Asian Corporate Governance Association (ACGA)

“Awakening Governance:
The evolution of corporate governance in China”

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Agenda

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2. Methodology
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1. Report objectives

- Explain China’s unique and evolving system of corporate governance to foreign investors.

- Explain the relevance of new global CG best practices to China listed companies and institutional investors.

- Make recommendations to regulators, companies and investors for moving CG forward in China.
2. Methodology

• Research carried out by a team from Hong Kong and China, starting from Q2 2017, using a range of primary and secondary sources. (References in “Endnotes” after each chapter.)

• Two surveys carried out in Q3 2017:

  1. **Foreign Institutional Investor Perceptions Survey**
     20 questions / 152 respondents

  2. **China Listed Company Perceptions Survey**
     13 questions / 182 respondents

• Original interviews done with 12 governance experts, including directors, board secretaries, academics, journalists, investors and former regulators
A large number of individuals and organisations supported ACGA’s work on this report.

We thank our contributors, editorial and production team, ACGA Council, ACGA Secretariat, and many others too numerous to mention!

For support in distributing our survey, we thank: CII, IFC, King Parallel, PwC, SynTao and Wind.

Please see page iii (in the Preface) and the Annexes for further details.
3. Regulatory context

- China introduced a range of “global standards” of corporate governance in the mid-1990s to early 2000s. This helped to build credibility among international investors, but did not resolve some deep-seated local governance problems.

- The past decade has seen a stronger emphasis on local governance solutions driven by the state/Party. Often very prescriptive and rules-based.

- The country now appears to be entering a new phase in its application of CG regulation. Renewed emphasis on regulatory enforcement and coordination, but also ESG, investor responsibility and a newly revised CG Code for companies.

- A hybrid system: “We will improve regulatory rules to ensure they are suited to the Chinese context and in accord with international standards”. (13th Five-Year Plan: 2016–2020)
4. Headline survey findings

China A share market, next 5-10 years: Relatively high levels of optimism among foreign investors. Higher among China companies.

Levels of optimism
Are foreign and China respondents positive about the investment potential of mainland China's A share capital market over the next five to 10 years?

Source: ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017
Was MSCI right?

Significantly more China respondents agreed with the inclusion of A shares in the MSCI Emerging Markets Index than foreign investors.

Source: ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017
Foreign investors need to undertake significant additional analysis of A share governance prior to investing (ie, formal disclosure is insufficient). Listed companies seem largely unaware of this fact.

**Delving deeper**

Do foreign investors undertake significant additional analysis on the governance of China A share firms in their investment process?

- **Foreign**
  - Yes: 90%
  - No: 10%

- **China**
  - Yes: 6%
  - No: 68%
  - Other view: 26%

*Source: ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*
Do foreign investors engage?

Foreign investors are seeking to engage in dialogue with A share firms about governance and other issues, but find the going difficult.

**Company advocacy**
Have foreign investors ever tried to engage with China A share firms, either SOEs or POEs?

- Yes: 46%
- No: 54%

*Source: ACGA Foreign Institutional Investor Perceptions Survey 2017*

**Hard going**
How foreign investors rate the degree of difficulty of engaging with A share firms

- Very difficult: 68%
- Somewhat difficult: 30%
- Not difficult: 2%

*Source: ACGA Foreign Institutional Investor Perceptions Survey 2017*
The value of CG to A share firms

Only a quarter of A share firms see good CG as “highly related” to good corporate performance and as making a difference in the listing process. Good CG is not seen as highly rewarding.

CG and performance
How China listed companies view the relationship between good corporate governance and good company performance

- Highly related: 26%
- Somewhat related: 27%
- Not related: 46%
- No view: 1%

Source: ACGA China Listed Company Perceptions Survey 2017

CG quality and listing potential
Do China listed companies think that the governance standard of unlisted companies in Mainland China has a significant impact on their ability to list?

- Yes: 2%
- No: 72%
- No view: 26%

Source: ACGA China Listed Company Perceptions Survey 2017
Two-thirds of the foreign and half the local respondents see overseas-listed China firms as being better governed than A shares. A similar proportion see no difference.

**Do overseas listings have better CG?**

How foreign investors view the average quality of governance in overseas-listed mainland companies compared to A shares.

- Yes: 64%
- No: 30%
- No view: 6%

**Source:** ACGA Foreign Institutional Investor Perceptions Survey 2017

**Overseas listings have better CG**

Do you consider the quality of corporate governance in overseas-listed mainland Chinese companies (ie, in Hong Kong, New York, Singapore) is usually superior to locally listed mainland Chinese companies on average?

- Yes: 53%
- No, they are similar: 27%
- No, local-listed companies are better: 17%
- No view: 2%

**Source:** ACGA China Listed Company Perceptions Survey 2017
5. CG with Chinese Characteristics

1. The Party Organisation/Committee: Leadership core
2. The Board of Directors: Business core
3. The Supervisory Board: Monitoring directors
4. Independent Directors: Form and substance
5. SOEs vs POEs: Similarities and differences
6. Audit Committees and Auditing
The Party Organisation: Leadership core

- The Party Organisation (PO) has the right and duty to pre-approve the “three important, one large” decisions.

- Strong overlap ("cross offices") between the PO and the board of directors (BOD), supervisory board (SB), and senior management.

- The PO has a basis in the Company Law and CPC Constitution.

- Policy initiatives starting in 2010 reaffirmed the role of POs. This picked up momentum in 2013. Major statements over 2015-17, including Article amendments.

Is the Party's role clear?
Foreign investor views on whether the Party committee has a clear and accountable role in listed companies

Source: ACGA Foreign Institutional Investor Perceptions Survey 2017

Recommendations: More disclosure on the role of the PO. A “Report of the PO” like the BOD and SB reports.
• Although its governance role is limited by the functions of the Party Organisation, the board of directors plays an important role in business and operational decision-making.

• Challenging management is difficult, especially in board meetings. A lot of substantive discussion takes place between meetings.

• The “9-person” board with three independent directors is common (to meet the 33% minimum).

• Foreign investors are not clear about the different roles played by the PO, BOD, supervisory board and so on.

**Recommendations:** Clarify relationship between the PO and BOD in the Company Law. Enhance board evaluations and committees.
The “9-person” phenomenon (BOD)

Range of board sizes in China A share listed companies
May 2018

Source: ACGA analysis, based on Valueonline data

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The Supervisory Board: Monitoring directors

- The second and weaker limb of the dual-board structure in China.
- “Monitor” a better word for the supervisory board’s role than “supervise”, which in English implies authority over the supervisee.
- Overlap between the functions of the SB and BOD, including the audit committee.
- Confidence in SBs is low among both foreign and China respondents to our survey (see chart).

**Recommendations:** Clarify the separation of duties between the SB and BOD in the Company Law and official guidelines. Encourage SBs to use their full powers. Give private firms choice regarding SBs.
The “3-person” phenomenon (SB)

Distribution of supervisory boards
By size and number of companies, May 2018

Source: Valueonline; ACGA analysis
Independent directors (IDs) have been a feature of Chinese CG since 1999.

Traditionally, they are drawn from academia, accountants, lawyers, and former officials (the latter banned in 2013).

Most companies stick rigidly to the one-third rule. Little “organic growth” in ID numbers. Pay is low.

ID influence is seen as limited—yet at their best they play an important role in major transactions.

Recommendations: Revise the one-third rule upwards and/or encourage companies to grow their ID capacity organically (in line with their business needs). Abolish attendance by proxy. Promote broad-based director training.
Average pay falling!

2012: 89,000
2017: 78,660

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SOEs vs POEs: Similarities and differences

• Despite major differences in ownership structure, management and performance, privately owned enterprises (POEs) share similar attributes and challenges as SOEs: the imbalance of concentrated ownership, an insider mindset, policy uncertainty, controlled markets, the need to maintain good government relations, formation of Party orgs.

• Slightly less than a quarter of foreign respondents prefer them as an investment proposition (see chart).

• Only 10% of China respondents see POEs as better governed than SOEs (see chart over).
• Significant differences are seen, however, in the level of government intervention in POEs, and the importance of the chairman (see charts over).

• Since 2015, SOEs are increasingly being categorised by role and function, such as “commercial enterprises” vs “public welfare enterprises”.

• An SOE’s category will determine its objectives, governance reform path, performance metrics, evaluation system, and so on.

**Are POEs better governed?**

How China listed companies view the quality of corporate governance in privately owned enterprises compared to state-owned enterprises

![Diagram showing survey results]

*Source: ACGA China Listed Company Perceptions Survey 2017*
Perceptions on POE governance

Does the state intervene in company decision-making?
How foreign institutional investors view Chinese government intervention in the decision-making of SOEs compared to POEs

Does the chairman matter?
Does the individual holding the position of chairman influence foreign investment in SOEs and POEs?

Source: ACGA Foreign Institutional Investor Perceptions Survey 2017

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• China has voluminous rules and guidelines on audit committees, as well as internal and external audit.

• While disclosure quality lags developed Asian markets, in the eyes of foreign investors, they believe it will improve (see chart).

• Potential confusion in role of audit committee vs the supervisory board. Also in the role of internal audit.

• External auditors face numerous challenges.

**Recommendations:** More meaningful disclosure from the audit committee (AC). Internal audit should report to the AC. External auditors need a much stronger voice.
6. ESG Reporting / Investing

• “CSR” reporting began in China in 2006, following a range of official rules and exchange guidelines.

• Rapid increase in numbers of reports (see chart) before peaking in 2014. Listed reports increased to 2016. Unlisted declined.

• Environmental issues have received most attention from the public. But other catalysts drove companies (see chart over).

• Focus is now on quality and relevance to investors.

Recommendations: Focus attention on large caps. Investors should prioritise information needs around key issues, create demand for third-party data. Experiment with “comply or explain”.

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Corporate catalysts for CSR reporting

CSR reporting in China—reasons for
2013 (%)

- Improve brand awareness and industry influence: 87.5%
- Strengthen communication with the public: 68.8%
- Attract excellent employees: 46.9%
- Improve risk management and governance: 31.3%
- Promote enterprise innovation: 28.1%
- Satisfy regulatory requirements: 21.9%
- Improve relations with investors: 21.9%
- Promote CSR management in company: 18.8%
- Promote CSR recognition among employees: 15.6%
- Improve corporate economic benefit: 12.5%
- Other: 0%

Source: SynTao
• Following encouragement from AMAC, domestic institutional investors are starting to integrate ESG factors into their investments. From 34% of funds in 2008 to 59% in 2016.

• Green finance/bonds has been an important catalyst. Green bond market worth Rmb294 billion in 2017, with the number of bonds issued doubling from the previous year.

• ESG index investing starting: as of Feb 2017, there were 19 indices and 18 fund products, AUM of almost Rmb11 billion.

• Retail investors are showing some interest in ESG (see chart over).

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Negative screening by China funds
Criteria used to screen investments

Note: Number of fund companies (out of 63 respondents)
Source: Asset Management Association of China
Reasons for retail interest in CSR/ESG

Why retail investors consider CSR

- Lower investment risk: 733
- Create value for society: 683
- Improve investment return: 605
- Respond to government call: 214
- Increase personal reputation, influence: 163
- Recommendations from media or others: 144
- Religious beliefs: 38
- Others: 18

Source: SynTao Green Finance, Aegon-Industrial Fund
7. M&A with Chinese characteristics

- Deregulation over 2014-2016 fired up the domestic M&A market, which peaked in 2016 (see chart).

- Tender offers rare: of 1,578 major asset restructurings over 2014-16, only four involved tender offers.

- Hostile takeovers are also rare: the first successful one concluded in May 2018 (ST Biochemical).

- “Corporate shells” are valuable, stimulating backdoor listings.

- SOEs account for minority of deals by number, but most of the value. Horizontal mergers in same sector. Policy drivers.

**Recommendations:** Takeover regulations need review, as does the Company Law regarding shareholder meetings and voting.
8. Company case studies

1. **Sinopec: “Blended governance”**
   - Party organisation / mixed ownership / remuneration

2. **ICBC: “Green giant”**
   - Party organisation / green finance / talent retention

3. **Vanke: “Shape shifter”**
   - Fighting Baoneng / change of ownership / takeover regulations

4. **Minsheng Bank: “Repairing its reputation”**
   - Ownership and board struggles / internal control risks

5. **Tencent: “Two sides to the coin”**
   - Balanced ownership / votes against at AGMs / emerging risks
9. Conclusions

1. Corporate governance reform in China has passed through different stages in recent decades, evolving into a hybrid with strong “Chinese characteristics”.

2. Given China’s growing importance in global capital markets, there is a need to bridge the gap in expectations and CG/ESG understanding between domestic and foreign market participants.

3. Numerous areas for concrete improvements in governance at the company level. Many of these are incremental steps and extensions of current practice.

4. Greater clarity needed in company law, takeover regulations.

5. ESG will take on greater prominence in coming years, as will the green finance market.
### “CG Watch” report: Market scores 2010 to 2016

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<td>1. Singapore</td>
<td>67</td>
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<td>65</td>
<td>65</td>
<td>-</td>
<td>Action, reaction: the cycle of Hong Kong life</td>
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<td>3. Japan</td>
<td>57</td>
<td>55</td>
<td>60</td>
<td>63</td>
<td>(+3)</td>
<td>Cultural change occurring, but rules still weak</td>
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<td>4. Taiwan</td>
<td>55</td>
<td>53</td>
<td>56</td>
<td>60</td>
<td>(+4)</td>
<td>The form is in, now need the substance</td>
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<td>5. Thailand</td>
<td>55</td>
<td>58</td>
<td>58</td>
<td>58</td>
<td>-</td>
<td>Could be on the verge of something great, if…</td>
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<td>55</td>
<td>58</td>
<td>56</td>
<td>(-2)</td>
<td>Regulation improving, public governance failing</td>
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<td>7. India</td>
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<td>51</td>
<td>54</td>
<td>55</td>
<td>(+1)</td>
<td>Forward movement impeded by vested interests</td>
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<td>8. Korea</td>
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<td>(+3)</td>
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<td>9. China</td>
<td>49</td>
<td>45</td>
<td>45</td>
<td>43</td>
<td>(-2)</td>
<td>Falling further behind, but enforcement better</td>
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<td>10. Philippines</td>
<td>37</td>
<td>41</td>
<td>40</td>
<td>38</td>
<td>(-2)</td>
<td>New policy initiatives, but regulatory strategy weak</td>
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<td>11. Indonesia</td>
<td>40</td>
<td>37</td>
<td>39</td>
<td>36</td>
<td>(-3)</td>
<td>Losing momentum after progress in past survey</td>
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*Source: Asian Corporate Governance Association.*

*CG Watch is a joint publication between ACGA and CLSA. ACGA carries out the market ranking survey.*
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