### Studies on the Legal Problems of Executive Stock Option Compensation in Chinese Listed Companies

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<th>著者</th>
<th>樊 健</th>
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<td>学位授与機関</td>
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Studies on the Legal Problems of Executive Stock Option Compensation in Chinese Listed Companies

Legal and Political Studies
Graduate School of Law
Tohoku University

B1JD1012  Fan Jian

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Fan Jian
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Finally, I want to thank my parents, who have always supported me!
Abstract

Granted stock option compensation, executives can purchase a certain number of stocks of the company at pre-determined price and conditions within a designated period of time in the future. Given the strike price is fixed, the higher the stock price is when executives exercise their rights, the more profits they will make from their stock option compensation. Thus when executives are reaping the highest yields from the stock option compensation, shareholders can also receive the highest benefits. Therefore, stock option compensation can align the interests of executives with those of shareholders, thus encouraging executives to maximize shareholders’ value of their own volition. To a great extent, executive stock option compensation can efficiently address the agency problems resulting from the separation of ownership and management in listed companies.

But executive stock option compensation also has its own shortcomings or agency problems:

A. Executives may be granted excessive stock option compensation because the compensation committee and its independent directors fail to perform their duties efficiently. Under the influence of executives, it is difficult for them to make objective, independent and fair compensation decisions.

B. Stock option compensation may induce executives to violate securities law and regulations to satisfy the conditions for gaining their stock options, for exercising their rights, or for artificially raising the stock price when they exercise their rights so as to make excessive and unjust profits from their options.

C. Stock option compensation may provide executives with the unethical incentives to time information disclosures by the means of causing their company’s stock price to drop shortly before the date of issuance or boosting the stock price shortly before the date of exercise so as to maximize the value of their options, which I call timing problem in this dissertation.

D. Stock option compensation may wrongly encourage executives to pursue short-term profits through making excessive risk-taking investments, cutting R&D
Abstract

budgets or laying off masses of workers at the costs of the long-term interests of shareholders, which I call short-termism problem in this dissertation.

E. Due to executives’ huge influence, they may be granted windfalls by the board or the compensation committee (e.g. the strike price will not be raised even if the good performance of the company is due to the good market development), which cannot coexist with the objective of this kind of compensation from the perspective of shareholders, which I call windfalls problem in this dissertation.

This dissertation intends to make some suggestions to address the aforementioned five agency problems of executive stock option compensation through three different legal approaches: first, enhancing supervision inside the company; second, enhancing supervision by compensation consultants; and third, enhancing supervision by public authorities. Furthermore, each approach is divided into two strategies: ex ante strategy and ex post strategy. Frankly speaking, I have no expectation that my suggestions will completely address these agency problems. I only hope that my suggestions can do better than current laws and regulations, thus improving the development of executive stock option compensation in China.

The core suggestions of this dissertation are:

A. The role of the compensation committee shall be expanded. 1. It shall be granted the sole power to make executive stock option compensation; and 2. It shall be granted the exclusive power to hire, compensate, supervise and fire its own compensation consultant.

B. The role of the independent directors in the compensation committee shall be expanded. 1. They shall be granted stock compensation to align their interests with those of shareholders; 2. More efficient shame sanctions shall be imposed on them through well-defined power and the improved disclosure of executive stock option compensation; 3. Independent, objective and professional advice shall be provided to them; and 4. More efficient threat of civil liabilities shall be imposed on them through easier shareholders’ derivative suits and clear and stricter standard of judicial review.

C. The CSRC shall play a critical role in addressing the aforementioned agency problems in China, where the powers of the courts and the capital market are not strong. 1. It shall update and improve its disclosure rules to make the disclosure of executive
Abstract

stock option compensation more understandable, transparent and comprehensive to minority shareholders and the media; 2. It also shall establish the non-independence standard of a compensation consultant and ban it from providing professional opinions on the stock option plans; and 3. It shall make “comply or explain” rules to address three specific agency problems (timing problem, short-termism problem and windfalls problem) of executive stock option compensation.

Key Words:  Executive stock option compensation; Agency problems;
Three different legal approaches; Two strategies
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<td>Company Law</td>
<td>Company Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006)</td>
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<td>Content and Format of Annual Report</td>
<td>Administrative Measures for the Content and Format of Annual Report (promulgated by the CSRC, effective Jan. 1, 2013)</td>
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<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
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<td>Dodd-Frank Act</td>
<td>Dodd-Frank Wall Street Reform Act of 2010</td>
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<td>EESA 111</td>
<td>Section 111 of the Emergency Economic Stabilization Act of 2008</td>
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<td>Eligible Participants</td>
<td>Those who are granted stock options according to the stock option plan</td>
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<td>Guidelines for Behavior of Directors</td>
<td>Guidelines for Behavior of Directors of Companies Listed on the Small and Medium Enterprise Board of the Shenzhen Stock Exchange (promulgated by the Shenzhen Stock Exchange, effective Mar. 1, 2005)</td>
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<tr>
<td>Guidelines for Nomination and Behavior of Directors</td>
<td>Guidelines for Nomination and Behavior of Directors of Companies Listed in Shanghai Stock Exchange (promulgated by the Shanghai Stock Exchange, effective Aug. 25, 2009)</td>
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<td>Independent Director Opinion</td>
<td>Guidance Opinion on the Establishment of an Independent Director System in Listed Companies (promulgated by the CSRC, effective Aug. 16, 2001)</td>
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<td>Measures for Equity</td>
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Abbreviations

**Incentive Plans**
of Listed Companies (For Trial Implementation)
(promulgated by the CSRC, effective Jan. 1, 2006)

**Measures for Lawyers’ Fees**
Measures for the Administration of Lawyers’ Fees
(promulgated by the National Development and Reform Commission and the Ministry of Justice, effective Dec. 1, 2006)

**Measures for Payment of Litigation Costs**
Measures for the Payment of Litigation Costs (promulgated by the State Council, effective Apr. 1, 2007)

**Memo No.1**
Memo No. 1 on the Matters of Equity Incentive
(promulgated by the CSRC, effective Mar. 17, 2008)

**Memo No.2**
Memo No. 2 on the Matters of Equity Incentive
(promulgated by the CSRC, effective Mar. 17, 2008)

**Memo No.3**
Memo No. 3 on the Matters of Equity Incentive
(promulgated by the CSRC, effective Sept. 18, 2008)

**SEC**
Securities and Exchange Commission

**Securities Law**
Securities Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006)

**Several Provisions on the Trial of Compensation Cases for Civil Tort Involving Accounting Firms**
Several Provisions of the Supreme People’s Court on the Trial of Compensation Cases for Civil Tort Involving Accounting Firms Engaging in the Audit Business (promulgated by Supreme People’s Court, effective June 15, 2007)

**SOLCs**
State Owned Listed Companies

**Some Provisions on Trying Cases of Civil Compensation Arising from False Statement**
Some Provisions of the Supreme People’s Court on Trying Cases of Civil Compensation Arising from False Statement in Securities Market (promulgated by Supreme People’s Court, effective Feb. 1, 2003)

**SOX 304**
Section 304 of the Sarbanes-Oxley Act of 2002

**SSE**
Shanghai Stock Exchange

**SZSE**
Shenzhen Stock Exchange

**TARP**
Troubled Asset Relief Program
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Introduction

I. Executive Stock Option Compensation and Its Functions

A. Approaches to address the agency problems in listed companies

For a listed company, the purpose of corporate governance is to efficiently resolve the agency problems caused by the separation of ownership and management. These agency problems include: executives stealing their company’s business opportunities, executives trading with their company, executives making reckless decisions and so on.

Generally speaking, these agency problems can be addressed in two legal approaches: one is strengthening supervision (the stick); another is providing incentive (the carrot). The supervision approach includes: 1. empowering shareholders (e.g. accumulating voting and shareholders’ derivate suits); 2. expanding the role of independent directors; 3. enhancing directors and executives’ fiduciary duties (duty of care and duty of loyalty) to their company; and 4. other methods outside a company: (1) enhancing gatekeepers’ supervision, for instance, lawyers checking the reliability of disclosed information; (2) enhancing supervision by regulators, for example enhancing supervision by the China Securities Regulatory Commission (CSRC); and (3) enhancing the supervision (judicial review) by courts.

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1 Corporate governance has different meanings, see Jean Jacques du Plessis et al, Principles of Contemporary Corporate Governance (London: Cambridge University Press, 2005), at 1 (“One thing that is clear about the concept of corporate governance is that there is not set definition as to what it means.”). In this dissertation, corporate governance means to design a proper legal mechanism (both inside and outside a listed company) to deter controlling shareholders or executives from pursuing their own interests at the costs of the minority shareholders or the shareholders as a whole.

2 There are three kinds of agency problems in a listed company: 1. the conflicts of interest between shareholders and executives; 2. the conflicts of interest between controlling shareholders and minority shareholders; and 3. the conflicts of interest between a company itself and other parties with whom it contracts, such as creditors, employees and customers. See Reinier H. Kraakman et al, The Anatomy of Corporate Law: A Comparative and Functional Approach (Second Edition) (London: Oxford University Press, 2009), at 36. In this dissertation, I will try to argue how executive stock option compensation can efficiently resolve the 1 and 2 agency problems. In economics, the losses caused by these agency problems, especially the conflicts of interest between shareholders and executives, are called agency costs, see Stephen M. Bainbridge, Corporation Law and Economics (New York: Foundation Press, 2002), at 35-38.

3 In this dissertation, “executives” refers to “the manager, vice managers, chief financial officers, the secretary of the board of directors of a listed company, or any other persons provided in the bylaw” (Article 217 (1) of the Company Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, hereinafter Company Law) and includes the executives also act as non-independent directors, who are called “executive directors”.

4 Surely, these agency problems may also be addressed in a market approach, such as the market for executives, the products market and the market for corporate control. However, this dissertation only discusses the legal approaches.
The incentive approach includes: 1. promoting executives’ positions in the company; and 2. awarding executives attractive compensation. Awarding attractive compensation is a very important method for addressing these agency problems in China, because the bankruptcy system and the M&A market are inefficient in the country; meanwhile the minority shareholders cannot easily supervise the directors and executives, thus executives’ compensation becomes more important. Stock option compensation—the focus of this dissertation—has several key functions, which make it the most important element of the executives’ whole compensation package.

B. The functions of executive stock option compensation

In general, as they are granted stock option compensation, executives have the rights, but not the obligations, to purchase certain amounts of the company’s stocks at pre-determined price (strike price) and conditions within a designated period of time in the future determined ex ante. In essence, stock option compensation refers to the contracts between a company and its executives, which are usually called stock option plans in practice. Suppose the timing is right and the stock price is higher than the strike price (in-the-money), executives will exercise their rights; but if the stock price is equal to (at-the-money) or lower than (out-of-the-money) the strike price, executives will not exercise their rights. Hence, given the strike price is fixed, the higher the stock price is when executives exercise their rights, the greater the profits executives will make from their stock option compensation. In theory, stock option compensation can yield unlimited profits with only the options themselves being at risk for loss. Stock option compensation for executives can serve four key functions in efficiently addressing agency problems in listed companies.

1. Stock option compensation can align the interests of executives with those of the

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6 See Andrew C.W. Lund, Compensation As Signaling, 64 Florida L. R., 591, 600 (2012) (“Incentive pay was thought to work its magic where it was relatively difficult to observe managers’ behavior, where shareholders did not have the skill or motivation necessary to determine the proper business decision ex ante, and where executive decisions affected firm percentage returns rather than dollar returns. In those cases, market and legal discipline seemed to fail, and appropriately structured pay was thought to be a helpful device for preventing mass defection by managers away from share value maximization.”).
7 Article 19 of the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the CSRC, effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans) provides, “the stock options as mentioned in the Measures for Equity Incentive Plans shall refer to the right of the eligible participants granted by a listed company to purchase a certain number of shares of the company within a certain period in the future at the pre-determined price and conditions. The eligible participants may purchase a certain number of shares of a listed company through the stock options granted to it at the pre-determined price and conditions within a prescribed time limit, or may waive such right.” Here, the “eligible participants” refers to those who are granted with stock options according to the stock option plan.
shareholders, thus encouraging executives to maximize the shareholders’ value of their own volition, which is the most efficient way to resolve agency problems. When the strike price is fixed, the higher the stock price is when executives exercise their rights, the more profits they will make from their options. As a result, when executives are reaping the highest yields from stock option compensation, the shareholders are also able to receive the highest benefits. He Qing Ming generalizes this process as “the executives’ hard-working determines the performance of a company, the performance of a company determines the stock price, and the stock price determines the executives’ compensation”. Furthermore, as a group, executives are granted huge amounts of stock options at the same time, so this form of compensation encourages mutual supervision. For example, if some executives are able to make money from a decision that lowers the stock price while others cannot, the decision will likely be rejected by other executives.

2. Since executives invest most of their human capital into their companies, they

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8 See Brian J. Hall, Six Challenges in Designing Equity-Based Pay, Vol.15 No.3 Journal of Corporate Finance 21, 21 (2003) (“well-designed stock and stock option packages can increase corporate productivity and value by better aligning top managers’ interests with those of the shareholders”). Also see Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation: Focusing and Committing to the Long-Term, 26 Yale J. on Reg. 359, 363 (2009) (“incentive compensation in the form of stock and stock options is, in general, a highly effective mechanism for aligning manager and shareholder interests.”).

9 In other words, stock option compensation encourages executives to maximize the stock price. To some extent, the stock price is the most objective and direct method of evaluating a company. “Although not a perfect measure of wealth creation, stock prices reflect the market’s estimate of the company’s current and future cash flows, which in turn reflect the market’s beliefs regarding the company’s investment or divestment opportunities and the managers’ response to those opportunities.” See Kevin J. Murphy, Politics, Economics, And Executive Compensation, 63 U. Cin. L. Rev. 713, 722 (1995). Since the Chinese capital market is a “weak-form efficiency” market, it could reflect the basic value of a company and allocate money relatively efficiently. See Zhang Bing & Li Xiao Ming, An Evolving Market Efficiency Test On Chinese Stock Market, No.1 Economic Research Journal 54, 61 (2003). However, because of the information asymmetry between investors, different expectations between a company’s future and irrational investment behaviors, some scholars believe that the stock price is a poor criterion for a company’s value, see Lynn A. Stout, Share Price As A Poor Criterion For Good Corporate Law, 3 Berkeley Bus. L.J. 43 (2005) (The author argues that because of the problem of private information; obstacles to effective arbitrage; investors’ cognitive defects and biases; options theory and the problem of multiple residual claimants; and the problem of corporate spillover effects that erode diversified shareholders returns, a tight connection between stock prices and underlying corporate wealth generation cannot be assumed any more.). This dissertation agrees that the stock price cannot perfectly reflect a company’s intrinsic value, but is the second best method. We have no other better method, or theory, at hand to evaluate a company. Another controversial question is whether the maximization of shareholders’ value is a desired goal of company law. It is a big question which is not suitable to be discussed in detail here. The short answer to this dissertation is yes, because shareholders are the residual claimers of a company, only the rights of other parties are satisfied, and the shareholders can earn profits. Only shareholders have the incentive to maximize the value of the company. Surely, under some situations, the maximization of shareholders’ value may harm the interests of creditors (e.g. when the company is on the verge of bankruptcy) or employees (e.g. firing employees to save costs), but these problems in maximizing the shareholders’ value can be resolved in bankruptcy law or labor law. So, at least, for the purpose of company law, maximization of the shareholders’ value is desirable. For more detailed discussion, see Seiichi Ochiai, The Elements of Corporate Law (Beijing: Law Press, Chinese translation edition, translated by Wu Ting et al., 2011), at 49-63.

10 He Qing Ming, How the Equity Incentives Will Impact the Listed Companies and Investment Opportunities, Vol.6 Securities Market Herald 43, 44 (2007).

11 Sharon Hannes, Reverse Monitoring: On the Hidden Role of Employee Stock Ownership Plans (August 23, 2006), available at http://law.bepress.com/expresso/eps/1608/ (The author argues that the recipient employee can be viewed as the potential monitor of other employees and that stock options motivate her to fulfill this task.)
cannot diversify their investments. If a company awards only fixed compensation to its executives, the risk-averse executives will not make optimal business decisions from the perspective of shareholders. This is because if these decisions are successful, they will not make extra money; but if the decisions fail, they could lose their jobs or suffer reputational sanctions. “A system of exclusively cash compensation creates its own perverse incentives, motivating managers to avoid risk and bankruptcy and to pursue inefficient growth maximization, because a larger firm size generally implied higher cash compensation for its senior managers.” On the contrary, if executives are granted stock option compensation, “they will undertake more risky but positive net present value and hence firm value-increasing projects.” Considering shareholders’ limited liability and diversification-oriented investment strategies, risky decisions by executives are worth making.

3. For start-up companies, “offering employee stock options in lieu of cash compensation allows companies to attract highly motivated and entrepreneurial employees and also lets companies obtain employment services without (directly) expending cash.” The best example of this function is the “Silicon Valley” phenomenon, where “the companies in the Silicon Valley grant those technology elites huge amounts of stock options, which creates a totally new culture ... If the Silicon Valley is said to be the engine of the world economy, stock option compensation is the fuel.”

4. In a company with concentrated ownership, in theory, controlling shareholders are able to efficiently supervise executives, so stock option compensation seems

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13 Shivaram Rajgopal & Terry Shevlin, Empirical Evidence on the Relation Between Stock Option Compensation and Risk Taking, 33 Journal of Accounting and Economics 145, 146 (2002). Also see Hall, supra note 8, at 29 (“Options promote more risk-taking because increases in the volatility of a company’s stock price actually increase the value of its options (while leaving stock prices unaffected). Options can thus add value by encouraging managers to move the firm closer to its optimal level of risk.”).
14 In order to offset the risks faced by executives (non-transferability and illiquidity (“put all the eggs in one blanket”)), a company shall grant its executives more compensation, which is called “risk premium”. See Kevin J. Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 859 (2002). Generally, the value of the stock options granted to executives is 30% to 40% less than the market value of these options. See Hall, supra note 8, at 26.
18 Here, “a controlling shareholder” refers to “a shareholder whose stocks occupies more than 50% of the total equity stocks of a joint stock limited company or a shareholder whose proportion of stock is less than 50% but who enjoys a voting right according to the stocks it holds is large enough to impose an big impact upon the resolution of the shareholders’ meeting.” (Article 217 (2) of Company Law).
unnecessary. However, in this scenario, some diverging interests still exist between controlling shareholders and executives. For example, executives may make sub-optimal or reckless decisions which are difficult to trace by controlling shareholders. As a result, from the perspective of controlling shareholders, stock option compensation can motivate executives to work harder and make better decisions. For instance, stock option compensation encourages executives to take more active roles in asset reconstruction, to sell or spin-off “cash trap” businesses and buy ones with increasing value. From the perspective of minority shareholders, stock option compensation can play a very important role in preventing controlling shareholders from placing their benefits in jeopardy, and at the same time, can address agency problems resulting from the separation of ownership and management. This is because stock option compensation encourages executives to resist “tunneling” behaviors by controlling shareholders. Tunneling behaviors keep stock prices down, thus reducing the profits that executives can make from their options. This is the very reason that despite the prevalence of companies with concentrated ownership in China, scholars, the media and regulators are still passionately encouraging listed companies to use stock option compensation.

19 He, supra note 10, at 45.
20 See Kun Wang & Xing Xiao, Controlling Shareholders’ Tunneling and Executive Compensation: Evidence From China, 30 J. Account. Public Policy 89, 90 (2011) (“A strong association between executive compensation and firm performance would strengthen executives’ incentives to increase firm performance and reduce their willingness to collude with controlling shareholders.”); also see Lei Gao & Gerhard Kling, Corporate Governance and Tunneling: Empirical Evidence From China, 16 Pacific-Basin Finance Journal 591 (2008) (The authors argue that the stock ownership of senior managers is a guarantee for preventing tunneling).
21 “The ownership of China’s publicly traded firms is highly concentrated. In most firms there is a single dominant shareholder whose large share ownership gives considerable power and influence over the way the firm is run. This is especially the case regarding the appointment and compensation of the CEO or the board. Typically, the largest shareholder owns about 43% of the firm’s shares, the second largest about 9%, and the third largest about 4% . . . China’s ownership pattern stands in stark contrast to the US, where low-concentration and ownership diffusion is the norm. It is rare for investors to own more than 10% of common equity in Anglo-Saxon firms.” See Martin J. Conyon & Lerong He, Executive Compensation and Corporate Governance in China, 17 Journal of Corporate Finance 1158, 1160 (2011). “The largest shareholder is usually the State or a legal entity, although there are a growing number of cases where the dominant shareholder is a private business or non-state institution.” See Michael Firth et al., Corporate Performance and CEO Compensation in China, 12 Journal of Corporate Finance 693,697 (2006).
22 “Share ownership by CEOs and executive directors is very low and their main source of income is from cash compensation...The lack of executive stock options is one reason why share ownership by CEOs and top managers is so low. The absence of executive stock options removes one method of aligning the interests of managers and the shareholders.” see Michael Firth et al., How Ownership and Corporate Governance Influence Chief Executive Pay in China’s Listed Firms, 60 Journal of Business Research 776, 776 (2007).
C. The empirical research of executive stock option compensation in Chinese listed companies

The Measures for Equity Incentive Plans as well as three memos on the matter of equity incentives promulgated by the CSRC have established solid legal foundations for the development and flourishing of executive stock option compensation in Chinese listed companies. By the end of May, 2012, a total of 284 listed companies in the Shanghai and Shenzhen Stock Exchanges had already implemented equity incentive plans, accounting for 12% of all the listed companies. About 20% of all companies in the ChiNext Market and 30% of all information technology companies have already implemented equity incentive plans. After analyzing companies listed in the Shenzhen Stock Exchange in 2007, Xia Li Na found that the 06’EPS and net asset margin for companies that had implemented equity incentives was far above normal. In addition, profit forecasting was much easier for companies with stock options than those with restrictive stock incentives. In the same year, He Qing Ming compared the performances of companies that had implemented equity incentive plans with the indices of the Shanghai and Shenzhen Stock Exchanges, finding that the former was much better than later. He concluded that equity incentive could raise stock prices and bring investment opportunities to investors. Sun Tang Gang studied 63 companies that had implemented equity incentive plans in the Shanghai and Shenzhen Stock Exchanges by the end of Sept. 30, 2008, concluding that equity incentives had a significantly positive impact on the performances of these companies. After studying 89 companies that had implemented equity incentive plans from Jan. 1, 2006 to Dec. 31, 2009, besides

23 Respectively, Memo No. 1 on the Matters of Equity Incentive (promulgated by the CSRC, effective Mar. 17, 2008, hereinafter Memo No.1); Memo No. 2 on the Matters of Equity Incentive (promulgated by the CSRC, effective Mar. 17, 2008, hereinafter Memo No.2); and Memo No. 3 on the Matters of Equity Incentive (promulgated by the CSRC, effective Sept. 18, 2008, hereinafter Memo No.3).
24 These equity incentive plans include restricted stock plans and stock option plans, but more than 80% of these plans are stock option plans.
25 ChiNext market, which was inaugurated in Shenzhen Stock Exchange on Oct. 23, 2009, provides “an important platform for implementing the national strategy of independent innovation. It helps accelerate the transformation of economic development mode and galvanizes growth in emerging industries of strategic importance.” “As of Dec. 30, 2011, there were 281 companies listed on the ChiNext, of which 93% are hi-tech firms. The total market capitalization of ChiNext listed companies reached RMB 743.4 billion (USD 118 billion). IPO proceeds hit RMB 196.1 billion (USD 31.1 billion). Total trading value of ChiNext was RMB 1.9 trillion (USD 301.6 billion) in 2011.” Information is disclosed by Shenzhen Stock Exchange, available at http://www.szse.cn/main/en/ChiNext/.
26 See Yan Xue Feng, CEOs’ Compensation in Listed Companies Is Becoming Rational, No. 11 Directors & Boards 73, 74 (2011).
28 See He, supra note 10, at 46-47.
confirming the aforementioned results, He Fan found that the effect of stock option plans was better than that of restricted stock plans. He Fan also recommended that high growth companies make better use of stock option plans.  

In short, stock option compensation gives executives a better incentive to behave in the interests of shareholders by the means of providing a direct link between realized compensation and company stock price performance, thus realizing a win-win situation for both shareholders and executives.

II. The Agency Problems of Executive Stock Option Compensation and the Purpose of This Dissertation

A. The agency problems of executive stock option compensation

Though executive stock option compensation has several advantages, it cannot be regarded as a panacea to address every agency problem in listed companies, as it also has its own shortcomings or agency problems. The deep root of these agency problems lies in the “enormous discretion managers have over most aspects of corporate business, coupled with traditional deference from boards” or according to Bebchuk and Fried’s famous remark, the “managers’ power”, which gives managers huge influence on the board and independent directors in the compensation committee. Executives can help controlling shareholders to tunnel the companies for personal benefits, thus hurting the interests of minority shareholders; they can decide when and what to disclose; they can also determine whether to invest in risky ventures or reduce R&D investments and so on. The executives’ huge influence (either power or discretion) will definitely hurt the interests of shareholders, especially the minority shareholders in Chinese context, where the ownership of publicly traded companies is highly concentrated. Specifically, this dissertation will discuss the following five common agency problems of executive stock option compensation:

1. The compensation committee and its independent directors are not able to perform their duties efficiently to supervise executive stock option compensation, which makes it possible for executives to be granted excessive stock option

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30 See He Fan, supra note 24, at 61.
31 Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 Journal of Economic Perspective 71, 72 (2003) (“Executive compensation is viewed not only as a potential instrument for addressing the agency problem but also as part of the agency problem itself.”).
compensation which they normally would not be able to obtain while “dealing at arm’s length”. Excessive stock option compensation has a variety of forms: executives may be granted more stock option compensation for a given incentive purpose; the conditions for executives to exercise their rights are easy to satisfy; or executives gain windfalls from their stock option compensation, which means the strike price will not be raised in the event of favorable developments in the market or industry and so on.

Because of “collective action problems” and “rational apathy”, shareholders have neither the ability nor the willingness to supervise executives. The independent directors elected by shareholders are presumed to act in the interests of shareholders, but unfortunately, there are several reasons why a board would, when granting compensation, often “puts the interests of the CEO as the primary concern and relegate(s) shareholder interests to a secondary consideration.” 34 First of all, independent directors have incentives to keep their jobs. Opposing executives substantially increase the likelihood that an independent director will not be nominated again and will lose their benefits along with the positions. Secondly, executives can exercise influence over companies on whose boards they serve to help the board of directors acquire additional lucrative directorships. 35 Finally, social relationships, group thinking and structural bias 36 may also lead independent directors to consider the interests of executives rather than those of shareholders’. “Personal and psychic ties to the individuals who are responsible for one’s appointment to a board make it difficult to engage in necessary confrontation.” 38

With regard to the situation in China, besides the aforementioned problems, stock option compensation may become a tool for controlling shareholders to pursue their own interests. For example, a controlling shareholder may exchange their vote on a stock option plan for the agreement of executives to support tunneling behaviors. 39

37 Bebchuk & Fried, supra note 33, at 4 (“directors have various economic incentives to support, or at least go along with, arrangements favorable to the company’s top executives. Various social and psychological factors-collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friends and loyalty-have also pull board member in that direction.”).
Besides, the compensation committee having limited power as well as the faults plaguing independent directors in China may also contribute to awarding excessive stock option compensation to executives.

2. Stock option compensation may induce executives to break securities laws and regulations, for example, by manipulating earnings or other accounting figures, so as to satisfy the conditions under which they can be granted stock option compensation (or they can exercise their rights) or/and artificially raise the stock price when they exercise their rights to make unjust money.\(^40\)

3. Stock option compensation may provide executives with unethical incentives to time corporate information disclosures to maximize their profits, which has been called a “case of misaligned incentives”.\(^41\) “The executives who know when their options will be issued and become exercisable have incentives to disclose negative corporate news shortly before the issuance of such options and to disclose positive news shortly before their exercise date while delaying disclosure of negative news.”\(^42\)

Thus, stock option compensation creates “a new potential conflict between the interests of the corporation and its shareholders in credible, timely, and accurate disclosure and the CEO’s newly created interest in disclosure timed to maximize the value of his pay package.”\(^43\) In short, there is a “dark side” to executive stock option compensation: “absent special controls, more options means more fraud.”\(^44\)

4. Stock option compensation may wrongly encourage executives to pursue short-term profits by means of making excessive risk-taking investments, cutting research and development budgets, laying off masses of workers and so on, which hurts the long-term interests of shareholders. The reasons why executives do so are: (1) They can exercise their rights and sell their stocks in a short period of time; (2) Since “the holder of an option participates in the gains in value, but not the losses”,\(^45\) executives will be “indifferent to losses, an option holder in the pursuit of gains will rationally expose the company to potential suicidal risks.”\(^46\) So, “perhaps the leading

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\(^{40}\) For example, see Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives*, 30 J. Corp. L 807 (2005) (They identify and analyze one problem of Fannie Mae’s executive compensation arrangements during the period 2000-2004 that “by richly rewarding executives for reporting higher earnings, without requiring return of the compensation if earnings turned out to be misstated, Fannie Mae’s arrangements provided perverse incentives to inflate earnings.”).

\(^{41}\) Yablon & Hill, *supra* note 32.

\(^{42}\) Id. at 87.

\(^{43}\) Id. at 89.

\(^{44}\) Coffee, *supra* note 12, at 64.


corporate governance concern of legislators and commentators at present is the reckless pursuit of short-term profits by corporate executives who will have cashed out before the long term repercussions are felt”. 47 Short-term orientation is said to be one of the causes of the 2008 financial crisis. 48

5. Stock option compensation may award windfalls to executives, which cannot coexist with the objective of the compensation mode from the perspective of shareholders, namely, “profiting together, losing together”. In practice, if the stock price goes up quickly because of favorable developments within the economy or industry, companies will not raise their strike price accordingly, which gives executives “the benefit of all the appreciation of the company's underlying stock rather than limiting the benefit to merely the stock price appreciation that is directly related to the option holder's performance at the company.” 49 In contrast, if the stock price goes down quickly because of non-favorable developments in the economy or industry, or even due to incompetence by executives, companies will always grant new stock options to executives to replace the old ones. This “windfalls” problem provides a poor incentive structure to executives: “heads I win, tails we start over”. 50

Some other agency problems brought on by executive stock option compensation, such as executives buying financial derivatives to hedge the risks of stock options, 51 the board backdating the day the compensations are granted, 52 and the dilution effect of executive stock option compensation 53 have all caught the attention of many

50 Bebchuk & Fried, supra note 33, at 145.
51 See Steven A. Bank, Devaluing Reform: The Derivatives Market and Executive Compensation, 7 DePaul Bus. L.J. 301, 318 (1995) (“One common way that executives use the derivatives market is by employing an ‘equity swap.’ An equity swap is a type of derivative contract in which the holder of the stock pays a second party the stock’s dividends for a certain period of time and also pays the second party the net gain in the stock’s value at the end of that period. In return, the second party agrees to pay the owner of the stock the income from a diversified investment based upon the value of the stock and will also pay for any loss in value to the stock at the stock at the end of the specified period. Unexercised stock options can also be sold in the derivatives market.”). But such hedging is quite rare in practice, see Hall & Murphy, supra note 15, at 55.
52 See William Hughes, Stock Option “Springloading”: An Examination of Loaded Justifications and New SEC Disclosure Rules, 33 J. Corp. L. 777, 782-783 (2008) (“Companies engage in ‘backdating’ when they retroactively determine the grant date for options issued to management so that it appears that the company made the award on an earlier date. Because the exercise price of the options is also typically the stock’s market price on the date of the grant, this retroactive decision permits executives to choose a date when the market value of the stock was at a low point, or at least at a lower price than the current stock value.”).
53 See Richard A. Booth, Why Stock Options are the Best Form of Executive Compensation (And How to Make Them Even Better), 6 N. Y. U. L. & Bus. 281, 310-323 (2010). And also see Randall S. Thomas and Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 Wake Forest L. Rev. 31, 35-36 (2000) (“As stock option awards increase in size and value, the existing shareholders of a company will face potential dilution of their ownership stake as the company issues more shares of its stock to satisfy the exercise
scholars. However, I do not intend to discuss and analyze these problems in detail in this dissertation, as these problems are either resolved in law and practice or not serious in the US nor in China.

In the case of China, the financial derivatives market is under-developed, and instances of executives buying financial derivatives to hedge the risks of stock options remain unseen. Second, it is almost impossible to backdate the day which determines a strike price in China because of strict regulations. Neither such case has been ever heard of in practice to date. Third, the dilution effect of executive stock option compensation is indeed a problem, but it is not so serious. The reasons are: 1. Article 10(1) of the Measures for Equity Incentive Plans provides that the aggregate stocks involved in all the effective equity incentive plans of a listed company shall not exceed 10% of the total equity of the company accumulatively. So, there exists an upper limit on the dilution effect; 2. A company usually buys stocks from the stock markets to fulfill its duty when executives exercise their rights, thus reducing the number of shares in the market. Actually, this behavior is functionally equivalent to cash distribution, which is warmly encouraged and welcomed by shareholders and the CSRC; 3. If shareholders think their rights have been diluted, they can sell their stocks. Ultimately, the problem lies in whether the costs of dilution effect could be offset by the benefits brought by executive stock option compensation. It depends on whether the aforementioned agency problems of executive stock option compensation can be successfully and efficiently addressed.

**B. The purpose of this dissertation**

The aforementioned five agency problems affecting executive stock option compensation are quite common in China though the practice has been legally allowed since 2006. Some problems, such as executives being paid without heed to
performance,\(^{55}\) a lack of a proper supervision mechanism existing in listed companies,\(^{56}\) executives timing information disclosures\(^{57}\) and so on have been strongly criticized by shareholders, scholars, and the media. Since certain markets, such as the managerial labor market, the market for control, the market for additional capital, and the products market can play a very limited role in addressing the five agency problems,\(^{58}\) the law is expected to play an important role in resolving these problems.\(^{59}\)

Though some law scholars have pointed out several agency problems in executive stock option compensation and have made some suggestions, they have yet to discuss these problems in detail nor made suggestions on how to address these them. For some important issues, such as clawback provisions, compensation consultants and “comply or explain” rules have received no attention from law scholars. Furthermore, there are quite a few faults and uncertainties regarding the regulations on executive stock option compensation, and this dissertation intends to fill in the gap.

In sum, the purpose of this dissertation is to efficiently resolve these problems via legal approaches with reference to the laws and practices of the US, the UK and Japan. I hope that the suggestions made in this dissertation can contribute to the improvement and development of the law and practices regarding executive stock option compensation in Chinese listed companies.

### III. Addressing the Agency Problems of Executive Stock Option Compensation Through Legal Approaches and Strategies

This dissertation intends to address the five aforementioned agency problems of executive stock option compensation in three different legal approaches and each approach is divided into two strategies: ex ante and ex post.

The three legal approaches include: enhancing supervision inside the company, enhancing supervision by compensation consultants and enhancing supervision by public authorities. Companies shall be allowed to make their own executive stock

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56 See Cao Nai Cheng, *Could They Make So Much Money?: Analysis of the Executives’ Compensation in Listed Companies*, Vol. 10 Innovation 85 (2011) (The author found that only 40% of all listed companies have proper supervision mechanisms).


option compensation systems based on their own unique circumstances. They shall also respond quickly to changes in the market.\textsuperscript{60} In short, corporate self-governance should be highly respected. Hence, it is efficient and justified to address the agency problems of executive stock option compensation by enhancing supervision inside the company, such as expanding the role of the compensation committee and its independent directors and improving the disclosure on executive stock option compensation. Because of the “collective action hazard” and “majority rule”, minority shareholders are unwilling and unable to supervise executives or controlling shareholders (e.g. approving or objecting to a stock option plan at a shareholders’ meeting).\textsuperscript{61} So, this dissertation does not intend to discuss the role of minority shareholders in addressing the five agency problems ex ante. Though minority shareholders can pursue the liabilities of independent directors through shareholder’s derivative suits, such cases rarely happen in practice in China because of various obstacles. Thus, I will discuss how to remove the obstacles to make it easier for minority shareholders to bring derivative suits. Because the job of supervisors in listed companies is only to check the list of eligible compensation recipients, they cannot play a substantial role in addressing the agency problems of executive stock option compensation. Therefore, this dissertation does not intend to discuss the role of supervisors.

Actually, the strategy of enhancing supervision inside the company by itself cannot completely resolve the five agency problems. An independent compensation consultant is needed to provide objective and professional opinions to the directors and supervise the reasonableness of the compensation allocated to executives. The CSRC is also needed to make “comply or explain” rules to address various agency problems, for example, executives may time information disclosure or pursue short-term profits, to protect the shareholders while respecting the uniqueness of each company. Finally, a judicial review in court cannot only adjudicate the independent directors who breach their duty of care to pay for damages to their company, but also enhance the threat of civil liabilities of independent directors in the compensation

\textsuperscript{60} The Conference Board, \textit{The Conference Board Task Force on Executive Compensation}, at 12 (2009), available at http://www.conference-board.org/pdf_free/execcompensation2009.pdf. (“To succeed in a competitive global economy, a company should be able to tailor compensation programs to address the success drivers for its business, its unique business strategy, and its status within the evolution of that strategy. Companies should also be able to adjust the elements of their compensation programs from time to time as market needs and other conditions change. For these reasons, a ‘one-size-fits-all’ or ‘rules-based’ approach to executive compensation is not workable”.).

\textsuperscript{61} Bebchuk \& Fried, \textit{supra} note 33, at 48-51. And James E. Heard, \textit{Executive Compensation: Perspective Of The Institutional Investor}, 63 U. Cin. L. Rev. 749, 758 (1995) (“In most cases, objectionable pay practices come to light after the fact, when voting can have only a very limited and largely symbolic impact.”).
What needs to be emphasized is that the focus of supervision inside the company, by compensation consultants or public authorities should be the process of how executive stock option compensation is made, rather than focusing on concrete compensation numbers. As long as an executive’s compensation mode really serves the interests of shareholders, even high compensation is acceptable.\(^62\)

The ex ante strategy refers to the approach of addressing agency problems before executive stock option compensation becomes effective (namely during the process of creating the compensation scheme); meanwhile, the ex post strategy refers to the approach of addressing agency problems after executive stock option compensation becomes effective. In contrast to ex post strategies, the ex ante strategies are more efficient in China. But, in practice, the line between ex ante and ex post strategy is not so rigid. This is because if someone can anticipate that their behavior may be punished by laws and regulations ex post, they will adjust their behaviors ex ante so as to be free of punishment. For instance, clawing back executive stock option compensation cannot only recoup unjust compensation ex post, but also discourage executives from breaking securities law and regulations in the first place. Specifically:

### A. Enhancing supervision inside the company

The ex ante strategies of this approach include: expanding the role of the compensation committee and its independent directors and improving the disclosure of executive stock option compensations; meanwhile, the ex post strategies of this approach include: clarifying the provision of clawing back executive stock option compensation and making it easier for minority shareholders to bring derivative suits. Since the shareholders’ derivative suits have a close relationship with the judicial review, I will discuss the issues of shareholders’ derivative suits together with the judicial review.

### B. Enhancing supervision by compensation consultants

The ex ante strategies of this approach include: granting the compensation committee the exclusive power to hire, compensate, supervise and fire its own independent financial consultant (compensation consultant); establishing the non-independence standard of a compensation consultant and preventing the

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\(^62\) Bebchuk & Fried, *supra* note 33, at 8.
non-independent compensation consultant from issuing professional opinions on the stock option plans; the ex post strategy of approach is imposing more efficient civil liabilities on the compensation consultants.

C. Enhancing supervision by public authorities

The ex ante strategy of this approach is the CSRC shall make “comply or explain” rules to address some specific agency problems of executives stock option compensation; the ex post of this strategy is the court shall clarify the standard of judicial review when they have to determine whether the independent directors in the compensation committee break their duty of care when they make executive stock option compensation.

The following table sets out the approaches and strategies for addressing the five agency problems within executive stock option compensation.63

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63 This framework of addressing the five agency problems is gained from the famous book “The Anatomy of Corporate Law: A Comparative and Functional Approach”, especially chapter two. See Kraakman et al, supra note 2, at 35-53.
### Ex ante strategies

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<th>Enhancing supervision by compensation consultants</th>
<th>Enhancing supervision public authorities</th>
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<td>1. Expanding the role of the compensation committee and its independent directors; 2. Improving the disclosure of executive stock option compensation</td>
<td>1. Granting the compensation committee the exclusive power to hire, compensate, supervise and fire its own compensation consultant 2. Establishing the non-independence standard of a compensation consultant 3. preventing the non-independent compensation consultant from issuing professional opinions;</td>
<td>1. The CSRC shall make “comply or explain” rules to address some specific agency problems</td>
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### Ex post strategies

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<td>1. Clarifying the provision of clawing back executive stock option compensation 2. Making it easier for minority shareholders to bring derivative suits</td>
<td>1. Imposing more efficient civil liabilities on compensation consultants</td>
<td>1. The courts shall clarify the standard of judicial review</td>
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### IV. Methodology

**A. Legal Interpretation**

The main methodology used in this dissertation is legal interpretation. I will clarify
the meanings of various legal terminologies (literal interpretation), systematize the laws and regulations on executive stock option compensation (systematical interpretation), and seek the objectives of legislators and regulators (teleological interpretation). In addition, I will fill in the gaps in laws and regulations with my suggestions.

**B. Comparative Analysis of Law**

As for the legal approaches and strategies for addressing the five agency problems of executive stock option compensation in China, we can learn a lot from the experience of the US, the UK and Japan.\(^4\) When faced with the same problems in a business context, the legal approaches and strategies of dealing with them in each country will not be quite different. In my opinion, there are some basic principles that we could follow. Surely, since there are many differences between these countries, some questions, for example, like what approaches we could use directly and to which approaches we should make changes so as to fit them into the Chinese reality, are difficult to answer.

**C. Economic Analysis of Law**

When explaining laws and regulations or making suggestions to address the five agency problems affecting executive stock option compensation, I will compare the costs with the benefits of these explanations or suggestions, then choose the most efficient explanation or suggestion. Addressing agency problems at a minimum cost is the goal of this dissertation.

**D. Empirical Analysis of Law**

Financial and accounting research papers are used in this dissertation to discuss and analyze the agency problems of executive stock option compensation from a macro perspective via the effectiveness of stock option compensation or the compensation committee and its independent directors and so on. Moreover, case studies are also used in this dissertation to discuss and analyze the agency problems from a micro perspective, for instance, by taking a glance at a stock option plan from a specific company or a piece of news.

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\(^6\) For the functions and shortcomings of comparative company law, see Donald C. Clarke, “Nothing But Wind”?The Past and Future of Comparative Corporate Governance, 59 American Journal of Comparative Law 75 (2011).
V. Notes about This Dissertation

I do not intend to (and cannot) discuss every issue related to executive stock option compensation, so I would like to limit the scope of my dissertation here.

First, I do not intend to discuss the accounting nor tax issues of executive stock option compensation. The two causes are said to be popular reasons for executive stock option compensation in the US. In China, the accounting treatment of stock option compensation is the same as the US, namely, stock option compensation is regarded as a cost. And only when executives exercise their rights and when the difference between the strike price and stock price is positive will executives pay income tax based on the profits they make by exercising their rights. There is no limit on the deductibility of the executives’ compensation.

Second, I do not intend to discuss executive stock option compensation with any particular emphasis on financial companies. Compared with ordinary companies, the capital structure of financial companies is risky and their function in modern society is of critical importance, so they face more serious problems than ordinary companies, such as their “too-big-to-fall” situation and their systematic risks. Therefore, the most serious problem in financial companies is that stock option compensation may induce executives to pursue excessively risky investments, which bring negative externality to the creditors and the whole society. So, the approaches and strategies for addressing...
the problems of financial companies are different from the aforementioned approaches and strategies in this dissertation.

Third, I do not intend to discuss executive stock option compensation in state-owned listed companies (“SOLCs”). The reasons are: 1. Executive stock option compensation is not popular in SOLCs; 69 2. Maximizing the interests of shareholders is not the goal of SOLCs; and 3. Different standards are used to evaluate the executives’ contributions to their companies. 70

Fourth, I do not intend to compare stock option compensation with other kinds of incentive compensation, such as bonuses, restricted stock compensation or stock appreciation rights, and I will not discuss the advantages and disadvantages of these different incentive compensation schemes. I will show stock option compensation to be an important part of executives’ compensation packages, point out its innate problems and provide some suggestions to make the scheme work better. This dissertation does not intend to argue that stock option compensation is the best way to pay executives. 71 However, at least in China, stock option compensation is the most popular way to incentive executives.

VI. Proceedings of This Dissertation

This dissertation proceeds as follows. Chapter one points out three factors that cripple the role of the compensation committee and its independent directors, and makes suggestions on how to fix the problem of the compensation committee having limited power and independent directors being paid without incentive compensation. Chapter two points out some deficiencies in the current executive stock option compensation disclosure system in China and makes suggestions on how to improve it. Chapter three clarifies some uncertainties regarding clawback provisions of executive stock option compensation in China. Chapter four discusses how to make compensation consultants really serve the interests of shareholders rather than surrender themselves to executives. Chapter five argues that the CSRC shall make

69 Some scholars doubt whether it is suitable for SOLCs to grant stock option compensation to executives. Because most of them are monopoly enterprises, it is difficult to evaluate the executives’ contributions to the companies. See Kong Jie Ming, Changing of Executive Compensation in Listed Companies, Vol. 5 CFO World 31, 35-36 (2011).

70 See Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 DJCL 125, 141 (2006) (“It is no secret that one of the very purposes of state ownership of enterprises is to enable the state to use its ownership, and thereby control, to cause the enterprise to engage in activities that a profit-maximizing firm would avoid, such as the sale of essential products at below-market prices, enforcement of state birth control policies among employees, or pursuit of an urban full employment policy.”).

71 Some scholar believes that “stock compensation is the most expensive way to pay future cash”, see Johnson, supra note 45.
“comply or explain” rules to address some specific agency problems of executive stock option compensation. Chapter six makes some suggestions on how to make it easier for minority shareholders to bring derivative suits and discusses what standard of judicial review the courts shall apply to determine whether the independent directors are breaching their duty of care when they create executive stock option compensation. The last chapter offers a short conclusion with regard to the whole dissertation, the contribution of this dissertation as well as the limits and shortcomings of this dissertation.
Chapter One  Ex Ante Strategy (1) of Enhancing Supervision Inside the Company: Expanding the Role of the Compensation Committee and Awarding Stock Compensation to Independent Directors

I. Introduction

This chapter discusses how to expand the role of the compensation committee and its independent directors, so as to partly address the first agency problem of executive stock option compensation; that is, the compensation committee and its independent directors are not able to perform their duty to supervise executive stock option compensation, making it possible for executives to be granted excessive compensation that they could not obtain under “at the arm’s length” dealings. Excessive stock option compensation has a variety of forms: executives may be granted more stock option compensation for a given incentive purpose; the conditions for executives to exercise their rights are easy to satisfy; or executives gain windfalls from their stock option compensation, which means the strike price will not be raised in the event of favorable developments in the market or industry and so on.

In China, three factors cripple the functions of the compensation committee and its independent directors: First, executives have huge influence on the board and independent directors in the compensation committee. Specifically, executives have huge influence in nominating the candidates who can become independent directors, and they can also collude with controlling shareholders to gain private benefits. The more influence executives have on the board and among independent directors, the more likely it is that they will be granted excessive stock option compensation. Second, the compensation committee cannot solely decide executive stock option compensation numbers. Third, there are some shortcomings in the institution of independent directors, such as limits on the standard of non-independence, the independent directors themselves having little business experience, the independent directors being paid without incentive compensation and so on. The weaker the power wielded by the compensation committee and its independent directors, the greater the
stock option compensation that executives can receive. Hence, for most companies that grant stock option compensation to executives, a critical question is how to expand the roles of the compensation committee and its independent directors so as to encourage them to pursue the interests of shareholders and supervise illegal or unethical behaviors during the implementation process of stock option compensation.

The strategy of expanding the roles of the compensation committee and its independent directors is the cornerstone of all strategies for addressing agency problems within executive stock option compensation. Right at the start when a stock option plan is being drafted, if the compensation committee and its independent directors can engage in arm’s-length bargaining with the executives, and the compensation committee and its independent directors can closely supervise any illegal or unethical behaviors of executives during the duration of the stock option plan, the other agency problems will also be resolved. Therefore, compensation consultants, the China Securities Regulatory Commission (CSRC), and the courts are less needed in addressing these agency problems of executive stock option compensation. But, unfortunately, lessons from other developed countries show that compensation committees and their independent directors can only play a very limited role in supervising executive stock option compensation. So, the question of how to expand the roles of the compensation committee and its independent directors is one of the global concerns within corporate governance.

This chapter proceeds as follows. Part II introduces the laws and rules within the process of making executive stock option compensation (or executive stock option plans) in China. Part III introduces some empirical research on the effectiveness of compensation committees and their independent directors, then analyzes why they have trouble performing their responsibilities. Part IV makes some suggestions on how to expand the roles of the compensation committees and their independent directors. Part V offers a conclusion.

II. The Law and Rules on the Process of Making Executive Stock Option Compensation in China

According to the Company Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, hereinafter Company Law), directors’ compensation shall be approved at the shareholders’ meeting; and executives’ compensation shall be decided by the
board. However, subject to Article 34 of the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the CSRC, effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans), executive stock option compensation should be approved at the shareholders’ meeting. The reasons why the Company Law and the Measures for Equity Incentive Plans have different requirements are: First, if a company fulfills its duty through issuing new stocks when executives exercise their rights, which will change its registered capital, it shall be approved at the shareholders’ meeting according to the Company Law.¹ Second, if a company fulfills its duty through repurchasing its stocks when an executive exercises their rights, it shall also be approved at the shareholders’ meeting according to the Company Law.² In principle, any shareholder who owns more than 5% of the company’s shares shall not become an eligible participant.³ In addition, neither the independent directors ⁴ nor the supervisors ⁵ shall become eligible participants. When implementing a stock option plan, the directors, supervisors, and senior executives shall be “honest and in good faith, diligent, and maintain the interests of the company and all its shareholders.”⁶ Specifically, the process of making executive stock option compensation is:

First, the stock option plan shall be drafted by the compensation committee.⁷ The majority members of the compensation committee shall be independent directors.⁸

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¹ Article 38 of the Company Law provides, “the shareholders’ meeting shall exercise the following functions: ...(7) making resolutions about the increase or reduction of the company’s registered capital.”

² Article 143 of the Company Law provides, “a company shall not purchase its own shares except under any of the following circumstances:...(3) To award the employees of this company with shares. Where a company needs to purchase its own shares for any of the reasons as mentioned in items (3) of the preceding paragraph, it shall be subject to a resolution of the shareholders’ meeting.”

³ Here, the “eligible participants” refers to those who are granted stock options according to the stock option plans, such as executives and employees.

⁴ Article 8 of the Measures for Equity Incentive Plans provides, “eligible participants may include the directors, supervisors, senior executives, and core technicians or business personnel of a listed company, and other employees that shall be granted the equity incentive as the company may deem necessary, but shall not include independent directors.”

⁵ Article 1 of the Memo No. 2 on the Matters of Equity Incentive (promulgated by the CSRC, effective Mar. 17, 2008, hereinafter Memo No.2) provides, “in order to assure the independence of the supervisors and let them perform their duty fully, the supervisors shall not be the eligible participants.”

⁶ Article 3 the Measures for Equity Incentive Plans.

⁷ Article 28 (1) of the Measures for Equity Incentive Plans provides, “the compensation and examination committee established under the board of directors of a listed company shall be responsible for drafting out the draft of an equity incentive plan.”

⁸ According to article 1(1) of the Guidance Opinion on the Establishment of an Independent Director System in Listed Companies (promulgated by the CSRC, effective Aug. 16, 2001, hereinafter Independent Director Opinion). The term “independent director” refers to “a director who does not hold any position other than the position of director in the company she works and has no relationship with the company or the controlling shareholder of the company that may affect her independent and objective judgment upon company affairs.” By the end of 2008, 98% of all the listed companies have already established compensation committee, see Gao Wen Liang & Luo Hong, Compensation Regulation, Remuneration Committee and Corporate Performance, Vol.33 No.8 Journal of Shanxi Finance and Economics University 84, 85 (2011). Concerning the institution of independent directors in China, see Donald C. Clarke, The Independent Director in Chinese Corporate Governance, 31 DJCL 125 (2006). Article 3 of Independent Director Opinion provides, “anyone falling under
The chairperson of the compensation committee shall be an independent director.9

Second, the draft shall be submitted to the board of directors for discussion.10 Also, any conflicted directors have to withdraw from the discussion.11 Independent directors shall present their independent opinions on whether the stock option plan is conducive to the sustained development of a listed company, and whether it obviously impairs the interests of the listed company and all of its shareholders.12 The supervising committee shall check the list of eligible participants.13 A listed company shall retain an attorney to issue legal opinions to its stock option plan, and present professional opinions.14 When the compensation committee deems it necessary, it may request the listed company retain an independent financial consultant to issue professional opinions on the feasibility of the stock option plan, whether it is conducive to the sustained development of the listed company, whether it will impair the interests of the listed company, and its affect to the shareholders’ interests.15 “Within 2 trading days after the board has adopted the draft through deliberation, the company shall announce the resolutions of the board, the excerpts of the draft of the stock option plan, and the opinions of the independent director.”16

Third, after the board has adopted the compensation draft, the company shall submit the documents and materials comprising the stock option plan to the CSRC for archival filing.17 If the CSRC does not reject the application documents and materials

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10 Article 28 of the Measures for Equity Incentive Plans.
11 Article 4(2) of the Memo No.2.
12 Article 29 of the Measures for Equity Incentive Plans.
13 Article 1(1) of the Memo No.2.
14 Article 31 of the Measures for Equity Incentive Plans provides, “a listed company shall retain an attorney to issue legal opinions to its stock option plan, and present professional opinions on at least the following matters: 1. Whether the stock option plan complies with the provisions of the Measures for Equity Incentive Plans; 2. Whether it has gone through legal procedures for the stock option plan; 3. Whether the listed company has fulfilled its obligation on information disclosure; 4. Whether there is any circumstance that obviously impairs the interests of the listed company and all of its shareholders, and circumstance that is in violation of the relevant laws and administrative regulations in the stock option plan; and 5. Other matters need to be stated.”
15 Article 32 of the Measures for Equity Incentive Plans.
16 Article 30 of the Measures for Equity Incentive Plans.
17 Article 33 of the Measures for Equity Incentive Plans provides, “after an stock option plan is adopted by the board of directors through deliberation, a listed company shall report the relevant materials to the CSRC for archival filing, and send a copy to the stock exchange and the securities regulatory bureau at the locality of the company at the same time.”
for archival filing within 20 workdays from the day it receives the full application and related materials, a listed company may begin sending out notifications to hold a shareholders’ meeting for discussing and implementing the stock option plan. If the CSRC sends out a rejection within the aforementioned time limit, the listed company cannot deliver a notice to convene the shareholders meeting.\textsuperscript{18}

Finally, when the stock option plan is submitted to the shareholders’ meeting for approval and a shareholder has any relation with any matter to be deliberated at the shareholders’ meeting, “she/it shall withdraw from the voting, her/its voting shares shall not be included in the total amount of voting shares of the shareholders that attend the general assembly of shareholders.”\textsuperscript{19} After the stock option plan is approved by the shareholders’ meeting, the company shall handle information disclosure matters at the stock exchange upon the strength of the relevant documents, and handle the relevant depository and clearing matters at the securities depository and clearing institutions.\textsuperscript{20}

The compensation committee and its independent directors are expected to play a very important role in creating executive stock option compensation, but then the question arises of whether they can responsibly perform their duties.

III. The Reality of the Compensation Committee and its Independent Directors and the Reasons for Their Dysfunction

A. Can the compensation committee and its independent directors function correctly in China?

Though almost all listed companies have already established compensation committees and the majority members of these committees are independent directors, can they function well and assure that executives are granted fair stock option compensation that truly reflects their contributions while bringing benefits to shareholders? Empirical studies show pessimistic results. Niu Jian Bo and Liu Xu Guang collected panel data from the Shanghai and Shenzhen Stock Exchanges from 2002 to 2005, and they concluded that “no evidence shows that a compensation committee can positively benefit shareholders and the compensation committee

\textsuperscript{18}Article 34 of the Measures of Equity Incentive Plans.

\textsuperscript{19}Article 31 (1) of the Rules for the Shareholders’ Meeting of Listed Companies (promulgated by the CSRC, effective Mar. 16, in 2006).

\textsuperscript{20}Article 38 of the Measures for Equity Incentive Plans.
cannot efficiently supervise the executives." 21 Made in 2008, one study also confirmed that “although 90% of all listed companies have already established compensation committees, the committees play a very limited role in supervising executives’ compensation.” 22 Based on a sample of listed companies in 2001-2008, Gao Wen Liang and Luo Hong found that the establishment of compensation committees was positively related to executive pay. At the same time, it had no significant effect on pay-performance sensitivity in listed companies, which meant that the role of the compensation committee needed to be expanded. 23 Relying on data from the Shanghai and Shenzhen Stock Exchanges from 2005 to 2010, Yang Wei Guo and Wu Bang Zheng found that a compensation committee could reduce the level of executives’ monetary remuneration and inhibit the expansion of executive pay. However, the compensation committee’s impact on managerial ownership and compensation sensitivity was not significant. 24 As for the effectiveness of independent directors in supervising executives’ compensation, one study shows that “the implementation of the independent director system has increased executive salaries while decreasing executives’ salary-performance sensitivity... Therefore, it can be concluded that the independent director system has become a tool for executives to increase their salary without the function of improving the salary system in China.” 25

It is very unfortunate that neither compensation committees nor their independent directors can function well and serve the interests of shareholders. The next question to ask is, why exactly do they fail?

B. The reasons why the compensation committee and its independent directors cannot function well

In my point of view, there are three factors that cripple the functions of the compensation committee and its independent directors: First, executives have huge influence on the board and the independent directors in compensation committees. Second, compensation committees by themselves cannot approve executive stock

21 Niu Jian Bo & Liu Xu Guang. The Effectiveness and Governance Premium of Sub-Committee-Based on the Experience of Chinese Listed Companies, No. 1 Securities Market Herald 64, 70 (2008).
23 Gao & Luo, supra note 8, at 91.
option compensation. And third, there are some shortcomings within the institution of independent directors.

1. Executives have a huge influence on the board and the independent directors of the compensation committee

In China, subject to the Independent Director Opinion, at least one-third of the board must be independent directors. Generally, executives also occupy one-third of board seats, while controlling shareholders (if they are natural persons) or people acting on the behalf of controlling shareholders (if they are legal persons or other entities) serve as the remaining directors. If there are no controlling shareholders, executives may occupy more than one-third of the seats on the board. So, in both dispersed-ownership companies and concentrated-ownership companies, executives have huge influence on the board. Thus, executives can also have huge influence on the independent directors in the compensation committee. The reasons are:

(1) The independent directors are usually recommended by executives and nominated by the board

According to the Independent Director Opinion, the board of directors, the board of supervisors and individuals or groups representing at 1% of the shares could nominate independent director candidates. In practice, 75% independent directors are nominated by the board and 18% are nominated by the controlling shareholders.26 Usually, the chairperson of the board or CEO recommends independent directors to the board. Since independent director can gain financial and non-financial benefits,27 one who wants to be nominated again or in other companies will try to please, at least not oppose, the CEOs. “Developing a reputation for haggling with the CEO over compensation would hurt rather than help a director’s chances of being invited to join other companies’ boards.”28 Levitt vividly describes the feeling of those persons: “Once we are on that board, how likely are we to challenge the person who invited us and to go against the persons who will reinvite us if we enjoy that service? The culture is almost fraternal.”29

(2) Independent directors gain benefits from the board

27 See Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 Journal of Economic Perspectives 71, 73 (2003) (“Besides an attractive salary, a directorship is also likely to provide prestige and valuable business and social connections.”) In China, the independent director’s pay is not generous. So, the main reasons she is willing to become a independent director are: (1) acquiring business experience; (2) expanding her social network; and (3) increasing her social reputation.
28 Id. at 74.
According to the Independent Director Opinion, independent directors’ salaries are drafted and submitted at shareholder’s meeting by the board and are approved at the meeting. In reality, how much the independent directors can get depends on how much the board drafts. So, if the compensation committee grants the executives “good” stock option compensation, as an exchange, its independent directors can also be awarded “good” salaries.

In short, “for the independent directors, generally, they are recommended by the executives and paid by the company. So, they usually do not want to go against the executives. As long as the decisions or executives’ behaviors do not break laws or rules, the independent directors will turn a blind eye to them. If the decisions or executives’ behaviors break laws or rules, they will resign rather than use their power.”30 Under the influence of executives, the independent directors are “reluctant to bargain effectively with management because, despite their fiduciary obligations, the independent directors find themselves more closely aligned with management than with the shareholders. The product of such a ‘bargain’ is no bargain at all to the corporation and its owners.”31

In China, the ownership of listed companies is highly concentrated.32 “In most firms there is a single dominant shareholder whose large share ownership gives considerable power and influence over the way the firm is run. This is especially the case with regard to the appointment and compensation of the CEO and the board.”33 Thus, the executives’ influence can be reduced by the strict supervision by controlling shareholders. However, since controlling shareholder’s tunneling behaviors (e.g. selling assets, goods and services to listed companies at high prices or transferring assets from listed companies to member firms under controlling shareholders at low prices) are usually achieved through collusion with executives,34 executives may use their influence to gain more stock option compensation in exchange for supporting

32 In China, though most companies have controlling shareholders, a few of them are also dispersed-ownership companies. For example, the largest shareholder of PingAn Insurance, a company listed on the Shanghai Stock Exchange and the Hong Kong Stock Exchange, only holds 8.43% shares of the company, which means that the executives in PingAn have huge influence in practice. So, it is not surprising that Ma Ming Zhe, the chairman of the board & CEO of PingAn, gained more than RMB 60 million (about US dollars 10 million) in 2007 (more than 90% was the result of him exercising his stock options), which was strongly criticized by shareholders and media at that time.
controlling shareholder’s tunneling behaviors.\(^{35}\) While, on the other hand, controlling shareholder’s tunneling behaviors may depress stock prices, thus reducing the profits executives earn from their options. So, there is a dynamic balance between the numbers of stock options and stock prices. As a result, executives may support some tunneling behaviors in favor of more stock options; or they may object to some tunneling behaviors in favor of higher stock prices.

In practice, executives may use their influence on the board and among independent directors to obtain excessive stock option compensation or incentive compensation, which has been confirmed by empirical studies. Looking at the data of Chinese listed companies from 2003 to 2009, Wang Qing Gang and Hu Ya Jun studied the relationship between atypical executive compensation (compensation paid to executives was highly unrelated to the performance of the company) and managerial power. They found that there was a significant positive correlation between atypical executive compensation and managerial power. The more power managers had, the more seriously they could set their own compensation in companies, especially in companies where CEOs were seated as chairman simultaneously, and these companies also had dispersed shareholding patterns and a lesser first shareholder proportion.\(^{36}\) With regard to data between 2006 and 2010 of listed companies implementing stock incentive plans, Gong Yong Hong and He Fan found that high managerial power increased stock compensation level and the compensation gap; and high managerial power was positively related to enterprise performance level and increased its fluctuation.\(^{37}\) Another study made in 2009 found that managerial compensation incentives were more related to net non-operating income with the interference of manger power. In addition, managerial power lowered the sensitivity between core performance and compensation, which implied that compensation

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\(^{35}\) Article 125 of the Company Law provides, “where any of the directors has any relationship with the enterprise involved in the matter to be decided at the meeting of the board of directors, she shall not vote on this resolution, nor may she vote on behalf of any other person. The meeting of the board of directors shall not be held unless more than half of the unrelated directors are present at the meeting. A resolution of the board of directors shall be adopted by more than half of the unrelated directors....” According to this article, related directors (controlling shareholders themselves or on behalf of controlling shareholders) cannot vote on the meeting, so the remaining directors include executives (act as directors), independent directors and a few unrelated directors. So, without the executives’ support, controlling shareholder’s tunneling behaviors cannot be successful in China. See Zhao Chun Xiang, Does Managerial Power Harm the Validity of Compensation Incentive Contracts? No. 1 Accounting Forum 87, 90 (2012).


contracts are indeed a part of agency problems.\textsuperscript{38}

2. The compensation committee does not enjoy the exclusive power to make stock option compensation

According to Article 28 of the Measures for Equity Incentive Plans, the power of compensation committees only allows for the drafting of a stock option plan -- whether the plan can actually be adopted or not falls within the discretion of the board. Thus, this requirement has a fatal flaw: “if the committee only has the power to propose but not to decide, its function will be crippled. The main function of the committee is to provide a mechanism for the independent directors to make independent decisions on some matters of the company without the participation of executives so they can supervise them. If the committee cannot decide independently, the independent directors and the committee cannot work well.”\textsuperscript{39} Under such circumstances, the compensation committee just acts as a comparatively independent compensation consultant but without its professional knowledge and experience.\textsuperscript{40} Another problem affiliated with this flaw is the “obscurity of accountability” effect. Suppose that a stock option plan is fiercely criticized by minority shareholders and the media, then the compensation committee could blame it on the board, which has adopted the plan. Meanwhile, the board could also blame it on the committee, which has drafted the plan. In the end, no party will be accountable for the controversial stock option plan.

3. The shortcomings of the institution of independent directors in China\textsuperscript{41}

(1) The limits of the standard of non-independence

According to Article 3 of the Independent Director Opinion, when a director or a director’s direct relatives have some sort of relationship with the company or its controlling shareholders which may impair the director’s independent or objective judgments, she cannot be regarded as an independent director anymore.\textsuperscript{42} However, another circumstance may also discourage an independent director from fulfilling her duty independently and objectively, but it is not included in the Independent Director Opinion. Namely, the independent director has some economic relationship with executives:\textsuperscript{43} a. “Interlock directors”. Suppose that A is an executive at a firm on

\textsuperscript{38} Zhao, supra note 35, at 100.
\textsuperscript{39} Xie Zheng Yi, Board Committees and Corporate Governance, No.5 Legal Studies 60, 67 (2005).
\textsuperscript{40} Chen Jun Ren, Corporate Governance and The Power to Make Compensation Decision, Vol. 207 Yue Dan Legal Journal 48, 48 (2012).
\textsuperscript{41} The focus of this part is the shortcomings of the institution of independent directors in the compensation committee, but it also applies to other independent directors.
\textsuperscript{42} See supra note 9.
\textsuperscript{43} According to Article 3 of the Independent Director Opinion, companies and the CRSC can also make
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whose compensation committee B sits, meanwhile B is an executive at a firm on whose compensation committee A sits. In this case, both of them can benefit from each other by using what influence they have has as a member of the other company’s compensation committee; or b. The independent director and one executive (or some executives) have a business relationship, for example, they are the only two partners in a venture capital.

(2) The independent directors lack of business knowledge and experience

Though the “determination of meaningful long-term incentives requires profound knowledge of the company’s core business,” the Independent Director Opinion does not require the independent directors in the compensation committee to have any professional knowledge or experience in compensation. In contrast, Article 52 of the Code of Corporate Governance requires that at least one independent director in the auditor committee shall be an expert in accounting. “We find that few compensation committee members have the experience of being executives. Without this background, discussions on compensation are not practical. In fact, the chairpersons of compensation committees in many listed companies are professors, who have no experience in managing companies. So, their opinions and suggestions are from the perspective of the academics, not the managements.” Therefore, even though the independent directors are well-meaning, well-intentioned and smart people, they still cannot understand some of the key aspects of compensation schemes. This problem can be resolved by hiring a compensation consultant. But, obviously, there is an incentive for it to please executives.

44 See Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 Ind. L. J. 59, 76 (1992) (“As for ability, these committees suffer several handicaps, including: (1) Because the committees are composed of other executives, not compensation specialists, they often lack technical expertise in compensation issues; (2) Time constraints preclude a thorough analysis of extremely complicated contracts; (3) As outsiders, they seldom know enough about a company’s inner workings to effectively review corporate plans and objectives or evaluate executive performance; and (4) They rely heavily on outside consultants who in turn are hired and fired by the CEOs whose pay packages are under consideration, making their recommendations suspect.”).


46 Yan Xue Feng, The Chairman of Compensation Committee Should be More Powerful, No. 4 Directors &Boards 96, 97 (2012). The reasons why university professors are welcomed by listed companies are: (1) They are more independent (compared with others); (2) Their opinions and suggestions are more macro and logical; (3) They are trusted by public investors. See Zhu Bao Chen, Independent Directors: the Persons and Stories, Securities Daily, Aug. 5, 2011.

47 See Mary-Hunter Morris, The Price of Advice, 86 U. Det. Mercy L. Rev. 153, 166 (2009) (“Seeking to counteract the board’s inherent informational disadvantage, companies routinely employ compensation consultants from outside firms who scrutinize the company’s situation and provide the board with the information and advice it needs to make a quick and rational decision.”).

48 In chapter four, I will discuss problems relating to compensation consultants in detail.
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(3) The Independent directors are paid without performance-based compensation

Currently, Chinese independent directors are paid fixed salaries mainly based on the following considerations: (a) the company’s scale; (b) the standards of the industry; and (c) the experience level of the independent directors. Because they are paid without performance-based compensation, they have little incentive to seriously supervise executives and maximize the shareholders’ profits.

(4) The independent directors are faced with little in terms of shame sanctions.

Because of the “obscurity of accountability” effect and the flaws and limits of transparency regarding executive stock option compensation, the minority shareholders and the media cannot tell whether independent directors have fulfilled their duties or not. Hence, there is not much of a difference between good independent directors (who pursue the interests of minority shareholders) and bad independent directors (who pursue the interests of controlling shareholders or executives) from the perspective of minority shareholders and the media. Thus, why would the independent directors bother opposing executives at the risk of losing their benefits?

(5) The independent directors are unlikely to be sued and found liable

Because it is difficult for minority shareholders to bring derivative suits against the independent directors who breach their fiduciary duties, few cases involves the civil liabilities of independent directors. For example, “nearly 70 independent directors were publicly condemned by the Shenzhen Stock Exchange by the end of 2007, but among these directors who failed to perform their fiduciary duties, only one director was penalized with a fine of RMB 100,000 by the CSRC. None of them were held liable for violating their fiduciary duties in the courts.”

C. Some reflections on the limited functions of the compensation committee and its independent directors

Though a dysfunction of a compensation committee and its independent directors can lead to excessive stock option compensation, we cannot say that the huge amounts of stock options paid to executives are just the result of the executives’ influence, the limited power of the compensation committee or the shortcomings of the institution of independent directors. The reasons are:

49 Wu Jian Bin, On Independent Directors’ Responsibilities and Restrictions of Listed Companies, No.3 Journal of NaJing University (Philosophy, Humanities and Social Sciences) 36, 39 (2006).
First, both in China and other countries, creating an absolutely fair stock option compensation scheme is almost mission impossible, as “to determine what part of one’s pay is deserved and what part is not, we must first determine the precise value of one’s services. Unfortunately, this is not an easy task; for what is the true value of the deployment of human capital?”  

Second, executives are scarce resources in the competitive human capital market. So, executives have “bargaining power” when they negotiate with compensation committees. Hence, “boards that try to hire a top-performing manager from another company will often have to pay top dollar. This high-performing manager has tremendous leverage.”

Finally, executives have many high-pay alternatives -- if they are not paid well in public companies, they can create venture capital or hedge funds themselves. In short, we cannot apply the concept of “arm’s-length transactions” to the corporate scene, especially in the stock option compensation scene, although there is much room to improve this kind of compensation.

The objective of this dissertation is to make some suggestions to partly address the agency problems in executive stock option compensation, thus making it more reasonable from the perspective of shareholders, especially the minority shareholders. At the same time, I do not want to amend or revise current laws and rules too much. I only hope that my suggestions will do better than current laws and rules.

IV. Expanding the Role of the Compensation Committee and Awarding Stock Compensation to Independent Directors

As aforementioned, the reasons why the compensation committee and its independent directors have not been performing well are: first, executives carry huge influence among board members and the independent directors in the compensation committee; second, the compensation committee cannot finalize executive stock option compensation figures on its own; and third, there are shortcomings in the institution of independent directors. In theory, by reducing the influence of executives;

52 Elké, supra note 31, at 654.
54 Symposium, Current Issues in Executive Compensation, 3 NYU J. L. & BUS. 519, 527 (2007).
55 In China, a few managers from public offering funds have resigned and joined in or created their own private offering funds because they can be paid more money, see Zhao Juan & Wang Li Ming, Saving the Public Offering Funds, Economics Observers, July 4, 2009. I think such a situation can also occur in listed companies if executives cannot get what they want.
expanding the role of the compensation committee, and fixing the shortcomings of the independent directors, the compensation committee and its independent directors will be able to better fulfill their duties and grant fair stock option compensation to executives, thus serving the interests of the shareholders. In practice, reducing the influence of executives is a difficult task in China, although expanding the role of the compensation committee can reduce executives’ influence over the board. The reason is that most listed companies have controlling shareholders in China, and as long as executives collude with the controlling shareholders, minority shareholders cannot really play a role in nominating and creating benefits for the independent directors, let alone collectively act.\textsuperscript{57} Though we can improve shareholders’ proposal system\textsuperscript{58} and cumulative voting system\textsuperscript{59} to encourage minority shareholders to speak up regarding executives’ pay, I doubt these methods will work well in practice.

Considering the framework of this dissertation, this chapter only discusses two problems: a compensation committee having limited power and independent directors being paid without incentivized compensation. Chapter two will discuss how to address the problem of the limits on non-independence in addition to the independent directors being faced with little shame sanctions within regard to creating transparency for executive stock option compensation. Chapter four will discuss how to address the problem of inadequate experience among independent directors with the help of real independent compensation consultants. Chapter five will discuss how to reduce the executives’ influence by enhancing supervision by the CSRC. Chapter six will discuss how to address the problem of independent directors facing little civil liabilities.

In short, the compensation committee should be responsible for executive stock

\textsuperscript{57} Edward M. Iacobucci, The Effects of Disclosure on Executive Compensation, 48 U. Toronto L.J. 489, 496 (1998) (“The benefits of disciplinary activity, either through monitoring or influencing the board, are shared equally by all shareholders, yet each would individually bear the cost of such activity. Consequently, each shareholder faces an incentive to take a free ride on the disciplinary actions of others. Since each shareholder relies on others to take action, no action is taken, and disciplinary activity is underprovided.”).

\textsuperscript{58} Article 103 of the Company Law provides, “the shareholders separately or aggregately holding 3% or more of the shares of the company may put forward a written interim proposal to the board of directors 10 days before a shareholders’ meeting is held. The board of directors may notify other shareholders within 2 days and submit the interim proposal to the shareholders’ meeting for deliberation. The contents of an interim proposal shall fall within the scope to be decided by the shareholders’ meeting, and the interim proposal shall have a clear topic for discussion and matters to be decided.” But, the 3% shareholding requirement is too high for minority shareholders.

\textsuperscript{59} Article 106 of the Company Law provides, “a shareholders’ meeting may adopt a cumulative voting system to elect the directors or supervisors according to the bylaw or its resolutions. The term ‘cumulative voting system’ as mentioned in the Company Law refers to a system of voting by shareholders for the election of directors or supervisors at the shareholders’ meeting in which the shareholder can multiply his voting rights by the number of candidates and vote them all for one candidate for director or supervisor.” But, in practice, most listed companies do not use this system. See Hu Ru Yin, The Reform of the Institution of Independent of Directors in China (Dec. 18, 2010), available at http://money.163.com/10/1218/ 16/6O6USJIC100254 KRA.html.
option compensation and independent directors should practice true independence from other company parties while working diligently to serve the interests of shareholders, especially minority shareholders, who pay and rely on them. Frankly speaking, my suggestions will not completely solve agency problems relating to executive stock option compensation, but they will certainly prove superior to current laws and rules.

A. Expanding the role of the compensation committee

This dissertation suggests two ways (not compatible) to expand the role of the compensation committee.

1. The CSRC shall amend the Measures for Equity Incentive Plans and the Code of Corporate Governance to grant the compensation committee the exclusive power to make a stock option plan and submit it for approval at a shareholders’ meeting, granting it the right to hire, pay, supervise and fire its own compensation consultant. The stock option plan, on the other hand, is not to be submitted to the board for discussion. The inclusion of independent directors and a special committee under the board was brought over from the US to China in 2002, although China had no experience with this system. So, in order to accumulate experience and not to violate the power of the board, which would make it easier to transplant this corporate practice to China, it made sense at that time to grant the compensation committee limited power. But after more than 10 years of practice, it is evident that Chinese compensation committees have been unable to fulfill their duties with their limited power. In my point of view, it is high time that the situation shall be changed, because, “ultimately, the solution to the pay problem is a compensation committee that has reclaimed its dual role as the sole arbiter of compensation and the ultimate custodian of the shareholders’ interest throughout compensation negotiations.” 60 Once the compensation committee is granted exclusive power, the compensation committee, the majority of whose members are independent directors, could create a “win-win” stock option plan for both shareholders and executives with the help of independent compensation consultants. Moreover, the executives’ influence in the board will be reduced, as the board would not be able to play any role in creating the company’s executive stock option plan. In turn, the compensation committee would not be able to blame the board for adopting a controversial stock option plan. So, besides resolving

60 Morris, supra note 47, at 174; and Xie, supra note 39, at 68.
the “obscurity of accountability” problem, granting compensation committees exclusive power would also make the independent directors in the committee more sensitive to bad decision-making. The independent directors would become the only people who would be blamed or applauded by minority shareholders and the media, causing them to heighten their sensitivity. “If the independent directors can maintain their objectiveness and independence, their reputation will improve, which will grant them more job opportunities; otherwise, if they commit fraud, their reputations would be seriously damaged, thus reducing their worth in the labor market. Therefore, in order to maintain their reputations, the independent directors would choose to work hard rather than collude with executives.” 61 Not only would shame sanctions become more efficient, but the executives’ influence over the independent directors would also be reduced. Compared with gaining influence over the board, it would likely be more difficult for executives to influence the majority independent director members in the compensation committee. It would also become more difficult for controlling shareholders to influence the independent directors in the compensation committee than to influence the board, thus making it difficult for controlling shareholders to grant excessive stock option compensation to executives in exchange for support of their tunneling behaviors.

2. Alternatively, the CSRC could make a small alternation to Article 28 of the Measures for Equity Incentive Plans via adding just one requirement: if the board decides to amend or withdraw the draft made by the compensation committee, it shall disclose the reasons why it does so in detail. Hence, unless the board has sufficient justifiable reasons, it will not amend or withdraw the compensation committee’s draft; otherwise, minority shareholders and the media would criticize the board and the company would be penalized by a reduction in its stock price. 62 Much worse, if the stock option plan were to be criticized by the country’s top news sources, it is very possible that the stock option plan would be rejected by the CSRC. 63

B. Awarding stock compensation to independent directors

When granted an appropriate level of stock compensation, the independent

63 Yang De Ming & Zhao Can, Media Monitoring, Media Governance and Managers’ Compensation, No. 6 Economic Research Journal 116 (2012) (The authors argue that though the media reports can not directly reduce the excessive compensation, they can urge the regulators to intervene in the compensation matters.).
directors in the compensation committee would see their interests aligned with those of the shareholders. They will monitor executives more closely so as to protect their own interests. “Because of this apparent link between effective oversight and equity ownership, an equity based approach to the problem of the passive board appears to be highly desirable and, is the most effective solution.” 64 Furthermore, as the chairperson is in charge of the committee and should be doing more work than other members, she may be paid more than the others. 65 Although the Measures for Equity Incentive Plans prohibits listed companies from granting restricted stocks and stock options to their independent directors, stock compensation has never been banned. Thus, the CSRC should require listed companies to pay their independent directors some amount of stock compensation based on their personal wealth, the time they spend on their jobs, the skills required by the jobs and so on.

Surely, we cannot put too much emphasis on this method, because the independent directors have to trade off benefits for costs to gain their enhanced supervision. If the gains from the stock compensation are smaller than the losses from their enhanced supervision, this method would not be viable. 66 For example, suppose an independent director holds 0.005 percent of the company’s shares and the shareholder value will be reduced by 10 million dollars through a value-reducing stock option plan, what an independent director can get is only 500, but she will lose much more than that amount, and risk not being nominated again by executives or hired by other companies. 67 In short, there are limits to what laws and rules can really do. Serving on a board is akin to belonging to a club, and that is not likely to change. 68

V. Conclusion

This chapter points out that three factors cripple the functions of compensation committees and their independent directors: first, executives command a huge influence over the board and the independent directors of compensation committees; second, compensation committees are unable to create executives stock option

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64 Elson, supra note 31, at 653.
packages by themselves; and third, there are shortcomings that exist within employing the use of independent directors. In China, most listed companies have controlling shareholders, and as long as executives collude with controlling shareholders, minority shareholder cannot really play a role in nominating and benefiting the independent directors, thus reducing executives’ influence on the independent directors.

Considering the framework of this dissertation, this chapter only focuses on addressing two problems: the compensation committee having limited power and independent directors being paid without incentivized compensation. This chapter suggests that the compensation committee should be granted the exclusive power to make executive stock option compensation packages, including hiring, paying, supervising and firing its own compensation consultant. If this method seems too radical, the chapter also suggests another method: if the board decides to amend or withdraw a draft made by the compensation committee, it has to disclose the reasons why it did so in detail. Furthermore, the independent directors in the compensation committee shall be granted stock compensation so as to align their interests with those of shareholders.
Chapter Two  Ex Ante Strategy (2) of Enhancing Supervision Inside the Company: Improving the Disclosure of Executive Stock Option Compensation

I. Introduction

The disclosure of executive stock option compensation can play a critical role in addressing agency problems of the compensation. More understandable, transparent and comprehensive disclosure can expand the role of independent directors in the compensation committee and make them more independent from the executives and the controlling shareholder\(^1\) in the company. Specifically, the disclosure can remedy non-independence limits experienced by independent directors, prevent independent directors from being recruited away by professional consultants, and force independent directors in the compensation committee to work under more efficient shame sanctions, which maybe the most important tool for supervising independent directors in China. With independent directors able to play a more key role in supervising executives, the influence of the executives over the independent directors in the company can be reduced. Thus, when they perform their duties, they will be truly “in good faith, honest and diligent” and “maintain the interests of the company and all its shareholders”.\(^2\) In this scenario, it becomes more difficult for the executives to gain excessive stock option compensation.

Since the rules on disclosure of executive stock option compensation are made by the CSRC itself, the CSRC can update or amend these rules quickly to meet the needs of the current market and address certain agency problems related to executive stock option compensation, which is useful and efficient with regard to resolving agency problems in China. For example, just in 2008, the CSRC promulgated three memos on

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1. See Martin J. Conyon & Lerong He, *Executive Compensation and Corporate Governance in China*, 17 Journal of Corporate Finance 1158, 1160 (2011) (“The ownership of China’s publicly traded firms is highly concentrated. In most firms there is a single dominant shareholder whose large share ownership gives considerable power and influence over the way the firm is run. This is especially the case regarding the appointment and compensation of the CEO or the board. Typically, the largest shareholder owns about 43% of the Firm’s shares, the second largest about 9%, and the third largest about 4% . . . China’s ownership pattern stands in stark contrast to the US, where low-concentration and ownership diffusion is the norm. It is rare for investors to own more than 10% of common equity in Anglo-Saxon firms.”).
Chapter Two  Ex Ante Strategy (2) of Enhancing Supervision Inside the Company

the matters of equity incentives to address some controversial issues about the disclosure of executive stock option compensation (as well as other issues within executive stock option compensation). The disclosure rules of the CSRC are important instruments for regulating executive stock option compensation, considering other supervision mechanisms are weak in China.

Surely, increasing the disclosure of executive stock option compensation has costs. First, companies have to pay for the drafting, printing and act of disclosing the information, as well as bearing the costs of hiring accountants, lawyers or independent financial consultants and so on. Second, disclosing executive stock option compensation would likely give rise to the “Lake Wobegon” effect and “Ratchet” effect, as “company boards generally believed that their executives were above average, or believed that admitting that their executives were below average would undermine investor confidence. In both cases, fuller disclosure of pay appeared to lead more often to pay increases than decreases, as low-pay firms sought to bring pay levels up at least to the average of the relevant peer group.” A rising tide floats all boats. Thus, every time a CEO moves up the median, the median goes up, thus ratcheting up executives’ compensation. Third, since more disclosure means more potential legal liabilities for directors, it may cause the board to choose a suboptimal compensation plan. Considering that stock option compensation is not popular despite its positive functions in China, too much disclosure maybe not good for shareholders.

Ultimately, when determining the optimal amount of transparency for executive pay, the important but often ignored costs of disclosure must be weighed against the benefits, namely, helping minority shareholders to collect and analyze information as well as supervise the independent directors in the compensation committee. What I want to emphasize here, is that the disclosure of executive stock option compensation

3 Respectively, Memo No. 1 on the Matters of Equity Incentive (promulgated by the CSRC, effective Mar. 17, 2008, hereinafter Memo No.1), Memo No. 2 on the Matters of Equity Incentive (promulgated by the CSRC, effective Mar. 17, 2008, hereinafter Memo No.2); and Memo No. 3 on the Matters of Equity Incentive (promulgated by the CSRC, effective Sept. 18, 2008, hereinafter Memo No.3).
4 Deng Hui& Zhang Yi Chao, Rethinking the Functions of Executives’ Compensation Disclosure, No.6 Modern Legal Study 55, 61 (2010).
5 David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 453–454 (2010); Richard A. Posner, Are American CEOs Overpaid, and If So, What If Anything Should Be Done About It? 58 Duke L.J. 1013, 1035 (2009) (“If the true level of compensation were publicized it would actually drive up compensation. Some CEOs would learn that they were being paid less than their peers, and they would push for more. This is especially likely because people are highly sensitive to their relative as well as their absolute wage.”).
is not directly aimed at limiting executives’ compensation, but rather atshedding more light on pay practices to create greater restraint. 

This chapter proceeds as follows. Part II briefly discusses the roles that the media and shame sanctions can play in supervising independent directors in the compensation committee in China (It also applies to other independent directors, non-independent directors and even the executives). Part III introduces the rules and practices of executive compensation disclosure (including stock option compensation) in the US. Part IV synthesizes the rules on the disclosure of executive stock option compensation in China. Part V points out several problems in these rules and practices. Part VI makes some suggestions for improving the disclosure of executive stock option compensation. Lastly, part VII offers a short conclusion.

II. The Roles of the Media and Shame Sanctions in Supervising the Independent Directors in China

It is generally accepted that shareholders have the right to know how much the executives are paid, and that more disclosure is always preferred to less. 

Disclosing executive stock option compensation can help minority shareholders to save the costs of collecting and analyzing it, thus encouraging them to take active parts in corporate governance and supervising the independent directors in the compensation committee. 

With more understandable, transparent, and comprehensive disclosure, minority shareholders can express their outrages, complaints and dissatisfactions on executive stock option compensation through the media (e.g. interviewed by newspapers, magazines or TVs), which may indirectly influence the companies and behaviors of the independent directors, thus, to some extent, supervising executive stock option compensation.

8 Walker, supra note 5, at 453.
9 Murphy, supra note 7, at 9.
10 Edward M. Iacobucci, The Effects of Disclosure on Executive Compensation, 48 U. Toronto L.J. 489, 500 (1998) (“Disclosure lowers the shareholders’ cost of monitoring the setting of executive compensation and publicizes the results of shareholder activism, thus encouraging shareholder supervision, particularly because of the recent rise of the institutional investor.”).
11 Such case has never happened in China till now, but minority shareholders can always complain executive stock option compensation by the way of being interviewed by financial presses.
12 Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 Journal of Economic Perspectives 71, 75 (2003) (“Outrage caused by the public opinion might bring embarrassment or reputational harm to directors and managers, and it might reduce shareholders’ willingness to support incumbents in proxy contests or takeover bids. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve the arrangement and the more hesitant managers will be to propose it in the first instance.”).
A. The role of the media in corporate governance and supervising the independent directors in China

In China, the media can play an important role in corporate governance and supervising the independent directors with the intervention of public authorities. As a result, the media could play a role in supervising executive stock option compensation. Just as Liebman and Milhaupt believed that “at first glimpse the important role of China’s non-free media in corporate governance issues might appear counterintuitive. In practice, however, the Chinese media enjoy significantly more autonomy in reporting on financial misconduct than they do reporting on most other areas of Chinese law and society. The media are perhaps the most effective regulator of corporate wrongdoing in China today. China’s leadership has clearly recognized the valuable role the media can play in curbing corporate misdeeds—even as they continue to limit the media’s ability to report on many other areas.” I cannot agree with them anymore.

Cu Wei Hua & Li Pei Gong found that among all 96 sanctioned listed companies by the CSRC, 60.42% of which were challenged by various media before the investigation of the CSRC. This evidence indicated that the Chinese media fulfilled an active “watchdog” role in monitoring corporate governance violation and protecting minority shareholders. Descriptive results showed that negative reports by media invoked significant market reaction, mean abnormal return and cumulative abnormal return was -0.83% (t=-2.076) and -3.19% (t=-2.447) respectively. Li Pei Gong and Shen Yi Feng found that the media took a positive part in improving corporate governance and protecting minority shareholders. The probability for listed companies to redress violations of corporate governance increased as the number of media exposure climbed. The mechanism that the media shaped its governance role in China was the involvement of administrative organizations, which was motivated by the media exposure of governance violations of the listed firms. Yang De Ming and Zhao Can found problematic executives’ compensation were more likely to be

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13 Benjamin L. Liebman & Curtis J. Milhaupt, Reputational Sanctions In China’s Securities Market, 108 Colum. L. Rev. 929, 933 (2008) (“Domestic media coverage of the sanctions of affected firms and individuals serves as an important mechanism of discipline, particularly in the Chinese context.”)

14 Id. at 980. Also see Cu Wei Hua & Li Pei Gong, Empirical Study on Media as Watchdog in Corporate Governance, Vol.15, No. 1 Nankai Business Review 33, 34 (2012) (“The increasing competition for advertising revenues and circulation as well as the sheer cut of government fund force Chinese media to respond more actively without touching the bottom line which government set.”).

15 Cu & Li, supra note 14, at 40.

reported natively by the media, but only by using the path of government could the
media play a role in monitoring executives’ compensation. 17 One paper studied the
relationship between the media coverage and the resignation of independent directors,
based on the panel data of Chinese listed companies which were negatively reported
by the media from 2006 to 2009, it found that the number of negative media had
significant positive relations to the probability of independent directors’ resignation.
The more influential the media, the higher probability of resignation of independent directors, which meant that media coverage played a positive role, while
influential media played a key role. After the media coverage, the more independent
director cared about her reputation, the higher probability of independent director
resignation was, which meant that reputation played a positive role in company
governance of independent directors. 18 There is no empirical study on the
relationship between the media and executive stock option compensation. But one
piece of news reported that the CSRC, in 2008, objected the stock option plan of
Midea, a electric appliances company listed on Shenzhen Stock Exchange, because of
its low strike price and huge amounts of options granted to executives. 19 I could not
find the exact reasons why the CSRC objected the plan, but the media’s negative
reports maybe one of them.

In short, with the improved disclosure of executive stock option compensation
information, it becomes more easily for minority shareholders and the media to find
the excessive or problematic stock option compensation. With the negative reports,
the CSRC will be urged to intervene in the matters of executive stock option
compensation.

B. Shame sanctions and independent directors

When required to make more understandable, transparent and comprehensive
disclosure on executive stock option compensation, the independent directors in the
compensation committee will exercise more restraint in determining executive
compensation. 20 They must provide a reasonable justification for their choices.

17 Yang De Ming & Zhao Can, Media Monitoring, Media Governance and Managers’ Compensation, No. 6
18 Li Yan & Qin Yi Hu, Media Coverage, Reputation Mechanism and Resignation of Independent Directors, No.3
19 Huang Han Ying, The “Face Off” of Midea’s Stock Option Plan, Southern Metropolis Daily, Jan. 16, 2008.
20 Mark J. Loewenstein, Reflections on Executive Compensation and a Modest Proposal for (Further) Reform, 50
S.M.U. L. Rev. 201, 216 (1996); Iacobucci, supra note 10, at 500 (“Disclosure compels directors to give
reasons for their choice of compensation structures, and therefore directors who care about their reputations
will carefully consider how executives are paid.”). Empirical study shows that disclosure does not appear to
alter pay levels but it does enhance incentives. And when pay is opaque to shareholders, the managerial
otherwise, they will be criticized as either doing their jobs in bad faith (or gloss negligence) or lacking of competence, which will bring severe shame sanctions down on them.21

In China, the reputation mechanism is a crucial factor motivating and restricting the behavior of independent directors. Whether independent directors will accept the invitation to join a company, how they will behave during their tenure, and under what circumstances they will remain in the company or resign all depend on reputation considerations.22 Because independent directors cannot earn as much compensation in China, the main reason they choose to act as independent directors is to enhance their reputation and social position. Since the community of independent directors is small, most of them are social elites, such as lawyers, professors and retired officials, they care about their reputation very much. Moreover, they often share the same social networks and values, so shame sanctions can play a critical role in their supervising.23 Examining 75 independent directors’ job-switches from 2001-2005, Fan et al. believed that economic factors did not provide enough incentive for independent directors, although their reputations appeared to be of high concern.24 One study showed that after receiving the media coverage, independent directors caring more about their reputation, had a higher probability of resigning from their posts, indicating that reputation played a positive role in company governance for independent directors.25 Chen Yan also found that when listed companies chose their independent directors, they would avoid choosing those from the companies which had been involved in scandals in order to not tarnish their own reputations.26 So, not only does reputation hold high importance for independent directors, but also for the companies hiring them as well. Shame sanctions, therefore, play an important role (maybe the most important role) in supervising independent directors’ behavior.

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22 Ning Xiang Dong et al. *On Reputation and Behavior of Independent Directors*, No.1 Journal of Tsinghua University (Philosophy and Social Sciences) 129, 130 (2012). Liebman & Milhaupt, *supra* note 13, at 978 ("Reputational sanctions may have particular force in China given both the underdeveloped status of China’s legal institutions and the strong emphasis on reputation evident in Chinese society today.").
23 Skeel, *supra* note 11, at 108 ("Shaming works best in closely knit communities whose members hold similar views about morality and appropriate social behavior.").
In China, the effect of shame sanctions on independent directors can be enhanced by “public censure”, which is enforced by the Shanghai and Shenzhen Stock Exchanges. If the independent directors break listing rules or their promises to the exchanges, the exchanges may publicly condemn them.27 From 2001-2006, the Shanghai Stock Exchange sanctioned 25 independent directors and the Shenzhen Stock Exchange sanctioned 40 --10 were in 2005 and 28 were in 2006. There are two main reasons that the two stock exchanges publicly condemn independent directors or others. The first one is for maintaining their high reputation. Because the Shanghai and Shenzhen Stock Exchanges have to compete with stock exchanges of other countries or districts, for example, many good Chinese companies are listed on the Hong Kong Stock Exchange. So, if investors know that the stock exchanges do not punish illegal or unethical behaviors, they may invest in the companies listed in the Hong Kong Stock Exchange. The second one is that the two stock exchanges are quasi-public authorities in China, meaning they must protect the interests of the public.28 In practice, independent directors are censured for a variety of reasons: such when an independent director continuously fails to participate in board meetings or committee meetings,29 fails to supervise the company in its timely disclosure of information30 and so on. “A variety of collateral consequences befall individuals who have been criticized by the stock exchanges. Publicly criticized directors may in practice, if not formally, be forced to resign, in particular for companies listed in Shenzhen (Stock Exchange).”31 What is worse, is that they are regarded as unsuitable candidates for directorship, which means it then nearly impossible for them to be elected again as directors, both within the same company or at other companies.32 These directors also suffer severe reputation losses, as “officials, lawyers, and

29 For example, the Shenzhen Stock Exchange publicly censured Yang Cang, an independent director of Yulong Tour, for being absent at board meetings six times in a row in 2006.
30 For example, the Shanghai Stock Exchange publicly censured Wu Mao Qing and Xiao Lian Zhang, two independent directors of Liaoning Baike, for not disclosing RMB 9.93 million in losses caused by the company investing in securities and futures trading in 2011.
31 Liebman & Milhaupt, supra note 13, at 971.
32 Article 8 (2) of the Guidelines for Nomination and Behavior of Directors provides that an individual who has been subject to one or more exchange public criticisms within a three year period will be deemed to be unsuitable to serve as a director for listed companies; article 41 (2) of Guidelines for Behavior of Directors provides that an individual who has been subject to two or more exchange public criticisms within a three year period will be deemed to be unsuitable to serve as a director for listed companies.
corporate officials all stated that the consequences of a public criticism on an individual’s reputation can be severe.”\textsuperscript{33} So, it is quite understandable that “corporate officers and independent directors frequently attempt to persuade the exchanges to sanctions only the company, not them individually.”\textsuperscript{34}

**C. Short conclusion**

In short, independent directors care highly about their own reputations, while shame sanctions can play an important role in supervising their behaviors and urge them to serve the interests of shareholders, especially those of minority shareholders. With more information, transparency and comprehensive disclosure of executive stock option compensation, the effectiveness of shame sanctions can be enhanced by media reports (because the media can more easily catch wind of problematic stock option compensation) and public censures.\textsuperscript{35}

**III. The Rules and Practices of Executives’ Compensation Disclosure in the US**\textsuperscript{36}

“Under the theory that sunlight is the best disinfectant, the disclosure rules of the Securities and Exchange Commission (SEC) have long been a favorite method used by the SEC and Congress in attempts to curb perceived excesses in executive compensation.”\textsuperscript{37} But the SEC has never expressed an opinion regarding executive compensation levels. Rather, its interest is in ensuring that the shareholders receive the information they need to make an informed judgment, and that they have a vehicle through which they can express their judgment to the board.\textsuperscript{38} The SEC has made three big reforms on executive compensation disclosure in 1992, 2006 and 2010, which will be introduced as follows:

\textsuperscript{33} Liebman & Milhaupt, supra note 13, at 974.
\textsuperscript{34} Id. at 974.
\textsuperscript{35} Id. at 973 (“The criticisms are virtually always reported in the Chinese media, which ensures broad public exposure of the fact that a company or individual has received scrutiny and criticism by a stock exchange.”).
\textsuperscript{36} This chapter does not intend to introduce the whole content of the rules of executives’ compensation disclosure in the US, it only focuses on the issues closely related to the topic of this paper, namely stock option compensation, and what can be learned from the perspective of Chinese law and practice.
\textsuperscript{37} Murphy, supra note 7, at 4.
\textsuperscript{38} Chairman Mary L. Schapiro, Remarks at the George Washington University Center for Law, Economics and Finance Fourth Annual Regulatory Reform Symposium (October 26, 2012), available at http://www.sec.gov/news/speech/2012/spch102612mls.htm. Also see Symposium, Current Issues in Executive Compensation, 3 NYU J. L. & BUS. 519, 532 (2007) (“The SEC has articulated its role as simply one of making executive compensation as transparent as possible. The SEC’s role is not to limit compensation, not to be a compensation review board, but merely to encourage full disclosures to shareholders.”).
A. 1992 Reform

Largely in response to escalating executive compensation packages and the criticisms which accompanied them, the SEC adopted major revisions to Item 402 of Regulation S-K, the item governing disclosures of issues pertaining to executive compensation in 1992. The new rules represent sweeping reforms of executive compensation disclosure. Essentially, they require compensation data to be presented in a concise, tabular format and require new disclosures regarding stock options. In fact, the new SEC disclosure rules introduced in 1992 were focused primarily on providing better details on stock option compensation, thus making it harder for CEOs to camouflage or hide compensation in stock options. Among other things, the 1992 rules include:

1. A compensation committee report

The 1992 rules require the compensation committee of a board (or the board as a whole if there is no committee) to disclose its compensation philosophy and the specific reasons for pay awards to the CEO made during the previous year, including the relationship between executives’ compensation and companies’ performance in a report to shareholders. The goal of this report is to enhance shareholders’ ability to assess how well directors are representing their interests. The report is not subject to liability under Section 18 of the Securities Exchange Act of 1934.

2. A performance graph

A graph is required to compare the company’s cumulative total shareholder return, including dividends, on its common stock with (1) a broad equity index such as the S&P 500 or equivalent; and (2) a published industry or line-of-business index comprised of peer companies selected in good faith on an industry or...
line-of-business basis. If the company cannot reasonably identify its peer group and it does not use an industry or line-of-business index, then an index must be comprised of companies with similar market capitalizations. The graph can bring benefits to shareholders, because “the inclusion of the performance graph and a desire to improve performance as depicted on the performance graph will help drive companies toward more effective compensation policies.” Following is a sample of a performance graph:

3. Certain compensation committee “interlocks” between corporations

In order to expose potential conflicts of interest due to interlocking parties who may be setting each other’s compensation, the 1992 rules require companies to disclose the following circumstances, when: (1) there are interlocks between compensation committee members at two companies; (2) a company executive serves on the board of (a second) company and an executive from (that) second company serves on the first company’s (executive) compensation committee; or (3) a company executive serves on


Mark A. Clawson and Thomas C. Klein, Indexed Stock Options: A Proposal for Compensation Commensurate with Performance, 3 Stan. J.L. Bus. & Fin. 31, 48(1997). Companies may omit specific quantitative or qualitative performance-related targets, even where they are material to compensation policies and decisions, if disclosing them would likely cause competitive harm to the company.

The graph is a very simple line graph - one line represents company return, a second line represents the “market” return, and a third line indicates an “industry” or “peer group” return. See Ragsdale, supra note 30, at 558.

the compensation committee of another company, and an executive of the second company serves on the first company’s board.\(^{50}\)

**B. 2006 Reform\(^{51}\)**

Faced with corporation scandals at the beginning of the new century, the SEC made comprehensive new reforms to the 1992 rules.\(^ {52}\) The goal of the 2006 reforms was to provide investors with a more transparent and comprehensive picture of executive and director compensation through extensive tabular presentations supplemented by improved narrative disclosures.\(^ {53}\) Among other things, the 2006 rules include:

1. Plain English disclosure
   “Philosophy, plans, and disclosures (on executives’ pay) should be easily understood and presented in plain English.”\(^ {54}\) As a starting point, the 2006 rules generally require companies to disclose executive and director compensation in plain English, such as: (1) using clear, concise sections, paragraphs and short sentences; (2) using definite, everyday words and active voice; (3) avoiding multiple negatives, legal jargon, highly technical terminology, glossaries and defined terms; (4) using descriptive headings and subheadings; and (5) using tabular presentation or bullet lists for complex material. Companies should avoid legalistic, overly complex and “boilerplate” disclosures.\(^ {55}\)

2. Compensation Discussion and Analysis (CD&A)
   The board has to explain the material factors underlying compensation policies and decisions according to data presented in the compensation tables in the CD&A, which includes: (1) an examination of such items as the company’s compensation objectives and what a compensation program is designed to reward, (2) an identification of each element of compensation and (3) an explanation of why the company chose to pay an element, how the company determined the amount for each element, and how the company’s decisions in terms of each element fit into the company’s overall compensation objectives.\(^ {56}\) The CD&A, which is supposed to explain the objectives

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51 Generally see Leigh Johnson et al., Preparing Proxy Statements under the SEC’s New Rules Regarding Executive and Director Compensation Disclosures, 7 U.C. Davis Bus. L.J. 373 (2007).
53 Johnson et al., supra note 51, at 375.
56 Johnson, supra note 51, at 380.
of the compensation program as well as each component part of the program and the rationale supporting each component part, is essential to providing investors with meaningful insight into the compensation policies and decisions of the companies in which they choose to invest. Additionally, CD&As are treated as SEC filings, so the parties who sign one will be subject to liabilities under Section 18 of the Securities Exchange Act of 1934.

3. Compensation committee report

The 2006 rules also require the company to disclose a brief compensation committee report similar to an audit committee report. In this report, the compensation committee must disclose whether it has reviewed and discussed the CD&A with management, and, based on the review and discussions, whether the committee recommended to the entire board of directors that the company include the CD&A in the company’s annual report and proxy statement.

The CD&A and the compensation committee report replace the previously required board compensation committee report on executive compensation.

4. Identifying and describing the roles of all consultants

2006 rules require companies identify and describe the roles of all consultants who provided advice on executive compensation, as well as to disclose whether the consultants are engaged directly by the compensation committee rather than by the company’s management.

C. 2010 Reform

“The current economic crisis, precipitated by a meltdown in the financial services industry, has led to a loss of public trust incorporations and other institutions. Executive compensation has become a flashpoint for this frustration and anger.” As a response to the crisis, the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank

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58 Parratt, supra note 46.
59 In December 2009, the SEC expanded its disclosure rules by requiring firms that purchase more than $120,000 in other services from their executive-pay consultants to disclose fees paid for both compensation consulting and other services. Under the new regulations, firms could avoid such disclosures if the board retained its own compensation consultant and if that consultant provided no other services. Murphy, supra note 7, at 7-8.
Act) adds some disclosure requirements for executive compensation. Among other things, the 2010 rules include:

1. Disclosure of pay versus performance

Section 953 of the Dodd-Frank Act requires that the SEC shall devise rules requiring companies to disclose, in any proxy or consented solicitation material for an annual shareholder meeting, a “clear description” of the relationship between the compensation actually paid to the company’s executives and its financial performance, taking into account any changes in the value of the company’s stock, dividends and other distributions. This disclosure can include a graphic representation of the required information.  

2. Conflicts of interest for compensation consultants

Section 952 of the Dodd-Frank Act requires that each issuer must disclose, in accordance with regulations of the SEC, whether: (1) The compensation committee has retained or obtained the advice of a compensation consultant; and (2) 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.

3. Disclosure of CEO compensation versus median employee compensation

Section 953 of the Dodd-Frank Act also requires that the SEC devise rules requiring companies to disclose the median of the annual total compensation of all employees of the issuer, excluding the compensation of the chief executive officer; the annual total compensation of the chief executive officer; and the ratio of these two amounts. However, a “lack of consistency and the absence of firm specific data minimize the ability to use the metric to assess CEO compensation within a particular company. Thus, while they can demonstrate broad trends in compensation, they have not been particularly helpful in providing shareholders with a tool for assessing the reasonableness of compensation in their own company.”

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62 Huntington, supra note 60.
64 Pagnattaro & Greene, supra note 57, at 606.
IV. Rules on the Disclosure of Executive Stock Option Compensation in China


A. Rules on the disclosure of the process of granting stock option compensation to executives

A listed company shall disclose: 1. How the executives are paid; 2. The important opinions presented and suggestions are made by the compensation committee; 3. How the independent directors perform their duties, including: what their names are; how many times they have attended board meetings; the content of their dissenting opinions; how many times they have attended shareholders’ meetings; and whether the company generally heeds their advice. Each independent director shall present her independent opinions on whether the stock option plan is conducive to the sustained development of the listed company, and whether it impairs the interests of the listed company and all of its shareholders. 4. A lawyer’s legal opinion on the stock option plan as well as the independent financial consultant’s opinion (if hired by the company); and 5. Identifying the independent financial consultant and disclosing how much compensation shall be paid (if the consultant is hired by the company).

B. Rules on the disclosure of information relating to executive stock option compensation implementation

According to Article 13 of the Measures for Equity Incentive Plans, a listed company shall set out or specify the following matters in its stock option plan: 1. the
purpose of the plan; 2. the basis for determining the eligible participants\(^{72}\) and the scope thereof; 3. the quantity of rights and interests to be granted pursuant to, and the class, source, and number of the stocks involved in the stock option plan; 4. in case the eligible participants are directors, supervisors, or senior executives, the quantity of rights and interests may be granted to them respectively, and their proportions to the aggregate amount of rights and interests to be granted pursuant to the stock option plan; 5. the effective duration of the stock option plan, the date of grant, and date of exercise; 6. the exercise price of stock options or the method for determining the exercise price; 7. the conditions for an eligible participant to be granted the rights and interests, and to exercise the rights; 8. the quantity of rights and interests involved in the stock option plan or the methods and procedures for adjusting the exercise price; 9. the procedures for the company to grant rights and interests and for the eligible participants to exercise their rights; 10. the rights and obligations of the company and its eligible participants respectively; 11. how to implement the stock option plan in case any alteration is made to the controlling power of the company, merger, or division of the company, or the eligible participants have their posts changed, removed, or die, and other matters; 12. alteration or termination of the stock option plan; and 13. other important matters.

A listed company also must disclose how it implements its stock option plan in its regular report within its regular reporting period.\(^{73}\)

Compared to other kinds of compensation disclosures, the disclosure of executive stock options in China is comprehensive and concrete, which includes almost every aspect of stock option compensation. In particular, it incorporates many ideas from the rules and practices of the US, such as reporting stock options as costs to the company and strictly regulating adjustments to the strike price. But there are still some problems in these rules and practices.

\(^{72}\) Here, “eligible participants” refers to those who are granted stock options according to the stock option plan, such as executives and employees.

\(^{73}\) According to Article 41 of the Measures for Equity Incentive Plans, a company shall disclose: 1. the scope of eligible participants within the report period; 2. the aggregate amount of rights and interests granted, exercised, and invalidated within the report period; 3. the aggregate amount of rights and interests having been granted but not exercised accumulatively till the end of the report period; 4. each adjustment on the exercise price within the report period and the updated grant price and exercise price after the adjustment; 5. name and duties of directors, supervisors, and senior executives respectively, and each grant to and exercise of power by them within the report period; 6. equity alteration conditions given rise due to the exercise of power by eligible participants; and 7. accounting disposal method for equity incentive.
V. Problems in the Rules and Practices

Though it seems that the rules on the disclosure of executive stock option compensation are comprehensive, there are still several problems in these rules and practices, which, in my point of view, make it difficult for minority shareholders and the media to understand and evaluate the stock option plans.

A. The disclosure of executive stock option compensation is not understandable

In reality, the documents that disclose stock option compensation plans are not easily readable. They are full of legal jargon, highly technical terminology and mathematical models.\(^\text{74}\) The independent opinions represented by each independent director are boilerplate and similar to the opinions released by the lawyers and independent financial consultants, so their opinions are not from the unique perspectives of the independent directors, thus their opinions cannot bring any special information about the company to the attention of minority shareholders and the media. Moreover, there is no graph nor chart to show important figures that minority shareholders and the media are eager to know, including the relationship between the stock option compensation and the performance of the company. Furthermore, a company’s performance compared with the index of the market or the industry is also lacking. “Through comparing the company’s performance with the index of the market or industry, the performance of the company in recent years will be clearly displayed. With the help of this, shareholders, the media or other outsiders can evaluate the reasonableness of the executives’ compensation.”\(^\text{75}\)

B. The disclosure of the process of making executive stock option compensation is not transparent

Most companies simply disclose the fact that they have a thorough compensation decision-making mechanism without presenting any other meaningful information to minority shareholders and the media.\(^\text{76}\) Other important information regarding the

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74 For example, there were several problems in the 2011 Vanke Stock Option Plan, a real estate company listed in the Shenzhen Stock Exchange: 1. It did not explain the meaning of ROE and its relationship with the performance of the company; 2. It was difficult to understand how the company would adjust the conditions for executives to exercise their options if it issued new shares to the market; 3. It was difficult to understand the accounting treatment of stock option compensation and so on.

75 Tong Wei Hua et al., Research on Disclosure of the Executive Compensation in Listed Companies, Vol. 12 No. 5 Journal Of ChongQing University (Social Science Edition) 47, 52 (2006).

process of making stock option compensation is also lacking, for example: 1. The role that insider directors in the compensation committee play in granting executive stock option compensation, and whether these directors who have conflicts of interest participate in the decision-making and how the conflicts of interest are prevented; 2. Whether the company hires a professional agency\textsuperscript{77} to help the compensation committee or the board to draft its executives stock option compensation packages; and 3. Whether the lawyers and independent financial consultants (if hired by the company) have any conflicts of interest.

C. The disclosure of the executive stock option compensation with regard to content is not comprehensive

The following key information, which is needed by minority shareholders and the media, is not disclosed: 1. The philosophy, background, and specific objectives of the company’s executive stock option compensation;\textsuperscript{78} 2. Whether the conditions for exercising one’s rights are feasible or not;\textsuperscript{79} 3. Whether executive stock option compensation scheme may bring excessive risks to the long-term interests of the shareholders nor not;\textsuperscript{80} and 4. How effective the executive stock option compensation plan will be.

As for these questions, China can learn a lot from the experiences of the US.

VI. Some Suggestions on Improving the Disclosure of Executive Stock Option Compensation

Since paying executives with stock options is not quite popular in China, the disclosure of executive stock option compensation should not bring too high of a cost to companies so as to encourage them to use this kind of compensation. Therefore, the suggestions made in this chapter intend to balance the costs and benefits of disclosure.

\textsuperscript{77} The function of the professional agency here is to assist the compensation committee or the board to create a stock option compensation plan, not supervise its reasonableness.

\textsuperscript{78} For instance, the objectives of 2011 Vanke Stock Option Plan are: 1. to initiate a value-creating performance culture and establish a benefits-and-risks sharing mechanism between shareholders and executives; 2. to ensure the sustainable development of the company; 3. to balance the executives’ short-term and long-term goals; and 4. to maintain the stability of the managers group and middle-level group. But it does not tell: 1. How the stock option compensation of this plan can realize these objects; and 2. Whether it is necessary for the company to grant stock option compensation to its executives in the current situation, and so on.

\textsuperscript{79} The conditions for exercising rights which are easy to satisfy are often criticized by minority shareholders and the media, see Ye Tan, \textit{The Troubles Caused by Excess Incentives}, No. 4 Directors & Boards 27 (2008).

\textsuperscript{80} “Currently, the rules do not require the companies to disclose the risks that the executives’ compensation will bring to the companies. Because the financial market and financial derivative products are not as developed as the US, the relationship between executive compensation and the risks to companies has not caught the eyes of the regulators”.\textsuperscript{\textsuperscript{76}} Ge & Tian, \textit{supra} note 76, at 39.
against the background of the realities and legal environment of China. For example, as for comparing the performance of a company with the index of the market or industry, it costs little for the company, but makes it much easier for minority shareholders and the media to understand the effectiveness of stock option compensation.\footnote{Currently, in China, there are several market indices and industry indices which can be selected by listed companies to serve as a benchmark.} Using everyday words while avoiding legal jargon, mathematical models, highly technical terminology as well as boilerplate disclosure will actually add to a company’s expenses, because it cannot simply copy or make small changes to templates provided by professional agencies or HR departments. On the contrary, the company will have to write out its own disclosure documents. On the other hand, the benefits of this approach, which makes disclosure documents easier to understand, will exceed the costs. Though the costs of disclosing more information about the process and the content of executive stock option compensation maybe huge and require more work such as writing more materials, doing more research and putting the directors and executives under more potential legal liabilities,\footnote{Article 58 of the Measures for the Disclosure of Information provides, “the directors, supervisors and senior managers of a listed company shall be liable for the genuineness, accuracy, completeness, timeliness and fairness of the information disclosure of the company, unless adequate evidence shows they have fulfilled the obligation to be diligent and duteous.” So more disclosure means more potential legal liabilities.} disclosing such information will help avoid conflicts of interest and enhance the effectiveness of shame sanctions. This in turn will encourage the independent directors in the compensation committee to do their jobs diligently and in good faith.\footnote{Article 5 of the Measures for Equity Incentive Plans.} In contrast, the costs of disclosure of CEO compensation versus median employee compensation are huge, but the benefits are quite small. “The calculation costs alone can be immense for large multinational or multi-segment corporations where payroll is decentralized; to compute the median the company needs an often non-existent single compensation database with all employees worldwide. More importantly, however, is what shareholders are supposed to do with this new information, or how they should determine whether a ratio is too high or too low.”\footnote{Murphy, \textit{supra} note 7, at 9.} In short, the main principles for the disclosure of executive stock option compensation are: understandability, transparency, and comprehensiveness. Specifically speaking:
A. The disclosure of executive stock option compensation shall be easy to understand for minority shareholders and the media\(^85\)

When information about executive stock option compensation may have a major impact on investors’ investment decisions, companies should disclose such information in an easily-understood way, such as: 1. using clear and concise sections, paragraphs and short sentences; 2. using everyday words; and 3. using graphs or charts to display key financial figures while avoiding using too much legal jargon, highly technical terminologies and complex mathematics models. Particularly, companies should avoid boilerplate disclosures and disclose their own information to the shareholders.

B. Disclosures about the process of creating stock option compensation for executives shall be transparent so as to prevent conflicts of interest

Since drafting and adopting executive stock option compensation is assigned to two different authorities, each of these authorities should disclose their decision-making processes.

Among other things, the compensation committee shall disclose: 1. Whether the following relationships exist between independent any directors and executives: (1) “interlock directors” or (2) business relationship. 2. Whether any insider director in the compensation committee is also an eligible participant in the decision-making process, and if so, what role the inside director plays and how conflicts of interest are prevented; 3. Whether the committee has hired a professional agency to assist it or the board in drafting the stock option compensation, and if so, its identity, the compensation paid to it and whether it provides other services to the company; also, if so, what measures have been taken to prevent conflicts of interest; and 4. Whether the lawyers and independent financial consultants (if hired by the company) provide other services for the company; if so, what measures have been taken to prevent conflicts of interest.

Among other things, the board shall disclose: whether the board has amended the stock option compensation draft made by the compensation committee; and if so, what the board has amended and the detailed reasons for doing so.

\(^85\) It is also encouraged by the CSRC, see Article 8 (4) and Article 20 (6) of the Content and Format of the Annual Report.
Disclosing such information cannot only help to remedy the non-independence limits of independent directors, but also to prevent conflicts of interest and the independent directors from being recruited by insiders and professional agencies.

C. The disclosure of the content of executive stock option compensation shall be comprehensive so as to let minority shareholders and the media evaluate the performance of the board and the compensation committee

Among other things, the company shall disclose the following information: 1. The background of the company granting the executives stock option compensation; 2. What the objectives of the stock option compensation scheme are and how it can realize these objectives, written in detail; 3. How the company chooses eligible participants for its stock option plan; 4. How the company determines the conditions for exercising rights (whether these conditions are easy, difficult or feasible to satisfy); 5. How the company determines the vesting time and the duration of stock option compensation (whether they will bring excessive risks to the company); 6. Whether the company has chosen indexed stock options, and if so, what kind of indexes does the company choose and how does it choose them; 7. When the company grants stock option compensation or when the executives exercise their rights, whether the company will take precautions for any potential illegal or unethical behaviors, if so, what these precautions are; 8. The effectiveness of the stock option compensation scheme shall be shown using one graph to convey the relationship between the compensation plan and the performance of the company and by comparing the performance of the company with the market or industry standards from five years before the company began granting stock option compensation until present.

Disclosing such information will not only help minority shareholders and the media to clearly understand the objectives and effectiveness of stock option compensation, but also help to enhance the effectiveness of shame sanctions on the independent directors in the compensation committee by the way of evaluating the performance of the compensation committee.

86 The CSRC may require financial companies to disclose such information in the first place. When enough experience is accumulated, then it can ask all listed companies to disclose such information so as to improve corporate governance in China. See Ge & Tian, supra note 76, at 40.

87 “Using a graph to show the company’s performance will help to evaluate the reasonableness of executives’ compensation and prevent the executives from raising their pay in unjustified ways.” Tong et al., supra note 75, at 53.
All of these information shall be disclosed when the company grants stock option compensation to its executives for the first time, except disclosures of the relationship between the stock option compensation and the performance of the company; and comparisons of the performance of the company with the market or industry standards. This information shall be disclosed at least one year after the company begins its stock option compensation scheme. To reduce the costs of disclosing such information, the annual report may quote the information that has already been disclosed. If disclosing some information may break the laws or rules or may harm the interests of the company, the company can apply for exempting certain information from disclosure.

VII. Conclusion

Compared to other kinds of compensation disclosure, the disclosure of executive stock option compensation in China is comprehensive and concrete, but there are still some problems in its rules and practices, mainly that the disclosure documents of executive stock option compensation are not easy to understand, the disclosure of the creation process is not transparent, and the disclosure of the content is not comprehensive. All of these problems make it difficult for minority shareholders and the media to understand and evaluate executive stock option compensation plans.

Based on the rules and practices of the US and considering the current situation and legal environment in China, this chapter suggests: first, the disclosure of executive stock option compensation shall be easy for minority shareholders and the media to understand; second, the disclosure of the process of making stock option compensation shall be transparent so as to prevent conflicts of interest; and third, the disclosure of the content of executive stock option compensation shall be comprehensive so as to let minority shareholders and the media evaluate the performance of the board and compensation committee.

Understandable, transparent, and comprehensive disclosure of executive stock option compensation will not only help minority shareholders reduce the costs of collecting and analyzing the information, and thus helping them to express their complaints; but also force the independent directors in the compensation committee to work under more effective shame sanctions, which maybe the most efficient method of supervising independent directors in China.
Chapter Three  Ex Post Strategy of Enhancing Supervision Inside the Company: Clarifying the Provision of Clawing Back Executive Stock Option Compensation

I. Introduction

This chapter discusses how to clarify the provision of clawing back executive stock option compensation in China in order to address the second agency problem of executive stock option compensation in this dissertation: executives may break securities law and rules, for example, by manipulating earnings or other accounting figures, to satisfy the conditions for gaining their stock options, for exercising their rights, or for artificially raising the stock price when they exercise their rights so as to make excessive and unjust profits from their options.¹

According to Lawrence E. Mitchell, there maybe three ways to keep earnings on the upswing (at the same time, to keep raising stock prices): the first way is the old-fashioned way: to earn the additional funds. This approach, however, takes time; the second way is to cut costs as much as possible, for example, by laying off masses of skillful workers; the third option is to cook the books to show better earnings than the company actually has, a path which Enron once chose.² In China, a positive relationship between stock incentives and financial restatement has been confirmed by empirical studies. Looking a sample of firms that had implemented stock incentives and paired firms from 2005 to 2007, Hu Gao Qiang and Peng Jia Sheng found that “the firms that have implemented stock incentives have a significantly higher

¹ Richard A. Posner, Are American CEOs Overpaid, and If So, What If Anything Should Be Done About It?, 58 Duke L.J. 1013, 1026 (2009) (“Tying an executive’s compensation to the value of the corporation’s stock creates an incentive to manipulate the stock price, and there is evidence that this incentive has been responsible for a number of financial debacles.”); Richard L. Kaplan, Mother of All Conflicts: Auditors and Their Clients, 29 J. Corp. Law 363, 366 (2004) (“The proliferation of managers’ compensation formulate that are tied to corporate financial performance measures, exacerbated in many cases with munificent grants of options on the corporation’s stock, make managers keenly interested in their corporation’s financial statements”).

² Lawrence E. Mitchell, Learning the Lessons of Enron (Before It’s Too Late), JURIST, June 13, 2002, available at http://www.jurist.org/forum/forumnew55.php. “Two years predating Enron’s bankruptcy, Enron’s top executives created artificially high trading values for Enron stock by managing corporate earnings in a way that kept ‘debt off the balance sheet’ and created the ‘illusion of exploding cash flow.’ Enron’s top corporate executives capitalized on this manipulation by acquiring millions of shares of stock under outstanding fixed-price stock option grants and then disposing of those shares prior to the issuance of financial restatements that caused a dramatic decline in stock price.” see Janice Kay McClendon, Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders’ Interests and Promote Corporate Long-Term Productivity, Wake Forest L. Rev. 971, 974-975 (2004).
possibility of financial restatement than the firms that do not have stock incentives. Compared to other firms that have implemented stock incentives based on performance, in firms that have implemented stock incentives based on stock prices, financial restatements are more likely to happen.”

Another empirical study by Ren Chuan Yan and Li Yang found that “listed companies that have proposed equity incentive programs are more likely to make financial restatements, indicating that the implementation of domestic equity incentive has turned executives into opportunists who are more motivated to adopt aggressive accounting policies or commit financial fraud. Hereinto, stock options and the possibility of financial restatements are related.”

In short, “when one pays the CEO with stock options, one creates incentives for short-term financial manipulation and accounting gamesmanship,” thus, “absent special controls, more options means more fraud.”

So, the provision of clawing back executive stock option compensation has been used as a method to deter such illegal behaviors. Here, “illegal behaviors” refers to executives illegally satisfying the conditions under which they can be granted stock options( or exercise their rights), or artificially raising the stock price while exercising their rights via “false records, misleading statements or serious omissions” in the companies’ accounting statements. These are three common methods that executives in Chinese listed companies use to manipulate accounting statements.

Article 46 of the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the China Securities

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6 Coffee, supra note 5, at 64.

7 Generally, clawback is defined as “are policies that allow corporate boards to recoup incentive-based compensation paid for results that are later found to be inaccurate or fraudulent.” see Donald Delves, Clawback Requirement Removes Board Discretion, Forbes, July 14, 2011, available at http://www.forbes.com/sites/donaldelves/2011/07/14/clawback-requirement-removes-board-discretion/

All incentive compensation, such as bonus, stock compensation and stock option compensation, can be clawed back. But this chapter solely focuses on the clawback of executive stock option compensation.
Regulatory Commission (CSRC), effective Jan. 1, 2006, *hereinafter Measures for Equity Incentive Plans*) provides that “in case there are any false records in the financial and accounting documents of a listed company, an eligible participant\(^8\) who is responsible shall return all the interests she has obtained pursuant to the equity incentive plan within 12 months from the day when the financial and accounting documents were announced.” Because this Article has never been discussed or analyzed in detail by Chinese law scholars\(^9\) and no related cases have reached courts in China, some confusing uncertainties exist within this Article, including: First, what exactly are financial and accounting documents? Second, is it only when false records are used in financial and accounting documents that eligible participants should return all of their interests? If not, are there any other circumstances? Third, what is the specific range of executives whose stock option compensation should be clawed back? Forth, what does *all the interests* means? And fifth, who exactly can claw back executive stock option compensation? This chapter intends to clarify these uncertainties, thus embodying this Article so as to make it more applicable in practice.

This chapter proceeds as follows. Part II introduces the legal requirements, objectives, and effectiveness of clawback provisions in the US. Obviously, Article 46 of the Measures for Equity Incentive Plans was copied from the US, so how the clawback provisions really work in the US; what controversies they have caused among scholars and practitioners; and what suggestions scholars have made on it will bring inspiration and reference to Chinese law and practice. Part III analyzes four specific questions in clawback provisions in the US: What is the trigger event? Who is covered? How much should be clawed back? And, who can claw back the compensation? Part IV points out and clarifies some uncertainties of Article 46 of the Measures for Equity Incentive Plans. Part V offers a short conclusion.

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8 The “eligible participant” refers to anyone who is granted stock option compensation according to the stock option plan, such as manager or employee.

9 I used key word “clawback” to search related Articles, cases and news reports in the database CNKI, but unfortunately, I found only two short papers written on the subject by accounting professors, and no law scholars have ever discussed or analyzed it, last visiting day: Nov. 6, 2012.
II. The Legal Requirements, Objectives, and Effectiveness of Clawback Provisions in the US

A. The legal requirements of clawing back executives’ compensation

Three federal legislations require that executives’ incentive compensation shall be clawed back under certain circumstances:

1. Section 304 of the Sarbanes-Oxley Act of 2002 (SOX 304)

   As “a reaction to excesses at WorldCom and Enron, where executives received substantial incentive compensation as a result of blatantly fraudulent accounting”, SOX 304 requires that CEOs and CFOs, belonging to companies that are required to restate their earnings due to material non-compliance under any financial reporting requirements of securities laws, must pay back to their company their bonuses or other incentive-based or equity-based compensation and turn over to their companies their profits from company stock sales, that is, if there statement is a result of misconduct. According to rulings by the federal courts, only the Securities and Exchange Commission (SEC) can recoup executives’ compensation, so it is no surprise that this section is seldom used in practice. This has been satirized by Murphy as “notable mostly for its ineffectiveness”. From 2002 to 2008, only two cases were brought by the SEC, in which the executives all had been charged with frauds. But new trends after 2008 Financial Crisis show that even if CEOs and CFOs do nothing wrong, the SEC may still recoup their compensation.

2. Section 111 of The Emergency Economic Stabilization Act of 2008 (EESA 111)

   EESA 111 requires that any Troubled Asset Relief Program (TARP) recipient must provide a means to claw back any bonuses, retention awards, or incentive

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10 Delves, supra note 7.
11 Joseph McCafferty, When Clawbacks Attack, available at http://www.complianceweek.com/when-clawbacks-attack/article/253998/ (“The clawback provision of the Sarbanes-Oxley Act was rarely used; the SEC invoked it fewer than a dozen times from 2002 to 2009.”).
14 Securities and Exchange Comm’n v. Jenkins, Case No. cv 09-1510 (D.Ariz.) (Litigation Release No. 21149A, July 23, 2009). See Spencer C. Barasch & Sara J. Chesnut, Controversial Uses Of The “Clawback” Remedy In The Current Financial Crisis, 72 Tex. B. J. 922, 924 (2009) (In this case, the SEC sought to claw back incentive-based compensation from Maynard L. Jenkins, the former chief executive officer of a public company, without any allegations that Jenkins had any involvement in or knowledge of the corporate misconduct.)
compensation paid to a senior executive officer or any of the next 20 most highly compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate. As opposed to SOX 304, EESA 111 clearly requires that the company itself is able to recoup the compensation from its executives. In addition, the “TARP recipient must enforce the clawback provisions unless the TARP recipient can show that it would be unreasonable to do so (i.e. if the cost of enforcement exceeds the potential recovery).” 15 After the TARP recipient repays its obligations to the US Treasury, it will cease to be subject to the requirement of EESA 111. 16

3. 954 of the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank 954)

Dodd-Frank 954 instructs the SEC to adopt regulations 17 which require every listed public company to adopt a policy, whereby in the event of a restatement, the company will recover from current and former executives any incentive-based compensation. All compensation earned within three years preceding the restatement which would not have been awarded under the restated financial statements would be recovered. According to Dodd-Frank 954, a failure to do so will result in delisting. 18 This new provision can co-exist with SOX 304, but differs from it in a number of ways: (1) Perhaps most importantly, this section puts the onus to force the clawback on the company itself rather than the SEC; 19 (2) The restatement need not be due to executives’ fraud or misconduct; rather, a restatement caused by an errant (or aggressive) interpretation of GAAP is sufficient; (3) SOX 304 only applies to CEOs and CFOs, while Dodd-Frank 954 requires reimbursement from all current and former executives; (4) SOX 304 reaches to all incentive-based and equity-based compensation, plus profits from selling stocks, while Dodd-Frank 954 claws back only excess incentive-based compensation which shall not be paid under accurate financial metrics; (5) The period of receipt of compensation subject to clawback under SOX 304 is the year following issuance of a financial statement that was misstated, while Dodd-Frank 954 covers the three years preceding the date on which the company was required to file the restatement.

15 Id. at 924.
17 As of today’s (May 26, 2013) completion of this chapter, the SEC is still developing regulations to implement this new clawback provision.
4. A map of clawback provisions can be seen on the following chart

This chart is based on the one made by Joseph E. Bachelder III.

<table>
<thead>
<tr>
<th>The trigger event</th>
<th>SOX 304</th>
<th>EESA 111</th>
<th>Dodd-Frank 954</th>
</tr>
</thead>
<tbody>
<tr>
<td>Misconduct resulting in required restatement of any financial reporting required under securities laws</td>
<td>Statements of earnings, revenues, gains, or other criteria…found to be materially inaccurate</td>
<td>Accounting restatement due to material noncompliance with reporting requirements under securities laws</td>
<td></td>
</tr>
<tr>
<td>Who shall be clawed back</td>
<td>CEO and CFO</td>
<td>A senior executive officer and any of the next 20 most highly compensated employees</td>
<td>Current and former executives</td>
</tr>
<tr>
<td>Enforcement</td>
<td>The SEC</td>
<td>The company</td>
<td>The company</td>
</tr>
<tr>
<td>How much shall be clawed back</td>
<td>Bonus or other incentive-based or equity-based compensation; in addition to recovery of profits of certain sales of securities</td>
<td>Bonus, retention award, or incentive compensation</td>
<td>Incentive-based compensation (including stock options) in excess of what would have been paid under the accounting restatement</td>
</tr>
<tr>
<td>Time period</td>
<td>The 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of the financial document giving rise to the required restatement</td>
<td></td>
<td>Three-year period preceding the date the company is required to prepare the accounting restatement</td>
</tr>
</tbody>
</table>
B. The objectives of clawing back executives’ compensation

1. Reducing executives’ motivation to engage in illegal behaviors

Incentivized compensation through benefits like stock options can align executives’ interests with the shareholders’, but it could also induce executives to engage in illegal behaviors, such as cooking the books to falsely satisfy the conditions to be granted stock options, or to falsely satisfy the conditions for exercising their rights or artificially raise the stock price so as to make unearned profits from their stock option compensation. Subject to the clawback provisions, once executives are found to have gained unjust compensation through illegal behaviors, the SEC or the company can recoup all benefits from the executives. Especially, according to SOX 304, what can be recouped includes the profits of certain securities sales, which are quite punitive for executives. As a result, clawbacks can reduce executives’ inclination to act illegally. Moreover, “permitting executives to keep pay that is not merited by actual performance reduces the payoff differential between good and poor performance, thereby weakening pay-performance sensitivity and executives’ incentives to increase firm value.”

2. Preventing executives from getting unjust benefits

“The concept of corporate clawback is derived from the breaching of fiduciary duties, but operates as an equitable notion of restitution. The theory is that the employee has received an unjust benefit by getting money that was not properly earned.” The goal of restitution is to return the defendant to the position it would have been in but for the wrongdoing, and prevent the defendant from profiting at the plaintiff’s expense.

According to the theory of restitution, even for executives who committed no faults and acted in good faith, the SEC or the company can still recover unjust benefits these executives may have received. “Very few people think that executives should be

20 Generally see James E. Earle & Allison Wilkerson, Dodd-Frank Clawbacks: Hot Issue for 2012, available at http://www.klgates.com/files/Publication/bb10169e-d26f-476f-ad8c-13aadb4841f/Presentation/PublicationAttachment/a8c14bfa-f86f-459f-9bea132d9c25/DoddFrank_Clawback.pdf. (Clawback serves three purposes: (1) To limit the risk of manipulation; (2) To penalize bad behaviors; and (3) The Prevention of windfall.)
22 Delves, supra note 7 (“clawbacks are a remedy for and deterrent against fraudulent, unethical or erroneous accounting practices.”).
23 Fried & Shilon, supra note 21, at 2.
25 The new tendency of SOX 304, the EESA 111 and the Dodd-Frank 954 all do not require any direct illegal action by executives.
able to keep bonuses that were obtained under false premises, even if they didn’t take part in the fraud, but just benefited from it.”

The money recouped from executives’ unjust benefits can then be distributed to shareholders or invested in other ventures, thus protecting the interests of shareholders.

C. The effectiveness of clawing back executives’ compensation

In Walker’s opinion, “clawback provisions in executive compensation agreements that allow firms to recoup bonuses paid based on inaccurate financial results may be an effective means of combating earnings manipulation.” Since only the SEC can recoup compensation from CEOs and CFOs, the effectiveness of SOX 304 is disappointing. But, for those companies who have voluntarily adopted clawback policies, one empirical study shows that “the incidence of accounting restatements declines after firms initiate such provisions. In addition, investors and auditors view such provisions as increased accounting quality and lower audit risk. Specifically, a firm’s earnings response coefficients (ERC) increase after the adoption of clawback provisions. Furthermore, for firms that adopt clawbacks, auditors are less likely to report material internal control weaknesses but more likely to charge lower audit fees as well as issue audit reports with a shorter lag.”

Another study shows that “firms that have paid large M&A bonuses and experienced value-reducing mergers and acquisitions are more likely to adopt clawback provisions,” which hints that compensation clawback policy will deter such behaviors. Surely, clawback provisions have their own limits, because they “(do) not offer a remedy for a lack of foresight, (it) merely offers token assurance that ‘bad-boy’ executives will not collect a windfall at the expense of shareholders.”

III. Four Specific Questions in Clawing Back Executives’ Compensation in the US

In this part, four specific questions will be discussed and analyzed as follows:

26 McCafferty, supra note 11.
A. What is the trigger event?

A trigger event refers to under what circumstances an executive’s compensation will be recouped. Under SOX 304 and Dodd-Frank 954, the trigger event is the restatement of any financial reporting required under securities laws. Generally, a public company must restate its financial statements if they do not comply with GAAP or violate federal securities laws. But ESSA 111 makes different requirements for trigger events, including: the statements of earnings, revenues, gains, or other figures that are later found to be materially inaccurate. Here, non-quantitative elements such as consumer satisfaction may lead to a clawback. Some criticisms have been aimed at the requirement for a trigger event in SOX 304 and Dodd-Frank 954:

1. Since the restatement of a financial report will lead to a clawback, it will deter the company from revealing its errors.

Because restating financial reports or other criteria will cause executives to return their compensation, the consequences will “discourage corporate accounting departments from revealing errors that might trigger restatements because of the corporate tumult that might ensue... Alternatively, the clawback provision may encourage accounting and finance departments to take the most conservative accounting positions possible, lowering the risk of restatements but also lowering reported results more than necessary.”

In particular, disclosing soft information may lead to more restatements of financial reports, so a requirement for all companies to provide restatements of their financial reports will also discourage them from disclosing such information. Ultimately, as opposed to focusing on the trigger event, “the appropriate allocation of the risk of accounting mistakes or fraud between the company and the executive should be left to firm-specific contracts.”

2. Companies may use more fixed compensation or more subjectivity based incentive compensation programs

Fears exist that, “given the inherent risks that a triggering financial restatement could occur, combined with the broad scope and ‘no fault’ nature of Section 954, some companies may consider shifting their compensation policy towards greater proportions of fixed compensation (such as salaries) or to more subjectively based incentive compensation programs that may escape the risk of clawback under Section

32 Delves, supra note 7.
This result may happen, but it is also not so serious. Because pay-for-performance, especially pay-for-stock-performance, is welcomed and strongly encouraged by institutional shareholders, if any executives’ compensation goes against this principle, the compensation arrangements will be objected to by them. Because shareholders can have a voice with regard to executives compensation now in the US, institutional shareholders’ opinions will be given more attention than in the past. Furthermore, IRC§162(m) enacted in 1993, limits the deductibility of non-performance-based compensation issued to certain senior executives to 1 million dollars per year. If a company wants to reduce an executive’s compensation, the compensation shall be performance-based and approved at a shareholders’ meeting. Simply, clawbacks will not lead to more fixed compensation or subjective-based incentive compensation.

**B. Who should be clawed back?**

The scope of executives whose compensation shall be clawed back are different in three federal legislations: only the CEO and CFO in SOX 304; a senior executive officer and any of the next 20 most highly-compensated employees in ESSA 111 and current and former executives in Dodd-Frank 954.

One controversial problem of who should be recouped is whether executives should be responsible for material non-compliance with securities law or material inaccuracies in financial reports or other documents. Though some argue that only those who have personal culpability with respect to the underlying misconduct shall be recouped, both the new trends of SOX 304 and the requirements of ESSA111 and Dodd-Frank 954 make it clear that even executives who are at no fault themselves, if their incentive compensation is based on false financial reporting or other data, will still be clawed back. Only in this way can executives be prevented from receiving dishonest payments. One concern of such “no-fault liability” is that it will hurt

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34 Earle & Wilkerson, supra note 20. Also see Ribstein, supra note 34 (“If the law subjects ‘incentive-based’ compensation to a potential penalty for bad accounting, the parties can always contract for non-incentive-based pay, or increase the non-incentive component of pay to reflect the risk. It is not clear how shareholders or society benefit from messing with incentive compensation in this way.”).

35 Section 951 of the Dodd-Frank Act creates a new § 14A of the Securities Exchange Act, pursuant to which companies must conduct a shareholder advisory vote on specified executive compensation not less frequently than every three years. At least once every six years, shareholders must vote on how frequently to hold such an advisory vote, which is called “say-on-pay”.

36 In SEC v. Jenkins, a federal district court held that the misconduct referred to is that of the issuer itself and does not require misconduct by the CEO or CFO. The court stated that “the plain language of the statute indicates that the misconduct of corporate officers, agents or employees acting within the scope of their agency or employment is sufficient misconduct to meet this element of the statute.” See Bachelder, supra note 16.
innocent executives,\textsuperscript{37} which will deters them from choosing incentivized compensation. Anyway, “if such misconduct has occurred and the CEO and CFO did not know about it, then they were not doing the jobs for which they were paid and should give up a large part of their compensation.”\textsuperscript{38}

**C. How much shall be clawed back?**

The amount that can be recovered under SOX 304 and ESSA 111 is quite punitive compared to the excess-pay clawback\textsuperscript{39} in Dodd–Frank 954.\textsuperscript{40} For example, according to SOX 304, the SEC could recover not only excess pay, but the entirety of incentive pay received during the 12-month period following the misleading statement and profits of certain sales of securities. But, in reality, “how a financial restatement might have retrospectively impacted stock prices is anybody’s guess. Consequently, determining what constitutes ‘excess’ compensation under Section 954 may prove extremely problematic.”\textsuperscript{41}

**D. Who can claw back?**

Since only the SEC can recoup executives’ compensation according to SOX 304, this provision has been rarely used after it became effective. Therefore, the goal of the legislation has not yet been reached. This being the case, both ESSA 111 and Dodd–Frank 954 grant the power of recouping executives’ compensation to the company itself. The controversy among scholars in the US lies within whether the board will have the discretion to claw back the compensation.

Those who support that the board has the discretion to recover the funds argue that:
1. Mandatory clawback will discourage companies from using incentivized compensation;\textsuperscript{42} and 2. “The inevitable, real-world variation in possible

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{38} Schwartz, supra note 13, at 4.
\item \textsuperscript{39} Excess compensation in Dodd-Frank 954 is defined as the difference between what the executive was paid and what the executive would have received if the financials had been correct. See Bainbridge, supra note 37, at 8.
\item \textsuperscript{41} Earle & Wilkerson, supra note 20.
\item \textsuperscript{42} Stuart R. Lombardi, Note, *Interpreting Dodd-Frank Section 954: A Case For Corporate Discretion In Clawback Policies*, 2011 Colum. Bus. L. Rev. 881, 910 (2011) (“Granting companies such discretion is both desirable and reasonable because: (1) it will reduce the risk that Section 954 will produce unintended consequences by encouraging companies to abandon incentive-based compensation...”).
\end{enumerate}
\end{footnotesize}
circumstances supports giving the board discretion to find the facts and make appropriate individual holdback or clawback determinations (with advice and counsel of management when it is not implicated).”

So the board may not perform their clawback even in minor amounts, where costs would outweigh the benefits.

Those who object that the board has the discretion to recoup the funds argue that: 1. There requirements of ESSA 111 and Dodd-Frank 954 to recoup erroneous compensation are mandatory and allow no discretion by the board; 2. “Directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation, or simply ineffectual in overseeing compensation,” so if the board has the discretion, it will not claw back the compensation from the executives. From the costs-and-benefits perspective, what the directors can get from a clawback is quite small, but what they can end up losing is quite large and real, such gaining a reputation as a dishonest person, which would ruin their relationship with the executives and lose them their chance of being nominated again; 3. Mandatory clawbacks will lower the cost of recovery. “If an executive knows that the firm will pursue him until the excess pay is recovered, he has little incentive to resist recoupment; thus, the cost of recovery will be low;” and 4. Even if the cost of recovery always exceeds the excess pay recouped, there are likely to be desirable deterrent effects associated with mandatory clawbacks. Because the executive knows that no matter how trivial the unjust compensation is, if the company can recover it ex post, her or she will have no motivation to engage in illegal behaviors ex ante.

### IV. The Uncertainties and Clarifications of the Chinese Clawback Provision

Article 46 of the Measures for Equity Incentive Plans (hereinafter Article 46) provides that “in case there are any false records in the financial and accounting documents of a listed company, the eligible participant who is responsible shall return all the interests she has obtained pursuant to the equity incentive plan within 12 months from the day when the financial and accounting documents are announced.”

43 Brown & Lifshits, supra note 31.
44 Delves, supra note 7.
46 See Fried and Shilon, supra note 40, at 732-734.
47 Id. at 739.
48 Id.
Based on this Article and what was discussed in part III, this part will also discuss four questions about this Article: What is the trigger event? Who shall be clawed back? How much shall be clawed back? And, who can claw back? I will clarify these questions in order to make this Article more applicable in practice.

A. What is the trigger event in the Chinese clawback provision?

As for the trigger event, the requirement of Article 46 is quite brief and vague. The trigger event is only one, namely that “there are any false records in the financial and accounting documents of a listed company”. So some confusing questions emerge:

1. what exactly is the meaning of financial and accounting documents?

Does this term refer to “accounting documents, account books, accounting statements and other accounting materials” (Article 13 (1) of Accounting Law of the People's Republic of China (1999 Revision) (promulgated by Standing Committee of the National People’s Congress, effective July 1, 2000))? Or does it only refer to accounting statements, which should be disclosed according to securities law and rules? Considering Article 46 also requires that “the financial and accounting documents are announced”, while only accounting statements in listed companies’ annual and interim reports shall be disclosed according to securities law and rules. So, in my point of view, the financial and accounting documents only refer to accounting statements that will be disclosed.

In current Chinese practice, almost all the listed companies use the same financial metrics in accounting statements, like earnings, basic earnings per share, return on equity, compound growth rate or net profits, as the conditions for the companies to grate stock options or for the executives to exercise their rights. Though, in some situations, the executives may manipulate some financial metrics which need not be disclosed in accounting statements or non-financial metrics to artificially raise the stock price and maximize the difference between the stock price and strike price. Such behaviors have rarely been seen in current practice. So, at least currently, it is proper

49 According to Article 21 of the Administrative Measures for the Disclosure of Information of Listed Companies (promulgated by the CSRC, effective Jan. 30, 2007, hereinafter Measures for the Disclosure of Information), among other things, the listed company shall disclose the full texts of the financial accounting statements in its annual report, which shall be audited by an accounting firm which has the relevant qualifications for business of securities or futures (Article 19 (2) of the Measures for the Disclosure of Information).

50 According to Article 22 of the Measures for the Disclosure of Information, among other things, the company shall disclose the financial accounting statements in its interim report.
to only require any false records\textsuperscript{51} in a company’s accounting statements as a trigger event.

(2) Besides \textit{any false records} in the financial and accounting documents, are there any other circumstances in which executives shall also return their compensation to the company?

The answer is definitely yes. From my point of view, misleading statements or serious omissions in the accounting statements should be equally treated with false records.\textsuperscript{52} Therefore, these two illegal behaviors should also lead to a clawback of executive stock option compensation.

**B. Who should be clawed back in the Chinese clawback provision?**

Article 46 demands that \textit{the eligible participant who is responsible for} false records (also including misleading statements and serious omissions) in accounting statements shall return their compensation. Three issues shall be discussed about this requirement.

1. The considerations in determining the scope of executives

   In my opinion, the determination of the scope of executives’ involvement depends on two considerations:

   (1) Executives’ influence on the financial report or other criteria

   The more influence the executives have on the truthfulness, accurateness and completeness on the accounting statements or other criteria (“policy-making” authority), the more possibility that the executives will engage in illegal behaviors to artificially satisfy the conditions to be granted stock options (or exercise their rights) or raise the stock price when they exercise their rights in order to make unjust profits. So the incentive compensation paid to them shall be recouped so as to discourage them from acting illegally.

   (2) The trade-off between how much can be recouped and how much the clawback will cost

\textsuperscript{51} Surely, it also shall include misleading statements or serious omissions in accounting statements, which I will discuss below.

\textsuperscript{52} Article 63 of the Securities Law of the People’s Republic of China (2005Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, \textit{hereinafter Securities Law}) provides, “the information as disclosed by issuers and listed companies according to law shall be accurate, accurate and complete and shall not have any false record, misleading statement or serious omission.” And, article 2 of the “Administrative Measures for the Disclosure of Information” provides “an information disclosure obligor shall disclose its information truthfully, accurately, completely and in time. The information disclosed shall not contain any false record or misleading statement or serious omission.” So there is no reason to exempt misleading statements or serious omissions.
Since executives are rich and the number of them is small, the costs of clawback will be low meanwhile the profits of it are high. By contrast, most of the employees are middle-classes and the number of them are large. So, the costs of claw backing the compensation from the employees are high but the profits are low. As a result, from the cost-and-benefit perspective, it is economically justified to only claw back the compensation from executives. Therefore, even if ordinary employees and middle-level employee are responsible for the illegal behaviors, they need not return the stock option compensation. Considering their influence on the accounting statements, their number and their wealth, it makes senses that Article 46 exempted them from being clawed back. If one company find it necessary to recoup compensation from some middle-level employees, for example, the manager of a branch company, it can write it in the stock option plan.

2. The specific range of who shall be clawed back

According to Article 68 (3) of the Securities Law, “the directors, supervisors and senior managers of a listed company shall guarantee the accuracy and integrity of the information as disclosed by the listed company.” In addition, the independent directors\(^{53}\) and supervisors\(^{54}\) cannot be granted stock option compensation. Hence, the specific range of who shall be clawed back may be the current or former non-independent directors and senior managers if they are responsible for the illegal behaviors. Surely, the focus of this chapter is the senior managers, namely the executives.

3. The fault requirement of Article 46

According to Article 69 of the Securities Law, if the current or former executives are able to prove that they had no faults in making any false records, misleading statements or major omissions in the accounting statements, they shall not be responsible for such behaviors. As a result, if the current or former executives can prove that they have no faults, they will not have to return their stock option compensation. I think this requirement is appropriate, at least, currently. In part II, my argument is that clawback provision has two objectives: (1) reducing executives’ motivation to engage in illegal behaviors; and (2) preventing the executives from

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53 Article 8 (1) of the Administration for Equity Incentive Plans provides, “the persons eligible for being granted the incentive under the equity incentive plan may include the directors, supervisors, senior executives, and core technicians or business personnel of a listed company, and other employees that shall be granted the equity incentive as the company may deem necessary, but shall not include independent directors.”

54 Article 1 of the Memo No.2 of the Matters of Equity Incentive (promulgated by CSRC, effective Mar. 17, 2008, hereinafter Memo No.2 ) provides, “in order to assure the independence of the supervisors and perform their supervisory functions more effectively, supervisors can not granted with equity incentive compensation.”
getting unjust benefits. Although requiring those executives who have shown no involvement in making any false records, misleading statements or major omissions in accounting statements to return their stock option compensation could help prevent them from receiving unjust benefits, it will not help reduce executives’ motivation to engage in illegal behaviors. This is because, in this situation, their compensation is getting recouped under circumstances beyond their control. More worse, it may reduce executives’ willingness to receive stock option compensation, because they could be hurt by others’ illegal behaviors, which may be difficult for them to prevent. As the two goals of clawbacks cannot be compatible at the current time, we have to choose the primary one. Considering the positive functions of stock option compensation and that only a small portion of listed companies use this kind of compensation, we should encourage more executives to receive it, so the obstacles that discourage executives from receiving it shall be removed. Requiring executives who made no false records, misleading statements nor major omissions in accounting statements to return their stock option compensation funds, in my opinion, is an obstacle that should be removed. Actually, Article 46 does so. When stock option compensation becomes popular among listed companies in China, we then can improve this Article to require executives who have not erred to return compensation, which EESA 111 and Dodd-Frank 954 in the US do now.

C. How much shall be clawed back in the Chinese clawback provision?

As for the amount to be clawed back, Article 46 names “all the interests she has obtained pursuant to the equity incentive plan within 12 months”. The question then, is what is the exact meaning of “all the interests”?

There may be existing two literal explanations: 1. One broad explanation: “all the interests” means: granted but not exercised stock options; the benefits from exercising options (the difference between the stock price and the strike price times the amount exercised); and profits from selling stocks which the executives gain after exercising options; and 2. One narrow explanation, “all the interests” means: granted but not exercised stock options and the benefits from exercising options. From the deterrent point of view, the broad explanation may have strong a deterrent effect with regard to reducing the motivation to perform illegal acts. But on the other hand, requiring executives to return all their interests may reduce their motivation to accept stock
option compensation. So, in order to encourage executives to accept stock option compensation, the narrow explanation is better than the broad one.\textsuperscript{55}

D. Who can claw back in the Chinese clawback provision?

Article 46 requires that an eligible participant who is responsible for creating false records (misleading statements or serious omissions) in accounting statements shall return all the interests she has obtained pursuant to the equity incentive plan. But it is unclear who can claw back all the interests. It is naive to expect executives to return all the interests willingly by themselves. As for who can claw back, there are two parties:

1. The CSRC. The reason is: Article 46 is in Chapter VI of the Measures for Equity Incentive Plans, titled “Supervision and Punishment”, the subject which can use the power of supervising and punishing in this chapter is only the CSRC.

2. The company itself, because: (1) The reason why the executives shall return their compensation is that the conditions they could be granted stock options, or they could exercise their rights are not satisfied, or the stock price is artificially raised, so the company incurs losses and the executives obtain unjust compensation. This is a special circumstance of unjust enrichment, which is a private law relationship. Thus, the company rather than the CSRC can recoup the compensation; (2) Unlike other Articles in Chapter VI, “Supervision and Punishment”,\textsuperscript{56} Article 46 does not clearly require that the CSRC claw back the compensation, which hints that those who made the Measures for Equity Incentive Plans never expected the CSRC to utilize this power; (3) Experience from the US shows that if only the SEC can recoup the compensation, the objectives of the clawback provision cannot be realized. I agree with this explanation.

\textsuperscript{55} Actually, the most appropriate amount that shall be clawed back is excess compensation, which means the difference between what executives were paid and what executives would have received if the accounting statements had been truthful, accurate and complete. Because, for the company, the losses it incurs are only the excess compensation it paid to executives due to wrong accounting statements rather than the entirety of the incentive compensation, let alone the profits of certain sales of securities. If the company may recoup all the incentive compensation, on the contrary, it will get unjust benefits. Suppose, the CEO and the company made such a deal: if the company’s annual income growth rate reaches 10%, the CEO will be granted 1 million stock options. Based on this benchmark, if the growth rate increases with 1% more, the CEO can be granted 100,000 more stock options. Suppose again, that the company’s real growth rate of annual income in this year is 11%, but the CEO manipulates the income report, raising the growth rate to 14%. As a result, the CEO will get an excessive 300,000 stock options. What the company loses are just the 300,000 stock options, not the whole 1.4 million stock options. If the company can recover all 1.4 million stock options, it will get unjust benefits.

\textsuperscript{56} For example, Article 47 in Chapter VI provides, “in case a listed company implements the equity incentive plan without complying with the provisions of the Measures for Equity Incentive Plans, the CSRC shall order it to correct, and give a punishment to the company and the relevant responsible persons according to law; during the period of ordering correction, the CSRC shall not accept the application documents of the company.” Similarly, article 48, 49, 50 in this chapter all grant the power of supervising and punishing to the CSRC.
When the company can claw back compensation, the following question is whether the board of the company has the discretion to claw back executive stock option compensation. The answer is no. Because according to the literal meaning of Article 46, the executive shall return all the interests, in other words, the company shall claw back her stock option compensation. This explanation makes sense considering the realities of China.

In chapter one, I proved that executives have a huge influence over the board, so if the board has the discretion to claw back, it is highly possible that there will be no clawbacks at all. Also, controlling shareholders in China also have huge influence over the board, so it is possible that a controlling shareholder will use this influence to demand the board not to claw back executive stock option compensation, thus the executives may then support the controlling shareholder to tunnel the company, which hurts the interests of minority shareholders. Furthermore, if the board decides not to claw back and supposes that minority shareholders are dissatisfied with its decision, it is difficult for minority shareholders to sue the directors of board and prove that the directors breached their duty of care. But if the board shall claw back executive stock option compensation, there will be no excuse for the board not to claw back. Therefore, it is quite easy for minority shareholders to prove that the directors of the board have breached their duty of care, though it is still difficult for them to bring a derivative suit against the directors of the board. Even if minority shareholders cannot efficiently supervise the board through a derivative suit, requiring that the board shall claw back executive stock option compensation may help the stock exchanges to determine whether the board violates Article 46 or not. Thus, if the board decides not to claw back, it is obvious that it violates Article 46, and the stock exchanges can publicly censure the directors of the board, which may bring financial and reputational losses to them. One disadvantage of this explanation is if the

57 “The ownership of China’s publicly traded firms is highly concentrated. In most firms there is a single dominant shareholder whose large share ownership gives considerable power and influence over the way the firm is run. This is especially the case regarding the appointment and compensation of the CEO or the board.” See Martin J. Conyon & Lerong He, Executive Compensation and Corporate Governance in China, 17 Journal of Corporate Finance 1158, 1160 (2011).


59 This requirement is similar to recoup the profits from executives’ short-swing trading according to article 47 of the Securities Law, which provides “where any director, supervisor and senior manager of a listed company or any shareholder who holds more than 5% of the shares of a listed company, sells the stocks of the company as held within 6 months after purchase, or purchases any stock as sold within 6 months thereafter, the proceeds as generated therefrom shall be incorporated into the profits of the relevant company. The board of directors of the company shall take back the proceeds.”

benefit of recouping is indeed trivial or moot, the mandatory clawback requirement will force companies to incur high costs.\(^{61}\)

**V. Conclusion**

Clawing back executive stock option compensation can reduce executives’ motivation to conduct illegal behaviors, such as manipulate earnings or other accounting figures, to satisfy the conditions which allow them to be granted stock options, to satisfy the conditions which allow them to exercise their rights or to artificially raise the stock price when they exercise their rights.

This chapter introduces and compares three different clawback provisions in three federal legislations in the US and reaffirms the clawback provision’s positive functions. I also discuss four specific questions in clawback provisions in the US in detailed: What is the trigger event? Who shall be clawed back? How much shall be clawed back? And who can claw back?

I clarify some uncertainties of Article 46 of the Measures for Equity Incentive Plans.: What exactly is the meaning of financial and accounting documents? Whether only in the circumstance of false records in the financial and accounting documents shall the eligible participant return all the interests. If not, are there any other circumstances? What is the specific range of executives whose stock option compensation shall be clawed back? What does “all the interests” mean? And, who can claw back executive stock option compensation?

I hope that my clarifications will make this Article more applicable in practice in the future.

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\(^{61}\) Another not bad choice is to grant the compensation committee the discretion to claw back executive stock option compensation. Specifically, the CSRC could require the compensation committee to claw back executive stock option compensation subject to Article 46. But, if the compensation committee decides not to claw back executives’ compensation, it shall disclose the reasons why it will do so in detail. Under some circumstances (e.g., the benefit of recouping is indeed trivial or moot), this suggestion may be better than the mandatory clawback. But, generally speaking, assigning clawbacks to the board is the best choice at present.
Chapter Four  Enhancing Supervision by Compensation Consultants: Preventing Conflicts of Interest and Imposing More Efficient Civil Liabilities

A corporate official interviewing two accounting firms and asking each of the partners, “How much is two plus two?” The first firm’s partner said “four,” but the second firm’s partner replied, “What number did you have in mind?” The second firm won the client.*

I. Introduction

A compensation consultant¹ can play an important role in addressing agency problems in executive stock option compensation. Briefly speaking, under the supervision by a compensation consultant, the influence that executives have over the board and the independent directors in the compensation committee will be weakened. The reason is that the stock option compensation which hurts the interests of shareholders will be objected or advised to be amended by the compensation consultant, thus the board and the compensation committee have to reconsider their compensation decisions and adjust their sympathetic to executives. Besides, the professional help offered by a compensation consultant can also address the problem that cripples the roles of independent directors in the compensation committee, namely, they lack of experience and necessary information in making stock option compensation.² In short, “compensation consultants lower agency costs and help solve the latent principal-agent problem. Resulting pay contracts are optimal for

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1 According to Article 31 of The Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the China Securities Regulation Commission (CSRC), effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans), the one who releases professional opinion on stock option plan is called a “independent financial consultant”. This chapter calls it as a compensation consultant in order to show its unique role in supervising executive stock option compensation. In the US and UK, those who help the board or the compensation committee to make compensation decisions are often called compensation consultants. See Martin J. Conyon, Executive Compensation Consultants and CEO Pay, 64 Vand. L. Rev.399,403 (2011)
2 Mary-Hunter Morris, The Price of Advice, 86 U. Det. Mercy L. Rev. 153,166 (2009) (“Seeking to counteract the board’s inherent informational disadvantage, companies routinely employ compensation consultants from outside firms who scrutinize the company’s situation and provide the board with the information and advice it needs to make a quick and rational decision.”).
shareholders (and other stakeholders) and lead to better alignment of pay with performance.”

In the US and UK, since a compensation consultant takes an active part in the whole compensation-making process, it can play three different roles: first, providing professional advice and assistance to independent directors in the compensation committee, who are with neither the time nor the experience to undertake this task; second, legitimizing the compensation committee’s decisions; and third, serving as an intermediary between shareholders and the company.

In China, according to Article 32 of the Measures for Equity Incentive Plans, the primary function of a compensation consultant is to provide professional opinion on the feasibility of the stock option plan, whether it is conducive to the sustained development of the listed company, whether it will impair the interests of the listed company, and its affect to the shareholders’ interests, which, in my point of view, to scrutinize or check the reasonableness of the stock option plan. As a result, the decision of the board and compensation committee can be legitimized by the compensation consultant’s opinion. In most cases, a compensation consultant does not join in the making-process of executive stock option compensation and advise the board and compensation committee. So, in China, a compensation consultant only performs a supervising function ex post. This function of the compensation consultant

3 Conyon, supra note 1, at 408.
5 It provides, “where the salary and examination committee under the board of directors of a listed company believes it necessary, it may request the listed company to retain an independent financial consultant to issue professional opinions on the feasibility of the stock option plan, whether it is conducive to the sustained development of the listed company, whether it will impair the interests of the listed company, and its affect to the shareholders’ interests. The independent financial consultant shall issue a report of an independent financial consultant, and issue professional opinions at least on the following matters: 1. Whether the stock option plan complies with the provisions of the Measures for Equity Incentive Plans; 2. The feasibility of the company to implement the stock option plan; 3. The checking opinions on the scope and qualification of eligible participants; 4. The checking opinions on the amount of rights and interests granted under the stock option plan; 5. Financial measurement on the company’s implementation of the stock option plan; 6. The impact of the company’s implementation of stock option plan on the sustained management capacity of the listed company and shareholders’ rights and interests; 7. The checking opinions on whether the listed company has provided any form of financial subsidy to the eligible participants; 8. Whether the stock option plan is under any circumstance that obviously impairs the interests of the listed company and all of its shareholders; 9. The reasonableness of the performance examination system and examination measures of the listed company; and 10. Other matters that shall be stated.”
6 In practice, some listed companies do hire professional agencies to help the boards and compensation committees to make the stock option plans. For example, the 2006 Vanke Stock Option Plan was made by the help of Hewitt Associates, see Kong Ie Ming, Changing of Executive Compensation in Listed Companies, Vol. 5 CFO World 31, 35 (2011). But, because the listed companies do not need to disclose whether they have hired professional agencies to help them to make stock option plans or not, this chapter cannot collect the necessary information and discuss its functions and problems. In chapter two, I have suggested that the company should disclose whether the company has hired a professional agency to assist the compensation committee and the board in drafting stock option plans, if so, its identity, compensation paid to it and whether the professional agency provides other services to the company; if so, what measures have been taken by the company to prevent conflicts of interest.
is similar to that of a law firm, who issues legal opinions on the stock option plan,\(^7\) that of a accounting firm, who audits accounting statements in the company’s annual report, or that of a rating agency, who issues credit a rating for the company’s securities. All of these capital market intermediaries, who are also called gatekeepers, scrutinize the information disclosed by the company and release their professional opinion on the information so as to enhance the reliability of the information. As a result, they can reduce information asymmetry between shareholders and companies, thus also reducing agency costs in corporate governance.

The premise that a compensation consultant can enhance the reliability of the stock option plan is that its opinion shall be objective and fair, which depends on whether it is independent of the executives or not. If its opinion is based on the consideration of providing other services to the company or maintaining a business relationship with the company, the so-called “independent compensation consultant” will surely surrender itself to executives. “A potential problem with (compensation) consultants, however, is that they are usually hired by the executives themselves to assist the compensation committee of the board. While these consultants no doubt generally act in good faith, they must feel at least implicit pressure to satisfy the executives who hired them.”\(^8\)

Though some rules in the Measures for Equity Incentive Plans regulate compensation consultants, such as how a compensation consultant shall perform its duty\(^9\) and the administrative liabilities if a compensation consultant breaks its duty,\(^10\) but there still exist some serious problems which will disappoint the rule-makers and shareholders:

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\(^7\) Article 31 of the Measures for Equity Incentive Plans provides, “ a listed company shall retain an attorney to issue legal opinions to its stock option plan, and present professional opinions at least on the following matters: 1. Whether the stock option plan complies with the provisions of the Measures for Equity Incentive Plans; 2. Whether it has gone through legal procedures for the stock option plan; 3. Whether the listed company has fulfilled its obligation on information disclosure; 4. Whether there is any circumstance that obviously impairs the interests of the listed company and all of its shareholders, and circumstance that is in violation of the relevant laws and administrative regulations in the stock option plan; and 5. Other matters need to be stated.”


\(^9\) Article 5 of the Measures for Equity Incentive Plans provides, “any professional institution that issues opinions for the equity incentive plan of a listed company shall be honest and in good faith, diligent, and ensure that the documents it issues are truthful, accurate, and complete.”

\(^10\) Article 50 of the Measures for Equity Incentive Plans provides, “in case the relevant professional institutions that issue opinions on the equity incentive plan of a listed company fails to fulfill the diligent duty, or the professional opinions issued by them have false record, misrepresentation, or great omission, the CSRC shall take such measures as the supervision talk, issuing warning letter, ordering to rectify, and etc. to the relevant professional institutions and the personnel who sign their names on the opinions, and transfer them to the competent departments in charge of the relevant professional institutions for punishment; if the circumstance is serious, they shall be given warnings, fines and other punishment; if an illegal securities act is constituted, they shall be subject to legal liabilities according to law.”
First, the power of the compensation committee is limited. 1. It cannot directly hire its own compensation consultant without requesting the company to retain it. 2. It is not clear whether the compensation committee has the power to compensate, supervise and fire the hired compensation consultant directly.

Second, although a compensation consultant is required to be independent, the standard of independence or no-independence is not established in the Measures for Equity Incentive Plans.

Third, the Measures for Equity Incentive Plans only focuses on administrative liabilities if a compensation consultant breaches its fiduciary duty. How to expose it to more efficient civil liabilities is unknown, especially more efficient imputation of liabilities and scope of liabilities. At the same time, neither securities law nor rules efficiently solve this problem.

So this chapter intends to make some suggestions to partly resolve these problems. I hope that my suggestions can do better jobs than the current securities law and rules. Because problems concerning compensation consultants have not been given enough attention by Chinese law scholars, this chapter will refer to the law and practice in the US as an important means to resolve the aforementioned problems. Though the laws and rules, the development stage of the capital market and the functions of compensation consultants in China are different from those in the US, as a rational institution, when facing the same conflicts of interest, compensation consultants or their employees will react similarly.

This chapter proceeds as follows. Part II firstly discusses the roles of a compensation consultant, secondly points out the conflicts of interest faced by it, thirdly provides empirical studies to show the serious problem caused by the conflicts of interest. Part III analyzes how compensation consultants are regulated in the US ex ante and what suggestions scholars in the US have made to enforce gatekeepers to a more strict litigation ex post. Part IV first introduces the law, rules and practice about compensation consultants in China, then points out the problems in them; lastly it makes some suggestions. Part V offers a short conclusion.

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11 I used the keywords “compensation consultant” and “independent financial consultant” to search related articles in the database CNKI. Unfortunately, no academic articles were found. I only found a few news reports on independent financial consultants, lasted visiting day: Nov. 19, 2012.
II. The Roles of A Compensation Consultant and the Conflicts of Interest Faced by It

In this part, firstly, I will discuss the roles of a compensation consultant; secondly, points out two kinds of conflicts of interest faced by it; and thirdly, I will provide empirical studies to show the conflicts of interest may lead the compensation consultant to favor executives.

A. The roles of a compensation consultant

1. A compensation consultant as a gatekeeper

“The gatekeeper is an agent who acts as a reputational intermediary to assure investors as to the quality of the ‘signal’ sent by the corporate issuer. The reputational intermediary does so by lending or ‘pledging’ its reputational capital to the corporation, thus enabling investors or the market to rely on the corporation’s own disclosures or assurances where they otherwise might not.” 12 Since the gatekeeper is the repeat player in the capital market, its success depends on its reputation which has accumulated for quite a long time. In theory, “because the gatekeeper’s business depends on its reputation for honesty, probity, and accuracy, it will not ruin that reputation to aid one client to cheat.” 13 Based on the characteristics of gatekeeper, the compensation consultant in China who issues professional opinion on the reasonableness of stock option plan, is definitely, one kind of gatekeepers. In the US and UK, a compensation consultant also plays the role of justifying the decisions made by the compensation committee, so this chapter also regards it as one kind of gatekeepers. Here, I want to emphasize three points:

(1) Those who a gatekeeper should really serve are the shareholders not the executives. But, in reality, the gatekeeper always colludes with the executives.

(2) Though independence is a necessary condition but not a sufficient condition for a gatekeeper to provide objective and fair opinion, the independence is the solid foundation for it to perform its duty successfully.

(3) Good reputation can help a gatekeeper gain the trust of shareholders, so it has the incentive to maintain and enhance its reputation. But only good reputation is far from enough. “The central theoretical point is that reputational arguments related to gatekeepers are complex and reputation alone is not necessarily a viable constraint on

gatekeeper certification.”14 The reasons are: (a) It is difficult for shareholders to evaluate the opinions issued by gatekeepers; and (b) The employees and the firms have different interests, so the employees will do something benefiting themselves even at the costs of the firms. As for the case of accounting firm, “it matters little that the accounting firm is huge with hundreds of large clients. The individual audit partner has only a few. As a consequence, at the level where the most important decisions are made regarding financial statement disclosures, the balance of power lies with the client.”15

2. The roles of a compensation consultant

In the US and UK, a compensation consultant can play three different kinds of roles: (1) providing professional advice and assistance to independent directors in the compensation committee; (2) legitimizing the compensation committee’s decisions; and (3) serving as a intermediary between shareholders and the company.16 Because a compensation consultant takes an active part in the whole process of drafting the compensation package, its primary role is to advise the compensation committee to make compensation decision. The situation in China is a little bit different. The primary role of a compensation consultant is to legitimize the stock option plan made by the board and compensation committee. But such a difference cannot be exaggerated. On one hand, when a compensation consultant legitimizes the decision in China, it may communicate with the board and compensation committee at the same time. Suppose that some articles in the stock option plan are not reasonable from the perspective of shareholders, the compensation consultant may suggest the board and the compensation committee to amend these articles and provide their advice. From this point of view, the compensation consultant in China can also help the board and the compensation committee to make compensation decision and address the problem that the independent directors in the compensation committee lack of experience and necessary information in making executive stock option compensation.

On the other hand, if the decision recommended by a compensation consultant is strongly criticized by shareholders in the US and UK, its reputation will be hurt. As a result, the compensation consultant will carefully choose its recommendations. From

15 Richard L. Kaplan, Mother of All Conflicts: Auditors and Their Clients, 29 J. Corp. Law 363, 367 (2004). Also see Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash. U. L.Q. 491, 502 (2001) (“Even if gatekeeper managers do not face incentives to deplete the reputation of the entity for short-term gain, lower level employees might face precisely those incentives. It is especially costly to monitor such employees, given the annual bonus compensation structure of most gatekeepers and the incentives for employees to maximize short-term profits.”).
16 Bender, supra note 4, at 3-9.
this perspective, the compensation consultant supervises the compensation committee’s decision. Besides, as a reputational intermediary in the capital market, the compensation consultant can explain the company’s compensation decision and policy to shareholders and feedback shareholders’ concerns to the company. In short, not matter in China or in the US and UK, the compensation consultant can play three different roles, but its primary role is not the same. Specifically speaking:

(1) A compensation consultant can provide professional advice and assistance to independent directors in the compensation committee (the primary role of compensation consultant in the US and UK)\(^{17}\)

a. When the compensation committee makes compensation decision, it need refer to the executives’ compensation level and structure in the same industry as its benchmark. But the company itself has no such data or its data is not enough. “The (compensation) consultants are privy to pay data that are not shared directly among companies. Firms participate in consultant’s compensation surveys with the understanding that individual company data will be kept confidential. The consultants then use the date to improve the design of their clients’ compensation arrangements.”\(^{18}\)

b. Making executives’ compensation is a knowledge-and-experience-demanding job, it involves “the value of complex pay packages and associated tax, disclosure, and accounting issues.”\(^{19}\) So, with the help of a compensation consultant, the problem that independent directors in the compensation committee lack of information and experience can be addressed.

(2) A compensation consultant can legitimize the board or/and compensation committee’s decision (the primary role of compensation consultant in China)\(^{20}\)

Because there is no world-widely recognized level and structure of executives’

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17 See United States House of Representatives Committee on Oversight and Government Reform Majority Staff (hereafter the 2007 Congress Report), Executive Pay: Conflicts Of Interest Among Compensation Consultants, at 1 (December 2007), available at http://www.rieri.com/PDF/Executive-Consultant-Conflicts.pdf. (“Large companies routinely retain compensation consultants to provide advice on executive pay, such as developing compensation peer groups, designing equity compensation plans, conducting compensation surveys, and analyzing the tax, accounting, and legal implications of specific pay packages. These consultants can be retained by either the corporate board (typically, the compensation committee of the board) or management, and they may advise the board, management, or both on executive pay issues. Whether retained by the board or management, these consultants can have a major impact on executive pay decisions.”).


19 Conyon, supra note 1, at 408.

20 Ruth Bender, Paying For Advice: The Role of the Remuneration Consultant in U.K. Listed Companies, 64 Vand. L. Rev. 361, 363-364 (2011) (“It suggests that the use of compensation consultants can be best explained using theories of legitimacy: by taking outside advice, the compensation committee legitimizes its decisions in the controversial area of executive pay.”).
compensation, if the board or/and compensation committees’ decision is advised or checked by a compensation consultant, their decision will be immunity from being criticized by shareholders or lawsuits. As a result, to “employ and rely on compensation consultants have become prevalent within judicial opinions and corporate best practices.” In fact, courts “have generally given greater deterrence to board decisions that relied on advice by outsiders,” thus, “compensation consultants can similarly add legitimacy to board compensation decision in the eyes of others.”

(3) A compensation consultant can serve as a intermediary between shareholders and the company

Only executives’ compensation is accepted by shareholders, will the board and compensation committee be avoided of being criticized, blamed or even sued by them. On one hand, the compensation consultant can explain how and why the executive are paid for shareholders, thus quelling potential public outrage over executives compensation. This function is quite important in those counties that grant the shareholders the rights of say-on-pay. On the other hand, the compensation consultant can provide the concerns of shareholders, especially the institutional shareholders to the company. So, it can improve the understandings of both sides.

The premise that a compensation consultant can successfully play the three roles is to maintain its independence. However, independence is the “Achilles Heel” of a compensation consultant. “The core criticism is that (compensation) consultants are not sufficiently independent or impartial and this leads to pay packages that are not optimal from the shareholders’ perspective.”

B. The conflicts of interest faced by a compensation consultant

In theory, a compensation consultant is retained by the company and it shall serve

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21 See Charles M. Elson, The Duty Of Care, Compensation, And Stock Ownership, 63 U. Cin. L. Rev. 649, 686 (1995) (“Compensation structuring is not a precise art or science. It is based on comparisons with what other businesses are paying. There is tremendous subjectivity involved in deciding with what businesses the client’s compensation structure will be compared.”).

22 Morris, supra note 2, at 186 (“Because directors can hide behind expert consultants and their contrived ‘comparable’ data to justify exorbitant pay packages, shaming tactics are unlikely to be very effective.”).

23 Id. at 155.

24 Bebchuk & Fried, supra note 18, at 70. In the court, “in order to survive a motion to dismiss in a case alleging due care violations where the board was advised by an expert, plaintiffs must: allege particularized facts ... that, if proved, would show, for example, that (a) the directors did not in fact rely on the expert; (b) their reliance was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject mater ... that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the board was so unconscionable as to constitute waste or fraud.” see Morris, supra note 2, at 193.

25 Bebchuk & Fried, supra note 18, at 70.

26 Conyon, supra note 1, at 408.
the interest of the company and its’ shareholders. But, as a matter of practice, the company is a artificial person, which is represented by the executives or those who under the control of them. “Often, a (compensation) consultant is selected to provide services to the committee because of the consultant’s established relationship with the corporation’s human resources department, a department that reports directly to the corporation’s CEO.” 27 So, from the perspective of a compensation consultant, it is hired by the executives rather than the company. Consequently, “when pay consultants depend on management for their livelihood, they might be easily persuaded to recommend very generous compensation packages.” 28 Generally speaking, a compensation consultant faces two kinds of conflicts of interest:

1. A compensation consultant wants to provide other service to the company (cross-selling problem)

Besides providing executives’ compensation consultancy services to the company, a compensation consultant usually provides other services to it, such as “employee benefit administration, human resource management, and actuarial services,” 29 thus “the ability of consultants to provide independent, unbiased advice to directors regarding the pay of senior executives can be compromised if the senior executives are at the same time paying the compensation consultants to provide other services to the company.” 30 According to a report from the US Congress, “for each dollar these (compensation) consultants received for executive pay advice, they received almost $11 in payments for other services.” 31 Therefore, cross-selling problem may turn a compensation consultant from “a watchdog to a salesman”. 32

2. A compensation consultant wants to continue the business relationship with the company (repeat business problem)

Comparing to the competition of other gatekeeper industry, such as auditing and credit-rating service, the compensation consultant industry is quite competitive. 33 In

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29 Id. Also see Joann S. Lublin, Conflict Concerns Benefit Independent Pay Advisers (December 10, 2007), available at http://www.delvesgroup.com/wp-content/uploads/2010/08/WSJ-Article-Dec.-10-2007.pdf. (“Activist shareholders have long complained that large consulting firms often simultaneously advise directors about executives’ compensation and provide benefits consulting or other human-resources advice to managers. Activists say these consultants have an incentive to please managers, who control those more lucrative contracts.”).
30 Id. The 2007 Congress Report, supra note 17, at 1.
31 Id. The 2007 Congress Report, supra note 17, at 4.
32 Coffee, supra note 12, at 28.
33 Prior to 2010 there were existing six leading compensation consultants in the US: Frederick W. Cook & Company, Hewitt Associates, Mercer Human Resources Consulting, Pearl Meyer & Partners, Towers Perrin,
such a competitive industry, if a compensation consultant makes trouble for a client, it will jeopardize not only the compensation consultant fee, but also the potential for cross-selling services, which are more profitable than compensation consultancy per se.\textsuperscript{34} As a result, “(compensation) consultants who fear being fired, losing repeat business, or both are more likely to recommend pay contracts that favor the CEO at the expense of shareholders.”\textsuperscript{35} In short, “(to) lose the client, and your career is eclipsed.”\textsuperscript{36} Surely, there are existing some constraints on the “overtly self-serving” compensation consultant. “A compensation consultant who is exposed as colluding with management, or recommending lucrative pay deals for poor performance, will suffer a loss of valuable market reputation. In addition, the consultant may risk termination by the client firm’s board of directors, fail to attract and retain assignments at other firms, or even risk litigation.”\textsuperscript{37} For its own sake, a compensation consultant will find a subtle balance between shareholders and the executives, but it is impossible for it to put its full heart and soul to protect the interests of shareholders. “To the extent that the gatekeeper is hired by corporate managers to reassure its shareholders or investors, a reputation for unbending intransigence may alienate corporate managers, even if it pleases investors—thereby producing an uncertain trade-off. In short, there is no natural equilibrium.”\textsuperscript{38}

\textbf{C. Empirical studies about the influences of conflicts of interest on executives’ compensation}

Whether aforementioned two conflicts of interest of compensation consultant will lead to grant executives excess or less pay-for-performance compensation, empirical

\textsuperscript{34} Also see Lucian Arye Bebchuk \& Jesse M. Fried, \textit{Executive Compensation as an Agency Problem}, 17 J. ECON. PERSP. 71, 78–79 (2003) (“Providing advice that hurts the CEO’s pocketbook is hardly a way to enhance the consultant’s chances of being hired in the future by this firm or, indeed, by any other firms”).

\textsuperscript{35} Conyon, \textit{supra} note 1, at 410.

\textsuperscript{36} Testimony of Professor John C. Coffee, Jr., \textit{The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets}, at 4 (Before the Senate Banking Committee On September 26, 2007), available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d1c0419e-d84a-4b43-b02d-4e246e2d8ec7.

\textsuperscript{37} Conyon, \textit{supra} note 1, at 410–411.

\textsuperscript{38} Coffee, \textit{supra} note 3, at 333.
studies offer different findings. The reason maybe “the retention of the consultant is endogenous, and missing explanatory variables may plague model estimation.” But, at least, the different findings of these studies show the potential harms that the conflicts of interest faced by a compensation consultant may bring to shareholders.

What a pity thing is that there is no empirical studies on the conflicts of interest problem of compensation consultant in China. But, in my opinion, the findings made by foreign scholars may also apply in China. Facing the same conflicts of interest, from my point of view, a compensation consultant (including its employees) will react in similar way. Besides, the Chinese compensation consultants are under more cruel competition and less possibilities of shame sanctions and litigation than their foreign counterparts, so it may be more difficult for them not to favor executives.

1. The influence of cross-selling problem

Using a unique data set of compensation consultant service fee in US S&P 500 firms in 2009, Wei Cen and Na Qiong Tong found that “CEO salary, bonus and total compensation are higher in firms where the consultants provide other service and that pay is higher when the fees paid to consultants for other services are larger.”Besides, according to Murphy and Sandino, “in both the US and Canada that CEO pay is higher in companies where the consultant provides other services, and that pay is higher in Canadian firms when the fees paid to consultants for other services are large relative to the fees for executive-compensation services.”

2. The influence of repeat-business problem

The influence of repeat-business problem can be observed by the following method: if a compensation consultant is changed, whether the level or structure of executives’ compensation will become more favorable to them. If so, repeat-business will cripple the independence of a compensation consultant. The reason is that a compensation consultant can anticipate that if it recommends less favorable compensation, it may lose the chance of being hired again. In order to maintain its relationship with the

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39 Bender analyzed 11 research studies and concluded different findings, see Bender, supra note 4, at 20-22.
40 Conyon, supra note 1, at 424.
42 Kevin J. Murphy & Tatiana Sandino, Executive Pay and “Independent” Compensation Consultants, 49 Journal of Accounting and Economics 247, 248 (2010). Surely, there are existing different findings of the influence of crossing-selling problem. For example, according to Conyon, “there is little evidence that consultants with potential conflicts of interest, such as supplying other business to client firms, leads to greater CEO pay or the adverse design of pay contracts.” see Martin J. Conyon, Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom, (May 2008), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=1106729. But, in his paper, “Executive Compensation Consultants and CEO Pay”, Conyon held the different opinion, Conyon, supra note 1, at 424 (“CEO pay is higher in firms where the consultant supplies other business services, or where management is involved in the selection of the compensation consultant.“).
company, it is better for it to recommend favorable compensation to executives. Using a sample of FTSE 350 firms in UK from 2002 to 2008, Goh and Gupta found that “executives of firms that switch their main consultant receive higher salary increments in the year of the switch (both absolute and adjusted for median peer levels) and a less risky compensation package, through a higher proportion of bonus and a lower proportion of equity pay. The results provide some evidence that companies successfully engage in opinion-shopping between consultants for more favorable compensation packages for executives."\(^{43}\) But, by examining whether CEO pay is related to a proxy for managerial influence over the decision to appoint (or reappoint) consultants, i.e. an indicator of whether the consultant worked exclusively for the committee or also worked for management, Murphy and Sandino found that “CEO pay is actually about 13% higher in US companies where the consultant works exclusively for the compensation committee rather than for management. The lack of support for the repeat business hypothesis is robust to a variety of specifications, including a propensity-score matching approach that mitigated the endogeneity of the board’s choice to retain its own consultant.”\(^{44}\) “One interpretation of the data is that pay consultants recommend greater pay-at-risk for the CEOs of client firms, reflecting greater pay-for-performance. ...Risk-averse CEOs whose contracts contain more risky compensation such as stock options will demand greater levels of pay.”\(^{45}\)

### III. How Compensation Consultants Are Regulated in the US

It is clear that only self-discipline and market competition is not enough to address the conflicts of interest problem faced by a compensation consultant. So, laws and rules can play a critical role in addressing this problem. This part, first, briefly introduces how compensation consultants resolve the conflicts of interest problem in the way of self-discipline; second, analyzes how the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank Act) addresses this problem ex ante; third, shortly discusses how to reform compensation consultant’s civil liabilities ex post based on Coffee and Partnoy’s suggestions.

44 Murphy & Sandino, *supra* note 42, at 248.
45 See Conyon, *supra* note 1, at 410.
A. How a compensation consultant addresses the conflicts of interest problem in the way of self-discipline

If a compensation consultant cannot provide objective and fair advice or opinions, its reputation will be harmed and its future may become dim. So in order to protect its own reputation, it will solve this problem in the way of self-discipline:

1. The first approach is to only provide compensation consultancy service. For example, Frederic W. Cook and Pearl Meyer in the US do not offer other service than the compensation consultancy service to companies. 46

2. The second approach is to implement Chinese walls. For example, in a letter to Chairman Waxman in 2007, then Towers Perrin listed several policies and procedures for ensuring the soundness and objectivity of its consulting advice, including: “(1) a code of conduct that articulates a commitment to providing impartial and objective services; (2) the designation of a senior consultant to review and resolve all potential conflicts of interest before an engagement proceeds; (3) review of significant executive pay recommendations by a senior consultant not on the consulting team performing the work; and (4) a policy precluding an individual who advises a company’s board on executive pay from serving as the firm’s relationship manager with the company, where the firm provides other services to the same company.”47

3. The third approach is to spin off compensation consultancy service. For example, Hewitt spined off its compensation consultancy business in February, 2012.48 “By spinning off separate practices, implementing Chinese walls, and changing their operational practices, they (compensation consultants) are demonstrating an understanding of what has alarmed outside constituencies,”49 but “there is evidence to suggest that the lines between those providing executive compensation advice and those providing other services may not be as bright as the consultants described.”50

B. How the Dodd-Frank Act regulates compensation consultants ex ante

1. The compensation committee is granted the exclusive power to hire, compensate, supervise and fire its own compensation consultant

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46 The 2007 Congress Report, supra note 17, at 3.
48 Bender, supra note 21, at 372.
49 Id. at 394.
50 The 2007 Congress Report, supra note 17, at 8.
“The compensation committee should have direct and unrestricted access to external advisers who are independent of management. ... The committee should have the ability to directly engage its own advisers when it determines such engagement is appropriate.”

Only under this condition will a compensation consultant deem itself to work for the compensation committee not the executives and will it not worry about pleasing the executives in order to continue business relationships with the company.

Section 952 of the Dodd-Frank Act requires the SEC to adopt rules to prohibit the stock exchanges and NASDAQ from listing any issuer that does not have a compensation committee, whose member shall be independent directors. The considerations of independence of directors shall include: (1) the source of the director’s total compensation, including such items as consulting, advisory, or other fees; and (2) whether the director is affiliated with the company, any of its subsidiaries, or any of its other affiliates. However, the self-regulatory organizations are allowed to develop their own definition of independence besides aforementioned considerations.

More importantly, Section 952 of Dodd-Frank Act makes it clear: (1) The compensation committee must have authority to retain a independent compensation consultant at company expense; and (2) The committee is to be solely responsible for selecting, retaining, and determining the compensation of a compensation consultant, which also have been regarded as the best practice for listed companies.

The relationship between the compensation committee and the compensation consultant was unclear before the Dodd-Frank Act. The compensation consultant usually regarded itself as to be hired, compensated, supervised and fired by the executives. As a result, the compensation consultant would serve the interests of executives for its own sake. With the new rules have come into force, the compensation consultant, whose master is the compensation committee, can be more independent from the executives.

2. The company shall disclose the conflicts of interest of a compensation consultant

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52 In practice, almost all the listed companies in New York Exchange and NASDAQ have compensation committees, whose member are all independent directors, except in the case of NASDAQ, majority of the independent directors can also make compensation decisions. See NYSE Listed Company Manual, 303A.05 Compensation Committee (a) and NASDAQ listing standard 5605(d).

53 The Conference Board, *supra* note 51, at 24 (“If the compensation committee decides that engaging a compensation consultant is desirable, the compensation consultant should report directly to the committee. The compensation consultant should be independent of management and selected and engaged by the committee. The committee should review and approve all key terms of the engagement, including the scope of the engagement and the work to be undertaken.”).
Chapter Four  Enhancing Supervision by Compensation Consultants

The Dodd-Frank Act does not require a compensation consultant to be independent, only that the company to disclose whether—(1) the compensation committee of the issuer retained or obtained the advice of a compensation consultant; and (2) 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.\textsuperscript{54} Section 952 (b) (2) of the Dodd-Frank Act specifies the factors that affect the independence of a compensation consultant, including: (1) the provision of other services to the issuer by the person that employs the compensation consultant; (2) the amount of fees received from the issuer by the person that employs the compensation consultant, as a percentage of the total revenue of the person that employs the compensation consultant; (3) the policies and procedures of the person that employs the compensation consultant that is designed to prevent conflicts of interest; (4) any business or personal relationship of the compensation consultant with a member of the compensation committee; and (5) any stock of the issuer owned by the compensation consultant. In the final rule, the SEC add one factor that affect the independence of a compensation consultant, namely, (6) any business or personal relationships between the executive officers of the issuer and the compensation consultant or the person employing the consultant.\textsuperscript{55} Because the company has to disclose information about the hired compensation consultant, if the compensation committee has no justified reasons, it will not retain a compensation consultant having conflicts of interest. Otherwise, the compensation committee may be criticized and blamed by shareholders or even sued by them because of breaking their fiduciary duties.

C. Reforming compensation consultants’ civil liabilities ex post

Though preventing conflicts of interest can lay a solid foundation for a compensation consultant to provide objective and fair advice ex ante, it may still break its duty simply because of fraud, carelessness or even incompetent. For example, a compensation consultant recommends a generous stock option plan or in Chinese

\textsuperscript{54} Section 952 (c) (2) of Dodd-Frank Act. Besides, in 2006, the SEC required companies to identify and describe the role of all consultants who provided advice on executive compensation, and to disclose whether the consultants are engaged directly by the compensation committee rather than by management. Besides, in 2009, the SEC expanded its disclosure rules by requiring firms that purchase more than $120,000 in other services from their executive-pay consultants to disclose fees paid for both compensation consulting and other services. Under the new regulations, firms could avoid such disclosures if the board retained its own compensation consultant and if that consultant provided no other services. See Kevin J. Murphy, \textit{The Politics of Pay: A Legislative History of Executive Compensation}, at 7-8 (Marshall Research Paper Series Working Paper FBE 01.11, August 24, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916358.

context, the compensation consultant issues a professional opinion supporting the plan which hurts the interests of shareholders because it has been bribed by the executives or it has done the job in a negligent manner. Therefore, it is also necessary to “expose gatekeepers to a higher threat of litigation,”56 which will “logically make them more attentive to the interests of investors.”57 “If the gatekeeper is subject to effective litigation remedies, then, even in the absence of significant reputational capital, the gatekeeper will face losses exceeding the expected gains from involvement in fraud. Because the gatekeeper is inherently an agent of its principal, its expected fee or commission is likely to be far less than the gain that the principal itself expects to make from the transaction. As a result, because the gatekeeper/agent expects less profit than its principal does, it can be more easily deterred than its principal.”58 Under Section 11 of 1933 Securities Act in the US, the gatekeeper has a due diligence based defenses. It may escape liabilities by showing that, after reasonable investigation, it had reasonable grounds to believe that the materially misleading statements are in fact true.

As a matter of practice, “in applying due diligence-related standards, courts and regulators inevitably err in specifying the optimal level of gatekeeper monitoring and, more importantly, in adjudicating disputes about whether gatekeepers engaged in adequate monitoring. These errors are magnified when the gatekeeper activity is complex (as it increasingly is, given rapidly evolving financial technologies) and when the law is ambiguous (as it increasingly is, given the dearth of reported and relevant gatekeeper cases),”59 thus due diligence based defenses creating “incentives for them to engage in costly activities they otherwise might avoid.”60

So both Coffee61 and Partnoy62 suggest that gatekeepers shall be strictly liable for any securities fraud damages paid by the issuer and not have any due diligence based defenses for securities fraud. According to Coffee’s point of view, strict liability has three advantages: “1. Strict liability gives the gatekeeper greater incentive to take precautions and exercise due diligence; 2. Strict liability induces the gatekeeper to limit its level of activity, for example, by rejecting overly risky corporations as clients; and 3. Strict liability spares both courts and regulators the need to descend into the Serbonian

56 Coffee, supra note 12, at 334.
57 Id.
58 Id. at 5.
59 Partnoy, supra note 15, at 512.
60 Id. at 492-493.
62 Partnoy, supra note 15, at 492.
bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.” But the gatekeeper’s liabilities shall be limited to a percentage on the scope of its liabilities for the issuer’s damages or the amount based on the revenues it received from the issuer in order not to cause too much deterrence, for example, the compensation consultant may charge too much fee. But one serious problem of the latter method is that it measures “only private costs to gatekeepers, not social costs, and therefore would either under-deter or over-deter, depending on the relationship between gatekeeper revenues and overall shareholder damages.”

IV. Law and Rules, Practice, Problems of Compensation Consultants in China and Suggestions on How to Improve Them

A. Law and rules and practice of compensation consultants in China

According to Article 32 of the Measures for Equity Incentive Plans, when the compensation committee believes it necessary, it may request the company to hire a compensation consultant (independent financial consultant) to provide professional opinion on the feasibility of the stock option plan, whether it is conducive to the sustained development of the listed company, whether it will impair the interests of the listed company, and its affect to the shareholders’ interests. Obviously, the compensation committee has the discretion to hire a compensation consultant or not. By contrast, the company shall retain an attorney to issue legal opinions to its stock option plan. In China, the primary role of a compensation consultant is to legitimize the board and the compensation committee’s decision. If the stock option plan is checked and scrutinized by a compensation consultant, the board and the compensation committee can claim that they have already fulfilled their duties, as a result, they need not to be worried about being criticized, blamed or even sued by shareholders. It is not common for a compensation consultant to help the board and the compensation committee to make the stock option plan.

In practice, the company often hires a investment consulting company or a securities company to issue professional opinions on the stock option plan. Generally

63 Coffee, supra note 61, at 346-347.
64 Partnoy, supra note 15, at 492.
65 Coffee, supra note 61, at 350 (“The one mandatory element in this proposal would be a minimum floor on the gatekeeper’s insurance policy that would have to equal some adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years.”).
66 Partnoy, supra note 14, at 371.
speaking, the report of a compensation consultant has following parts and contents:


Part 2. Statements. The compensation consultant discloses the sources of the materials and documents that its opinions based on, how it performs its duty, and the conditions exempting its legal liabilities.  

Part 3. Basic assumptions. Such as the laws and regulations will not be greatly changed, the materials and documents provided by the company are accurate and complete and so on.

Part 4. The excerpts of the draft of the stock option plan.

Part 5. Professional opinions concerning the ten items of Article 32 of the Measures for Equity Incentive Plans.

Part 6. Contact information.

B. The problems of compensation consultants in law and rules and practice in China

1. The power of the compensation committee is quite limited

According to Article 32 of the Measures for Equity Incentive Plans, when the compensation committee believes it necessary, it may ask the company to retain a compensation consultant. There are existing two problems in this requirement: (1) Generally, executives or those who under the control of executives act for the company to hire a compensation consultant. As a result, the compensation consultant will consider itself to be hired by executives not the company or the compensation committee. Therefore, it will not be against the executives’ will, even though from its professional perspective, the stock option plan is not reasonable, thus not good for shareholders. (2) Whether the compensation committee can supervise and fire the compensation consultant is unclear. If the power of supervising and firing the compensation consultant it at the hands of executives, it is highly possible that the compensation consultant will surrender itself to executives in order to keep its job.

2. The standard of independence or no-independence of a compensation consultant is not established

Though the Measures for Equity Incentive Plans requires the company to hire a compensation consultant declares that its professional opinion cannot be seen as a recommendation for the investors. It will not take any responsibility for the losses the investors incur.

Independent compensation consultant. But the standard of independence or no-independence of a compensation consultant is not established. Besides, the company does not need to disclose information about the compensation consultant, so even the compensation consultant is not independent, the outsiders cannot know. By contrast, other regulations have made some requirements of the independence of other gatekeepers.\(^69\)

3. The civil liabilities mechanism on compensation consultants is not workable

According to Article 5 of the Measures for Equity Incentive Plans, when a compensation consultant performs its duty, it shall be honest and in good faith, diligent, and ensure that the documents it issues are truthful, accurate, and complete. But, suppose that the documents it issues are not truthful, accurate, and complete, the means to impose civil liabilities on it is not very efficient. According to the Securities Law, a gatekeeper in China also has due diligence based defenses for securities fraud.\(^70\) As for the scope of liability, if a gatekeeper who knows or ought to know the issuer’s or listed company’s false statement, but does not correct it or issue reserved opinions, its behavior shall constitute a joint tort, and it shall bear joint liabilities for

\(^69\) Article 11 of the Measures for the Administration of the Provision of Securities Legal Services by Law Firms (promulgated by the CSRC and Ministry of Justice, effective May 1, 2005) provides, “a same law firm shall not simultaneously issue legal opinions for both the issuer and the recommender or the securities underwriting company for a same securities issuance, and shall not simultaneously issue legal opinions for the acquirer and the listed company being acquired in a same acquisition initiative, nor may it simultaneously issue legal opinions for different clients that have a conflict of interests in a same securities business. In case a lawyer acts as the director, supervisor or senior manager of a company or a related party thereof, or is under the circumstance that will affect her independence, her law firm shall not accept the entrustment of the said company or provide securities legal services for it.”Article 17 of the Administrative Measures for the Financial Consultancy Business in the Merger, Acquisition and Reorganization of Listed Companies (promulgated by the CSRC, effective Aug. 4, 2008) provides, “where a securities company, securities investment consulting agency or any other FCA (“financial consultancy agencies”) is hired to act as an independent financial consultant of a listed company, it shall keep its independence, and shall not be an interested party to the listed company. In any of the following circumstances, it shall not act as an independent FCA: 1. It holds alone, or holds jointly with others through an agreement or any other arrangement, 5% or more of the shares of the listed company, or appoints a delegate to act as a director of the listed company; 2. The listed company holds alone, or holds jointly with others through an agreement or any other arrangement, 5% or more of the shares of the FCA, or appoints a delegate to act as a director of the FCA; 3. The FCA has had a relationship of authorized asset management or provided any mutual guaranty with the listed company during the recent 2 years, or has offered financing services to the listed company during the recent 1 year; 4. Any director, supervisor, senior manager, signatory or his lineal relative of the FCA assumes a post in the listed company, etc., which may affect the impartiality of his performance of duties; 5. It provides financial consultancy service to the opposite party of the listed company during the merger, acquisition or reorganization; and 6. Other circumstances in which it is an interested party to the listed company, which may affect the independence of the FCA and its signatories.”

\(^70\) Article 173 of the Securities Law of the People’s Republic of China (2005) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006) provides, “where a securities trading service institution (including: investment consulting institution, financial advising institution, credit rating institution, asset appraisal institution, or accounting firm) formulates and issues any auditing report, asset appraisal report, financial advising report, credit rating report or legal opinions for the issuance, listing and trading of securities, it shall be assiduous and dutiful by carrying out examination and verification for the authenticity, accuracy and integrity of the contents of the documents applied as the base. In the case of any false record, misleading statement or major omission in the documents it has formulated or issued, which incurs any loss to any other person, the relevant securities trading service institution shall bear several and joint liabilities together with the relevant issuer and listed company, unless a securities trading service institution has the ability to prove its faultlessness.”
the losses caused to the investors. Otherwise, it shall only bear the liabilities for compensation for the part that it is liable. Here the “false statement”, according the explanation of the supreme court, refer to “any of the behaviors of the obligor for information disclosure in violation of the securities laws, such as making false records on major events by violating the true facts, making misleading statement, having major omissions when disclosing the information or disclosing information inappropriately during the issuance or transaction of securities.” Concerning the civil liabilities on compensation consultants, there are existing two problems: (1) The due diligence based defenses may consume much time and energy for the courts, plaintiffs and defendants to determine whether compensation consultants have already fulfilled their duties or not; (2) Several and joint liability may put too much deterrence on compensation consultants.

C. Some suggestions on improving compensation consultants in China

1. Granting the compensation committee the exclusive power to hire, compensation, supervise and fire its own compensation consultant

In chapter one, I have already pointed out that the compensation committee having limited power is the very reason that it cannot successfully play its role. So, granting the compensation committee the exclusive power to hire, compensation, supervise and fire its own compensation consultant can expand the role of the compensation committee and make it serve the interests of shareholders better. The reasons are: (1)
This strategy can efficiently reduce the executives’ influence on the compensation consultant, because its livelihood is at the hand of the compensation committee now. So, the compensation consultant will consider the interests of shareholders at the first place. As a result, the repeat-business problem will also be resolved at the same time;

(2) This strategy can reduce the executives’ influence on the board and the independent directors in the compensation committee. Since the compensation consultant will give objective and fair opinions on the stock option plan, suppose that the plan favors executives too much, thus hurting the interest of shareholders, it will surely be objected or suggested to be amended by the compensation consultant. Considering this point, the board and compensation committee will reconsider their compensation decision, which, in my point of view, will reduce the influence of the executives on the board and the independent directors compensation committee. Surely, a listed company may simply not hire a compensation consultant to issue professional opinions, but how it justifies its compensation decision will be a difficult task.

2. Establishing the non-independence standard of a compensation consultant and prohibiting the non-independent compensation consultant from providing opinions on the stock option plan

If a compensation consultant cannot keep its real independence, it is impossible for it to issue objective and fair opinions. So, the compensation consultant who face conflicts of interest shall be prohibited from issuing opinions on the stock option plan. Based on the new provisions of Dodd-Frank Act and Article17 of the Administrative Measures for the Financial Consultancy Business in the Merger, Acquisition and Reorganization of Listed Companies, this chapter suggests that in any of the following circumstances, a compensation consultant shall not regard as independent, as a result, it cannot issue professional opinions on the stock option plan: (1) It has helped the board and the compensation committee make the stock option plan; (2) It has provided other services to the company, such as M&A consultancy service, employee pension plan consultancy service, financial consultancy service, securities sale service (“sale by proxy” or “exclusive sale”) and so on; 74 (3) Any director, supervisor, senior manager, undertaker or her lineal relative of it is also the eligible participant 75 in the stock option plan; (4) Any director, supervisor, senior manager or

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74 Under circumstance (1) and (2), it is highly possible that cross-selling problem can cripple the independence of a compensation consultant.

75 Here, “the eligible participant” refers to anyone who is granted stock options according to the stock option plan, such as executive or employee.
undertaker of it has close business relationship with the executives, for example, both of them are general partners in the same LP partnership;\(^{76}\) (5) It holds alone, or holds jointly with others through an agreement or any other arrangement, 5% or more of the shares of the listed company, or appoints a delegate to act as a director of the listed company;\(^ {77}\) (6) The listed company holds alone, or holds jointly with others through an agreement or any other arrangement, 5% or more of the shares of it, or appoints a delegate to act as a director of it;\(^ {78}\) (7) Other circumstances which may affect the independence of it and its undertakers.

In my opinion, since the Chinese compensation consultants face more cruel competition and less possibilities of shame sanctions and litigation than their foreign counterparts, so it is better to ban the compensation consultants who are not independent from issuing professional opinions on the stock option plans at present time. This requirement will not bring much costs to the company due to less choices for it, because many compensation consultants are still available in the market. Even if the company does incur some costs, it is still good for it. Because “the costs of ensuring real independence are a tiny fraction of the aggregate compensation being paid out. This seemingly obvious approach can help guard against situations in which too much money is paid for nonperformance.”\(^ {79}\) Besides, the company shall disclose the identity of the compensation consultant and assures that the compensation consultant is really independent and without aforementioned circumstances.

3. Imposing more efficient civil liabilities on compensation consultants ex post

Imposing more efficient civil liabilities on compensation consultants ex post will make them more attentive to the interests of shareholders. But, in China, shareholders have never sued the compensation consultants for issuing false opinions to date. One reason maybe that the compensation consultants have successfully fulfilled their duties. So there is no need for shareholders to impose civil liabilities on them. But, if the reason is that it is difficult for the shareholders to sue the compensation consultants because it costs too much time and energy on arguing the standards of care for them, thus something shall be done to change this situation. So I suggest that we may follow Coffee and Partnoy’s advice to impose strict liabilities on the

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\(^{76}\) Under circumstance (3) and (4), it is also highly possible that the independence of a compensation consultant may be crippled.

\(^{77}\) Under such circumstance, because a compensation consultant has a major stake in the company, its independence will be affected. Besides, it may collude with the executives to hurt the interests of other shareholders.

\(^{78}\) Under such circumstance, the executives of the listed company may have a huge influence on the compensation consultant, which may also cripple the latter’s independence.

\(^{79}\) Symposium, Current Issues in Executive Compensation, 3 NYU J. L. & BUS. 519, 528 (2007).
compensation consultants; meanwhile, their liabilities shall be limited to some percentage of the amount that the company has to compensate the victims. Frankly speaking, comparing to aforementioned suggestions, this suggestion is not so urgent that needs to be adopted now and maybe controversial and objected by others. Here, my purpose is only to offer another choice for the rule-makers and shareholders when they are not satisfied with the current civil liabilities mechanism on the compensation consultants.

**V. Conclusion**

This chapter discusses the roles that a compensation consultant can play in addressing some agency problems of executive stock option compensation. In the US and UK, a compensation consultant can: provide professional advice and assistance to independent directors in the compensation committee; legitimize the compensation committee’s decisions; and, serve as a intermediary between shareholders and the company. In China, the primary role of a compensation consultant is to legitimize the board and the compensation committee’s decision. When facing conflicts of interest, such as providing other services to the company or continuing business relationship with the company, a compensation consultant may surrender itself to executives. It is also confirmed by foreign empirical studies.

The conflicts of interest problems also cripple the Chinese compensation consultants, so this chapter suggests that: first, the compensation committee shall have the exclusive power to hire, compensation, supervise and fire its own compensation consultant; second, the non-independence standard of a compensation consultant shall be established and the non-independent compensation consultant shall be prohibited from providing professional opinions on the stock option plan; and third, strict liabilities shall be imposed on the compensation consultants; meanwhile, their liabilities shall be limited to some percentage of the amount that the company has to compensate the victims.
Chapter Five  Ex Ante Strategy of Enhancing Supervision by Public Authorities: The CSRC Shall Make “Comply or Explain” Rules

I. Introduction

This chapter discusses how the vital role of the China Securities Regulatory Commission (CSRC), which is akin to the Securities and Exchange Commission (SEC) in the US, can play in addressing some specific agency problems of executive stock option compensation. In the chapter of introduction, I have pointed out three agency problems of executive stock option compensation: 1. Stock option compensation may induce executives to time information disclosure to maximize their personal profits; 2. Stock option compensation may wrongly encourage executives to pursue short-term profits at the costs of shareholders’ long-term interests; and 3. Stock option compensation may bring windfalls to executives. The deep root of these agency problems lies in the “enormous discretion managers have over most aspects of corporate business, coupled with traditional deference from boards,” or according to Bebchuk and Fried’s famous remark, the “managers’ power”. Because executives can actually decide when and what to disclose, especially they can disclose voluntarily earlier than they are required by securities law and rules; executives also have huge influence on whether to invest in risky ventures or reduce R&D investments, which has fatal relevance to the company’s long-term development; or executives can influence the board and the compensation committee not to filter out windfalls in their stock option compensation. So the task faced by shareholders, rule-makers, and scholars is how to grant enough power to executives to encourage them to maximize shareholders’ interests, at the same time, to prohibit them from abusing their power and influence. This “trade-off” job needs intelligence, knowledge, experience and some luck and is difficult to finish.

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1 In China, banking and trust industries are regulated by the China Banking Regulatory Commission (CBRC); while insurance industry is regulated by the China Insurance Regulatory Commission (CIRC).  
I have already made some suggestions on how to address the managers’ power problem in other chapters, such as expanding the role of compensation committee and its independent directors, improving the disclosure of executive stock option compensation, enhancing supervision by compensation consultants and so on. Besides, the CSRC can also play a very critical role in resolving the managers’ power problem by means of regulating the substantial terms of stock option plans, which may take way or, at least, restrict the executives’ influence. In fact, the CSRC has already done so.4

But, the approach which the CSRC adopts to address the managers’ power problem is to make totally mandatory rules (too powerful) or totally default rules (too weak), there are no other alternatives lying between the two extremes. However, under some circumstances, this approach has its own weak points.

The problem of mandatory rules is over-inclusiveness5 or under-inclusiveness. For example, Article 12 (1) of the Measure for Equity Incentive Plans provides that the aggregate target stocks6 involved in all the effective equity incentive plans shall not exceed 10% of the total equity of the company accumulatively. But under some circumstance, the company may have to grant more than 10% of the total equity to realize its goal to retain or attract needed talents. So, as a result, the 10% limit is over-inclusiveness.7 With regard to the under-inclusiveness problem, Article 27 of the Measure for Equity Incentive Plans provides that the eligible participants8 shall exercise their rights at the second trading day after the announcement of the regular report of a listed company, and within 10 trading days before the announcement of the next regular report, but shall not exercise power during the following periods: 1. 2

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4 The Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the SCRC, effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans), Memo No. 1, No.2 and No. 3 on the matters of Equity Incentive (promulgated by the SCRC, effective respectively Mar. 17, Mar. 17 and Sept. 16, 2008, hereinafter respectively the Memo No.1, Memo No.2 and Memo No.3) and other regulations promulgated by the CSRC aim at assuring that the stock option plan is “conducive to the sustained development of the listed company and shall not impair the interests of the listed company.”

5 David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 470 (2010) (“One-size-fits-all regulation inevitably involves some over-inclusiveness, and firms have little choice but to comply with compulsory regulation.”).

6 Here, “target stocks” means the stocks of a listed company, granted to or purchased by the eligible participants pursuant to the equity incentive plan (article 51 of the Measures for Equity Incentive Plans).

7 Mark A. Clawson and Thomas C. Klein, Indexed Stock Options: A Proposal for Compensation Commensurate with Performance, 3 Stan. J.L. Bus. & Fin. 31, 39 (1997) (“The number of shares of stock subject to the options-and the percentage of the company these options represent for key executives-depends upon a number of factors. These factors include the maturity of the company, … the stage of development of the company’s products, the cohesiveness of the company’s management team, the nature and extent of the competition for the company’s products, and the competition for the prospective executive and the resulting negotiations that take place over his compensation package.”).

8 Here, the “eligible participants” means those who are granted stock options according to the stock option plan, such as executives and employees.
trading days during the determination of a major transaction or a great event until after the matter is announced; and 2. 2 trading days from the day when any other great event that may affect the stock price occurs until after it is announced. But executives can still increase their wealth through disclosing the news that can boost stock price shortly before they exercise their rights even though they can only exercise their rights 2 days after the disclosure. Because comparing with disclosing the news after they exercise their rights, disclosing such news shortly before they exercise their rights can surely raise the stock price, thus increasing the difference between the stock price and the strike price. Counter to the objectives of the rule-makers, the “one-size-fits-all” approach may not protect but hurt the interests of shareholders. Because a company cannot tailor the terms in stock option plan based on its own conditions and needs.

The problem of totally default rules is that such rules cannot realize the objectives of the rule-makers, in other words, they are too weak. For example, Article 5 of the Memo No.2 provides that companies are encouraged to use market index, component stocks index or an index of related companies when they design the conditions for executives to exercise their rights, which aims at filtering out windfalls in executive stock option compensation. But, in practice, few companies use such indexed stock option compensation.

In short, “it is highly unlikely that the same design option design will be efficient in all cases. The incentives created by options depend on a variety of grantee-specific factors, including the executive’s portfolio and risk preference. At the same time, a variety of firm-specific factors, such as growth opportunities and debt load, determine which incentives will be desirable. Besides differing from firm to firm, these factors may vary within a single firm over time.” So, the CSRC is highly suggested in this chapter to make “comply or explain” rules to regulate some substantial terms of stock option plans.

This chapter proceeds as follows. Part II introduces some key characteristics and functions of “comply and explain” approach and suggests that the CSRC regulate the substantial terms of stock option plans through this approach. Part III discusses how to address the timing problem of executive stock option compensation through “comply and explain” approach. Part IV discusses how to address the short-termism problem of executive stock option compensation through “comply and explain”

9 Bebchuk & Fried, supra note 3, at 160.
approach. Part V discusses how to address the windfalls problem of executive stock option compensation through “comply and explain” approach. Part VI offers a short conclusion.

II. The CSRC Shall Make “Comply or Explain” Rules

As aforementioned, the “one-size-fits-all” approach may not protect but hurt the interests of shareholders, meanwhile, totally default rules are too weak. So this chapter suggests that the CSRC\textsuperscript{10} shall adopt a “comply or explain” approach to regulate some substantial terms of stock option plans aiming at reducing the executives’ power and influence. At least, the CSRC shall make “comply or explain” rules (as suggested by this chapter) to resolve the timing, short-termism, and windfalls problems of executive stock option compensation.\textsuperscript{11} In China, this approach has been

\begin{footnotesize}
\textsuperscript{10} The reasons why I suggest the CSRC to make the “comply or explain” rules rather than others (e.g. the people’s congress or a stock exchange. It is not a tradition in China that other market agencies except the stock exchange provide the best practice or recommendations etc. on corporate governance for listed companies) are: 1. The rules regulating stock option plans are made by the CSRC, so it is appropriate for the CSRC to make “comply or explain” rules on the matters of stock option plans, and if it is necessary, the CSRC is able to act quickly to amend or cancel the rules too. Besides, the Code of Corporate Governance of Listed Companies in China was promulgated by the CSRC (effective Jan. 7, 2002), since stock option compensation is a matter of corporate governance, logically, the CSRC shall be granted the power to make “comply or explain” rules on executive stock option compensation. Even if the Company Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, \textit{hereinafter Company Law}) adopted the “comply or explain” approach, it is highly possible that the CSRC would be granted the power to make the specific rules, so from a practical standpoint, why not directly granting it this power at the beginning. 2. In China, it will take long time for the national people’s congress to amend the Company Law if it wants to adopt the “comply or explain” approach; let alone it is not sure whether the people’s congress would like to adopt this approach or not in the Company Law. For instance, no Articles of the Company Law have been amended, canceled or added since the law was amended in 2005 though some Articles have generated hot controversies in practice and some new problems are needed to be addressed in the Company Law. And, if we adopted the “comply or explain” approach in the Company Law and found it was not useful in China, it will be difficult to change. Besides, there are lots of laws needed to be made or amended on people’s congress’s schedule, obviously, the Company Law is not one of them (at least in the next 5 years). So it is not workable to adopt “comply or explain” approach in the Company Law currently. 3. In theory, a stock exchange is a good substitute for the CSRC to make “comply or explain” rules in its listing standard or guidelines, but the difficulty faced by a stock exchange is that it lacks of the power to regulate the substantial matters of a listed company. According to Article 102 (1) of the Securities Law of the People’s Republic of China (2005) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, \textit{hereinafter Securities Law}), a stock exchange “refers to a legal person that provides the relevant place and facilities for concentrated securities trading, organizes and supervises the securities trading...” Specifically, it shall announce up-to-the-minute quotations of securities trading (Article 113 of the Securities Law), may take the measures of a technical suspension of trading or decide a temporary speed bump (Article 114 of the Securities Law) or it shall supervise and urge listed companies to disclose information in a timely and accurate manner according to law (Article 115 of the Securities Law) and so on. In all, the function of a stock exchange is to organize and supervise the securities trading not to regulate the substantial matters of a listed company. So, if a stock exchange makes the “comply or explain” rules, its authority and the legitimacy of these rules may be challenged by listed companies. But, arguably, stock exchanges in China did make some guidelines on the substantial matters of a listed company. For example, the Shenzhen Stock Exchange (SZSE) made the Guidelines for Behavior of Directors of Companies Listed on the Small and Medium Enterprise Board of the Shenzhen Stock Exchange in 2005 to regulate the behaviors of directors (including independent directors). But, from the perspective of legitimacy, requiring the CSRC to make the “comply or explain” rules will definitely bring no objections.

\textsuperscript{11} As for the information disclosure rules, the format and content of information disclosure is mandatory according to securities law and regulations. Maybe, it is efficient to do so. Because it saves the costs for the players in the capital market to compare the different disclosed content in different format. As for the
never adopted in laws or regulations; therefore, it has not been paid enough attention by Chinese law scholars. Thus, whether this approach can offer the rule-makers another good choice and be successfully adopted in China or not is uncertain. But, from the successful experience of the UK and other countries that adopt this approach, the “comply or explain” approach can “do improve corporate governance.” This approach is “strongly supported by both companies and shareholders and has been widely admired and imitated internationally” So, it is a beneficial attempt for China to adopt this approach based on the same needs of the listed companies and the goals of corporate governance. And the stock option plan maybe a appropriate touchstone.

Procedures of shareholders meeting, it is also mandatory in China (See The Rules for the Shareholders’ Meeting of Listed Companies (promulgated by the CSRC, effective Mar. 16, in 2006). It may not be so necessary for companies to design their own procedures of shareholders meeting. I cannot dig this problem deeply in this chapter. But the interesting problem is what kind of rules shall be designed as totally default rules, while other shall be designed as rules between the two extremes, for example “comply or explain” rules or rules that “automatically applied if not opted out by shareholders”. The basic logic maybe whether these rules involve a third party and whether the private parties can negotiate these rules in less costs.

12 I only found one article written by Prof. Wu Jian, who seriously discussed this approach in China, see Wu Jian, “Principle of “Comply or Explain” in the Enforcement of Corporate Governance Code”, Vol. 10, No.1, Journal of Beijing University of Technology (Social Science Edition) 46 (2010).


14 Financial Reporting Council (FRC), The UK Corporate Governance Code (September 2012) (UK CGC), at 4.

15 Most Chinese scholars believe that the capital market in China is a weak-form efficiency market, which means the market can evaluate the information disclosed by companies (though not fast), see Ming, An Evolving Market Efficiency Test On Chinese Stock Market, No.1 Economic Research Journal 54, 61 (2003). So, in theory, the market can evaluate the unjustified explanations disclosed by companies and react to these unjustified explanations. Besides, the media can play an very important role in monitoring corporate governance violation and protecting minority shareholders (which I have argued in chapter two), thus supervising companies to disclose detailed and justified explanations. Even stock exchanges could publicly censure those companies which do not disclose detailed explanations. By the end of 2010, the institutional shareholders owned about 51.535% of all shares listed in the Shanghai and Shenzhen Stock Exchanges. So they can and have the incentives to involve in corporate governance of the companies which they invest in. Most Chinese scholars believe that the capital market in China is a weak-form efficiency market, which means the market can evaluate the information disclosed by companies (though not fast), see Zhang Bing & Li Xiao, An Evolving Market Efficiency Test On Chinese Stock Market, No.1 Economic Research Journal 54, 61 (2003). So, in theory, the market can evaluate the unjustified explanations disclosed by companies and react to these unjustified explanations. Besides, the media can play an very important role in monitoring corporate governance violation and protecting minority shareholders (which I have argued in chapter two), thus supervising companies to disclose detailed and justified explanations. Even stock exchanges could publicly censure those companies which do not disclose detailed explanations. By the end of 2010, the institutional shareholders owned about 51.535% of all shares listed in the Shanghai and Shenzhen Stock Exchanges. So they can and have the incentives to involve in corporate governance of the companies which they invest in. Even stock exchanges could publicly censure those companies which do not disclose detailed explanations. By the end of 2010, the institutional shareholders owned about 51.535% of all shares listed in the Shanghai and Shenzhen Stock Exchanges. So they can and have the incentives to involve in corporate governance of the companies which they invest in. Quite a few empirical studies have already confirmed the positive value that the institutional shareholders can bring to the companies by the means of involving in the corporate governance, such as supporting or objecting the reorganization of companies or M&As. See Li Wei An & Li Bin, An Empirical Study on the Effect of Institutional Investors Participating in Corporate Governance: Based on the Data of 2004-2006, CCGINK Vol.11 No. 1 Nankai Business Review 4, 12-13 (2008) (They found that “institutional investors have played an important role in promoting the level of listed companies corporate governance, and then reduces the agency cost with the improving of corporate governance quality in China. Meanwhile, there is a significantly positive correlation relation between institutional investor’s shareholding ratio of listed companies and corporate performance or market value.”). So, the institutional shareholders can and have incentives to evaluate the explanations disclosed by companies. However, if the matters are not important, the institutional shareholders may not involve in from a cost-and-benefit perspective. In the case of executive stock option compensation, I am not sure whether the matter of stock option compensation will be as important as the reorganization of companies or M&As that the institutional shareholders would like to evaluate the stock option plan and the explanations on it. 3. With regard to the substantial matters of companies, as a rule of thumb, it is better to let companies make their own decisions. From the perspective of comparative law, the “comply or explain” approach, in general, is successful in European countries, where concentrated ownership is also prevailing. 4. Companies do not provide sufficient reasons why they do not comply with the rules is a crucial factor that hurts the efficiency of “comply or explain” approach, so I suggest that if we adopt such approach, companies shall provide detailed reasons to explain why they do not comply with the rules. What can be regarded as “detailed reasons” is difficult to define now. But, after we have enough experience, the
The “comply or explain” approach is “the trademark of corporate governance in the UK” and has been transplanted to the EU countries as well as the EEA-countries. Under this approach, the company shall comply with the code and the rules therein, or explain why the company depart from them, specifically, the company shall: “illustrate how its actual practices are consistent with the principle to which the particular provision relates, contribute to good governance and promote delivery of business objectives. It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle.” The main premise of this approach is that “it is not appropriate to impose a strict and rigid regulation common to all, companies should choose the structure that best suits them.” In general, the companies will comply with the rules, because “the code (at least in the United Kingdom) represents the view of institutional investors as to best practice.” If companies do not comply and do not provide justified reasons either, shareholders and the capital market will lower their valuation of them. “Bad explanations-explanations assessed by investors as having a negative effect on the expected return on their investment-will be penalized by a reduction in the stock price.” In short, for the sake of simplification, the “comply and explain” approach could realize the objectives of the rule-makers, at the same time, it also can provide

CSRC may make some formats to guide companies to make their explanations so as to make it easy for the market to evaluate the explanations. In short, I think it is worthwhile for us to adopt this approach, though I cannot be sure that it will be successful in China. Anyway, if we do not adopt this approach, how can we know whether this approach can be successful or not in China?

16 FRC, supra note 14, at 4.
17 Andersson, supra note 13, at 92 (“Today the principle of comply or explain is – more or less – mandatory in the Member States of EU as well as in the EEA-countries.”) Some US scholar also supports this approach. See Janice Kay McClendon, Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders’ Interests and Promote Corporate Long-Term Productivity, Wake Forest L. Rev. 971, 1013 (2004) (“To accommodate various corporate structures, however, listed companies should generally be given the option of either complying with the additional standards or sufficiently explaining non-compliance.”).
18 FRC, supra note 14, at 4. But see Andersson, supra note 13, at 92. (The company shall: (1) report every deviation; (2) describe the alternative solution; and (3) explain the reasons why the alternative solution chosen by the company is superior to the solution preferred in the code.”).
19 Siddhartha Arcot et al., Corporate Governance in the UK: Is the Comply-or-Explain Approach Working? 30 International Review of Law and Economics 193, 194 (2010); Wu, supra note 12, at 47 (“Under this approach, the company itself can opt out some rules according to its unique conditions. Since only the company itself knows its needs and preference best, the governance rules made by it are usually more efficient than the mandatory rules.”); and Dr. Marc T. Moore, The End of “Comply or Explain” in UK Corporate Governance?, 60 N. Ir. Legal Q. 85 (2009) (“In theory, this novel regulatory technique permits a company to opt out, in effect, from any one or more requirements of the Code that its board considers to be cost-ineffective or otherwise inappropriate for that company’s specific circumstances.”).
flexibility to companies, as a result, they need not adopt a “one-size-fits-all” model, at the same time, they cannot directly avoid applying the default rules. With regard to China, my suggestion is: based on the successful experience of other developed countries, the CSRC shall make rules that can protect the interests of shareholders (at least, from its own perspective) and require the listed companies to comply with those rules. At the same time, companies are allowed not to comply with those rules under some circumstances, but they shall explain and disclose the reasons why they do so in detail based on their own conditions. Only with detailed explanations can shareholders know whether their interests are protected and whether to support companies’ explanations or not. Besides, the media and stock exchanges can also supervise whether the company provide justified explanations or not.

III. How to Address the Timing Problem

A. Executives have motivation to time information disclosures to increase their profits from stock option compensation (the timing problem)

The profits that executives can make from their stock option compensation equal to the difference between the stock price when they exercise their rights and the strike price times the amount of options exercised. Thus, the lower the strike price and higher the stock price is, the more profits executives can make. Naturally, if executives can cause their company’s stock price to drop shortly before the date of issuance (or delay the stock price from rising until after the date of issuance) or boost the stock price shortly before the date of exercise (or delay the stock price from dropping until after the date of exercise), they can earn more money from their

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22 See Arcot et al., supra note 19, at 199. (“If there is full compliance, or if no meaningful explanations are observed (in cases of non-compliance), the ‘explain’ part of the Code is ineffective. The relative benefit of flexibility, relative to a statutory regime, must be therefore commensurate to the number of good explanations.”).

23 Generally see Jeffery J. Haas, Corporate Finance (St. Paul, MN: West, 2003), at 162-164.

24 Wen Xiu, The Controversial Chinese Equity Incentive Compensation, No. 3 Financial Practices (2008), available at http://magazine.caijing.com.cn/2008-03-03/110070938.html. And Yablon & Hill, supra note 2, at 87 (“CEOs who know when their options will be issued and become exercisable have incentives to disclose negative corporate news shortly before the issuance of such options and to disclose positive news shortly before their exercise date while delaying disclosure of negative news.”). Lucian A. Bebchuk & Jesse M. Fried, Paying for Long-Term Performance, 158 U. Pa. L. Rev. 1915, 1940 (2010) (“executives may have an interest in accelerating the release of negative information before the equity award and delaying disclosures about positive developments until after the award. Artificially lowering the stock price in this manner can benefit executives, whether their grant consists of options or restricted stock.”). Empirical study see David Aboody & Ron Kasznik, CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, 29 Journal of Accounting and Economics 73 (2000) (“Our findings suggest that CEOs make opportunistic voluntary disclosure decisions that maximize their stock option compensation.”) No such empirical study has been made in China, but newspapers have reported the same suspicious behaviors, see infra note 26, 27, 29 and 30.
stock option compensation. Thus, “(stock option compensation) creates a new potential conflict between the interests of the corporation and its shareholders in credible, timely, and accurate disclosure and the CEO’s newly created interest in disclosure timed to maximize the value of his pay package.”

In China, such behaviors have also arisen recently and been reported by newspapers. For example, “at the beginning of 2007, one CEO in some listed company called a manager of some investment fund to depress the stock price before the company disclosing its excerpts of the draft of the stock option plan so as to obtain a lower strike price.” Yu Kai also pointed out that, “because granting stock option (to executives) needs time, the company may make full use of this period to depress stock price. There are lots of means to do so. For example, the company can disclose poor financial results in newspapers.” With regard to executives may boost the company’s stock price shortly before the date of exercise in the way of disclosing good news in advance, it is reported that the ShiJi Information Inc. disclosed on Feb. 25, 2011 that its net profits in 2010 was 62.46% more than that of 2009 because its hotel management system developed very quickly. One anonymous expert believed that the reason why the company disclosed such information at this moment was to boost its stock price aiming at helping its executives exercise their rights successfully. The fact was that the date of exercise (Mar. 9, 2011) was approaching, but the stock price was only slightly higher than the strike price (RMB 48.9 v. RMB 44.7). It is

25 Yablon & Hill, supra note 2, at 89.
26 Wen, supra note 24. Article 24 of the Measures for Equity Incentive Plans provides, “a listed company shall, when granting stock options to the eligible participants, determine the exercise price or the method for determining the exercise price. The exercise price shall be no less than the following prices, whichever is higher:1. The closing sales price of the target stock of the company at one trading day before the promulgation of the excerpts of the draft of the equity incentive plan; and 2. The average closing sales price of the target stock of the company within 30 trading days before the promulgation of the excerpts of the draft of the equity incentive plan.” So, if executives can depress the stock price low for one month, or even only a few days before the disclosure of the excerpts of draft of the plan, they will increase the value of their stock options.
27 Yu Kai: Jilin Forest Industry Group: Equity Incentives Boost Stock Price, Oriental Morning Post, Nov. 16, 2006. Delaying disclosing good news until after executives are granted with stock options may violate securities law and regulations, so it is not common in practice in China, see infra III A.2. Here the “bad news” and the “good news” mean any news about the major event that may considerably affect the trading price of a listed company’s stock. According to article 30 (2) of the Administrative Measures for the Disclosure of Information of Listed Companies (promulgated by the CSRC, effective Jan. 30, 2007, hereinafter Measures for the Disclosure of Information), such major event includes: a decision of the company on any major investment or major purchase of asset; an important contract as concluded by the company, which may produce an important effect on the assets, liabilities, rights and interests or business achievements of the company; a major change in the external conditions for the business operation of the company and so on. In all, article 30 (2) lists 20 circumstances maybe considered as major events.
28 Delaying disclosing bad news until after executives have already exercised their rights may violate securities law and regulations, so it is not common in practice in China either, see infra III A.4.
29 Song Yuan Dong, ShiJi Information Inc.: The Date of Exercise Is Approaching, National Business Daily, Feb. 27, 2011. Article 27 of the Measures for Equity Incentive Plans provides, “the eligible participants shall exercise power at the second trading day after the announcement of the regular report of a listed company, and within 10 trading days before the announcement of the next regular report, but shall not exercise power during the following periods: 1. 2 trading days during the determination of a major transaction or a great event until
also reported that “some private funds recommended Grandland Decoration Inc. to investors recently because its date of exercise was approaching but its stock price was lower than the strike price. It was highly possible that the company would boost its stock price before the date of exercise, which meant investment opportunity for investors.”

Obviously, it is well-accepted by the players in the capital market that executives may boost the company’s stock price shortly before the date of exercise.

In theory, executives can also make more profits from stock option compensation by means of timing the date of granting stock options. For example, executives can request the company to grant stock options shortly after its stock price drops; or executives can request the company to grant stock options before its stock price rises. But granting stock options takes long time, executives cannot assure that the company will grant stock options in time as they want. By contrast, when and what to disclose is largely under the control of executives. Besides, Article 26 of the Measures for Equity Incentive Plans and Article 2 (2) and (3) of the Memo No.2 strictly regulate the date when the listed company can grant stock option compensation. Consequently, in practice, the cases that executives increase their profits from stock option compensations through timing the date of granting stock

after the matter is announced; and 2. 2 trading days from the day when any other great event that may affect the stock price occurs until after it is announced.” But executives can still increase their wealth through disclosing good news shortly before they exercise their rights even they only can exercise their rights 2 days after the disclosure. Because comparing with disclosing the good news after they exercise their rights, disclosing good news shortly before they exercise their rights surely can raise the stock price.


31 This kind of stock option is called “spring loaded option”, which means “a company waits for announcements of good news that it knows will bump up market price and then grants options to executives on the day before the announcement. The value of the options is ‘spring loaded’ because a day or two after they are granted there is a high likelihood that the options will be ‘in the money’ — the exercise price will be below market price, affected by the new announcement of good news.” see J. Robert Brown, Desimone, Spring Loaded Options and Insider Trading, available at http://www.theracetothebottom.org/preemption-of-delaware-law/desimone-spring-loaded-options-and-insider-trading.html.

32 Article 40 of the Measures for the Disclosure of Information provides, “when the directors, supervisors and senior managers have the knowledge of a major event, they shall, according to the provisions of the company, immediately perform their reporting obligation. When the chairman of the board of directors receives a report, she shall immediately report it to the board of directors and urge the secretary of the board of directors to organize the work of disclosure of temporary reports.” Article 44 of the Measures for the Disclosure of Information provides, “the senior managers shall timely report to the board of directors the major events arising in the business operations or financial aspect of the company, the progress and changes of the events already disclosed, and other relevant information.”

33 It provides, “ a listed company shall not grant stock options to the eligible participants within the following periods: 1. 30 days before the promulgation of the regular report; 2. 2 trading days during the determination of a major transaction or a great event until after the matter is announced; and 3. 2 trading days from the day when any other great event that may affect the stock price occurs until after the matter is announced.”

34 Article 2 (2) provides, “the listed company shall not grant stock options during it intending to issue new stocks, inject assets, or issue convertible debts until 30 days after such great events completed.” Article 2 (3) provides, “the company shall not issue new stocks, inject assets, or issue convertible debts during it disclosing the excerpts of draft of the stock option plan until 30 days after the shareholders meeting ratifying the plan.”
option have been never heard of since 2008. So, this chapter only focuses on the problem of timing information disclosure to increase executives’ profits.

B. Whether executives time information disclosure violates the securities law and regulations

Article 6 of the Measures for Equity Incentive Plans provides that “no one may make insider trading, manipulate the securities transaction prices, or carry out fraudulent securities activities by making use of the equity incentive plan.” So, Do executives time information disclosure to increase the value of their stock option compensation violates this Article or other laws and regulations? “The answer to that question depends very much on the precise nature of the manipulation involved.”35 I will analyze whether under the following four circumstances, executives violate the securities law and regulations respectively:

1. Executives disclose a piece of bad news in order to depress the stock price shortly before the date of issuance.

   (1) Does it constitute insider trading? The answer is no. Because executives are granted stock options after they disclose information. The “abstain or disclose” rule applies in such circumstance.36

   (2) Does it constitute manipulating the securities transaction prices? Maybe. If executives disclose a piece of bad news shortly before the date of issuance aiming at depressing stock price, thus, they can be granted stock options at lower strike price, it will constitute manipulating the securities transaction prices.37 But, if the goal of executives to disclose the bad news is to clarify some rumors about the company, which is required by securities regulations,38 thus it will not constitute manipulating

35 Yablon & Hill, supra note 2, at 91.
36 Article 76 (1) of the Securities Law provides, “any insider who has access to insider information or has unlawfully obtained any insider information on securities trading may not purchase or sell the securities of the relevant company, or divulge such information, or advise any other person to purchase or sell such securities.” But, because such information is disclosed, it is not insider information anymore. So executives can sell or buy stocks except restricted by other rules. Also see Yablon & Hill, supra note 2, at 99 (“It is important to recognize that, because the CEO has made disclosure prior to receiving the options, the suit against him would not be for insider trading...”).
37 Article 77 of the Securities Law provides, “anyone is prohibited from manipulating the securities market by any of the following means: (1) Whether anyone, independently or in collusion with others, manipulates the trading price of securities or trading quantity of securities by centralizing their advantages in funds, their shareholding advantages or taking their information advantage to trade jointly or continuously; (2) Where anyone collaborates with any other person to trade securities pursuant to the time, price and method as agreed upon in advance, thereby affecting the price or quantity of the securities traded; (3) Where anyone trades securities between the accounts under his own control, thereby affecting the price or quantity of the securities traded; or (4) Where anyone manipulates the securities market by any other means.” This behavior is another means of manipulating the securities market.
38 Article 31 of the Measures for the Disclosure of Information provides, “the listed company shall timely disclose the present situation and the risk factors which may affect the progress of the major event, when this major event has been divulged or there is already any hearsay in the market.”
the securities transaction prices, even though clarifying such rumors depresses the stock price in effect. So the key question is what is the executives’ intent? If shareholders want to sue executives based on manipulating the securities transaction prices, they shall prove the intent of executives is to depress the stock price so as to be granted stock options at lower price. It is very difficult even not impossible for them to prove it.\(^\text{39}\) This is because there many explanations are available for executives to decide when and what to disclose.

(3) Does it constitute carrying out fraudulent securities activities? According to securities law and regulations,\(^\text{40}\) executives shall disclose truthful, accurate and complete information in time, so except the information disclosed by executives contains any false records, misleading statements or serious omissions, executives disclose a piece of bad new shortly before the date of issuance does not constitute carrying out fraudulent securities activities. Because executives do not break the “timely” requirement in securities law and regulations, on the contrary, they even do better than they are required.

2. Executives delay disclosing a piece of good news until the excerpt of the draft of the stock option plan is disclosed in order not to raise the stock price, thus, obtaining a lower strike price.

(1) Does it constitute insider trading? Very likely. Generally speaking, executives occupy one-third seats in the board in Chinese listed companies, so it is highly possible that they know when they will be granted stock option compensation. Therefore, it is very likely that the reason why they delay disclosing a piece of good news is to be granted stock option at a lower strike price.

(2) Does it constitute manipulating the securities transaction prices? Maybe. If the intent of executives to delay disclosing a piece of good news is not to cause the stock price to risen before they are granted stock option compensation, as a result, they will gain a lower strike price, it will constitute manipulating the securities transaction prices. But, in practice, it is difficult for shareholders to prove the intent of executives.

(3) Does it constitute carrying out fraudulent securities activities? The answer is yes. Because executives violate the requirement of disclosing information in time, except the information disclosed by executives contain any false records, misleading


\(^{40}\) Article 63 of the Securities Law provides, “the information as disclosed by issuers and listed companies according to law shall be authentic, accurate and complete and shall not have any false record, misleading statement or major omission.” Article 2 of the Measures for the Disclosure of Information provides, “an information disclosure obligor shall disclose its information truthfully, accurately, completely and in time. The information disclosed shall not contain any false record or misleading statement or serious omission.”
statements or serious omissions. Article 30 (1) of the Measures for the Disclosure of Information provides that “in the case of a major event that may considerably affect the trading price of a listed company’s shares and that is not yet known to the investors, the listed company shall disclose it to them in time, stating the cause, the present situation, and the possible legal consequence of the event.”\textsuperscript{41} So, if executives delay disclosing a piece of good news, they violate the securities law and regulations, even they do not intend to make profit from it.

3. Executives disclose a piece of good news to boost the stock price shortly before the date of exercise. The results of this situation are similar to the first circumstance, it does not constitute insider trading, it may constitute manipulating the securities transaction prices and it does not constitute carrying out fraudulent securities activities.

4. Executives delay disclosing a piece of bad news until they finish exercising their rights in order not to depress the stock price. The results of this situation are similar to the second circumstance, it constitutes insider trading, it may constitute manipulating the securities transaction prices and it constitutes carrying out fraudulent securities activities.

So, it is highly possible for executives to violate the law and regulations if they delay disclosing a piece of good news until the excerpt of the draft of the stock option plan is disclosed in order not to raise the stock price or delay disclosing a piece of bad news until they finish exercising their rights in order not to depress the stock price. Therefore, in practice, the safe methods for executives to increase their profits from stock option compensation are to disclose a piece of bad news to depress the stock price shortly before the date of issuance or disclose a piece of good news to boost the stock price shortly before the date of exercise. Under such circumstances, only shareholders can prove that the intent of executives to disclose the bad or good news is to manipulate the securities transaction prices will executives are regarded as violating the securities law and regulations. It is a very hard task for shareholders. Ultimately, the nature of the timing problem is how much discretion executives have in disclosing information according to securities law and regulations. The answer is very much because “the law assumes the existence of such discretion and further

\textsuperscript{41} At the same time, article 31 (1) of the Measures for the Disclosure of Information also provides, “a listed company shall timely perform the obligation to disclose the information about a major event when any of the following circumstances is the first to occur: (1) The board of directors or board of supervisors makes a resolution about the major event; (2) The parties concerned enter into a letter of intent or agreement on the major event; or (3) The directors, supervisors or senior managers know the major event and report it...”
assumes that it will be applied by management in the best interests of the corporation and the shareholders as a whole.”

C. Suggestions on how to address the timing problem

The profits that executives can make from disclosure timing are exactly the losses incurred by the company, in other words, its shareholders. It is a “zero-sum” game. So, in order to protect the interests of shareholders, the CSRC shall make some rules to prohibit or constrain executives from making profits by the means of disclosure timing. But, frankly speaking, “managerial discretion over disclosure timing is not an oversight or an accidental effect of the system that can be easily changed.”

Considering the complexity of stock option compensation, for example, the strike price alone is determined by many factors, such as “the degree of managerial risk aversion (which in turn might be affected by the manager’s age and wealth), the project choices available to the company, the volatility of the company’s stock, the expected rate of inflation and the length of the manager’s contract”, hence, “there is no reason to expect that ‘one size fits all’—that the same exercise price is optimal for all executives at all firms, in all industries and at all times.” So, this chapter suggests that the CSRC shall make the “comply or explain” rules to require listed companies to comply with the following suggestions, but the companies are allowed to change or just disobey these rules as long as they provide and disclose their choices and detailed reasons (whether these choices are appropriate and reasons are justified are up to shareholders).

1. In order to address the problem that executives may disclose a piece of bad news to depress the stock price shortly before the date of issuance so as to gain a lower strike price, the CSRC may amend Article 24 of the Measures for Equity Incentive Plans to require companies to extend the period determining the strike price from 30 trading days to one year, and cancel another method to determine the strike price,

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42 Yablon & Hill, supra note 2, at 104.
43 Id. at 103.
45 Id.
46 Such behavior is called “one big payday”, see Yablon & Hill, supra note 2, at 104 (“where the CEO has a much greater interest in having the company’s stock achieve a certain price on one particular day (the issuance date, the exercise date) than he has in the stock price the rest of the time. The bigger the potential payday, the greater the incentives to manipulate stock prices around that date.”).
47 This suggestion is based on Bebchuk and Fried’s proposal. See Bebchuk & Fried, supra note 24, at 1942. According to their suggestion, “to reduce the potential for gaming, the terms and amount of equity awards should not be based on the grant-date stock price.” Specifically, their suggestion is “consider an executive who is promised that, over each of X years, Y options will be granted each year. Instead of setting the exercise price to the stock price on the grant date each year—a price that could be manipulated—the exercise price could be set
namely, “the closing sales price of the target stock of the company at one trading day before the promulgation of the excerpts of the draft of the equity incentive plan.” So the new strike price shall be no less than “the average closing sales price of the target stock of the company within one year trading days before the promulgation of the excerpts of the draft of the equity incentive plan”. Because it is hard to image that executives are willing and able to maintain the stock price low for whole one year. If they do so, two bad outcomes will arisen: (1) The financial performance of the company maybe disappointing, so executives cannot satisfy the conditions to exercise their rights; (2) Suppose that executives have some unexercised stock options or stocks, their benefits will be hurt by such behavior. So this approach can address the one big payday problem, at least, to some extent.

2. As to the problem that executives may disclose a piece of good news to boost the stock price shortly before the date of exercise, frankly speaking, there is no good method to address this problem. According to Bebchuk and Fried’s proposal, the CSRC may require executives to disclose their intended exercising in advance, for example, if executives want to exercise their rights on May 1, they have to disclose their intent before Apr. 1. So, before the date of exercise, their behaviors will be closely scrutinized by the board, shareholders, the media and the CSRC. Suppose that one executive discloses that she will exercise her rights on May 1. On April 28, she requires the company to disclose a piece of good news. Usually the board will directly follow her requirement. But now, considering that the date of exercise is approaching and the executive’s motivation to disclose the good news maybe to increase her personal wealth, the board will carefully scrutinize her requirement. Even, the board may postpone disclosing the good news if it will not violate the securities law and regulations until she finishes exercising her stock options. Because the board is afraid of being accused of helping executives manipulate securities transaction prices. This approach may partly reduce the executive’s motivation to time information disclosure. But considering the executive’s influence on the board, whether the board is willing to be against the executive’s requirement is unclear.

49 A similar way to address this problem is suggested by Prof. Fried, which is called “hands-off” options, which refers to “options that are cashed out according to a fixed, gradual, and pre-announced schedule. By removing
IV. How to Address the Short-termism Problem

A. Stock option compensation may wrongly induce executives to pursue short-term profits at the costs of shareholders’ long-term interests (short-termism problem)

It has been widely accepted by many scholars for long time that stock option compensation may wrongly induce executives to pursue short-term profits, which will hurt the sustainable development of the company and the long-term interests of shareholders.\(^{50}\) Because, “the value of a stock option depends entirely on the market price of the company’s stock on the date the option is exercised. As a result, managers were incentivized to focus their efforts not on planning for the long term, but instead on making sure that share price was as high as possible on their option exercise date (usually only a year or two in the future), through whatever means possible.”\(^{51}\) The possible means include: “adopting massive stock-buyback programs that drained much-needed capital out of firms; jumping into risky ‘proprietary trading’ strategies with credit default swaps and other derivatives; cutting payroll and research-and-development budgets; and even resorting to outright accounting fraud, as Enron’s options-fueled and stock-price obsessed executives did.”\(^{52}\) Furthermore, the nature of stock option also encourages executives to “undertake risks that are suicidal for the company as a whole.”\(^{53}\) The reason is “an option holder does not share in downside risk on the underlying stock. If the stock loses value, the option

\(^{50}\) Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 Ind. L. J. 59, 68 (1992) (“Since her compensation depends on the company’s performance, and the company’s performance is measured primarily by earnings-per-share or market price, the executive has incentive to do whatever is necessary to prop up this quarter’s earnings or increase the market price of shares. Instead of positioning the company for the future, which is an important objective of shareholders, the executive’s attention is diverted to positioning the company to meet his own short-term goals.”).

\(^{51}\) Clawson & Klein, supra note 7, at 44 (“Options ...create incentives to inflate share price in the short run, at the expense and risk of other objectives such as long-term corporate viability or a steady, less volatile, upward drift in the stock price.”)

\(^{52}\) Mark J. Loewenstein, Reflections on Executive Compensation and a Modest Proposal for (Further) Reform, 50 S.M.U. L. Rev. 201, 221 (1996) (“If a CEO’s compensation is largely dependent on share price, the CEO may pursue strategies that raise short-term profits and, thus, share prices, at the expense of long-term returns.”).

holder will simply fail to exercise the option and will thus avoid the loss. Risks that would properly scare the flesh off a shareholder are a matter of indifference to the option holder.\textsuperscript{54} The excessive risk-taking activity among financial companies is said to be the very reason that caused the 2008 financial crisis.\textsuperscript{55}

In theory, the ideal compensation incentives should be designed to “produce long-term value for shareholders without encouraging excessive risk-taking,” which is highly recommended by institutional shareholders and academic institutions.\textsuperscript{56} But, “until very recently, firms have taken surprisingly few steps to prevent or to regulate the unwinding of the incentives created by option and restricted-stock grants. Managers thus have been enjoying broad freedom to unload their options and shares. Such unloading either weakens managers’ incentives or force the firm to provide additional options or shares to restore incentives.”\textsuperscript{57}

In China, the CSRC also strongly emphasizes that stock option compensation shall encourage executives to create long-term value for shareholders.\textsuperscript{58} But, in practice,  

\textsuperscript{54} Id. Also see Brian William Hughes, \textit{Stock Option “Springloading”: An Examination of Loaded Justifications and New SEC Disclosure Rules}, 33 J. Corp. L. 777, 779 (2008) (“Linking pay to short-term gains through options appears to magnify the risk that executives are willing to take, since they are compensated for stock price increases, but-unlike shareholders they are not punished for decreases in stock price.”).

\textsuperscript{55} Lucian A. Bebchuk & Holger Spamann, \textit{Regulating Bankers’ Pay}, 98 Geo. LJ, 247, 249 (2009). And Samuelson & Stout, supra note 51 (“There have been nearly as many reasons proposed for the current crisis as there are experts to propose them. But if we had to pick one overarching cause, it would be business leaders taking on excessive risk in the quest to increase next quarter’s profits. This short-term thinking, in turn, was driven by two trends in the business world: shareholders’ increasingly clamorous demands for higher earnings, and compensation plans that paid managers handsomely for taking on risks today that would only be realized later.”). But see David Yermack, \textit{Keeping the Pay Police at Bay} (October 10, 2009), WSJ.com, available at http://online.wsj.com/article/SB10001424052748703746460457446146259812640.html (“In most companies executive pay works rationally and effectively. No evidence whatsoever indicates that errant executive compensation ‘caused’ the financial crisis of 2008, or that its reduction would prevent similar events in the future. The recent scrutiny of executive pay seems to stem from an odd mix of envy and vengeance, unsupported by facts or theories.”).


\textsuperscript{57} Bebchuk & Fried, supra note 3, at 174.

\textsuperscript{58} Article 2 (1) of the Measures for Equity Incentive Plans provides, “the equity incentive as mentioned in the Measures for Equity Incentive Plans refers to the long-term incentive provided by a listed company for its directors, supervisors, senior executives, and other employees by granting stock of its own company to them.” Article 22 (1) of the Measures for Equity Incentive Plans provides, “the interval between the date of grant of the stock options and the exercisable date of the granted stock options for the first time shall be less than one year.” And article 23 (1) of the Measures for Equity Incentive Plans provides “ a listed company shall prescribe that the eligible participants exercise power by installment within the effective duration of the stock options.” Besides, article 142 (2) of the Company Law also provides, “the directors, supervisors and senior managers of the company shall declare to the company the shares held by them and the changes thereof. During the term of office, the shares transferred by any of them each year shall not exceed 25% of the total shares of the company he holds. The shares of the company held by the aforesaid persons shall not be transferred within 1 year from the day when the stocks of the company get listed and are traded in a stock exchange. After any of the
almost all the stock option plans issued by listed companies last for quite short time. According to Qu Hai Xiang and Cao Yan Dong, “concerning the effective duration of stock option, the average duration period is 5.64 years. Comparing to average 10 years’ duration in western countries, stock option compensation in China actually encourages short-termism, which means it is highly possible that executives will take some illegal behaviors to benefit themselves.”

Zhu Rui Min and Li Chang Qiang believe that “the vesting time in Chinese executives’ stock option compensation is relatively short, only one year. How long executives shall wait before they can exercise rights and how can they exercise their rights are two key issues in stock option compensation and they are shall be designed to provide long-term incentives.”

Recently, in order to totally avoid the limitation and restriction on them and make “quick bucks”, many executives in Chinese listed companies resign from their companies, which enhances their already existed short-termism.

**B. How to address the short-termism problem**

One of the feasible approaches to address the short-termism problem is to require executives to hold the stock options for longer time than current practice. “In order to overcome managerial myopia, managerial wealth should be tied to firm performance over the longer term, which, in the view of finance theorists, helps explain vesting requirements on stock and options, and long-term incentive plans with multi-year horizons.” Surely, this approach has its disadvantages, for example, it requires executives to “bear more risk (from a lack of diversification).”

1. Two influential proposals made by US scholars

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59 Qu Hai Xiang & Cao Yan Dong, *On the Harms that Executive Stock Option Compensation May Bring to Minority Shareholders and How to Do with It*, No. 9 Accounting Study 47, 47 (2011).
61 Gao Ming Hua, *Equity Incentives Should Be Postponed*, No.6 Broad and Directors 109, 109 (2011). For example, subject to Article 43 (2) of the 2011 Vanke Stock Option Plan, if a executive resigns from the company or after her tenure, she and the company do not renew the contract, her stock options that have already been granted but cannot be exercised shall be canceled and her stock options that can be exercised shall be exercised in 12 months.
63 Walker, *supra* note 5, at 441.
64 Steven N. Kaplan, *Response, Weak Solutions to an Illusory Problem*, 159 U. PA. L. REV. PENNUMBRA 43, 44 (2010). Also see Walker, *supra* note 5, at 442 (“managers resist having too much of their wealth tied to long-term performance because of the negative effects on the diversification of their portfolios and liquidity.”).
Specifically, there are two influential alternatives: one is made by Sanjai Bhagat and Roberta Romano; another is made by Lucian A. Bebchuk and Jesse M. Fried.

(1) According to Sanjai Bhagat and Roberta Romano’s proposal, “(80-90%) incentive compensation plans should consist only of restricted stock and restricted stock options, restricted in the sense that the shares cannot be sold (or the option cannot be exercised) for a period of at least two to four years after the executive’s resignation or last day in office.”65 The reasons why they choose two and four years are “two years should be the short end of the waiting period because managers’ discretionary authority, under current accounting conventions in the United States, to manage earnings unravels within a one-to two-year period. On the other side, four years is a reasonable time for at least the intermediate-term results of the executives’ decisions to come to realization.”66 Under this proposal, executives will have “diminished incentives to make public statements, manage earnings, or accept undue levels of risk, for the sake of short-term price appreciation,”67 hence, “the proposal will diminish the perverse incentives (to manipulate or emphasize short-term stock prices over long-term value), yet retain the benefits of equity-based incentive compensation plans.”68 There are three important concerns about their proposal: (a) It will lower the risk-adjusted expected return for the executives. Their solution to this concern is to grant additional (restricted) shares and options to them and prohibit them from buying financial derivatives to hedge risks.69 (2) It will cause executives to lack of liquidity. Their solution to this concern is to raise cash compensation deduction ceiling, for example, to $2 million (comparing to $1 million according to current tax law ) and allow 10-15% incentive compensation in a given year not covered by their proposal.70 (3) It will lead to early management departures. They admitted this scenario would happen, but it was not so serious. Because, “managers who develop a reputation for early departures from firm to firm are likely to negatively impact their future career opportunities.”71

2. According to Lucian A. Bebchuk and Jesse M. Fried’s proposal, “after allowing

65 Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation: Focusing and Committing to the Long-Term, 26 Yale J. on Reg. 359, 363 (2009). Such proposal has also been made by other scholars, see Lloyd Blankfein, Do Not Destroy the Essential Catalyst of Risk, FIN. TIMES, Feb. 2009 (“Senior executive officers should be required to retain most of the equity they receive at least until they retire, while equity delivery schedules should continue to apply after the individual has left the firm.”).
66 Bhagat & Romano, supra note 65, at 363.
67 Id.
68 Id.
69 Id. at 367-368.
70 Id. at 368-369.
71 Id., at 371.
for any cashing out necessary to pay any taxes arising from vesting, equity-based awards should be subject to grant-based limitations on unwinding that allow them to be unwound only gradually, beginning some time after vesting.”  

Even executives retire from the company, this requirement is still applied to them, thus (1) removing any incentive for the CEO to accelerate her retirement; and (2) making it less likely that she will focus on short-term results while making decisions for the firm just prior to retirement.”  

Because “each equity grant is made at a different point of time and must be unwound gradually, the executive does not face a situation in which she can cash out almost all of her unliquidated equity at once. Thus, even when the executive is in her last year or two in office, she will still have an incentive to consider the effect of her decisions on long-term share value,” hence, executives will be encouraged to pursue long-term interests for shareholders.

2. How to address the short-termism problem in China

This chapter agrees that “the optimal term (of executives’ compensation contracts) would vary considerably by industry, firm, and executive. ... ‘one-size-fits-all’ targets for executive pay term that have real bite will inevitably exceed the optimal mark for some firms and executives.”  

So, this chapter suggests that the CSRC shall make rules to require the listed companies to comply with my following suggestions in order to address the short-termism problem of executive stock option compensation, however, the companies could disobey or change these rules and provide their own solutions as long as they disclose detailed explanations to shareholders. For the focus of this chapter, my suggestion is:

(1) Prolonging the vesting time from 1 year to at least 3 years. It is also suggested by other scholar that “if the effective duration of stock option plan is 10 years, the vesting time shall be 3-5 years; if the effective duration of stock option plan is five years, the vesting time shall be 2-3 years.”

(2) In China, listed companies do not grant stock options to executives every year. Considering this reality, the CSRC may require that executives shall only exercise no

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72 Bebchuk & Fried, supra note 24, at 1928-1931. Similar approach has also been suggested by David Yermack, see Yermack, supra note 55 (“Companies might benefit by imposing more restrictions on how and when managers can sell their holdings, perhaps by considering limits on the amount that can be liquidated each year or requiring advance notification to the market before a sale takes place (current law requires 48-hour retroactive disclosure.”).  

73 Bebchuk & Fried, supra note 24, at 1931.  

74 Id. at 1929.  

75 Walker, supra note 5, at 461-462. Also see Zhu & Li, supra note 60, at 58-59 (“For each listed company, how long the vesting time shall be and when executives can exercise their rights are determined by the company’s unique conditions.”).  

more than 20% options that they are granted for the first time every year after 3 years’ vesting time.\textsuperscript{77} For example, if one executive is granted 1 million stock options at a given year, after waiting for 3 years, in the fourth year, she can exercise no more than 200,000 stock options, in the fifth year, she can also exercise no more than 200,000 stock options, and so on. Then, at least after 8 years, she can exercise all her 1 million stock options. Besides, the CSRC may also require that even executives resign from the companies, they shall still be subject to this requirement, which can prevent the executives from avoiding this requirement through resigning. This approach may deter some executives from taking stock option compensation because they will bear more firm-specific risks and illiquidity, which is not good for shareholders. In order to resolve this concern, I also suggest that if executives are subject to this requirement, the stocks which they gain from exercising their rights are exempting from the restrictions of Article 142 (2) of the Company Law (restriction on selling stocks) and Article 47 (1) of the Securities Law (restriction on short-swing trading),\textsuperscript{78} which means they can freely sell the stocks and keep the profits. This is a proper balance between long-time holding (from the perspective of shareholders) and risk aversion and needs for liquidity (from the perspective of executives). As Bebchuk and Fried believed, “an efficient contract can be expected to strike a balance between maintaining these incentives and satisfying managers’ legitimate liquidity and diversification.”\textsuperscript{79}

V. How to Address the Windfalls Problem

A. Windfalls of executive stock option compensation

When executives exercise their rights, the higher the stock price is, the more profits they can make. But in practice, the stock price when executives exercise their rights is determined by many factors, such as: 1. the general market situation, for example, stock price is boosted by low interest rate; 2. the industry development, for example, government subsidies may help the company to make more profits; and 3. the specific

\textsuperscript{77} Currently, the typical practice is: after waiting for one year, executives can exercise 30-40% options, at the third year, they can exercise another 30-40% options, and at the fourth year, they can exercise the remaining options. If they cannot exercise all their options in four years, their stock options shall be canceled.

\textsuperscript{78} It provides, “where any director, supervisor and senior manager of a listed company or any shareholder who holds more than 5% of the shares of a listed company, sells the stocks of the company as held within 6 months after purchase, or purchases any stock as sold within 6 months thereafter, the proceeds as generated therefrom shall be incorporated into the profits of the relevant company. The board of directors of the company shall take back the proceeds....”

\textsuperscript{79} Bebchuk & Fried, supra note 3, at 174-175.
situation of a company itself, for example, the competence of its executives and the skillfulness of its employees. According to Johnson, 80 percent of the volatility in respect of a share of stock is out of executives’ control. So, “the performance of a company changes not only because of the executives’ diligence, but also other factors. As a result, even executives do not manage the company well, its performance can still be promising; on the contrary, even executives try their best to run the company, its performance may still be disappointing.”

Ideally, “executives and managers should be rewarded for the actions and decisions within their control, not general market movements.” But, in reality, when the stock price goes up quickly due to good market or industry development, the company will not filter out this factor through raising the strike price. “One widespread and persistent feature of stock option plans is that they fail to filter out stock price rises that are due to industry and general market trends and thus completely unrelated to managers’ own performance.” Hence, “fixed price stock options are like the lottery tickets referred to above in that the appreciation in their value may be wholly unrelated to the executive’s performance.” By contrast, when the stock price declines below the strike price (out-of-money stock option), the company usually cancels the old stock options and grant new stock options to replace them with lower strike price. The main reason why the company does so is that “if the company is severely troubled, and all the options are deeply underwater, then directors say our first priority in compensation is to retain these people and to assure continuity, so we

80 Clawson and Klein, supra note 7, at 43 (“The stock price could appreciate due to a favorable economy, favorable industry trends, or other exogenous events, and the executive with fixed price options would receive the benefit of such appreciation.”). Richard A. Posner, Are American CEOs Overpaid, and If So, What If Anything Should Be Done About It?, 58 Duke L.J. 1013, 1026 (2009) (“Many things move a company’s stock besides the decisions of its CEO. To tie his income to the value of his company’s stock is a bit like tying the salary of the president of the United States to GNP. The analogy is particularly close in an industry like oil, in which the profits of an oil company are largely a function of the price of oil, over which the companies have little control.”).
81 Johnson, supra note 53, at 1276 (“It appears that about 80 percent of the volatility in respect of a share of stock arises from industry wide or stock-market wide factors over which management has no control.”).
83 Samuelson & Stout, supra note 51.
84 Bebchuk & Fried, supra note 44, at 83. Also see Matthew A. Melone, Are Compensatory Stock Options Worth Reforming? 38 Gonz. L. Rev. 535, 567 (2003) (“traditional stock options fail to filter out general market effects thereby increasing the possibility that the firm overcompensates or under compensates the managerial effort for which it bargained.”).
85 Clawson & Klein, supra note 7, at 46.
86 Melone, supra note 84, at 557 (“Corporations, under the theory that deeply out-of-the-money options offered no incentives to employees, often reduced the strike price of options or canceled existing options and reissued replacement options with a lower stock price.”). Actually, repricing stock option is uncommon in the US now. According to the requirements’ of NYSE listing standard, only ratified by the shareholders’ meeting could the company reprice stock option since 2003, so almost “no new plans have repricing provisions” in practice. See Andrew C.W. Lund, What Was the Question? The NYSE and Nasdaq’s Curious Listing Standards Requiring Shareholder Approval of Equity-Compensation Plans, 39 Conn. L. Rev. 119,136 (2006).
can’t pay them below the norm.”\textsuperscript{87} Otherwise, these executives will quit and find jobs in other companies, which means a disaster to the company. But “the alignment of shareholder and management incentives only exists if executives are unrewarded when stock prices fail to rise, or fall.”\textsuperscript{88}

In short, “the challenge in designing multi-year option plans is to create sufficient upside potential for incentive alignment purposes while at the same time preserving the company’s ability to retain and motivate executives if the stock price falls sharply.”\textsuperscript{89}

In China, we are facing the same problem. Article 5 of the Memo No.2 provides that companies are encouraged to use market index, component stocks index or an index of related companies when they design the conditions for the executives to exercise their rights. But, in practice, few companies use this kind of stock option compensation. As a result, when the stock price goes up quickly due to good economy or industry development, the company will not raise the strike price; meanwhile when the stock price declines below the strike price, the company will routinely cancel the old stock option plan. Usually, the company makes following explanation: “since major changes have taken place in the capital market, if our company still continues the stock option plan, it is difficult to realize the objectives of the plan. So, the board decided to cancel the stock option plan. We will wait for the opportune moment to issue new stock option plan again.”\textsuperscript{90} Canceling the stock option plan has three disadvantages: 1. The company incurs lots of costs in making the stock option plan, such as holding board and compensation committee meetings, hiring lawyers and compensation consultants or other professional agencies. So, if the stock option plan is canceled, company’s wealth will be wasted; 2. The reasons why the stock price declines below the strike price maybe out of executives’ control, for example, because of 2008 Financial Crisis. Thus, if the stock option plan is canceled, executives will be discouraged to maximize shareholders’ interests. Because, even they do their best, it is impossible for them to gain profits from their stock option compensation; and 3.

\textsuperscript{89} Hall, \textit{supra} note 62, at 28.
\textsuperscript{90} Zeng Fu Bing, \textit{Ningbo GQY Canceled Its Stock Option Plan}, Oriental Morning Post, June 18, 2011 (GQY, listed in Shenzhen ChiNext market, describes itself as the world’s leading expert of visual-info system solutions). “Statistics suggested that the stock price of 30 listed companies that issued stock option plans since 2011 was below the strike price. According to a market analyst, under such circumstance, the stock option plans may be canceled by those companies.” see Wang Dan, \textit{Equity Incentive in Grandland Decoration May be Canceled}, Beijing Business Today, Oct. 12, 2012.
Subject to Article 1 (2) of the Memo No.3, if the board decides to cancel the stock option plan, the company shall not issue any stock option plan again within 6 months. So, if the stock option plan is canceled, the company cannot issue new stock option plan again within 6 months, even though it is necessary for it to retain and attract needed talents by the means of issuing new stock option plan.

**B. How to address the windfalls problem**

It is suggested by a few scholars that using indexed stock option can address this windfalls problem.\(^{91}\) Under this approach, “the exercise price of the option is adjusted to the price movements of a designated index such as the Standard & Poor’s 500 or to an index more narrowly tailored to the company’s industry group.”\(^{92}\) Indexed stock option can ensure that “the increase in value of the company’s stock that relates to favorable economic or industry conditions (which presumably the executive had no influence in bringing about) is reserved for the shareholders, and only the incremental increase in the company’s stock price (which is presumably attributable to good management by the executive team and good rank-and-file performance), if any, increases the value of the executive stock options.”\(^{93}\) At the same time, when market or industry declines, indexed stock option will also ensure that executives’ options “remain valuable, and that managers continue to have incentives to perform.”\(^{94}\) Because, “the executives who perform adequately relative to their peers will always be rewarded.”\(^{95}\)

In spite of these obvious advantages, indexed stock option is virtually nonexistent in the US\(^ {96}\) or in China either. The reasons maybe:

1. Choosing a proper index, especially a industry index, is difficult. “Picking the comparison group (all companies? all companies of the same size? All companies of the same profitability, capital structures, markets?) involves considerable

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\(^{91}\) Hall, *supra* note 62, at 24 (“With indexed options, executives are rewarded (or punished) according to their success in outperforming their competitors or the broad market.”); Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. Chi. L. Rev. 847, 862 (2002) (“to the extent that company stock returns are affected by common market-wide shocks, paying based on relative performance can reduce the ‘noise’ in the performance measure without affecting incentives.”).


\(^{93}\) Clawson & Klein, *supra* note 7, at 47.

\(^{94}\) Bebchuk & Fried, *supra* note 3, at 166 (“Using indexed options that automatically correct for market-wide and sector-wide shocks in both directions will generally ensure that options remain valuable, and that managers continue to have incentives to perform, when market decline.”).

\(^{95}\) *Id.* at 167.

uncertainty.” This concern is not serious. Because in the US, a listed company shall disclose a performance graph, which compares the company’s cumulative total shareholder return, including dividends, on its common stock with (1) a broad equity index such as the S&P 500 or equivalent; and (2) a published industry or line-of-business index comprised of peer companies selected in good faith on an industry or line-of-business basis. If the company cannot reasonably identify a peer group and it does not use an industry or line-of-business index, then an index must be comprised of companies with similar market capitalizations. So, it is easy for the company to choose a market index or industry index. In China, lots of market or industry indices are available both in Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE), so it is also not difficult for a listed company to choose a proper index in China.

2. Indexed stock option will cause executives to pursue more risky investments, because only when the executives beat their competitors instead of only assuring the stock price is higher than the strike price can they make profits from their stock options compensation. “Indexed options pose a special danger because they encourage or tempt option-holding managers to push the firm to riskier (but lower expected-value) activities,” which is called by Saul Levmore as “super-risk alteration”. This problem can be addressed by long-holding requirement, which I have already discussed in detail in part IV.

3. The companies have no ideas what will happen if they use indexed stock option first. Because, when a company use indexed stock option first, its stock option compensation will become less attractive to executives (there are less windfalls in indexed stock option). Thus, executives may refuse to accept this kind of stock option compensation or even resign from the company.

4. The huge influence that executives have over the board and the compensation committee may bring windfalls to them. “Given that using conventional options will

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97 Posner, supra note 80, at 1026.
98 When a company refers to a peer group used for benchmarking purposes, the SEC will ask for the names of the peer group companies and how the company selected them, and where actual awards fell relative to the benchmark. See Shelley Parratt, Executive Compensation Disclosure: Observations on the 2009 Proxy Season and Expectations for 2010, available at http://www.sec.gov/news/speech/2009/spch110909sp.htm.
99 CLawson & Klein, supra note 7, at 48.
104 Id.
be legitimate and acceptable (after all, most firms use them) and that moving to indexing or any other form of reduced-windfall options is likely to be costly or inconvenient for managers, the lack of any real movement toward such options is consistent with the managerial power approach.” ¹⁰⁵

Considering the reason 3 and 4, it is unlikely that listed companies will willingly use the indexed stock option compensation in China (or in the US either). So this chapter suggests that the CSRC shall require all the listed companies to adopt indexed stock option compensation. The companies can choose either market-indexed stock option compensation or industry-indexed stock option compensation. For example, Vanke, a real estate company listed in Shenzhen Stock Exchange, can choose a market index, such as SZSE Component Index or SZSE 100 Index or a industry index, such as Real Estate Index or SZSE Financials. ¹⁰⁶ But, at the same time, the companies are allowed not to comply with this requirement, but they shall explain why they do not adopt marker or industry indexed stock option in detail based on their unique circumstances. For example, Vanke can choose its own index, which is composed of other real estate companies listed in Shanghai Stock Exchange or/and Hong Kong Stock Exchange as long as it explain why it do so and how it choose the index.

VI. Conclusion

This chapter discusses how to address three agency problems (timing problem, short-termism problem and windfalls problem) of executive stock option compensation by the means of “comply or explain” approach. I suggest that the CSRC shall make rules that can address (at least partly address) the aforementioned three problems so as to protect the interests of shareholders and require the listed companies to comply with those rules. At the same time, companies are allowed not to comply with these rules under some circumstances as long as they disclose the reasons why they do not comply in detail. Since this “comply or explain” approach has never been adopted in China before, I am not sure that this approach can also be successful in China. But, this approach can offer another good choice for the rule-makers and it is also a beneficial attempt to address the three agency problems of executive stock option compensation with this approach. Specifically:

¹⁰⁵ Bebchuk & Fried, supra note 44, at 84.
¹⁰⁶ Vanke is one of the companies that constitute the two indices.
First, with regard to how to address the timing problem, this chapter suggests that the CSRC shall amend Article 24 of the Measures for Equity Incentive Plans to require the companies to extend the period determining the strike price from 30 trading days to one year and request executives to disclose their intended exercising in advance.

Second, with regard to how to address the short-termism problem, this chapter suggests that the CSRC shall require the listed companies to prolong the vesting time from 1 year to 3 years. And, executives can only exercise no more than 20% options that they are granted at the first time every year after 3 years’ vesting time. If the executives are subject to this requirement, the stocks that they gain from exercising options are exempting from the restrictions of Article 142 (2) of the Company Law (restriction on selling stocks) and Article 47 (1) of the Securities Law (restriction on short-swing trading).

Third, with regard to how to address the windfalls problem, this chapter suggests that the CSRC shall require the listed companies to adopt market or industry indexed stock option compensation.
Chapter Six  Ex Post Strategy of Enhancing Supervision by Public Authorities: Shareholders’ Derivative Suits Shall Be Made Easier for Minority Shareholders to Bring and Courts Shall Clarify the Standard of Judicial Review

I. Introduction

This chapter mainly discusses how to enhance the threat of civil liabilities to address one problem that the independent directors in the compensation committee (the independent directors) facing little chance of being held liable for violating their duty of care may lead them to fail to supervise executives and grant them excessive stock option compensation.

In theory, if the independent directors are found to break their duty of care when they make executive stock option compensation, they shall be held liable for their behaviors and compensate the company for the losses, thus protecting the interests of shareholders, especially the minority shareholders. Furthermore, being defendants alone may impose severe shame sanctions on the independent directors.

In practice, however, the threat of civil liabilities is very weak in China. Lacking of shareholders’ derivative suits and the uncertain standard of judicial review, in my opinion, are two major reasons for the weak threat of civil liabilities.

1 This chapter only focuses on the independent directors’ duty of care and civil abilities. Actually, in law and practice, independent directors and non-independent directors are not treated differently. See Fu Qiong & Cao Li, On the Boundary of Independent Directors’ Duty of Care and Liability Relief Approach, No.12 Social Science 111, 113 (2011).

2 For example, “nearly 70 independents directors have been publicly condemned by the Shen Zhen Stock Exchange by the end of 2007, but among these directors who failed to perform their fiduciary duties, only one director was penalized for RMB 100,000 by the China Securities Regulatory Commission (CSRC). None of them are held civil liable for violating their fiduciary duties in the courts” see Peng Wen Ge & Qiu Yong Hong, On Improving the Institution of Independent Directors from the Perspective of Stock Exchange, No.2 Securities Market Herald 36, 41 (2007). Since the independent directors have no conflicts of interest in making executive stock option compensation, this chapter only discusses the duty of care.

3 Ning Xiang Dong et al., On Reputation and Behavior of Independent Directors, No.1 Journal of Tsinghua University (Philosophy and Social Sciences) 129, 130 (2012) (“In China, reputation mechanism is a crucial factor motivating and restricting the behavior of independent directors.”).

4 Shareholders in listed companies have only brought one derivative suit since the shareholders’ derivative suits mechanism has been transplanted into China since 2005, see infra part III.

5 The standard that the Chinese courts may apply to determine whether the independent directors break their duty of care when they make executive stock option compensation (or other decisions) is uncertain, see infra part IV.

6 Benjamin L. Liebman & Curtis J. Milhaupt, Reputational Sanctions In China’s Securities Market, 108 Colum. L. Rev. 929, 943 (2008) (“Doctrinal obstacles and uncertainties, the lack of a class action mechanism to aggregate claims, local favoritism in the courts, uncertain enforcement prospects, political pressure, and a lack of assets
argues that the threat of civil liabilities could be enhanced by two methods: shareholders’ derivative suites shall be made easier for minority shareholders to bring and the courts shall clarify the standard of judicial review when they have to determine whether the independent directors break their duty of care as they make executive stock option compensation.

What needed to be emphasized is making executive stock option compensation is the internal matter of a listed company. It is drafted by the compensation committee, discussed by the board and approved by the shareholders’ meeting. Hence, only under limited and exceptional circumstances, shall the courts involve in this matter and determine whether the independent directors break their duty of care. Otherwise, “the normal business operation activities of a company may be affected by the supervision and inspection of courts; meanwhile, courts’ enormous power will increase their rent-seeking activities and lead to judicial corruptions in the end.”

Therefore, how to balance the needs of a company to manage its own business and the minority shareholders’ needs to protect their legitimate rights and interests is a tough job faced by the Chinese courts (or the courts in other countries).

This chapter proceeds as follows. Part II briefly discusses the standard of independent directors’ conduct when they make executive stock option compensation. Part III points out the reasons why shareholders’ derivative suits are rare in China and makes some suggestions on how to make it easier for minority shareholders to bring derivative suits into the courts. Part IV discusses the standard of judicial review the courts shall apply when they have to determine whether the independent directors break their duty of care or not. Part IV offers a short conclusion.

II. The Standard of Independent Directors’ Conduct When They Make Executive Stock Option Compensation

Subject to Article 3 of the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the CSRC, effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans), when the independent directors make executive stock option compensation, they shall behave honestly, diligently, in good faith and maintain the interests of the company and all its

against which to collect a judgment from an erstwhile defendant corporation all work to diminish the viability of the legal system as a means of protecting investors.”
shareholders.\textsuperscript{8} With regard to this requirement, I want to emphasize two points:

First, When the independent directors perform their duty of care, they shall exercise the care that other ordinary independent directors would use in the similar circumstance.\textsuperscript{9} The reasons are:

1. According to Article 2 (4) of the Guidance Opinion on the Establishment of an Independent Director System in Listed Companies (promulgated by CSRC, effective in 2001, \textit{hereinafter} Independent Director Opinion), the independent directors must have more than five years’ working experience in law or economics etc. They shall have the ordinary skill, experience and knowledge that required by their jobs, in other words, they shall have “business common sense” as the independent directors.\textsuperscript{10} Obviously, the requirement for the independent directors when they perform they duties is higher than ordinary persons.

2. According to Article 7 (1), (2) of the Independent Director Opinion, listed companies shall provide the independent directors with sufficient materials and information to help them to fulfill their duties. Besides, if the independent directors believe it is necessary, they can require the companies to hire gatekeepers to provide professional opinions to them, and the costs shall be borne by the companies.\textsuperscript{11} So, the independent directors can inform themselves by different kinds of means.

Second, though there are no universal rules or procedures that the independent directors can follow when they make executive stock option compensation, basically, they are expected to do following things: 1. They shall evaluate executives’ pay structure and the necessity of granting stock option compensation to them; 2. They shall evaluate executives’ potential contributions to the company; 3. They shall collect important information on executive stock option compensation in other companies.

\textsuperscript{8} Article 148 (1) of Company Law of the People’s Republic of China (2005 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Jan. 1, 2006, \textit{hereinafter} Company Law) also provides, “the directors, supervisors and senior managers shall comply with the laws, administrative regulations, and bylaw. \textit{They shall bear the obligations of loyalty and diligence to the company.”}

\textsuperscript{9} Fu & Li, \textit{supra} note 1, at 113. Articles 4 (2) of Guidelines on Directors’ Conduct in the Listed Companies on the SME Board in Shenzhen Stock Exchange (promulgated by Shenzhen Stock Exchange, effective Oct.1, 2011) also provides, “directors shall act diligently and perform their duty with the knowledge, skill and experience that a director shall have...” Also see Article 330 of the Japanese Company Law and Article 644 of the Japanese Civil Law. But see Liu Jing Wei, \textit{A Comparative Study on the Criteria of Directors’ Duty of Diligence}, No.5 Contemporary Law Review 148, 152 (2007) (The author suggests that we shall use ordinary person standard, which is applied in the US). According to the American Law Institute, 4.01 (a) of Principles of Corporate Governance: Analysis and Recommendations, “a director or officer has a duty to the corporation to perform the director’s or officer’s functions... with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances.”

\textsuperscript{10} Seiichi Ochiai, \textit{The Elements of Corporate Law} (Beijing: Law Press, Chinese translation edition, translated by Wu Ting et al., 2011), at 99. Surely, the independent directors shall not be required to act as business experts, see \textit{Id}.

\textsuperscript{11} Article 7 (4) of the Independent Director Opinion and Article 32 of the Measures for Equity Incentive Plans.
within its own industry; 4. They shall hire a professional agency or a compensation consultant to provide professional advice to them or check the reasonableness of the stock option compensation if they believe it is necessary; 5. They shall really discuss the matters of executive stock option compensation with other directors in the compensation committee and the board; 6. They shall keep the minutes of the meeting of board and the meeting of compensation committee; and, most importantly, 7. They shall truly believe that the executive stock option compensation they have made is the best decision for the company and its shareholders.

But, if the independent directors break their duty of care and grant excessive stock option compensation to executives, thus hurting the interests of shareholders, especially the minority shareholders, who are the real masters that the independent directors shall serve, could the minority shareholders successfully pursue the independent directors’ civil liabilities? Next part, I will discuss some problems of shareholders’ derivative suits in China and provide some suggestions.

III. Shareholders’ Derivative Suits Shall Made be Easier for Minority Shareholders to Bring

A. The current situation of shareholders’ derive suites in China

Subject to Article 152 of the Company Law, if the independent directors break their duty of care, the shareholders, who solely or aggregately hold 1% or more of the total shares of a listed company for 180 consecutive days or more, can request in writing the board of supervisors to initiate a lawsuit against these independent directors in the

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12 Jennifer S. Martin, *The House of Mouse And Beyond: Assessing the SEC’s Efforts to Regulate Executive Compensation*, 32 DJCL 481, 518-519 (2007) (“To comply with the best practice, the compensation committee members should first receive (preferably in advance of the meeting) a spreadsheet or document prepared by a compensation expert disclosing the amounts the executive might receive under various alternatives. Second, the compensation expert, or a committee member, should explain the spreadsheet or document to the committee, with the document itself attached to committee minutes. Finally, the committee members should then have deliberations and discussion.”).

13 According to Article 29 of the Measures for Equity Incentive Plans, “an independent director shall present his independent opinions on whether the stock option plan is conducive to the sustained development of a listed company, and whether it obviously impairs the interests of the listed company and all of its shareholders.” So, the independent directors in the compensation committee shall also issue their opinions on executive stock option compensation.

14 For example, the compensation committee may just recommend the stock option plan, which is drafted by the professional agency who collude with executives, to the board without any checking, discussing and amending on the plan. In other words, it becomes a rubber stamp. Also see Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. Corp. L. 145, 153 (2000) (“if a director approving the plan without taking any time whatsoever to read the plan, failing to seek help in understanding the plan, or taking any action that would better inform him of the plan’s effects and possible consequences. In other words, if the director’s approval is merely a ‘rubber stamp’ on the plan, then that director has violated his duty of care.”).

15 Article 1 (2) of the Independent Director Opinion.
courts. If the board of supervisors refuses to initiate a lawsuit after receiving a written request, or if they fail to initiate a lawsuit within 30 days after receiving the request, or if, in an emergency, the failure to initiate an action immediately will cause unrecoverable damages to the interests of the company, the shareholders can, on their own behalf, directly initiate a lawsuit in the courts.

Though the objective of this article is to protect the interests of minority shareholders when the company (represented by the board of supervisors) does not sue against the independent directors who break their duty of care, in practice, this objective has never been achieved. Minority shareholders in listed companies have only brought one derivative suit since the shareholders’ derivative suits mechanism was transplanted into China in 2005. In that case, the minority shareholders of ST SanLian sued its controlling shareholder (SanLian Group) for violating ST SanLian’s trademark rights. The case that minority shareholders sue the independent directors for breaking their duty of care when they make executive stock option compensation has been never heard of to date.

B. The possible reasons why minority shareholders are not willing to bring derivative suits in China

In my opinion, there maybe two reasons that discourage minority shareholders to bring derivative suits, one is the high shareholding requirement and another is the benefit-and-cost consideration.

1. The high shareholding requirement

According to Article 152 of the Company Law, only the shareholders, who solely or aggregately hold 1% or more of the total shares of a listed company can bring derivative suits. This high shareholding requirement makes it difficult for minority shareholders to bring derivative suits. Only institutional shareholders may satisfy this requirement.

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17 Hitoshi Maeda, Understanding Company Law (Beijing: Beijing University Press, Chinese translation edition, translated by Wang Zuo Quan, 2012), at 334. Also see Zhong Zhang, Making Shareholder Derivative Actions Happen in China: How Should Lawsuits Be Funded? 38 Hong Kong L.J. 523, 524 (2008) (“Allowing individual shareholders to take legal action on behalf of a company where the company is unable to do so because of wrongdoing control, the shareholder derivative action has been regarded as a useful tool to check the dominant powers of controlling shareholders and to curb opportunistic behavior of management.”).
20 There are several other hot debates about Article 152 of the Company Law, such as how to calculate the 180 consecutive days or more, the role of a company and other shareholders in the suit, what the meaning of emergency is, whether the plaintiffs shall provide securities and so on. See Liu, supra note 16, at 158-166. For the purpose of this dissertation, I only discuss the possible reasons why minority shareholders are not willing to bring derivative suits and provide some suggestions.
requirement, but institutional shareholders will not protect their rights through bringing derivative suits. They are more willing to involve in corporate governance through having meeting with controlling shareholders and executives or voting at the shareholders’ meetings.21 For other minority shareholders, obviously, it is not easy for them to aggregate more than 1% of the total shares.22 Besides, under some circumstances, this requirement may generate unfairness among shareholders. For example, suppose that the stock price of A company is RMB 100 and it has 100 million outstanding shares, meanwhile, the stock price of B company is only RMB 5 and it also has 100 million outstanding shares, for the minority shareholders in A company, only they solely or aggregately hold shares worth more than RMB 100 millions can they bring derivative suit in the courts, while the minority shareholders in B company who only hold RMB 5 million can bring derivative suit. It is clear that it is easier for the minority shareholders in B company to bring derivative suit. Even though the shareholding requirement is not an obstacle for minority shareholders to bring a derivative suit, considering the benefits and costs of a derivative suit, they would not positively bring it.

2. Benefit-and-cost consideration

Shareholders’ derivative suits are designed for the interests of the company or its whole shareholders, the plaintiffs cannot benefit directly from the suits if they win the cases; meanwhile, the plaintiffs shall bear the costs directly if they lose the cases. Thus the plaintiffs of derivative suits have nothing to gain, but much to lose. The benefits and costs of a derivative suit are not balanced. As a result, it is impossible that minority shareholders will positively use this weapon to protect their rights.23 Specifically:

(1) If plaintiffs win the derivative suits, the benefits gained from the suits may include: a. The compensation paid by the independent directors to the company, thus shared by all the shareholders according to their share holdings; b. The price of their

21 Geng, supra note 18, at 176.
22 Zhong, supra note 17, at 525 (“the 1 per cent minimum shareholding requirement in respect of companies limited by shares rules out the possibility that public shareholders other than institutional investors actively bring up derivative actions to pursue wrongs done to listed companies which are the focal concern of corporate governance.”).
23 Id. at 526 (“It is thus clear that the potential benefits and costs from a derivative action for litigating minority shareholders are so incommensurate that they would have little incentive to bring up a lawsuit.”) It is the result of so-called “collective action problem”, see Edward M. Iacobucci, The Effects of Disclosure on Executive Compensation, 48 U. Toronto L.J. 489, 496 (1998) (“The benefits of disciplinary activity, either through monitoring or influencing the board, are shared equally by all shareholders, yet each would individually bear the cost of such activity. Consequently, each shareholder faces an incentive to take a free ride on the disciplinary actions of others. Since each shareholder relies on others to take action, no action is taken, and disciplinary activity is underprovided.”).
stocks will rise due to improved corporate governance. Actually, each shareholder can receive few benefits from winning the suits. In practice, however, it is difficult for minority shareholders to win the suits, meanwhile, it is high possible for them to lose suits.

(2) If plaintiffs lose the derivative suits, the costs they shall bear may include: a. The litigation costs. According to Article 29 of the Measures for the Payment of Litigation Costs (promulgated by the State Council, effective Apr. 1, 2007, hereinafter Measures for Payment of Litigation Costs), “the litigation costs shall be borne by the party that loses the lawsuit, unless the party that wins the lawsuit bears the costs at his free will. Where the party concerned partially wins the lawsuit and partially loses it, the people’s court may, at its discretion, decide on the amounts of litigation costs to be borne by the parties respectively;”\(^{24}\) b. Lawyer’s fees. In general, each party in a suit shall pay their own lawyer’s fees, regardless of whether they win or lose. Only under very limited circumstances, if the plaintiff win the suit, the lawyer’s fees paid by the plaintiff can be compensated by the defendant;\(^{25}\) and c. Other costs (e.g. traffic expenses and accommodation expenses for plaintiffs to attend the suits).

C. Some suggestions on making it easier for minority shareholders to bring derivative suits

1. One alternative to 1% shareholding requirement

I suggest that if shareholders solely or aggregately have shares worth RMB 50,000 (or more) in a listed company, they shall be allowed to bring derivative suits. The reason why I choose RMB 50,000 is that the average salary of Chinese employee in 2012 is about RMB 43,000,\(^{26}\) thus if shareholders invest RMB 50,000 (or more) in a company, it may indicate that she/it has a stake in the company (because she invests more than one year’s salary into the company). Hence, she/it has some incentives to

\(^{24}\) According to Article 6 of the Measures for Payment of Litigation Costs, the litigation costs include: (1) filing fees, which are payable when the plaintiff minority shareholders bring up a suit to the courts; and expenses incurred during the suit, such as the traffic expenses, accommodation expenses, living expenses, and subsidies for missed work, which incurred by witnesses, authenticators, interpreters and adjustment makers for their appearing in the courts at designated dates. Among them, filing fees in a property case are charged at a percentage of the value of claim. The applicable percentage is scaled down when the amounts of value go up. For fees of filing a claim, the maximum percentage is 2.5% for value below RMB 10,000 and the minimum 0.5 per cent for value above RMB 20 million (Article 13 of the Measures for Payment of Litigation Costs).

\(^{25}\) Only in antitrust suits, the intellectual property suits or torts suits, the lawyer’s fees can be compensated by the losing party. Besides, the lawyer’s fees should be reasonable. See The Supreme Court, Suggestions and Opinions Issued by the Supreme Court to the Netizens, available at http://news.ifeng.com/mainland/200912/1223_17_1485438.shtml.

improve the corporate governance of the company.\(^7\)

2. Reducing the costs for minority shareholders to bring derivative suits\(^8\)

(1) Reducing the filing fees

“The filing fees present a substantial obstacle to the pursuance of derivative actions. For derivative actions to actually happen and play a role in corporate governance in China, the rule on filing fees has to be changed.”\(^9\) So, I suggest that we learn from the experience of Japan, thus treating the shareholders’ derivative suits as non-property suits.\(^10\) Hence, according to Article 13 (2) of the Measures for Payment of Litigation Costs, the plaintiffs only have to pay RMB 50-100 to the courts. Reducing the filing fees has an important impact on whether minority shareholders will bring derivative suits or not. Since Japan changed the filing fees to a small fixed amount 8, 200 YEN in 1993,\(^11\) “there was immediately an explosion of derivative suits.”\(^12\)

(2) Compensating plaintiffs for the lawyers’ fees if they win the suits

If plaintiffs win the suits, the compensation shall be returned to the companies. So I suggest that the companies shall compensate the plaintiffs for reasonable lawyer’s fees.\(^13\) Two points shall be emphasized here:

a. The lawyer’s fees shall be reasonable. Since the lawyer’s fees are negotiated by

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\(^7\) Another suggestion is to delete the shareholding requirement like Japan (Article 847 (1) of the Japanese Company Law) and US (Federal Rule of Civil Procedure 23.1), thus any shareholder can bring derivative suit if she/he holds one or more shares for 180 consecutive days or more. From the experience of the two countries, it will not cause “a flood of derivative suits” to the courts. For example, during 1999 and 2000 there were only 134 filings of derivative suits in Delaware, among them, eighty percent of the derivative complaints (108) were brought against public companies with the remaining 20 percent (26) against closely held companies. See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 Vand. L. Rev. 1747, 1762 (2004).

\(^8\) Minority shareholders are on the behave of companies to bring derivative suits, if they win the suits, the compensation shall be returned to companies. Not matter in law or in practice, minority shareholders cannot directly gain the compensation from the defendants. So, this part only focuses on reducing the costs for minority shareholders to bring derivative suits.

\(^9\) **Zhong**, supra note 17, at 545.


\(^11\) Now the filing fees are 13,000 YEN, which is equal to about RMB1,000.


\(^13\) Article 852 (1) of the Japanese Company Law. If plaintiffs lose the suits, they shall not “be obligated to compensate the relevant Stock Company for the damages arising as a result thereof, except when the shareholder was in bad faith.” (Article 852 (2) of the Japanese Company Law). But they still have to bear the lawyer’s fees, one way to address this problem is the plaintiffs can assign a contingent fees contract with the lawyer. Under such contract, “if a case is successful, the lawyer is paid by the company out of the recoveries from the action; If a case is lost, the lawyer is not entitled to payments, which is called ‘no win, no fees’.” see **Zhong**, supra note 17, at 534. It is legitimate in China. According to Article 13 of the Measures for the Administration of Lawyers’ Fees (promulgated by the National Development and Reform Commission and the Ministry of Justice, effective Dec. 1, 2006, *hereinafter* Measures for Lawyers’ Fees), “to charge fees on the basis of risk agency, a law firm shall conclude a risk agency charging contract with the client and stipulate the risks and liabilities both parties should assume, the methods of payment, and the charging amount or proportion. To charge fees on the basis of risk agency, the maximum charging amount shall not be higher than 30% of the amount stipulated in the charging contract.”
the plaintiffs and the lawyer, it is likely that the plaintiffs and the lawyer may collude to hurt the interests of company. Besides, since the lawyer and the plaintiffs could sign a contingent fees contract, the plaintiffs may not care about how much the company pays the lawyer. So the courts shall review whether the lawyer’s fees are reasonable based on the following considerations: (i) the time spent on the work; (ii) the complexity of the legal affair; (iii) the affordability of the clients; (iv) the risks and responsibilities the lawyer might assume; and (v) the social reputation and working level, etc. of the lawyer.34

b. Wining the suits shall be explained in a broad meaning, besides the independent directors compensate the company, other circumstances can also be regarded as wining or partial wining if the companies can get some non-financial benefits from the derivative suits.35 For example, because of the shareholders’ derivative suit, the company promises to improve its disclosure of executive stock option compensation, thus the court may require the company compensate the plaintiff (or partly) at its discretion.

Frankly speaking, my suggestions may lead to some nuisance suits or strike suits. One solution to this problem is if defendants can prove that the plaintiffs who bring derivative suits are in bad faith36 (e.g. defaming the defendants. For the independent directors, they are very sensitive to the media reports and shame sanctions.), the courts may refuse to accept the suits. The first and most important concern of shareholders’ derivative suits mechanism in China is to make it easier for minority shareholders to bring derivative suits into the courts. The side-effects of easier shareholders’ derivative suits are the second concern. Only after accumulating enough experience can we make the shareholders’ derivative suits better.

When more shareholders’ derivative suits can be brought into the Chinese courts, what standard shall the courts apply to determine whether the independent directors break their duty of care so as to protect the interests of minority shareholders, at the same time, respect the self-governance of the company? Next part will answer this question.

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34 Article 9 of the Measures for Lawyers’ Fees.
35 This is called “substantial benefit” test, under this test, a non-pecuniary relief may constitute a ‘substantial’ benefit when “it corrects or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affects the enjoyment or protection of an essential right to the stockholders’ interest”. See Zhong, supra note 17, at 535.
36 Article 847 (8) of the Japanese Company Law.
IV. The Courts Shall Clarify the Standard of Judicial Review

Suppose that based on my suggestions, more shareholders’ derivative suites against the independent directors are brought into the courts, how shall the courts review those suits? Or, in other words, what standard of judicial review shall the courts apply to protect the interests of minority shareholders meanwhile respect the self-governance of the company? It is not clear in law and practice. Most Chinese scholars suggest that we shall also apply the US business judgment rule (BJR), but one critical point neglected by them is under the BJR, the courts will use gross negligence standard to determine whether the independent directors break their duty of care or not, but shall the Chinese courts also apply this so lenient standard?

First, this part briefly introduces the BJR in the US; then introduces Chinese scholars’ suggestions on how to transplant the BJR into China and one critical problem neglected by them; last, offers my suggestions.

A. The BJR in the US

The BJR is widely applied in US corporate law, such as M&As, paying out of dividends, charitable donations, executive compensation and so on. But, the BJR is still full of controversies even till now. “Countless cases invoke it and countless scholars have analyzed it. Yet, despite all of the attention lavished on it, the business judgment rule remains poorly understood. We lack a coherent and unified theory that explains why the rule exists and where its limits should be placed.” Put simply, the BJR is a presumption that favors the directors. It is presumed that “in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.”

According to such presumption, the BJR is not a rule, since it does not tell directors what to do or what not to do. On the contrary, it is just a standard of judicial review,

37 William T. Allen et al., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem, 96 Nw. U.L. Rev. 449, 463 (2002) (“Any claim that the duty was breached would be reviewed under the lenient gross negligence standard, and if a breach of duty and resulting harm were found, then liability would be imposed.”).
or a standard of judicial “no-review”.\textsuperscript{41} But, the BJR can be also understood in the following way: when the directors make business decisions, if they 1. reasonably inform themselves; 2. act in good faith and 3. have no financial interest in the decisions, their decisions will be respected by the courts. Hence, the BJR becomes a case law rule (similar to other case law rules in contract law, torts law or property law) because it does tell the directors what they shall do when they make business decisions by the means of judicial judgments. Ultimately, the BJR represents a passive attitude of the courts to intervene in internal matters of companies. So, the BJR is called as an “abstention doctrine”.\textsuperscript{42} In practice, it is unusual that directors are found to be held liable for breaking their duty of care in the US.

The BJR has two very important functions:\textsuperscript{43} first, it encourages directors to invest in “potentially valuable corporate opportunities that have some risks of failure”\textsuperscript{44} and preventing courts’ “hindsight bias”.\textsuperscript{45} A reasonable business decision ex ante may generate bad results because of some factors out of the directors’ control, so if the directors are held liable for the bad results, they will not pursue risky but valuable ventures.\textsuperscript{46} Besides, because of “hindsight” effects, the courts may make mistakes in determining whether the directors have fulfilled their duty of care ex post. The second one is “judges are trained as lawyers, not compensation experts. Most have little if any experience in compensation matters”,\textsuperscript{47} so the “policy matters involved in compensation decisions are “totally outside the expertise of the courts.”\textsuperscript{48}

\textsuperscript{41} Douglas M. Branson, The Rule That Isn’ t a Rule - The Business Judgment Rule, 36 Val. U.L. Rev. 631 , 635 (2002) (“The much misunderstood business judgment rule is not a ‘rule’ at all. It has no mandatory content. It involves no substantive ‘do’s’ or ‘don’ts’ for corporate directors or officers. ... Alternatively, it could be called a standard of non-review, entailing no review of the merits of a business decision corporate officials have made.”).

\textsuperscript{42} Bainbridge,\textit{ supra} note 39, at 95.

\textsuperscript{43} Generally see Franklin A. Gevurtz, Corporation Law (Second Edition) (St. Paul, MN: West, 2010), at 298-310; Allen et al.\textit{ supra} note 37, at 454-457; Telman,\textit{ supra} note 38, at 839-861; and Bainbridge,\textit{ supra} note 39, at 110-219.

\textsuperscript{44} Allen et al.\textit{ supra} note 37, at 449.

\textsuperscript{45} see Hal R. Arkes & Cindy A. Schipani, Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias, 73 OR. L. REV. 587 (1994) (“Hindsight bias is the tendency for people with knowledge of an outcome to exaggerate the extent to which they believe that outcome could have been predicted.”).

\textsuperscript{46} Allen et al.\textit{ supra} note 37, at 452 (“If the risk of liability is disproportionate to the directors’ incentives for service, directors may avoid making economically valuable decisions that might subject them to litigation risk.”).

\textsuperscript{47} Symposium, Current Issues in Executive Compensation, 3 NYU J. L. & BUS. 519, 538 (2007).

\textsuperscript{48} Id. Also see Heller v. Boylan 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941) (“Courts are ill-equipped to solve or even to grapple with these entangled economic problems. Indeed, their solution is not within the juridical province.”). Another function of the BJR is to respect corporate self-governance. Since directors are elected and powered by the shareholders to manage the company, if shareholders are dissatisfied with their decisions, they can remove them. So, “where stockholders are able to change the board because of inadequate performance, there is less reason for courts to intervene and police whether the directors are behaving reasonably.” see Allen et al.,\textit{ supra} note37, at 456.
B. Chinese scholars’ suggestions and one problem neglected by them

Though the independent directors own the duty of care to the company, the specific component of this duty is not clearly prescribed by the law and the courts lack of unified and clear standard to determine whether the independent directors break their duty of care. In practice, in the cases of shareholders of closed companies suing managers or chairmen of the board for breaking their duty of care, the local Chinese courts usually use torts law principles (behaviors that bring damages to the plaintiffs, subjective faults of the defendants, losses that incurred by the plaintiffs and the causation between the behaviors and the losses) to determine whether the defendants break their duty of care.\textsuperscript{49} So, it is necessary, as most Chinese scholars suggest, that the Supreme Court shall make unified judicial interpretations on this matter. Considering the important functions of the BJR, they suggest that we shall also apply the BJR in the US.\textsuperscript{50} Specifically, the Supreme Court shall make it clear that:

1. When the independent directors make business decisions, they are presumed to: (1) have no conflicts of interests in the decisions; (2) inform themselves with respect to the decisions; and (3) act in good faith."\textsuperscript{51}

2. Only the plaintiff minority shareholders can provide sufficient evidence to rebut one of the three presumptions will the courts accept the suits, otherwise the courts will “issue a ruling within seven days to refuse to accept the suit which fails to meet the conditions for instituting an suit.”\textsuperscript{52} As a result, “with such presumption, the shareholders will think carefully before they intend to sue the directors. Hence, the authority of directors is protected; meanwhile shareholders’ undue intervention is deterred.”\textsuperscript{53}

3. The focus of the judicial review shall be the process of making business decisions not the substance of the business decisions,\textsuperscript{54} especially whether the

\textsuperscript{52} Article 123 of the Civil Procedure Law of the People’s Republic of China (2012 Revision) (promulgated by the Standing Committee of the National People’s Congress, effective Aug. 31, 2012, \textit{hereinafter} Civil Procedure Law). Article 121 of the Civil Procedure Law provides, “A written complaint shall state... (3) claims and supporting facts and reasons;…”.
\textsuperscript{53} Zhu, \textit{supra} note 50, at 107.
\textsuperscript{54} Ren Zi Li, \textit{Studies on the Standard of Directors’ Duty of Care}, No.6 China Legal Science 83, 90 (2008); Liu Yin Shuang, \textit{supra} note 50, at 145.
independent directors have informed themselves or not. As for the executives’ compensation, it is very difficult for the courts to determine whether executives’ compensation is reasonable or not, because “(1) We cannot measure exactly how big roles the executives play in the company; (2) We cannot reliably distinguish good CEOs from bad, let alone make fine gradations among them on a spectrum; (3) Even if we could truly estimate ex post how much impact the executives had on the company’s performance, we cannot do so ex ante; (4) We do not know how many people have the skills to be competent executives of large companies; and (5) We lack any basis for determining the ‘fair’ allocation of profits between the executives who have worked to create the wealth and the shareholders who have financed it.”55 Thus, “procedural justice is critical to the legitimacy of executive remuneration. It is of pressing necessity to create the firm value maximization and orient executive remuneration procedures with independence, fairness and transparency so as to curb the super remuneration and regain public confidence.”56

But one serious problem that neglected by those scholars is when the US courts apply the BJR, they will use gross negligence standard to determine whether the independent directors break their duty of care. But shall the Chinese courts also apply the gross negligence standard?

C. The Chinese courts shall apply ordinary negligence standard

I suggest that the Chinese courts shall apply the ordinary negligence standard instead of the gross negligence standard to determine whether the independent directors break their duty of care when they make executive stock option compensation. The reasons are:

1. The social background of China is different from that of the US
   (1) The M&A (including hostile M&A and friendly M&A) market is well developed in the US, the directors will be punished by the market for their reckless decisions. By contrast, the M&A market is at its primary stage in China, the independent directors cannot feel the stresses from the M&A market.57
   (2) The different competence and reputation of judges. “The success of BJR lies in

57 Surely, the independent director maybe supervised by controlling shareholders in China, thus making them more prudent when they make decisions. But one flaw of this “supervision model” is the independent directors are not willing and able to supervise controlling shareholders when the latter do something that hurt the interests of minority shareholders.
its high qualified judges,”58 for example, the five judges in the Delaware Chancery Court are specialized in company law matters and enjoy very good reputation, their judgments are highly respected by lawyers and executives and have huge influence on them and the courts in other state (even in other countries). In China, we lack of highly qualified judges specialized in company law matters, at least currently. Also, judicial corruption is a serious problem in China, judges may abuse the gross negligence standard to protect the rich and powerful independent directors. One solution to this problem is the courts shall be stopped from intervening in the internal matters of a company, thus the realities of Chinese judges (not so competent and easy to be corrupted) will not become a problem. But, considering the needs to protect minority shareholders and improve corporate governance, this solution maybe not good for China now. So another solution to this problem is limiting the courts’ discretion by using stricter ordinary negligence standard. Thus, the judges have no much room to make their own decisions.

2. If the courts use gross negligence standard to review the independent directors’ behaviors ex post, suppose other things are the same, it is highly possible that the independent directors will not behave with due care as they are expected ex ante. So, in my opinion, it is not realistic that the standard of conduct can diverge from the standard of judicial review in practice.

3. Policy consideration

The reality in China is that there are few cases that the independent directors are held liable for breaking their fiduciary duties in the courts.59 If we still apply so lenient gross negligence standard, the civil liabilities shall be totally ignored by the independent directors. Besides, if plaintiffs know that the courts will use so lenient standard to review the independent directors’ decisions, they may not be willing to sue against them, thus further reducing the threat of the civil liabilities on the independent directors. So the standard of judicial review shall be raised. It is a little bit like the idea of punitive damages: for the independent directors, the possibility of being sued is low, if we still use the gross negligence standard, the independent directors can escape liabilities easily, thus the threat of civil liabilities cannot be realized. So we must raise the standard of judicial review to offset the low possibility of the independent directors’ being sued to maintain the threat of civil liabilities.

I admit that the ordinary negligence standard may deter some independent directors

58 Rong, supra note 7, at 56.
59 See Peng & Qiu, supra note 2, at 41.
from accepting the jobs. There are several methods to relieve this concern:

1. Granting the independent directors more stock compensation to offset the risks generated by the stricter standard of judicial review. Shareholders can also benefit from granting the independent directors more stock compensation, because this kind of compensation may align the interests of the independent directors with those of shareholders.

2. Buying liabilities insurance for the independent directors. According to Article 7 (6) of the Independent Director Opinion, “listed companies may establish liabilities insurance system for the independent directors to reduce the risks that they could face when performing their duties.” I suggest that listed companies shall buy liabilities insurance for all the independent directors to offset the stricter standard of judicial review. Hence, if the independent directors break their duty of care due to ordinary negligence, their liabilities can be covered by insurance policies.

3. Besides, special circumstances shall also be considered, for example, if a decision has to be made in a very short time, there is no enough time for the independent directors to collect and analyze related information and discuss it completely with other independent directors or directors, the standard of conduct and judicial review shall be relieved.

In short, in my opinion, considering the current realities in China, it is necessary to put the independent directors under stricter standard of judicial review so as to enhance the threat of civil liabilities.

V. Conclusion

I believe that the enhanced threat of civil liabilities will urge the independent directors to “take shareholders’ interests more seriously” and perform their duties more diligently. For the independent directors, being defendants alone will generate severe reputation losses. When the independent directors perform their duties, they shall exercise the care that other ordinary independent directors would use in the similar circumstance.

In China, the threat of civil liabilities is weak. This chapter mainly discusses two reasons for this phenomenon: we lacking of shareholders’ derivative suits and the uncertain standard of judicial review.

60 Generally see Ren Zi Li & Cao Wen Ze, On the Limitation of Directors’ Liability, No. 5 The Jurist 84 (2007). Thus, to some extent, the independent directors will also be supervised by insurance companies, which may bring a new supervision mechanism to Chinese corporate governance.
Hence, this chapter suggests that shareholders’ derivative suits shall be made easier for minority shareholders to bring by the means of changing the shareholding requirement, reducing filling fees and compensating plaintiffs for lawyers’ fees if they win the suits. Furthermore, the Chinese courts shall make it clear that: 1. When making executive stock option compensation, the independent directors are presumed to: (1) have no conflicts of interests in the decisions; (2) inform themselves with respect to the decisions; and (3) act in good faith; 2. Only the plaintiffs can provide sufficient evidence to rebut one of the three presumptions will the courts accept the suits; 3. The focus of the judicial review is the process of making stock option compensation not the substance of the decision; 4. The courts shall apply ordinary negligence standard to determine whether the independent directors break their duty of care when they make executive stock option compensation.
Conclusion

I. The Short Conclusion of This Dissertation

Executive stock option compensation grant executives the rights but not the obligations to purchase certain amounts of the company’s stocks at a pre-determined price (strike price) and conditions within a designated period of time in the future.\(^1\) Given the strike price is fixed, the higher the stock price is when executives exercise their rights, the more profits executives will make from their stock option compensation. Thus when executives are reaping the highest yields from their stock option compensation, shareholders can also receive the highest benefits. As a result, when granted stock option compensation, executives will be motivated to maximize shareholders’ value, hence, the interests of shareholders will align with those of executives. To a great extent, executive stock option compensation can reduce the agency problems resulting from the separation of ownership and management in listed companies.

To those risk-averse executives, who invest most of their human capitals in the company, stock option compensation can encourage them to undertake more risky but positive net present value projects. Otherwise, they will not do so because they cannot make profits from those projects. Considering shareholders’ limited liability and diversification-oriented investment strategies, risky decisions by executives are worth making.

For a start-up company, which lacks of cash but has a bright future, granting stock option compensation to executives makes it possible for it to attract and retain highly motivated and entrepreneurial executives without directly expending cash. The best example of this function of stock option compensation is the high-tech companies in the US Silicon Valley grant millions of stock options to their executives and ordinary employees.

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\(^1\) Article 19 of the Measures for the Administration of Equity Incentive Plans of Listed Companies (For Trial Implementation) (promulgated by the China Securities Regulatory Commission (CSRC), effective Jan. 1, 2006, hereinafter Measures for Equity Incentive Plans) provides, “the stock options as mentioned in the “Measures of Equity Incentive Plans” shall refer to the right of the eligible participants granted by a listed company to purchase a certain number of shares of the company within a certain period in the future at the pre-determined price and conditions. The eligible participants may purchase a certain number of shares of a listed company through the stock options granted to it at the pre-determined price and conditions within a prescribed time limit, or may waive such right.” Here, the “eligible participants” refers to those who are granted stock options according to the stock option plan, such as executives and employees.
In a concentrated-ownership company, which is prevailing in China, executive stock option compensation can also bring some positive value to both controlling shareholders and minority shareholders. From the perspective of controlling shareholders, stock option compensation can stimulate executives to work harder and make better decisions; meanwhile, from the perspective of minority shareholders, stock option compensation can encourage executives to resist some “tunneling” behaviors of controlling shareholders. Because such behaviors will depress the stock price, thus reducing the profits that executives can make from their options. These positive functions of executive stock option compensation and its value to shareholders have been confirmed by empirical studies in China as well as in other developed countries.

But executive stock option compensation cannot be regarded as a panacea to address all the agency problems in listed companies. It also has its own shortcomings or agency problems. The deep root of these agency problems lies in the “enormous discretion managers have over most aspects of corporate business, coupled with traditional deference from boards,” or according to Bebchuk and Fried’s famous remark, the “managers’ power”. Executives have huge influence over the board and the independent directors in the compensation committee; they can help controlling shareholders to tunnel the companies for personal profits, thus hurting the interests of minority shareholders; they can decide when and what to disclose; they can also determine whether to invest in risky ventures or reduce R&D investments and so on. The executives’ huge influence (either power or discretion) will definitely hurt the interests of shareholders, especially the minority shareholders in the Chinese context, where the ownership of publicly traded companies is highly concentrated. So, the main focus of this dissertation is to reduce the influence of executives to protect the interests of shareholders through different kinds of legal approaches and strategies.

Specifically, this dissertation intends to discuss and address the following five common agency problems of executive stock option compensation in Chinese listed companies:

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2 Lucian Arye Bebchuk & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 Journal of Economic Perspective 71, 72 (2003) (“Executive compensation is viewed not only as a potential instrument for addressing the agency problem but also as part of the agency problem itself.”).


A. Executives may be granted excessive stock option compensation because the compensation committee and its independent directors fail to perform their duties efficiently. Under the influence of executives, it is difficult for them to make objective, independent and fair compensation decisions.

B. Stock option compensation may induce executives to violate securities law and regulations to satisfy the conditions for gaining their stock options, for exercising their rights, or for artificially raising the stock price when they exercise their rights so as to make excessive and unjust profits from their options.

C. Stock option compensation may provide executives with the unethical incentives to time information disclosures by the means of causing their company’s stock price to drop shortly before the date of issuance or boosting the stock price shortly before the date of exercise so as to maximize the value of their options, which I call timing problem in this dissertation.

D. Stock option compensation may wrongly encourage executives to pursue short-term profits through making excessive risk-taking investments, cutting R&D budgets or laying off masses of workers at the costs of the long-term interests of shareholders, which I call short-termism problem in this dissertation.

E. Due to executives’ huge influence, they may be awarded with windfalls (e.g. the strike price will not be raised even if the good performance of the company is due to the good market development), which cannot coexist with the objective of this kind of compensation from the perspective of shareholders, namely, “profiting together, losing together”, which I call windfalls problem in this dissertation.

This dissertation intends to make some suggestions to address the aforementioned five agency problems of executive stock option compensation through three different legal approaches: first, enhancing supervision inside the company; second, enhancing supervision by compensation consultants; and third, enhancing supervision by public authorities. Furthermore, each approach is divided into two strategies: ex ante strategy and ex post strategy. Frankly speaking, I have no expectation that my suggestions will completely address these agency problems. I only hope that my suggestions can do better than current laws and regulations, thus improving the development of executive stock option compensation in China.

The ex ante strategies of enhancing supervision inside the company are: expanding the role of compensation committee and its independent directors and improving the disclosure of executive stock option compensation; the ex post strategy of enhancing
supervision inside the company are: clarifying the provision of clawing back executive stock option compensation and making shareholders’ derivative suits easier for minority shareholders to bring. Since the shareholders’ derivative suits have a close relationship with the judicial review, I will discuss the issues of shareholders’ derivative suits together with the judicial review.

The ex ante strategies of enhancing supervision by compensation consultants are: granting the compensation committee the exclusive power to hire, compensate, supervise and fire its own compensation consultant, establishing the non-independence standard of a compensation consultant and preventing the non-independent compensation consultant from issuing professional opinions on the stock option plans; the ex post strategy of enhancing supervision by compensation consultants is imposing more efficient civil liabilities on them.

The ex ante strategy of enhancing supervision by public authorities is the CSRC shall make “comply or explain” rules to address three specific agency problems (the timing problem, short-termism problem and windfalls problem) of executive stock option compensation; the ex post strategy of enhancing supervision by public authorities is the courts shall clarify the standard of judicial review.

The core suggestions of this dissertation are:

A. The role of the compensation committee shall be expanded. 1. It shall be granted the sole power to make executive stock option compensation; and 2. It shall be granted the exclusive power to hire, compensate, supervise and fire its own compensation consultant.

B. The role of the independent directors in the compensation committee shall be expanded. 1. They shall be granted stock compensation to align their interests with those of shareholders; 2. More efficient shame sanctions shall be imposed on them through well-defined power and the improved disclosure of executive stock option compensation; 3. Independent, objective and professional advice shall be provided to them; and 4. More efficient threat of civil liabilities shall be imposed on them through easier shareholders’ derivative suits and clear and stricter standard of judicial review.

C. The CSRC shall play a critical role in addressing the aforementioned agency problems in China, where the powers of the courts and the capital market are not strong. 1. It shall update and improve its disclosure rules to make the disclosure of executive stock option compensation more understandable, transparent and comprehensive to minority shareholders and the media; 2. It also shall establish the
non-independence standard of a compensation consultant and ban the non-independent compensation consultant from providing professional opinions on the stock option plans; and 3. It shall make “comply or explain” rules to address three specific agency problems (timing problem, short-termism problem and windfalls problem) of executive stock option compensation.

The following is the short conclusion of this dissertation.

A. In the chapter of introduction, first, I briefly analyze the agency problems in listed companies and the solutions to address these problems; second, I point out the positive functions and five common agency problems of executive stock option compensation and the purpose of this dissertation; third, I briefly introduce three legal approaches and two strategies to address these problems; forth, I introduce the methodology of this dissertation; fifth, I make some notices on what will not be discussed in this dissertation; finally, I introduce how this dissertation proceeds.

B. In chapter one, I point out that executives may be granted excessive stock option compensation because of 1. executives’ influence on the board and the independent directors in the compensation committee; 2. the compensation committee having limited power; and 3. some shortcomings of the institution of independent directors in China. Considering the framework of this dissertation, this chapter makes suggestions on how to address the problem of the compensation committee having limited power and the problem of the independent directors being paid without incentive compensation. This chapter suggests that the compensation committee shall be granted the exclusive power to make executive stock option compensation. Or if the board decides to amend or withdraw the draft of executive stock option compensation made by the compensation committee, it has to disclose detailed reasons why it does so, as a result, its decision will be supervised by minority shareholders and the media. Besides, companies shall grant the independent directors stock compensation to align their interests with those of shareholders.

C. In chapter two, I point out some problems of the disclosure of executive stock option compensation in China, such as the disclosure of executive stock option compensation is not understandable, the disclosure of the process of making executive stock option compensation is not transparent, and the disclosure of the content of executive stock option compensation is not comprehensive, which make it difficult for minority shareholders and the media to understand and evaluate executive stock option compensation, thus reducing the effectiveness of shame sanctions on the
independent directors in the compensation committee, which maybe the most efficient method to supervise them. So, this chapter suggests: 1. The disclosure of executives’ stock option compensation shall be easy for minority shareholders and the media to understand; 2. The disclosure of the process of making stock option compensation shall be transparent so as to prevent conflicts of interest; and 3. The disclosure of the content of stock option compensation shall be comprehensive so as to let minority shareholders and the media evaluate the performance of the board and the compensation committee, especially the independent directors in the compensation committee.

D. In chapter three, I point out that executives may break securities laws and regulations, for example, by manipulating earnings or other accounting figures, to satisfy the conditions for gaining their stock options, for exercising their rights, or for artificially raising the stock price when they exercise their rights so as to make excessive and unjust profits from their options. So the provision of clawing back executive stock option compensation is created to deter such behaviors. According to Article 46 of the Measures for Equity Incentive Plans, “in case there are any false records in the financial and accounting documents of a listed company, the eligible participant who is responsible shall return all the interests she has obtained pursuant to the equity incentive plan within 12 months from the day when the financial and accounting documents are announced.” There some uncertainties in this Article, including: 1. What exactly are the financial and accounting documents? 2. Whether only in the circumstance of false records in the financial and accounting documents shall the eligible participant return all the interests. If not, are there any other circumstances? 3. What is the specific range of the executives whose stock option compensation should be clawed back? 4. What does the “all the interests” mean? 5. Who exactly can claw back executive stock option compensation? This chapter clarifies these uncertainties as follows: 1. The financial and accounting documents only refers to the accounting statements that shall be disclosed; 2. Misleading statements or serious omissions in the accounting statements shall also lead to claw back executive stock option compensation; 3. The specific range of who should be clawed back includes the current or former non-independent directors and senior managers if they are responsible for the illegal behaviors; 4 “All the interests” means granted but not exercised stock options and the benefits from exercising options (not including the profits from selling stocks which executives gain after exercising their
options); 5. The board of the company shall claw back executive stock option compensation.

E. In chapter four, I discuss the roles that a compensation consultant can play in addressing agency problems of executive stock option compensation. In China, the primary role of a compensation consultant is to legitimize the board and the compensation committee’s decision. When facing conflicts of interest, such as providing other services to the company or continuing business relationship with the company, a compensation consultant may surrender itself to executives, hence, this chapter suggests: 1. The compensation committee shall have the exclusive power to hire, compensation, supervise and fire its own compensation consultant; 2. Non-independence standard of a compensation consultant shall be established and the non-independent compensation consultant shall be prohibited from issuing professional opinions on the stock option plan; 3. More efficient civil liabilities shall be imposed on compensation consultants in the future.

F. In chapter five, I suggest that the CSRC shall make “comply or explain” rules that could address the timing problem, short-termism problem and windfalls problem of executive stock option compensation and require companies to comply with those rules. But, at the same time, companies are allowed not to comply with those rules under some circumstances if they explain and disclose the reasons why they do so in detail.

Specifically, with regard to how to address the timing problem, this chapter suggests that the CSRC shall amend Article 24 of the Measures for Equity Incentive Plans to require companies to extend the period determining the strike price from 30 trading days to one year and require executives to disclose their intended exercising in advance. With regard to how to address the short-termism problem, this chapter suggests that the CSRC shall require companies to prolong the vesting time from 1 year to 3 years. In addition, executives can only exercise no more than 20% options that they are granted at the first time every year after 3 years’ vesting time. If executives are subject to this requirement, the stocks that they gain from exercising options are exempting from the restrictions of Article 142 (2) of the Company Law (restriction on selling stocks) and Article 47 (1) of the Securities Law (restriction on short-swing trading). With regard to how to address the windfalls problem, this

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chapter suggests that the CSRC shall require companies to adopt market or industry indexed stock option compensation.

G. In chapter six, I point out that the independent directors in the compensation committee face weak threat of civil liabilities may lead them to less care about the interests of shareholders, especially the interests of minority shareholders and to grant excessive stock option compensation to executives. The main reasons for this phenomenon are: shareholders’ derivative suits are lacking and the standard of judicial review is uncertain in China. Hence, this chapter suggests that shareholders’ derivative suits shall be made easier for minority shareholders to bring by the means of changing the shareholding requirement, reducing filling fees and compensating plaintiffs for lawyers’ fees if they win the suits. Furthermore, the Chinese courts shall make it clear that: 1. When making executive stock option compensation, the independent directors are presumed to: (1) have no conflicts of interests in the decisions; (2) inform themselves with respect to the decisions; and (3) act in good faith; 2. Only the plaintiffs can provide sufficient evidence to rebut one of the three presumptions will the courts accept the suits; 3. The focus of the judicial review is the process of making stock option compensation not the substance of the decision; 4. The courts shall apply ordinary negligence standard to determine whether the independent directors break their duty of care when they make executive stock option compensation.

II. The Contributions of This Dissertation

This dissertation points out five common agency problems of executive stock option compensation in Chinese listed companies in detail. Based on the experiences of other developed countries, especially the experiences of the US and Japan, and the realities in China, this dissertation provides some suggestions on how to address these problems. Specifically:

A. This dissertation comprehensively discusses the issues of clawing back executive stock option compensation and the compensation consultant for the first time in China.

B. In China, “the comply or explain” approach and the functions of “shame sanctions” are not paid enough attentions by law scholars. As a result, few law articles have ever discussed the two topics seriously before. This dissertation studies these topics more detailed than former studies.
III. The Shortcomings and Limits of This Dissertation

Frankly speaking, I lack of practical experience with regard to executive stock option compensation and have little knowledge of financial and accounting theories, so my understanding of stock option compensation is still inadequate. So, some shortcomings and limits cannot be avoided in this dissertation. Specifically:

A. Though this dissertation discusses the practice of executive stock option compensation in China by the means of referring to the empirical studies made by financial or accounting scholars and news reports, it does not discuss and analyze the judicial judgments with regard to executive stock option compensation. The reason is that lawsuits on executive stock option compensation (especially lawsuits with Chinese characteristics) have never happened in practice to date.

B. This dissertation does not discuss the success and failure of institutions of Chinese independent directors in detail. This dissertation only focuses on the compensation, civil liabilities and shame sanctions of independent directors. So, my suggestions with regard to independent directors are not comprehensive.

C. The role of stock exchanges in addressing the agency problems of executive stock option compensation and the different social and legal backgrounds of China, the US and Japan are not discussed in detail in this dissertation.
A. Books


B. Articles and News Reports


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