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“Improving corporate governance by deferring to international experience and letting institutional investors play their role”

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Abstract
In recent years, institutional investors around the world have taken a more active part in corporate governance. Accordingly, the regulators of different countries have paid more attention to the role of institutional investors in corporate governance and have established various regulatory regimes to promote further participation of institutional investors.

Against this background, the Asian Corporate Governance Association (ACGA) held its 16th Annual Conference in Tokyo from November 14-16, 2016. During the conference, ACGA released its eighth biennial *CG Watch Report,* which evaluates the corporate governance performance of 11 Asian markets. Also, the conference facilitated an in-depth exploration of Japan’s corporate governance reform and the market effects of “Abenomics three arrows” policy. By deferring to the international experience, we believe Chinese institutional investors will be able to play their roles more actively and thus improve corporate governance standards in China.

Background of the ACGA Annual Conference

1. **About ACGA**
   ACGA is an independent, non-profit membership organisation dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. ACGA was founded in 1999 and is based in Hong Kong. The vision of ACGA is to promote the long-term development of corporate governance in Asian economies and capital markets. ACGA now has more than 110 members from 18 different markets around the world.

   Unlike similar associations in China where most of their members are public companies, two-thirds of the members of ACGA are investment funds, insurance companies and pension funds, along with other long-term institutional investors. The total assets under management (AUM) of ACGA members now exceed US$24 trillion. ACGA's scope of work covers three areas: research, advocacy and education. ACGA issues its *CG Watch Report,* which evaluates corporate governance performance of different Asian markets, every two years. ACGA has substantial influence among global institutional investors, given that the majority of its members are European and American institutions.

   Over the years, ACGA has made many significant contributions to the reform of corporate governance and capital market regimes in different Asian markets both on its own behalf and for its members. For example, ACGA opposed Alibaba's proposed non-standard listing in Hong Kong in 2014, on the grounds that Hong Kong should not compromise its governance principles for short-term interests, otherwise the cost will be losing the long-standing trust of institutional investors.

ACGA also includes mainland China in its research and has done more China-related work in recent years. ACGA's evaluation of China's corporate governance had a major impact on the MSCI's decision to include A-shares in the MSCI index. Most domestic organisations and institutions in China are not aware of this fact and have little knowledge of ACGA. To date, China Universal Asset Management (CUAM) is still the only company from mainland China that is a member of ACGA.

2. Corporate governance reform in Japan

Given the fast pace of corporate governance reform in Japan in recent years, ACGA chose to hold its Annual Conference in Tokyo in 2016. As is well known, the main economic policy under "Abenomics" is the "three arrows": the first arrow targets monetary policy; the second targets fiscal policy; while the third targets structural reform. The major part of the third arrow involves raising the long-term return of investors by reforming Japan's corporate governance regime and promoting industry restructuring.

Japan followed the UK's lead during its corporate governance reform. After the Global Financial Crisis in 2007, regulators in the UK thought institutional investors had placed too much emphasis on the quarterly reports of listed companies, resulting in short-termism and even causing market misconduct such as accounting fraud in some instances. This short-term market movement has had a negative impact on the long-term development of listed companies. For this reason, UK regulators invited Professor John Kay to conduct an independent evaluation, which resulted in the *Kay Review of UK Equity Markets and Long-term Decision Making* report (the "Kay Review Report"). Following its release, UK regulators subsequently devised the Corporate Governance Code and the Stewardship Code. However, the codes are not mandatory and follow a "comply or explain" principle.

In turn, Japan followed the UK's example. Japan's Financial Services Agency (JFSA) invited Professor Kunio Ito from Hitotsubashi University to lead an academic team to conduct an independent evaluation of the Japanese stock market. He released the *Ito Review of Competitiveness and Incentives for Sustainable Growth – Building Favourable Relationships between Companies and Investors* report (the "Ito Review Report"). Japan then issued its Corporate Governance Code and Stewardship Code, in accordance with the report, and both codes also follow the "comply or explain" principle.

3. UN PRI

In 2005, the United Nations-supported Principles for Responsible Investment (PRI) which was drafted by a group of the largest institutional investors in the world, and counts Kofi Atta Annan, former UN Secretary General, among its advocates. It is an international network of investors working together to put the six principles of responsible investing into practice to serve "environmental", "social" and "governance" (ESG) responsibilities.

The PRI initiatives aim to promote sustainable long-term economic growth, steadily improve human rights and curb the effects of global warming. At present, more than 1,600 financial institutions have signed the PRI, including pension funds, investment funds, insurance companies, asset managers and so on. The total AUM of these institutions exceeds US$64 trillion. Also, the UN has set up a Responsible Investment Organisation headquartered in London.

Japan highly values the work of UN PRI and has incorporated some relevant content from the UN PRI into its Stewardship Code. The Government Pension Investment Fund (GPIF) of Japan, which has about US$1 trillion assets under management, has also signed the PRI. One of the major topics of the ACGA conference was how institutional investors can factor ESG elements into their investment decisions in Japan. However, China should also be familiar with the concepts of PRI and ESG, since at the G20 Forum held in Hangzhou in September 2016, the country committed to encouraging PRI in G20 countries as well as globally, and to increase the number of Chinese signatories through "green finance".

ACGA Annual Conference Summary

The ACGA Tokyo Conference began with a keynote speech, then simultaneous workshops and ended with a summary speech. CUAM sponsored the Gala Dinner of the conference. ACGA has expressed interest in doing more work related to China, such as making contributions to the revision of the Corporate Governance Code and helping China to draft its own Stewardship Code. The main topics of the conference were as follows:

1. **CG Watch 2016**

   First on the conference agenda was introducing the *CG Watch 2016* report with evaluations of the corporate governance performance of 11 Asian markets. The report was jointly published by ACGA and CLSA. Australia was included in the survey for the first time and topped the rankings. The other rankings, from 2nd to 11th, are Singapore, Hong Kong, Japan, Taiwan, Thailand, Malaysia, India, Korea, China, Philippines and Indonesia, respectively.

   The ACGA CG ranking was based on objective benchmarks and a questionnaire. The theme of *CG Watch 2016* is "Ecosystems matter". ACGA believes that a balanced ecosystem is vital for a market's stability and long-term standards of corporate governance, and this underpins the rankings awarded in the report.

   However, the corporate governance ecosystem involves elements beyond the control of listed companies or through simply having good corporate governance measures in place: it has to include market regulation; participation from industry bodies; engagement by institutional investors; judicial systems; regulatory enforcement; and for shareholders to be aware of their rights. Therefore, genuine improvement of corporate governance standards in a market requires persistence and holistic reform, rather than relying on any single party.

   China was ranked ninth, only scoring 43 in the survey this time, not far above the last-ranked market, Indonesia (36) and the second-to-last market, the Philippines (38).

There is still a huge gap between China and the top-ranked market, Australia (78). Historically, this was the worst score for China in the *CG Watch* rankings, a big drop from its highest score (49) in the 2010 survey. When asked about the reasons for this backsliding, ACGA said that there was not much happening in China in terms of corporate governance reform, some regulations were not being effectively implemented, and the stock crisis in 2015 had exposed the immaturity of the Chinese market. ACGA also talked about the Vanke ownership battle, citing that in contrast to other markets a company takeover in China does not necessarily result in better corporate governance.

According to ACGA, two key factors hindered China from gaining a higher score in the enforcement category: one factor is that regulators lack manpower and financial resources, and the staff at several authorities are either thinly dispersed or inexperienced. The other is the low engagement of domestic investors, especially institutional investors. However, ACGA noted that China's regulatory bodies have been playing a more active role since 2016. For example, the Shanghai Stock Exchange (SSE) issued 22 public reprimands and criticisms in the first half of 2016, a 150% increase year-on-year, and the comparable figure for the Shenzhen Stock Exchange (SZSE) was 40 sanctions, a more than 40% increase.

The *Financial Times* newspaper published a feature on China's corporate governance ranking in *CG Watch 2016*, titled "China's corporate governance standards fall". The article quoted JP Smith, a partner at investment consultancy Ecstrat, as saying that, "The overall effect of China going into the MSCI would be disastrous. Ill-informed investors buying the index for asset allocation reasons would be exposed to companies with terrible governance. There is no way MSCI should consider adding China to the index." He also added, "Minority shareholders are just there as a potential source of cash. There is really not a reason for them to be acknowledged at all. Governance has definitely been getting worse."

Although there has been no media coverage of the *CG Watch* rankings in mainland China to this date, the Chinese capital market should take a close look at the results and make improvements accordingly.

2. Japan's corporate governance reform status

During the conference, institutional investors from different parts of the world probed into the status of Japan's corporate governance reform and the effect of "Abenomics three arrows". Speakers at the conference included Kunitake Ando, the former CEO of Sony, local institutional investors and global institutional investors who have investments in Japan. All participants provided their different perspectives on various issues which lead to many productive discussions.

The delegates from Japan generally agreed with the conclusions of the Ito Review that Japan faces challenges in its corporate governance reform that are contrary to those faced by Western markets. The main issues facing listed companies in Japan are insufficient innovation, lack of accountability in investment decisions, long-term underperforming ROE, the culture of family businesses, the agency cost of management putting its own benefit above those of shareholders, ineffective management incentive schemes and little concern for shareholder returns.

For this reason, although Japan has applied the UK model to its corporate governance reform, the main focus of its regulatory change is opposite to the UK. Japanese regulators hope that domestic listed companies can lead Japan's economy onto an innovative track by more engagement between institutional investors and listed companies, and thus pressure management of those companies to make capital returns and stimulate Japanese entrepreneurship. To gauge whether any progress has been made, international institutional investors can compare the cash to total asset ratio, financial leverage and other objective references of Japanese listed companies.

During the conference, both local and international delegates engaged in practical discussions around corporate governance issues. The status quo of Japanese society has been established over generations and is affected by various factors made up of culture, population and social influences. This reminds us again that the seeds of entrepreneurship need to be planted in advance, while the path to an innovative society takes time to build and needs systemic support.

During the Gala Dinner, Ken Shibusawa, the great-grandson of Eiichi Shibusawa—known as "the father of Japanese capitalism", who founded the first bank and stock exchange in Japan—made a speech titled, "A Long-Term Vision-Japan Beyond 2020". In his speech, Shibusawa used his own family as an example to illustrate how Japanese society had evolved since the Meiji Restoration in the 1860s. Shibusawa said that after five generations, his family had now completely adapted to US society and all his three children now lived in the US. After more than 20 years working on Wall Street, in 2016 Shibusawa decided to return to Tokyo to found a mutual fund company. People like the generations of the Shibusawa family, stemming from the Meiji era, embody the forward-looking spirit of reform and will provide the hope and momentum to transform Japanese society.

However, when local delegates talked about Japan's reform progress, almost none of them praised the "Abenomics three arrows", and some of them even highlighted the policy's counterproductive results. But despite the pessimism, the discussion sent out a positive signal that Japanese people are beginning to think about reform and making improvements.

3. The Stewardship Code in Japan

One of the major themes of the conference was the implementation of the Stewardship Code in Japan and the effect ESG factors can have on investment decisions. Japan has paid more attention to ESG factors in investments as a result of the "Abenomics three arrows". Although banks are still the main source of financing, the percentage of direct financing has been rising over the years. Asking institutional investors to factor ESG into their investment strategy through voluntary compliance with the Stewardship Code is an effective way to adjust the market structure of the finance industry.

Institutional investors from companies such as Capital Group and Fidelity International have stated that they think it is feasible to incorporate environmental and social factors into their investment decisions in Japan, given that these concepts are embedded in the Japanese market and the disclosure of Japanese listed companies fully covers these areas. Some institutions have even provided evidence that listed companies that paid more attention to ESG factors had made better and more sustainable growth in both their operations and share price. This aligns with the slogan often repeated by the Chinese Communist Party in recent years that “lucid waters and lush mountains are invaluable assets.”

The grand finale of the conference was the dialogue between Hiromichi Mizuno, Chief Investment Officer of GPIF and Jamie Allen, Secretary General of ACGA. As noted previously, GPIF is the world’s largest asset owner that manages assets valued at around US$1 trillion. Prior to joining GPIF in 2015, Mizuno was a partner of a London-based private equity fund. He speaks excellent English and has an international view on different issues. Under his lead, GPIF signed the UN PRI and asked its fund managers to take into account ESG factors in their investment decisions.

Mizuno said that GPIF, as a national pension fund, should put social responsibility as its top priority rather than the pursuit of profit. Also, he mentioned that the size of the AUM of GPIF restricts it to making only an average return, otherwise the “spill-over” effect would probably squeeze other financial institutions out of the market. Therefore, as CIO, his first priority is to make sure that GPIF performs its social responsibility properly.

Mizuno mentioned that key to providing better security for the pensions of Japanese civil servants, GPIF places more emphasis on the role ESG factors play in investments, thereby improving the economic framework for a more sustainable economy. Recently, GPIF also signed onto the US and UK “30% Clubs” targeting improved gender diversity, and all its investee companies must have more than 30% female employees.

Compared to Japan, China still lags behind on both the recognition and the practice of investor stewardship. The UN PRI has almost zero signatories in China. The Chinese fund industry at large still generally considers ESG to consist of philanthropic efforts, instead of linking these factors to their investment return. National pension funds like the Social Security Fund are still choosing their fund managers based on investment returns rather than looking to set role models for the industry. We hope that China can turn these differences into momentum for change. Thinking about the sky in Beijing while standing on the earth in Tokyo, it appears even more essential for Chinese national pension funds to become signatories of the UN PRI.

Thoughts about the ACGA Annual Conference

Although the ACGA Annual Conference lasted for only one-and-a-half days, it was a very productive and worthwhile trip. There was a lot of constructive discussion among international institutional investors about China’s capital market at the conference. The conference also revealed the extent of corporate governance development in Japan over the past few years. The beautiful surroundings, friendly society, convenient business environment and transparent judicial system are making Tokyo the largest Asian hub for international financial institutions.

China can learn a lot from both the success and failure of Japan's fund industry. Unfortunately, due to the red tape involved in overseas travel for Chinese companies, fund companies in China are not yet able to enjoy the geographic benefits of being frequent visitors to Tokyo like ACGA and other international organisations. However, it is recommended that Chinese fund companies begin to open more bilateral dialogue to attract more foreign investment in China by international institutional investors.

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