Research on the Compensation Incentive System of Independent Directors in Chinese Listed Companies

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Abstract. The independent director system is one of the important components of modern corporate governance. The huge liability of independent directors in the Kangmei Pharmaceutical case in 2021 has once again become a hot topic of discussion. In the exploration of the causes of the failure of the independent director system, the motivation of independent directors to perform their duties and their incentives are also worth considering. Based on the relevant theories of independent director incentives, this paper conducts a comparative analysis of the incentive models of independent directors in China and other countries and concludes that the legislative level of incentives for independent directors in China is relatively low, and the remuneration forms, standards, and payment subjects are unreasonable and lack implementation. In addition, the establishment of independent directors' associations and the gradual construction of independent directors' reputation incentives were proposed.

Keywords: independent director, salary incentive, reputation incentive.

The independent director system was born in the "Investment Company Act" promulgated by the United States in 1940. The purpose is to introduce the role of independent directors to prevent the company's major shareholders and management from controlling the company. The independent director system was formally established in China in 2001. After more than two decades of practice, it has become an indispensable part of Chinese corporate governance. However, during this period, the discussion on the effectiveness of the independent director system never stopped, and there are even voices of doubt that independent directors are "vase directors" and "renqing directors". What is the incentive for independent directors to perform their duties? How to effectively motivate independent directors, a special group in corporate governance, to promote the independent director system to play a better role in corporate governance.

1. Analysis of Independent Directors' Incentive Tools and Models

In terms of form, independent directors' incentive tools can be divided into material incentives and spiritual incentives. Material incentives are the most intuitive means of incentives, and a reasonable and complete remuneration mechanism can maximize the incentives for independent directors to perform their duties. As the main embodiment of spiritual incentives, reputation incentives can effectively motivate independent directors to perform their supervisory duties and, to a certain extent, avoid "collusion" between nonexecutive directors (independent directors) and executive directors. Material incentives and spiritual incentives complement each other and have a beneficial impact on the degree of diligence of independent directors.

1.1 Independent director remuneration incentives Tools

1.1.1 Cash incentives

The cash incentive system is that the listed company or the independent directors management agency pays the independent directors in the form of remuneration through cash or bank transfer or check according to the agreed cash type, payment amount, and payment time. The fixed remuneration usually does not pose a threat to the independence of independent directors because it is a prior

agreement between the listed company and the independent directors and is not related to the company's performance, operating conditions, and the performance of independent directors. However, the incentive effect of the cash allowance on independent directors is mainly reflected in the early stage of employment. The effect of the fixed allowance on the motivation of independent directors will decrease with the progress of the tenure of office. Therefore, it is difficult to motivate independent directors in the long run.

1.2 Stock option incentives

Comparing cash incentives, stock incentives and stock options are long-term incentives. Based on the consideration of independence, China's current legal system for equity incentives explicitly excludes independent directors from the scope of the main body. However, some scholars believe that appropriate equity compensation can make independent directors more concerned about the interests of the company and motivate them to actively perform their duties. Independent directors have a small amount of equity, which makes them more closely related to the interests of the company and achieves the purpose of mobilizing the enthusiasm of independent directors to perform their duties. This incentive method can prompt independent directors to truly stand on the position of the company's minority shareholders and encourage them to focus on the long-term healthy development of the company, effectively overcoming the short-term behavior of independent directors in the traditional incentive mechanism.

1.3 Reputation incentives

Due to the independence characteristics of independent directors, it is difficult for a simple fixed subsidy to play an incentive role, and the applicability of stock and stock option incentives is also controversial in China. Therefore, the reputation incentive of independent directors is also an incentive method that cannot be ignored. If there is an external market for independent directors that values reputation, reputation will have a strong incentive for independent directors, and independent directors will not collude with company managers to maintain their reputation. From the perspective of economics, independent directors pursue a good reputation for the purpose of maximizing their interests. In the managerial market, independent directors with a good reputation have more room for bargaining, which enhances their competitiveness and brings long-term benefits to them. According to Maslow's hierarchy of needs, independent directors' pursuit of a good reputation meets their needs for respect and self-realization.

2. Analysis of the incentive model of independent directors in various countries

2.1 Incentive model for independent directors in the United States

The board of directors in the United States has various functional committees to deal with the various functions of the board of directors. The remuneration of independent directors in the United States is determined by the remuneration committee. The salary level of independent directors in the United States shows a trajectory of gradual increase but also prosperous and declining. Since 1999, the remuneration of independent directors in the United States has been rising year by year. After the Enron incident, in the context of the continuous strengthening of corporate governance, the legal responsibilities of independent directors have increased, and many independent directors have resigned due to the fear of taking huge risks. At the same time, the Sarbanes-Oakley Act requires that all audit committee members of listed companies be served by independent directors, which, to a certain extent, has caused a scarcity of independent directors, resulting in a significant increase in the remuneration of independent directors. At the same time, the remuneration system for independent directors has also changed, and it tends to adopt multiple forms of incentives, such as stock options, unrestricted stocks, and deferred stocks.

2.2 Incentive model for independent directors in the UK

In addition to a fixed salary, independent directors in the UK rarely have equity incentives. The Caybury Report pointed out that the remuneration of independent directors should not impair the independence of independent directors and suggested that independent directors should not hold shares in the company they hold. The subsequent Greenberry Report recommended that the board of directors of listed companies set up a remuneration committee, whose members are all independent directors. The remuneration committee is responsible for setting the remuneration of executive directors, but independent directors themselves can only receive fixed remuneration from the listed company. In the UK, the incentive model for independent directors emphasizes the balance between incentives and independence. More precisely, the focus is on fixed compensation rather than incentives. Under this model, there may be ineffective incentives for independent directors.

2.3 Incentive model for independent directors in China

In recent years, the industry of independent directors in China has developed rapidly, but thus far, the compensation incentive tool and structure of independent directors have been maintained as a single incentive method with a fixed subsidy. Independent directors receive a fixed salary each year from the listed company in which they work, and some listed companies will give independent directors meeting allowances and vehicle expenses. At the level of the legal system, the regulations on the independent director system in China's "Company Law" are rather vague and nonspecific. "The regulations on the remuneration of independent directors in the "Regulations on Independent Directors of Listed Companies"" are only listed in the chapter ""independent directors' performance guarantee""." At the legal level, the compensation incentive system for independent directors in China lacks a systematic and comprehensive legal system.

3. Problems of Incentive system for independent directors in China

3.1 The legislative rank of the independent director incentive system is low.

The relevant legal system for independent directors in China is stipulated in the "Company Law" and the "Securities Law", but neither of the two laws provides guidance on the incentive system for independent directors. In January 2022, the China Securities Regulatory Commission (CSRC) promulgated the "Regulations for Independent Directors of Listed Companies", which only stipulated that the incentives for independent directors were set by the board of directors of listed companies and approved by the general meeting of shareholders. The substantive content of the system has not been uniformly and detailedly specified. It can be seen that there are legislative gaps in the incentives for independent directors in China, the legislative level of the relevant legal system is relatively low, and implementation and binding forces are lacking in operability. Implementation and effective supervision. Regarding the remuneration incentive system for independent directors, at the present stage, while filling the legal gap as much as possible, the legislative level should be improved to make the remuneration incentive system for independent directors maneuverable in terms of coercive force, execution force, and binding force so that the incentives can be exerted in practice. The work enthusiasm of independent directors and the binding force on the professional norms of independent directors.

3.2 Limitations of China's independent directors' compensation incentives

Since the introduction of the independent director system in China, Chinese laws and regulations have not provided detailed regulations on the remuneration standards of independent directors. Therefore, there are still many problems to be solved in the design of the remuneration system for independent directors. Only by facing the salary issue can the formation of independent directors have a solid market foundation.

3.2.1 Inconsistent remuneration standards for independent directors

The annual salary gaps of independent directors in listed companies are very different, and there is a large gap between the maximum allowance and the average allowance. Excessively low remuneration is an objective fact that cannot support independent directors in performing their duties as internal directors. This disorderly state in remuneration will have a negative impact on the formation of the independent director market, and it is also difficult for independent directors to work hard. The "Regulations for Independent Directors of Listed Companies" only prescribes a basic principle similar to the payment of allowances-""appropriate allowances"" for the payment form and specific standards of allowances for independent directors." "This provision shows considerable flexibility. The "appropriate allowance" here means that it will not damage the independence of independent directors but can also play a role in motivating independent directors." Studies have shown that for independent directors, a social elite group that focuses on external market reputation, a differentiated remuneration policy that simply motivates ordinary employees cannot achieve the expected incentive effect. Only when independent directors are relatively adequately motivated can differentiated independent directors. Salary design will play an expected incentive role. Therefore, when designing the compensation incentive system for independent directors, the average remuneration of independent directors can be increased to a moderate level. At the same time, the remuneration standards for independent directors should be unified as much as possible. Industry management agencies conduct differentiated designs of incentive policies for independent directors.

3.2.2 Single cash compensation lacks incentives

The "Independent Directors Rules for Listed Companies" stipulates the benefits that independent directors can obtain from listed companies. In addition, according to China's "Measures for the Administration of Equity Incentives for Listed Companies", the compensation system for independent directors in China does not hold a positive attitude toward incentives other than allowances and restricts the issuance of equity incentive plans to independent directors. Under the fixed remuneration model in China, the utility goal of independent directors is to find the optimal combination of diligence and remuneration under the limited time supply, while the remuneration of independent directors cannot be matched with their performance, business conditions and development prospects. It is difficult to mobilize the enthusiasm of independent directors. Moreover, in the case that the reputation incentive mechanism has not been fully established, it is difficult to achieve the original intention of the incentive system with a simple subsidy and salary model. Therefore, it can be considered to close the relationship between independent directors and the company's minority shareholders to a certain extent by donating restricted stocks to independent directors.

3.2.3 Unreasonable salary payment subject

The payment entities of independent directors' remuneration can be divided into two situations: the first is the "direct payment" in which the company is the payment entity, and the second is the "indirect payment" in which the third-party industry management agency pays the remuneration to the independent directors. In the case of indirect payment, the independence of the legal status of independent directors can be guaranteed. Under the direct remuneration system, independent directors are directly hired by the enterprise, and independent directors assume the responsibilities of consulting and supervision based on the employment contract and have the right to receive matching remuneration. In the listed companies in the United States, the United Kingdom and other countries, the payment of independent directors is generally the company itself, and the compensation of independent directors in China is also directly paid by the listed company, but it is difficult for the independent directors who are paid by the employer to be completely independent. The subsidy standard of independent directors in China is largely controlled and determined by major shareholders. Once the remuneration decision power of independent directors is in the hands of these major shareholders, it is difficult to maintain their true "independence" after the independent directors take

office or even ignore the small and medium-sized enterprises. Interests of shareholders and other stakeholders.

3.3 Absence of reputation incentive mechanism

The premise of the role of reputation incentives is that the reputation of independent directors can be used as public information and can be effectively transmitted. Only when reputation information can be accurately evaluated and transmitted can the role of reputation incentives be fully exerted so that independent directors pay more attention to their own reputation in the management of listed companies. If an independent director holds an objective and independent attitude and pays attention to the interests of the enterprise and small and medium shareholders when performing his or her duties, then his or her appointment will bring a good reputation to himself/herself and promote his or her career development. In contrast, if independent directors neglect to perform their duties, collude with internal directors to damage the long-term interests of small and medium shareholders and the enterprise and are exposed by the news media or are punished, their reputation will be greatly affected, and their professional careers will be irreparably affected. The reputation incentive mechanism can also play a certain role in restraining independent directors. It is an effective means to enable independent directors to actively perform their duties while maintaining their independence. However, at this stage, the market mechanism of selection, competition, and evaluation of external directors has not been formed in China, and it is difficult to transmit the reputation information of independent directors.

4. Incentive system for independent directors in China Improvement suggestions

4.1 Raising the legislative rank of the independent director incentive system

4.1.1 Add relevant guiding provisions to the revision of the Company Law

The "Corporate Law" is one of the important legal departments in China's legal system and is a comprehensive law on corporate governance." It is formulated and promulgated by the National People's Congress. It has a high level of effectiveness. It adjusts the economic relationship between companies in the process of national coordination of economic operation and plays a vital role in the construction of China's market economy. The "Company Law" stipulates that listed companies should establish an independent director system, but it does not provide guidance on how to establish the system and authorize it to the State Council." Some scholars believe that if the "Company Law" is not amended, the power of independent directors will be greatly restricted. Therefore, it is recommended to include relevant provisions in the revision of the “Corporate Law” to provide guidance on the incentive tools, compensation structure, and payment subject in the independent directors incentive system, which can be used as the upper law basis for the specific incentive system for independent directors.

4.1.2 Enactment of separate laws or regulations such as the “Law on Independent Directors of Listed Companies”

"Since the "Corporate Law" is a comprehensive law of corporate governance, it has the characteristics of stability and lag, so it is necessary to formulate a separate law or rules and regulations on this basis to provide detailed regulations on the specific institutional issues of independent directors." The “Independent Directors Law of Listed Companies” can be considered to correspond with the guiding provisions of the “Company Law” and the “Securities Law” on the independent director system. Meanwhile, the design of each part of the system should be separated into chapters, such as the incentive system. In this chapter, issues such as incentive tools, salary structure, and payment subject are detailed to improve the design of the incentive system for independent directors at the legislative level to strengthen the practicality and operability of the incentive system.

4.2 Optimizing the remuneration incentive system for independent directors

4.2.1 Authorities for determining the remuneration of independent directors

"According to the previous article, the best way to ensure the ""independence" of independent directors is to establish an indirect remuneration system in which a third-party management agency pays independent directors." However, the indirect compensation system requires the establishment of an independent director industry management body, which cannot be realized in a short time. Currently, the remuneration decision mechanism for independent directors can be changed. The “Regulations for Independent Directors of Listed Companies” promulgated on January 5, 2022 stipulate that the remuneration of Chinese independent directors shall be determined by the board of directors and be reviewed and determined by the general meeting of shareholders. This rule is rather vague. Under the reality of “one share dominance” corporate governance in China, the board of directors is actually controlled by the majority shareholders, which will lead to the actual control of the majority shareholders’ right to determine the remuneration of independent directors, which is in line with the independent directors’ right to decide. Independence is contradictory. Accordingly, in the design of the remuneration decision-making body for independent directors, we can refer to the practice of British and American countries and set up a remuneration committee under the board of directors. Review whether it is passed or not.

4.2.2 Enriching the form of remuneration

At present, the salary of independent directors in China is only the annual salary, conference fees, and travel expenses. This fixed salary is not affected by whether the independent directors are actively performing their duties and whether they play a role in the stable development of the company and cannot reflect the company’s business performance. Nonfloating remuneration will cause independent directors to perform their duties only formally and will not actively study the market conditions and the company’s operational performance, thereby failing to provide valuable suggestions for the company’s long-term business development and reducing the efficiency of corporate governance. Short-term fixed remuneration makes it difficult to achieve the goal of maximizing the enthusiasm of independent directors to perform their duties, which needs to be combined with long-term incentives. It is recommended that the remuneration incentive scheme should be a combination of cash and stocks. Taking into account the characteristics of the independence of independent directors, a special stock option plan that is different from that of internal directors and senior management personnel of the company is designed. For example, the number of shares held by independent directors within a certain period of time is stipulated. When the shareholding of independent directors reaches a certain percentage, they will automatically lose the qualification to continue to hold office in the company. Or independent directors cannot circulate within a fixed period of time after acquiring the shares, cannot exercise their options within a certain period of time after their resignation or improper performance of their duties, and clarify the conditions for the loss of options by independent directors.

4.2.3 Unify the remuneration standards of independent directors

At present, the salary of independent directors varies from region to region in China. To standardize and unify the remuneration standards while taking into account the independence of independent directors, it is an ideal solution to establish a special organization to formulate the remuneration standards of independent directors and to conduct a standardized evaluation of the performance of independent directors. However, at present, independent directors in China do not have an intermediary institution to evaluate independent directors, and it is difficult to uniformly and objectively evaluate the ability and performance of independent directors. Independent directors should receive remuneration commensurate with the risks they bear. In addition, an independent directors insurance system can also be implemented to reduce the risks that may be caused by the normal performance of independent directors. In addition, the remuneration level of independent directors should be consistent with the value of their human capital. According to the requirements

of the Independent Directors Rules for Listed Companies and the actual situation, Chinese independent directors are basically those with achievements and influence in relevant fields. Experts and scholars. In this regard, it is necessary to reasonably evaluate its time value and formulate an attractive salary level.

4.3 Establishing a reputation incentive mechanism for independent directors

Reputational incentives can have a positive impact on the motivation and even behavior of independent directors to perform their duties. Since China does not have a talent market for independent directors in the strict sense, and it is impossible to build one overnight, the establishment of a reputation incentive mechanism in China can be considered at this stage. On the one hand, the association of independent directors can establish a talent pool or archive of independent directors' professional, knowledge and study backgrounds, practice experience and reputation evaluation, names of listed companies where they hold independent directorships, and their practice performance, etc. The association will rate the independent directors within the association and set different levels of remuneration. On the other hand, the association is responsible for providing professional training to existing and potential independent directors. At the same time, a performance evaluation mechanism for independent directors should be established. The evaluation subjects should include the association of independent directors, the board of directors of the listed companies where the independent directors serve, the board of supervisors, the minority shareholders, and the self-evaluation of the independent directors. The evaluation indicators should include, for example, diligence, consultation, and the effectiveness of the supervisory role played. The evaluation results shall also be included in the independent directors' file database, which will have an impact on the professional reputation of independent directors.

5. Conclusion

There are voices of support and skepticism for independent director system in China. In recent years, the phenomenon of "vase directors" and "independent directors who do not know what to do" has been highlighted, and one of the important reasons is the lack of incentives for independent directors in China. It is suggested that the legislative level can clarify the guiding provisions of independent directors' incentive in the Company Law and further specify the incentive system of independent directors in separate regulations or rules; in terms of remuneration incentive, the remuneration standard of independent directors should be unified, the average salary of independent directors should be increased to a certain extent and the form of independent directors' remuneration incentive should be enriched, and the remuneration committee should decide the remuneration of independent directors and submit it to the general meeting of shareholders. China should establish an association of independent directors, establish a performance evaluation mechanism for independent directors, build an external market for independent directors and promote the formation of a reputation incentive mechanism.

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