⁹ P.R.C. Company Law 2006, arts. 38 & 100.

¹³⁰ China Securities Regulatory Commission, Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies 2001, art. 4(1).

¹³¹ P.R.C. Company Law 2006, art. 103.

¹³² *Id.* at art. 104.

¹³³ Wei Cai, *Path Dependence and Concentration of Ownership and Control of Companies Listed in China*, 20(8) INT'L CO. & COM. L. REV. 281, 291 (2009).

¹³⁴ Xiong Jinqiu, *Improve the System of Nomination of Directors*, NAT'L BUS. DAILY, June 2, 2012, <http://ntt.nbd.com.cn/articles/2012-06-02/658010.html>.

influential factor in the nomination discussion. In the concentrated shareholding context, since the board is dominated by controlling shareholders, it will likely act as the protector of the controlling shareholders, rather than the shareholders as a class. The controlling shareholders can always have their wishes at the meeting and make the meeting into a mere formality.¹³⁵ This arrangement inevitably creates a very high-powered conflict of interest on the board.

Second, as noted, executives of SOEs are usually appointed by the state and it is a general practice for ex-executives to serve as government officials after their term of office.¹³⁶ According to a 2007 survey, almost 27% of the CEOs in a sample of newly partially privatized SOEs were former or current government bureaucrats.¹³⁷ Presumably, given their political connection with the Party, these executives would have strong influence over the board and be able to reward themselves with better pay packages.¹³⁸ Empirical evidence also shows that executive pay is higher, and less sensitive to performance, when executives have more power.¹³⁹ Meanwhile, the effect of incentives is less, when controlling shareholders have more controlling powers.¹⁴⁰

Third, as observed by Professors Bebchuk and Fried, even in companies with diversified shareholding structure, directors would prefer to go along with arrangements that favor the company's top executives, given a variety of economic incentives and psychological factors, such as

¹³⁵ Hui Huang, *Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis*, 27 B.F.L.R. 619 (2012).

¹³⁶ See *supra* text accompanying notes 102–03.

¹³⁷ Joseph P.H. Fan, T.J. Wong & Tianyu Zhang, *Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms*, 84 J. FIN. ECON. 330, 330 (2007).

¹³⁸ To prevent controlling shareholders from exercising influence over the nomination process, Article 20 of the P.R.C. Corporate Governance Code provides that “the nominated candidates shall process relevant expertise and decision-making, as well as the ability to supervise the board.” “Controlling shareholders shall not approve the nomination of directors or appoint executives without the approval of the general meeting.” Article 31 of the code also provides that cumulative voting must be employed in listed companies which have controlling shareholders who possess more than 30% shareholdings. Nevertheless, as the code is disciplinary and enforceable by law, compliance with the code is an issue in practice.

¹³⁹ Quan Xiaofeng, Wu Shinong & Wen Fang, *Management Power, Incentives and Compensation*, 11 ECON. RES. 73, 85 (2010).

¹⁴⁰ Xia Jijun & Zhang Yan, *The Conflicts Between Control Rights and Incentives: An Empirical Analysis on the Effect of Stock Incentives in China*, 3 ECON. RES. J. 87, 97 (2008).

collegiality, team spirit and friendship.¹⁴¹ In China, although a director is excluded from participating in the board's evaluation of his or her own compensation package,¹⁴² there is no reason to assume that the board of directors would not consider the above factors while fixing executive compensation. Especially, as Chinese law does not require separation of the CEO and the chairman of the board, it is very common for a director or a chairman of the board to serve as the general manager or the CEO simultaneously.¹⁴³ Arguably, these directors are able to exercise considerable influence over the design of their own remuneration, given their power in the company.

C. Ineffective Compensation Committees

In the U.S. and the U.K., the compensation committee plays a significant role in designing appropriate pay programs that are in the company's best interests. In comparison, Chinese laws seem inadequate in addressing the role of compensation committees in the setting of executive pay.

First, unlike the U.S. where the compensation committee is compulsory for listed companies,¹⁴⁴ Chinese listed companies are not obliged to set up compensation committees.¹⁴⁵ In the U.K., compensation committees have delegated responsibility for reviewing and approving compensation for senior executives.¹⁴⁶ It sets the compensation for all executive directors and the chairman, and recommends to the board the compensation levels for senior management immediately below board level.¹⁴⁷ It is responsible for appointing consultants in respect of executive

¹⁴¹ Bebchuk & Fried, *supra* note 111, at 10.

¹⁴² P.R.C. Corporate Governance Code 2002, art. 71.

¹⁴³ Wei & Minghua, *supra* note 17, at 94.

¹⁴⁴ NYSE LISTED COMPANY MANUAL § 303A.05, <http://nysemanual.nyse.com/lcm/> (last visited May 14, 2014).

¹⁴⁵ P.R.C. Corporate Governance Code 2002, art. 52. It provides that "the board of a listed company may, according to the shareholder resolution, establish specialized committees such as the strategy committee, the audit committee, the nomination committee and the compensation committee."

¹⁴⁶ These duties include setting compensation values and overseeing corporate information. Members in the committee also have an implied duty of care and loyalty.

¹⁴⁷ U.K. Corporate Governance Code § D.2.2 (2012).

director compensation.¹⁴⁸ However, the PRC Company Law is silent on the roles and duties of the compensation committee.¹⁴⁹

Also, the U.K. Corporate Governance Code specifies the setting of the performance-related remuneration for executive directors (e.g. variable compensation should be reclaimable in exceptional circumstances of misstatement or misconduct)¹⁵⁰ and regulations on the so-called “reward for failure issue” (avoiding the payment of excessive compensation when a director is removed during his or her term of office).¹⁵¹ On the contrary, there is no such regulation under PRC Corporate Governance Code. The code simply provides a general provision stating that the main duties of the remuneration and appraisal committee are, “(1) to study the appraisal standard for directors and management personnel, to conduct appraisal and to make recommendations; and (2) to study and review the remuneration policies and schemes for directors and senior management personnel.”¹⁵² Meanwhile, although the CSRC Measures state that the compensation committee is responsible for drafting the equity incentive schemes, the committee has no deciding power over the schemes and the approval right is left with the board.¹⁵³ Due to the legislative gaps, many compensation committees are operating without a clear role and objective.

Second, independence of compensation committees is an important factor in ensuring fair executive compensation. Many jurisdictions require compensation committees to operate on an independent basis. Under the NYSE Listed Manual, members in the compensation committee must consist of independent directors only.¹⁵⁴ The U.K. Corporate Governance Code provides that “a remuneration committee [shall consist] of at least

¹⁴⁸ U.K. Corporate Governance Code § D.2 (2012).

¹⁴⁹ Article 117 of the P.R.C. Company Law merely provides that a company shall make regular disclosure on the compensation of directors, supervisor and senior management.

¹⁵⁰ U.K. Corporate Governance Code § A (2012).

¹⁵¹ U.K. Corporate Governance Code § D.1.4–1.5 (2012).

¹⁵² P.R.C. Corporate Governance Code 2002, arts. 52, 56 & 70.

¹⁵³ China Securities Regulatory Commission, Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation), ZHENGJIANGONGSIZI (2005), No. 151, art. 28.

¹⁵⁴ NYSE LISTED COMPANY MANUAL, *supra* note 144, § 303A.05 (stating that the compensation committee of an exchange-listed company must be comprised of independent directors. Only listed companies in which a shareholder or group of shareholders acting together own 50 percent or more of the stock are exempt from this requirement.).

three, or in the case of smaller companies two, independent non-executive directors.”¹⁵⁵

Nevertheless, the PRC Corporate Governance Code simply requires a majority of independent directors in the compensation committee.¹⁵⁶ There is no explanation as to what constitutes “majority” and there is no standardized procedure on the appointment of chairman and members of the committee either. It is argued that a simple majority of independent directors is not enough to ensure the committee functions in a truly independent fashion. Even if the majority of committee members are independent directors, there is a reasonable doubt as to how they could determine the executive pay independently and provide impartial advice, as the independent directors of the compensation committee have to work in a collegiate manner with the executives in a board structure.¹⁵⁷ In fact, independent directors have long been accused of being too close to executives, and thus biased in favor of high awards.¹⁵⁸

A 2007 survey shows 89.14% of the companies listed on SZSE set up compensation committees. Among them, independent directors accounted for 60.7% in compensation committees.¹⁵⁹ 92% of the companies listed on SSE established compensation committees and 87% of them had independent directors being the majority of the compensation committees.¹⁶⁰ A 2008 survey indicates that more than half of the A-share Companies did not disclose the composition of compensation committees

¹⁵⁵ U.K. Corporate Governance Code § D.2.1 (2012).

¹⁵⁶ P.R.C. Corporate Governance Code 2002, art. 52.

¹⁵⁷ Ruth Bender, *Paying for Advice: The Role of the Remuneration Consultant in U.K. Listed Companies*, 64 VAND. L. REV. 361, 370 (2011).

¹⁵⁸ See, e.g., Brian G.M. Main et al., *The CEO, the Board of Directors and Executive Compensation: Economic and Psychological Perspectives*, 4 IND. & CORP. CHANGE 293, 326–28 (1995); Brian G.M. Main & James Johnston, *Remuneration Committees and Corporate Governance*, 23 ACC. & BUS. RES. 351, 534–36 (1993); Kevin J. Murphy, *Executive Compensation*, 3 HANDBOOK OF LABOR ECONOMICS 2485, 2517–18 (Orley Ashenfelter & David Card eds., 1999), cited in Ruth Bender, *Paying for Advice: The Role of the Remuneration Consultant in U.K. Listed Companies*, 64 VAND. L. REV. 361, 370 (2011).

¹⁵⁹ Shenzhen Stock Exchange, *Practices of Independent Directors, Audit Committees and Remuneration Committees in Companies Listed on Shenzhen Stock Exchange 2007*, http://news.xinhuanet.com/fortune/2008-06/03/content_8307969.htm.

¹⁶⁰ Wu Minghui, *Practices of Audit Committees and Remuneration Committees in Companies Listed on Shanghai Stock Exchange 2007*, available at <http://business.sohu.com/20080604/n257262589.shtml>.

and among those companies that disclosed the composition of compensation committees, only 59% had independent directors being the chairmen of the compensation committees.¹⁶¹ However, the compensation committees play a limited role in executive pay arrangements in the sense that they can only advise on pay issues, and have no deciding power over executive remuneration. Evidence also indicates compensation committees only advised on executive pay issues one to two times a year on average.¹⁶²

D. Directors' Duties

Duties of directors (including statutory duties and common law duties) play an important role in mitigating the shareholders' agency problem as well as the setting of executive pay. While the connotation of directors' duties varies from jurisdiction to jurisdiction, the duty of care and the duty of loyalty are generally considered the core duties owned by directors to the shareholders and the corporation.¹⁶³ Directors owe a duty of care to act with reasonable skill, care and diligence.¹⁶⁴ This duty is mostly concerned with how directors perform their responsibilities.¹⁶⁵ Directors also owe a duty of loyalty in that directors are required to exercise their institutional power over corporate processes or property in a good-faith effort to advance the interests of the company.¹⁶⁶ Particularly, in the negotiation of executive pay, directors have a duty to exercise reasonable skill, care and diligence, as well as to pursue the best interests of the corporation and shareholders.¹⁶⁷ Meanwhile, shareholders who believe they have been harmed by the acts of the directors in the designing of an executive package, have a right to bring derivative or direct actions to recover excessive or inappropriate compensation.¹⁶⁸

¹⁶¹ *Towers Perrin Report on Executive Compensation in Chinese Listed Companies 2008*, CEIBS BUS. REV. 1 (2010), <http://www.ceibsonline.com/commentary/show/index/classid/2/id/871>.

¹⁶² See PROTIVITI, *supra* note 40, at 18.

¹⁶³ See PAUL DAVIS, *PRINCIPLES OF MODERN COMPANY LAW* 488 (Sweet & Maxwell 2008).

¹⁶⁴ U.K. Companies Act 2006 § 174.

¹⁶⁵ JAMES A. FANTO, *DIRECTORS' & OFFICERS' LIABILITY* § 2:2.3 (2d ed. 2010), *cited in* Daniel Crane, *Excessive Compensation Without a Remedy*, 45 ARIZ. ST. L.J. 281, 287 (2013).

¹⁶⁶ WILLIAM T. ALLEN ET AL., *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 295 (3d ed. 2009).

¹⁶⁷ JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 136 (7th ed. 2008).

¹⁶⁸ *Id.* at 136–61.

Fiduciary duties of directors were not officially introduced and codified in China until 2006, when the revised PRC Company Law was enacted.¹⁶⁹ Article 148 of the PRC Company Law states that the directors, supervisors and senior executives of a company shall comply with the laws, administrative regulations and the articles of association of the company and bear the duties of loyalty and due diligence towards the company. Regrettably, the law does not expressly define the duty of loyalty (*zhongcheng yiwu*). It simply provides a list of prohibited activities by directors and officers to assist practitioners in understanding the connotation of the duty of loyalty.¹⁷⁰ These activities include: (1) acceptance of bribes or illegal income; (2) seizure of company asset; (3) misappropriation of company funds; (4) opening accounts with the company capital in the (director's) own name or others name; (5) providing capital to other parties with the company's capital or providing security to third parties with the company's asset, without authorization from the constitution, or consent from shareholders' general meeting or the board of directors; (6) conclusion of contracts or conducting self-dealing transaction with the company, without consent from shareholders; (7) expropriation of company opportunities without consent from shareholders; (8) conducting competitive business with the company; and (9) breaches of confidentiality.

The duty of diligence (*qinmian yiwu*) is not defined clearly under the PRC Company Law either. To help the public have a better understanding of the duty, Article 98 of the CSRC Guidelines for Articles of Association of Listed Companies 2006 specifies that directors' duty of diligence includes: (1) treating all shareholders equally; (2) understanding the business operations of the company; (3) endorsement on the regular reports of the company in written form and ensuring that the disclosed information is true, accurate and complete; and (4) providing information and materials to the supervisory board.

Arguably, the above lists are far from enough to cover all potential situations that fall within the category of the duty of loyalty or the duty of diligence. Especially, they fail to specify directors' duty in compensation

¹⁶⁹ Although the P.R.C. Company Law 2006 introduced duties of directors such as duty of loyalty and duty of diligence, they are statutory duties created by statutory law. They are not equivalent to the fiduciary duty in common law which are developed from the concept of fiduciary and trust.

¹⁷⁰ P.R.C. Company Law 2006, arts. 148 & 149.

negotiations. Although there are catch-all clauses in the PRC Company Law and the CSRC Guidelines, and they include other acts which violate the duty of loyalty or the duty of diligence,¹⁷¹ the above lists are too general to provide clear judicial guidance in proving breach of duties. In particular, since there are a large number of controlling shareholders in Chinese listed companies, detailed rules restraining controlling shareholders' misconduct are crucial in protecting the minority shareholders. Moreover, there is no business judgment rule under Chinese law and the law is silent on the standards required for proving the breach of the duty of diligence and the duty of loyalty. Since Chinese courts lack authority to make or interpret law where no legislative statute exists,¹⁷² the statutory duties alone would not be effective in constraining directors' misbehavior in negotiation of executive pay, or in creating incentives for directors to bargain actively with management over compensation issues.

E. A Non-functioning Supervisory Board

Like Germany and the Netherlands, China also has a two-tier board system, i.e. the board of directors and the supervisory board. However, the supervisory board has long been considered an ineffective mechanism for improving the independence and effectiveness of the board's operations in China. In contrast to its German counterpart which governs the board of directors, a Chinese supervisory board has no authority to nominate, appoint or remove directors and has no decision-making powers in the operation of a company. Although supervisors are allowed to attend board meetings and make suggestions or enquiries to the board, they have no voting rights in board meetings. It only supervises the decision-making process of the board of directors,¹⁷³ and monitors whether directors and managers violate laws or the articles of association.

Moreover, unlike German supervisory boards which are appointed by and may be dismissed by the supervisors,¹⁷⁴ Chinese supervisors are

¹⁷¹ CSRC Guidelines for Articles of Association of Listed Companies 2006, art. 98; P.R.C. Company Law 2006, art. 149.

¹⁷² Statutes and written legal documents are the main sources of law in China.

¹⁷³ P.R.C. Company Law 2006, arts. 54–55.

¹⁷⁴ Cindy A. Schipani & Junhai Liu, *Corporate Governance in China: Then and Now*, 2002 COLUM. BUS. L. REV. 1, 15 (2002).

appointed by and may be dismissed by the shareholders. Under PRC Company Law, the supervisory board must comprise at least three individuals, including representatives of shareholders and employees.¹⁷⁵ The representatives of employees must account for not less than one-third of the supervisors, but it is left for the articles of association to decide the exact number of representative employees.¹⁷⁶ In concentrated shareholding context, it is common for controlling shareholders' representatives to prevail in the supervisory board. Moreover, as the board decides employee compensation, it is questionable whether the supervisory board composing employee representatives would go against the board's proposal on executive pay. Empirical evidence shows the supervisory boards only held an average of five meetings in 2011¹⁷⁷ and most of the supervisory boards agreed to the board's proposals.¹⁷⁸

In addition, under Dutch Corporate Governance Code, the supervisory board has the right to determine the remuneration of the individual members of the management boards, on a proposal made by the remuneration committee.¹⁷⁹ The German legislature has recently considered that the remuneration of managing directors be reserved for the whole supervisory board,¹⁸⁰ while the Chinese supervisory board does not have the authority to decide executive pay.

F. The "Independent" Directors

The independence of the board of directors and the supervisory board has long been a point of contention in Chinese corporate governance. The concept of independent directors was not formally introduced into China

¹⁷⁵ P.R.C. Company Law 2006, art. 118.

¹⁷⁶ *Id.*

¹⁷⁷ *Performance of Directors, Supervisors and Senior Management in Companies Listed on the Shanghai Stock Exchange*, SHANGHAI STOCK EXCHANGE (2011) [hereinafter SHANGHAI STOCK EXCHANGE], <http://www.sse.com.cn/researchpublications/research/c/research20120810f.pdf>, at 4.

¹⁷⁸ *Id.* at 4–6.

¹⁷⁹ Dutch Corporate Governance Code 2008, Principle of Determination and Disclosure of Remuneration & Best Practice provision 11.2.10.

¹⁸⁰ Davies & Hopt, *supra* note 123, at 311, 362.

until 2001.¹⁸¹ By law, the board of directors in listed companies must consist of at least one-third of independent directors.¹⁸² As a practical matter, independent directors are referred by controlling shareholders, directors and executives, nominated by the board, and approved by the shareholders' general meetings. In companies with a concentrated shareholding structure, the controlling shareholders are able to exercise substantial influence over the board and dominate the shareholders' general meeting; therefore, it is difficult for minority shareholders to have a say over the nomination of independent directors. In the realm of executive compensation, if independent directors challenge the executive compensation, they might face the risk of being expelled by the board. Empirical evidence from companies listed on the SSE also indicates that most independent directors agreed to the board proposals. Only 48 out of 3,081 independent directors expressed objections to 36 board proposals¹⁸³ and only 4 objections were made to board proposals on the appointment of executives on average in 2011.¹⁸⁴

Moreover, many independent directors are not appointed on the basis of distinctive skills or interests, but are appointed to build up connections for listed companies and provide useful sources or add value to the companies.¹⁸⁵ Empirical evidence proves most independent directors in Central SOEs are ex-government officials or ex-executives in other SOEs.¹⁸⁶ Arguably, companies led by politically connected CEOs are more likely to appoint bureaucrats rather than professionals to the board,¹⁸⁷ and these independent directors have a natural desire to avoid conflict within the board.

¹⁸¹ Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (promulgated by China Securities Regulatory Commission, Aug. 16, 2001), available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/200708/t20070810_69191.htm (China).

¹⁸² *Id.* at art. 1(3).

¹⁸³ SHANGHAI STOCK EXCHANGE, *supra* note 177, at 8–9.

¹⁸⁴ *Id.* at 8.

¹⁸⁵ See Jing Liao, Martin R. Young & Qian Sun, *Independent Directors' Characteristics and Performance: Evidence from China* (Oct. 14, 2009), available at <http://ssrn.com/abstract=1489088>.

¹⁸⁶ *Annual Reports Reveal that Most of the Independent Directors in Central SOEs are Ex-government Officials or Ex-executives in Other Central SOEs*, NETEASE (May 9, 2011), <http://news.163.com/11/0509/04/73JALS5F00014AED.html>.

¹⁸⁷ Joseph P.H. Fan, T.J. Wong & Tianyu Zhang, *Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms*, 84 J. FIN. ECON. 330, 330 (2007).

IV. THE WAY FORWARD FOR REGULATING EXECUTIVE COMPENSATION

The next question for examination is what legal strategies shall be made to address the concerns over executive pay. In particular, which techniques should be deployed to align the self-interest of executives with the interests of shareholders? As illustrated, the existing arrangement is such that executives, especially state-appointed executives in SOEs, are able to control the board and decide their own pay. Therefore, the major task of the regulator is to ensure that the design of the executive compensation is taken out of the hands of the board as a whole and lodged in the hands of the executives and shareholders as a class.¹⁸⁸

Efforts to regulate executive compensation have ranged widely, including, *inter alia*, implementing taxes, shareholder say-on-pay votes, judicial involvement, institutional shareholder activism, compensation disclosure and compensation recovery (“clawback”) policy.¹⁸⁹ This section examines a few of the possible solutions and discusses whether they have been or will be effective in solving problems with executive pay in China. Some of the proposals made to the CSRC may also have potential value for other jurisdictions in regulating executive compensation.

A. Heightened Disclosure

Disclosure is frequently employed as a response to the growth of executive compensation. This mechanism enables company stakeholders to know and decide whether or not the compensation of executives is fair. The U.S. and the U.K. have well-established disclosure rules. The U.K. requires companies to release all details of executive remuneration in the annual accounts.¹⁹⁰ The U.S. requires listed companies to disclose all compensation paid to the CEO, CFO and the next three highest paid executive officers.¹⁹¹ In recent years, the Securities and Exchange

¹⁸⁸ PAUL DAVIES, INTRODUCTION TO COMPANY LAW 206 (2010).

¹⁸⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

¹⁹⁰ Companies Act, 2006, c. 6, part 15 (Eng.).

¹⁹¹ 17 C.F.R. § 229.402 (2013).

Commission (SEC) Proxy Statement Disclosure Rules have been enhanced several times to improve the disclosure mechanism.¹⁹²

Many scholars have argued that mere disclosure is not an effective remedy to mitigate executive compensation abuses.¹⁹³ Especially, disclosure is a potential cause for rising CEO pay, as the pay itself serves as a signal affecting outsiders' perceptions of a firm's performance and value—the so-called “Lake Wobegon Effect.”¹⁹⁴ Indeed, disclosure of existing compensation arrangements has been a double-edged sword. Many jurisdictions do not impose a stringent disclosure requirement on executive pay. For example, the European Community (EC) only requires annual disclosure of aggregate compensation to key management personnel.¹⁹⁵ In Japan, executive compensation amounts were not disclosed publicly before 2009.¹⁹⁶ Individual compensation packages for executives receiving more than 100 million Japanese yen were not made public until 2010.¹⁹⁷

One might further argue that the prevalence of excessive executive compensation in the U.S. indicates that their stringent disclosure requirement does not work effectively to solve the problem. Indeed, there is no perfect regulation of executive pay and disclosure alone does not curb excessive pay. However, there is no doubt that heightened disclosure would increase transparency within the firm and enable stakeholders to be better informed of the pay issue. In the Chinese context, disclosure rules of listed companies are far from satisfactory as a remedy for compensation problems.

¹⁹² E.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 953–954, 124 Stat. 1376 (2010).

¹⁹³ E.g., Rachel M. Hayes & Scott Schaefer, *CEO Pay and the Lake Wobegon Effect*, 94 J. FIN. ECON. 280 (2009); Michael Faulkender & Jun Yang, *Is Disclosure an Effective Cleansing Mechanism? The Dynamics of Compensation Peer Benchmarking* (Mar. 14, 2011), available at <http://ssrn.com/abstract=1786109> (suggesting that the SEC's 2006 regulatory requirement of disclosing compensation peers did not mitigate firms' opportunistic peer benchmarking of CEO compensation).

¹⁹⁴ Hayes & Schaefer, *supra* note 193, at 280–82; Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 498 (2013).

¹⁹⁵ Council Regulation 632/2010, 2010 O.J. (L 186) 1, 7 (EC).

¹⁹⁶ Hideaki Sakawa, Keisuke Moriyama & Naoki Watanabel, *Relation Between Top Executive Compensation Structure and Corporate Governance: Evidence from Japanese Public Disclosed Data*, 20 CORP. GOVERNANCE: AN INT'L REV. 593, 595 (2012).

¹⁹⁷ *Id.* at 593.

In China, only since 1999 had listed companies been required to disclose annual compensation and shareholdings of executives.¹⁹⁸ PRC Company Law simply provides, “a joint-stock limited company shall disclose the remuneration of its directors, supervisors and executives on a regular basis.”¹⁹⁹ The Regulations on Information Disclosure of Listed Companies 2007 (the Disclosure Measure 2007) states that listed companies shall “disclose the appointment of directors, supervisors and senior managers, as well as their annual remuneration in annual reports.”²⁰⁰ A listed company must also disclose the implementation of the equity incentive plan in periodic reports.²⁰¹ However, top executives’ pension schemes are not subject to disclosure, even though they constitute a significant part of their remuneration.²⁰² It is suggested that the CSRC should mandate disclosure of the composition of individual executive pay, including their pension schemes.

Moreover, there is no specific disclosure requirement on SOEs either. Central SOEs generally do not disclose executive compensation or on-duty consumption, while the primary income of senior executives is the on-duty consumption and grey income.²⁰³ The lack of transparency and external supervision of SOEs gives rise to corruption and inevitably undermines public confidence in these companies. The SASAC should improve public disclosure of SOEs, such as requiring detailed disclosure of individual executive pay, including on-duty consumption, pension schemes, etc.

In addition, serious consideration should be given to the form of disclosure so as to ensure a clear and concise disclosure of executive pay. In

¹⁹⁸ Notice of Improvement of the Quality of Financial Information in Listed Companies (promulgated by China Sec. Regulatory Comm’n, Oct. 1, 1999) (China).

¹⁹⁹ P.R.C. Company Law 2006, art. 117 (Article 72 of the P.R.C. Corporate Governance Code 2002 also generally provides that the board of directors and the supervisory board shall disclose to the shareholders’ meeting on the compensation of directors and supervisors.).

²⁰⁰ Regulations on Information Disclosure of Listed Companies (promulgated by China Sec. Regulatory Comm’n, Jan. 30, 2007), art. 21(5).

²⁰¹ Notice of the China Securities Regulatory Commission on Promulgating the Measures of Administration of Equity Incentive Plans of Listed Companies for Trial Implementation (promulgated by China Sec. Regulatory Comm’n, Dec. 31, 2005), art. 42.

²⁰² See Liang Tong-ying, Feng Li & Chen Xiude, *Pyramid Structure, Executive Perks and Corporate Value: Empirical Evidence from Chinese Listed Companies*, NOV. J. SHANXI FIN. & ECON. U. 75, 76 (2012) (noting that on-duty consumption constitutes a significant part of the executive’s pay).

²⁰³ Wang Shichuan, *Call for Disclosure of Executive Pay in Central SOE*, CHINA BUS. TIMES (Feb. 25, 2011), <http://finance.people.com.cn/GB/14004711.html>.

contrast to the SEC which requires compensation disclosure on the annual proxy statement, Chinese executive compensation is presented in scattered sections in annual reports.²⁰⁴ This creates enormous difficulty for the public to collect and understand compensation information. It is suggested that the CSRC may follow the SEC rules in requiring listed companies to present executive pay information in a simple and consolidated table, known as the “Summary Compensation Table,”²⁰⁵ in order to assist the public in understanding the disclosure in a clearer way.

B. Strengthened Independence of Compensation Committees

As observed by Professor Gordon, the better remedy in improving the corporate governance apparatus in the executive compensation area “is not a wholesale expansion of shareholder power, but a tailored series of measures designed to bolster the independence of the compensation committee.”²⁰⁶

First, as discussed, a listed company is not obliged to have a compensation committee under Chinese law and it plays a limited role in the designing of executive arrangement.²⁰⁷ In order to prevent directors from interfering in the setting of executive pay, it is submitted that Chinese law should require all listed companies to set up compensation committees. The authority and duties of the compensation committee shall be clearly set out in the articles of association. In particular, the compensation committee shall have the authority to review, approve and revise the compensation proposals independently. Moreover, to minimize potential conflicts of interest, more stringent independence requirements should be imposed on the compensation committee. In particular, all members, including the chairman of the committee, must be independent directors.

Second, in the U.S., listed companies must disclose the degree of the relationship between the company’s executive compensation practices and

²⁰⁴ This information is usually stated in the sections of “changes of shareholders and shareholder information,” “directors, supervisors and senior management,” “board report” and “financial statement annex” of annual reports.

²⁰⁵ 17 C.F.R. § 229.402(c) (2013).

²⁰⁶ Jeffrey N. Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,”* 30 J. CORP. L. 675, 676 (2005).

²⁰⁷ See *supra* note 52.

corporate performance.²⁰⁸ Chinese listed companies are required to disclose this content but they are subject to less stringent disclosure requirements than their U.S. counterparts.²⁰⁹ Evidence also shows that a number of companies listed on SSE failed to disclose the procedures and operation of the compensation committees.²¹⁰

It is suggested that the CSRC mandate listed companies to disclose the composition, procedures and operation of the compensation committee, so as to strengthen the independence of the committee. CSRC may also consider following the SEC in requiring company executives to explain all material elements of the compensation of the executives under the “Compensation Discussion and Analysis” (CD&A),²¹¹ such as each element of compensation; why the company chooses to pay each element; how the registrant determines the amount for each element to pay; etc.²¹²

C. Say on Pay in China?

To align the interest of shareholders with executives, almost all jurisdictions require some form of shareholder vote on executive compensation. In 2002, a new section, 241A, was inserted into the U.K. Companies Act, which gave members the right to an advisory vote on the directors’ remuneration report (the so-called “say on pay”).²¹³ The U.K. Companies Act also requires shareholder approval for payments to dismiss directors by way of compensation for loss of office.²¹⁴ Recently, proposals have been made by the British government for a three-yearly binding vote

²⁰⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 953–954, 124 Stat. 1376 (2010).

²⁰⁹ See Notice of the China Securities Regulatory Commission on Promulgating the Standards Concerning the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 2—Contents and Formats of Annual Reports (2012 revision) (promulgated by China Sec. Regulatory Comm’n, Sept. 19, 2012), art. 41(3).

²¹⁰ Minghui, *supra* note 160.

²¹¹ 17 C.F.R. § 229.402(b) (2013).

²¹² *Id.*

²¹³ U.K. DEP’T FOR BUS., INNOVATION & SKILL, SHAREHOLDER VOTES ON EXECUTIVE REMUNERATION, IMPACT ASSESSMENT BIS/12/648, at 27 (2012), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31374/12-648-shareholder-votes-executive-remuneration-impact-assessment.pdf.

²¹⁴ U.K. Companies Act, 2006 ch. 46, §§ 215–26 (Eng.).

on pay policy.²¹⁵ In the U.S., the say on pay mechanism became effective in 2011 under the far-reaching Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).²¹⁶ It requires companies to conduct a shareholder advisory vote on specified executive compensation not less than once every three years.²¹⁷ At least once every six years, shareholders must vote on how frequently to hold such an advisory vote.²¹⁸ More recently, countries such as Germany, Italy, and Sweden have followed the U.K. and given the general assembly a say on pay, but this is consultative and relates merely to the remuneration system and structures.²¹⁹

In China, shareholders also have votes to approve general remuneration²²⁰ and stock option plans.²²¹ However, they have no right to design or propose executive pay and their approval right is not detrimental to the board proposals on executive pay. One might argue that shareholders' advisory votes would give the board certain pressure and make them more prudent in setting executive pay. Nevertheless, it does not seem imperative or feasible to adopt the shareholders say on pay vote in the Chinese context.

First of all, the say on pay mechanism was introduced by the U.K. which features a dispersed shareholding structure. However, as noted, the shareholding structure is much more concentrated in Chinese listed companies than their British counterparts.²²² Thus, it is unlikely that minority shareholders in Chinese listed companies would defeat the board proposal.

Second, in contrast to the U.K. where institutional shareholders have long exercised influence over corporate governance rule-making,²²³ Chinese

²¹⁵ Davies & Hopt, *supra* note 123, at 362.

²¹⁶ See BAINBRIDGE, *supra* note 7, at 122; Martin J. Conyon, *Executive Compensation Consultants and CEO Pay*, 64 VAND. L. REV. 399, 400 (2011).

²¹⁷ Securities Exchange Act of 1934 § 14A, 15 U.S.C. § 78n-1 (2012).

²¹⁸ *Id.*

²¹⁹ Davies & Hopt, *supra* note 123, at 362–63.

²²⁰ P.R.C. Company Law 2006, art. 38(2).

²²¹ Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the China Sec. Regulatory Comm'n, Dec. 31, 2005, effective Jan. 1, 2006), ZHENGJIANGONGSIZI 2005, No. 151, art. 12.

²²² See *supra* text accompanying notes 113–23.

²²³ Davies & Hopt, *supra* note 123, at 368. See also Gordon, *supra* note 206, at 701 (noting that institutional investors in the U.S. have great capacity and long experience in acting collectively in corporate law issues).

institutional shareholders play a negative role in improving corporate governance and they do not develop the expertise to engage in this activity. Due to policy constraints, institutional investors were not permitted to make equity investment until the 1990s. Only during the early 2000s did insurance companies, social security funds and corporate pension funds begin to engage in securities investment.²²⁴ In 2002, the Qualified Foreign Institutional Investor (QFII)—a program allowing licensed foreign investors to buy and sell A-shares in China’s stock exchanges was launched. The pilot scheme for the Renminbi Qualified Foreign Institutional Investors (RQFII)²²⁵ was introduced in 2010 and was revised in 2013.²²⁶ As at the end of 2008, the institutional investor ownership (including securities investment funds, National Social Security Fund, QFII, Insurance companies, enterprise pension funds, securities companies and other institutions) accounted for 54.62% of the A-share equity in listed companies.²²⁷ However, as the ownership of securities investment funds managed by a single fund manager is capped at 10% in a listed company,²²⁸ their ownership in a particular company is small. Empirical evidence also proves that the average ownership concentration ratio of the first largest institutional investors was relatively low.²²⁹ Arguably, the low level of ownership concentration of institutional investors creates difficulties for institutional investors to “act in concert” and to defeat board proposals on executive pay. Also, the small size of their ownership stakes provides no

²²⁴ For example, the National Social Security Fund (NSSF) started to make securities investments in 2003.

²²⁵ The pilot scheme of RQFII was originally limited to Hong Kong subsidiaries of PRC incorporated fund management companies and securities companies which have obtained a type of license from the Hong Kong regulator.

²²⁶ Under the revised RQFII scheme, qualified Hong Kong subsidiaries of PRC incorporated commercial banks or insurance companies and other financial institutions which are registered and domiciled in Hong Kong are entitled to invest in a broad range of RMB equity and debt instruments traded on a Chinese stock exchange or the National Interbank Bond Market and can trade stock index futures to hedge its holding of A-shares.

²²⁷ Ye Jing, *Institutional Investors Account For More Than Fifty Percent of A-Shares Equity*, INFORMATION TIMES, May 6, 2009, <http://finance.ifeng.com/stock/zqyw/20090506/623743.shtml>.

²²⁸ Administrative Measures for the Operation of Public Securities Investment Funds (promulgated by the China Sec. Regulatory Comm’n, 2013), art. 32 (China).

²²⁹ Gao Minghua, *Why Are Institutional Investors Not Willing to Participate in Corporate Governance?*, 9 DIRECTORS & BOARDS 100 (2010).

incentive for institutional investors to monitor the designing of compensation arrangement closely.

Third, the effectiveness of say on pay is highly contested.²³⁰ It has been accused of doing little to slow the growth of executive pay.²³¹ Even in the U.K. where the say on pay mechanism was introduced, executive compensation has continued to rise significantly since the introduction of the mechanism.²³² Additionally, there are substantial legislative and economic costs for the adoption of the say on pay mechanism and it is uncertain whether the benefits would outweigh the costs involved.

There are alternatives to improve the shareholder vote on executive compensation. For example, regulators may consider requiring companies to disclose the shareholder voting according to the types of shareholders (e.g., controlling shareholders, institutional investors and minority shareholders). This may give shareholders greater legitimacy to inquire about executive compensation. Under the U.S. Securities Exchange Act, institutional investment managers shall report at least annually how it voted on any shareholder vote, including those of executive compensation.²³³ China may also consider requiring controlling shareholders or large shareholders to disclose how they vote on executive pay, in order to prevent them from covering up the grievances of minority shareholders.

D. Compensation Consultants?

In the U.S., a compensation committee customarily retains an expert executive compensation consultant to advise on executive pay.²³⁴ Under the

²³⁰ BAINBRIDGE, *supra* note 7, at 122–27.

²³¹ Thomas & Wells, *supra* note 7, at 847.

²³² Jeffrey N. Gordon, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323, 341 (2009).

²³³ “DISCLOSURE OF VOTES—Every institutional investment manager subject to section 13(f) shall report at least annually how it voted on any shareholder vote pursuant to subsections (a) and (b), unless such vote is otherwise required to be reported publicly by rule or regulation of the Commission.” Securities Exchange Act of 1934 § 14A(d), 15 U.S.C. § 78n-1(d) (2012).

²³⁴ Conyon, *supra* note 216, at 401. However, it must be noted that the Dodd-Frank Wall Street Reform and Consumer Protection Act does not require that a compensation committee engage any consultant or other advisors. It only requires that, before selecting a compensation consultant, a compensation committee must take into factors specified in the Act and other factors determined appropriate by the SEC.

U.K. Corporate Governance Code, the remuneration committee should be responsible for appointing consultants in respect of executive director remuneration.²³⁵ By contrast, Chinese listed companies are not obliged to appoint compensation consultants.²³⁶ CSRC Measures generally state that listed companies may employ financial advisers to advise on the equity incentive schemes when necessary.²³⁷ When is it necessary to encourage compensation committees to retain an expert compensation consultant? Since directors in the compensation committee are accused of being too close to executives, would the use of external advice from acknowledged experts help to confer legitimacy on the committee's decisions?

The effectiveness of executive pay consultants is controversial. On the one hand, compensation consultants provide valuable data, information, and professional expertise to client firms.²³⁸ They help the board and the compensation committee to understand the value of complex pay packages and associated tax, disclosure, and accounting issues.²³⁹ In economics, a firm can design an optimal compensation contract at a lower cost with the help of compensation consultants, rather than devising the pay plan itself.²⁴⁰ Meanwhile, by helping to design an optimal compensation package, compensation consultants would better align the interests of executives and firms, and thus lower agency costs.²⁴¹ Empirical evidence also proves positive correlation between CEO pay and the presence of compensation consultants.²⁴² On the other hand, opponents contend that consultants are

²³⁵ U.K. Corporate Governance Code § D.2 (2012).

²³⁶ Under Article 57 of the P.R.C. Corporate Governance Code 2002, specialized committees of the board, including compensation committee, may appoint a third-party agency to provide professional advice.

²³⁷ Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the China Sec. Regulatory Comm'n, Dec. 31, 2005, effective Jan. 1, 2006), ZHENGJIANGONGSI 2005, No. 151, art. 32.

²³⁸ See Kevin J. Murphy & Tatiana Sandino, *Executive Pay and 'Independent' Compensation Consultants*, 49 J. ACCT. & ECON. 247 (2010), cited in Conyon, *supra* note 216, at n.32.

²³⁹ Conyon, *supra* note 216, at 408.

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² See, e.g., Rezaul Kabir & Marizah Minhat, *The Effect of Compensation Consultants on UK CEO Pay* (May 31, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1646926> (finding that executive compensation is higher when firms use multiple consultants, and also that high market share of the compensation consultants has a positive effect on CEO compensation); Georgios Voulgaris et al., *Compensation Consultants and CEO Pay: UK Evidence*, 18 CORP. GOVERNANCE:

not sufficiently independent or impartial, and would contribute to excessive compensation.²⁴³ Even if they are truly independent, there are practical concerns on who has the capacity to serve in this position and who will be willing to serve in this position.

It is hard to predict the effects of compensation consultants in the Chinese context. Firstly, due to the short history of the Chinese capital market, the sector of compensation consultant is still emerging. Presumably, there is a shortage of qualified individual experts who are able to provide valuable expertise and information on executive pay. Secondly, as the independence of independent director is questionable at the current stage, it would be equally challenging to ensure the independence of the compensation consultant. In particular, conflicts of interest would arise when the consultant who assists a company in determining executive pay also provides additional (non-executive compensation-related) services to the company. Thirdly, the role of consultants is supplementary. Ultimately, it depends primarily on the board and the compensation committee to fix the problems of executive compensation.

Nonetheless, one can speculate that the subject and the role of compensation consultants will receive more attention in the near future. With increasing public and shareholder concerns on executive pay, the compensation committee may be required to be more conversant in designing compensation arrangements. Particularly, listed companies, especially the state-controlled listed companies, may tend to move toward engaging professional consultants as a way of educating the compensation committee, so as to improve the fairness and transparency in the designing of executive pay.

Additionally, to avoid conflict of interest of compensation consultants, the U.S. Securities Exchange Act requires companies to disclose whether “the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.”²⁴⁴ The U.K. Corporate Governance Code also provides “where remuneration consultants are appointed, they should be identified in the

INT’L REV. 511, 515 (2010) (finding that CEO pay is positively correlated with the presence of a compensation consultant).

²⁴³ Graef S. Crystal, *Why CEO Compensation Is So High*, 34 CAL. MGMT. REV. 9, 12 (1991).

²⁴⁴ Securities Exchange Act of 1934 § 10C(e)(2), 15 U.S.C. § 78j-3(e)(2) (2012).

annual report and a statement made as to whether they have any other connection with the company.”²⁴⁵ It is suggested that mandatory disclosure requirements should also be imposed on the compensation consultant and Chinese listed companies should disclose any potential conflict of interest with regards to their compensation consultations.

E. Court's Role in Executive Pay

American courts, including Delaware courts, have been monitoring executive compensation in public companies since the 1930s,²⁴⁶ though the desire of courts to subject executive pay to scrutiny and the role of courts in reviewing executive compensation practices have been evolving.²⁴⁷ Recently, Delaware courts have taken a more proactive role in monitoring executive compensation by scrutinizing rigorously officers' actions in negotiating their own compensation agreements. The Delaware Chancery Court has recently held that corporate officers are bound by their duty of loyalty to negotiate employment contracts in an arm's-length and adversarial manner.²⁴⁸ In Germany, there is a more aggressive judicial approach towards executive compensation.²⁴⁹

In the Chinese context, although the P.R.C. Company Law provides legal basis for shareholders to bring a derivative action against directors,²⁵⁰ there is no derivative suit against directors regarding excessive executive compensation since the derivative action was adopted in China in 2006.²⁵¹ Moreover, there is no specific judicial interpretation of the statutory duty of

²⁴⁵ THE FINANCIAL REPORTING COUNCIL, CORPORATE GOVERNANCE CODE § D.2.1 (2012) (U.K.), available at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf>.

²⁴⁶ See Harwell Wells, *No Man Can Be Worth \$1,000,000 a Year: The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 717–27 (2010); Thomas & Wells, *supra* note 7.

²⁴⁷ Thomas & Wells, *supra* note 7, at 865–66 (discussing the history of executive compensation in American courts).

²⁴⁸ *Id.* at 849.

²⁴⁹ KRAAKMAN ET AL., *supra* note 3, at 76–77, 165.

²⁵⁰ P.R.C. Company Law 2006, arts. 150 & 152.

²⁵¹ The author conducted a search on the widely-used electronic database of Chinese law, *Bei Da Fa Bao* (Law Info China), Law Info China, <http://www.lawinfochina.com>. However, as of the date of this article, no case was found on derivative action against directors on excessive executive compensation.

loyalty and duty of diligence.²⁵² Given the lack of a doctrine of precedents and clear judicial guideline in interpreting directors' duties in designing executive pay, it is difficult for judges to decide on executive matter. Further, there is no business judgment rule in China, creating greater difficulties for courts to exonerate the board from civil liability in setting executive pay. To enhance the role of courts in executive compensation, legislature may consider specifying the duty of the board and the compensation committee in setting executive pay. For example, both the board and the compensation committee must exercise due diligence in preparing and approving executive pay packages and policies.

V. CONCLUSION

The article offers a critical assessment of the special regulatory framework that leads to the current state of executive pay practices in China. It reveals that the various governance institutions do not function effectively in administering a fair and transparent procedure for executive compensation. These factors include the lack of mandatory requirement of the compensation committee, ineffective monitoring by independent directors and the supervisory board, as well as a less stringent disclosure requirement for listed companies and SOEs. The government's administrative influences over executive pay and the political-linked appointment of executives in SOEs also lead to a less optimal design of executive compensation.

It concludes that the primary role of Chinese law should not simply be to curb excessive pay, but it should be to improve the regulatory structure for setting executive compensation in a more transparent and effective way. In particular, regulators should ensure that the designing of executive compensation is taken out of the hands of the board. To achieve this, further legal strategies and techniques must be deployed, including heightening disclosure, strengthening the independence of the board and the compensation committee, imposing mandatory requirements on listed companies to set up compensation committees, and granting the

²⁵² See *supra* note 169.

compensation committee the authority to set executive compensation (not simply make recommendations to the board).

It is suggested that listed companies should optimize the ownership structure and corporate governance, as a fundamental solution to the compensation problem. Serious consideration should be given to reduce state equity and political influence in SOEs and ensure transparent and fair appointment of executives. In addition, regulators should consider how to utilize the taxation regime to incentivize executive compensation, as well as how to encourage institutional investors to play a proactive role in the setting of executive compensation.