ACGA China CG Report 2018

Awakening Governance

The evolution of corporate governance in China

ACGA China CG Report 2018

Awakening Governance

The evolution of corporate governance in China

Lead authors and editors
Jamie Allen, Li Rui (Nana Li)

Contributing authors
Guo Peiyuan, Lin Zhaowen (Maggie Lin)
Zhang Zhengjun, Zhou Chun

Translator
Jia Ruo

Lead production team
Heath Grow, Helen Wong

Editorial and production support
Lucy Colback, Chen Yunfei

Chinese version advisor
Wang Feng

Published by
Asian Corporate Governance Association [ACGA]
Room 1801, 18th Floor
Wilson House
19–27 Wyndham Street
Central
HONG KONG SAR

www.acga-asia.org

First published by ACGA in 2018

Cover image	Li Chao, Inner Mongolia, China
Chinese calligraphy	theinkless – Packy Lai, Hong Kong
Layout and design	Heath Grow and R&R Publishing, Hong Kong

British Library Cataloguing in Publication Data.
A catalogue record for this book is available from the British Library.

Creator	Allen, Jamie, editor Li, Rui (Nana Li), editor
Title	Awakening governance : the evolution of corporate governance in China / edited by Jamie Allen, Rui (Nana Li) Li.
ISBN	978-988-78682-2-4 (paperback) 978-988-78682-3-1 (ebook : pdf)
Other creators/ Contributors	Asian Corporate Governance Association (Central, Hong Kong SAR), issuing body.

Foreword

A strong and effective capital market is key to the efficient and equitable allocation of capital necessary to sustain long-term economic growth and development. Good corporate governance is the foundation of such a market.

In essence, good corporate governance is based on the clear definition and transparent execution of responsibilities within a company. It ensures that the board, management, and staff have the relevant authority to carry out their responsibilities and are held accountable to shareholders who provide capital to run the business, employees who contribute their physical and intellectual labour, customers who buy a company's goods and services, and the community at large. The impact that companies have on society and the environment is becoming a matter of increasing importance to boards and business leaders.

This study is dedicated to enriching the body of knowledge on corporate governance in China for companies, public policy makers, regulators, investors and the financial community at large as they work to carry forward the task of good governance.

Linda Tsao Yang
Chairman Emeritus
Asian Corporate Governance Association

July 2018

Acknowledgements

This report owes its gestation over several years to a wide range of supporters, contributors, ACGA members and staff members, and supporting organisations. The ACGA Council under the leadership of former chairmen, Linda Tsao Yang (2001-14) and Douglas Henck (2014-18), championed the project and provided ongoing guidance and budgetary support. We wish to extend our sincere thanks to Linda for generously sponsoring the early research for this report through the Give2Asia Foundation. We also wish to recognise our founding chairman, Dr David Chiang, for his inspiration in establishing ACGA.

We thank our contributing authors—Dr Guo Peiyuan of SynTao, Lin Zhaowen (Maggie) of the IFC, Dr Zhang Zhengjun of King Parallel, and Dr Zhou Chun of Zhejiang University—for providing detailed research and analysis to different chapters of the report. Parts of this report were written originally in Chinese, translated into English before being edited, and then translated back into Chinese. Other parts were written first in English. Our appreciation goes to Jia Ruo for her efficient translation skills and to Chen Yunfei for diligently proofreading the Chinese text.

For generously giving of their time and willingness to be interviewed, we thank our interviewees: Peter Bowie, Paul Gillis, John Law, Li Wen, Professor Lu Tong, Dr Ma Jun, Vincent Poizat, David Smith, Jenn-hui Tan, Tang Bin, Lynn Turner, Shirley Yam and Dr Zhang Wei.

For helping to distribute the two original surveys in this report—the first targeted at foreign institutional investors and the second at China listed companies—we owe our gratitude to organisations both within China and outside. They are: the Council of Institutional Investors; the International Finance Corporation; King Parallel; PricewaterhouseCoopers; SynTao; and Wind.

Other organisations that provided various forms of assistance include: AmCham Shanghai; Brunswick Group; BSR; Glass Lewis; Institutional Shareholder Services; the International Corporate Governance Network; and Valueonline. Our thanks go also to FTChinese.com, a Financial Times company, for being our media partner and to Wang Feng, Editor-in-chief, for reviewing the Chinese edition.

Many other individuals deserve recognition too, including (in alphabetical order): Pru Bennett, Chiu Tzu-Kuan, Patrick Chu, Susan Dietz-Henderson, Guo Li, He Jibao, Hu Xuemei, Liang Jie, Ju Guang, Pan Miaoli, Qian Yuyi, Shen Li, Shi Donghui, Daniel Smith, Su Longfei, Flora Wang, Wang Junxian, Jeffrey R Williams, Xie Yan, Zeng Bin, Zhong Cheng, and Zhu Xu.

Last but not least, my deepest gratitude to the entire ACGA Secretariat for their moral support and encouragement. The Association is lucky to be served by such a dedicated team. Three individuals in particular deserve special recognition for their indefatigable efforts over the past year: Li Rui (Nana Li), Senior Research Analyst; Dr Heath Grow, Senior Research and Publications Manager; and Helen Wong, Proofreader and Editor. My thanks also to Lucy Colback for editorial support and to Melissa Brown for expert advice on survey design.

While many people have contributed to this report, any errors remain the responsibility of ACGA.

Jamie Allen
Secretary General

July 2018

Executive Summary

With its securities market growing in complexity and becoming ever more significant internationally, China appears at a turning point in its application of corporate governance and ESG (environmental, social, governance) principles. In the early years of its capital market development, China leaned strongly towards adopting "global standards" of corporate governance. While this helped to build credibility among international investors, practical and political imperatives soon dictated a need to find local solutions as well. China today has a hybrid policy framework, increasingly coordinated regulatory agencies and a desire to create a modern financial system that meets the needs of its real economy. As its 13th Five-Year Plan (2016–2020) states: "We will improve regulatory rules to ensure they are suited to the Chinese context and in accord with international standards".[1]

Our goal in writing this report is to strengthen communication between domestic and foreign participants in China's capital market, and expand their appreciation for how corporate governance practices could improve. We seek to explain the unique system of corporate governance in China, how it has evolved over the past four decades, its current direction and challenges. We also outline a range of new global best practices that we believe are relevant to China listed companies and domestic institutional investors.

The Introduction to the report outlines our objectives and describes key results from two original surveys we have undertaken on perceptions towards CG in China, one involving foreign institutional investors and the second with Chinese listed companies.

The Policy and Regulatory Backgrounder reviews the history of corporate governance and capital market regulation in China since the late 1970s. It introduces the tricky status of the variable-interest entity (VIE), the alphabet soup of different Chinese listings at home and abroad, and current policy initiatives—SOE reform, the new CG Code, insurance reform, and financial regulatory coordination.

CG with Chinese Characteristics is the main part of the report. It looks at the role of Party organisations/committees, the board of directors, supervisory boards, independent directors, SOEs vs POEs, and audit committees/auditing. Each chapter explains the legal and regulatory basis for each governance institution, the particular challenges that companies and investors face, and concludes with suggestions for next steps. Our intention has been to craft recommendations that are practical and anchored firmly in the current CG system in China.

We then move on to the topical issue of ESG, examining both the evolution of ESG Reporting in China since 2006 and the more recent part played by ESG Investing. Key issues include the need for ESG reporting to move up the quality chain and for institutional investors to gain a better understanding of the value of ESG to their work. The new area of green finance is highlighted.

M&A with Chinese Characteristics starts with the state of play in the domestic merger market, followed by a review of trends in inbound and outbound M&A. The unique challenges of M&A in China, in particular the interaction with domestic law and regulation, are examined.

Company Case Studies delve into the governance structures and challenges of five major institutions, two state and three private or mixed. They are Sinopec, ICBC, Vanke, Minsheng Bank and Tencent.

Adding colour to the report are a series of interviews with leading experts, directors, board secretaries and investors. We conclude with 60 questions for analysing the governance of listed companies in China.

[1] 13th Five-Year Plan, Chapter 16, Section 3, p45

About ACGA

The Asian Corporate Governance Association (ACGA) is a not-for-profit membership association chartered under the laws of Hong Kong and founded in 1999. ACGA is dedicated to working in a constructive manner with regulators, listed companies and investors across Asia to improve corporate governance standards and practices, which we believe are a foundation for economic and capital market development. We are guided by a practical, long-term approach that is relevant to each individual market.

ACGA has more than 110 corporate members from around Asia and other parts of the world. Two-thirds are institutional investors with more than US$30 trillion in assets under management globally. Our members include global investment institutions, listed and unlisted companies, accounting firms, pension funds, business associations and educational institutions.

For nearly 20 years ACGA has conducted independent research and in-depth analysis of the corporate governance sphere in 11 securities markets in Asia, covering China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

Our bimonthly publication, *Asia Regional Briefing*, provides members with contemporary analysis of the key corporate governance developments and issues from 11 Asian markets.

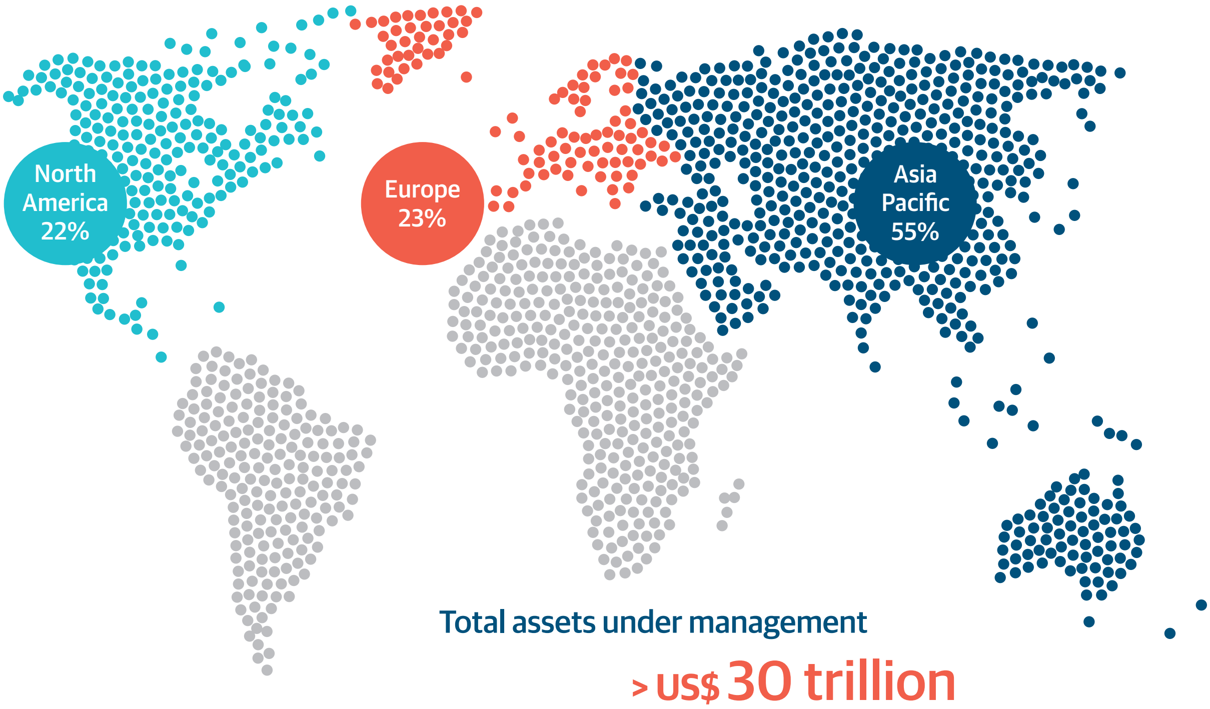
Since 2003, we have published the *CG Watch* regional survey report which ranks the corporate governance performance of 12 major markets in Asia-Pacific, in collaboration with our founding sponsor CLSA. This biennial report is widely recognised as the authoritative publication on the state of corporate governance in the region. The ninth edition will be published in 2018.

Confidential meetings are regularly held to enable members from Asia Pacific, Europe and North America to interact and discuss the pertinent issues affecting corporate governance in Asia. These discussions are enhanced by member participation in our specialised working groups on Japan and Korea. New working groups on China and India are being formed.

As well as regular updates and in-person Members Briefings in key markets, our signature annual conference, the "Asian Business Dialogue on Corporate Governance", is a highly anticipated event known for its stimulating and educative discussions. Held in a different Asian city each year since 2001, the event has become a forum in which senior level executives, investors, regulators, auditors and other professionals can engage and share a diverse range of views on topical issues of corporate governance in Asia. Our 2018 conference will be held in Beijing in November.

For more information about who we are, please visit our website: www.acga-asia.org

Our Membership



Industry Sectors	Markets	
Accounting and Auditing Firms	Australia	Netherlands
Asset Management	Belgium	Norway
Associations and Institutions	Canada	Philippines
Banks	China	Singapore
Education	France	Sweden
Insurance	Hong Kong	Taiwan
Listed Companies	India	United Kingdom
Pension Funds	Japan	United States of America
	Malaysia	Vietnam

Contents

Interviews

Twelve interviewees, presented below in order of surname, provided their insights into corporate governance issues in China.

Figures

ESG Reporting and Investing

M&A in China

Company Case Studies

Tables

Glossary

Commonly used acronyms in this report include:

Organisations and related terms

AMAC	Asset Management Association of China
CAPCO	China Association for Public Companies
CASS	Chinese Academy of Social Sciences
CBRC	China Banking Regulatory Commission (merged in March 2018 with the China Insurance Regulatory Commission)
CCB	China Construction Bank
CCDI	Central Commission for Discipline Inspection
CDB	China Development Bank
CDP	Carbon Disclosure Project
CIC	China Investment Corporation
CICERO	Center for International Climate Research
CICPA	Chinese Institute of Certified Public Accountants
CIRC	China Insurance Regulatory Commission (merged in March 2018 with the China Banking Regulatory Commission)
CPC	Communist Party of China
CSF	China Securities Finance Corporation
CSOE	Central state-owned enterprise
CSRC	China Securities Regulatory Commission
HKEX	Hong Kong Exchanges and Clearing
IAASB	International Auditing and Assurance Standards Board
ICBC	Industrial and Commercial Bank of China
IFC	International Finance Corporation
IPE	Institute of Public and Environmental Affairs
ISC	China Securities Investor Services Center
MEE	Ministry of Ecology and Environment (formerly MEP)
MEP	Ministry of Environmental Protection (now MEE)
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
NDRC	National Development and Reform Commission
NPC	National People's Congress
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PBOC	People's Bank of China
PCAOB	Public Company Accounting Oversight Board
POE	Privately owned enterprise
QFII	Qualified Foreign Institutional Investors
SASAC	State-owned Assets Supervision and Administration Commission
SEC	US Securities and Exchange Commission

SETC	State Economic and Trade Commission
SOE	State-owned enterprise
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
VIE	Variable Interest Entity

Others

AGM	Annual General Meeting
CITI	Corporate Information Transparency Index
CSMAR	China Stock Market and Accounting Research
CSR	Corporate social responsibility
ESG	Environmental, social, governance
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GRI	Global Reporting Initiative
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
KAM	Key audit matters
Rmb	Renminbi
SEZ	Special Economic Zone
US$	US Dollar
WFOE	Wholly foreign-owned enterprise
WMP	Wealth Management Product

簡介

Chapter One

Introduction

1.1 Introduction

With its securities market continuing to internationalise and grow in complexity, China appears at a turning point in its application of CG and ESG principles. The time is right to strengthen communication and understanding between domestic and foreign market participants.

Introduction: Bridging the gap

The story of modern corporate governance in China is closely connected to the rapid evolution of its capital markets following the opening to the outside world in 1978. The 1980s brought the first issuance of shares by state-owned enterprises (SOEs) and a lively over-the-counter market. National stock markets were relaunched in Shanghai and Shenzhen in 1990 to 1991, while new guidance on the corporatisation and listing of SOEs was issued in 1992. The first overseas listing of a state enterprise came in October 1992 in New York, followed by the first SOE listing in Hong Kong in 1993. Corporate governance reform gained momentum in the late 1990s, but it was less a byproduct of the Asian Financial Crisis than a need to strengthen the governance of SOEs listing abroad. The early 2000s then brought a series of major reforms on independent directors, quarterly reporting and board governance aimed squarely at domestically listed firms.

A great deal has changed in China since then, with periods of intense policy focus on corporate governance followed by consolidation. In recent years, China's equity market has undergone a renewed burst of internationalisation through Shanghai and Shenzhen Stock Connect, relaxed rules for Qualified Foreign Institutional Investors, and the landmark inclusion of 234 leading A shares in the MSCI Emerging Markets Index in June 2018. While capital controls and other restrictions on foreign investment remain, there seems little reason to doubt that foreign portfolio investment will play an increasing role in China's public and private securities markets in the foreseeable future.

Running parallel to market internationalisation, and facilitated by it, is a broadening of the scope of corporate governance to include a focus on environmental and social factors ("ESG"), and a deepening concern about climate change and environmental sustainability. Pension funds and investment managers in China are now encouraged by the government to look closely at ESG risks and opportunities in their investment process. And green finance has become big business in China, with green bond issuance growing steadily. Indeed, these themes are also part of the newly revised Code of Corporate Governance for Listed Companies (2018) from the China Securities Regulatory Commission (CSRC); this is the first revision of the Code since 2002.

Turning point

China thus appears at a new turning point in its market development and application of corporate governance principles. While it is difficult to predict how this process will unfurl, we believe three broad developments would be beneficial:

- That unlisted and listed companies in China see corporate governance and ESG not merely as a compliance requirement, but as tools for enhancing organisational effectiveness and corporate performance over the longer term. This applies as much to entrepreneurial privately owned enterprises (POEs) as established SOEs. The view that good governance is not relevant or possible in young, innovative firms is misguided.

- That domestic institutional investors in China see corporate governance and ESG not only as tools for mitigating investment risk, but as a platform for enhancing the value of existing investments through active dialogue with investee companies. The process of engagement can also help investors differentiate between companies that take governance seriously and those which do not.
- That foreign institutional investors view corporate governance in China as something more nuanced than a division between "shareholder unfriendly" SOEs and "exciting but risky" POEs. We recommend foreign asset owners and managers spend more time on the ground in China and invest in studying China's corporate governance system, if they are not already doing so.

Of course, there are many exceptions to these broad characterisations. It is possible to find companies which view governance as a learning journey—and they are not necessarily listed. Certain mainland asset managers have begun investigating how to integrate governance and ESG factors into their investment process. And there are a growing number of foreign investors, both boutique and mainstream, that have developed a deep understanding of the diversity among SOEs and POEs—and which have achieved excellent investment returns from SOEs as well.

Not surprisingly, however, our research has found that significant gaps in communication and understanding do exist between foreign institutional investors and China listed companies. According to an original survey undertaken by ACGA for this report, a majority of foreign investor respondents (59%) admitted that they did not understand corporate governance in China. Only 10% answered in the affirmative, while another 31% felt they "somewhat" understood the system. Conversely, it appears that most China listed companies do not appreciate the challenges that foreign institutional investors face in navigating "corporate governance with Chinese characteristics".

This report is written for both a domestic and international audience. Our aim is to describe in as fair and factual a manner as possible the system of corporate governance in China, highlighting what is unique, what looks the same but is different, and areas of genuine similarity with other major securities markets. The main part of the report focuses on "Chinese characteristics" and looks at the role of Party organisations/committees, the board of directors, supervisory boards, independent directors, SOEs vs POEs, and audit committees/auditing. Each chapter explains the current legal and regulatory basis for the governance institution described, the particular challenges that companies and investors face, and concludes with suggestions for next steps. Our intention has been to craft recommendations that are practical and anchored firmly in the current CG system in China—in other words, that are implementable by companies and institutional investors. We hope the suggestions, and indeed this report, will be viewed as a constructive contribution to the development of China's capital market.

The remainder of this Introduction provides an overview of key macro results from our two surveys. We start with the good news—that a large proportion of foreign institutional investors and local companies are optimistic about China—then highlight the challenges both sides face in addressing governance issues. The following chapters draw upon additional material from the two surveys.

ACGA survey – The big picture

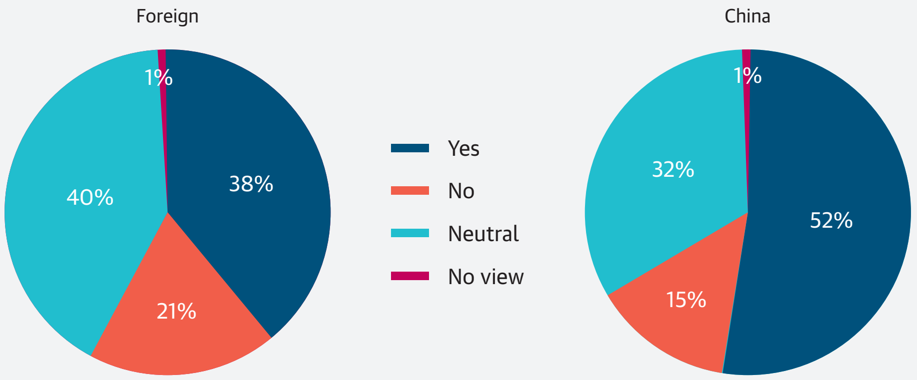
Are you optimistic?

The good news from our survey is that a sizeable proportion of both foreign investors (38% of respondents) and China listed companies (52%) are optimistic about the investment potential of the A share market over the next five to 10 years, as Figure 1.1 below shows. Only 21% of foreign investors are negative, while the remainder are neutral. Not surprisingly, only 15% of China respondents were negative, while almost one-third were neutral.

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?

Fig 1.1



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

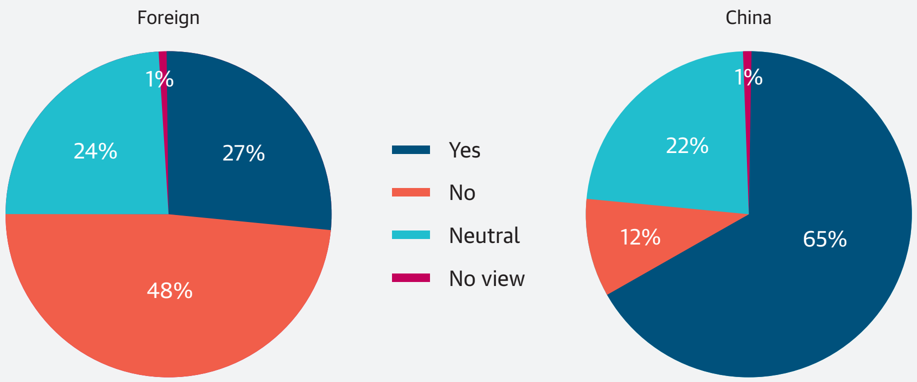
Do you agree with MSCI?

The picture diverges on the issue of whether MSCI was right to include A shares in its Emerging Markets Index in 2018: only 27% of foreign respondents agreed compared to 65% of Chinese respondents, as Figure 1.2, below, shows. Almost half the foreign respondents did not agree compared to a mere 12% for Chinese respondents. A similar proportion was neutral in both surveys.

Was MSCI right...

...to include A shares in its Emerging Markets Index?

Fig 1.2



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

Challenges – Foreign institutional investors

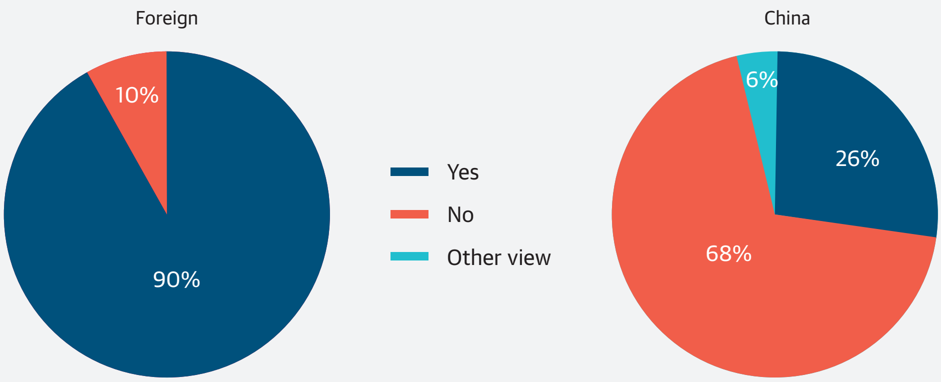
The investment process

Foreign investors face a range of challenges investing in China, the first of which is understanding the companies in which they invest. As Figure 1.3 below indicates, foreign investors do not rely solely on information provided by companies when making investment decisions, but utilise a range of additional sources. It appears that listed companies are not aware of this issue.

Delving deeper

Fig 1.3

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



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

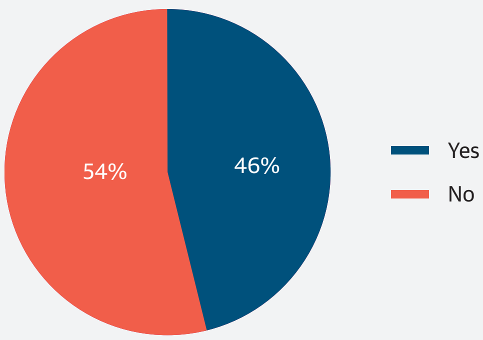
Company engagement

Globally, institutional investors seek to enter into dialogue with their investee companies. It is no different in China, as shown in Figure 1.4.

Company advocacy

Fig 1.4

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



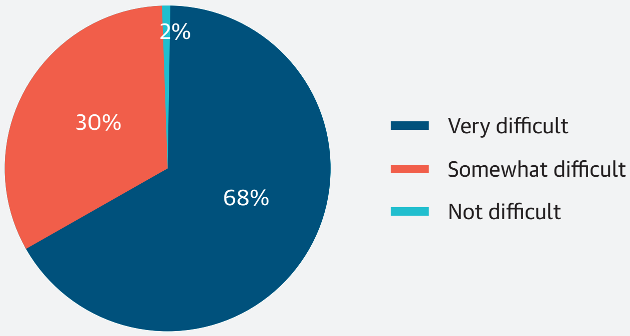
Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

But the process is not easy.

Hard going

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

Fig 1.5



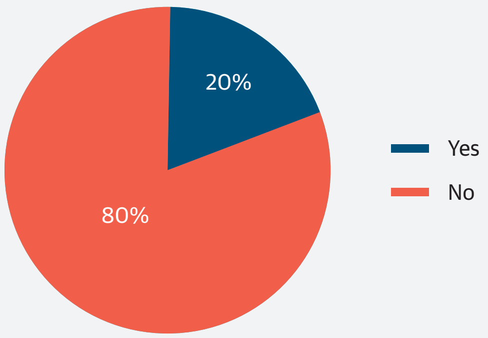
Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

And successful outcomes are fairly thin on the ground to date.

Low impact

Did company engagement by foreign investors lead to constructive outcomes?

Fig 1.6



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

Common threads

Respondents gave a range of answers as to why the process of engagement was difficult and successful outcomes limited, but some common threads were discernible:

- Language and communication: In addition to straightforward linguistic difficulties (ie, companies not speaking English, investors not speaking Chinese), the communication problem is sometimes cultural. As one person said, "Even though I am from China, it is hard to interpret hidden messages."
- Access: Getting access to companies can be difficult. Getting to meet the right senior-level person, such as a director or executive, can be even more challenging.
- Investor relations (IR): While some IR teams are professional, many are not. As one respondent commented: "IR (managers) are not very well trained and some of them lack basic understanding or knowledge of corporate governance or even financial information."

- CG as compliance: A common complaint is that companies view CG as merely a compliance exercise. Some refuse to give "detailed answers beyond the party line".
- Non-alignment: There is a recurring feeling that the interests of controlling shareholders in SOEs are not aligned with minority shareholders. One investor commented on the "lack of responsiveness" to outside shareholder suggestions, adding that SOEs "wait for government to give the direction, not investors".
- Lack of understanding: There can be a significant gap in the awareness of CG and ESG principles.

Empathy for companies

Conversely, a few respondents expressed empathy for the position of companies. As one wrote: "There also appears to be an under appreciation by international investors of the differences in culture, political context, and the path and stage of economic development between China and the rest of the world. Any attempt at influencing changes without a reasonable understanding of these differences is likely to be ineffective and (may) at times lead to unintended consequences."

Another explained some of the regulatory challenges facing listed companies: "With a few exceptions, both SOEs and POEs have to deal with stringent and ever-changing industry regulations and government policies."

A third said that some engagement had been positive: "Generally, where I have had access to the right people, engagement has been constructive. I suspect this is a result of the companies already appreciating the value of good governance in attracting non-domestic investors."

And perhaps the most positive comment of all: "A number of the Chinese companies we speak to, especially the industry leaders, already address ESG risks in their businesses. Most of them publish ESG reports annually, which help to set the benchmark for their industry and also to garner positive feedback from society and hence, end-customers. Some of such companies end up enjoying a pricing premium on their products once this positive brand equity has been established. This creates a virtuous cycle, where ESG becomes part of their corporate culture. They understand that for the long-term sustainability of their business, and for the benefits of all their stakeholders, such investment can only enhance their competitiveness."

Brave new world of stewardship

Yet most investors still find engaging with companies a challenge. A further reason may be that China is one of only three major markets in Asia-Pacific that has not yet issued an "investor stewardship code". Such codes push institutional investors to take CG and ESG more seriously, incorporate these concepts into their investment process, and help to enourage greater dialogue between listed companies and their shareholders (see Table 1.1, opposite). In recent years, the bar has been quickly raised on this issue in Asia and expectations have risen commensurately.

Without an explicit policy driving investor stewardship, it is unlikely that the average listed company will give proper weight to a dialogue with shareholders. As one foreign investor said: "Generally speaking, it is relatively easier to engage with bigger listed companies. SOEs and larger companies tend to be more responsive. SOEs have more incentive to do so following government guidelines and trends."

A key question to ask is who within a company should be responsible for engaging with shareholders? The short answer is the board, as a group representing and accountable to shareholders. Indeed, on a positive note, our survey found that most Chinese listed companies do admit that the responsibility for talking to shareholders should not be placed solely on the investor relations (IR) team (see Figure 1.7 opposite). But given that delegating this task to IR remains a common practice, it would appear that there is an inconsistency between words and actions here.

Spreading
Investor stewardship codes in Asia-Pacific

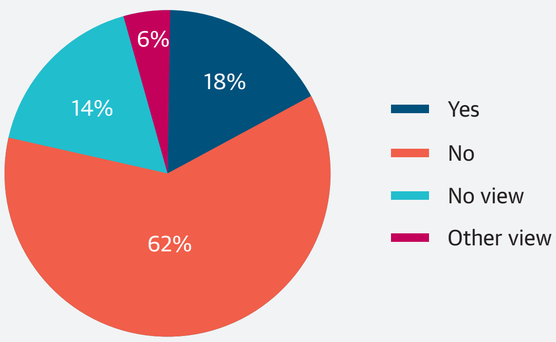
Tab 1.1

Market	Date of Adoption	Comply or explain?
Japan	February 2014 (revised 2017)	Yes
Malaysia	June 2014	Yes
Hong Kong	March 2016	Voluntary
Taiwan	June 2016	Yes
Singapore	November 2016	Voluntary
Korea	December 2016	Yes
Thailand	February 2017	Yes
India	March 2017 (for insurers only)	Yes
Australia	2017 and 2018 (two industry codes)	Yes
China	-	-
Indonesia	-	-
Philippines	-	-

Note: Only markets covered by ACGA are included in this table.
***Source:** ACGA research*

Communication channels
Do China listed companies think investor relations is the only group responsible for talking to shareholders?

Fig 1.7



***Source:** ACGA China Listed Company Perceptions Survey 2017*

Challenges – China listed companies

Some additional factors clearly play on the willingness of companies to take CG and ESG seriously, as Figures 1.8 and 1.9 below show.

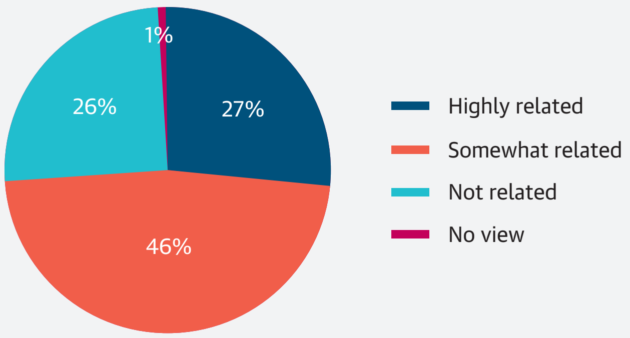
Does the market reward good CG?

Only 27% of the respondents to our China listed company survey believe there is a close correlation between good corporate governance and company performance. Another 46% think they are "somewhat related", while a quarter see no relationship. These results broadly align with the view common in most markets, including China, that only a minority of companies (usually the large caps) feel incentivised to improve their governance practices and that they will be rewarded by investors if they do so.

CG and performance

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

Fig 1.8



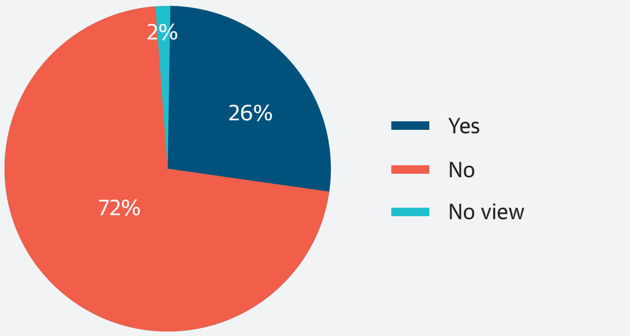
Source: *ACGA China Listed Company Perceptions Survey 2017*

Even more concerning is the largely negative view on whether better governance helps a company to list.

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?

Fig 1.9



Source: *ACGA China Listed Company Perceptions Survey 2017*

As an aside, this might also help to explain why listed POEs in China are generally not seen as being a better investment proposition or as having better governance than SOEs—an issue we explore in Chapter 3.5.

Only 23% of foreign respondents said they preferred investing in POEs over SOEs, while two-thirds said they did not. Meanwhile, only 10% of China listed companies thought POEs were better governed than SOEs. Around one-third thought they were about the same, while 54% thought POEs were worse.

Even so, in a fast-growing market such as China, there is a risk in taking a static or one-dimensional view.

'Companies will have to become more ESG aware'

We conclude this section with a wide-ranging comment from a China-based institutional investor on the need to see governance and ESG as a process:

> Chinese companies are generally financial weaker than their more established peers in developed markets. This is a symptom of markets being at different stages of development. For Chinese companies, survival is the top priority. Once they have gained enough market share and accumulated a certain level of capital reserves, they will start to consider ESG issues. This will help them cement their market position and grow more healthily in the long term.
>
> At the moment, we recognise that the cost of not practicing ESG is not high in China. But things are changing, especially on the environmental front. We can see that the government is very serious about closing down small players who are not compliant with emission standards. The quality of air, earth and water concerns the livelihood of every citizen, and we believe that there will be heightened enforcement of pollution laws.
>
> Corporate governance is also improving as public shareholders get more actively involved in major corporate actions. Having said that, shareholder structures remain highly concentrated, especially for SOEs in China, and external forces may not be strong enough to ensure a proper division of power.
>
> We see increasing numbers of entrepreneurs and companies more willing to give back to society and the challenge here is simply that philanthropy is quite new in China.
>
> As society becomes more civilised and consumers become more aware of issues such as child labour and environmental pollution, Chinese companies will have to become more ESG aware and responsible.

Interview: 'Character and quality of management is critical'

David Smith CFA
Head of Corporate Governance, Aberdeen Standard Investments Asia, Singapore

What is your view on investing in A shares?

We have an A share fund, so naturally, we have spent substantial time and effort getting comfortable with both the market and the companies. There are well-documented risks surrounding investing in China, but the market has obvious attractions China is leading the world in some of the sectors, like e-commerce, for example. As investors, we always have to balance return with macroeconomic risk, political risk, regulatory risk, and so on, and this is certainly the case for China.

What is your view on stock suspensions in China?

The situation is getting better but companies too often still choose to suspend given a pending "restructuring", which protects potential investors at the expense of existing investors, something that can be incredibly frustrating given how long we can be locked up for. There is a general misunderstanding in China as to what suspension means: companies should only suspend when there is information asymmetry, not when there is uncertainty. We are paid to analyse and deal with uncertainty, and the market will find a price for it. If companies have to suspend whenever there is uncertainty, we won't have a stock market in place.

In general, there are too many suspensions in China. If a company has a restructuring plan or a regulatory investigation is going on, it should just disclose this through an announcement; as long as everyone in the market knows the same information, the stock should keep trading. The issue of price-sensitive information has already been taken care of by regulations around continuous disclosure, so a suspension is often not protecting anyone, it just removes liquidity for existing investors. This issue is exacerbated by the bizarre and unusual situation of dual-listed A/H share companies suspending on one exchange and not the other

In developed markets, in contrast, suspensions of issuers lasting more than a month for whatever reason are very rare. Part of the issue is also that promoter shares might sometimes have been pledged, so promoters want to avoid a share price fall triggering a margin call.

What are the top CG issues you have observed in Chinese companies?

Entrepreneur risk (people risk) is the most obvious one, including related-party transaction risks, along with operational and execution risks. For Aberdeen, we never invest if we feel uncomfortable with the founder or management. Both the character and quality of the people inside the company is something we value a lot in our investment decision-making process.

Regulatory risk is another issue. Changes in regulations can affect not just SOEs but also POEs to different extents. For example, the recent regulatory change on the reinforcement of Party committees inside Chinese companies is not what foreign investors expected to see as the direction of corporate governance development in China.

Another issue is that given more and more onus put on independent directors, maybe we need to think about another way to elect them. The current situation involves voting for independent directors on their independence, rather than competence. However, "independence" can be easily gamed in Asia. Many independent directors are structurally independent but rely on the company for their living (pension), so investors are increasingly asking if/how they add value to board discussions.

What is your view on voting trends among China listed firms? Does voting lead to engagement

Not much has changed. Any voting against has tended to focus on resolutions like related-party transactions, or other corporate actions, rather than issues across the board.

Engagement is getting a little bit better in China. We have seen more and more companies listening to us, and dialogue is getting much better. Companies increasingly understand that we are not in China for the short-term and that our interests are aligned. That certainly helps.

1.2 Methodology

A tale of two surveys

The two surveys in this report, the "ACGA Foreign Institutional Investor Perceptions Survey 2017" and the "ACGA China Listed Company Perceptions Survey 2017", were developed internally in the first half of 2017 and carried out over 21 July to 1 September of that year. They were distributed through ACGA's global network of members and contacts, and by a number of supporting organisations both inside and outside China (see the Acknowledgements page for details).

Purpose

We decided to conduct a survey at the preliminary stage of this project for two main reasons. The first was to add a broader range of perspectives to the report and to complement the extensive research carried out by ACGA and our contributing authors.

The second was to develop new data on corporate governance in China. When we began researching this report, we found that much of the information on board structures and governance practices in China was out of date, incomplete or non-existent. We developed the survey to partially fill this gap. To complement this information, we turned to data providers such as Wind and Valueonline to provide raw data on which we could do original analysis—and we carried out our own reviews of specific governance practices among large listed companies.

Foreign Institutional Investor Perceptions Survey

The Foreign Institutional Investor Perceptions Survey contained 22 questions and focused on areas that we believe are relevant to China's investment potential and governance. They can be divided into the following categories:

- Macro questions, such as capital market development, MSCI inclusion, SOEs vs POEs, and mainland-listed vs overseas-listed firms.
- Shareholder rights, including investor protection in China vs overseas.
- Company governance, including corporate reporting, role of chairman, independent directors, supervisory boards.
- Role of government, including appointment of chairmen, intervention in SOEs and POEs, the role of the Party organisation/committee.
- Investor engagement with companies.

Several of the questions provided options for respondents to give detailed answers and, where relevant, these comments are incorporated into our text.

The survey was developed by ACGA in Q2 2017 and first tested with a select group of ACGA global investor members in June of that year. It was refined based on feedback received before being sent out electronically in July. The recipients were primarily drawn from among ACGA's list of institutional investor members based in Asia and around the world. This was complemented by recipients from our supporting organisation membership networks.

In total, we received 155 complete and comparable responses. Partial responses were not counted.

Based on information gathered about respondents' titles, they fell into three broad groups: CEOs, directors, managing directors or partners; portfolio managers and analysts; and managers or specialists in CG, ESG or stewardship. A large proportion held senior roles in their organisations.

The total assets under management (AUM) of all respondents amounted to around US$40 trillion, with the range from US$20m to US$6 trillion. In other words, a mix of both boutique investment managers and large mainstream institutions.

China Listed Company Perceptions Survey

The China Listed Company Perceptions Survey contained 12 questions and likewise focused on areas that we believe are relevant to such companies, their directors and managers. While there were fewer questions in this survey, they covered similar categories as in our foreign survey, namely macro issues, company governance, role of government, and investor engagement.

We designed some questions to be identical to the Foreign Institutional Investor Survey, in order to allow direct comparisons between corporate and investor perspectives on the same issue.
We also asked some unique questions of companies, such as whether or not they see a close correlation between corporate governance and performance, and whether better governance helps a firm list its shares.

The survey recipients were drawn from among ACGA's corporate membership base, as well as clients and contacts of supporting organisations.

In total, we received 182 complete responses from which we extracted the survey results.

Most respondents held senior positions in their companies such as directors, executives, board secretaries and senior managers. Most of the companies represented have been listed in China for more than five years and have a market cap of more than Rmb5 billion (US$800m approx).

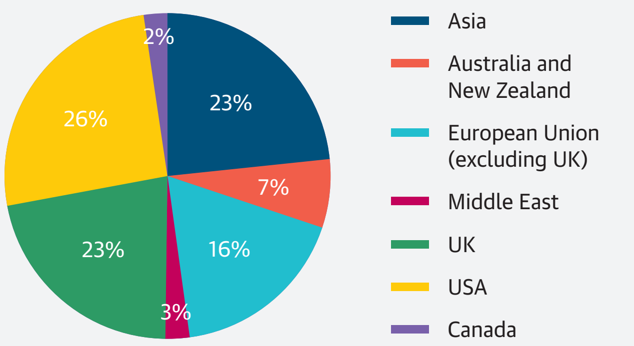
Further demographic data on the two groups of respondents follows:

Foreign respondents

The foreign institutional investors who responded are mostly from the US, UK, Asia and the European Union, as shown in Figure 1.10 below. The response is consistent with the distribution of ACGA members by region. Investors from Australia, New Zealand, the Middle East and Canada also responded to the survey.

Location of respondents
Foreign institutional investors

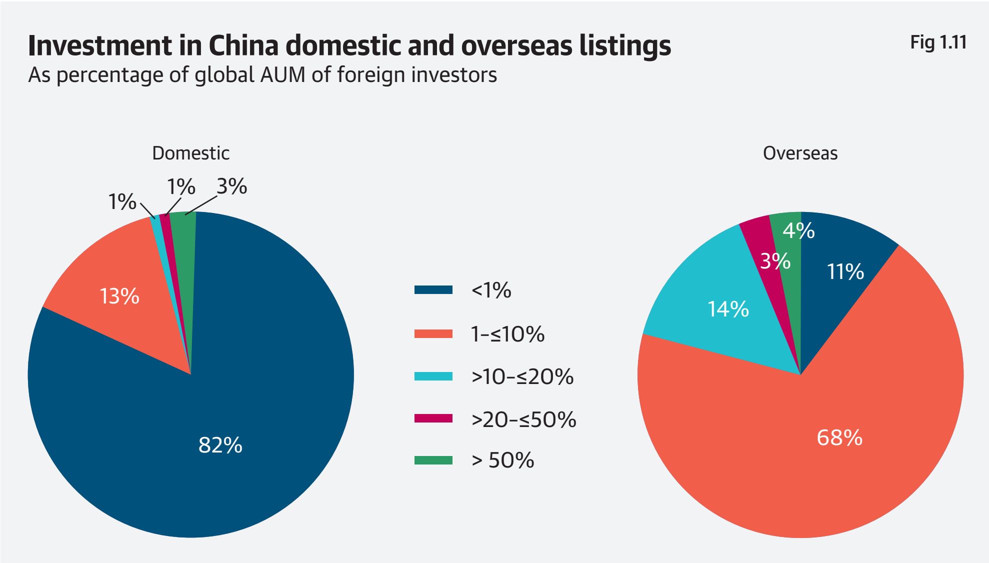
Fig 1.10



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

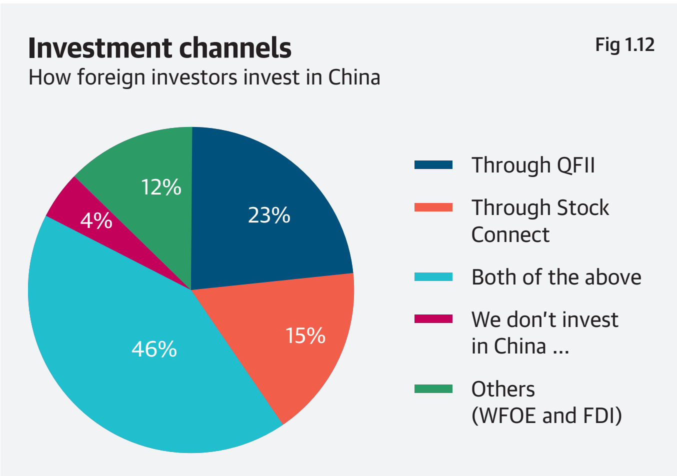
In terms of their global AUM, the vast majority of respondents have less than 1% invested in China A shares, while a significant minority have between 1% and 10%. Very few have more than 10% of their funds invested in China domestic listings, although interestingly a few have more than 50%. The latter would be smaller investment managers with a dedicated China focus, as shown in Figure 1.11, opposite.

The picture changes markedly when overseas-listed Chinese firms are taken into account: the majority of foreign respondents allocate between 1% to 10% of their global AUM to such companies and a sizeable proportion, about one-fifth, invest more than 10%.



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

How do foreign investors invest in China? As Figure 1.12 below shows, around a quarter go only through the Qualified Foreign Institutional Investor (QFII) scheme, 15% only through Stock Connect, and almost half through both channels. Interestingly, a significant minority invest directly through wholly owned foreign enterprises (WFOEs) or other foreign direct investment (FDI) channels.



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

China respondents

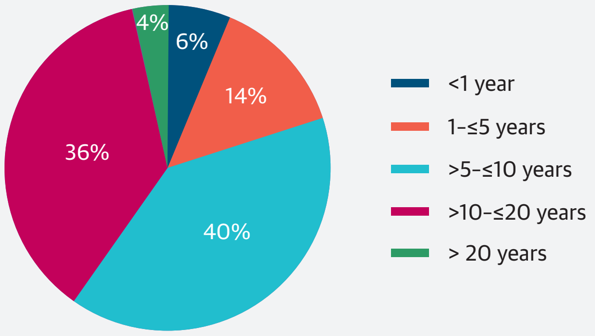
Most respondents to our China Listed Company Perceptions Survey work for a company that has been listed for more than five years. Around 40% of the companies have been listed for more than 10 years, which is a relatively long period given that the Chinese stock market is still less than 30 years old (see Figure 1.13, overleaf).

The market cap of 54% of respondents' companies was more than Rmb5 billion, as highlighted in Figure 1.14, overleaf, and 19% have a market cap of more than Rmb10 billion. Generally, the larger firms are likely to be SOEs.

Listing history of China respondents

Fig 1.13

How long has your firm been listed in China?

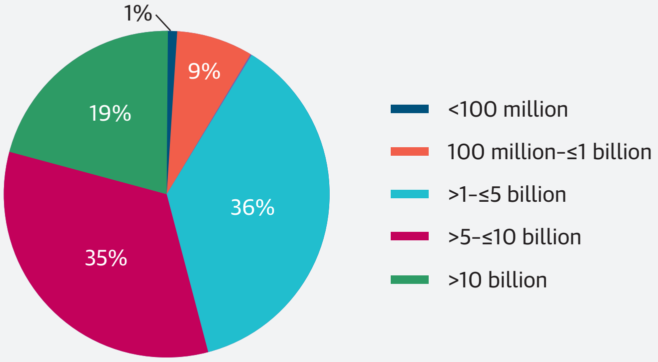


Source: *ACGA China Listed Company Perceptions Survey 2017*

Market cap

Fig 1.14

China respondents (Rmb)

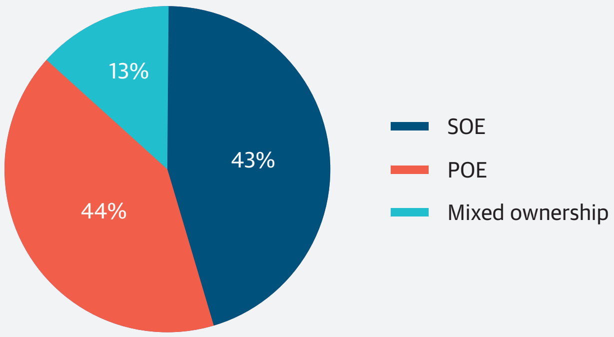


Source: *ACGA China Listed Company Perceptions Survey 2017*

Ownership type

Fig 1.15

China respondents



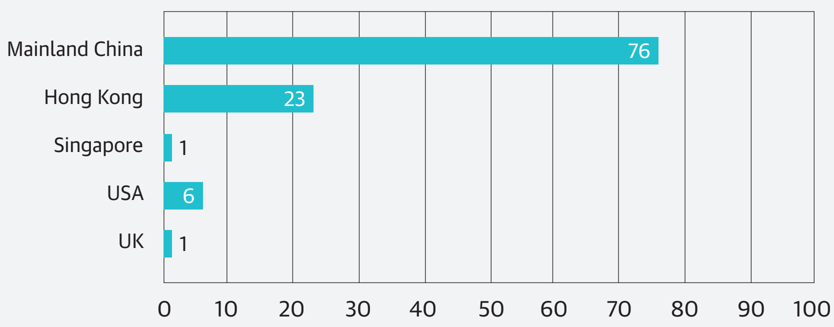
Source: *ACGA China Listed Company Perceptions Survey 2017*

In terms of ownership, the distribution of respondents falls evenly between SOEs and POEs, with 13% being of a "mixed-ownership" type (see Figure 1.15, opposite). This gives us confidence that the survey results incorporate a range of views from different participants in the Chinese market.

As for where respondents' companies are listed, Figures 1.16 and 1.17, below, highlight that almost 60% are listed in a single jurisdiction. Mainland China comes first, not surprisingly, followed by a reasonable number in Hong Kong. Only a few respondents work for Chinese companies listed in Singapore, the US and the UK. Regarding the remaining companies listed in more than one jurisdiction, again the most popular venue is a dual-listing in China and Hong Kong, followed by a listing in China and the US. Some companies have a listing in China, Hong Kong and the US.

Companies listed in one market
Number of companies (59% of sample)

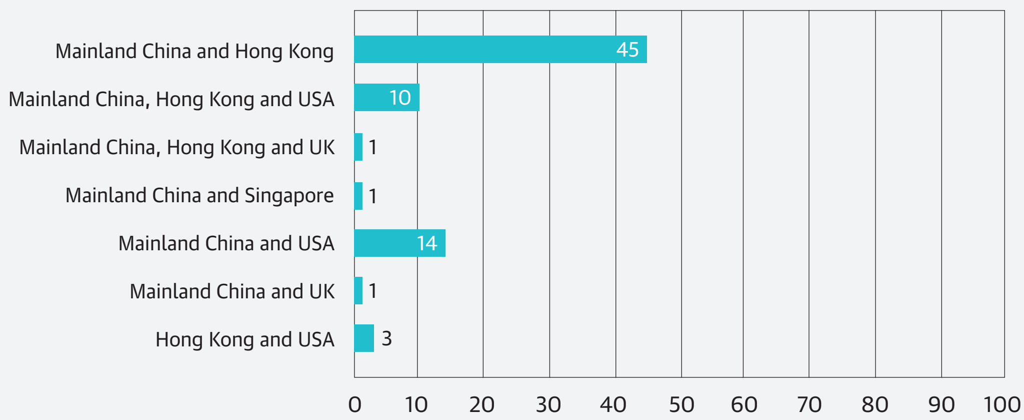
Fig 1.16



Source: *ACGA China Listed Company Perceptions Survey 2017*

Companies listed in two or more markets
Number of companies (41% of sample)

Fig 1.17



Source: *ACGA China Listed Company Perceptions Survey 2017*

攻集背景

Chapter Two

Policy Backgrounder

2.1 Policy and Regulatory Backgrounder

In the early years of its capital market development, China leaned strongly towards adopting "global standards" of corporate governance. While this helped to build credibility among international investors, practical and political imperatives have dictated a need to find local solutions as well. China today has a hybrid policy framework and more coordinated regulatory agencies.

Introduction

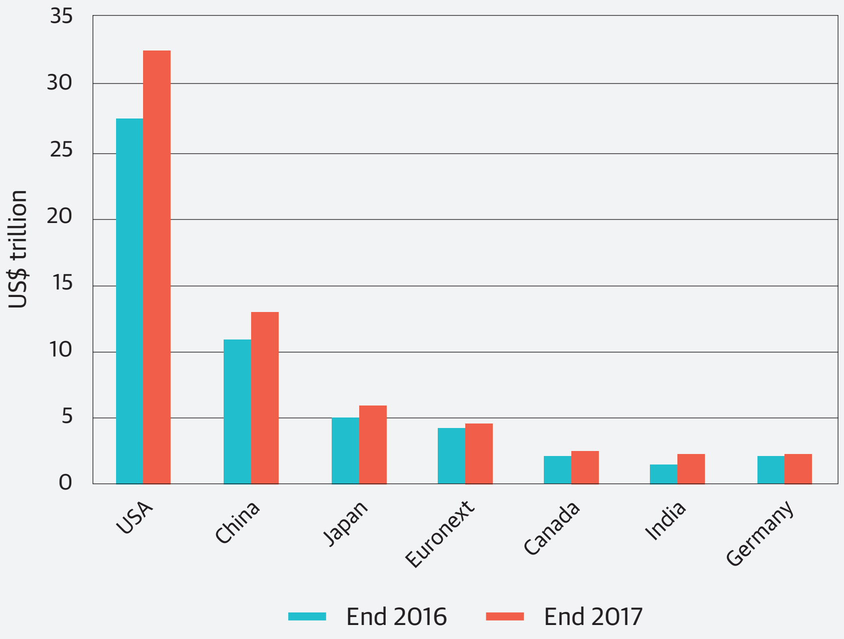
A useful starting point for viewing the history of corporate governance reform in China in recent decades is through the lens of convergence and divergence with "global standards". As a relatively new entrant to the current global capital market, China has needed to accommodate international norms to attract foreign funding for its national economic development and state-enterprise restructuring. Its forays into the global capital market have been highly successful, with large and growing listings of both state and private enterprises at home and abroad. Two data points among many give a feel for this dramatic change: 27 of the 50 stocks on Hong Kong's Hang Seng Index, which tracks the largest and most liquid stocks, are mainland owned and controlled; and 16 of the 20 most highly traded stocks on the Hong Kong stock exchange are now mainland firms.

It would be fair to say that from the early 1990s to the mid-2000s, the dominant corporate governance reform trend in China was towards global standards. During the late 1990s and early 2000s, Chinese financial regulatory officials were avid participants in global corporate governance conferences and, after extensive research, transplanted numerous foreign best practice concepts into its laws, regulations and guidelines. The shock and disappointment of the Global Financial Crisis over 2007 to 2009 brought an understandable cooling in official enthusiasm for "Western" corporate governance ideas—although it could be argued the reassessment began earlier, as authorities realised that the global governance canon did not contain solutions to all of China's complex and sometimes unique problems. The last decade has often seen China turning inward for answers and exhibiting more confidence in solving its own challenges. The reinforcement of the role of the Party committee in listed and even unlisted enterprises is probably the pinnacle of this trend.

Yet as a huge economy with the second largest domestic equity market in the world (see Figure 2.1 overleaf), and with an increasing number of firms going abroad to invest and acquire, there is little chance that the local/global dynamic will disappear from policymaking any time soon. Indeed, other recent policy initiatives suggest that China is seeking a new level of engagement with the international investment community. The emphasis placed on big picture issues such as the environment and climate change place China within an international dialogue. It is determined to lead on green finance. And the Stock Connect schemes allow for cross-border investing in shares listed in Hong Kong—and vice-versa—despite the continuation of capital controls.

It is also important to highlight the often differing views within the Chinese government over the direction of capital market reform, the role of the state, and the management of SOEs, among other things. Policy is not made in a monolithic echo chamber. The travails of major policy initiatives like the "IPO registration system", based on the US system, are instructive. This was proposed to make the process of listing less bureaucratic and more efficient than the current approval system. Proponents claimed it would solve China's backlog of listing applicants, but opponents said the country was not ready for such a system. In the end, it has been delayed. Similar debates are going on over the future of variable-interest entity (VIE) structures, SOE governance reform, the degree to which the role of Party organisations in listed companies should be disclosed, IPO moratoriums,

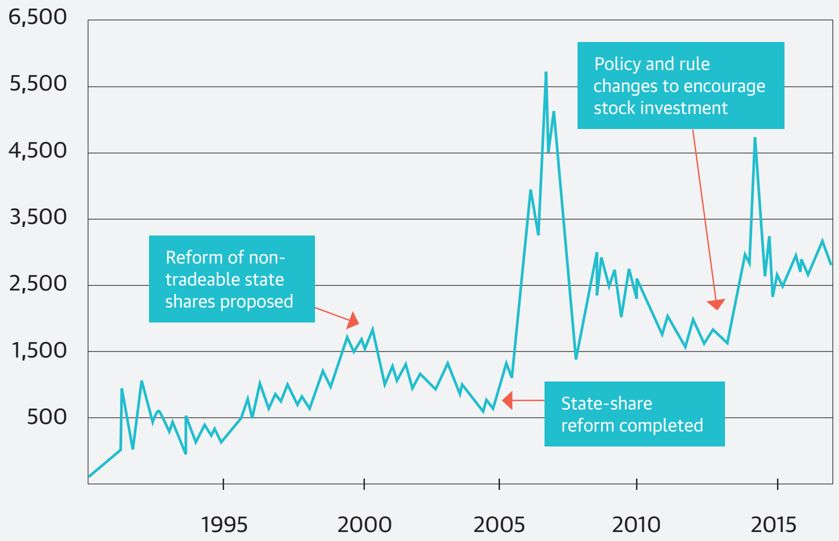
Biggest domestic equity markets globally Fig 2.1
Aggregated by country, 2016–17



Note: USA = NYSE and NASDAQ; China = SSE, SZSE and HKEX; Japan = JPX; Euronext = pan-European exchange: Belgium, France, the Netherlands, Portugal and the UK; Canada = TMX, India = BSE, Germany = Deutsche Borse
***Source:** World Federation of Exchanges, ACGA analysis*

stock suspensions, and many other issues. While these policy areas may seem esoteric, the long-term success of China's capital market will be affected by the way in which these debates play out. An added complication is that the dominance of retail investors in stock trading means that the market is highly sensitive to policy messages and changes of direction, as Figure 2.2 below shows.

Volatile Fig 2.2
Shanghai composite stock market index
1990–2018



***Source:** Trading Economics*

Historical trends

In broad terms, corporate governance reform in China has passed through four waves over the past four decades, with each wave conveniently overlapping to a reasonable degree with each decade.

The 1980s: Experimenting with markets[1]

Although China's "shareholding experiment" reportedly began in the countryside following a state policy allowing rural enterprises to sell shares in late 1979, the first wave really picked up momentum over 1984 to 1986 with the creation of new corporate forms, the issuance of shares by urban enterprises, and the creation of the first securities companies. The first public offering of shares is credited to a Shanghai-based firm in 1984, while over-the-counter trading followed in Shanghai in the mid-1980s. The first securities exchange opened in Shenyang in 1986 and then Shenzhen Development Bank undertook a landmark IPO in 1987, with a portion of the offering denominated in Hong Kong dollars. Its announcement of a generous dividend in 1989 helped to ignite "share fever".

The 1990s: Formalising markets[2]

The second wave took off with the formation of stock exchanges in Shanghai in December 1990 and Shenzhen in July 1991, exactly 100 years after the Shanghai Stock Exchange was first established in 1891. All new issues and listings were subsequently restricted to these two exchanges. The primary policy objective was to facilitate SOE restructuring and reduce pressure on bank lending. In this way a "modern enterprise system" would be created and state firms given a degree of autonomy from government. In practical terms, this was intended to mean reducing administrative intervention, majority shareholder interference and connected transactions.

Other key dates during this period include:

- May 1992: Government issues the "Standard Opinion" on SOE corporatisation and listing, which introduced a distinction between "tradeable" and "non-tradeable" state shares.
- October 1992: First overseas IPO—Brilliance China Automotive on the New York Stock Exchange (NYSE).
- October 1992: The China Securities Regulatory Commission (CSRC) formed. It began overseeing the Shanghai and Shenzhen Exchanges in July 1993. Elevated to ministerial status in 1998.
- July 1993: Tsingtao Brewery becomes the first SOE "H share" to list in Hong Kong. Investment bankers deal with the sensitive issue of the Party organisation by not mentioning it! A pattern is thus set in train until 2017, when H shares start amending their articles to formalise the Party organisation.
- December 1993: First Company Law passed in National People's Congress. Becomes effective in July 1994.
- August 1994: State Council issues "Special Regulations" raising governance standards of overseas offerings, followed by the "Mandatory Obligations".
- December 1998: First Securities Law passed in National People's Congress. Becomes effective in July 1999.
- March 1999: CSRC issues new "Opinions on Further Improving the Standard Operation and Deepening Reform for Listing Overseas".
- September 1999: First IPO of a commercial bank since 1987: Shanghai Pudong Development Bank.

The 2000s: Experimenting with global standards and local solutions

The third wave began in the early 2000s when the CSRC, under the leadership of Zhou Xiaochuan (later governor of the People's Bank of China) issued landmark regulations for companies listed in China. While much of the regulatory focus in the 1990s had been on preparing the first state enterprises for restructuring and mandating that those listing overseas meet higher governance standards, in the 2000s the attention turned squarely on raising the quality of domestically listed firms and banks.

A major challenge in the first half of this decade was how to reform the system of "non-tradeable state shares", the large blocks of stocks owned by the state and which could not be traded by enterprises. The enduring fear, which weighed heavily on investor sentiment, was that the government might suddenly allow these shares to be traded and the market would be flooded, driving down prices. When the CSRC mulled a policy change in the early 2000s, the markets plummeted—and did not stop sliding, as Figure 2.2 on page 22 shows, until the issue was resolved in the mid-2000s.

This period was also characterised by China creating new institutions to address management and governance challenges in SOEs. The key organisation here has been SASAC, which stands for the "State-owned Assets Supervision and Administration Commission". Headquartered in Beijing, provincial and local level SASACs were also formed.

Key dates during this decade included:

- April 2001: CSRC introduces mandatory quarterly reporting.
- August 2001: CSRC introduces new rules on independent directors.
- January 2002: CSRC publishes the "Code of Corporate Governance for Listed Companies".
- 2004/5: SASAC launches pilot scheme setting up boards of directors in central SOEs.
- 2005: China Banking Regulatory Commission (CBRC) issues its first CG guidance for commercial banks.
- 2005/6: Company and Securities Laws amended and take effect.
- 2005/6: Reform of non-tradeable, government-owned shares ("G shares") undertaken. Minority shareholders allowed to vote on the plan.
- 2007: Convergence of domestic accounting and auditing standards with IFRS and ISA.
- 2006: Shenzhen Stock Exchange releases guidance on CSR reporting.
- 2008: Shanghai Stock Exchange releases guidance on CSR reporting.
- February 2009: A revised Criminal Law provides tougher penalties for insider trading. The CSRC[3], Shanghai Stock Exchange[4] and Shenzhen Stock Exchange[5] issued related regulations to crack down on such trading.

Another local solution implemented during this decade with mixed success was the "IPO moratorium", a complete ban on new listings so as to calm the market and stop liquidity rushing out of existing stocks and into new issues. This policy had first been tried out in the mid-1990s with some success: markets rallied strongly after the first moratorium in the latter half of 1994, though less strongly after the second one in the first half of 1995. Moratoriums in 2001 and 2004 (to early 2005) did not achieve the desired bounce, but the longest IPO stop from May 2005 to January 2006, prior to the G share reform, was followed by a robust market rebound.

The 2010s: Emphasising local priorities

The fourth wave picked up momentum following Xi Jinping's elevation to the position of General Secretary of the Communist Party of China (CPC) in November 2012 and President in March 2013. State policy since then has emphasised an anti-corruption drive, SOE reform, and the reinforcement of Party organisations in state enterprises, listed companies and other major companies, including private-sector firms. These policies are all connected by the philosophy that China's systems of public and corporate governance need a firmer guiding hand from above, namely that of the CPC, to avoid the excesses of the past and ensure those in positions of authority act ethically and responsibly.

Other reforms during this period are extensions on what has gone before. For example, the decade began with new regulations in 2011 to increase penalties for false disclosure of information. The current 13th Five-Year Plan (2016-2020) puts a strong focus on green finance and environmental improvements. More recently, there has been a strong focus on the need for domestic investment managers to take account of ESG factors in their investment process. And in June 2018, the CSRC published a consultation draft of a long-awaited revision to the Code of Corporate Governance for Listed Companies from 2002. While it still takes the OECD Principles as a point of reference, the new Code incorporates the Party organisation for the first time.

One issue that is new is the thorny problem of the variable-interest entity (VIE) corporate structure. These have been used by private firms raising capital for entities operating in restricted sectors of the economy, such as telecoms and internet services, and listed typically in Hong Kong or New York. In 2015, the Ministry of Commerce (MOFCOM) released a revised Foreign Investment Law for consultation that proposed significant changes to the way in which VIEs would be regulated (see 'VIE: Very interesting equity' on page 26). MOFCOM has yet to release a final version of the law.

Without question, however, the biggest challenge for China's capital market during the 2010s has been the June 2015 stock market collapse. Stoked in part by official encouragement and policies to allow insurance companies to increase their investment in equities, the rapid boom and bust highlighted a range of underlying problems in regulation and market behaviour: excessively flexible rules on stock suspensions, the role played by shadow banking in margin lending, and an extreme short-term investor focus, among others.

Other key dates during this decade include:

- July 2013: CBRC issued new guidelines on corporate governance for commercial banks, with stricter rules on the time that independent directors and supervisors should spend in banks each year, among other things.
- November 2013: Third Plenary Session of 18th CPC Central Committee issued four new policies to deepen SOE reform.[6]
- September and December 2015: The Shanghai and Shenzhen exchanges issued guidelines for information disclosure by industry/sector, including key performance indicators for each.
- March 2018: A major reorganisation of state ministries and agencies is announced, including a merging of the banking (CBRC) and insurance (CIRC) regulators into the CBIRC.

VIE: Very interesting equity

"VIE" stands for "variable interest entity" and is a term originally used by the Financial Accounting Standards Board (FASB) in the US. It refers to control of an entity through contracts that simulate equity ownership, hence can also be called "contractual control" or control through "structured contracts". Such contractual control requires the primary beneficiary to consolidate the accounts of a VIE into their financial statements. This is accepted by US GAAP and confirmed in FASB Interpretation No.46.[15]

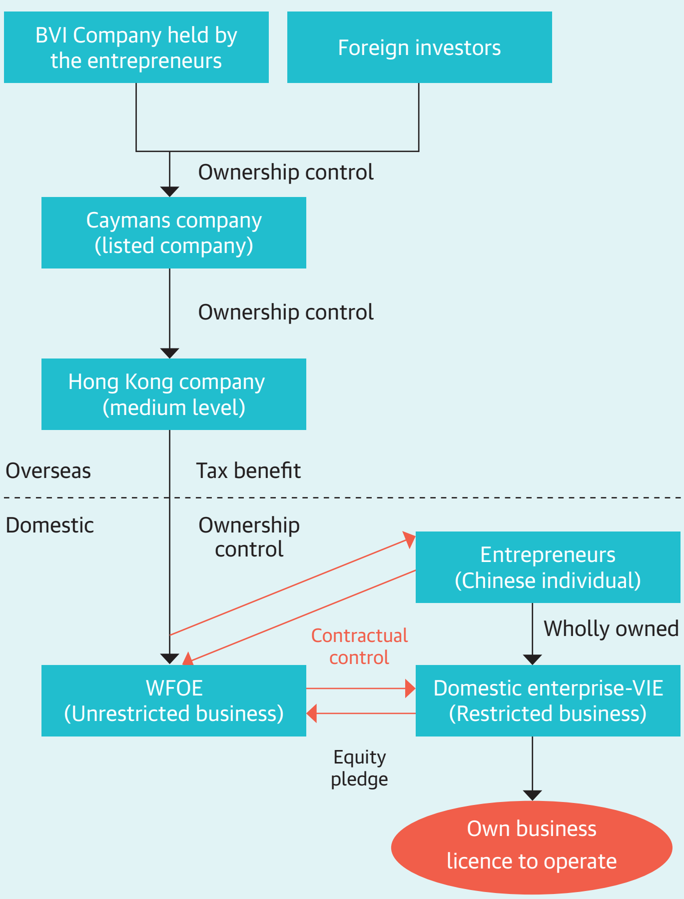
The VIE structure originated in China with the listing of Sina.com, an online news provider and owner of the micro-blogging site, Weibo, in New York in 2000. According to Reuters, 95 of the more than 200 Chinese companies listed on the New York Stock Exchange and Nasdaq had adopted a VIE structure by 2015. Other big names using this corporate form include internet giants such as Baidu, Alibaba and Tencent, which is listed in Hong Kong. Indeed, the VIE structure is common in Hong Kong too and was used in late 2017 by China Literature, a subsidiary of Tencent.

The rationale for creating these structures is quite simple: Chinese government policy prohibits or restricts foreign investment in many domestic industries, such as telecommunications, media and publishing, technology and so on. But many companies in these industries, especially privately owned firms, have seen tremendous growth over the past 10 to 20 years and needed capital support. Yet they had trouble raising funds domestically because A share listing rules set a profitability requirement that many early stage companies could not meet. This pushed entrepreneurs into raising funds offshore.

The structure

Generally in a VIE, a natural-person entrepreneur will set up a BVI company as his personal shareholding entity and then set up a Caymans company. The Caymans firm will act as the main investment holding company entity, which will bring in outside financial investors through a listing in Hong Kong or the US. If the listing is in Hong Kong, the Caymans holdco may also form a wholly-owned subsidiary registered in Hong Kong, which will in turn register a wholly foreign-owned enterprise (WFOE) in mainland China. The reason for the intermediate Hong Kong company is to enjoy certain dividend tax benefits under the tax treaty between China and Hong Kong. At the same time, or earlier, the Chinese entrepreneur will establish one or more domestic operating companies that hold licences to carry out business in the prohibited or restricted sectors. The ownership of these operating companies will be in the hands of the same entrepreneur(s) and the

A typical VIE structure Fig 2.3



Source: ACGA Research

equity must be held by Chinese citizens. Foreign ownership at the operating company level is not permitted.

Given that the listed entity incorporated in the Caymans owns no assets in China, how does it enjoy the economic benefits flowing from the operating companies? It does so through a series of contracts between the WFOE, which the listed entity does own, and the operating companies. These contracts typically specify a number of things, all designed to protect the listed entity/WFOE:

- That all residual earnings/cashflow of the operating companies are passed to the WFOE in return for the latter providing management and consulting services, intellectual property, R&D support, and so on.
- That the equity of the domestic operating companies is wholly pledged to the WFOE.
- That full ownership of the intellectual property rights of the domestic operating companies will vest with the WFOE.
- That the domestic operating companies are prohibited from entering new business lines in China unless permitted to do so by the holding company/WFOE.

Risks

There is one major and one minor risk to the VIE structure in China. The major risk is that the Chinese government has never issued detailed provisions regulating VIE structures and it would appear that many of these businesses conflict with at least the spirit of state policy prohibiting or restricting foreign investments in certain sectors. VIEs operate in a legal grey area where the "absence of legal prohibition means freedom".

In 2015, the Ministry of Commerce (MOFCOM) released for consultation a revised version of the Foreign Investment Law. This essentially suggested that VIEs controlled by PRC citizens would be acceptable, while those controlled by foreign-invested enterprises would not. In the parlance of PRC Contract Law, it is not permissible to "conceal illegal intentions with a lawful form". Yet the draft law, which has yet to be released in final form, did not address some key issues: how existing VIEs would be treated; and how to deal with VIEs in which neither a PRC citizen nor a foreign entity has outright control of the company or its board.

Nevertheless, all the prospectuses of VIE listing applicants contain assurances from PRC lawyers that the company's structure does not transgress mainland law as it currently stands and all the contracts are valid. They also contain warnings that policy and/or regulatory changes may make their business models invalid at some point in the future. At the same time, there is a market consensus that it would not be in China's interest to ban all VIEs, since this would significantly harm many of the country's large private firms and damage its rapidly growing internet and telecoms sectors.

The minor risk is the possibility of a business or personal split between the listed holding company/ WFOE and the operating companies. Most VIEs deal with this possibility through both watertight contracts covering every future eventuality, as highlighted above, and by ensuring that the entrepreneurs behind the listed entity are also the owners of the domestic operating companies. Yet it is worth reading prospectuses carefully: one recent VIE listing in Hong Kong admitted that a dispute resolution provision built into its contracts "may not be enforceable under the PRC laws".[16]

Current policy areas

Four pillars of SOE reform

The four pillars of SOE reform enunciated by the CPC Central Committee in November 2013 sought to move SOE reform forward in the following ways:

1. Strengthen supervision of state-owned assets by "giving priority to capital management";
2. Clearly define the functions of different SOEs;
3. Improve the "legal-person" governance structure; and
4. Actively develop the mixed-ownership economy.

This decision was followed by a range of support measures.

Capital management

The policy of giving priority to "capital management" was first raised in November 2013 by Liu Shijin, vice chairman of the Development Research Center (DRC), a think tank under the State Council.[7] It was most recently ratified in a directive from the State Council in April 2017.[8] It means that state asset supervision and administration bodies (ie, central and provincial-level SASACs) should focus on maintaining and improving the value of state investments in enterprises (and, critically, avoiding losses), while delegating more decision-making power to these enterprises. The reform restricts the duties and responsibilities of the state asset owning bodies, and more clearly defines the boundary between "supervision" and "management". In theory, more authority is delegated to the board of directors.[9]

As a practical matter, the government has produced a list of functions that SASAC should either cease undertaking or delegate to central state-owned enterprises (CSOEs) and/or local SASACs. Of 43 areas where SASAC was previously required to supervise CSOEs, 26 of them have been cancelled. These include such things as guiding the selection of an evaluation agency, inspecting the status of overseas property rights management, evaluating information work, and guiding archival work. Another nine items have been delegated to either CSOES or local SASACs, while the remaining eight have been given entirely to CSOEs.

In other words, the state should intervene much less in the daily minutiae of enterprise management and behave more like an institutional asset owner focused on overall governance and financial returns. The closest comparison to this model is Temasek, the domestic government investment holding company in Singapore. Indeed, there has long been a close relationship between SASAC and Temasek, with the latter providing regular director training courses to SOE managers from China. If well implemented, this policy should allow SOEs more board and managerial autonomy, but within certain bounds. The state cannot afford to let go too much, since past experience shows that problems arise when SOEs are not properly supervised. On the other hand, SOEs will continue to underperform if they cannot professionalise their management and face excessive intervention from government.

Categorising SOEs

"Clearly defining the functions of different SOEs" involves dividing SOEs into different categories depending on their ownership structures, method of supervision, and economic/social functions. Previously, SOEs were classified on the basis of their different equity ownership structures and the state asset supervision body to which they reported. Because there was no definition of their different functions and natures, it was hard to develop differentiated polices for reform, supervision and administration, assessment and adjustment for SOEs. This led to problems in the national economy such as over-dispersed industry distribution, inefficient allocation of resources, and so on. In 2015, the CPC Central Committee released its "Guidelines to Deepen SOE reform", which introduced a new categorisation system.[10] (For a longer discussion, see Chapter 3.5.)

Legal-person governance

Improving the "legal-person" governance structure involves addressing contradictions within the governance of enterprises (legal persons). Although many SOEs have successfully undergone corporate restructuring and set up formal governance structures comprising "three meetings and one level" (that is, the shareholder general meeting, board of directors, supervisory board, and management level), implementation is often more in form than spirit. To be specific, in some SOEs it is still the "boss" who has final decision-making power and few collective decisions are made in the board. The supervisory board does not discharge its supervisory responsibilities well and only meets the minimum membership requirements of the Company Law (that is, most members are SOE insiders and do not raise any objections to board resolutions). Meanwhile, incentive mechanisms for SOE managers are inadequate: their income does not match the value they create.

The government's proposed solutions to these problems involve, first, strengthening the independence and expertise of the board of directors, and authorising the board to implement its intended duties and responsibilities. Second, strengthening the supervision of SOEs through enhancing the oversight of the supervisory board. Third, ensure that the remuneration of SOE executives is in accordance with public expectations and has a positive incentive effect. This means setting an upper limit for the salaries of Party and political cadres, while allowing professional managers to be paid in line with the market. Fourth, strengthening the decision-making and supervisory role of the Party through: "cross-offices" between Party committee members, board directors and supervisors; formalising the pre-approval power of the Party committee; and incorporating the Party committee's role into the articles of association of an SOE so as to enhance the Party's leadership.

In other words, reinforcing the role of the Party committee is very much seen by the authorities as a governance-enhancement mechanism—it involves the Party providing stronger leadership and guidance to SOEs and ensuring that the priorities and policies of the state are followed. SOEs are reminded that they are there to serve the greater good, not their own narrow interests (a perennial problem in the past). On the other hand, extending Party/state control over SOEs would appear to contradict the other worthy objectives listed above, namely enhancing the independence of the board of directors and the supervisory role of the supervisory board. It remains to be seen how these policies will play out. Clearly, each SOE will need to find that right balance and ensure that the spirit of the reforms are followed.

Mixed-ownership

The fourth policy, mixed ownership, is a new take on an old subject. While listed SOEs have had a form of mixed ownership since their entry onto stock markets, the new policy envisages a deeper level of governance and management reform. In official language, the policy allows SOEs to combine "state-owned capital, collective capital and social capital" into a form of "joint ownership". Social capital refers to private capital. This will "amplify the function of state-owned capital" and "realise the goal of combining the complementary advantages of state-owned capital and private capital".

Despite much excitement following Sinopec Corporation's announcement of a major mixed-ownership plan in 2014—the restructuring of its oil sales business and the creation of a new retail company, Sinopec Marketing, with 25 state and private investors—progress in this area has been relatively slow until recently.

The policy received a boost in August 2017 when, after an initial false start, China Unicom announced a mixed-ownership plan for its A share-listed subsidiary, China United Network Communications Ltd. It brought in the country's four big tech firms—Tencent (Rmb11 billion), Alibaba (Rmb4.33 billion), JD.com (Rmb5 billion) and Baidu (Rmb7 billion)—as well as a number of SOEs. The company hopes that this move will improve its corporate governance and business structure. Indeed, in February 2018 it announced that the new board of the A share firm would include representatives from Baidu, Alibaba and Tencent, as well as other new strategic investors. The board has broadened from seven to 13 members, with eight non-independent directors and five independent directors. However it remains to be seen just how much impact the new investors will have: the four big tech firms own only a small portion of the company and China Unicom still holds almost 38%.

In future, it is likely that mixed-ownership reform will parallel corporate and shareholding reforms among large CSOEs. As at the end of 2016, 69 group corporations out of 101 are still enterprises "owned by the whole people" (ie, wholly owned by the government). On 26 July 2017, the general office of the State Council issued the "Implementation Plan for Restructuring Central Enterprises into Companies", which provides that before the end of 2017 all central enterprises under the supervision of SASAC and their subsidiaries (excluding financial and cultural enterprises) will be restructured into limited liability companies or joint stock limited companies and registered under the Company Law. By the end of 2017, all CSOEs had completed the restructuring except for two: China Metallurgical Geology Bureau and China National Administration of Coal Geology (and neither had made progress as of end-June 2018). The government sees this restructuring as crucial to the establishment of a modern enterprise system for central enterprises, and is a precondition for a series of reforms, including mixed ownership, the securitisation of assets and so on.[11]

However, while mixed ownership may take root among SOE subsidiaries, it is unlikely to affect the equity structure of SOE group/parent companies. This is because first-level parent companies have sufficient financing and therefore little need for capital from outside investors. Second, equity diversification could lead to litigation by non-state investors, which would have a negative impact on the reputation of the group company and hence the government. Mixed ownership among second- or third-level subsidiaries is more feasible.

Revised CG Code

In June 2018, the CSRC issued a draft of its newly revised Code of Corporate Governance for Listed Companies for consultation. The Code builds on the 2002 version and takes as one of its reference points the revised "OECD/G20 Principles of Corporate Governance (2015)", which puts more focus on such things as the role of institutional investors and the duties and responsibilities of the board of directors.

One major difference in the new Code is the mention of Party organisations/committees as an integral feature of corporate governance in China (this was not in the 2002 Code). The section is quite brief and does not require companies to disclose what their Party organisations do. However, its inclusion is significant.

Other changes include a greater emphasis on:

- The role of institutional investors as stewards;
- ESG disclosure;
- Reinforcing the accountability of the board of directors, including independent directors; and
- Reinforcing the role of the supervisory board.

The Code states that further detailed guidance will be coming from the two stock exchanges, the China Association for Public Companies and the Asset Management Association of China.

Insurance governance reform

The insurance sector has had a torrid few years in China, as Chapters 5.1 and 6.4 in this report highlight. While the industry overall is in relatively good shape, certain players have been characterised by: aggressive business models and a mismatch of assets and liabilities; deficient corporate governance structures, insider control, and inadequate internal control systems; fake capital injection by shareholders; and varying levels of solvency, especially among small- and medium-sized enterprises. Moreover, as the financial industry has developed and diversified, the insurance sector increasingly overlaps with banks, securities companies and fund managers, thus raising the risk that problems in one sector will be transmitted to others.

The underlying problems in insurance stem in large part from policy relaxations initiated by the then China Insurance Regulatory Commission (CIRC) over 2012 to 2013. The CIRC widened the scope of permissible investments for insurance funds through a series of reform measures, the so-called 13 new policies, covering asset allocation, investment by external managers, bond investment, debt investment in infrastructure, overseas investment, margin trading, derivative products, and so on. At the same time, the regulator relaxed rules on investment in the insurance industry, which attracted more private capital and intensified competition. In 2014, the State Council issued a set of new measures to accelerate the development of the insurance industry.[12] These policy benefits brought unprecedented opportunities, but led to an accumulation of risks.

Current policies to strengthen regulation in insurance cover the investment of insurance funds, reinforcing the matching of assets and liabilities, and stricter rules on overseas investment to reduce the risk of overly aggressive investment by individual institutions. Meanwhile, in late 2016, the CIRC began pledging to work more closely with other financial regulators to prevent regulatory arbitrage.[13]

Institutional reform

The regulatory system in China has long been described as comprising "one bank and three commissions", namely the People's Bank of China (PBOC), which is the central bank and oversees macro-economic controls, financial reform and stability, and the development of financial markets, while the CBRC, CSRC and CIRC have responsibility for banking, the securities market, and insurance, respectively. While this system worked quite well in the past, a topic of discussion for many years has been the need to strengthen coordination among financial regulators in order to respond to the growing complexity of the system and frequent turbulence in the market. Market-based interest rates have been reformed. Innovative financial products have increased explosively. The mixed business models of commercial banks have accelerated. And non-bank financial institutions and non-financial enterprises have set up platforms for mixed businesses. In the model of "regulation by industry", the power and responsibilities of each regulator overlap, which inevitably results in conflicts and problems. Many view the turbulence in the stock market in 2015 as being partially a byproduct of this model.

To an extent, the government foresaw the problem some time back. In August 2013, the State Council approved the formation of an inter-ministerial meeting for financial regulation and coordination. The joint meeting is headed by the central bank, the PBOC, and has standing representatives from the CBRC, CSRC, CIRC and the State Administration for Foreign Exchange (SAFE). It may also invite the DRC, MOF or other units to attend, as necessary. The main objectives of this joint meeting are to share financial information and coordinate financial policies, law and regulation. But it would appear that since no new powers have been given to the PBOC, the meeting is largely for information sharing and has no power of administrative coercion.

In July 2017 during the National Financial Work Conference, a proposal was made to set up a "Financial Stability and Development Commission of the State Council", which would have overall management responsibility for financial supervision and administration. It would reinforce the role of the central bank in macro prudential management and guard against systemic risks, have oversight of financial regulators and strengthen their supervision and accountability. This commission has been set up directly under the State Council and above the "one bank and three commissions" to introduce a higher-level entity to manage financial development and supervision. Compared with the previous inter-ministerial joint meeting, this entity is expected to wield real authority.

It is also worth highlighting that since the major governmental reorganisation in March 2018, the "one bank and three commissions" has become the "one bank and two commissions" with the merger of the banking and insurance regulators into the China Banking and Insurance Regulatory Commission (CBIRC).

Corporate comparisons

Given that China's nascent stock markets have been unable to accommodate all the capital-raising needs of its diverse and rapidly changing corporate sector, numerous state and private companies have listed outside China. This has created a veritable alphabet soup of acronyms and labels with which to categorise such firms.

Alphabet soup

The smorgasbord of investment options includes firms incorporated in China:

- **A shares:** Listed in China and traded only in local currency (renminbi).
- **B shares:** Listed in China and traded only in foreign currency (US dollars in Shanghai and HK dollars in Shenzhen). They were available for sale only to foreign investors until 19 February 2001.
- **H shares:** Listed in Hong Kong and traded in Hong Kong currency. Most of the state enterprises in Hong Kong are "H shares".

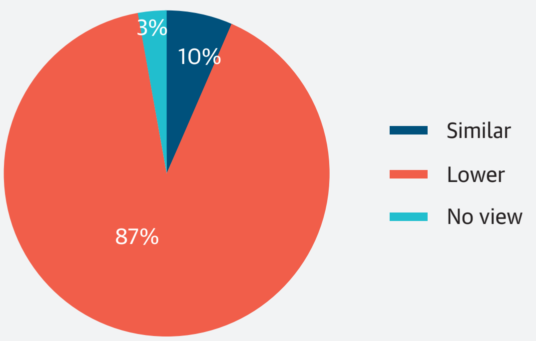
It also includes firms incorporated outside China:[14]

- **Red chips:** State-owned/controlled companies listed outside China and traded in foreign currency. Many are incorporated and listed in Hong Kong. (Some use this term exclusively for such firms listed in Hong Kong.)
- **N shares:** Companies listed in the US and traded in US dollars. Many are incorporated in BVI, Bermuda or the Caymans and listed on the NYSE or NASDAQ.
- **P chips:** Private-sector firms listed in Hong Kong and traded in Hong Kong dollars. Many are incorporated in BVI, Bermuda or the Caymans.
- **S chips:** Companies listed in Singapore and traded in Singapore dollars.

For companies incorporated outside China, their origin, ownership/control, and most of their business operations

Rating investor protection in China Fig 2.4

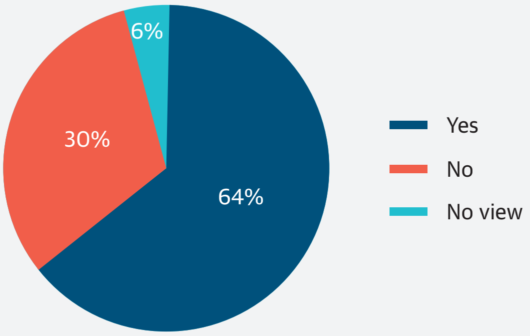
How foreign institutional investors compare investor protection in China to developed markets in Asia-Pacific (ie, Australia, Hong Kong, Japan and Singapore)



Note: The variable 'Higher' was offered, but not selected by any respondent.
***Source:** ACGA Foreign Institutional Investor Perceptions Survey 2017*

Do overseas listings have better CG? Fig 2.5

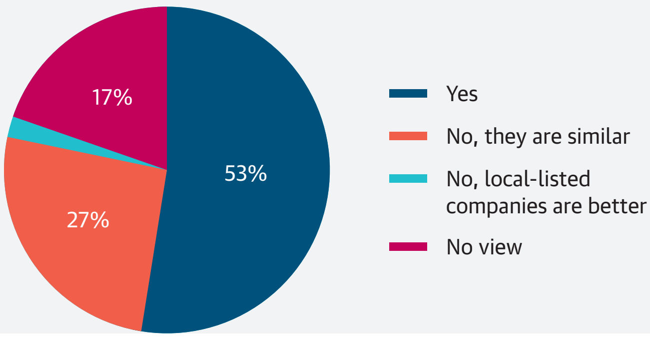
How foreign investors view the average quality of governance in overseas-listed mainland companies compared to A shares



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

Overseas listings have better CG Fig 2.6

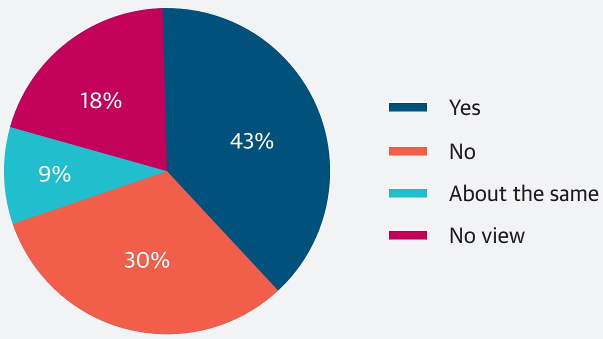
Do you consider the quality of corporate governance in overseas-listed mainland Chinese companies (ie, in Hong Kong, New York, Singapore) is usually superior to locally listed mainland Chinese companies on average?



Source: *ACGA China Listed Company Perceptions Survey 2017*

Investor protection in the US vs HK Fig 2.7

Do you consider the level of investor protection offered to shareholders of mainland companies listed in the United States is superior to comparable firms listed in Hong Kong?



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

should be in China in order to qualify for one of the four labels. It is also important to stress that these labels have been developed by stock exchanges as handy nicknames to differentiate these companies from China-incorporated issuers; they are not based on regulation. In contrast, the terms A share, B share and H share do have a basis in listing rules.

Who has better governance?

A compelling question is which types of firms have better standards of corporate governance? This is a question we posed to respondents in both our Foreign Institutional Investor and China Listed Company Perceptions surveys. The results can be seen in Figures 2.4, previous page, and 2.5, above. They show that while the vast majority of foreign investors believe China's investor protection system is weaker than that found in developed markets in Asia-Pacific, they view overseas-listed mainland firms as having better governance on average than A shares. In addition to differences in regulatory and enforcement regimes, a contributing factor would be the role played by overseas institutional investors who are more inclined to challenge companies and insist they communicate.

Most respondents to our China survey agreed that the governance of overseas-listed companies is better than A share enterprises as shown in Figure 2.6, above.

Interestingly, when asked if shareholders of mainland firms listed in the US enjoyed better investor protection than comparable firms listed in Hong Kong, less than half the respondents to our Foreign Investor survey agreed. Almost a third disagreed (see Figure 2.7, opposite)

Conclusion

In its first four decades of capital market development, China has undertaken fundamental and wide-ranging reforms that seek to balance its internal needs with those of international investors. After experimenting with global standards in the 1990s and early 2000s, China later turned more to local solutions to address various deep-seated domestic governance challenges. With the advent of new international connections in its capital market, and the growing internationalisation of its corporations and financial sector, the current policy framework reflects a mixed approach. Beijing is emphasising both local characteristics/solutions where it feels it needs to do so and reinforcing or introducing global norms. The fruits of SOE reform, if implemented well, could be significantly positive for the capital market. Meanwhile, investors wait to see the outcome of deliberations on the new Foreign Investment Law and look forward to steadier regulatory leadership from the new Financial Stability and Development Commission and the "one bank and two commissions".

Endnotes

[1] For an excellent summary of the history of China's stock markets, see Carl E Walter and Fraser JT Howie, "Privatising China: The Stock Markets and their Role in Corporate Reform", John Wiley & Sons (Asia), 2006 (2nd edition). Our section on the 1980s draws heavily on this book.

[2] This section draws in part from Walter and Howie, 2006.

[3] State Council, "Opinions on Cracking Down on, Preventing and Controlling Insider Trading in the Capital Market" No. 55 [2010]; CSRC, "Provisions on Establishing the Registration and Administration System of the Persons with Inside Information", No. 30 [2011].

[4] Shanghai Stock Exchange, "Stock Listing Rules" (2014 Revision), No. 65 [2014].

[5] Shenzhen Stock Exchange, "Stock Listing Rules", No. 378 [2014]; "Guidelines for Standardised Operation of Companies Listed on the Main Board" (2015 Revision) No. 65 [2015], (Chapter 5, Section 2 & 3: "Registration and Administration of Persons with Inside Information"); "Guidelines for Standardised Operation of Companies Listed on the Small and Medium-Sized Enterprise Board" (2015 Revision) No. 65 [2015], (Chapter 5, Section 4: "Registration and Administration of Persons with Inside Information").

[6] Communist Party of China (CPC), "Decision of the CPC Central Committee on Some Major Issues Concerning Comprehensively Deepening the Reform", 18th CPC Central Committee, Third Plenary Session, 15 November 2013.

[7] CPC News, "Liu Shijin: Clearly Raised the Idea of Strengthening Supervision of State-owned Assets by Managing Capital for the First Time", 19 November 2013: See: http://cpc.people.com.cn/n/2013/1119/c164113-23592860.html

[8] State Council, "Notice on Forwarding the Plan of SASAC for Promoting the Transformation of Functions with the Focus on Capital Management", No. 38 [2017]", 27 April 2017. See: http://www.gov.cn/zhengce/content/2017-05/10/content_5192390.htm

[9] State Council, "Notice on Forwarding the Plan of SASAC on Focusing on the Capital Management and Advancing the Function Transformation", No. 38, 2017.

[10] CPC Central Committee, "Guidelines of the CPC Central Committee and the State Council to Deepen SOE Reform", No.22, 2015.

[11] Shenzhen Asset Management Association, "Great Transformation! A New Era Is Coming. The Interpretation of 9 Key Points for Restructuring of Central Enterprises", 28 July 2017.

[12] State Council, "Several Opinions on Accelerating the Development of the Modern Insurance Service Industry", No. 29, 2014.

[13] Xiang Junbo "CIRC Will Strengthen the Cooperation with CSRC and Other Regulators to Prevent the Regulatory Arbitrage", Sina Finance, 13 December 2016.

[14] FTSE Russell, "Guide to Chinese Share Classes. v1.3", March 2018.

[15] Financial Accounting Standards Board, Interpretation No.46, January 2013; revised in December 2003.

[16] China Literature Ltd, Global Offering, 26 October 2017, p204.

中國特色

Chapter Three

CG with Chinese Characteristics

3.1 The Party Organisation: Leadership core

The role of Party organisations is one of the least understood aspects of corporate governance in China. With a legal basis in both Company Law and the CPC Constitution, Party organisations play a leadership role in state enterprises and are increasingly influential in the private sector. Their role has been reinforced in recent years, with many SOEs adding them to their Articles over 2015 to 2017.

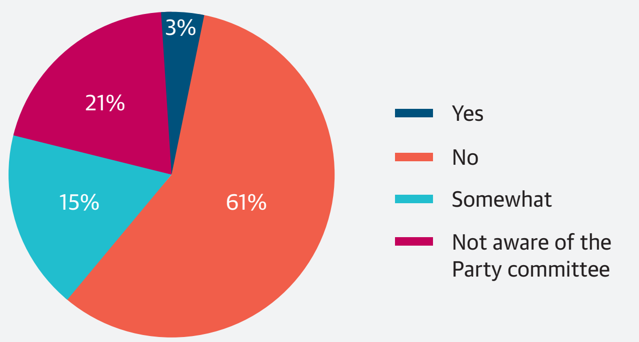
Introduction

One of the unique aspects of corporate governance in China is an entity called the "Party organisation" or "Party committee", a body established by and reporting to the Chinese Communist Party (CPC). Despite its long history, especially in state-owned enterprises (SOEs), the Party organisation/committee is perhaps the least understood feature of corporate governance with Chinese characteristics. As is apparent from our 2017 survey of foreign institutional investors (see Figure 3.1), one-fifth of respondents were unaware of the existence of Party organisations, while the remainder would welcome greater clarity as to their role and lines of accountability. This lack of understanding is due to the limited transparency historically provided on the power and responsibilities of the Party organisation and its relationship with the board and other governance bodies in a company. Such disclosure is not required by company law or securities regulations.

Policy initiatives over 2010 to 2017 reaffirmed the leadership role of Party organisations in state enterprises and their status above the board of directors in the business and governance decision-making chain. They are also widespread in domestic private firms where they serve as a focal point for Party members, exercise leadership over the trade union, and provide guidance on complying with state laws. More recently, multinational corporations in China have come under increasing pressure to form such organisations, and many have complied.

Is the Party's role clear? Fig 3.1

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*

While these policies would appear to be in direct conflict with previous more pro-market trends in China—and certainly offer a different model of corporate governance—they are best understood as an integral part of what the CPC calls the process of "socialist modernisation". As the preamble to the CPC's new constitution of October 2017 makes clear, the Party remains stoutly opposed to "bourgeois liberalisation" (ie, Western liberal values) and is still at an early stage of building a "socialist market economy". It is an economy in which "public ownership plays a dominant role", although different forms of corporate ownership can "develop side by side". The CPC plays the core leadership role over the entire society and "shall be firm in consolidating and developing the public sector" as well as "guiding the development of the non-public sector".

Although deeply entrenched within China's corporate governance system, the level of transparency around Party organisations/committees has traditionally been low. Reforms over 2015 to 2017 brought them front and centre as SOEs were required to incorporate these Party entities into their articles of association for the first time—a development that caused concern and controversy among many foreign investors. Paradoxically, however, the reforms may also serve to bring greater clarity to the role of the CPC in state enterprises and its influence over the private sector. Foreign investors would welcome increased disclosure on the work of Party organisations in listed companies, much in the same way that companies today routinely report on the activities of boards of directors and supervisory boards.

Legal status

The basic legal foundation allowing Party entities to operate in state and non-state enterprises can be found in the Constitution of the CPC. Article 32 of the 2012 Constitution described the primary-level Party organisation as the "political core" of a state-owned enterprise. Article 33 of the latest 2017 version elaborates further and states:

> The leading Party members groups or Party committees of state-owned enterprises shall play a leadership role, set the right direction, keep in mind the big picture, ensure the implementation of Party policies and principles, and discuss and decide on major issues of their enterprise in accordance with regulations.[1]

Both versions go on to explain that the role of primary-level Party organisations is to "guarantee and oversee the implementation of the principles and policies of the Party and the state in its own enterprise", and shall "support the meeting of shareholders, board of directors, supervisory board, and manager (or factory director), in exercising their functions and powers according to law". The organisation "participates in making final decisions on major questions in the enterprise" and shall "lead work on political thinking" as well as "efforts towards cultural-ethical progress" in the enterprise. Largely identical language can also be found in the 2002 version of the CPC Constitution.

As for private enterprises:

> Primary-level Party organisations in non-public sector entities shall implement the Party's principles and policies, guide and oversee their enterprises' observance of state laws and regulations, exercise leadership over trade unions, Communist Youth League organisations, and other people's group organisations, promote unity and cohesion among workers and office staff, safeguard the legitimate rights and interests of all parties, and promote the healthy development of their enterprises.

A fundamental role is also provided for Party organisations in the original Company Law of 1993 and as amended. Article 19 stipulates that:

> An organisation of the Communist Party of China shall be set up to conduct Party activities in a company in accordance with the provisions of the constitution of the Communist Party of China. A company shall provide the Party organisation with necessary facilities for its activities.[2]

These laws have had a marked impact on the landscape of corporate governance in China. By the end of 2016, CPC organisations had been established in 189,000 public enterprises, accounting for around 91% of total public enterprises. In addition, they had been established in 1.85 million non-public enterprises, accounting for almost 68% of the total and 16 percentage points higher than the previous year.[3]

What's in a name?

Reading the annual reports of SOEs can be a little confusing: some refer to their "Party organisation", some to a "Party committee", while others talk about the "leading Party member group" in their firm. What is the difference between these terms?

In essence, the labels "Party committee" and "leading Party member group" refer to the group of senior CPC members who play the leadership role in an enterprise, meet on a regular basis before the board of directors meets, and discuss/approve major decisions (see box story, 'What do Party committees do?', overleaf). While some enterprises, such as Sinopec, use the label "Party organisation" to refer to their senior leadership group, the term also has a wider meaning, namely the full CPC organisation in an enterprise. This includes not only the leadership group but party cadres working at other levels and in different functions, especially HR management. An important task for each Party organisation is also the supervision and disciplining of CPC members in an enterprise.

As Article 32 of the CPC Constitution (2017) elaborates: "Primary-level Party organisations play a key role for the Party in the basic units of social organisation; they are the foundation for all the Party's work and for its capacity to take on challenges." Moreover, within enterprises they "shall wholeheartedly rely on the workers and office staff and support the work of workers' representative congresses; and they shall participate in making decisions on major issues in the enterprise". (Article 33)

Reinforcing Party control

Since 2010 the CPC, State Council and the State-owned Assets Supervision and Administration Commission (SASAC) have issued several policy statements that seek to strengthen and clarify the leadership of Party organisations in SOEs. The first sought to enhance collective decision-making in enterprises through a focus on what are called the "Three Important, One Large" decisions. This term dates back to 1996, when it was proposed by the Central Commission for Discipline Inspection, a central Party agency that oversees political discipline among cadres. It refers to decision-making on major issues, including "important issues", the appointment and dismissal of "important cadres", and investment in "important projects". The "one large" refers to the use of large amounts of funds.[4]

Momentum increased following the 18th Party Congress in November 2012 and the election of Xi Jinping as General Secretary. In 2013, the CPC Organisation Department, a central agency tasked with major personnel appointments, and SASAC issued a policy opinion on the role of Party organisations as the political core in central SOEs under a "modern corporate system". This opinion also emphasised their role in personnel matters, especially supervising Party cadres, and leading ideological and political work.

On 24 August 2015, the CPC Central Committee and State Council published the "Guiding Opinions on Deepening SOE Reform". This reaffirmed the political importance of Party organisations and referenced the simultaneous positions that cadres could hold as members of the Party committee, board of directors or supervisory board, and senior management. The Guiding Opinions also suggested that by 2020 "the legitimate standing of the Party committee of SOEs in corporate governance will become more stable".

In late May 2016, SASAC published an article titled, "Promote Party Building while Comprehensively Deepening SOE Reform"[5] in the publication *Qiushi (Seeking Truth)*, a theoretical journal of the Central Committee of the CPC. The central theme of the article was the need to further strengthen Party leadership in SOEs and it proposed for the first time that Party committees should formally discuss and approve major decisions before the board of directors (the "ex-ante procedure").

What do Party committees do?

In theory, the function of Party organisations/committees is to participate in the governance of enterprises, while at the same time not directly meddling in their management and operational decision-making. From the beginning, Party committees were established to ensure that significant decisions made by enterprises would not deviate from national laws and regulations, Party discipline and basic political principles. Indeed, as the CPC Constitution makes clear, Party committees "set the right direction" and "keep in mind the big picture", while ensuring the "implementation of Party policies and principles" and deciding on "major issues". In practice, Party committees have three functions:

1. Making the "Three Important, One Large" decisions: namely, decision-making on "important issues", the appointment and dismissal of "important cadres", investment in "important projects" and the use of large amounts of funds.
2. "Double entry, cross offices": Party committee members can also serve on either the board of directors or supervisory board, and be part of the executive team and vice versa. This helps to put into effect the ideas of the Party and coordinate communication between the Party, the board of directors and executives.[11]
3. Overseeing the system of "Party supervising cadres" and "Party supervising talents": The former is aligned with the appointment of executives by the board of directors and human resource management.[12] In respect of "supervising talents", the Party carries out the induction, training and development of professional talent by implementing the "National Plan of Talent Development in Medium and Long Term (2010-2020)".[13]

On 11 October 2016, President Xi delivered a speech at a working meeting on Party building in SOEs, the goal of which was to "integrate the Party's leadership into each part of corporate governance, embed the Party organisation of the enterprise into the corporate governance structure, [and] specify and implement the legitimate standing of the Party organisation in the corporate governance structure of the enterprise".

This policy direction was entrenched yet further in May 2017 when the State Council published two circulars to bolster the leadership status of Party organisations in the governance structures of SOEs[6] and proposed a requirement that Party building should be added to their articles of association. Significantly, the two circulars also emphasise Party leadership over the supervision of cadres.

Attitudes towards these developments vary widely. People with pro-market views see them as regressive and fear they will weaken the function of other governance entities in companies, principally the board of directors. They question how such policies can cohere with a capital market that is becoming more international and will, presumably, undergo further liberalisation in future. Realists on the other hand note that the Party has always played a central role in the governance and management of SOEs, and contend that recent policy changes are more a matter of emphasis than a change of direction.

From the perspective of the government, these policies will not only strengthen the leadership role of the Party and hence enterprise governance in general, but in practical terms they should help to control corrupt behaviour by cadres and others. As the CPC 2017 Constitution says, the primary-level Party organisations operating in any entity must "ensure that Party officials and all other personnel strictly observe state laws and regulation" and "encourage Party members and the people to consciously resist unacceptable practices and resolutely fight against all violations of Party discipline or state law".

Putting the Party into the articles

From late 2015 onwards, enterprises listed in China began amending their articles of association to incorporate Party organisations. One of the earliest was Harbin Electric Corporation Jiamusi Electric Machine, which did so in December 2015, followed in January 2016 by Xinjiang Tianshan Cement and Sinoma International Engineering. From late 2015 to June 2017 almost 180 enterprises followed suit, according to data gathered by Institutional Shareholder Services, an international proxy voting advisory firm.

This wave reached Hong Kong in 2017, when more than 30 large state enterprises incorporated in China and listed in the city put forward similar resolutions to either annual or special general meetings. While some institutional investors were happy to accept these changes, others voted against them. For example:

- Sinopec received almost unanimous support from both its A and H shareholders, achieving votes in favour of 99.99% and 99.68%, respectively.
- Industrial and Commercial Bank of China (ICBC) received a mixed response: overall votes against (both A and H shares) amounted to only 5.7%, yet it would appear that a high proportion of H shareholders objected to the amendments. Total votes against numbered almost 17.5 billion, which was equal to almost 39% of the 45.2 billion H shares represented at the meeting. (While not all against votes may have been from H shares, it is reasonable to assume that the vast majority were given the high concentration of state ownership in the company via A shares.)
- China Construction Bank also saw mixed results: votes against amounted to 12.8% of all votes cast, but this accounted for only around 13% of all H shares voted.
- Chongqing Iron & Steel witnessed a very different pattern: more than 70% of its H share votes were opposed to the amendment.

One factor accounting for the differences in voting patterns could be the scope of amendments sought. While Sinopec only made two brief changes to its articles (see Chapter 6.2), ICBC made extensive alterations (see box story, 'ICBC 2017 AGM Circular – Role of the Party committee', overleaf, and Chapter 6.3). It could also be the result of investor engagement efforts made by each enterprise—anecdotal evidence suggests that foreign institutional investors based in Hong Kong were actively lobbied prior to AGMs in 2017. And some of the votes may have been influenced by international proxy advisers, which recommended votes in favour in some instances. (See Table 3.1, opposite, for voting data on other enterprises.)

Voicing concern Tab 3.1

H shares receiving the largest votes against Party committee reforms, 2017

Company	Against %	Meeting Date and Type	
China Suntien Green Energy	17.09	10 Nov	Special
Aluminum Corporation of China	16.11	26 Oct	Special
Harbin Electric	14.26	1 Dec	Special
Yanzhou Coal Mining	13.98	27 Nov	Special
China Longyuan Power Group	12.95	15 Dec	Special
Beijing Jingkelong	12.68	26 May	Annual
Guangzhou Automobile Group	12.52	23 Aug	Special
Maanshan Iron & Steel	12.21	30 Nov	Special
Chongqing Rural Commercial Bank	10.12	11 Dec	Special
China Galaxy Securities	7.86	29 Sept	Special
New China Life Insurance	7.85	19 Dec	Special
Bank of China	7.01	29 Jun	Annual
Poly Culture Group	6.63	11 Dec	Special
China Communications Construction	6.50	22 Nov	Special
China Machinery Engineering	5.87	26 Jun	Annual
Industrial & Commercial Bank Of China	5.69	27 Jun	Annual
Datang International Power Generation	5.64	15 Aug	Special

Source: *Glass Lewis (Permission to reprint)*

Meanwhile, in mid-2017, SASAC said that 100 large SOEs had duly amended their articles. In addition, the chairmen in 74 enterprises under SASAC had become the leader of the Party committee of their group, which reflected the higher status of the Party in these SOEs.[7] It is also understood that some SOEs which intended to list overseas, but whose state ownership was below two-thirds, received notices from local government SASAC bureaus to suspend the amendment lest overseas investors veto it (since a minimum two-thirds vote in favour was required for resolutions to pass).

Challenges

While the government's motives for pushing through these amendments are clear, a number of governance challenges remain:

Less efficient decision-making?

There are some concerns within China that formalising the role of the Party organisation/committee could make business decision-making less efficient. Some enterprises say that Party committees previously intervened in board decision-making only in principle. They did not have to make formal decisions on specific issues. Under the new policy, major issues first require the approval of the Party committee before going to the board of directors. This will require even more coordination than is currently the case and add to the workload and documentation tasks of the board secretary.

ICBC 2017 AGM Circular – Role of the Party Committee

Highlights of the main amendments to ICBC's articles:

Article 13: … the Party committee shall play the core leadership role, providing direction, managing the overall situation and ensuring implementation.

Article 52: The chairman of the board of directors of the Bank and the Secretary of the Party committee shall be the same person …

Article 53: The Party committee shall … perform the following duties:

i. Ensure and supervise the Bank's implementation of policies and guidelines of the Party and the State, and implement major strategic decisions of the Central Committee of the Party and the State Council, as well as important work arrangements of higher-level Party organisations;

ii. Strengthen its leadership and gatekeeping role in the management of the process of selection and appointment of personnel …

iv. Assume the primary responsibility to run the Party comprehensively with strict discipline, lead the Bank's ideological and political work …

v. Strengthen the building of the Bank's grassroots Party organisations and of its contingent of Party members, give full play to the role of Party branches as strongholds and to the role of Party members as pioneers and fine examples, and unite and lead officials and employees bank-wide to devote themselves to the reform and development of the Bank;

vi. Other material matters that fall within the duty of the Party committee.

Article 144 (former Article 141): The board of directors shall supervise the implementation of the development strategies of the Bank and regularly re-examine the development strategies so as to ensure such strategies are consistent with the operation of the Bank and changes of the market environment. The opinions of the Party committee shall be heard before the board of directors decides on material issues of the Bank.

Limiting the role of the board

Because of the system of "double entry, cross offices", there is a high degree of overlap between the composition of the Party committee and the board of directors, supervisory board, and management. The term "double entry" refers to people holding two roles or positions in an enterprise. "Cross office" refers to one person being both the secretary (head) of the Party committee and chairman of the board of directors. There are also cases where the board chairman is the deputy secretary of the Party committee. Or where the secretary of the Party committee holds the post of vice chairman of the board.[8] However, best practice today is for the Party secretary and board chairman to be the same person, so as to avoid conflict and competing agendas.

Since most Party committee members also serve on the board of directors and hold senior executive positions in enterprises, it is clear that this inner group will already have discussed key issues before any board meeting. There will be little need, therefore, for most executive directors to say much in board meetings, with only the chairman or general manager conveying the agreed opinions of the Party committee. This would diminish the potential for discussion between directors and reduces the contribution of non-executive directors, especially independent directors, on major decisions.

Clarifying the division of labour and the role of board committees

While the new policies state clearly that Party committees should pre-approve all important decisions of the enterprise, it is likely that foreign investors will remain confused as to the division of labour between the Party committee and the board. The reforms also raise questions about the function of certain board committees, especially on nomination, since oversight of major appointments to the board and management come within the purview of the Party committee, which itself reports to higher ranking Party organisations.

Concerns of foreign direct investors

Under this new wave of reform, privately owned enterprises in China have to accept that Party committees in their firms will do more than just 'organise social events for Party staff members'. Some seem happy to do so, including foreign-owned ones. Qi Yu, deputy head of the Central Organisation Department, said at a briefing on the side of the 19th National Party Congress in October 2017: "Some senior executives at foreign-invested companies say Party organisations can help them understand China's policies in a timely manner, resolve labour disputes and provide positive energy for their companies' development. The majority of them welcome and support Party organisations carrying out activities in their companies."

Indeed, Party units in foreign-invested companies more than doubled over 2011 to 2016, from 47,000 to 106,000, according to Qi. And around 70% of all foreign-funded firms in China—about 75,000—had set up Party branches. This is about the same proportion as for China's private sector, where almost 68% of private businesses had set up Party branches by the end of 2016.

> *The corporate governance requirements under the Company Law and the Equity Joint Venture (JV) Law are clear, the board of directors is the highest authority of an equity JV*
>
> The European Union Chamber of Commerce in China

Nevertheless, not all foreign multinationals have been so sanguine. In early November 2017, the European Union Chamber of Commerce in China issued a statement saying that while it respected China's law allowing for the establishment of Party organisations in businesses in general, including foreign-invested enterprises, it objected to the formal extension of Party organisations into the governance of joint ventures: "The corporate governance requirements under the Company Law and the Equity Joint Venture (JV) Law are clear, the board of directors is the highest authority of an equity JV and responsible for all key matters of the JV ... The European Chamber is not aware of any legal development that provides a basis for changing the corporate governance arrangements in JVs in this manner." And further: "A fundamental change of this nature would introduce an additional layer of governance and would have serious consequences for the independent decision-making ability of these JV companies."[9]

On 24 November 2017, the Delegations of German Industry & Commerce in China, part of the German Chambers of Commerce Worldwide Network, expressed identical concerns regarding wholly foreign-owned companies operating in China.[10] This came one week after the German Chamber of Commerce in China told a press conference that German companies were worried about the possibility of having Party members interfere in their operations. In their announcement, the Delegations stated: "Current legal and business practices create neither an obligation nor legal basis for companies to proactively promote the development of the Party within the respective companies ... We do not believe that foreign invested companies generally should be required to promote the development of any political party within company structures. This is an individual decision by corporate management and should not be guided at the behest of third parties." They also declared: "Should these attempts to influence foreign invested companies continue, it cannot be ruled out that German companies might retreat from the Chinese market or reconsider investment strategies."

Conclusion: Next steps

As our Foreign Institutional Investor Perceptions Survey 2017 shows, most foreign institutional investors would welcome more explanation and clearer lines of accountability around Party organisations/committees. What would such transparency look like? First, a model already exists with the reports that boards of directors and supervisors must present to the annual meeting. A report from the Party organisation/committee could include details on membership, structure and specific activities during the year. Second, the report could explain how the committee has addressed the "Three Important, One Large" decisions and explain its relationship and division of labour with the board of directors. Third, enterprises could engage more actively with their minority shareholders and brief them on the Party organisation's work.

Indeed, for any H share listed in Hong Kong, it is arguable that they will now need to disclose the role of the Party organisation/committee under the listing rules of Hong Kong Exchanges and Clearing (HKEX). Hong Kong's code of corporate governance requires that listed companies comply with, or explain their reasons for not doing so, board governance principles such as: "An issuer should be headed by an effective board which should assume responsibility for its leadership and control and be collectively responsible for promoting its success by directing and supervising its affairs." This is clearly a different model to that existing today in mainland China.

Realty check

On 6 January 2017, Tianjin Real Estate Development (Group), a company listed in Shanghai, called an interim general meeting to review a proposal for amending its articles of association. The company stated that the proposal was based on the requirement of the "Several Opinions on Adhering to the Leadership of the Party and Reinforcing the Building of the Party During the Deepening SOE Reform", issued by the CPC Central Committee in 2015 and related requirements by the Tianjin Municipal Committee and SASAC to incorporate the sections of the Party committee and Party building into articles of association.

The amendments and additions included:

1. The board of directors shall listen to the opinion of the Party organisation before coming to a final decision on important issues.
2. When the board of directors appoints executives, the Party organisation will discuss and provide its opinion on candidates nominated by the board nomination committee or general manager, or it may recommend candidates to the nomination committee and general manager. The Party organisation shall participate in the investigation of candidates and provide opinions in collective discussions.
3. The company shall set up a Party organisation and establish its working structures. The Party organisation will play the role of leadership core and political core.
4. Party members who assume the role of directors, supervisors and executives shall fully express the opinion of the Party organisation, reflect the intention of the Party organisation, and report to the Party organisation about relevant events.

The proposal achieved consenting votes of 62.5%, but this fell below the two-thirds majority required under company law for amending articles. Tianjin Realty put the proposal up again at its annual meeting in May 2017. It passed with an almost unanimous 99.99% vote.

It is understood that after the veto in January 2017, SASAC at all levels of government attached great importance to the result and proposed suspending amendments in listed companies where the state holds less than two-thirds of the shares.

Endnotes

[1] "Constitution of the Communist Party of China" (2017 version), Article 33.

[2] Company Law (2006), Article 19.

[3] 2016 Internal Statistics Communique of the Communist Party of China, 30 June 2017. See: http://www.xinhuanet.com/politics/2017-06/30/c_1121242478.htm

[4] General Office, CPC Central Committee, "Opinions on Further Improving the Implementation of Decision-Making System of the 'Three Important, One Large' in SOEs", No. 17 [2010].

[5] Party Committee of SASAC: "Promote Party Building while Comprehensively Deepening SOE Reform", Qiushi, 31 May 2016. See: http://www.qstheory.cn/dukan/qs/2016-05/31/c_1118938354.htm

[6] General Office of the State Council, "Guiding Opinions on Further Improving the Legal Person Governance Structure of State-owned Enterprises", No. 36 [2017], 3 May 2017; "Notice on Forwarding the Plan of SASAC on Focusing on Capital Management and Advancing the Functional Transformation", No. 38 [2017], 10 May 2017. See: http://www.gov.cn/zhengce/content/2017-05/03/content_5190599.htm and http://www.gov.cn/zhengce/content/2017-05/10/content_5192390.htm

[7] General Office of the State Council, "Notice on Forwarding the Plan of SASAC on Focusing on Capital Management and Advancing the Functional Transformation", No. 38 [2017], 10 May 2017.

[8] CPC Central Committee, "Decision of CPC Central Committee on Several Major Issues of SOE Reform and Development", 22 September 1999.

[9] The European Union Chamber of Commerce in China, "Chamber Stance on the Governance of Joint Ventures and the Role of Party organisations", 3 November 2017. See: http://www.europeanchamber.com.cn/en/press-releases/2583/chamber_stance_on_the_governance_of_joint_ventures_and_the_role_of_party_organisations

[10] Delegations of German Industry & Commerce, Press Announcement, 24 November 2017. See: http://china.ahk.de/. See also South China Morning Post, "German trade body warns firms may pull out of China over Communist Party pressure", 29 November 2017. See: http://www.scmp.com/news/china/economy/article/2122104/german-trade-body-warns-firms-may-pull-out-china-over-communist

[11] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", No. 5 [2013], April 2013.

[12] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", Article 13.

[13] CPC Central Committee, "Opinions of the Organisation Department of the CPC Central Committee and the Party Committee of SASAC of the State Council on the Party Committee of the Central Enterprises Giving Full Play to the Role as the Political Core under the Modern Corporate System", Article 16.

Interview: 'Moving Party committees in front of the curtain'

John Law
Board director; Former Principal Banking Specialist, International Finance Corporation (IFC), 2004 to 2012; Independent director (representing IFC)

The government recently reinforced the legal status of Party organisations/committees in corporate governance, an issue that is controversial for some investors of listed companies, especially those from overseas. How do you view the role of the Party committee in listed companies in China? How do they interact with the boards and management?

I believe this measure is meaningful. It means that the Party committee moves from behind the scenes to the front of the curtain, increasing transparency. In banks, the president (CEO) and other key executives are all Party members, while the secretary (head) of the Party committee is usually the chairman of the board of directors. The secretary of the commission for discipline inspection, which supervises Party members, will attend board meetings as well.

The Party committee has decision-making power over human resources. All significant issues will be agreed by the Party committee first and then submitted to the board. But these things have not been transparent in the past and I understand them only through exploration and communication over many years. Previously companies did not admit that the Party committee made decisions. You knew it, but everyone would beat around the bush and it felt like hitting cotton wool with your fist. Everyone knew that the board could not select and appoint the management, a decision made by the Party committee. But companies could not let us know about the process, even though we cared about the company's development. These questions had no answers at all.

If in future the Party committee moves in front of the curtain, it would bring the existing state of affairs out into public view. I believe it will be more transparent. At least we could find an approach to speaking to the Party committee.

Do you think there is key-person risk in listed companies in China?

I think the Communist Party of China (CPC) pays attention to checks and balances. Although in most circumstances the secretary (head) of the Party committee and the chairman of the board are the first-in-command (usually the same person), the first-in-command cannot decide on the second-in-command. The whole Party committee, which also comprises the senior operational executives, is appointed by a higher level Party committee in the CPC. Party committees make decisions collectively through 'one person one vote', and the secretary cannot make decisions by himself or herself. In banks, it is said that 'the secretary manages personnel and the president manages the business'. This means that the Party committee has the power to appoint human resources, while the president (CEO) is in charge of business operations.

This check and balance in practice limits key-person risk. For example, the president has no power to change the vice president and the Party committee of the higher level is responsible for the transfer and appointment of leading cadres. The president is like a sports coach or manager who cannot decide which players to buy, but does decide how to play the game. I believe that key-person risk in Chinese SOEs is lower than in many overseas companies.

See Chapters 3.2 and 3.4 for other parts of our interview with John Law.

Interview: 'Specifying the Party's role will improve transparency'

Jenn-Hui Tan
Head of Capital Markets and Corporate Governance – Asia Pacific, Fidelity International, Singapore

What is your view on investing in China? Has it changed over time?

Fidelity is committed to investing in China and has been investing in Chinese companies now for several decades. We are positive on the investment opportunity and, as the market has developed, we have built one of the largest Greater China buy-side research teams. A recent illustration of our commitment is becoming the first global asset manager to register with the Asset Management Association of China (AMAC) as a private fund management company. We subsequently launched three domestic Chinese funds and intend to introduce more onshore products in the future.

The investment opportunities for domestic and international investors have improved substantially in the last five to 10 years and we believe that the pace of development will continue. Factors that have generally improved and contributed to the changes in the market include the breadth and liquidity of stocks, disclosure levels and access to company management. The legal and regulatory framework has also evolved over time, and enforcement of rules has improved. Looking ahead, the further opening of China's capital markets will attract increased attention of institutional investors seeking new opportunities for their portfolios.

How has MSCI's decision to include A shares from June 2018 affected your business?

We believe that MSCI's inclusion of A shares is positive for us both in terms of investment within the market and the focus of our clients to the market and its investment opportunities. The A share market is already the second largest market in the world by value and the greater participation of institutional investors with longer term horizons and a systematic investment process will help the A share market to become more mature and efficient, improve liquidity and be driven by fundamental rather than speculative factors. We expect corporate governance by A share firms to further improve as their institutional shareholder base deepens.

How important is CG in your investment decision-making process? How do you measure it?

The consideration of governance and sustainability factors is a fundamental part of our investment decision-making process, from the perspective of both risk and opportunity. We believe that a company with superior corporate governance performance can outperform in the long run. We employ both qualitative and quantitative indicators to measure the quality of a company's corporate governance. Qualitative measures include the quality of the management team, accessibility of the board and company management, and levels of disclosure. Quantitative indicators include capital management, executive pay, and related-party transactions.

The* FT *article, "BlackRock and Fidelity put China's Communists into company laws", stated that Fidelity, among other foreign institutional investors had voted in favour of the article amendments of Chinese companies to involve the Party committee. Some saw this as an endorsement by foreign institutional investors. Could you elaborate on the reasons behind your vote? Was the interpretation accurate?

Our votes are cast in accordance with our Responsible Investment Policy and our guiding principle is that voting rights should be exercised in the best interests of our clients. As an active manager, our general policy is to support the management of companies in which we invest but we maintain a robust dialogue and we will form our own views on key governance and strategic issues.

With regard to the article amendments involving Party committees, we undertook a detailed review of this proposal type, weighing various considerations to develop a pragmatic voting approach. We noted that majority of these proposals involved companies which were SOEs and already maintained a Party committee. More importantly, we also wanted to identify if there was any change to the powers of the Board, shareholder general meetings, or impact on shareholders' rights. Our reasons can be summarised as follows: As the ACGA has noted, the proposed inclusion of the Party committee is developed from a local market legal framework including the Company Act and other more recent regulations. The regulators enforce the inclusion of Party committee terms in the Articles.

In our view, specifying the Party committee's roles and responsibilities in the Articles will improve transparency on this key aspect of Chinese corporate governance. Investors had previously little or no information on how a Party committee operates within an SOE. The proposed changes can assist SOEs streamline their internal decision-making process and formalise the working process of their Party committee. We encourage companies to provide annual disclosure on Party committee's activities in a format similar to the existing report of board of directors and supervisory board.

We also considered the amendments from a broader SOE reform perspective. The current run of SOE reform has included changes that grant company management greater autonomy to run their business. The goals have been to improve SOE's business efficiency and profitability and safeguard state assets. We understand that this practice is unique in China and has potential risks that should be assessed and monitored by shareholders on an on-going basis.

What is your view on ISS's* 2018 Proxy Voting Guidelines *that asked investors to vote down article amendments of Chinese companies regarding the Party committee if the proposal lacks transparency or clear board accountability?

We make our voting decisions based on our own Responsible Investment Policy and voting guidelines. Our approach involves consultation with our portfolio managers and analysts and engagement with our investee companies where appropriate.

With regard to the policies of different proxy voting advisory services, we may often come to a different voting conclusion but still understand and appreciate the agency's rationale for their policy and recommendation. We understand ISS's approach to only support what they view as best practice on transparency and accountability and we agree that greater disclosure and clearer lines of accountability relating to the Party organisation and committees is positive. We value the difference in views with the various commentators on votes and governance policies as they promote debate, challenge our approach and inform our policy on an issue.

Interview: 'Understand the spirit of the role'

Tang Bin, Senior Statistician, Senior Economist and General Manager
Shenzhen Qianhai Financial Assets Exchange

President Xi Jinping gave a speech on the legal status of the Party committee within CG. Since then many state-controlled listed companies have been revising their articles of association to specify the functions of the Party committee in corporate governance. What do you think of this?

I think this question could be handled following the principle of "inside and outside China are different, but united in spirit". In essence, no matter whether a company is listed overseas or on the mainland, all state-asset controlled companies must abide by the leadership of the Party, which is a feature of China's special political system.

As for international investors, the statement should be adjusted. I believe the meaning of President Xi's speech is that the influence of the controlling shareholder (ie, the state) should be better reflected in the decision making of companies. Whenever this spirit is expressed, the statement could be more flexible. There is no need for international investors to accept it word for word. If the implementation is rigid, international investors will probably vote with their feet and this would deviate from the original intention to open up the economy further and attract foreign investors.

See Chapter 3.2 for a longer interview with Tang Bin.

3.2 The Board of Directors: Business core

China has a "dual-board" system comprising both boards of directors and supervisory boards. While the system drew historically on governance concepts from European and UK company law, it has evolved differently. China was an early mover in Asia on CG Code development and board independence rules in the early 2000s, yet reforms in recent years have not kept pace with other markets. Although its autonomy is constrained by the Party organisation/committee, the board of directors in a state enterprise plays an important role in business and operational decision-making. The job of the board secretary is key.

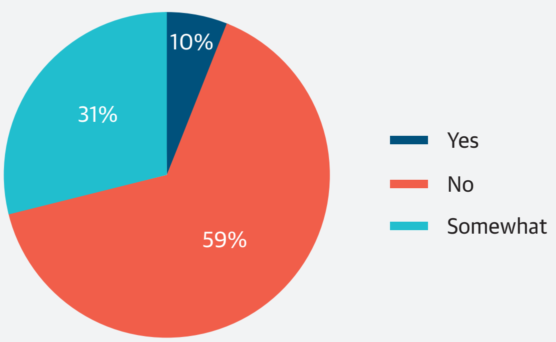
Introduction

The composition and structure of the board of directors in China shares important similarities and differences with boards in other jurisdictions. Although company law provides for both a board of directors and a supervisory board, this is not a "two-tier system" in the classic German/European sense. Whereas in Germany the "supervisory board" today has real power over the "board of management", including the right to hire and fire the chief executive, this is not the case in China for either the board of directors or supervisors. As the previous chapter showed, major personnel appointments fall within the purview of Party organisations higher up the decision-making chain.

At the same time, the board of directors in China is close in structure to a typical unitary board: it comprises executive directors who run the business, non-executive directors from parent or affiliated companies, and independent directors chosen using criteria that would be familiar to any global investor. What is not familiar is the fact that directors are usually divided into just two groups: independent directors and non-independent directors. The fact that China has elements of both the German and British systems of board governance, yet is not the same as either, may be why few foreign investors claim to understand this hybrid system. As our 2017 survey of foreign institutional investors found, only 10% said they comprehended corporate governance in China, another third had a partial understanding, while almost 60% admitted they did not understand (see Figure 3.2 opposite).

Does CG in China make sense?
Foreign investor understanding of the system of corporate governance in mainland China

Fig 3.2



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

Legal basis

The fundamental legal and regulatory basis for the board of directors in China is found in the Company Law (1993; amended in 1999, 2004/5 and 2013) and the Code of Corporate Governance for Listed Companies (2002), published by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission (SETC). Some highlights are presented overleaf.

- **Composition.** The number of directors in listed companies shall be between five to 19. The term of directors shall not exceed three years, but they can be re-elected.
- **Board meeting procedure and voting.**[1] Board meetings shall be called at least twice a year. Temporary/ad hoc meetings can be called by shareholders who hold more than one-tenth of the voting power, or by more than one-third of the directors, or by the supervisory board. The quorum is more than half of the directors. Board resolutions should be confirmed by more than half of all directors. Voting at meetings follows the system of "one director, one vote".
- **Chairman of the board.**[2] The chairman and vice chairman are formally elected by more than half of all directors. The chairman is responsible for overseeing implementation of the resolutions after the board meeting. It is worth noting that the Company Law in China does not give the chairman a casting vote when the board is deadlocked—however such instances are extremely rare.
- **Board committees.**[3] Listed companies may establish committees for strategy, audit, nomination, remuneration and others. Membership of these committees is limited to directors. Independent directors should chair and form the majority of the audit, nomination, and remuneration committees. In the audit committee, at least one independent director should be a professional accountant.

CSRC sets the pace on independence rules

Many of the above principles and best practices were developed in the early 2000s when China's corporate governance reforms hewed closely to international norms. At that time the CSRC formulated a series of key policies in quick succession—and often much earlier than Hong Kong. In addition to the Code of Corporate Governance for Listed Companies from 2002, the CSRC published a set of guidelines on independent directors in August 2001[4] and regulations on quarterly reporting in April 2001.[5] The guidelines for independent directors required all listed companies to have two independent directors by 30 June 2002 and at least one-third by 30 June 2003. These rules were in advance of Hong Kong, which did not require a minimum of three independent directors for existing listed companies until September 2004 and delayed its own one-third rule to December 2012.

CBRC sets the pace for banks

In the mid-2000s, the China Banking Regulatory Commission (CBRC) also became active in issuing specific corporate governance guidelines for banks. The first provisional document appeared in

'My own little ATM'

A flavour of the early policymaking urgency on board governance is apparent from the remarks of Laura Cha, then a vice chairman of the CSRC, at ACGA's inaugural annual conference held in Hong Kong in November 2001. Cha, who had earlier been deputy chairman of the Hong Kong Securities and Futures Commission, highlighted the work the CSRC was doing to try to inculcate a sense of good governance into Chinese companies.

She began by explaining why the regulator had to take a firm line at times: "We believe that incentives for good corporate governance will come from the market (as reflected in the value of a company's shares). However, in a market such as China, where a lot of the fundamentals are really not considered by investors, market incentives do not have their normal value. In an emerging market like China, we need to take a somewhat different approach. Or rather prescribe stronger medicine."

Cha went on to explain the "three separations" between a listed company and its controlling shareholder/parent. This relates to the need to have a clear division between the personnel, assets and finance of the two entities, such that the listed firm has a separate identity as well as segregated ownership rights and management

September 2005 and was called the "Code of Conduct Guidelines for Boards of Directors of Joint Stock Commercial Banks". It talked about the fiduciary duties of directors, the need to protect shareholder interests, and that boards should "perform their duties professionally and effectively". It covered in some detail the duties of directors, the conduct of board meetings, board composition (including a stipulation that any bank with registered capital of more than Rmb1 billion should have three independent directors), and how bank directors would be supervised. The CBRC has since updated these guidelines.

What boards do ...

According to the Company Law, boards in any enterprise incorporated under company law—state or private—have the following functions:[6]

- Calling general meetings and executing the resolutions of such meetings;
- Making key business decisions, such as determining any capital restructuring, business plans, investment or M&A programme, new financing;
- Approving the budget and accounts;
- Profit distribution;
- Oversight and appointment of senior management (including their evaluation and remuneration).
- Setting policies for risk management, internal controls and compliance;
- Overseeing information disclosure systems.

Identical language and ordering of duties is found in the articles of companies.

In formal terms, therefore, the board has authority to make the key business decisions of the company and plays a role in the appointment of senior management. The Company Law even accords companies limited by shares the power to appoint the chairman. Article 109 says: "A board of directors shall have one chairman and may have a vice-chairman. The chairman and vice-chairman of the board of directors shall be elected by more than half of all the directors." And Article 113 gives boards the power to appoint the CEO/president: "A company limited by shares shall have a manager, who shall be engaged or dismissed by decision of the board of directors." ("Manager" in this case means the "general manager", the head of the management team.)

responsibility. These are real and difficult issues in China, she said, because most listed companies (at that time) were restructured state-owned enterprises.

The situation was further complicated by the fact that while the state may have been the legal owner of most listed companies, it did not exert effective control over them. As Cha explained, the interests of the state were often "not clearly reflected in the management or properly represented". There were two main reasons. First, although management may have been appointed by the state, "because most managers are former government officials they tend to look at a listed company as a windfall for them" (indeed, in some cases, they had used listed companies as their "own little ATM machines").

Second, many managers lacked the experience to run their listed companies, which they still saw as part of government. "And so we have some very murky situations where the controlling shareholder has been misusing the funds of the listed company. There is no clear separation of personnel. The same person may serve as an officer or as a board member of the controlling shareholder and at the same time serve on the listed company."

... and don't do

Yet as the previous chapter on Party organisations outlined, despite the formal wording of the Company Law, the powers of an SOE board are constrained with regard to major decisions—the views of the Party organisation must be sought first—and the board has limited authority with regard to:

- The selection and appointment of the board chairman.
- The hiring and firing of the chief executive and/or president.
- The nomination and appointment of directors.
- The evaluation and remuneration of senior and middle managers.

While an SOE board does play a role in these areas, it is more in the nature of giving formal approval to decisions made by higher levels of the Party, government or enterprise. In contrast, the board of a privately owned firm would have an independent and final say on the selection of the chairman and CEO/president.

Interestingly, the articles of some SOEs more closely reflect reality and are often silent on the appointment of the chairman, while the appointment of the CEO/president comes with significant strings attached. For example, the articles of Shengjing Bank, based in Shenyang City and listed in Hong Kong, does not include appointing the chairman among the 21 duties of the board and further state that the board can "appoint or remove the Bank's president and Secretary to the Board ... *in accordance with the recommendations of the chairman*" (emphasis added).[7]

> *The chairmen of SOEs in China are often political appointees who lack business experience*

Some may argue that the appointment of a chairman to an SOE is a political decision in most jurisdictions, even developed countries, and that China is not so different in that respect. It is also fair to say that any leader of a major enterprise in China, whether state-owned or private, will need a strong sense of "political wisdom" to run his or her company well. However, there are still certain differences in the political appointment system of China compared to other countries First, it is not unusual for a government official who has little business experience to become the chairman of a major SOE in China. Second, the term of an SOE chairman is usually short—only a few years—leaving these political appointees insufficient time to fully understand and adapt to the business that they are overseeing. Third, Beijing will swap the chairmen of competing SOEs from time to time. And fourth, there is a general lack of disclosure in the nomination process. In some cases, enterprise managers find out through the media that their chairman has been changed.

Challenges

Strategy development

Although most listed SOEs have a strategy committee in their board of directors, the committee's power to develop strategy is constrained by the government's overarching five-year plan for their sector, especially in major sectors such as energy and resources. The committee will usually hold only one or two meetings each year, with most of the discussion on investment projects developed by management in response to the five-year plan. Discussion tends to be procedural and once management plans are submitted to the strategy committee for review, there is usually little room to amend them.

To the extent that strategy is discussed within an SOE, it will be led by the chairman of the board, developed with the help of strategy research analysts, and submitted to the Party organisation for discussion and approval. The chairman of the board will also communicate in advance with the major shareholder and seek its approval. In many cases, the chairman will already be part of the parent company's leadership team. He will communicate informally with the more important directors on his own board, such as directors appointed by the major shareholder or influential independent directors, and secure their support. The decision will then be approved by the board of directors and at a general meeting, if required, to satisfy procedural requirements.

Interestingly, the boards of banks are given, at least on paper, a more proactive role in strategy development. The CBRC's 2005 Guidelines list 'defining strategy' as the first duty of directors. It goes on to say:

> Directors shall cause commercial banks to define business strategy and direct commercial banks to conduct long-term business activities based on such defined strategy. Such strategy shall take adequate consideration of growth targets, the current status of business operations and risk exposures, the market and macro-economic environment of commercial banks, shall satisfy the needs of commercial banks for long-term development, and make reasonable estimates of potential risks.

Who challenges management?

Board dynamics in China are complicated by the fact that, despite their common fiduciary duties of loyalty and diligence to the company (Article 147 of the Company Law), non-executive directors clearly have different or competing agendas and objectives.

There are two kinds of non-executive directors: those nominated by shareholders (mostly the major shareholder); and independent directors. It is important to note that in China A share listed companies, except overseas dual-listed ones, do not use the terms "executive", "non-executive" and "independent non-executive directors". There are only "independent directors" and "non-independent directors"—a simpler construct that clearly reflects a director's role and primary loyalty. To decide if a non-independent director is a company executive, one needs to look at their other titles.

Non-independent, non-executive directors are generally nominated by the major shareholder and occupy a majority of seats on the board. Their practical role is to represent the opinions of the major shareholder. Before any board meeting, management will usually seek approval from the major shareholder on important issues. Hence, such directors have no real need to challenge management in a board meeting.

> *The SOE board meeting in China is often scripted, with the real discussion taking place between meetings*

Independent directors typically focus on compliance issues and the procedural legitimacy of board meetings. Some pay attention to the protection of minority shareholders. Historically, many independent directors have come from academia or government, hence lack a deep grasp of both business and the sector, market and operations of the listed company on whose board they sit. This usually makes it difficult for them to provide independent and authoritative opinions on significant business decisions.

The end result is often scripted board meetings and little challenge to management. Even independent directors with a deep understanding of business and the company's sector will often find it difficult to raise different ideas in a meeting. To be effective, directors have to raise issues before meetings, as the box story 'Influencing management: from persuasion to objection', presented overleaf, indicates.

Influencing management: from persuasion to objection

Five ways for a non-executive director to influence management include:

Step 1: Talking to the board secretary before meetings
Because A share companies are required to disclose director voting in board meetings, they must give reasons for dissenting votes and abstentions.[12] Board secretaries will try to avoid such votes by communicating with directors before meetings. This allows directors to pose questions they believe are important.

Step 2: Putting forward general views at meetings
Due to the communication before meetings, directors will know the issues to be decided and will have had their questions answered already. Even if a director does not agree with a decision, he or she will at most make only general comments in the meeting. This will not affect an affirmative vote.

Step 3: Asking for further information and a postponed vote
This is a more serious challenge to management and, therefore, does not happen often. While the chairman can refuse to postpone voting—due to a deadline—the company runs the risk of the director casting a dissenting vote or abstaining. Sometimes a chairman will agree to postpone voting, after which management will communicate with the director before the next board meeting. The proposal is duly approved at the next meeting.

Step 4: Missing the meeting
A stronger measure of opposition is where a director who holds a different opinion on a proposal, but does not want to be confrontational, decides not to attend a meeting (nor authorises another director to vote in his/her place). It is believed many independent directors in China have chosen this method to protect themselves and not offend the company. The problem is that since regulators have rules on meeting attendance, directors can only use this measure in rare cases or risk being judged as not performing their duties.

Step 5: Voting against or abstaining
This is the strictest challenge, hence it is extremely rare. After a director casts a dissenting vote or abstention, the company is required to record this in the minutes, which are sent to the exchange as a matter of course. Such disclosure may arouse the attention of the exchange or regulator, which may ask the company to explain. A director who casts a dissenting vote is usually in serious conflict with the chairman and management.

Nomination of non-executive directors

In contrast to the simplicity of the Company Law, the nomination of non-executive directors in state-controlled listed companies is complicated, with overlapping participation of Party and state entities. The general principle is that the appointment is made by the "organisation department" of the Party organisation of the company's controlling institution.

Each enterprise will have slight differences based on its special situation. If the shares of the company are wholly owned by SASAC (or one of its subordinate state capital operation centres), the appointment and dismissal of directors will be determined by SASAC. There will be some "outside" directors, but not "independent" directors (since the firm is unlisted).

If the controlling shareholder of the listed company is a wholly state-owned group company, the group company will have significant influence over the composition of the board of directors. In some listed companies—mainly financial institutions—even if the state shareholder owns less than 50%, the state still has the power of appointment and dismissal of non-independent directors. For example, the shareholders of a municipal commercial bank may include many SOEs each holding less than 50% of the shares. However, for historical reasons, the bank is determined to be a municipal enterprise and so the local SASAC has the power to appoint and dismiss the directors and management.

Nomination committees: form over substance

By 2012 more than 88% of listed companies had set up nomination committees to investigate the qualifications of director candidates. In practice, however, the role of the nomination committee is largely procedural. After candidates are nominated by the controlling shareholder, the nomination committee will conduct a formal review and submit them to the board of directors for approval. Few members of a nomination committee have the ability to select candidates from the market, nor any real power of selection or appointment. And certainly not in relation to non-independent directors.

In a few circumstances, such as certain large overseas listed companies, independent directors with strong networks may be invited to recommend candidates for the board. The nomination committee will then play a role in reviewing and possibly interviewing them. If the chairman agrees, the board will then discuss and make a decision.

> *The role of nomination committees in most listed companies is largely procedural.*

In other cases, listed companies may depend on former directors and some may turn to a database of independent directors, such as those created by the Shenzhen Stock Exchange and Listed Companies Association of Beijing. However, it is likely that such companies will be private sector firms, not SOEs. As in most markets, firms would prefer to appoint people they know rather than seek unknown candidates from a wider pool.

Remuneration linked to position or market average

The remuneration of directors in state enterprises follows a rigid pattern. For executive directors, their salary and benefits are determined by their management position. They are essentially not paid for performing the duties of a company director, but only in their capacity as a manager. Some may receive a director fee, but it will be very low and is not disclosed.

Non-executive directors nominated by a controlling shareholder, such as SASAC or a parent holding company, will usually hold positions in the controlling shareholder or parent firm and will be paid by that entity, not the listed subsidiary. While this may seem reasonable, the issue is that they may not behave in the best interests of the listed company, but in the interests of the party that appointed them or the parent company.

Remuneration for independent directors in all types of companies, state or private, adheres closely to the market average. According to a sample of 12,821 reports from A share listed companies over 2005 to 2014 (excluding finance firms), they tended to "keep abreast with each other" when determining the remuneration of independent directors.[8] Companies did not benchmark themselves against a national standard, but against companies in a similar industry or region, and of a medium size. The researchers believed that the reason for this phenomenon was the undeveloped market for independent directors in China and the lack of a "reputation mechanism" that allowed companies to compare, and value, them individually. The development of independent director pay has therefore depended more on external references than the intrinsic value of each individual director. Indeed, many enterprises cannot properly assess the capability of an independent director before he or she is appointed, hence their value will not be reflected in their remuneration. Fees have tended to converge. Moreover, in most cases, the pay of independent directors in A share companies bears no relevance to company performance. Their incentive to join a board is mainly reputational: adding the director position to their resume.

Diversity

According to research by Deloitte in 2016[9], the percentage of female directors in A share companies was 10.7%, an increase of 2.2 percentage points compared with 2015, while the percentage of chairwomen in boards was just 5.4%. There is no policy or regulation in China to mandate or recommend any percentage target for women directors. Indeed, gender diversification in listed company boards has aroused little attention.

Board size and independence ratios

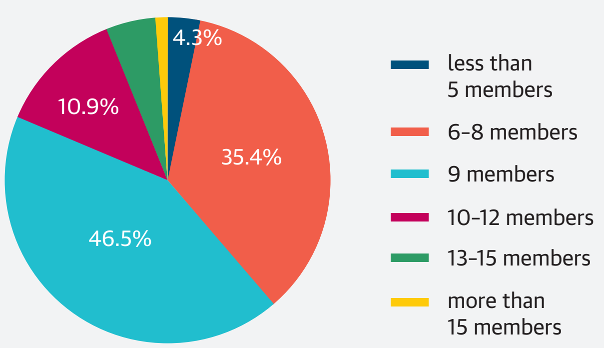
Another problem for boards is their size—they are often not big enough to fulfil their expanding duties. A common phenomenon is the "nine-person" board, structured to meet the minimum requirement of independent directors making up one-third of the board.

Mainboard companies in Shenzhen, for example, had an average of 8.87 people on their boards over 2012 to 2015, while those on the SME and ChiNext boards had an average of eight to 10 people, according to publicly available data. Board size in Shanghai is slightly bigger, with the average number of directors standing at 10.3 in 2013. However, just over half the companies had between eight to 10 directors, with around one-third having nine members.

Fast forward to May 2018 and the percentage of listed companies in China with a nine-member board had grown to just over 46%, according to data provided by Valueonline, a Shenzhen compliance consultancy (see Figure 3.3, below). Furthermore, another 35% of companies have boards of six to eight members, while around 4% have boards with four to five members. This means that more than 85% of listed companies in China have boards of nine or fewer members.

As for the difference between Shanghai and Shenzhen, the former still boasted bigger average boards in 2018 but the difference was not large: 8.83 versus 8.35 members, with both averages falling since 2013.

China A share listed company board size Fig 3.3
May 2018



Source: *ACGA analysis, based on Valueonline data*

Not surprisingly, companies with larger market caps tend to have bigger boards than mid- and small-caps. But what is interesting is that the difference has been diminishing. In 2013, the mean average size of boards in companies on the Shanghai Stock Exchange (SSE) 50 Index was 13.12 people, while for the SSE 180 Index it was 11.36.[10] But our research has found that the mean average board in the SSE 50 had dropped to 11.78 people by end-May 2018, while for the SSE 180 it had shrunk to 10.11 members, as Table 3.2 opposite shows. Meanwhile, the mode average for both indexes was a nine-member board.

Another salient fact from the table: in terms of the percentage of independent directors, large firms in China stick closely to the one-third requirement. Little has changed, therefore, since a 2012 study by the Chinese Academy of Social Sciences found that the top 100 A share firms by market cap had an average of 37.18% independent directors on their boards.[11]

Meanwhile, although some companies have very large boards, they are few in number—as Figure 3.4, opposite, shows.

In practical terms, small boards pose certain problems. A key challenge is that since independent directors must comprise a majority on each board committee, each has to sit on multiple committees whether or not they have the relevant expertise or time. This adds to the pressure of being an independent director on a listed company board in China. And it is questionable whether a small board can provide the requisite level of oversight and expertise required in a listed company operating in multiple sectors or countries. Indeed, the rigidity in terms of board size and the lack of natural growth in independence ratios is a striking feature of corporate governance in China over the past 15 years. Companies follow the rules; they do not seek to go beyond them.

Following the rules

Tab 3.2

Board size and independent director (ID) ratio, SSE 50 & SSE 180, May 2018

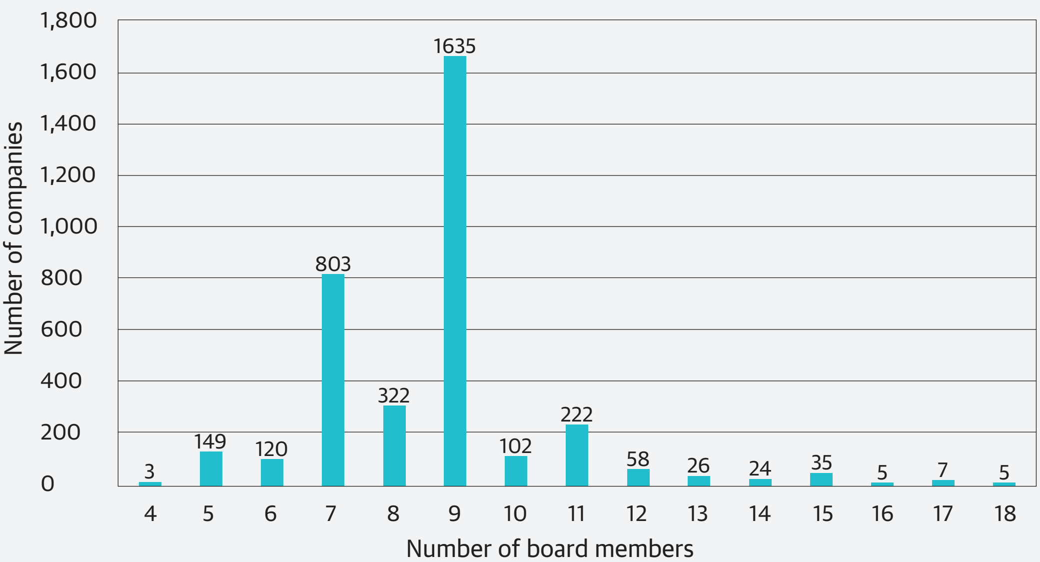
	Board size		Independent Directors (No.)		Independent Directors (%)	
	SSE 50	SSE 180	SSE 50	SSE 180	SSE 50	SSE 180
Average	11.78	10.11	4.5	3.8	39%	38%
Max	18	18	6	6	67%[1]	67%
Min	6	5	3	2	33%	22%[2]
Mode	9	9	5	3	33%	33%

[1] *Based on SSE 50 board with four IDs out of six directors.*
[2] *Five companies in the SSE 180 Index have less than one-third IDs on their boards.*
Source: *ACGA research for SSE 50; Valueonline, for SSE 180.*

Range of board sizes in China A share listed companies

Fig 3.4

May 2018



Source: *ACGA analysis, based on Valueonline data*

Conclusion: Next steps

Much of the focus over the past year in corporate governance in China has been on strengthening the Party organisation/committee. With this reform now in place, how could the board of directors be strengthened? Our observations and suggestions follow.

Clarify the role of Party organisations in the Company Law

Core functions of the board of directors in listed SOEs to appoint, dismiss, supervise, evaluate management and determine their remuneration have long been overridden by the policy of "Party managing cadres" in such enterprises. The board has only formal power in these areas; in practice it is the Party organisation or committee of the controlling institution which appoints the management of an SOE. While SASAC has tried some pilot programmes to let the board of directors appoint management, progress has been slow. Returning the power of appointment and dismissal to the board is a key aspect of mixed-ownership reform being tested in some state enterprises.

As China's economy and capital market develop, allowing SOE boards greater involvement in senior management appointments would likely lead to more efficiency in decision-making and clearer lines of accountability to the board and all shareholders. It will also be important to elaborate on the role of Party organisations in the Company Law, so that the "three important and one large" decisions they must pre-approve are clearly defined and their relationship with the board of directors, and the general shareholder meeting, is transparent. Any long-term lack of clarity in these areas is likely to lead to foreign investors applying discounts for governance opacity.

Increase the percentage of independent directors

As China nears her third decade of modern CG development, there are cogent reasons to suggest that the one-third rule be amended and companies be encouraged to increase the proportion of independent directors. This would not only be welcomed by institutional investors and other stakeholders, it would be good for companies: the rapid growth of the economy has led to larger and more complex firms with a greater need for specialist outside expertise and board committees. A one-third ratio puts a heavy burden on a small group of directors.

While the right percentage is a matter for policy discussion and it may be premature to introduce a hard 50% target, two next steps suggest themselves: encouraging companies to negotiate with their controlling shareholder/parent company to increase their independent director ratio; and activate current rules to allow minority shareholders to nominate independent director candidates.

Clarify the role of non-executive directors

We noted above the lack of differentiation between executive directors and non-executive directors among the "non-independent" director group on company boards. In addition to requiring clearer disclosure of these different roles in A share firms, more regulation and guidance should be put in place for affiliated non-executive directors so that they do not merely represent the major shareholder or parent company, but act in the interests of the whole company (including minority shareholders). The same should apply to any non-executive directors nominated by legal-person minority shareholders, such as other state enterprises. Currently, directors nominated by such shareholders exist mostly because of an investment agreement determining board membership in advance.

Enhance board evaluation

Board evaluation mechanisms are still at an early stage of development in China and there is limited assessment done on the operation of the board of directors as a whole and its composition. Some companies, such as ICBC, have a reasonably well-developed board evaluation system. We recommend that listed companies make efforts in the coming years to evaluate not only the whole board but individual directors. Regulators could issue guidelines on this and require companies to disclose the process they undertake to do evaluations. Methods range from self-evaluation (directors evaluating themselves and the board as a whole) to mutual evaluation (directors evaluating each other and the board as a whole), or engaging a third-party consultant to provide an independent assessment.

Enhance the role of board committees

The role of committees under the board of directors in many listed companies is limited. Responsibilities are often not clearly defined, members may not understand the objective of a committee and, in some cases, which committee he/she belongs to! In order to enhance the supervisory effectiveness of committees, more guidance needs to be given to companies on their functions, responsibilities and procedures. Committees need to have the right level of expertise in order to do their jobs properly, and the capacity to hire outside consultants for specialist advice.

Endnotes

1 Company Law (2013), Articles 48, 111, 112, 113; "Code of Corporate Governance for Listed Companies", Articles 45-47.

2 Company Law, Article 109.

3 "Code", Article 52, Article 57 and Article 58.

4 China Securities Regulatory Commission, "Guidelines on Establishing the Independent Directors System in Listed Companies", 16 August 2001.

5 China Securities Regulatory Commission, "Standards for the Contents and Formats of Information Disclosure by Companies Offering Securities to the Public No. 13 – Contents and Formats of Quarterly Reports", 6 April 2001 (revised in 2007, 2013, 2016).

6 Company Law, Article 46.

7 Shengjing Bank, Articles of Association, p. 49. See http://www.hkexnews.hk/listedco/listconews/sehk/2015/0121/LTN20150121298.pdf

8 Shen Yifeng, Chen Xuan, "The Determination of the Remuneration of External Independent Directors without Performance Evaluation", Nankai Business Review, 2016, 19(2):4–18.

9 Deloitte, "Gender Diversification of Members in the Board of Directors: Global Perspective", 5th version, 2016.

10 Deloitte, "Gender Diversification of Members in the Board of Directors: Global Perspective", 5th version, 2016.

11 Research Centre of Chinese Academy of Social Sciences, "The Evaluation of Corporate Governance of Top 100 Listed Companies in China in 2012", 2012.

12 Shanghai Stock Exchange, "Stock Listing Rules", Article 8.1.4; Shenzhen Stock Exchange, "Stock Listing Rules of the Shenzhen Stock Exchange", Article 8.1.4.

Interview: 'Board secretaries need higher status and a wider position'

Tang Bin
Senior Statistician, Senior Economist. General Manager, Shenzhen Qianhai Financial Assets Exchange
Awarded "Gold Medal Board Secretary" by New Fortune magazine for seven consecutive years from 2008 to 2015.

You worked in Industrial Bank for many years and served as board secretary and director. What are your observations on corporate governance in China?

Let us start from my personal experiences. I joined Industrial Bank in 1996. Before that I served in the Statistical Bureau of Fujian Province for 10 years and also worked in the general department and distribution system department in the Commission for Restructuring Reform of Fujian Province. The experience gained in these two periods helped me a lot with my work as a board secretary.

First, statistics gave me a macro view and equipped me with the ability to deal with mass data, so that when I was a board secretary I could communicate effectively with regulators and help investors analyse corporate value. Second, during my time in the Commission for Restructuring Reform, I worked in a pilot programme on reform of the shareholding system, which gave me exposure to taxation, social security, finance and other sectors, especially the macro picture of finance.

One lesson is that the improvement of corporate governance cannot be separated from the legal environment and social recognition. Take Industrial Bank, for example. It was founded in 1988 with approved registered capital of Rmb1.5 billion, but due to limited social recognition the bank could not mobilise social capital for funding. From 1988 to 1991, only Rmb500m had been collected after several rounds of financing, of which 85% had been provided by government. Objectively, the major shareholders of the bank turned out to be financial departments from different levels of government in Fujian Province.

As a result, in the first and second boards all the directors were the heads of the provincial financial departments and the major topic of discussion was the profit distribution plan. Furthermore, at the end of the 1980s and early 1990s, there was no "Company Law" and no clear definition of the shareholding system, board of directors or other corporate governance concepts. We had to crawl forward on one hand using foreign experiences for reference while dealing with China's reality. The Company Law was issued in 1993 and became effective in 1994. The law adopted the paid-in capital system, but Industrial Bank used the authorised capital system. In 1996, the People's Bank of China regulated the capital structures of commercial banks and cancelled foreign shares and individual shares, although Industrial Bank had had foreign shares and preferred shares since 1988. At that time the legal system was imperfect and the bank's innovation took place prior to regulation.

A second lesson is that a good ownership structure is the foundation of good corporate governance, with clear powers and responsibilities and effective checks and balances. Since 2000, Industrial Bank had several rounds of financing and introduced eight central enterprises including Shenhua, Baosteel, Shenzhen Hualian and others to optimise the ownership structure. The percentage of the largest shareholder, the financial departments of Fujian Province, gradually decreased from 80%. On 5 February 2007, when Industrial Bank was listed, the shareholding percentage of Fujian financial departments fell to 20%. At that time the governance of Industrial Bank had changed a lot and the board of directors played a more active role. In the four boards after 2000, because of the eight central enterprises, the board of directors had independent status and the directors proactively joined the discussion.

Therefore, I always think that the shareholders and the development of a company complement each other. The development strategy of a company determines the type of shareholder it wants. When Industrial Bank decided to seek international exposure in 2003, we invited overseas strategic investors such as IFC and Hang Seng Bank.

Furthermore, while the development of a bank needs sufficient capital, the continuous capital injection by external investors was not good for ownership stability. So we decided to reduce profit distribution to replenish capital and speed up the development of the bank. The profit distribution ratio was decreased from an earlier 70% to 35%.

From your experience, what are the key contributions that board secretaries can make to corporate governance in listed companies? What areas need improvement?

Your capability determines your status. Since the legal environment is in a process of gradual improvement and relevant laws and regulations are being issued and improved, the function and status of a board secretary depends on the authority of the company's leaders and his/her own experience and capability. My experience in the Commission for Restructuring Reform and working in statistics gave me more understanding about the shareholding system and capital market. In contrast to other banks, Industrial Bank provided special status and position for the board secretary. For example, in June 2007 I had a meeting with HSBC. In one day we discussed three topics, namely retail business, green finance and capital markets. HSBC was curious about my job and role in Industrial Bank and why I was so familiar and interested in these three business lines, which were not connected to each other. I explained that my job as board secretary put me in charge of corporate governance, investor relations and capital operations. At the same time, I was also in charge of innovation business, including the transformation strategy, inclusive finance and social responsibility, and I was familiar with the mainstream retail business of the bank. As far as I am concerned, the board secretary should participate in the whole process of significant decision-making and major deals of the bank.

Especially in China, where corporate governance is at a beginning stage, the board secretary needs to have higher status and a wider position. It was because of my full participation in the financing of foreign capital that I had smooth communication with international investors.

In the Western corporate governance system, there is a mature framework and scope of responsibilities for the corporate secretary. Their functions, powers and responsibilities are very clear. But in China the legal environment is still under construction, social recognition needs to improve, the business sector is still developing, and organisational structures are changing. If the board secretary limits himself/herself to a fixed framework, it will be hard to carry out activities.

I believe that the role of a board secretary should include the following aspects. I will explain with examples:

Be a participant and implementer

First, be a participant and implementer of significant decisions of the company, such as assisting the board chairman to call board meetings, participate in significant decisions regarding the bank's development and coordinate communication with stakeholders. In 2004, Industrial Bank planned to acquire Guangdong Foshan Commercial Bank. At that time the percentage of retail business in Industrial Bank was only 3% and the acquisition of Foshan Bank meant a significant transformation of our business. After a day's intense discussion, the directors held different opinions and came to no resolution. At the time, the coordinating role of the board secretary was very important because the directors who held different opinions were dispatched by international investors who were familiar to me. It was me who introduced them to the board during our international financing. So I took the directors for an on-site investigation in Guangdong. After the trip, we agreed with each other that the Pearl River Delta region had a rich economy and the retail business had a promising future, therefore we could extend our business from Foshan to the entire delta region. After a revision of the acquisition proposal, it was approved in the board meeting. The deal was done. So the board secretary must accurately convey the opinions of the board and must fulfill the promises made to investors in order to promote the transformation of the bank.

Be a practitioner and promoter

Second, the board secretary should be a practitioner and promoter of the idea of corporate governance. When Industrial Bank discussed its financing with overseas investors, they demanded a put option. We insisted on the principle of shareholder equality, that equity investment was not debt, and refused to add this option to the agreement. Finally, the overseas investors agreed with us.

Through overseas investors, however, we came into contact with new international trends and ideas, some of which happened to coincide with the development of Industrial Bank. For example, we started to focus on social responsibility and green finance. In June 2007, I was invited to attend the Global Sustainable Bank seminar organised by the *Financial Times* in London. At the seminar, I summarised the term "social responsibility" as "responsibility in profit", which meant to realise social responsibility in business activities. Afterwards, with the attention and promotion of the board, Industrial Bank proposed a new corporate governance idea, namely to "actively explore many measures to improve the implementation of social responsibility in the bank and build a harmonious situation between people and nature, environment and society". Under the guidance of the "green" governance idea, Industrial Bank became the first financial institution in China to adopt the Equator Principles in 2008 and after a decade's development has become the explorer and advancer of green finance in China.

In recent years, energy conservation, emissions reduction and environmental governance have been raised to a national activity in China. Thanks to its advanced governance ideas, Industrial Bank was ahead of the curve on this strategy. As a director and board secretary, I was honoured to experience the significant issue of adopting the Equator Principles and proud to witness the rapid development of environmental finance from scratch in Industrial Bank. For the board of directors, corporate governance is not an ivory tower, but a road sign to guide a company, especially a great company, to move forward.

Be a communicator

Third, the board secretary should be a communicator with regulators. Since 1988, the Basel agreement has evolved from its first to third version. The capital adequacy ratio of 8% seems the same, but requirements are actually increasing. The definition of the nominator (capital) is narrowing, while the denominator (risk weighted assets) is expanding through a requirement to increase interbank and operational risk capital. Therefore, a bank needs to replenish capital continuously. This responsibility is assumed by the CFO in the West, but in China it is assumed by the board secretary, which is a challenge. Industrial Bank planned to innovate and issue subordinate debt in 2003. Our preliminary proposal was vetoed by the China Banking Regulatory Commission (CBRC). I then communicated with CBRC and discussed the biggest difficulties of bank reform. All these contradictions could only be adjusted by increments, which meant increasing credit by issuing subordinate debt with subsidiary capital. Finally, the proposal was approved by the CBRC.

Be a window to Investors

Finally, the board secretary is a window to investors. Because I led the financing programme of Industrial Bank, I was close to our investors and understood their claims on risk control and transparency. During our communication, I could address their doubts and, at the same time, maintain the interests of the bank. I was once asked by investors when I would be stumped for an answer. I replied only when I would have to tell a lie. I believe the professional standards of a board secretary must be "honesty, transparency, professionalism and confidence".

How should the board secretary balance the relationship between the board and management?

In Industrial Bank the process of democratic decision-making is implemented well in board meetings. The meetings are always intense. Once management proposed to appoint two chief officers and many questions were raised in the board. Why would there be two positions? What are the qualifications of the candidates? What is the procedure? In the end, since the board adopted a voting system, the proposal was vetoed. So the voting system is very important and embodies the role of directors in decision-making. But an unavoidable issue in corporate governance is that the board's ability to perform its duties to the full depends on proposals submitted by management. These proposals are submitted to the board by the board secretary. Therefore, the board secretary must understand the business well by going deep into every business line, participate in Party committee meetings and general office meetings, and so on. He should fully understand what issues must be determined by the board and ensure it knows all the facts and has decision-making power.

What kind of independent directors do you think will bring value to a company?

I think the first quality is expertise. Independent directors are important members of the board and participate in decision-making. If they have insufficient expertise, they cannot fulfil this mission. The second quality is independence. Expertise provides the capability to perform the duties of an independent director, while independence is the foundation of these duties.

Currently, the major problems in finding good independent directors relate to resources and evaluation. Some institutions have tried to set up a "talent pool of independent directors", but current policies exclude many capable people from the pool. It is hard for the bank to find appropriate independent directors, hence one idea is to expand the scope of qualifications for independent directors. Second, an independent third-party could be engaged to evaluate the performance of independent directors and make recommendations. If professionals such as lawyers and accountants serve as independent directors, their professional abilities would help not only with their performance of duties but other independent directors in general. Regarding having university lecturers serve as independent directors, I do not support this practice. The reason is that lecturers in Chinese universities generally lack market experience, except those in legal and accounting majors who have been in the capital market for many years.

Is any improvement needed in the current board secretary system in China? What risks do board secretaries face?

I think many improvements are needed. First, the status of board secretaries should be guaranteed by the system. Most board secretaries are not executives. In most listed companies, they are middle-level managers. Each regulator has a different focus of regulation, hence their attention on board secretaries varies. The China Securities Regulatory Commission (CSRC) strives to protect the interests of investors and the board secretary is a window into the company for investors. The Company Law and other CSRC policies therefore reflect the importance of the board secretary. But in many companies although board secretaries are executives in name, in reality their position is in middle management. The importance of the board secretary will then be ignored and they cannot play their proper role.

Second, regulators should provide more rights to the board secretary and protect those rights. Regulators actually get to know companies through the board secretary. The risks for board secretaries are that their rights are not protected by law and they are appointed and dismissed by the board chairman. The corporate secretary in the West is often the chief legal counsel at the same time. The principles are clear and the duties are limited. In China, board secretaries have a lot of duties which greatly exceed their remuneration.

See Chapter 3.1 for another part of our interview with Tang Bin.

Interview: 'Board secretaries are the salt in cooking'

John Law
Board director; Former Principal Banking Specialist, International Finance Corporation (IFC), 2004 to 2012; Independent director (representing IFC)

John Law, an experienced director who worked in international banking for more than 30 years, gives his views on the central role that board secretaries play in boards of directors in China.

What is the value of board secretaries to listed companies in China?

The role of the board secretary is very important to the company. They are the information hub, understand what information should be disclosed to the board, and immediately notify non-executive directors in case of emergencies. The board secretary is like the salt in cooking: he activates the board meeting, understands the interests and wants of all parties, tries his best to balance them, and knows how to establish mutual trust with non-executive directors.

How does a board secretary balance the interests of Party committees, boards and management?

In order to balance the relationship between the Party committee and the board, the board secretary should fully understand the role that the Party should play in board activities and should be able to balance and coordinate the relationship from the business point of view. But some board secretaries only pay attention to the interests of the Party secretary, because the secretary is his real boss. He may be rude to other directors and may not make the effort to fully explain things. This kind of board secretary cannot play the role properly and will likely make matters worse. A good board secretary, besides being highly capable, should be respected by all parties.

See Chapters 3.1 and 3.4 for other parts of our interview with John Law.

3.3 The Supervisory Board: Monitoring directors

Supervisory boards are the second, and weaker, limb of the dual-board system in China. They typically suffer from issues such as a lack of independence, limited technical and business expertise, small size, and other factors. How could their role in governance be improved?

Introduction

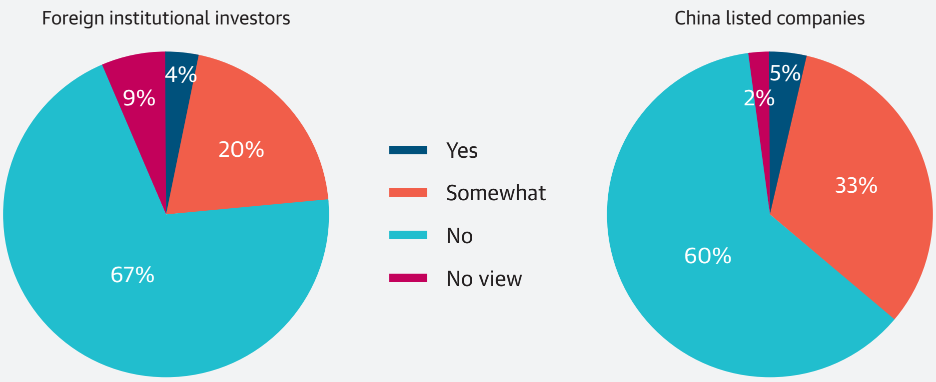
The supervisory board is the second limb of the dual-board system in China and is tasked with "supervising" the activities of the board of directors and management on behalf of shareholders. Like the German system, supervisory boards in China include employee representatives. Unlike the German system, these boards have limited authority over directors and management. They cannot hire or fire the CEO or president. They are placed after the board of directors in the text of the Company Law. And they are much smaller than the board of directors—typically only around one-third the size—making it hard for them to fulfil their formal role. The word "monitor" might be a better description of their actual function.

By common consent, the supervisory board is the weakest link in China's system of corporate governance. At best it provides an additional layer of comfort to the main shareholder in an SOE that directors and managers are behaving properly; although the main shareholder will know this already through the Party organisation and other avenues. In normal times, supervisory boards are seen as duplicating the work of the board of directors and/or internal audit. Their monitoring can be formalistic and often adds little informational value to companies or assurance to investors. As our surveys of foreign institutional investors and China listed companies both show, a large minority do not believe supervisory boards are adding value.

When the Company Law was revised in 2005, many institutions and experts suggested eliminating the supervisory board and allowing companies to design their own supervision mechanisms. Not surprisingly, the government did not support this proposal: supervisory boards provide another level of oversight over SOEs and allow employees to play a role, albeit minimal, in company governance. In other words, there were political considerations that needed to be taken into account.

Do supervisory boards add value to corporate governance in China? Fig 3.5

Perceptions of foreign institutional investors and China listed companies



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

Could supervisory boards add more value? Given that around 20% of foreign respondents and 33% of Chinese respondents believe supervisory boards add some value, the answer would appear to be a cautious yes. Part of the answer may be to carefully and transparently delineate their role from the board of directors, in particular the audit committee, and from internal audit. A second approach would be to allow supervisory boards to use, as a measure of last resort, some of the investigatory and litigation powers they enjoy under the Company Law. And third, if companies can build adequate supervisory mechanisms within their boards of directors, they could be given the option of not forming supervisory boards.

Legal basis

The legal and regulatory basis for the supervisory board in listed companies in China is provided by the Company Law, the Code of Corporate Governance for Listed Companies, the Guidelines for the Standard Operation of Listed Companies, the Interim Regulations on the Boards of Supervisors in State-owned Enterprises, and various other normative documents. The contents cover the structure and composition of supervisory boards, their duties and obligations, qualifications, operating procedures and so on. These points are further elaborated below.

Structure and composition

The basic structure of a supervisory board in a company limited by shares is provided in Article 117 of the Company Law:

- The number of members should not be less than three;
- Members comprise representatives of shareholders (“shareholder supervisors”) and representatives of employees (“employee supervisors”);
- The percentage of employee supervisors should not be less than one-third;
- The directors and senior management must not concurrently act as supervisors.

Meanwhile, some listed companies also have “external” and/or “independent” supervisors.

As their name suggests, “shareholder supervisors” represent the interest of shareholders—usually the largest shareholder(s). There is no mandatory law or regulation setting a minimum ownership percentage before shareholders have the right to nominate supervisors, leaving it to the articles of association of each company. However, the Shenzhen Stock Exchange encourages listed companies to allow shareholders who individually or collectively hold more than 1% to nominate a shareholder supervisor.[1]

In practice, where the state has a controlling stake, shareholder supervisors will be nominated by the State-owned Assets Supervision and Administration Commission (SASAC). In some cases, SASAC officers will assume the responsibilities of supervisors in listed companies under the supervision of SASAC and, since they do not assume any other position, are effectively full-time supervisors. A full-time supervisor will often be quite independent from the management of a listed company and will usually assume the role of chairman of the supervisory board. He or she may also assume the role of supervisor in two to three enterprises for three years each and will not serve another term.[2] Sometimes the secretary of the company’s discipline inspection committee, part of the Party organisation, will be the chairman.

The “employee supervisor” is elected by company employees in a general assembly of the representatives of employees, the employees’ assembly or other fora.[3] In practice, the position of employee supervisor is usually assumed by the chairman of the labour union in the company.

The term “external supervisor” is a broader category and refers to someone who has no other position in the listed company other than supervisor. There are two kinds of external supervisor:

one is a shareholder representative, who is usually an employee of the main shareholder and dispatched to a company as a supervisor (such as the full-time supervisors sent by SASAC); the second is an "independent supervisor", someone who is independent of the company's shareholders as well as management.

In the A share market, some companies have external supervisors and independent supervisors. For example, external supervisors make up more than half of Tsingtao Brewery's supervisory board. Sinopec has four external supervisors. Unfortunately, there is no rule requiring companies to differentiate between external supervisors who represent shareholders and those who are independent. Both can be called "external supervisors". This often makes it difficult for investors to tell the difference. Some companies do clearly differentiate, such as ICBC. Meanwhile, for companies listed overseas, external supervisors should make up more than half the supervisory board and there should be more than two independent supervisors.[4]

Rules for banks

The China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBOC) have specified more prescriptive rules for commercial bank supervisory boards. For example:

- Shareholders who individually or collectively hold more than 3% of the bank's shares may nominate a shareholder supervisor.[5]
- Shareholders who individually or collectively hold more than 1% of the bank's shares may nominate an external supervisor.[6]
- One shareholder shall only nominate one candidate for independent director or external supervisor, and shall not nominate both an independent director and an external supervisor.[7] Since the mission of the supervisory board is to supervise the activities of the board of directors, having representatives on both would create a conflict of interest.

In other words, the rules for commercial banks are stricter than for other listed companies. In many listed SOEs, SASAC will nominate both independent directors and external supervisors.

Functions and powers

The functions and powers of a supervisory board in a company limited by shares are provided in Articles 53 and 54 of the Company Law. They are extremely broad, as the following list shows:

- Examining the company's finances;
- Supervising the acts of directors and senior managers in the performance of their duties, and putting forward proposals for their removal if they violate laws, administrative regulations, company's articles or general meeting resolutions;
- Demanding directors or senior managers rectify any acts that damage the interests of the company;
- Proposing and presiding over an interim meeting of shareholders when the board of directors fails to perform this duty;
- Putting forward motions at shareholder meetings; and
- Taking legal action against directors or senior managers in accordance with Article 151 of the Company Law.

Supervisors have the right to attend meetings of the board of directors as non-voting members and address inquiries and suggestions regarding issues before the board.

The four models of supervisory boards

Supervisory boards in A share companies can be categorised into four basic models:[13]

The insider model. All members of the supervisory board are company employees, including shareholder supervisors. This model is found mainly in private enterprises and listed companies where the controlling shareholder and management personnel closely overlap. Since the members of the supervisory board are selected by the controlling shareholder, the former has no independence and is unlikely to be effective.

The outsider model. Shareholder supervisors are all outsiders and make up a majority in the supervisory board. This model exists in companies that have numerous "legal-person shareholders" (ie, other enterprises) or have diverse ownership structures. For example, in the Bank of Communications, apart from the chairman of the supervisory board, five shareholder supervisors represent five different legal-person shareholders. In this model, the supervisory board has relatively strong independence and is likely to be more effective.

The mixed model. Shareholder supervisors include both internal employees of the company and outsiders. There are independent supervisors and one of the supervisors dispatched by the controlling shareholder will assume the role of chairman. This is the mainstream model in China. The supervisory board has a certain degree of independence, but whether it will be effective depends on the performance of supervisors and the company's governance systems.

The no-shareholder-supervisor model. Apart from employee supervisors, all other members of the supervisory board are independents with expertise in different fields. This model exists in only a few companies and, while it means that the board may have strong independence, it tends not to produce strong and effective supervision.

According to clause 72 of the Code of Corporate Governance for Listed Companies, the supervisory board must report on its work to the shareholders' meeting each year (as must the board). The supervisory board also has the right, if not a duty, to conduct an investigation if it discovers anything unusual in a company's operations. It may also engage an accounting firm or other service provider to assist, with the expenses paid by the company.

In commercial banks, the supervisory board has a particularly important role in evaluating the board of directors, as well as any self-evaluation and mutual evaluation carried out by the directors themselves. The final evaluation will be delivered by the supervisory board.[8] The supervisory board should report the evaluation result to the general meeting and the board of directors, notify directors, and propose working suggestions or opinions based on the evaluation result.[9]

Qualifications

Whereas the Company Law (Article 146) sets out who cannot be a director or supervisor—such as people with criminal records or a history of bankruptcy—the Code of Corporate Governance for Listed Companies outlines the positive qualifications required of supervisors, namely expertise or work experience in fields such as law and accounting.[10] Like directors, supervisors owe fiduciary duties of loyalty and diligence to the company under the Company Law (Article 147).

Challenges

Like its counterparts in other markets in North Asia, notably Japan, the supervisory board in China has strong and extensive powers on paper, yet rarely takes tough action against an errant board of directors. Although there is no shortage of companies that have breached company and securities laws in recent years, it is hard to think of a case where a supervisory board has taken directors to court. This is in large part due to the following entrenched problems that supervisory boards face.

A lack of independence and authority

The rank and standing of supervisors is generally lower than directors in China. On the basis of administrative level and remuneration, the chairmen of many supervisory boards must report to the chairman of the board of directors, who also decides on the former's appointment and dismissal. The supervisory board is therefore not in a strong position to supervise the board of directors. According to an investigation by the China Association for Public Companies (CAPCO), most supervisors believe that "the primary reason for the non-independent and ineffective supervision of the supervisory board is that the supervisors are nominated, appointed, [and] led by the supervisees."[11] And some companies, including large caps, even operate for a time without a supervisory board chairman, as Table 3.3 below shows.

Empty seats
SOEs with no supervisory board chairman
end-May 2018

Tab 3.3

	Last chairman	Date of departure
Agricultural Bank of China	Yuan Changqing	6 June 2017
ICBC	Qian Wenhui	5 January 2018

Source: *ACGA research*

Some other interesting findings:

- The chairman of China Galaxy Securities, Chen Gongyan, is also the company's Party Secretary, while its supervisory board chairman, Chen Jing, is the Deputy Party Secretary. Under Party rules, a deputy could not challenge a superior.
- The same applies in CRRC Corporation, where Liu Hualong is the chairman of the board and Party Secretary, while Wan Jun is chairman of the supervisory board and Deputy Party Secretary.
- In Beijing Yanjing Brewery, the chairman of the board, Zhao Xiaodong, is clearly senior to the chair of the supervisory board, Wang Jinquan, who is head of company security and the labour union.

A lack of expertise and support

A large number of supervisors in listed companies have political backgrounds, having worked for the Party in administrative positions or labour unions. Despite the requirements of the Code of Corporate Governance for Listed Companies, many lack accounting, legal or professional expertise, thus making it difficult for them to supervise, on a business and operational level, the activities of directors and executives.

It is also common for supervisors to be part-time, with full-time supervisors few in number. Since most supervisors come from the leadership or middle-management ranks of controlling shareholders or institutional shareholders, they have their own full-time jobs and cannot devote sufficient time or energy to their role as supervisors.

Furthermore, many listed companies do not establish a separate organisational entity to support the supervisory board, but delegate its daily operations to the office of the board of directors, the administration office or other units. The process can become quite formalistic. One exception to the norm here is ICBC, which has a Supervisory Board Office that manages day-to-day administrative functions and is "responsible for supervising and scrutinizing matters such as corporate governance, financial activities, risk management and internal control of the Bank, and organizing meetings of the supervisory board and its special committee, preparing meeting documents, and taking minutes of the meetings," according to the bank's 2016 annual report.[12]

A lack of functional clarity

Since the work of supervisory boards overlaps with that of independent directors and board committees, it is often unclear how these different entities coordinate. If directors and board committees are doing their job, why is there a need for additional supervisors? How do companies manage these duplicating roles and ensure that the time of management is not wasted?

It is also apparent that some supervisors do not understand the scope of their responsibilities. Some cannot differentiate between their duties and those of the internal audit department regarding such things as financial supervision. Sometimes they undertake special audits, which is substantially no different from internal auditing. Moreover, in many commercial banks, the supervisory board has a responsibility to lead internal audit, which can cause problems for governance. This is because the chairman of the supervisory board must report to the company's president on administrative issues, which affects the independence of supervisors. Second, this function can overlap and conflict with the work of the audit committee.

A lack of accountability

It is apparent that the Company Law has not created a proper accountability mechanism for supervisors, since a supervisor who does nothing will not be held accountable. Even if supervisors strive to be effective, their right to know is not fully ensured since the will of the controlling shareholder usually takes precedence over the governance structure. This is probably more prevalent in private firms than SOEs, since in a family owned entity the bargaining power of a supervisory board will be much reduced.

Formalistic reporting

The style and structure of supervisory board reports tends to be highly formalistic. The annual supervisory report contained in a typical annual report covers the composition and function of the supervisory board, attendance of members, and work performance in compliance with rules and regulations. A few leading companies, such as Vanke and Sinopec, disclose resolutions passed at each supervisory board meeting, but this is unusual.

It is also apparent that the evaluation of directors in commercial banks is equally formalistic. Results do not differ much between banks, but follow the same set of clichés as to how independent directors could improve. Common phrases include "need to know more about the company", while for executive directors it is often "enhancing communication with independent directors".

Small size

Finally, a common factor working against the supervisory function of supervisory boards is their small size: the vast majority have only three people, one of whom must be an employee representative, while some have four or five. A tiny number of boards have six or more people, while an equally small number have only two. It is a challenge to see how such a small entity, lacking sufficient authority and expertise, can properly "supervise" a larger and more powerful board of directors. Figure 3.6 and Table 3.4, opposite highlight this issue. Larger market cap companies do have somewhat larger supervisory boards, as Table 3.5, opposite shows. However this does not appear to dramatically reduce the challenges outlined above.

Small Tab 3.4

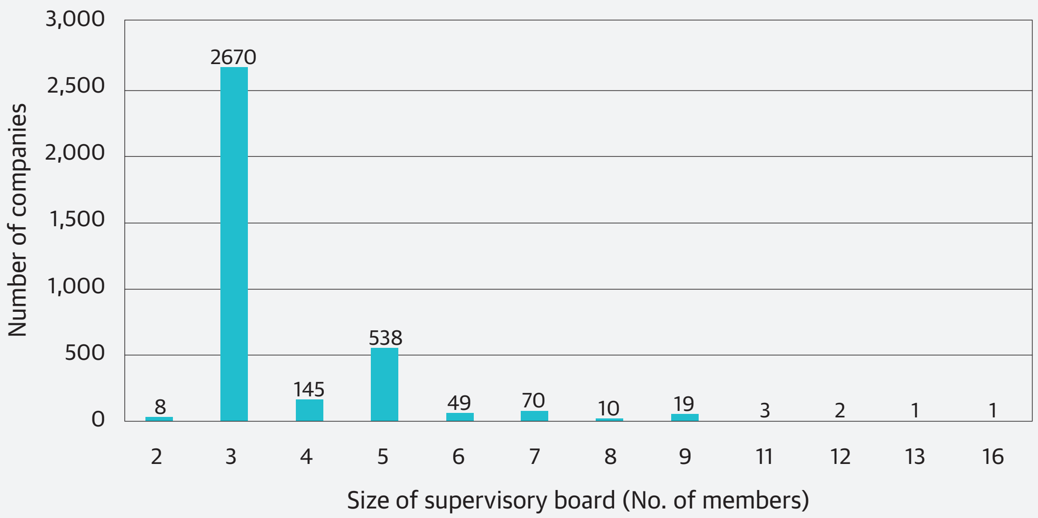
Average size of supervisory boards in China
May 2018

Average size (members)	3.53
Maximum	16
Minimum	2
Mode	3

Source: *Valueonline; ACGA analysis*

Distribution of supervisory boards Fig 3.6

By size and number of companies, May 2018



Source: *Valueonline; ACGA analysis*

Size matters somewhat Tab 3.5

Average supervisory board size
by market cap, May 2018

Top 100	5.15
Top 250	4.46
Top 500	4.18
Bottom 100	3.37

Source: *Valueonline; ACGA analysis*

Conclusion: Next steps

Working from the conclusion that the status quo could be improved, we envisage two broad ways forward for supervisory boards in China. The first is to find ways to strengthen and delineate their powers more clearly compared to other governance entities. The second is to give companies the option of dispensing with supervisory boards if they believe they are not adding value.

Clearer separation of duties

A clearer list of responsibilities for the supervisory board could start with the existing Company Law and official guidelines on the operation of supervisory boards. As the section above under "Functions and powers" indicates, the law gives supervisors certain functions that overlap with the board of directors, including:

- Examining the company's finances (including internal controls and audit);
- Evaluating directors and senior managers in the performance of their duties;
- Putting forward motions at shareholder meetings.

All the above are duties already performed, or should be performed, by the audit and nomination committees of boards of directors, as well as the board itself. It would be helpful for regulation to define more clearly how the supervisory board's work in these areas should differ, or narrow the scope of the supervisory board's work so that it does not duplicate tasks being undertaken by the board of directors. If two governance entities are carrying out similar or largely identical functions, which one bears final responsibility?

Enhancing technical expertise

Since the tasks undertaken by supervisory boards are almost all technical in nature—pertaining largely to accounting, finance and law—it is important to ensure that all supervisors have the requisite skills in these areas, as opposed to backgrounds in government or politics.

More reader-friendly reporting

More factual and less formalistic disclosure in the supervisory board's annual report would greatly help shareholders understand what they are voting on and approving at the annual meeting. Even in large SOEs, these reports can be short and general. Factual detail on the supervisory board's scope of work for a specific year, even where it does exist, is often buried within a verbiage of legalistic and boilerplate language. In some cases, basic factual information such as supervisor attendance statistics is provided in one year but not the next. More thought as to how to convey information in a reader-friendly and interesting way would be welcome.

Allowing companies to choose

Giving companies an option to strengthen their boards of directors, audit committees and internal audit functions, and at the same time dispense with their supervisory board, could create a more efficient and effective system of governance for certain types of listed companies. While we do not envisage this option as realistic for SOEs, it could be something that the government allows private-sector listed firms to undertake. An initial pilot programme with a small number of listed private firms would be a pragmatic and risk-free way to start.

Do supervisory boards add value to corporate governance in China?

Foreign institutional investors who voted "No" in the ACGA survey gave the following reasons:

- 'The roles of supervisors are ambiguous. They don't have real power of check and balance.'
- 'They are a talking shop.'
- 'There is a lack of genuine independence and expertise, so no effective oversight.'
- 'The actual role played by supervisory boards in individual companies is not made clear to investors.'
- 'Who is the supervisory board actually accountable to and in whose interests does it operate?'
- 'Genuine independence and effectiveness is hard to find, and almost impossible to assess from the outside.'
- 'It's possible that they have (added value), but there is no transparency.'
- 'Not really sure of how much power they have and how strong they are when it comes to challenging management. Seems like they are similar to statutory auditors in Japan, which have very little power and are really more like observers.'
- 'Supervisory boards are selected mainly by the major shareholder or management team. There exists no valuable mechanism to enable or empower average minority shareholders to influence the role of supervisory boards. Accordingly, supervisory boards tend to follow the view of the major shareholder or management team.'

Endnotes

1. Shenzhen Stock Exchange, "Guidelines for the Standard Operation of Listed Companies in Small and Medium-sized Enterprise Board", 2015, Article 2.2.11.
2. State Council, "Interim Regulations on the Supervisory Board in State-owned Enterprises", (2000), Decree No. 283, Article 14, Article 16
3. Company Law, Article 117.
4. State Economic and Trade Commission (SETC), China Securities Regulatory Commission (CSRC), "Opinions on Further Improving the Standard Operation and Deepening Reform for Listing Overseas", 1999.
5. China Banking Regulatory Commission (CBRC), "Working Guidelines for the Supervisory Board of Commercial Banks" (2012), Article 6.
6. CBRC, "Working Guidelines for the Supervisory Board of Commercial Banks" (2012).
7. People's Bank of China, "Guidance on Independent Directors and External Supervisors of Joint-Stock Commercial Banks" (2002).
8. CBRC, "Measures for Evaluating the Performance of Directors in Commercial Banks" (2010), Article 29.
9. CBRC, "Measures for Evaluating the Performance of Directors in Commercial Banks" (2010), Article 33.
10. CSRC, "Code of Corporate Governance for Listed Companies", Article 64, 2002.
11. CAPCO, "Report on the Performance of the Supervisory Board of Listed Companies", 2014, p46.
12. ICBC, Annual Report 2016, p106.
13. This section draws from chapter three of the "Report on Corporate Governance for Listed Companies in China", issued by the China Association for Public Companies (CAPCO) in 2014.

3.4 Independent Directors: Form and substance

Despite becoming mandatory over 1999–2001, independent directors are seen as playing only a limited role in board governance in China. The vast majority of companies stick rigidly to the one-third rule and pay is low. Yet independent directors can play an important role, especially overseeing major transactions. How could their contribution be enhanced?

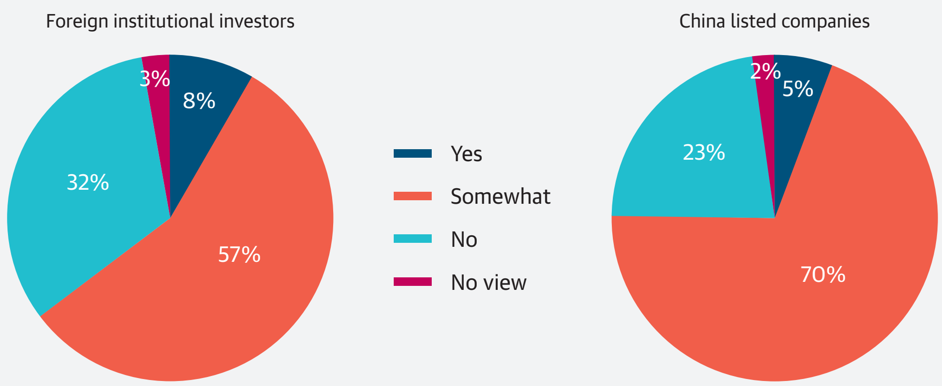
Introduction

Independent directors have been a feature of corporate governance in China for almost 20 years—since rules were introduced in March 1999 requiring state enterprises listing overseas to appoint more than two of them. Although the definition of "independent director" is similar to Western and other Asian governance rules, and regulatory guidelines accord them various supervisory powers on paper, there is little evidence that they enjoy real authority in practice in most listed firms. This should not be surprising given the overriding authority of the Party organisation—the true supervisor in Chinese corporate governance—and the duplicating role of the supervisory board in monitoring directors. But other systemic factors also work against independent director effectiveness: the selection process; low remuneration; a lack of business and commercial experience; small board size; and poor turnout in person at board and committee meetings. As our 2017 survey of foreign institutional investors and Chinese listed companies indicates, few respondents are satisfied with the overall performance of independent directors (see Figure 3.7 below). Yet much could be done to reinvigorate this critical governance mechanism.

Legal basis

The first independent director rules in China were introduced to meet the needs of Chinese enterprises listing overseas. In 1999, the China Securities Regulatory Commission (CSRC) mandated that such companies have more than two independent directors.[1] In 2000, the Shanghai Stock Exchange (SSE) required listed companies to have at least two independent directors and that they make up at least 20% of the board. When the position of board chairman is taken by the controlling shareholder, independent directors should account for 30% of board members.[2]

Do independent directors add value to boards in China? Fig 3.7
Perceptions of foreign institutional investors and China listed companies



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

Then in 2001, the CSRC issued its landmark "Guidelines on Establishing the Independent Director System in Listed Companies", which required listed companies to have at least one-third independent directors.[3] A series of documents[4] issued later by the CSRC further enhanced the independent director system. In the mid-2000s the amended Company Law provided a firmer legal basis for the establishment of the system in listed companies. Afterwards, the two exchanges issued a series of normative documents and guidelines relating to the appointment, duties, performance and training of independent directors.

Definition

An independent director in an A share company refers to a director who will assume no post other than that of independent director and has no relationship with the listed company or its major shareholders that could impair his or her independence and objective judgement.[5] The concept of the independent director in China is close to international norms, except that the definition does not emphasise independence from management as well. As in most markets around the world, the definition includes a negative list that would disqualify a person from becoming an independent director (see 'Who cannot be an independent director' on page 83).

One thing lacking from the definition is any mention of "cross-directorships" (as in the UK Combined Code[6]) or "interlocking directorships" (as in the US)[7], which usually rule out a person as an independent director. Another shortcoming is the limited cooling-off period on the negative list of only one year. Thus a person who has left or retired from a company for slightly longer than one year could qualify as an independent director.

Qualifications and restrictions

Regulations provide that the qualifications[8] to be an independent director include:

- Being independent;
- Having basic knowledge of the operations of the listed company;
- Familiarity with relevant laws, administrative regulations, provisions and rules;
- Five years or more of legal, economic or other relevant work experience.

An important change came in 2013, when the Organisation Department of the CPC Central Committee ("Central Organisation Department"), the key entity handling personnel appointments of Party cadres at the national level, issued an order prohibiting current and former leading cadres of the Party and government to serve as independent directors of listed companies within their first three years of retirement.[9] This rule led to numerous resignations from the boards of listed companies and a curbing of the well-established practice of "official directors" sitting as independents.

Meanwhile, the CSRC's Guidelines state that one person should not serve as an independent director on more than five listed companies. Among the independent directors there shall be at least one professional accountant, and independent directors shall not serve for more than six years.[10]

The CSRC authorises the two exchanges to review the qualifications and independence of candidates being proposed for independent director positions. If the exchanges do not approve the qualifications of candidates, they shall not serve as independent directors.

Who cannot be an independent director

The CSRC's Guidelines on independent directors and regulations from the two exchanges state that people falling into the following categories will not be considered independent.[23]

- An employee of a listed company or an affiliate and his/her immediate family and major social relationships;
- An individual ("natural person") shareholder who directly or indirectly holds more than 1% of the issued shares of a listed company or is among the top 10 shareholders of the company, and his/her immediate family;
- An employee of a company which directly or indirectly holds more than 5% of the issued shares of a listed company or is among the top five shareholders, and his/her immediate family;
- An employee of the controller of a listed company or its affiliate;
- A person who provides financial, legal or consulting services to a listed company and its controlling shareholder or their affiliates, including the whole project team in an agency who provides services, the reviewing persons at each level, the signing person on the report, the partner and the person in charge;
- A person serving as a director, supervisor or other executive in a company with significant business relationships with a listed company or its controlling shareholder or their affiliates, or serving as a director, supervisor or executive in the controlling company of the company with a significant business relationship;
- Any person who was in one of the above six categories in the preceding year.

Definitions
Immediate family: a person's spouse, parents and children.
Major social relationships: siblings and their spouses, siblings of a spouse and other in-laws.

Functions and powers of independent directors

The CSRC's Guidelines on independent directors provide the following functions and powers:

- Material related-party transactions must be confirmed by independent directors and then submitted to the board meeting for discussion. Before the independent directors come to a conclusion, a consultant can be engaged to provide independent financial advice. (The materiality threshold is transactions of more than Rmb3m or 5% of audited net asset value.)
- Recommend the appointment or dismissal of the accounting (auditing) firm to the board of directors;
- Propose the calling of interim general meetings to the board of directors;
- Propose the calling of board meetings;
- Independently engage an external auditing or consulting agency;
- Collect voting rights from the public before a general meeting.

Apart from the first item, however, these powers are rarely exercised by independent directors.

Demographic data

Although some data is collected on the demographics of independent directors in China, in particular by the two stock exchanges, much of it has remained unpublished in recent years. This makes researching the topic quite challenging.

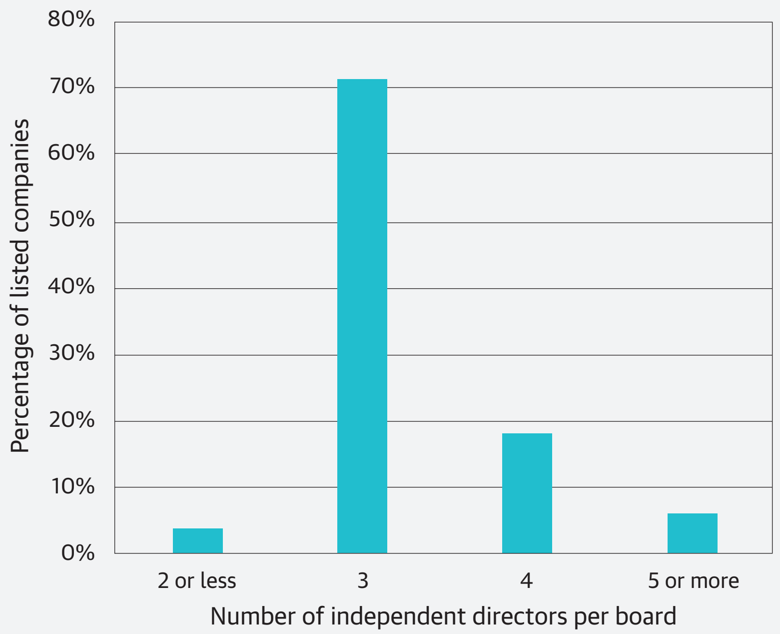
The CAPCO Report 2013

One of the last reports to give a detailed nationwide overview was the "Report on the Performance of Duties by Independent Directors in Listed Companies", published by the China Association for Public Companies (CAPCO) in 2013. Key statistics from the report follow.

Number

By the end of 2012, the number of independent directors in companies listed on the Shanghai and Shenzhen stock markets totalled 5,972 persons. Each served on an average of 1.39 companies and each company had an average of 3.3 independent directors. As Figure 3.8 below indicates, a small number of companies had two or less or five or more independent directors.

The popularity of three Fig 3.8
Spread of independent directors in China, 2012



Source: CAPCO

The large percentage of companies with three independent directors has led to a situation known as the "three-person phenomenon". And since companies must have one-third independents on their boards, this has created the "nine-person phenomenon" (ie, boards of nine people). Meanwhile, in almost 69% of listed companies, the proportion of independent directors fell between 33% and 40%—in other words, minimum compliance with the 2001 rule or slightly above it.

Age

By the end of 2012, the average age of independent directors in listed companies in Shanghai and Shenzhen was 54.7 years old, with the oldest at 84 years and the youngest at 28 years. In terms of age range, the vast majority of independent directors were between 41 and 70 years old.

Remuneration

Average annual fees paid to individual independent directors in 2012 was Rmb89,000 (US$14,000 approx), with a median of Rmb60,000. As Table 3.6 opposite shows, the most common pay range was between Rmb40,000-60,000 per year, while two-thirds of all independent directors received Rmb80,000 or less a year. At the upper end, less than 10% earned fees of more than Rmb200,000 per year. The highest paid individual took home Rmb1.24m (US$197,000) and 13 people were paid more than Rmb500,000.

On the low side Tab 3.6

Annual pay range for independent directors in China, 2012

Fee range (Rmb)	Number of Directors	Percentage of total	Cumulative percentage
Below 20,000	310	5.96	5.96
20,000-40,000	673	12.94	18.90
40,000-60,000	1,770	34.03	52.92
60,000-80,000	695	13.36	66.28
80,000-100,000	435	8.40	74.68
100,000-150,000	587	11.30	85.99
150,000-200,000	337	6.48	92.46
200,000-250,000	163	3.13	95.60
250,000-500,000	215	4.15	99.75
Above 500,000	13	0.25	100.00

Source: CAPCO

Notably, in 2012 there were six companies in the Shenzhen stock market where independent directors received no remuneration.[11] The issue was even bigger in Shanghai in 2013 when 312 independent directors—or 8.75% of the total—received zero remuneration. It appears that these independent directors provided services but were not compensated.

Professional backgrounds

By the end of 2011, professionals and scholars accounted for 41% of all independent directors, while company executives made up 19% and former government officials 13%.

New data

The latest statistics on independent directors broadly confirm the patterns outlined by CAPCO in 2013. In an October 2017 edition of *Directors & Boards* magazine, an article titled "Director Remuneration and Independent Director System is the New Breakthrough" stated that over the past five years the average proportion of independent directors in listed companies was 37%. In 2017, independent directors made up one-third of boards in almost 49% of listed companies, while in 1.91% of companies they exceeded 50%. The highest percentage—75%—was at Beijing Capital Tourism.[12] Analysis carried out by ACGA in May 2018 confirms the above trends.

Three independent directors remains the most common number among all listed companies (with the percentage in fact increasing from a little below 72% in 2012 to 78% in 2018) see Figure 3.9, overleaf.

The one-third ratio is prevalent among 47% of firms (see Figure 3.10, overleaf), while 68% of companies have between 33% to 40% of their directors being independent. Interestingly, the results also show that 28% of listed companies have around 40% to 50% of their boards made up of independent directors. Who are these companies? For the most part, they are not the largest listed companies. Our analysis of the top 100 companies by market cap in China found little deviation from the one-third norm, as indicated in Table 3.7, opposite.

Big end of town not leading Tab 3.7

Average number and percentage of independent directors in top 100 listed companies, May 2018

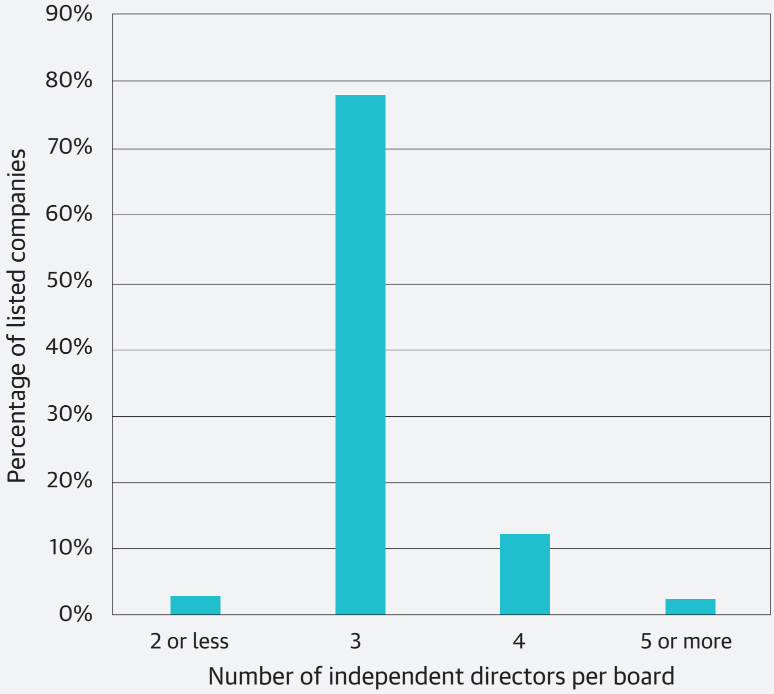
	Number	%
Mean average	4.1	39%
Maximum	6	67%
Minimum	3	33%
Mode	4	33%

Note: Percentages have been rounded
***Source:** Valueonline; ACGA analysis*

The growing popularity of three

Spread of independent directors across 3,516 listed companies, May 2018

Fig 3.9

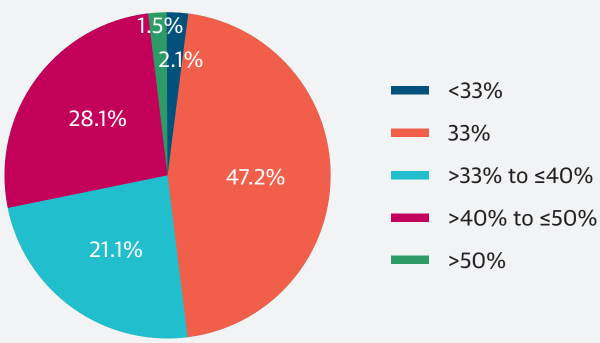


Source: *Valueonline; ACGA analysis*

Independent directors on boards

Percentage as at May 2018

Fig 3.10



Source: *Valueonline; ACGA analysis*

A quarter of companies have an independence ratio of 33%, sticking to the minimum regulatory requirement. Meanwhile 11 companies have 50% or more independent directors in their boards. The two companies with over 50% are: China State Construction (67%, six-person board) and Focus Media (57%, seven-person board).

It is also worth noting that there is no significant difference between companies listed in Shanghai and Shenzhen in terms of the average percentages (mean and mode) of independent directors on boards. The only major difference is the maximum percentage is somewhat higher in Shanghai than in Shenzhen.

Remuneration trimmed

A recent article[13] by Dr Zeng Bin, a researcher at the Shenzhen Stock Exchange, provided interesting numbers on the 15 highest paid independent directors in China (see Table 3.8, below). One notable change in independent director pay is that the highest earner in 2017 received Rmb990,000, markedly less than the top fee of Rmb1.24m in 2012.

Another finding by Dr Zeng was that the growth in independent director pay has been lower than inflation over the past 10 years. Some interpret this to mean that many listed companies have found independent directors provide less value than expected, hence pay them as little as possible. Indeed, average pay is also dropping: the average annual fee paid to independent directors in 2017 was Rmb78,660, which was about 11% lower than in 2012, and the median was Rmb65,000, according to data from Valueonline.

Banking the place to be

Tab 3.8

A share independent director remuneration: Top 15, 2017

	Company	Industry	Director	Annual fee (Rmb)
1	China Minsheng Bank	Banking	Xie Zhichun	990,000
2	China Minsheng Bank	Banking	Li Hancheng	950,000
3	China Minsheng Bank	Banking	Zheng Haiquan	880,000
4	China Minsheng Bank	Banking	Liu Jipeng	865,000
5	China Minsheng Bank	Banking	Liu Ningyu	810,000
6	Red Star Macalline Group	Furniture Dealer	Ding Yuan	800,000
7	China Minsheng Bank	Banking	Peng Xuefeng	680,000
8	Red Star Macalline Group	Furniture Dealer	Qian Shizheng	600,000
9	Red Star Macalline Group	Furniture Dealer	Li Zhenning	600,000
10	Red Star Macalline Group	Furniture Dealer	Li Junxiong	600,000
11	Bank of China	Banking	Nout Wellink	600,000
12	China Merchants Bank	Banking	Leung Kam-chung	500,000
13	China Merchants Bank	Banking	Pan Yingli	500,000
14	China Merchants Bank	Banking	Pan Chengwei	500,000
15	China Merchants Bank	Banking	Huang Guilin	500,000

Source: *Zeng Bin*

Challenges

In addition to the issues raised above regarding small board size, minimum compliance with rules on the number and percentage of independent directors, and low pay, the system of independent directors in China is fraught with challenges and obstacles.

A high degree of scepticism

From the perspective of best practice and the CSRC Guidelines, independent directors are expected to perform a wide range of functions:

1. Participate in decision-making and make the process more objective;
2. Monitor management and protect shareholder interests;
3. Balance the interests of different entities in the company, provide independent understanding and reduce conflict between entities with different interests;
4. Promote better risk management.

The consensus today in China, however, is that most independent directors are not performing as expected—a point clearly reflected in the ACGA perception surveys highlighted at the beginning of this chapter. Their role needs to be strengthened, starting with objectivity and professionalism. Since the selection process often depends on personal relationships with a controlling shareholder, the ability of independent directors to think objectively is impaired. Levels of professionalism have been inadequate, thus limiting their capacity to provide valuable input into strategy, risk management and board decision-making. And because independent directors are often there to "make up the numbers" in a board, few listed companies see value in exceeding the one-third minimum by any meaningful degree.

> *Few listed companies see any value in greatly exceeding the one-third minimum*

Earlier research supports the conclusion that most investors are sceptical of the role played by independent directors. In 2013, CAPCO also carried out a survey on independent director performance and sought the views of directors, executives, investors (institutional and individual) and interested parties in regulatory agencies, academia and so on. The results showed that the degree of satisfaction was lowest among investors. On a question regarding the extent to which independent directors helped to promote the development of companies, 57% of investors chose "medium" or "low", while the corresponding percentage from other respondents for those two answers was only 25%. On another question about the protection of minority investors, the combined percentages for "very good" and "good" from investors was only 36%, far below the average.[14]

Advisers not supervisors

Although independent directors are required by law and the Code of Corporate Governance to exercise oversight, in practice this is almost impossible because most listed companies have a controlling shareholder. In 2012 in Shenzhen, 65% of the main board, 76% of the SME board and 74% of the ChiNext market had a single controlling shareholder.[15] In Shanghai, only 35 companies clearly disclosed that they had no controlling shareholder, accounting for 3.67% of 954 companies which published annual reports in 2012.[16]

For these reasons, a major task for regulators is to prevent the controlling shareholder in a listed company from abusing its power. Chinese regulation provides that the independent directors shall "especially pay attention to protect the legal interests of minority shareholders".[17] Therefore, the legal system endows independent directors with certain special rights, such as approving material related-party transactions and expressing independent opinions on significant issues.

But in reality, when independent directors exercise such rights, their main focus is on compliance and procedure, not on whether minority shareholder interests are being damaged.

In practice, independent directors have played more of an expert advisory or strategic consulting role than a supervisory one. When asked to list the contribution of independent directors, listed companies mainly concentrate on such things as overseas investments, acquisitions, foreign exchange trading, financial derivatives and so on. With regard to supervision, the degree of challenge to management by independent directors is limited. However, some managers say that they will consider questions posed by independent directors before submitting materials to the board, thus allowing them to carry out a more comprehensive and detailed preparation on a project.

Finding appropriate candidates

Many companies find independent directors through the recommendation of the board chairman or management. There is no market-oriented mechanism to select and appoint candidates. Some institutions have set up talent pools, such as the Shenzhen Stock Exchange and the Listed Companies Association of Beijing, and some listed companies have used them to pick candidates. But this has not become a mainstream practice.

Sometimes, an external headhunter is needed to find an appropriate candidate. But headhunters are not cheap: an international recruitment firm will charge around Rmb400,000 for a successful candidate, while a local agency will charge half that. Compared with the average annual fee of Rmb78,660 for independent directors in 2017, the cost of using a headhunter is prohibitive for the average listed company.

Research undertaken in 2012 on enterprises listed on the SME Board in Shenzhen showed that social relationships played a big part in influencing the choice of independent directors.[18] Not only did general managers tend to appoint people they knew socially, but this phenomenon became more obvious the greater the general manager's power. Not surprisingly, the appointment of such independent directors did little to enhance the decision-making function of the board of directors.

Lack of business or industry expertise

One of the most common complaints in China since 2001 is that many independent directors have had academic or non-commercial backgrounds, leading to a lack of understanding of company operations and industry trends. Such directors are seen as providing little value on strategic issues facing companies or specific transactions. A recent article[19] published in the Tsinghua Financial Review in 2017 highlighted the extent of this problem in Shenzhen over 2012 to 2016. As Table 3.9 overleaf shows, the largest group of independent directors on Shenzhen Stock Exchange (SZSE) Main Board companies was "academics", with their proportion fluctuating somewhat but increasing over the five years from 42% to 47%. "Intermediaries" (accountants, lawyers) have consistently provided more than 20% of all independent directors. The proportion of "industry experts" grew quickly from just under 5% in 2012 to 29% in 2014, then dropped back to less than 4% in 2016. "Company executives" have fluctuated between 15% and 22%. More positively, retired officials have steadily declined in importance.

Table 3.9 also highlights fluctuations among the types of independent directors in listed companies on Shenzhen's other two boards, including:

- **On the SME Board:** A significant drop, then increase, in academics and company executives. The opposite trend affected industry experts, while intermediaries maintained a more steady influence. Retired officials declined in importance.
- **On the ChiNext Board:** An overall decline in the importance of academics and retired officials. Industry experts have fluctuated somewhat, but company executives now play a more influential role. Intermediaries have maintained their position.

Lots of scholars, accountants and lawyers Tab 3.9

Background of independent directors in Shenzhen listed companies, 2012-16 (%)

	Year	Academics	Industry experts	Intermediaries	Company executives	Retired officials	Others
Main Board	2012	42.00	4.70	20.30	15.40	15.50	2.20
	2013	44.21	10.86	21.07	5.62	11.76	10.73
	2014	45.06	29.10	26.29	21.84	9.55	7.06
	2015	41.88	8.18	23.94	17.61	4.16	4.23
	2016	47.39	3.82	23.76	16.11	3.37	4.29
SME Board	2012	45.50	8.50	20.30	17.10	7.60	0.60
	2013	41.58	9.72	23.56	1.83	16.46	5.27
	2014	25.79	21.56	22.75	18.96	4.45	8.33
	2015	40.02	10.52	21.70	15.78	2.84	9.14
	2016	40.70	7.94	23.86	18.86	2.27	6.09
ChiNext Board	2012	45.90	5.20	21.40	17.00	10.10	0.50
	2013	48.10	13.99	23.54	3.80	7.32	10.84
	2014	39.28	15.55	21.03	18.90	1.39	4.58
	2015	31.51	18.62	23.43	18.49	3.00	4.94
	2016	34.74	13.92	24.33	19.24	2.63	4.97

Note: Where an independent director has more than one role each one is accounted for in the respective category.
Source: *Tsinghua Financial Review, 2017*

Political backgrounds / Circular 18

The appointment of independent directors with political backgrounds has been of mixed benefit. Before the Central Organisation Department issued Circular 18[20] in 2013 to prohibit retired government officials from becoming independent directors, political relationships were a key reason for appointing them. In 2013, the newspaper China Youth reported that 44.9% of independent directors in the A share market had some form of government background.

Recent academic research from 2015[21] shows that independent directors with political connections play different roles in companies depending on the ownership structure. For example, since there is a natural relationship between an SOE and the government, independent directors with political relationships play only a limited role in state enterprises. Indeed, the SOE most likely appointed them out of regard for their position as former officials. In private listed companies, on the other hand, the appointment of directors with political connections probably has more to do with helping the company gain access to state-allocated resources and competitive opportunities, or advice on industry development, credit financing, fiscal subsidies, tax allowances and so on. Whether this has in fact occurred, however, would appear open to debate—at least in Shenzhen. As Table 3.9, above shows, the more entrepreneurial private companies on the Shenzhen Stock Exchange (ie, those listed on the SME and ChiNext boards) reduced the proportion of retired officials on their boards faster than Main Board companies (many of which are larger, state-owned enterprises).

It is worth noting in this context that Circular 18 applied not only to retired officials, but also academics who held administrative positions. This helps to explain why the percentage of academics did not fall on Main Board firms, but dropped on SME and ChiNext boards in and around 2014: in essence, they were prepared to leave their university jobs for well-paid director positions on Main Board companies, but not for lower paid and less prestigious roles at SME and ChiNext firms. Circular 18 also caused certain short-term problems for corporate governance in China, namely a reduction in the number of qualified independent directors that led some companies to breach the one-third rule.

No premium for quality

As our "Demographic data" section (see page 85) indicates, the average fee paid to independent directors in China is low. Another aspect of this issue is the way in which fees vary by company size, region and sector. It is not surprising that companies with better performance pay higher compensation. Less discussed, but also not surprising, is that companies in the wealthier south-eastern and eastern provinces pay more than those in poorer western China. And that remuneration of independent directors in banks and energy companies is comparatively higher than other listed firms. But what is of concern is that companies tend not to value the personal skills and qualities of individual independent directors when setting their fees.

Low attendance and question rates

One of the most dispiriting aspects of the independent director culture in China is the fact that many do not attend board meetings in person, only by phone, or they authorise an alternate to attend on their behalf. Data from the two stock exchanges indicates that there is a great deal of "communication voting" (ie, voting by phone or email) in board meetings of listed companies. For example, in Shenzhen in 2016, slightly less than 35% of independent directors on Main Board companies and 45% of those on SME Board firms attended board meetings in person. The remainder delegated proxies to attend on their behalf or called in by phone (see Table 3.10 below).

Meanwhile, available data on voting results in board meetings shows a low objection rate among independent directors. In 2015, for example, only one independent director in a ChiNext company cast a dissenting vote, while another three cast abstention votes. Moreover, from 2013 to October 2017, all "disagreement votes" (dissenting, reservation, abstention) cast by independent directors in Chinese listed companies only amounted to 277, which is a mere 0.1% of all the 201,197 votes cast during this period.[22]

Modes of participation

How directors joined Shenzhen listed company board meetings, 2012-16

Tab 3.10

Year	Main Board				SME Board			
	In person	By communication	By proxy	Absent	In person	By communication	By proxy	Absent
2012	41%	56%	3%	0%	55%	44%	2%	0%
2013	39%	57%	3%	0%	54%	44%	2%	0%
2014	41%	56%	3%	0%	53%	45%	2%	0%
2015	37%	60%	3%	0%	48%	51%	1%	0%
2016	35%	63%	2%	0%	45%	54%	2%	0%

Note 1: "By communication" means attended over the internet, social media or via conference call.
Note 2: Figures have been rounded, hence may not add up to 100%
Source: *Tsinghua Financial Review, 2017*

Conclusion: Next steps

Despite the systemic challenges facing independent directors in China and the low level of market confidence in their abilities, there is also a refreshing absence of any attempt to pretend the situation is better than it is and paper over the cracks. Indeed, all the official and semi-official research points to real issues that need to be resolved. One of these, the presence of retired officials and political appointees on boards, has been addressed since 2013. And evidence shows that some companies are appointing more people with business experience to their boards. At the same time, it would be fair to say that the concept of the independent director—which arrived with such a bang in 2001—has been largely neglected in policymaking circles over the past decade. It should, however, receive a boost with the publication of the revised Code of Corporate Governance for Listed Companies. What practical steps could companies take to strengthen this feature of their governance system? Our suggestions follow.

Build your board organically

We suggested in Chapter 3.2 that it might be time for China to revise its one-third rule on independent directors; and we noted the current regulation put a heavy burden on them (at least those taking their jobs seriously). Indeed, a natural evolutionary process in many markets is on the rise in the number of independent directors as companies grow and develop. While three independent directors might be sufficient in a small-sized firm, it is unlikely to be enough in a fast-growing mid-cap and certainly not a larger cap with a complex business. Rather than take a rigid, rules-based approach to appointing independent directors to boards, companies would be well served to consider what they need. Such an "organic" approach to board composition would take into account the complexity of the company's business, how this might change in future, the number of current and future board committees, and so on. The more board committees, the higher the number of independent directors required. This would likely lead to a higher proportion of independent directors on many boards—we are not suggesting that total board size should grow.

Initiate a programme of director development

While it is apparent that a small number of listed companies are making a genuine effort to find independent directors with broad expertise and business experience, it is fair to say that the majority are not doing so. In addition to undertaking board evaluation as a way to improve overall board performance, implementing a programme of director development can be a useful way to strengthen individual skills. Such a programme need not be entirely in the classroom, but could include site visits to different parts of the company's operations, meetings with shareholders, discussions with a wider range of stakeholders on issues such as the environment or societal factors that are relevant to the company, and so on. Being on a board should not be an ivory tower job. Move your board meeting around the country. Allow your independent directors to get to know your customers and stakeholders. Their interest level, and therefore value, will surely rise.

Utilise a "skills matrix" to diversify your board

A sensible way to approach board composition and diversity is the use of a "skills matrix", which outlines in detail the range of personal and professional skills, experience, educational background and other attributes possessed by each director. Companies map this against their business operations and strategy to highlight gaps in board composition. Does your board have the right balance of skills and expertise now and in future? Are you planning a move into a region or sector that is outside the knowledge base of most, if not all, members of your board? Does your board have sufficient expertise to provide leadership over the governance of sustainability? These issues are also important to consider when selecting independent directors.

Hold an annual meeting of independent directors

Many developed markets require or encourage independent directors to meet at least once a year on their own and without executive directors or the chairman (if he is non-independent) present. The purpose is to allow the independent directors to discuss strategy, risk, executive remuneration and other pertinent issues facing the company, then to report their conclusions to the chairman. In this context, it can be helpful to appoint one independent director as "lead independent director". He or she can take the lead in representing the views of other independent directors to the chairman and, as necessary, the board secretary.

Abolish attendance by proxy, discourage phone-ins

Although the Company Law allows directors who cannot attend board meetings in person to authorise an alternate to attend and vote, this practice significantly diminishes the effectiveness of board meetings and the coherence of the board. It should be abolished. The same applies to participating in meetings and voting by phone—except in exceptional circumstances, this too should not be permitted. We urge companies not to follow either practice, irrespective of whether or not the Company Law is amended.

Endnotes

[1] China Securities Regulatory Commission (CSRC), "Opinions on Further Improving the Standard Operation and Deepening Reform for Listing Overseas", March 1999.

[2] Shanghai Stock Exchange (SSE), "Guidelines of Shanghai Stock Exchange on Corporate Governance", 2000.

[3] CSRC, "Guidelines on Independent Directors", 2001, Article 1.

[4] CSRC, "Code of Corporate Governance for Listed Companies", 2002; "Several Provisions on Strengthening the Protection of Social Public Shareholders", 2004.

[5] "Guidelines on Independent Directors", Article 1.

[6] "UK Code of Corporate Governance", Article 8.1.1.

[7] On cross-directorships, NYSE Listing Standard 303A.02 (b)(iv) and Nasdaq Listing Standard 4200(a)(15)(E) provide that if a "director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee", then they will not be considered independent.

[8] "Guidelines on Independent Directors", Article 2.

[9] Central Organisation Department, "Opinions on Further Regulating the Part-time (Full-time) Employment in Enterprises of the Leading Cadres in the Party and Government", 2013.

[10] "Guidelines on Independent Directors", Article 1, Article 4.

[11] China Association for Public Companies (CAPCO), "Report on the Duty Performance of Independent Directors of Listed Companies", 2013.

[12] Directors & Boards, "A New Breakthrough in Director Remuneration and Independence", 21 October 2017.
See: http://mp.163.com/v2/article/detail/D1A4U5NJ0530IE6O.html

[13] Zeng Bin, 'Status quo and some thoughts about independent directors', 17 April 2018. See: https://mp.weixin.qq.com/s/zhldrQa7scYANGXfB3TU8A

[14] CAPCO, "Report on the Duty Performance of Independent Directors of Listed Companies", 2013.

[15] SZSE, "Report on the Corporate Governance of Listed Companies in Shenzhen Stock Market in 2012".

[16] SSE, "Special Survey and Research Report on Corporate Governance of Listed Companies in Shanghai Stock Market in 2012".

[17] CSRC, "Guidelines on Establishing the Independent Director System in Listed Companies", Article 1, 2001.

[18] Liu Cheng, Yang Jidong, Zhou Sijie, "Social Relationship, the Appointment of Independent Directors and the Independent of the Board of Directors", Journal of World Economy, 2012, (12):83-101.

[19] Zeng Bin, Chen Bing, "How to improve the independent director system in China base on their voting results", Tsinghua Financial Review, January Issue 2017.

[20] Central Organisation Department, "Opinions on Further Regulating the Part-time (Full-time) Employment in Enterprises of the Leading Cadres in the Party and Government", Central Organisation Department, 2013.

[21] Cu Weihua, "The Values of the Independent Directors: from the Evidence of the Concentrated Designation of the Independent Directors", Business Management Journal, 2015, 37(03):56-66.

[22] Directors & Boards, "A New Breakthrough in Director Remuneration and Independence", 21 October 2017.
See: http://mp.163.com/v2/article/detail/D1A4U5NJ0530IE6O.html

[23] "Guidelines on Independent Directors", Article 3; SSE, "Working Guidelines of Shanghai Stock Exchange on the Filing and Training of Independent Directors of Listed Companies" (2016 Revision), Article 12; Shenzhen Stock Exchange (SZSE), "Measures of Shenzhen Stock Exchange on the Filing of Independent Directors" (2017 Revision), Article 7.

Interview: 'Ask your questions before the meeting'

Peter Bowie
Former Independent Director, China COSCO Holdings Company Ltd (now called COSCO SHIPPING Holdings Company Ltd). Former CEO, Deloitte China.

How were you selected as an independent director of China COSCO Holdings in 2011? What vetting did you go through?

When I worked in China we participated in the annual Boao Forum in Hainan Island and met the Cosco people there. After I retired from Deloitte, Cosco was looking for another director. They knew me and I was recommended by another individual on the board.

The vetting was pretty extensive. There were many forms to fill in, covering my background, what I have done and where I worked. I also went through an orientation process over a day or two where I learned more about the company. I had to do a lot of reading ahead of time. Eventually I had to do an exam through the Shanghai Stock Exchange to qualify as a director in China. This involved three or four days of lectures and discussions about the rules of the Shanghai Stock Exchange and how they apply to companies listed there.

You have been a director of companies in Canada and China. What are the main differences?

One of the main differences is that in Canada a majority of the directors have to be independent and the chairman is usually independent. Whereas in state-owned enterprises in China the chairman is appointed by government and independent directors are not in a majority.

Another difference is that in China a lot of the discussion within state-enterprise boards is pre-meeting. For example, if I had any questions that I wanted to raise I would send them ahead of time. There was never any 'No, we can't talk about that' type of response. Contact with us was always very open and direct. They would get the right people, usually the heads of departments, to sit with me the day before or the morning of the meeting, depending on the length of time needed. They would go through all the questions and we would have a very broad discussion. It was always direct and very helpful.

Did you ever have an opportunity to have an open discussion in a board meeting and ask questions you had not asked before?

People did, but it didn't happen very often and it wouldn't be open. To be fair, board meetings would typically include the members of the supervisory board and many other people, around 30 to 40 in total. It wasn't really conducive to a back and forth discussion. It was much more formal.

I was on the risk committee and the strategic development committee of the board and we had some very good discussions. A lot of issues came out of those discussions, issues that you know had to be addressed. It was not unlike things I had experienced in other parts of the world with boards. The risk committee did a really good job in the sense of setting controls. They were very committed to it.

What advice would you give a prospective (foreign) independent director of a central SOE?

I would recommend that they do extensive due diligence to understand the structure of the enterprise and the differences in the way governance works versus Canada, the UK or the US. This would include the involvement of government, the appointment of the chief executive, their compensation and so on. It would include understanding decisions that are good for the country, but may not necessarily be strategic for the investors. They also need to think about the important role they play and factors such as non arm's-length transactions, providing oversight and input around independent audit and risk management and strategy.

On the important role that independent directors can play in non arm's-length transactions, how can they be effective?

In any of these transactions the company would retain an outside independent financial adviser who would go through a process of looking at the transaction, doing comparisons to multiple similar transactions, carrying out valuations and so on. This analysis is very broad and also in-depth. It is at that point that the expertise of the independent directors comes into play to challenge the process, the variables and the assumptions. There are some pretty clear rules in the Shanghai Stock Exchange regarding what has to happen to get this process done. And the only people who can vote on them are independent directors. The opinion of the independent director is there to protect the shareholders of the company.

In your experience, what was the level of director competence?

There was a lot of expertise on the board. Most of the people ran chunks of the business. They have a long history with the company and are usually long-serving leaders of significant parts of the business. I found them to be pretty smart people.

What improvements would you like to see in corporate governance in China?

I'd like to see the government increase the number of independent directors again. I would also like to see longer terms for independent directors. Right now the limit is two three-year terms. But when you get on the board of a state-owned enterprise, you find they are pretty complex organisations. It might be better to extend the term to 10 years, or something like that. Because it takes a while to become familiar with exactly how broad and complex some of these organisations are. I think that if they add more independent directors, lengthen their terms and look at additional disclosures, that would all help.

What additional disclosures would you like to see?

I think there could be more disclosure on operating results, more details on strategy and performance against strategy. Investors also want to see more disclosure of non-financial performance indicators.

Interview: 'Independent directors must have courage'

John Law
Board director; Former Principal Banking Specialist, International Finance Corporation (IFC), 2004 to 2012; Independent director (representing IFC)

What is the value of independent directors to listed companies in China?

This is a question both easy and difficult to answer. The purpose of corporate governance is transparency and independence. Independent directors should be independent enough to bring forward questions and constructive suggestions on the operational decisions of a company. In practice, many factors will influence the value of independent directors and limit their effectiveness.

First, the value of independent directors to a large extent will be subject to the appointment process. When a listed company selects an independent director, it usually will not choose a person whom it knows is 'against the company'. And an independent director's ability to play various roles will depend on the understanding reached with the company during the appointment process as to what an independent director should do. If the chairman and management team do not like independent directors who always challenge them, and if independent directors believe that their function is only attending meetings and voting, then independent directors will not play their proper role. In fact, many independent directors are friends of the chairman, which leads to one-sided discussions during board meetings. It is hard to brainstorm and make valuable contributions to a company in such an environment.

Second, the scope of the independent director role is limited. Like ordering food in a restaurant, you can only choose dishes from the menu, you cannot go into the kitchen and tell the chef to cook other dishes. The same applies to independent directors in board meetings: the company seeks their agreement on proposals that have all been prepared by the company. How many independent directors actively propose other topics? I am afraid there are very few.

Third, the status and personality of independent directors will affect their value to a company. The most important and difficult thing for an independent director is to have courage. They should be brave enough to challenge and question, so as to help the development of the company. A director who is more independent will bring more value to a company than one who is less independent. But this is very difficult in Asia, because Asian culture does not encourage people to stand out and challenge. In China, independent directors who work in the system will have many concerns and are unlikely to propose opposing opinions even if they have them.

The full value of the board meeting will be realised when all parties with different interests can sit together and discuss. The reason that I dare to stir up a hornets' nest is not because I have much courage, but because I am not working in the system. My voice will not have negative consequences for me and I don't need to pay the price for my voice. I have met some courageous independent directors who will not adopt my way of direct confrontation, but would also like to promote the development of the company. Therefore, whether an independent director will play their full role depends on his or her personal values. Some directors pay less attention, say nothing at board meetings, and only raise their hands, eat and leave. Their philosophy is 'please don't have any problems and let me finish my term as an independent director here, so that I can go to another company board'.

Are independent directors in Chinese listed companies competent? How do you compare them with their peers in other markets?

Whether independent directors are competent can be measured from several aspects. Regarding their qualifications, independent directors of listed companies in China are generally highly educated and can read financial statements. Many independent directors are scholars and professors, so are qualified in terms of their resumes. But such qualifications do not mean they are qualified for this work.

Especially for banks, many independent directors have no idea and cannot raise questions. Moreover, some independent directors have several jobs and can only allocate limited time and energy to their work. Some cannot even attend board meetings in person, but delegate their voting rights to the chairman. It should be mentioned that in the UK and US systems, the independent director is a personal duty and voting rights cannot be delegated to others.

With sufficient time and energy, independent directors can perform their duty well. Have they prepared fully before the board meeting? Have they read the meeting materials? Are they actively involved in discussions during the meeting or do they remain silent? All of these factors depend on the person and the company. For example, the large banks in China are international and have independent directors with experience in overseas companies and banks, so they know how to perform their duty. But in some small local banks, the extent of participation is little more than reading the company's proposals sentence by sentence and then voting.

See Chapters 3.1 and 3.2 for other parts of our interview with John Law.

3.5 SOEs vs POEs: Similarities and differences

The usual narrative around state-owned enterprises (SOEs) and privately owned enterprises (POEs) in China is about differences—in ownership, purpose, performance, management style and governance. While these perspectives are relevant, SOEs and POEs also share important similarities. Significantly, POEs are not seen as having better governance.

Introduction

Given all the known problems of SOE governance in China, a striking feature of the capital market is the failure of the private sector to establish a better reputation for corporate governance. While private firms outperform SOEs in terms of profitability, productivity, job creation and debt levels, they have yet to do so in governance. Part of the reason is that they exhibit many of the attributes of private firms around the region: strong family ownership and control, an insider mindset, and few incentives to do or disclose more than the regulatory minimum. Indeed, while dozens of names come to mind of poor or dubious governance among mainland private firms listed in China and overseas, very few shining lights stand out.

There are other contributing factors. In a state-led economy such as China, privately owned enterprises (POEs), as they are called, face similar risks to SOEs: political and regulatory uncertainty, market volatility, and distrust about shareholder rights. Despite having a different ownership structure, POEs must engage in many of the same activities as SOEs: maintaining good government relations, navigating the complex web of China's protected market, forming Party committees, and implementing state policies when required. The larger and more successful POEs enjoy many of the same benefits as SOEs, namely state subsidies and protected markets.[1] And, as many observers have pointed out, the dividing line between "private" and "state" ownership is often blurred: listed POEs often have state enterprises or entities on their ownership register, while listed SOEs count private institutions and individuals among their owners. According to our analysis, based on June 2018 data provided by Wind, 22% of listed POEs have substantial owners who report directly or indirectly to the State Council, while 63% of listed SOEs have an individual as one of their top 10 shareholders.

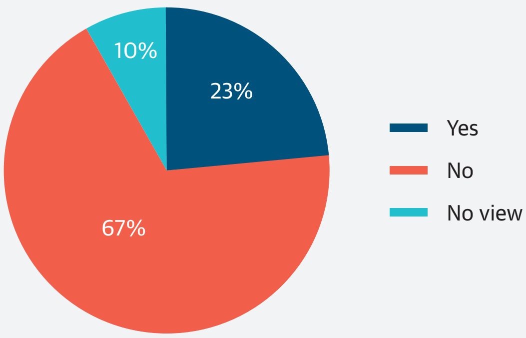
These dynamics help to explain why two-thirds of foreign institutional investor respondents to our survey said they did not favour investing in POEs over SOEs in China. Only 23% said they preferred POEs (see Figure 3.11 opposite).

To be fair to POEs, however, SOEs in China are given a significant advantage through national policies that ensure they control the traditional commanding heights of the economy, such as oil, banking, steel, transport and energy, leaving investors no choice but to invest in SOEs if they want exposure to these sectors.

Do you prefer investing in POEs?

Fig 3.11

How foreign investors view investing in privately owned enterprises compared to state-owned enterprises in China



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

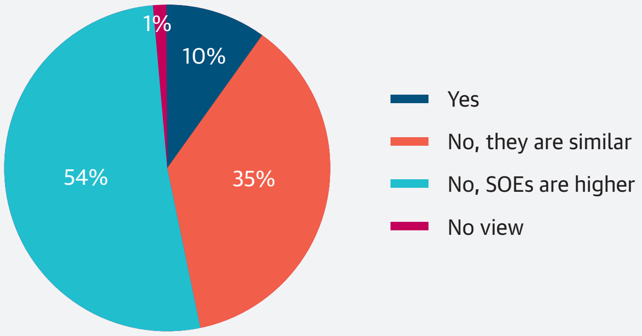
These monopoly or oligopoly positions allow some SOEs to offer attractive and stable investment returns through high dividends. Hence, while investment in SOEs may typically be less exciting than private companies, the level of risk is often lower.

Arguably, SOE governance is also more predictable than private sector governance in China. One curious phenomenon is that state-enterprise ownership is often more transparent than private-sector structures: contrast any major listed subsidiary of a central SOE with the likes of the HNA Group. Indeed, the results from our survey of Chinese listed companies showed a high degree of scepticism towards POE governance in general. Only 10% of respondents thought that POE governance was better than SOE governance, a third felt they were about the same, while more than 50% believed SOE governance was better.

Are POEs better governed?

Fig 3.12

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



Source: *ACGA China Listed Company Perceptions Survey 2017*

Similarities

Governance risks in SOEs

As other chapters have highlighted, systemic governance issues in SOEs cover a range of factors:

- The interests of state shareholders do not necessarily align with those of minority shareholders, since the percentage of shares owned by the "state" (government entities) and "legal-persons" (typically, other state enterprises) dwarfs the free float. The controlling entity often cares more about political or social factors than the performance of the company.
- A lack of effective incentives for management, since the evaluation, appointment and dismissal of management is not closely linked to the performance of the company. Management is evaluated, appointed and dismissed according to the Party cadre system and the careers of managers depend on decisions made by higher levels of leadership that are often more political in nature than linked to business performance. Hence, many senior managers regard their positions in listed companies as a "rising step" in their political career and their personal interests may not be aligned with the company.
- The board of directors is relatively weak as an independent governance mechanism. Boards are dominated by non-independent directors, in particular executives, with only a limited role for independent directors. The board has no autonomous authority to choose the chairman—that is done by the Party organisation at the higher level—nor can it hire or fire the CEO/president and other senior executives.
- The general meeting of shareholders has limited power to hold the board accountable (other than as a mechanism for the largest shareholder, the state, to ensure its policies are legally approved). Votes against resolutions by foreign shareholders, for example, appear to have little to no impact on company direction or governance. In some sensitive cases, management teams may actively lobby foreign investors to vote in favour, or abstain, rather than vote against. An example was the voting in 2017 on amendments to introduce the Party committee into the articles of H share firms listed in Hong Kong.

Governance risks in POEs

Private companies in China share many of the same governance problems as SOEs, starting with ownership structures. With their origins as family companies founded by entrepreneurs, ownership is highly concentrated. While the process of becoming listed has diluted concentration levels slightly over the 2010 to 2017 period, as Table 3.11 below shows, average stakes held by the largest shareholder remain significant and high enough to exercise outright control. At the same time, average combined stakes held by the second to fifth largest shareholders have slightly increased, leaving minority shareholders little room to exercise any influence over these companies.

Top heavy

Tab 3.11

Average stakes of largest shareholders in listed POEs in China 2010–17

Year	Average stake of largest shareholder (%)	Average combined stake of 2nd to 5th shareholders (%)	Total (%)
2010	35.02	21.06	56.08
2011	35.06	21.88	56.93
2012	35.56	21.38	56.94
2013	34.96	20.36	55.32
2014	34.78	20.38	55.17
2015	34.20	21.61	55.81
2016	33.14	22.53	55.67
2017	32.31	22.68	54.99

Source: *Wind, ACGA Research*

Weak or merely compliant governance systems is another feature of POEs. According to a "2014 Report on the Corporate Governance of China's Listed Private Enterprises", published in May 2015[2], and drawing on data from 1,232 privately listed firms on the Shanghai and Shenzhen stock exchanges in 2013, POEs did well in the following areas:

- Meeting the minimum one-third requirement for independent directors;
- Having unqualified audit opinions on the annual report;
- Avoiding public criticism from the regulator;
- Stability of the chairman and CEO;
- Having all four specialist committees of the board;
- Share ownership by the CEO and members of the board.

They scored noticeably less well for:

- Not separating the role of the chairman and CEO;
- Poor attendance of shareholders at annual general meetings;
- Marginalising the role of the supervisory board—a point reinforced in the mind of the authors by the low level of average share ownership by supervisors.

The detailed results are presented in Table 3.12, overleaf.

The shape of private firm governance

Tab 3.12

Key governance features of 1,232 POEs listed in Shanghai and Shenzhen, 2013

Governance practice	Yes	%	No	%
Do independent directors meet the one-third minimum?	1,231	99.92	1	0.08
Unqualified audit opinion?	1,197	97.16	35	2.84
No public criticism?	1,193	96.83	39	3.17
Has the chairman of the board remained unchanged?	1,150	93.34	82	6.66
Have all four board committees been established?	1,142	92.69	90	7.31
Has the CEO remained unchanged?	1,041	84.50	191	15.50
Do directors own the company's shares?	942	76.46	290	23.54
Does the CEO own the company's shares?	887	72.00	345	28.00
Is the chairman and CEO separate?	653	53.00	579	47.00
Full attendance of directors at AGM?	624	50.65	608	49.35
Do supervisors own the company's shares?	494	40.10	738	59.90

Source: *Li and Hao 2014*

From the point of view of effective governance, however, some of the "positive" scores above could be interpreted less favourably. Most obviously, meeting the regulatory minimum for independent directors and board committees should not necessarily be considered noteworthy—it all depends on the needs, size and complexity of the company. As companies grow and develop, one hopes their governance evolves to keep pace. Indeed, the voluntary appointment of more independent directors, in particular by the larger caps, is a feature of most markets in Asia and developed markets elsewhere in the world. More complex businesses require more sophisticated governance structures and systems. Yet as the discussion in Chapters 3.2 and 3.4 both indicated, listed SOEs and POEs in China have largely done the minimum as far as independent directors are concerned.

It is also debatable whether low levels of public criticism from the regulator is a sign of good governance. It could just as easily reflect the fierce compliance mindset in China and/or be a by-product of limited regulatory resources for enforcement. Interestingly, the same pattern holds for more recent data: enforcement announcements on the Shanghai and Shenzhen exchanges from the beginning of 2016 to the first half of 2017 show that the percentage of private listed companies to have been publicly criticised is a mere 1.9%.[3]

Meanwhile, chairman/CEO stability can just as easily be a bad thing if a company is underperforming and new leadership is required.

Differences

There are also substantive governance differences between state-owned and privately owned enterprises and how they are perceived by the market.

The governance in SOEs has a strong administrative style and business development can suffer from too much meddling and an insufficient focus on efficiency. The Party/government's objectives are to maintain their control over the enterprise, require SOEs to discharge various social responsibilities, and increase profit within the context of ensuring social stability and public security. Furthermore, Party requirements for cadres are sometimes stricter than the governance rules in the capital market (if fully implemented). Therefore, SOEs usually put compliance with the Party's regulations and fulfilling its requirements before the commercial interests of their enterprises.

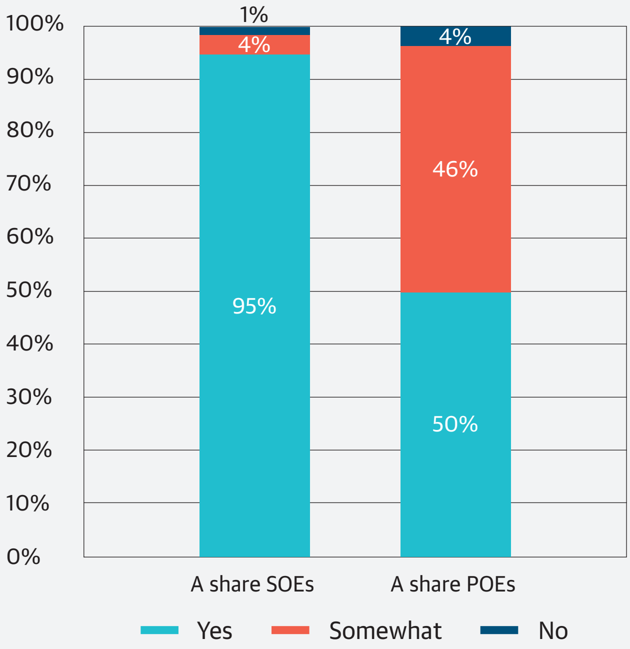
Government intervention

To what extent does government intervene in the decision-making of listed SOEs compared to POEs? As Figure 3.13 shows, almost all the foreign institutional investor respondents see the state as heavily intervening in SOEs. No surprise there. "Given the market structure and the role of the Party/state in the economy, it would be unrealistic not to expect any form of government intervention," said one respondent. In terms of sectors, intervention is seen to be highest in strategic industries such as telecoms, energy, defence and finance.

Does the state intervene in company decision-making?

Fig 3.13

How foreign institutional investors view Chinese government intervention in the decision-making of SOEs compared to POEs



Source: *ACGA Foreign Institutional Investor Perceptions Survey 2017*

Of more interest—and concern—is the level of perceived interference in private firms. Exactly half of the respondents answered "Yes" and 46% said "Somewhat". Comments from respondents ranged from the neutral:

> For POEs, most of their businesses is market-based. To the extent that they deal with the government on many areas such as tax policy, land acquisition, environmental emissions standards and local employment, government policy has an impact on them.

To the more political:

> POEs need to take into account the government's agenda and need to be cognizant that company strategies do not conflict with the government's directions.

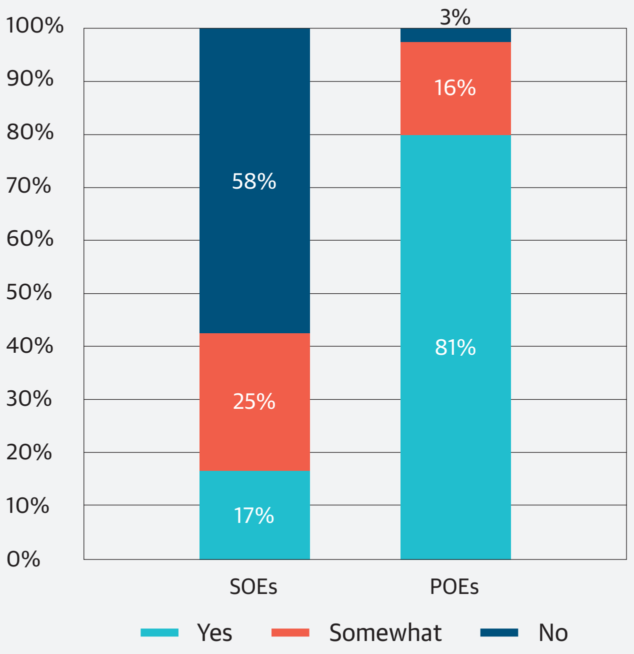
Does the chairman matter?

For a clear majority of respondents to our survey, the person occupying the position of chairman in an SOE does not figure significantly in their investment process, whereas it does for private firms, as Figure 3.14 below shows. The reasons given are also no surprise and could be distilled into the following: an SOE chairman is a government appointee whose primary job is to implement government policy and will be rotated after a few years, whereas a POE chairman is likely to be the controlling shareholder, will be firmly focused on the business and will stay for the long term. Respondents commented variously that POE leaders are seen as "key to the development of the company" and are "real decision-makers", whereas any individual chairman in an SOE will have "less influence" and may just be a "figurehead".

Does the chairman matter?

Fig 3.14

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



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

Not all respondents dismissed the person occupying the chairman's seat in SOEs: 17% said it did matter who the chairman was, while a further 25% said it mattered to some degree. As one investor said:

> In A share SOEs, if the chairman and the senior management are shareholders, we expect to see a market-based compensation scheme and management incentive scheme, which tend to better align management's interests with that of minorities. In competitive industries, such companies tend to do well because of better corporate governance and decision-making systems.

Another noted: "For SOEs, the quality of the Chair is often an indication of the seriousness with which the government and/or Party regard the company's future." And a third said: "Key leadership is always an important element of our analysis."

It is also worth highlighting the distinction between active and passive investors. As one investment manager said in answer to the question: "For active portfolios: it depends on whether we can make a fair assessment. Most of the time we cannot. For passive portfolios: no, we cannot take this into account." A passive investor agreed that who occupied the chairman's seat did "not directly impact our investment decisions". However, "good corporate governance enhances the value of the company".

And one respondent cautioned, with regard to POEs, the individual influence of the chairman "helps align interests in a POE, but it doesn't mean you will definitely be protected".

Categorising SOEs

A long-standing problem in China regarding SOEs is the lack of a clear definition on their different roles and functions. Some must carry out "special purpose business" as well as commercial operations, but there is no firm boundary between the two concepts. Industry policy and regulation is not clear cut, while administrative intervention in business operations is not uncommon. Because diverse SOEs have different requirements for supervision and corporate governance, the government recently concluded that different assessment indicators should be used.

In order to improve efficiency, the State-owned Assets Supervision and Administration Commission (SASAC) issued the "Guiding Opinions on the Function, Definition and the Categorisation of SOEs" in December 2015.[4] This document seeks to divide SOEs into two main groups—commercial enterprises and public-welfare enterprises—based on their main business.

According to the Guiding Opinions, commercial SOEs should vigorously undertake reform of their corporate and shareholding system in order to maintain and increase the value of state-owned assets. SOEs operating in significant industries or areas key to national security and the economy should take both social and economic benefits into account, and maintain the controlling position of the state, during any reform. Commercial SOEs should "optimise the allocation of resources, improve their innovative capabilities and competitive power, and strengthen the supervision of state-owned assets focusing on capital management". According to the different economic and social objectives of enterprises, different assessment criteria should be formulated in areas such as business performance, the maintenance and appreciation of state assets, and market competitiveness.

A long-standing problem in China regarding SOEs is the lack of a clear definition on their different roles and functions.

The main objective of public-welfare SOEs is to ensure the livelihood of the people, serve society and provide public products and services. Such enterprises can be wholly state-owned. Their business scope should be restricted and primary importance attached to serving the public. While the government can control prices, such enterprises should also actively introduce market mechanisms into their operations, improve the efficiency and quality of the products and services they provide to the public, incorporate efficiency and quality as key areas for supervision and examination, and increase efforts to disclose information to the public.

Local governments have followed up by making even more detailed guiding opinions of their own. Categorisation plans were issued in the first half of 2016 by Beijing and Shanghai, as well as by provinces such as Jiangsu, Hubei, Sichuan and Henan. These opinions went further and produced sub-categories, such as "commercial category 1" (pure commercial SOEs), "commercial category 2" (which some documents refer to as a special function category) and "public welfare category".

Take Beijing and Shanghai, for example. On 7 January 2017, the Beijing Municipal People's Government issued an "Implementation Opinion" categorising enterprises in the city into three groups: "municipal public services", "special functions", and "competitive". The municipal public service category aims to ensure the efficient and safe operation of the capital city. Special function enterprises implement important and special tasks assigned by the municipal Party committee and government. While the purpose of competitive enterprises is to increase returns from, and the efficiency of, state-owned capital.[5]

Shanghai issued its "Notice" on 1 December 2016 and divided its SOEs into three groups: "public service", "functional", and "competitive". It required that the articles of association of enterprises should reflect the market orientation of the competitive enterprises, and the special functions and positioning of the functional and public service enterprises.[6]

Conclusion

While there are material differences between the performance, operation and governance of SOEs and POEs in China, the distinctions between these two groups of firms are often less clear cut than many imagine. Not only do ownership structures overlap to a degree, with state or state-enterprise ownership in private firms and vice versa, but listed private firms face similar governance and political challenges as listed SOEs—the dominating influence of a controlling shareholder, weak independent directors, an overly rigid and compliance mindset in implementing new governance best practices, and the need to cater to state economic and social policies, among others. There is scope for both groups to significantly improve their corporate governance, as highlighted in previous chapters on the Party organisation, Board of Directors, Supervisory Board and Independent Directors.

Endnotes

1 A good discussion of this issue can be found in Curtis J. Milhaupt and Zheng Wentong, "Beyond Ownership: State Capitalism and the Chinese Firm", Georgetown Law Journal, 2015.
See: http://www.law.columbia.edu/node/5344/beyond-ownership-state-capitalism-and-chinese-firm-curtis-j-milhaupt-and-wentong-zheng

2 Li Ya and Hao Chen, "Report on the Corporate Governance of China's Listed Private Enterprises, 2014", Beijing, China Economic Publishing House, May 2015, p35.

3 Calculated by ACGA using the announcements on the Shanghai and Shenzhen stock exchanges.

4 SASAC, "Guiding Opinions on the Function, Definition and Categorization of SOEs", SASAC, No. 170, 2015, 7 December 2015.

5 Beijing Municipal People's Government, "Implementation Opinions on Reforming and Enhancing the System of SOE Asset Management", No. 3 [2017], 7 January 2017.

6 Shanghai SASAC, "Notice on Issuing the Measures for the Administration of the Article of Association of the Enterprises Contributed by the Shanghai SASAC", No. 393 [2016] of the Regulations of Shanghai SASAC, 1 December 2016.

Interview: 'How to move SOE governance reform forward'

Professor Lu Tong
Senior Fellow, Institute of World Economics and Politics, Chinese Academy of Social Sciences (CASS); Director of Corporate Governance Research Center, CASS; Professor and PhD Supervisor of World Economics and Politics, Graduate School of CASS.

The "Guiding Opinions of the General Office of the State Council on Further Improving the Legal Person Governance Structure of State-owned Enterprises [2017] 36" (Circular 36) was issued in May 2017. The pillars for the next round of reform of state-owned enterprises (SOEs) will be the enhancement of the modern corporate system and the improvement of "legal person" (ie, enterprise) governance structure. What do you think are the main problems and obstacles for the enhancement of SOE governance?

Circular 36 mentions three major problems of SOE governance, namely the confusion of rights and responsibilities, the shortage of restrictions on major shareholders, and the lack of checks and balances. In addition, I believe the incentive mechanism needs to be improved as well.

Another serious problem is that the separation of government administration from enterprise management has not yet been achieved. SOE governance is not only determined by internal governance factors, but also the external environment. The state asset management system is an important external influence on SOE governance. How to implement market-oriented reform of the state asset management system, and how to achieve the "management of capital", needs to be discussed further. This is a premise of SOE governance enhancement: unless the reform of the state asset management system is realised, SOE reform will not be completed.

What do you think of the statements in Circular 36?

The advantage of Circular 36 is that the definitions of the basic principles of SOE reform are clear and distinct. The new content about the "equality of rights and responsibilities" emphasises accountability, which is definitely an improvement compared with the previous version. The disadvantages include the following aspects.

Shareholders' rights and responsibilities

Unclear statements on the functions of the general meeting of shareholders. First, regarding the status of general meetings, Circular 36 acknowledges it is an organ of power in a company, but does not confirm it is the highest authority. In this respect, Circular 36 is not consistent with the Company Law. This in turn may allow government authorities like SASAC and others to meddle in the governance of enterprises. Second, the powers of general meetings are not clearly defined. Circular 36 does not mention all of the powers of general meetings laid down in the Company Law. Nor does it sufficiently cover the general meetings of state-owned enterprises and mixed-ownership enterprises. From the perspective of non-state shareholders, the lack of clarity over the rights and responsibilities of general meetings will likely affect their rights in the company. Non-state shareholders are investors in the enterprise and should be entitled to vote according to their equity rights. If the rights of non-state shareholders cannot be protected, then mixed ownership will not be truly developed.

Unclear definition of the rights and responsibilities of state asset supervisory agencies regarding the "management of capital": Circular 36 states that SASAC has "capital management" authority in accordance with laws, regulations and the articles of association of enterprises. But further elaboration is needed on the contents of "capital management" and how to implement it. This statement relates to restrictions on the rights of the major state shareholder. As the representative of the provider of capital, the rights of the major state shareholder should be clearly defined. Not all methods should be counted as the "management of capital". When private enterprises set up joint ventures with SOEs, these will be some of their major concerns.

Functions of the board of directors
Undefined scope of the functions of the board of directors. In Circular 36, the explanation of the responsibilities of the board of directors is not perfect. There are two main roles of boards in corporate governance, namely strategic adviser and management supervisor, and these should be made crystal clear in the "guiding opinions". The responsibilities are described as being "final decision-making, internal control, risk prevention and deepening reform". Whether all these are the responsibilities of the board is worth considering. Besides, Circular 36 mentions that "the board of directors should take the primary responsibility for the reform and development of enterprises". This statement is also not clear enough. The concept of "reform and development" is too vague to be implemented.

Limited selection scope of external directors. Nowadays the selection of external directors for SOEs is limited mainly to the current or retired executives in SOEs. In my opinion, the selection scope should be extended and not be limited to those original SOE executives. The advantage of SOE executives is that they are familiar with the operation of SOEs, but the disadvantage is the homogeneity of directors. The external directors should contribute in terms of supervision, complementary expertise, resources provision and value creation. For mixed-ownership enterprises, which we are now advancing, directors should be more professional. Selecting from the market should also be one of the recruitment methods when SOEs are looking for their director candidates.

Strengthening Party leadership
Further clarification about how to strengthen the leadership of the Party. The difference between Circular 36 and previous policy is the emphasis on Party leadership in SOE governance. When the Party is confirmed to be one of the governance entities, a series of concerns need to be addressed, such as how to define the relationship between the board and the Party, how to divide the duties, which entity leads the other and how to cooperate. In practice, many enterprises are confused about how to incorporate the leadership of the Party into corporate governance. Since corporate governance is a concept of the West, while the Party leadership has Chinese characteristics, further discussion needs to be carried out about how to combine Chinese characteristics with a modern corporate system.

Incentive Mechanisms
Incentive mechanisms for executives need to be developed. Circular 36 proposes a differentiated remuneration distribution and suggests developing a long-term incentive mechanism. But current practices run contrary to this idea. For example, in an enterprise with total assets as much as several trillion Rmb, the annual salary cap for executives is Rmb600,000. This means these executives are seen as administrators rather than entrepreneurs.

Selection of senior management
How to unify the selection of senior management by the board and the supervision of cadres by the Party remains uncertain. Circular 36 proposes to "actively develop the approaches and methods to combine the principle of supervision of cadres by the Party and the selection of management by the board", this proposal may bring some positive changes to SOEs.

Supervision system
The practice of implementing accountability and supervision in foreign enterprises is worth learning. One of the best practices for implementing a system of accountability and supervision in foreign enterprises is increasing transparency. Circular 36 proposes to "set up a formal and transparent system to publicly disclose all material information". As far as I am concerned, to implement this policy, SOEs should report to the National People's Congress (NPC) and publicly disclose their business operational information. This will help the public to both understand and oversee the operation of SOEs.

Do you think Circular 36 will strongly promote the enhancement of SOE governance?

The impact of Circular 36 will have limitations. It does not apply to all SOEs. Enterprises in finance and cultural areas are not included. Besides, many details of Circular 36 need to be clarified. If the guiding opinions have too many errors and unclear statements, the enterprises cannot put them into practice.

What do you think are the major problems of corporate governance in the public companies?

It should be acknowledged that corporate governance in public companies has been improving. In terms of their operation, state-owned enterprises are different from private enterprises. Generally there are two common problems. First, major shareholders dominate the company, and make the protection of minorities and other stakeholders much harder. How to restrict and regulate the rights of major shareholders is the key problem to be solved. While the major shareholder's interests need to be protected, this should be kept within the authorised scope. Ownership is highly concentrated in both private enterprises and SOEs. The advantage is that the major shareholder will supervise the business closely. The disadvantage is that the major shareholder has too much power and may wield excessive influence over board decision-making. The recently revised G20/OECD Principles of Corporate Governance (2015) focuses on the restriction of major shareholder rights. Likewise, in China we have also paid more attention to restricting major shareholder rights when revising our principles of corporate governance.

The second problem is the lack of expertise and independence in the board of directors. Most boards contribute little more other than to hold regular meetings and approve business matters. In addition, the board is heavily influenced by the chairman during decision-making.

What do you think are the major problems in the selection of independent directors in the public companies?

There is limited consideration about the independent directors' expertise and independence. For example, the selection of independent directors and their allowances are determined by the public company itself, so the board chairman has great influence on such decisions. If these were driven by another independent body, say the China Association for Public Companies (CAPCO), both the independence and expertise of independent directors would be improved. I hope regulators could consider this suggestion.

How can we improve the selection of independent directors?

I have two suggestions. The first is to use the double-track mode, which means the company's preferences and recommendations should not be set aside and the company is allowed to select and nominate the experts or professionals who can help with the business operation. The second suggestion is that there be an association of independent directors, or perhaps CAPCO, to set up a talent pool of independent directors. CAPCO may select and recommend independent directors from the talent pool to ensure their independence.

Interview: 'Governance of POEs is no better than SOEs'

Shirley Yam
Senior Editor and Columnist, REDDintelligence

What is your view of the recent SOE reforms in China?

China Unicom's mixed ownership reform is very telling. One of its shareholders is a new entity named the SOE Structural Reform Fund, which was founded in September 2016 and raised capital of Rmb350 billion (approx US$53 billion). It has a number of major SOEs as investors and is led by China Chengtong, an unlisted central SOE that emerged from the former Department of Materials to become a state asset manager. There are also other state firms among China Unicom's new shareholders. So when Beijing says the state has given up its absolute control, it is actually the right hand selling to the left hand. They control 53% of the telecom giant. There are several private firms but their holding is negligible.

If China Unicom becomes a model for future SOE reform, then the same thing will happen at provincial level SOEs. So the assumption that this kind of mixed-ownership reform will bring new ideas, and the new private capital flowing in will improve supervision and change the way SOEs operate, is not going to happen. The real question is how can we expect the left hand to operate differently from the right hand, no matter how you brand it?

One real case of mixed-ownership reform is Yunnan Baiyao, a producer of traditional Chinese medicine and famous for a herbal powder that stops bleeding. In April 2017, the state not only gave up absolute control to a private entrepreneur, but also changed the company's governance. The general manager has even forgone his civil servant identity to become a career manager of the company. The company is listed on the Shenzhen Stock Exchange and owned 50/50 by Yunnan SASAC and Xinhuadu Group, a private entity.

What is your view of the recent move to reinforce the role of Party committees in Chinese companies?

I am surprised by the silence of regulators in Hong Kong and the US on this issue. Also, there is little protest that I have seen from shareholders or independent directors of Chinese listed companies. Another shocking fact, despite the superior decision-making power granted to the Party committee (PC) in Chinese-listed companies, is that there is little transparency and regulatory control of these committees. I filed questions to 15 Hong Kong-listed Chinese companies to ask them about their PC members, but none of them responded. Without basic disclosure about who the PC members are, I am not convinced by the theory that this change is justifiable given the major overlap between the PC and management.

I also don't share the same view as people who say that the PC has been there for decades so this is not a significant change. Some Chinese companies are talking about increasing their Party staff by thousands of people and building the PC at every level of the company. For example, Sinopharm was among the first batch of SOEs that raised its hand to increase "Party building". It now has hundreds of PCs in the whole group.

The dominating role of the Party is a political reality. However, shouldn't its members be bound by the same set of rules as directors and senior managers? Hong Kong regulators require members of the board and the supervisory committee to sign a statutory undertaking to abide by the Listing Rules and other regulations. Why don't PC members have to sign? Some central SOEs have specific company policies and guidelines in place binding the behaviour of their directors and senior management, such as the handling of insider information. Are their PC members going to be bound by those policies or will they be subject only to Party discipline? If PC members are also bound by company policies, that would be a huge improvement in China's SOE reform. But it is politically incorrect.

If there are compulsory disclosure requirements on PCs in Chinese listed companies, such as their member identities, specific responsibilities, and clear accountability for their work, then maybe we will still see some progress from this big policy change in China.

What to watch next is how a more commercial enterprise such as the CITIC Group, headquartered in Beijing, will handle the introduction of PCs into the articles of its Hong Kong subsidiary, CITIC Limited. The group is one of the most market-oriented state enterprises. Yet it was criticised by the Central Commission for Discipline Inspection in February 2016 for a lack of political focus in its business development. It is now effectively a Hong Kong company, following the injection in 2014 of most of its assets into CITIC Limited, which is incorporated and listed in Hong Kong. Since Hong Kong company law makes shareholder meetings the top governing body, and has no provision for Party committees, it would appear CITIC Limited faces a challenge. So far none of the other Hong Kong-incorporated "red chips" have introduced Party committees into their articles.

Do you see any significant differences in the financial reporting quality of A and H share companies? Any improvements over the years?

The fundamental issue here is that when a company has cooked its books, Hong Kong law enforcement agencies can't do much about its directors or managers once they have crossed the border. If directors cannot be held accountable for the poor or even fraudulent financial reporting of their companies, where is the incentive for them to make improvements?

Another daunting issue is that on the surface most Hong Kong-listed mainland companies are still hiring the Big Four to do their audits. But the reality is that since 2015, following a new regulation from the Ministry of Finance (MOF) to help local audit firms in China, Hong Kong accountants can no longer audit in the mainland. They can only sign off reports prepared by their mainland partners, but have very limited access to the working papers. This means the quality of financial reporting of these Hong Kong-listed companies is in the hands of mainland accountants. China's accounting profession remains plagued by the "eat your own kill" reward structure. Much was said about this problem when two of the country's top auditors, BDO and Ruihua, were suspended for failure to detect fraud. Not much has been done though. Ruihua resumed its business after a two-month suspension despite reports from MOF saying that it had still failed on various aspects.

What are the main differences in the corporate governance of Chinese SOEs and POEs?

I don't think that the governance of POEs is better than SOEs. For POEs, I just can't see the incentive for controlling shareholders to improve the CG of their companies, given that most of the time their stock prices have nothing to do with their governance standards. Why would an entrepreneur appoint genuine independent directors to challenge him in the boardroom? The directors know their place very well.

In the end, I think it has to do with the fact that board members are not held responsible for what goes wrong within companies. In the worst case, board members may get named and shamed, but they can still become a director of another company. Many directors of fraud-ridden companies have done so.

In contrast, the state has an incentive to appoint more knowledgeable independent directors in SOEs to play a check-and-balance role against the management. It organises all kinds of training for independent directors. The check and balance, however, does not apply when the state has to push a policy or nomination through. For example, what feasibility studies or synergy analysis have we seen for any of the large mergers between state firms over the years?

I know there must be some POEs that have better corporate governance standards, but they are the minority.

3.6 Audit Committees and Auditing

China has voluminous rules and guidance documents on audit committees and auditing (both internal and external). Yet corporate practices and the quality of disclosure lag well behind expectations. With pressure for better audit quality following the MSCI A share inclusion in June 2018 and the advent of the long-form audit report, how can listed companies and CPA firms step up?

Introduction

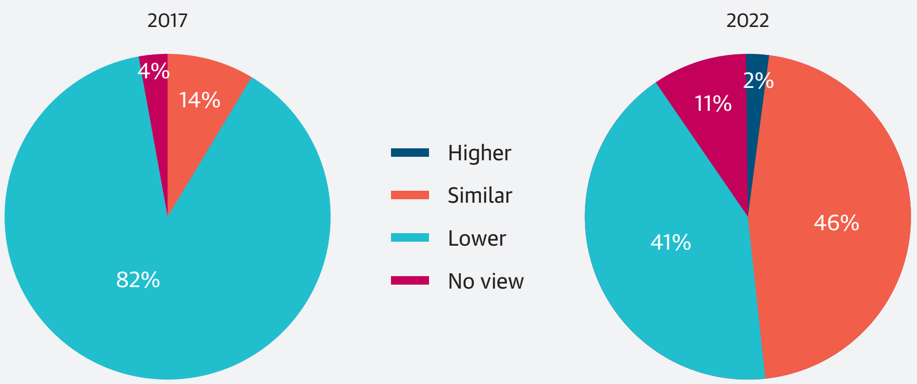
Over the past decade and more, China's financial authorities have issued numerous regulations and guidelines to improve the information disclosure and auditing of listed companies. Since 2015, the two bourses in Shanghai and Shenzhen have published a series of industry-based guidelines which provide key performance indicators to improve the disclosure standards of listed companies. While the best managed companies produce meaningful reports, many financial statements suffer from boilerplate reporting, limited narrative explanation of financial numbers, and a lack of English disclosure among other shortcomings. In the many meetings we have had with investors in Chinese-listed companies, it is not unusual to hear that they struggle to find useful information in annual reports. The term "form over substance" keeps coming up, while some foreign investors have to rely on third-party translation tools such as Google Translate to read reports, even those of certain large SOEs. Inconsistencies between the Chinese and English text are not uncommon.

These problems are reflected in our survey of foreign institutional investors in which 82% of respondents said, not surprisingly, that they thought the quality of corporate reporting and disclosure among A share firms was lower than that found in developed markets in the Asia-Pacific region, as shown in Figure 3.15, below. Yet there is hope things will get better: assessing the same question five years hence, the percentage of respondents answering "lower" dropped from 82% to only 41%, while those choosing "similar" increased from 14% to 46%.

Rating corporate reporting in China

Fig 3.15

How foreign institutional investors rate the quality of corporate reporting and disclosure (on financials, CG, ESG) of China A share firms compared to developed markets in Asia-Pacific (ie, Australia, Hong Kong, Japan and Singapore), 2017 v 2022



Source: *ACGA Foreign Institutional Investor and China Listed Company Perceptions Surveys 2017*

Getting to better disclosure, however, requires more than simply adding financial and narrative detail to annual and interim reports, or more English-language disclosure. Key to the process will be the role played by three groups involved in the reporting and accounting/auditing process: audit committees, internal auditors, and external auditors. This chapter discusses the rules, policies and duties pertaining to each, current practices in China today, and the main challenges they face. We conclude with a series of recommendations.

Audit committees

Regulatory basis

Audit committees are not mentioned in the Company Law of China. However, the original Code of Corporate Governance for Listed Companies (2002) introduced soft rules encouraging the setting up of audit committees following a resolution at a shareholder meeting. The Code stated that a majority of members and the chair of the audit committee should be independent directors, while at least one of the independent directors should have an accounting background.[1]

Stricter rules apply to state-controlled (including wholly owned) enterprises, which have been required by SASAC to set up audit committees under their board of directors since 2004. Members of the committee should be directors who are familiar with financial, accounting, and auditing practices, with the chair of the committee being an outside director.[2]

Audit committees are also mentioned in the "Basic Internal Control Norms for Enterprises", jointly issued by the Ministry of Finance (MOF), National Audit Office, China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and the China Insurance Regulatory Commission (CIRC) in 2008. This document stated that mid to large-size enterprises should set up audit committees under their board of directors and the committee should be responsible for supervising and evaluating internal controls, coordinating internal audit and other related issues. It also stated that audit committee members should be "relatively independent, have good business ethics and professional expertise".[3]

In December 2013, the Shanghai Stock Exchange (SSE) issued "Guidelines on the Operation of Audit Committees of Companies Listed on the Shanghai Stock Exchange". This document has much more specific guidance on audit committee composition and operation than the earlier CG Code of 2002. For example, in addition to saying that the chair and most members should be independent, it envisages a minimum of three members, that the chairman should have professional expertise and business experience, and that the committee hold at least four meetings every year (with at least two-thirds attendance at each meeting and instructions on how to delegate proxies to other members in case of absence). It also gave committee members the authority to invite other parties to join the meeting if necessary and requested that all meeting notes be documented and signed by all members who attended. Furthermore, the composition of the committee and the background and employment history of all members during the preceding five years should be disclosed.[4] This Guideline did not, however, introduce a mandatory requirement for companies listed on the SSE to set up audit committees.[5]

Following the same trend, the Shenzhen Stock Exchange (SZSE) in 2015 issued "Guidelines of the Shenzhen Stock Exchange for the Standardised Operation of Companies Listed on the Main Board", as well as separate documents for the SME and ChiNext boards. These contained similar requirements on the composition and expertise of audit committees as found in the SSE guideline.[6] It is worth highlighting that while companies on the Main Board "can" set up audit committees, those on the SME and ChiNext boards "should" and "must" set them up.

Until recently, therefore, audit committees have been mandatory only for SOEs and companies on the two smaller boards in Shenzhen. The situation changed in 2018 when the Shanghai and Shenzhen stock exchanges changed their listing rules in April followed by the CSRC introducing its revised CG Code draft in June, stating that all listed companies should form audit committees.

Not surprisingly, rules on audit committees in banks have been quite strict. In 2005, the CBRC published a document called "Guidance on the Corporate Governance of Joint Stock Commercial Banks" that said audit committees should be formed under the supervisory board. In 2013 it released an updated set of "Guidelines on the Corporate Governance of Commercial Banks", and in 2016 produced a new set of "Guidelines for the Internal Audit of Commercial Banks", first issued in 2007. While the composition and expertise requirements for audit committees do not differ much from the guidelines for listed companies mentioned above, the CBRC requires that each chairman of an audit committee work in the bank for at least 25 working days per year.[7] And in relation to internal audit, the banking regulator requires management to make regular reports to the audit committee and appoint a "chief auditor" or "auditor in charge" who will be responsible for the operation of audit committees in commercial banks.[8]

Likewise, the CIRC produced specific rules in 2015 to require insurance companies to set up audit committees, which should consist of more than three non-executive directors. It also required them to appoint a responsible person on audit and stated that the audit committee should listen to the working report made by this person at least quarterly.[9] In addition, the CSRC requires securities companies to set up audit committees if they are operating in more than two of the following areas: brokerage, investment management, IPO underwriting, and debt or equity underwriting. No less than half the committee members should be independent directors with at least one of them having more than five years working experience in the accounting profession.[10]

In total, there are more than 15 documents relating to audit committees issued by different authorities in China.

'Companies think more disclosure means more risk'

A senior expert in accounting in China comments on the state of corporate reporting:

"China is a large market, so regulators have to create a template to help them summarise the information and make sure companies disclose what they are required to. As for narrative descriptions (of financial information), Generally Accepted Accounting Principles (GAAP) provides the minimum requirements and companies only do that, which is why we have such little disclosure in place. Companies tend to think that the more they disclose, the more risk they will bring to themselves, and that there is no short-term benefit for going the extra mile. This is another reason why they don't disclose more than required. However, over the years we have been saying to companies that if you disclose beyond the minimum, you provide more valuable information to your investors and this will eventually affect your share price in a positive way. But I just don't feel companies in China get this idea.

"Also, some companies do not understand International Financial Reporting Standards (IFRS) well, because of the different forms of expression between English and Chinese. In English if the standard says, 'you are highly recommended to do this', it is still voluntary. But in the Chinese context it means you have to do it. But some companies just don't get this sense. With no clear accountability in place, people will not do things if they cannot see a short-term benefit. That said, there are still exceptions, such as Huawei, that are actively disclosing more than regulation requires to build-up their image in the market. But there are not many of them. That's why there is a saying that Huawei is the only real international company in China despite how many other Chinese companies market themselves."

Duties

In the original CG Code of 2002, the main duties of the audit committee are described as:[11]

- Proposing the appointment or replacement of the external auditing firm;
- Supervising the internal audit policy of the company and its implementation;
- Being responsible for communication between internal and external auditors;
- Auditing the financial information of the company; and
- Auditing the internal control policy of the company.

The Shanghai Stock Exchange published more detailed requirements in its "Guidelines for the Internal Control of Listed Companies"[12] in 2006 and subsequent "Guidelines on the Operation of Audit Committees" in 2013.[13] More specifically, audit committees should:

- Supervise and monitor the work of external audit firms, including any non-audit services provided;
- Supervise and guide the work of internal auditors and related internal audit policy and its implementation;
- Approve the appointment and replacement of external and internal auditors;
- Provide an independent view on financial information disclosure;
- Coordinate the internal and external auditors and the board of directors;
- Ensure the internal control system is adequate and effectively implemented; and
- If there is no separate risk management department or committee, the audit committee is also responsible for monitoring the risk management system to make sure all risks are considered and have been dealt with.

In practice

According to an analysis carried out by ACGA on all companies listed on the Shanghai and Shenzhen Stock Exchanges between 2012 and 2016, almost all companies in Shanghai and about 90% of those in Shenzhen had formed audit committees even though they were not strictly required to do so. According to Wind, as of June 2018, the average number of members in these committees was about three for both exchanges and, in approximately 97% of cases, the majority of members were independent directors and the committee was chaired by an independent director.

Boilerplate disclosure

For a flavour of boilerplate reporting on audit committees, we reviewed the 2017 annual reports of the top 50 A shares by market cap (dual-listed firms excluded). Only 28 of them (56%) disclosed meaningful information about their audit committees in their annual reports or audit committee performance reports.
Here are the patterns we found.

What audit committee reports usually include:

- Composition of the committee, including number of members.
- Names and bios of members.
- The formal role of the committee (terms of reference).
- Number of committee meetings held during the year.
- List of topics discussed and resolutions passed, but no details.
- A statement that the committee is "functioning well and has served its purpose properly". »

Does this mean that audit committees are functioning well in China? Not really. The concentration of ownership and insider control phenomena remain severe impediments and, while audit committees may comprise mostly independent members, they suffer from all the weaknesses discussed in Chapter 3.4. Indeed, one has the impression that the widespread adoption of audit committees has led to them being taken for granted by regulators and others. This is reflected in the boilerplate disclosure within the audit committee sections of the annual reports of many companies. For example, among companies listed on the Shenzhen Main Board in 2016, only about 43% disclosed the number of meetings held by their audit committee in that year. While most companies listed in Shanghai did disclose the number of meetings held, they did not provide much further information on their audit committees.

As Paul Gillis, Professor of Practice and Co-director, IMBA Program, Peking University, said to ACGA: "The problem of audit committees in Asia is that they are usually colonies of the management or controlling shareholders, they are independent in form but not in substance. They just go through the motions but tend to report to the CFO and management in the end. Boards in China are rarely truly independent either. It is highly unlikely that the board will stand up to the management and this is a universal issue. Audit committees in China are just doing what they are required to."

Internal audit

Regulatory basis

The Accounting Law of China requires all companies to establish an internal accounting supervision system and have a clear procedure for internal audit.[14] Over 2008 to 2010, the MOF, National Audit Office, CSRC, CBRC, and CIRC also jointly issued various rules and guidelines on the independence and working scope of internal auditors.[15] [16]

For listed companies, the CSRC encourages them to implement internal audit procedures.[17] The Shenzhen Stock Exchange, in a guideline for the Main and SME boards, further outlined specific requirements for internal auditing procedures in listed companies. In particular, the guideline specified that to maintain its independence the internal audit department should not be subject to the supervision of the financial department, or work with the latter.[18]

The CBRC in its guidelines asked commercial banks to build independent and vertical internal auditing systems. It specified that the board of directors had the final responsibility for the work, independence and effectiveness of the internal audit department. It also stated that the number of internal auditors in any commercial bank should not be less than 1% of the total staff. For banks that

What investors would like to know:

- Member attendance statistics.
- If meetings were held without management present.
- Description of topics discussed and conclusions reached.
- Priorities of the committee and how were these decided.
- Any other activities conducted by the committee within the reporting period.
- Any significant issues that drew the committee's attention and how were they resolved.
- How the committee reviewed the risk management and internal control system.
- How the committee reviewed internal audit.
- How the committee communicated with the external auditor.
- Whether the board assessed the committee's performance.

appointed chief auditors, the chief auditor and the internal audit department should make regular reports to the board of directors, the audit committee and the supervisory board, and inform the management when doing so.[19] [20]

Similar requirements can be seen from guidelines published by the CIRC for insurance institutions. The CIRC also required that the number of full-time internal auditors in insurance companies be at least three people and not less than 5/1000 of total staff, though the ratio can be loosened to 4/1000 in some cases. The Commission also required that no less than 35% of full-time internal audit staff should have a professional licence or qualification.[21] [22]

In summary, all the rules and regulations require internal auditors to be independent and have sufficient authority and qualifications to do their work, although different regulators in China set somewhat different standards for achieving these goals.

Duties

In the Main Board guidelines issued by the Shenzhen Stock Exchange, the duties of an internal audit department are defined as:[23]

- Reviewing and evaluating the completeness, authenticity and effectiveness of the internal control system of the company, its subsidiaries and significant associated companies;
- Auditing all the financial information disclosed by the company, its subsidiaries and significant associated companies to make sure it is fair, unbiased and in compliance with all regulations;
- Assisting in establishing an anti-fraud mechanism, including identifying key areas and steps for detecting fraud, and paying close attention to suspicious behaviour;
- Making at least quarterly reports to the board of directors or audit committee; the report content should include at least the implementation status of the internal audit plan and recent key findings during the internal audit process.

The CIRC, in its "Work Rules for the Internal Audit of Insurance Institutions" issued in 2015, provided a similar definition of the duties of internal audit. Simply put, the internal audit department is responsible for: auditing all the operations inside a company, including risk and internal control mechanisms, to make sure there are no major flaws; ensuring that all information, not just financial information, disclosed by the company and its associates gives outside stakeholders a fair picture of the company and that all rules have been complied with; and making regular reports to the audit committee or board of directors or even supervisory board when necessary.

In sum, an effective internal audit system can be a good—and perhaps the only—channel for audit committee members to understand the real performance and position of a company. In partnership with the audit committee—and especially if there is no risk management committee—the internal audit department is responsible for assessing potential risks inside a company and helping to ensure all deficiencies in the risk control system are properly managed.

In practice

The reality of internal audit in China is, not surprisingly, somewhat below the high standards set in the various guidelines above. This is partly due to the fact that most rules on internal audit are not effectively implemented. Our research has found that listed companies often have no internal audit department or the function is outsourced to an outside firm, which raises the possibility that the work will not be done to the same standard as an internal department that is committed to the success of the enterprise.

Our observation is consistent with a 2016 study[24] of 2,635 A share companies. In that study, only 221 companies, or 8.39%, had disclosed their internal audit policies as at the end of 2014. Among the 221 companies, about 37% outsourced their internal audit function while about 36% had an internal audit department reporting directly to the audit committee. As Table 3.13 opposite shows, most internal audit departments report to the board of directors or CEO, not the audit committee.

Who does internal audit report to? Tab 3.13

Disclosure of internal audit policies and practices (as at end-2014)

	Number of companies	% of companies
Board of directors	57	25.79
CEO	85	38.46
Audit committee	79	35.75
Total	**221**	**100.00**

Source: *China Internal Audit*

A second issue is that many staff members and sometimes management misunderstand the function of internal audit. Many employees in Chinese listed companies that we talked to think internal audit is the mirror image of external audit. Even worse, some staff members see internal auditors as an "enemy" and thus refuse to provide information to, or co-operate with, them. This information asymmetry puts internal auditors in such companies in a difficult situation.

A further risk is that many companies in China, even listed ones, do not have clear internal audit policies, or the policies have not been updated since listing. Internal auditors often find it impossible to follow proper procedure because there are too many unwritten rules.

Meanwhile, due to the lack of a proper corporate governance mechanism in many Chinese companies, the independence of internal audit departments is not guaranteed. In a number of cases, internal auditors are working with the finance department or report to the management directly. Even for internal auditors who directly report to the audit committee, the board of directors or the supervisory board, their work will not be properly considered if genuinely independent and competent directors or supervisors are not in place. Even worse, many internal auditors see their positions as a springboard to management, thus will be reluctant to query management too closely.

Last, but not least, internal auditors face a huge inequality between their duties and rights. The duties of internal auditors, as discussed above, are broad and significant. The real value of internal audit is to find any flaws in the operation of the company and to make useful suggestions to management to improve the long-term company performance. To achieve this, internal auditors need to have a certain level of authority within the company to conduct their investigations. In China, internal auditors seldom have sufficient powers to deliver on their mission.

External audit

Regulatory basis

Both the Company Law and the Accounting Law of China require companies to appoint external auditors to audit annual financial statements. The appointment and replacement of CPA firms should be approved during a shareholders' meeting or board meeting.[25] [26] For listed companies, the external audit firm's appointment and audit fee must be disclosed and approved in the annual general meeting.[27]

The CBRC requires commercial banks to appoint external auditors to audit the annual financial statements and assess their governance, internal controls and operations management. The auditor's report and recommendations should be sent to the related banking supervisory authority.[28]

The CIRC requires the board of directors of insurance companies to disclose the auditor's opinion at their annual shareholders' meeting—and in their audited annual accounts if they are listed companies. Insurance companies must also add a section on appointing and dismissing audit firms to their articles of association, including a clause to the effect that the external audit firm's appointment and audit fee should be approved by the shareholders' meeting.[29]

To preserve the independence of external audit work, government policies require the rotation of both audit firms and auditors under different sets of rules. Generally speaking, listed companies have to rotate their external audit firms every five years.[30] For central SOEs, the minimum term for auditors is two years and the audit firm has to be rotated after five years,[31] although it is possible to extend the period to eight or 10 years with SASAC's approval. In such cases, the audit team must be rotated if they have served the company for five consecutive years.[32]

For financial enterprises under the supervision of the MOF, the maximum term of an audit firm's appointment is five years, but in rare cases can be extended to eight years.[33] For financial institutions under the supervision of the CBRC, the rules are less strict—only the individual auditor who signs the audit needs to rotate off after five years. These financial institutions are also banned from using consulting services provided by the same audit firm.[34]

A major international development that has had ramifications for China in recent years is the introduction of the long-form audit report. The International Auditing and Assurance Standards Board (IAASB), the peak industry body for auditors, based in New York, released its enhanced auditor reporting standard in January 2015 and asked auditors to disclose "key audit matters" (KAMs) in their report as a way to improve information disclosure to investors and increase auditor accountability. KAMs are areas of potential material misstatement in the accounts and hence require significant auditor attention while conducting an audit. An auditor must explain procedures undertaken to audit these areas.

This new IAASB standard came into effect internationally for financial statements ending on or after 15 December 2016 and was adopted by most developed Asian markets. In December 2016, the MOF announced a phased adoption of the long-form report for listed companies in China: it would take effect from 1 January 2017 for mainland China and Hong Kong dual-listed companies, and from 1 January 2018 for all other Chinese-listed companies, including IPOs.[35] Following the announcement by the MOF, the Chinese Institute of Certified Public Accountants (CICPA) and the CSRC issued similar announcements to endorse the reform.

Duties

In addition to auditing company financial statements and providing an opinion accordingly, external auditors in China have duties to oversee the internal control and risk management systems of companies and to communicate with the board of directors, supervisory board or audit committee if they have questions on the efficiency of these two systems.[36 37] And external auditors in China now also need to disclose KAMs under the new audit report form.

In practice

Given weaknesses in audit committees and the internal audit function, as discussed above, the external audit is the final—and in many cases only—defence mechanism giving investors confidence in the financial information disclosed by Chinese companies. Unlike the early 2000s, when the Chinese audit market was firmly dominated by the Big Four, today local firms enjoy a material share of the market (see Table 3.14 opposite and Figure 3.16 opposite). This is reflected in the Annual Top 100 Accounting Firms Ranking conducted by CICPA. The most recent results for 2016,

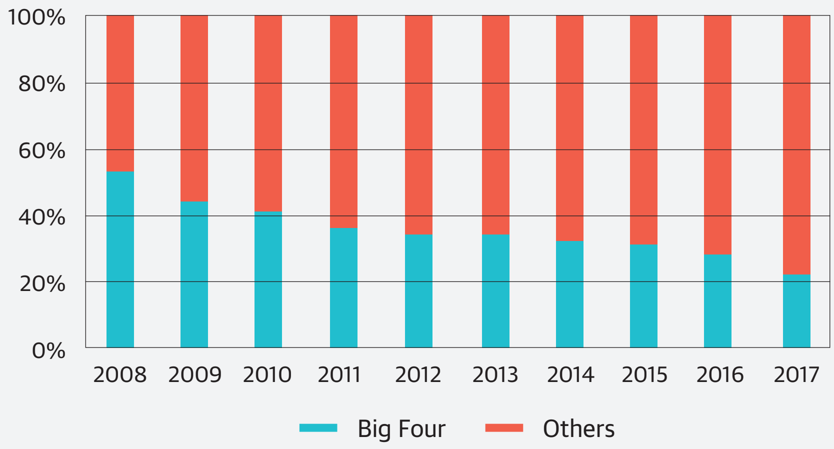
Top 10 accounting firms in China Tab 3.14
2016

1	PwC
2	Ruihua
3	Deloitte
4	BDO China
5	Ernst & Young
6	KPMG
7	Pan-China
8	Shinewing
9	Baker Tilly China
10	Da Hua

Source: CICPA

Total revenue of Top 100 accounting firms in China
Percent share of Big Four and others, 2008–17

Fig 3.16



Source: *CICPA*

published in early 2017, show that one of the top four accounting firms is local, Beijing-based Ruihua, which ranked second. Another homegrown firm that is now part of an international network, BDO China, ranked fourth.[38] BDO China's origins date back to 1927, when it was founded in Shanghai by Dr Shu Lun Pan, a pioneer in the accounting profession in China.

Ominously, both Ruihua and BDO China were banned by the MOF from auditing public companies for two months in early 2017. This was because the two firms each registered two disciplinary actions within two years, enough to trigger a suspension. Furthermore, on 12 June 2018, the CSRC announced it had stopped accepting IPO and refinancing materials from six accounting firms, namely BDO, Ruihua, Da Hua, Zhonghua, Xing Hua and Grant Thornton, because they all had unresolved litigation claims.[39]

In the Chinese market, the Big Four usually audit dual-listed or foreign-listed Chinese companies, while local firms focus mainly on A share companies. For national security reasons, it is understood that only local firms can audit certain large A share companies. Given that more and more A share companies are going abroad under the Belt and Road Initiative, while more foreign investors will be investing in China following the June 2018 inclusion of A shares in the MSCI Emerging Markets Index, local audit firms will come under increasing pressure to improve the quality of their auditing standards.

Legally, the right to appoint and dismiss external auditors is in the hands of shareholders, who are the ultimate users of auditors' services. But in reality the decision is largely made by management or the controlling shareholder. Combined with the fact that shareholder activism is rare in China, most external auditors are accountable in practice to their corporate clients and regulators, not shareholders.

As for the new KAMs, many are sceptical of their value. As one auditor said of the new long-form reports in A/H share companies: "The key audit matters that are disclosed in the auditor's reports are no more than what has already been disclosed in the footnotes. Most of the KAMs we see now are only stating the obvious. The mindset is the same: companies are reluctant to disclose more than they are required to."

Challenges

Sub-standard information from management

Although it is clearly stated in the Company Law that companies should provide true and fair records to external auditors, and companies cannot refuse an auditor's request for documents,[40] it is not uncommon to hear that auditors often have to negotiate with management to get the documents necessary for conducting an audit. In some cases, we are also told that auditors have to help companies prepare their final accounts, since clients lack the internal accounting expertise and systems to do the work. This complaint does not just apply to higher level accounting treatments such as calculating the fair value of assets or applying new IFRS accounting standards, it can also extend to basic book-keeping skills being poor. This is a significant conflict of interest and potentially undermines the quality of the subsequent audit.

This situation is partly the result of an immature accounting profession. But more importantly, management of companies have strong bargaining power and can pressure auditors in China. They tend to push auditors to provide an opinion based on as little information as possible. Sub-optimal or deficient information greatly complicates the work of auditors and puts them in an invidious position.

Limited ability to challenge management

One feature of concentrated ownership structures among both SOEs and POES is that the audit committee, independent directors, the internal auditor and the external auditor are generally all appointed by management. It is difficult, therefore, for these groups to challenge management, since to do so would be to put their employment contract or business relationship on the line. An auditor from a Big Four firm in China recently told us that in a meeting with a central SOE, the chairman pointedly said: "If your firm refuses to compromise on some items, we will simply shift to a local firm that would like to do so."

Overlapping lines of supervision

The multiple lines of governance supervision in China create some particular problems for auditors. The Company Law has given the supervisory board the power to supervise company operations (including financials)[41] , yet the Corporate Governance Code also says that a major function of audit committees is to review financials, as well as supervise internal audit and information

Time to improve audit quality

Paul Gillis, Professor of Practice and Co-Director, IMBA Program, Peking University urges regulators to focus more on improving audit quality in China:

"The Chinese government wants to clean up the market now—the actions against BDO and Ruihua are really shaking up the industry. But still, MOF and CSRC are focusing more on the stake, but not helping accounting firms to move to greater quality. They should focus more on the [performance of] individual partners, and (if necessary) revoke their licences.

"One accounting firm being penalised recently told me that it was unfair to punish them because at first they were under pressure from the government to grow their business. Then the regulators came up with a new rule to suspend firms for two violations—and by that time they were auditing more than 1,000 companies.

"The CSRC and MOF are tough regulators, but they would benefit from more specialisation. Also, they should look more carefully at effective policies to improve audit quality. The current system is like searching for problems when no problem exists. They need to redesign the regulatory system, not just look at problems but at the structure of the whole profession. Focusing on the accounting firm is a way to do it. Their enforcement should not be so binary."

disclosure.[42] No clear line has been drawn between the responsibilities of the audit committee and the supervisory board in the two documents, as we highlight in Table 3.15 below. Such an intrinsic conflict in rules has created two consequences: either the supervisory board and the audit committee fight for their turf and create unnecessary costs, or neither takes responsibility and waits for the other party to act first, thus becoming "free riders".

Passing the parcel? Tab 3.15
Overlapping responsibilities of supervisory boards and audit committees

Supervisory Board	Audit Committee
Examine company's finances	Review audited accounts, other financial disclosure
Demand directors or senior managers rectify any acts that damage the interests of the company	Supervise and evaluate the internal controls of the company
Supervise the acts of directors and senior managers and report directly to regulators if any misconduct under law, regulation and company article is found.	Responsibility for other matters under the laws, regulations, company articles or board meeting mandates (including reporting to regulators if any misconduct is found).

Source: *China CG Code (2018 Draft), ACGA analysis*

Price war among CPA firms

The audit rotation system and a minimum one-year audit appointment term were introduced in China to help strengthen the independence of external auditors. However, short rotation periods can create a moral hazard, namely the risk that an audit opinion will not be based on a good understanding of the position of a company. Given the weak footing auditors have in relation to listed companies, each rotation or reappointment could be used as a weapon by management to negotiate a better deal with CPA firms.

Indeed, the fact that audit fees have to be publicly disclosed makes it easy for CPA firms looking to win a bid to undercut the previous fee. Anecdotally, one often finds cases where the audit fee in the first year after a rotation is lower than the year before. With inflation and the fact that firms usually need to devote more resources to conduct audits in the first year with a new client, there is a good chance that audit quality will suffer.

Conclusion: Next steps

Our recommendations on ways to enhance the work of audit committees, internal auditors and external auditors in the coming years are as follows:

Audit committees 101

Although it is effectively mandatory for listed companies in China to form audit committees, simply setting them up is not enough. There are basic norms that audit committees should follow to ensure they deliver value to the board, shareholders and other stakeholders:

1. In addition to meeting at least quarterly, an audit committee should also meet internal and external auditors at least once a year to discuss audit procedures. There should be no inside directors present at this meeting. All meeting notes should be kept in a safe environment for future reference.
2. In addition to having written rules on the duties and scope of work, an audit committee should clearly define how its responsibilities differ from a supervisory board. It would be sensible for audit committees to focus on financial, internal control and risk-related issues, since its members have expertise in these areas, while the supervisory board could focus on more operational matters.
3. The board of directors should grant the audit committee the authority to conduct any investigation within the scope of its work. Such delegation powers should be incorporated in the audit committee's terms of reference and signed by the board. Company policy should require all employees to cooperate with the audit committee and its members upon request.
4. Each member of the audit committee should serve on no more than three public companies. The chair of the audit committee should serve on no more than two public companies. This is to ensure that the members can allocate enough time to perform their duties. If the board decides to make any exceptions, this should be fully disclosed in the annual proxy statement and annual report.

Correct misunderstandings around internal audit

Although internal audit is covered by rules and regulations issued by multiple authorities in China, the internal audit profession is not as promising as it should be because many rules are not effectively implemented. To overcome this, each listed company should produce an internal audit policy and the internal audit department should report regularly to the relevant authority, such as the MOF, CSRC or the relevant stock exchange. It is possible that this will only produce another round of formulaic reports from companies. On the other hand, it would force companies to pay more attention to the work of their internal audit departments.

Another key issue around internal audit is the misunderstanding of its working scope. Internal audit is not only about financial issues, but the whole governance structure inside a company. Management should make sure that all staff understand this so that internal auditors will no longer be seen as the enemy. In fact, the internal audit procedure of companies in developed markets is more risk-oriented than financial-oriented. This means the main focus of internal auditors should be on management accounting rather than financial accounting.

A third key area that companies should focus on is the communication skills of internal auditors. Internal auditors have to communicate with different parties on various sensitive issues, thus it is essential for them to have a high level of communication skills. Actually, this was also emphasised in research conducted by KPMG in 2016 that found communication skills to be the most important component for internal auditors.

Give external auditors a stronger voice

In order to give external auditors a stronger voice and make them accountable to shareholders, one approach would be to restrict voting on their election at annual meetings to minority shareholders only (especially in firms with a concentrated shareholding structure). A concentrated shareholding structure can be defined by one shareholder having more than 30% or the top three shareholders owning more than 50% collectively. This is not a perfect cure, but it would help external auditors to conduct their work more independently and without fear of being replaced by management.

Ongoing training and education

More training and education is needed not just for audit committee members, internal auditors and external auditors, but also the management and accountants of listed companies. For example, the effectiveness of external auditors could be improved if accountants furnished better-prepared statements and internal auditors provided detailed internal audit reports.

'How to stop the price war'

A partner of one of the Big Four in China commented on the price war and audit quality:

"How to stop the price war in the auditing profession? Had the regulation on audit quality been very robust, then firms would be caught for cutting corners on audit quality so they can lower costs and compete for business. Firms would not have started such a war in the first place. The only reason we now have this situation is that the cost of lowering audit quality is more than offset by the benefit of having more business, in the firms' view. The only way to stop this is for the accounting firms to help regulators improve regulation on audit quality and to raise the cost of being caught for low quality work. Otherwise, it is always the same story of a dog chasing its own tail. With proper inspections and tough regulation on audit quality in place, firms will not dare to risk their reputations and development for short-term benefits, but would try to cut costs in other areas such as through better internal management.

"Regulators also want to help local (CPA) firms improve audit quality, but they need more resources to do reviews. Their earnings (as government officials) do not provide them with enough incentive to make extra effort in their work. They also borrow staff from accounting firms to help do inspections from time to time, but they have no control over the quality of these voluntary staff, let alone the conflict of interest issue. Any rules or regulations in place will not have any effect if there are not proper inspections by the right reviewers.

"The MOF, CSRC and CICPA should do cross-inspections on accounting firms every three years (the idea was any two of them will not do inspections in the same year so that firms get inspected by one of them each year). But we haven't been inspected for at least five years. Most of the time, they just give us notice but never really inspect us. Normally, the regulators find problems in issuers through other channels and then extend the inspection to the working papers and auditors. But this kind of inspection pattern is very reactive, and it is unlikely that the audit will be able to stop misconduct by companies."

Endnotes

[1] State Economic and Trade Commission (SETC) and the China Securities Regulatory Commission (CSRC), Code of Corporate Governance (2002) Article 52.

[2] SASAC, "Interim Measures for Internal Audit Management of Central Enterprises (2004)", Article 7.

[3] Ministry of Finance et al, "Basic Internal Control Norms for Enterprises (2008)", Article 13.

[4] Shanghai Stock Exchange, "Guidelines on the Operation of Audit Committees of Companies Listed on Shanghai Stock Exchange (2013), Articles 7-10, 23-29, 33.

[5] See Shanghai Stock Exchange, "The Stock Listing Rules of the Shanghai Stock Exchange" (2014).

[6] Shenzhen Stock Exchange, "Guidelines for Standardized Operation of Companies Listed on the Main/SME/ChiNext Board (2015)", Article 2.3.4.

[7] China Banking Regulatory Commission (CBRC), "Guidelines on the Corporate Governance of Commercial Banks (2013)", Articles 22, 24, 55.

[8] CBRC, "Guidelines for the Internal Audit of Commercial Banks (2016)", Articles 9, 11, 12.

[9] CIRC, "Work Rules for the Internal Audit of Insurance Institutions (2015)", Articles 12, 15-17.

[10] CSRC, "Rules for Governance of Securities Companies (2012)", Articles 41-42.

[11] Code of Corporate Governance (2002), Article 54.

[12] SSE, "Guidelines for the Internal Control of Listed Companies (2006)", Articles 27, 31.

[13] SSE, "Guidelines on the Operation of Audit Committees of Companies Listed on Shanghai Stock Exchange (2013)", Articles 13-21.

[14] Accounting Law (1999), Article 27.

[15] MOF et al, "Basic Internal Control Norms for Enterprises (2008)", Articles 10, 15, 44.

[16] MOF at al, "No. 1 of the Application Guidelines for Enterprise Internal Control - Organisational Structure (2010)"; the "Guidelines for Application of Enterprise Internal Controls (2010)"; the "Guidelines for Evaluation of Enterprise Internal Controls (2010)"; and the "Guidelines for Auditing of Enterprise Internal Controls (2010)".

[17] CSRC, "Guidance for the Articles of Listed Company (2016)", Articles 156, 157.

[18] SZSE, "Guidelines for Standardized Operation of Companies Listed on the Main/SME Board (2015)", Articles 8.1.4, 8.7.1, 8.7.2, 8.7.5-9, 8.7.12.

[19] CBRC, "Guidelines for the Internal Audit of Commercial Banks (2016)", Articles 7, 8, 13, 14, 31, 32.

[20] CBRC, "Guidelines on the Corporate Governance of Commercial Banks (2013)", Articles 93, 113.

[21] CIRC, "Guidance on Articles of Association for Insurance Companies (2017)", Articles 65, 67.

[22] CIRC, "Work Rules for the Internal Audit of Insurance Institutions (2015)", Articles 13, 21, 26, 38.

[23] SZSE, "Guidelines for Standardized Operation of Companies Listed on the Main Board (2015)", Article 8.7.3.

[24] Yang Qiang, Tong Yuyao & Fu Jie, "Analyses and research of the outsourced internal audit of Chinese listed companies", China Internal Audit, 2016 Issue 5, p10-13.

[25] Company Law (2013), Articles 164, 169.

[26] Accounting Law (1999), Articles 20, 31.

[27] CSRC, "Guidance for the Articles of Listed Companies (2016)", Articles 159-161.

[28] CBRC, "Guidelines on the Corporate Governance of Commercial Banks (2013)", Articles 94, 95, 119.

[29] CIRC, "Guidance on Articles of Association for Insurance Companies (2017)", Articles 47, 66.

[30] CSRC, "Rules on Rotating Certified Public Accountant for Securities and Futures Audit Business (2003)", Articles 3, 7.

[31] SASAC, "Rules for Audit Work of Central Enterprises on Final Accounts (2004)", Articles 10, 12.

[32] MOF, "Notice of Questions for Accounting Firms Conducting Audit Work of Central Enterprises on Final Accounts (2011)", Item 2.

[33] MOF, "Measures for Financial Enterprises to Select and Employ Accounting Firms) (2016)", Article 26-28.

[34] CBRC, "Guidelines on the Supervision of External Audit of Banking Financial Institutions (2010)", Articles 11, 12.

[35] MOF, "Auditing Standards for CPAs of China No. 1504"—communicating the Key Audit Matters in the Auditor's Report.

[36] SZSE, "Guidelines for the Internal Control of Listed Companies (2006)", Articles 63, 64.

[37] CBRC, "Guidelines on the Corporate Governance of Commercial Banks (2013)", Article 120.

[38] CICPA, "2016 Annual Top 100 Accounting Firms Ranking Report", 12 January 2017.

[39] Xinhua Net, "Six accounting firms are suspended for material acceptance", 13 June 2018. See: http://www.xinhuanet.com/fortune/2018-06/13/c_1122976974.htm

[40] Company Law (2013), Article 170.

[41] Company Law (2013), Article 53.

[42] Corporate Governance Code (2002) Article 54.

Interview: 'Who pays the auditor is critical'

Lynn Turner CPA
Senior Advisor of Forensic and Financial Consulting Group, Hemming Morse LLP;
Former Chief Accountant of the US Securities and Exchange Commission (SEC);
Co-Founder, Glass Lewis; Former Partner, Coopers & Lybrand

What is the relationship between public auditing and corporate governance in your opinion?

An independent audit provides credibility to the financial statements that management and the corporate board provide to investors. Those financial statements establish accountability for the performance of management, as well as the oversight by the corporate board.

At the same time, the board audit committee oversees the financial reporting and has a key role in overseeing the independent audit. This includes the hiring of the auditor, evaluation of the auditor's performance, and periodically rotating or terminating them.

What is your view of the new long-form audit report with key audit matters (KAM)?

For decades, independent auditors have identified, documented and resolved issues that were and are of significance to the audit and auditor. As an auditor and audit partner signing audit opinions, I have prepared many a memo documenting such issues.

Ten years ago at a meeting with the Public Company Accounting Oversight Board (PCAOB), I recommended these issues would also be of interest and informative to investors. I am very happy to see the international auditing standard setter and PCAOB both require the auditor to discuss these matters in their report.

The success—or failure—of such disclosures will turn on whether the auditor is transparent and honest in their disclosures. Time will certainly be the ultimate judge of that.

In the past you have emphasised many times the importance of audit independence, and audit rotation is another topic you have highlighted. In China, most listed companies are under strict rules to rotate their auditors every five years. There are concerns it has caused problems such as a price war between audit firms and potentially moral hazard given the short-term appointment periods. Do you think a five-year rotation is a good system? What suggestions would you make to improve this system?

I disagree there is a "moral hazard". I think those saying this are like "Chicken Little" running around saying the sky is falling in, when in fact it never has.

Whenever I was an auditor on a company for the first time, I made sure we took the time to understand the business. The professional auditing standards require that. If an auditor says they are not able to gain an adequate understanding of a business in the first year of an audit, one must ask, how is it they are able to complete an audit in accordance with generally accepted auditing standards (GAAS)? The answer is simply they are not, as that is what GAAS requires. And if they are not able to gain such an understanding, then how is it that in their audit report to investors, as required by GAAS, do they tell investors they have complied with GAAS? Some of the largest financial statement frauds have involved companies where the auditor has been the auditor of record for years—sometimes decades and even perhaps centuries. What good did all that supposed knowledge do in those instances (eg, Parmalat, Enron)?

I would have preferred the EU go to a 10-year rotation rule, but was glad to see they adopted a rotation system. With rotation in place, it will provide a basis for research.

But ultimately, I firmly believe that until the system is changed as to who pays the auditor, the quality and value of audits will be highly questionable. I seriously doubt they provide the assurance investors "think" they are getting for the money that is spent on an audit.

Earlier this year, we attended a roundtable discussion held by the Monitoring Group regarding its consultation to strengthen the international audit standard-setting process. It seems that over the past decade, more parties including

regulators have expressed concern over the loss of confidence in the audit profession. Do you share this view? Could you elaborate more on your proposal for changing the funding structure of audit to improve independence and regain public confidence?

Auditors are very talented, well intentioned professionals. But ultimately, they are humans who are influenced greatly by the environment they find themselves in. The current system requires them to provide a "report card" on the very people who are paying them. If they make those writing their checks unhappy, they may well find they are terminated and no further checks—the annuity—will be received.

In the new payment system proposed, the PCAOB, which already collects a fee from each public company to fund the PCAOB, would collect an additional fee for the audit. The amount would be determined when the audit committee—not management—negotiated the fee for the current year.

What is different in this system is that determining the need for an audit, and who performs it, ultimately rests with the owners of the company, the investors. As such, the perspective of the auditor is changed from one of working for management, to one of working for investors.

The audit committee helps to facilitate that process through their role in governance and oversight of the independent audit. But their decisions are subject to the ratification of investors.

Ultimately it is investors, not the government, who "drive" the process. And they are able to do so as more transparent information is provided to them than they receive today, such as disclosures about audit quality indicators, and the quality of the audit firm retained.

Last but not least, we understand that cross-border auditing is a serious issue for audit firms globally. What is your view on this issue?

In a global economy, any public independent audit is only as good as its weakest link. That is to say that every auditor, in every country in which a company has material operations, must ensure they have complied with their professional obligations at the highest level. Ultimately, those obligations must ensure the reliability, credibility and completeness of the financial statements and disclosures made to investors. If the auditor fails in those obligations for which they have been retained and compensated, then it is only fair they be held accountable for their negligence and shortcomings.

In most of those instances where auditors find themselves the subject of litigation, I have found the auditors were aware of the shortcomings or errors in financial disclosures or numbers. However, they did not act in an unbiased and sceptical manner as they are required to do. They are too often found to have worked to "justify" the numbers they were given by management, rather than actually obtaining sufficient persuasive evidence to make an assessment as to whether the numbers were correct or not. In some instances, such as Parmalat or Colonial, there were members of the firm or a regulator who argued the numbers needed to be corrected. And in those instances, it is no surprise investors believe they are entitled to some form of compensation for the damages they suffered at the hands of the auditors, who failed in their duties.

ESG

Chapter Four

ESG Reporting and Investing

4.1 ESG Reporting

"CSR" reporting began in China with a burst of national policy making over 2006 to 2008. Given high levels of pollution, disclosure on environmental issues has received most attention. But other important catalysts for firms include brand image, NGO and media pressure, and rising global standards. Reporting needs to move up the quality chain. Green finance marks a new turning point.

Introduction

Reporting on corporate social responsibility (CSR) and sustainability owes its start in China to a burst of official policies over the 2006 to 2008 period. In 2006, the Shenzhen Stock Exchange was the first to propose the voluntary disclosure of social responsibility reports.[1] Two years later, the Shanghai Stock Exchange followed suit and encouraged listed companies to publish annual social responsibility reports at the same time as they released their annual reports.[2] These two measures led to hundreds of CSR reports from listed companies.

The next important document was the "Guiding Opinions on Performing Social Responsibility by Central Enterprises" issued by the State-owned Assets Supervision and Administration Commission (SASAC) in 2008. This provided that central enterprises which have the ability should regularly release social responsibility or sustainable development reports. In 2009, SASAC proposed that within three years all 100+ central enterprises should publish CSR reports—and most had done so by 2012.

Policies were also developed for certain sectors. The China Banking Regulatory Commission (CBRC) produced a policy for banks in December 2007, while the China Textile Industry Association (currently named the China National Textile and Apparel Council) promoted CSR reporting for its industry in June 2008 (see Table 4.1, overleaf).

The year 2008 also saw the State Environmental Protection Administration (now named the Ministry of Ecology and Environment) start to promote environmental information disclosure by both government departments and enterprises. The Administration issued the "Measures on Environmental Information Disclosure (for trial implementation)", which provided that enterprises with excessive emissions should actively disclose data on such things as pollution type, emission method, concentration and total amount, as well as the establishment and operation of environmental protection infrastructure in their factories. Other enterprises were encouraged to voluntarily disclose their environmental protection policies, annual objectives and achievements, and performance on social responsibility.

Indeed, within the ESG reporting universe, corporate environmental information has generally received the most attention. This is not only because of severe domestic pollution and its impact on society, but also because corporate environmental risk can easily lead to reputational damage and a loss of market competitiveness.

ESG: A note on terminology

Until recently the acronym "ESG" was not widely used in China and for most of the past decade this type of non-financial reporting was called "social responsibility reporting", "CSR reporting" or "sustainable development reporting". We have therefore used the acronym CSR for most of this chapter. In recent years, the discussion has shifted to ESG and the better reports have evolved into broader documents that address environmental, social and governance factors.

Big wave

The surge of CSR reporting policies in China, 2006-2008

Tab 4.1

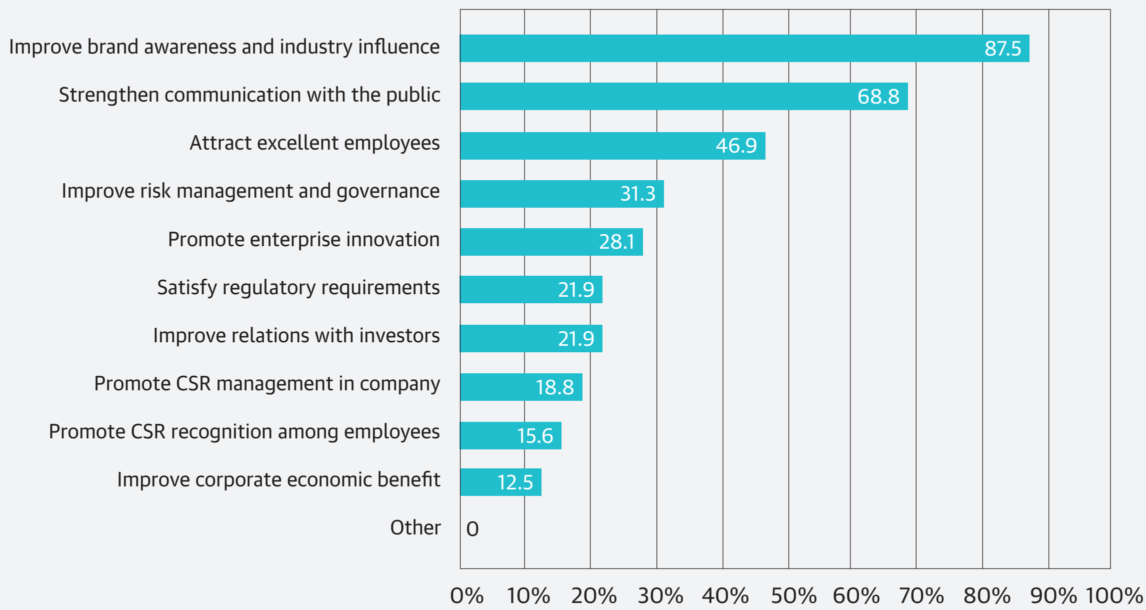
Date	Document title	Issued by	Contents
September 2006	Guidelines on Social Responsibility of Listed Companies	Shenzhen Stock Exchange	Enterprises shall regularly assess their CSR performance and voluntarily disclose a CSR report.
December 2007	Opinions on Strengthening the Social Responsibility of Financial Institutions	China Banking Regulatory Commission	Banking institutions should publish CSR reports based on the real situation of the bank.
January 2008	Guiding Opinions on Performing Social Responsibility by Central Enterprises	SASAC	Provides for a social responsibility report system. Central enterprises should regularly release CSR or sustainable development reports. They should enhance dialogue around social responsibility, understand and respond to suggestions of stakeholders.
February 2008	Measures on Environmental Information Disclosure (for trial implementation)	Former State Environmental Protection Administration	Provides detailed provisions on voluntary and mandatory environmental information disclosure by enterprises.
May 2008	Notice on Enhancing the Social Responsibility Work of Listed Companies Guidelines of the Shanghai Stock Exchange on Environmental Information Disclosure of Listed Companies	Shanghai Stock Exchange	Encourages listed companies to publish annual social responsibility reports on the Exchange's website at the same time as they release their annual report.
June 2008	China CSR Report Guidelines for Apparel and Textile Enterprises (CSR-GATEs)	China Textile Industry Association	Provides a set of comprehensive CSR reporting indicators for the textile and apparel enterprises.

Source: *ACGA research*

CSR reporting in China—reasons for

2013 (%)

Fig 4.1



Source: *SynTao*

Since 2006 the number of CSR reports in China has risen exponentially from only a few dozen to more than a thousand. The biggest increase came in 2009 when numbers jumped to 628 from 158 in 2008. The peak came in 2014 when total reports reached almost 1,600, then hit a plateau. Although the first decade of CSR reporting was all about improving brand awareness, public communication and attracting talent, the more advanced companies realise that reporting now needs to show that companies are adding value to their operations and meeting the needs of institutional and retail investors in the capital market.

Corporate catalysts

While official policy and regulatory changes were the initial drivers of CSR reporting in China, over time other factors became important.

Brand building

From the beginning, many Chinese enterprises have regarded CSR reports as a public relations exercise to build their brand image—a view that has strengthened over time. Survey results show that in 2008 most enterprises thought the main purpose of a CSR report was to strengthen communication with the outside world, followed by improving the enterprise's social image, attracting talent, and better risk management.[3] However, as shown in Figure 4.1, opposite, a follow-up survey in 2013 indicated that 87.5% of interviewees regarded "improvement of brand awareness and industry influence" as the most important driver for publishing a CSR report.[4] It also showed that only 28% saw this reporting as helping with enterprise innovation, while just 19% thought it would help with CSR management within their own company, and a mere 12.5% believed it would bring economic benefits.

NGO pressure

Non-profit organisations (NGOs) and private environmental institutes have played an important role in China in encouraging companies to publish CSR reports and improve disclosure on environmental matters. Two leading NGOs in this regard are the Institute of Public and Environmental Affairs (IPE), an environmental research organisation in China, and the Carbon Disclosure Project (CDP), an international organisation based in the UK that encourages companies to measure, report and reduce their carbon emissions.

Registered in Beijing and founded in May 2006, IPE has developed a pollution map of China called the "Blue Map" to improve public awareness and promote the enhancement of environmental governance mechanisms. The database contains information on environmental quality, emissions data and pollution sources published by provincial and municipal governments. To date it has 289 million items of data.

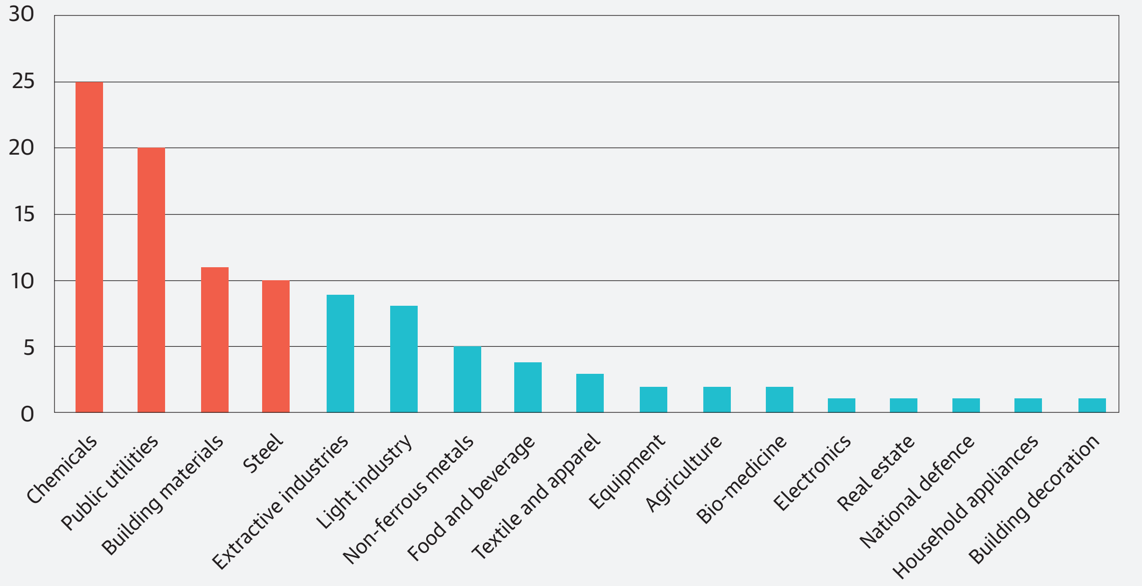
In January 2015, IPE and the *Securities Times,* a financial newspaper, jointly started a project to publish online pollution monitoring data from listed companies. It collects real-time self-monitoring data and the compliance status of important controlled enterprises published on the websites of 30 provincial environmental protection departments, and regularly publishes a list of the pollution risks posed by listed companies.[5] Industries at the top of the list include chemicals, public utilities, construction materials and steel, coloured red in Figure 4.2, presented overleaf.[6]

IPE also aims to shine a light on enterprises acting in contravention of regulations and communicates with them and their brand buyers. The aim is to encourage buyers who attach importance to greening their supply chains to pressure these enterprises to correct their behaviour. IPE regularly ranks the big brands based on its Corporate Information Transparency Index (CITI). And in recent years IPE has turned its focus to green finance. It hopes to force polluting enterprises to rectify their practices with the help of the investors, banks and other financial institutions.

Pollution status by industry

Number of companies exceeding pollution standards, 2015

Fig 4.2



Source: IPE

For its part, CDP is steadily making inroads into China. Its champion reporter to date has been China Mobile, which made the "CDP A List 2017" for its climate disclosure and is the only mainland firm to be so honoured.[7] CDP also carries out an annual survey that tracks corporate action on climate change among more than 1,800 large and systemically important companies worldwide.[8] In 2017 the number of respondents totalled 1,073, including several from China (see Table 4.2).

Other non-profit organisations that promote improved environmental information disclosure include the Global Reporting Initiative (GRI), an international non-profit that promotes the GRI reporting standard and is headquartered in the Netherlands. Another is Qingyue Environmental Protection Information Technology Service Centre, a domestic non-profit environmental protection institution based in Shanghai that promotes government and enterprise reporting on environmental issues.

Tracking climate action

Companies in China responding to CDP's 2017 survey

Tab 4.2

Company	Sector	Response permission
Bank of Communications	Financials	Public
BYD	Consumer discretionary	Not public
China Agri-Industries Holdings	Consumer staples	Public
China Citic Bank	Financials	Public
China Construction Bank (CCB)	Financials	Public
China Mobile	Telecommunications	Public
China Petroleum & Chemical Corp (Sinopec Corp)	Energy	Public
China State Construction International Holdings	Industrials	Public
China Telecom	Telecommunications	Not public
China Vanke	Real estate	Public
Huatai Securities	Financials	Public
ICBC	Financials	Public
Shanghai Electric Group	Industrials	Public
WH Group	Consumer staples	Responded late

Source: CDP

Media

Both the official media and social media play an important role in influencing CSR reporting. In 2017, for example, the *People's Daily Online* published two commentaries criticising "Honour of Kings", a blockbuster online game produced by Tencent.[9] The commentaries argued that while the game was very successful, it was having some negative impacts on society. After the commentaries, Tencent's stock price fell temporarily and the company announced it would introduce measures to promote healthier playing and guard against gaming addiction.

Emerging overseas standards

Given the rising expectations among governments, consumers and investors around the world for more effective corporate responses to ESG risks, it is likely that evolving overseas standards will continue to have an impact on China. In 2014, for example, the European Union issued guidelines requiring public-interest entities with more than 500 employees to disclose ESG information in their audited annual reports. The guidelines allow companies to choose what environmental problems to disclose, but require them to follow the principle of "comply or explain".[10] While this has yet to have a direct impact on China, it is possible that the "comply or explain" option could become more widely used. To date it is largely restricted to firms with listings in Hong Kong. Indeed, one of the more influential documents of recent years has been the "Environmental, Social and Governance Reporting Guide", issued by Hong Kong Exchanges and Clearing (HKEX). The first version of these guidelines was released by HKEX in December 2011 and encouraged listed companies to publish ESG reports voluntarily. In December 2015, HKEX issued revised guidelines that introduced a "comply or explain" mechanism for the disclosure of ESG information.

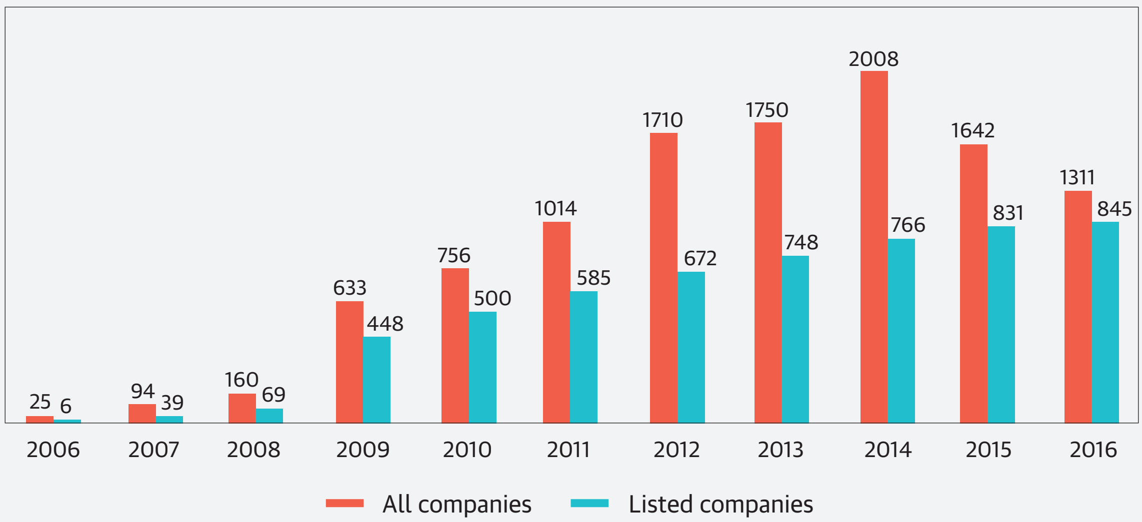
The reporting landscape

By the numbers

The earliest CSR report in China was a corporate sustainable development report published by Shell (China) Oil Company in 1999. In subsequent years the numbers slowly increased to 25 in 2006 and 94 in 2007. Then came the burst in 2009, when the total reached 633. Five years later, in 2014, it more than tripled to 2,008. But by 2015 growth had hit a plateau and numbers decreased for the first time; although among listed companies they increased slightly in that year, as shown in Figure 4.3.

CSR reporting—By number
2006-16

Fig 4.3



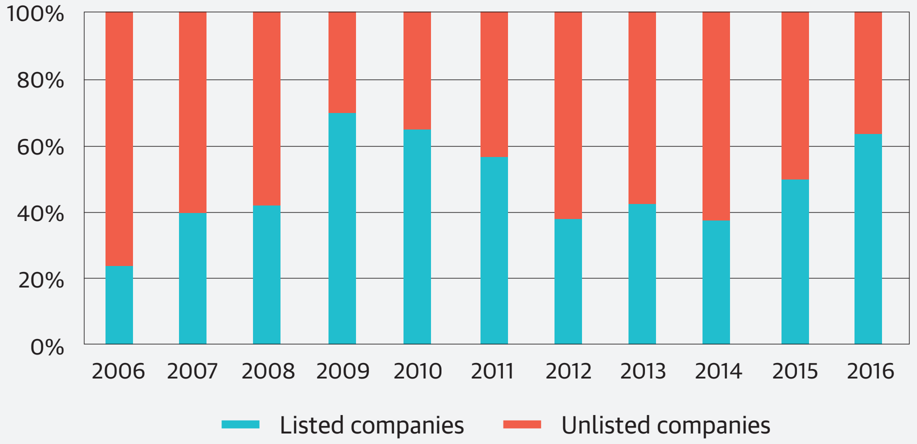
Note: Includes Chinese enterprises listed overseas.
***Source:** SynTao*

By listing status

Somewhat surprisingly, listed companies have not always been the main source of CSR reports. They made up more than half the number in 2009, 2010, 2011, and 2016, and only just reached 51% in 2015, as shown in Figure 4.4.

CSR reporting—By listing status
2006–16 (%)

Fig 4.4



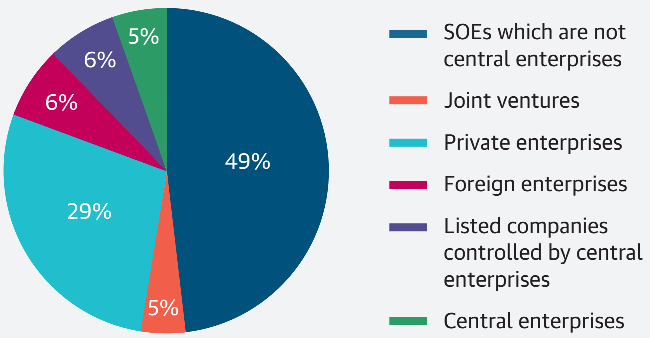
Source: SynTao

By ownership nature

In terms of ownership type, state enterprises accounted for more than half of all CSR reports in 2016. This group includes central enterprises and listed companies controlled by central enterprises, and a larger group comprising SOEs controlled by other levels of government. Private enterprises account for almost 30%, while joint ventures and foreign enterprises make up the rest (see Figure 4.5, opposite).

CSR reporting—By ownership type
2016 (%)

Fig 4.5



Source: SynTao

By industry and location

Certain industries rank at the forefront of CSR reporting, including finance, power, transportation, storage and postal, chemical, pharmaceuticals, and electronics. With respect to their geographic location, these industries are concentrated in the main industrial zones of Shanghai, Beijing, Guangdong, Zhejiang and Fujian.

By standard

Most CSR reports—around 60% to 70%—are prepared according to standard guidelines, with the most common being the Global Reporting Initiative (GRI). While the UK's Integrated Reporting standard has been introduced into China, no company follows it at this stage.

Meanwhile, less than 5% of 2016 CSR reports in China have been assured by an independent third party. The main reason is that regulation does not mandate assurance and to do it voluntarily would increase costs, hence enterprises are not motivated to seek it.

Quality problems

As the number of reports has increased and the reporting experience of enterprises has grown, the quality of disclosure by the larger firms has gradually improved. Among the best reporters are PetroChina, Ping An, Baosteel, Shanghai Pudong Development Bank and Sinopec, all of which have published CSR reports for 10 years or more.

Yet the quality of the average report remains disappointing for a number of reasons. First, many reports avoid important issues and dwell on the trivial, lacking pertinent analysis on core topics of enterprise ESG, but choose instead to illustrate non-core topics like charitable work. Second, a common problem is the over-emphasis on qualitative descriptions of CSR work, with limited quantitative analysis that would allow for meaningful comparisons of corporate performance across the environmental, social and governance spectrum. Third, almost all CSR reports are characterised by "reporting only the good news and not the bad". The reports either do not discuss negative ESG events or touch on them only slightly. These trends have been apparent since the beginning of CSR reporting in China and, while there has been some improvement, problems persist.

Limited data

An evaluation in 2015 confirmed that data paucity was a key problem. This research assessed the CSR reports of listed companies in eight industries: electric power, finance, coal mining, agriculture and fisheries, auto manufacturing, oil and natural gas, smelting, and pharmaceuticals manufacturing. The results show that the average disclosure on a set of 20 key quantitative indicators rose from just 25% in 2012 to 29% in 2015.[11]

In July 2017 the same evaluation was done on the CSI 100 Index, which tracks the top 100 firms by market cap in Shanghai and Shenzhen.[12] The results show that the average disclosure on the same set of 20 key quantitative indicators was 41%—a better outcome than the earlier studies, but still indicating that CSI 100 firms only provided disclosure on around eight indicators on average. The highest disclosure score of 85% was achieved by Shanghai Pudong Development Bank, whose CSR report contained information on 17 key indicators. The lowest score was 5%, meaning that only one key indicator was reported on (see Figure 4.7, overleaf).

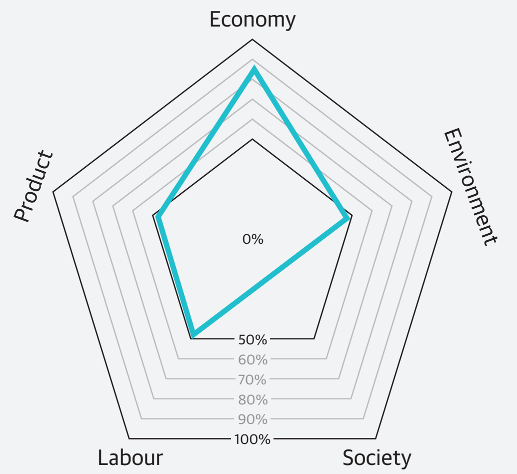
In terms of industry, average disclosure levels in coal mining, telecommunication services, and oil and natural gas ranked first, second and third, with all above 60%. Although the finance industry had the largest number of reports, its average disclosure percentage was only 44%—not much above the average. The sector at the bottom of the pile, with average disclosure of just 10%, was internet and software services.

Limited social information

The research also pointed out that for disclosure on five broad factors—economy, environment, society, labour and product—the economy scored highest, while disclosure on broad social factors such as rule compliance, anti-corruption and community was the lowest in each industry (see Figure 4.6, opposite).

CSR reporting—By factor
2016 (%)

Fig 4.6

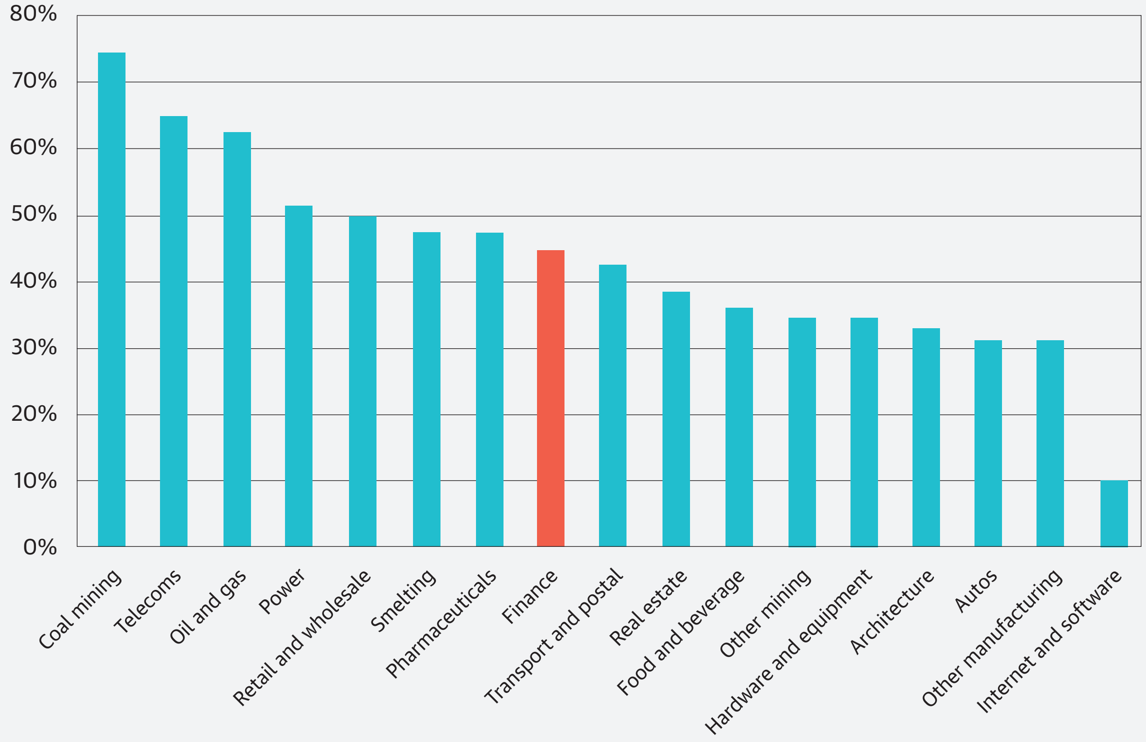


Source: *SynTao*

CSR reporting—By industry

Average disclosure on 20 key indicators in CSR reports, 2016 (%)

Fig 4.7



Source: *SynTao*

Too much positive news

The quality of a CSR report has a big impact on its application value, especially in the capital market. But as Qian Minwei, assistant director in the special research department of Aegon-Industrial Fund, once said, "Currently the CSR reports of listed companies in China have little reference value for investors because they are full of positive issues. We have advocated on many occasions that when companies are developing their core businesses they should first analyse what are their responsibilities to stakeholders, what problems they have faced, and what is the (potential) impact of their business on related parties. If something is wrong in these areas it cannot be avoided, since the purpose of information disclosure is to express the objective and true situation to investors. Corporate responsibility is far more than simply donating money, which is an indicator with low importance."[13]

No link to operations or management

The practical value of CSR data gathering and reporting for internal management purposes is also being missed in China. GRI guidelines point out that the preparation of reports helps enterprises identify environmental and social issues that could have a significant impact on their operations, allowing them to carry out continuous supervision and correction in these areas. However, it is rare for companies to integrate reporting and management. The main reasons follow.[14]

First, many companies publish their report only to satisfy regulatory requirements. Once the report is done, the mission is completed. The company lacks the willingness to integrate the report with management. Second, the task of report preparation is usually assigned to marketing or investor relations, neither of which want to meddle with the company's business lines. Third, even though some companies would like to move towards a more integrated approach, the person in charge of the process may not be senior enough to allocate the necessary resources.

Declining brand effect

While the main motivation to publish CSR reports was once building brand awareness, the rapid increase in the number of reports has undermined the value of PR. In the early years, when only a few dozen enterprises published, the media was curious about this new phenomenon. Today, the release of a CSR report has become routine and the media has limited interest. Fewer and fewer enterprises hold press conferences to announce their reports, while the media lacks reporters who have the knowledge and capability to evaluate their quality. This in turn means that enterprises lack the motivation to promote their brand image by improving reporting quality.

Green the hottest colour

As it did in the beginning, a key factor for stimulating material improvements in CSR reporting in China today is the environment. It is not only the strengthening of regulation and enforcement in recent years, but the emergence of green finance as a major rallying cry for banks, companies and institutional investors.

New laws

On 1 January 2015, a newly revised "Environmental Protection Law" came into force. According to this law, large emitting enterprises should accurately disclose to the public the name of the main pollutant, emission method, concentration and total amount, and the operation of infrastructure for preventing and resolving the pollution. The government has also issued and amended several important laws and regulations. These include:

- Atmospheric Pollution Prevention and Control Law, amended in August 2015, effective from 1 January 2016.
- Action Plan on Soil Pollution Prevention, issued in May 2016.
- Environmental Impact Assessment Law, amended in July 2016, effective from 1 September 2016.
- Environmental Protection Tax Law, issued in December 2016, effective from 1 January 2018.
- Water Pollution Prevention and Control Law, amended in June 2017, effective from 1 January 2018.

Looking forward, the "Law of Soil Pollution Prevention" has been incorporated into the legislative plan of the National People's Congress and was supposed to be issued in 2017.[15] As of early July 2018, however, it was still going through the review process by the Congress. (The consultation of the second review draft ended on 27 January 2018.[16])

Enforcement

Statistics show that the enforcement of environmental regulations has increased over the three years from 2014 to 2016. The number of administrative penalty cases rose by almost 50%, while the monetary value of penalties more than doubled[17] (see Table 4.3, below).

Environmental enforcement Tab 4.3

Administrative cases and penalties, 2014-2016

	2014	2015	2016
Cases	83,000	97,000	124,000
Penalties (Rmb billion)	3.168	4.25	6.63

Source: *Ministry of Environmental Protection*

Green finance

These trends have intensified since 2014 with the rapid development of green finance in China. In 2015, a research group in the People's Bank of China (PBOC) made several suggestions for nurturing green finance in China, some of which related to environmental disclosure by listed companies and bond issuing companies, including:

1. Developing provisions on mandatory disclosure of environmental information;
2. Requiring quantitative disclosure of key information by listed companies and debt issuing companies according to disclosure standards;
3. Giving play to intermediary agencies in the assessment, supervision, guidance and incentives on environmental information disclosure;
4. Strengthening cooperation on the supervision and enforcement of environmental information disclosure.[18]

In 2016, the momentum gathered pace with the inclusion of green finance into the 13th Five-Year Plan for the Economic and Social Development of the People's Republic of China. In the same year, the PBOC joined with six ministries and commissions to issue the "Guiding Opinions on Establishing a Green Finance System".[19] These required banks to disclose information on green credit asset-backed securities; disclosure by green bond issuers; a mandatory environmental disclosure system for listed companies and bond issuers; and improved disclosure on green finance from foreign investors.

In September 2016, the G20 Summit held in Hangzhou published the "2016 G20 Comprehensive Report on Green Finance", drafted by the central banks of China and the UK. On 14 June 2017, the State Council chose five provinces, namely Zhejiang, Jiangxi, Guangdong, Guizhou and Xinjiang, in which to establish green finance reform and innovation pilot zones.

These policies are having an effect as related ministries and industry associations start to take action. In June 2017, the Ministry of Environmental Protection and the CSRC signed an agreement on "Jointly Carrying Out the Environmental Information Disclosure Activities of Listed Companies". The two entities now jointly promote a mandatory environmental disclosure system in listed companies and urge them to act responsibly.

Meanwhile, the consumer market in China is changing. As more and more people become aware of environmental issues, green products are emerging as a new growth sector in the retail industry. According to data from Alibaba, on "Singles Day" in 2016 (11 November) revenue from the online sale of green products increased by 40% and the number of customers increased by 31% compared to the year before.[20] Green products include, for example, those which have a better environmental performance in terms of energy efficiency during production or consumption. Another survey that analysed trading data on Taobao, the online marketplace created by Alibaba, discovered that the number of green consumers had increased 14 times in nearly four years.[21]

Conclusion: Next steps

Having reached a plateau in terms of numbers, the next stage in the development of CSR reports in China will be a focus on quality. Some suggestions and observations follow.

Focusing on large caps

One way to improve quality would be for regulators and research institutions to shift the focus of their supervision and research from all enterprises to a smaller group of large enterprises which are more likely to be sensitive to ESG issues. For example, all the central enterprises, those in the CSI 100, CSI 300, Fortune Global 500, China Top 500, top 100 private enterprises and so on.

Addressing supply and demand imbalances

Some institutional investors have expressed a clear wish to acquire information relating to the ESG performance of listed companies, especially in industries sensitive to environmental supervision such as pharmaceuticals and chemicals. In addition, ratings agencies and index providers want more information to assess the ESG of listed companies. According to media reports, MSCI plans to rate the ESG of all A shares incorporated into the MSCI Emerging Markets Index after June 2018. Companies with insufficient ESG disclosure may not be incorporated into the index.[22]

With a rapid increase in demand for all types of ESG information, it is likely that the conflict between supply and demand will persist for several years. This could force ESG ratings agencies and investors to rely too heavily on public news, government websites, enterprise websites and so on, leading to information of low quality and high cost. To address this challenge, investors could strengthen communication with key listed companies and stakeholders around ESG topics. For example, they could first choose significant ESG topics or indicators on which to start a conversation.

A phased approach

The original policies that drove the first round of CSR report growth were mainly issued by SASAC and the Shanghai and Shenzhen Stock Exchanges between 2006 and 2008. For many years afterwards, there was no powerful new policy impetus on CSR in China. This has changed in recent years, as noted above, with the prominence given to green finance and amendments to various environmental laws.

If international trends are any guide, any new policies will likely be targeted mainly at listed companies and financial institutions, and will take a step-by-step approach in the implementation of higher standards. That is, from voluntary disclosure to semi-mandatory disclosure (the "comply or explain" model) and then mandatory disclosure. Such new policies will probably set clear disclosure requirements on some key indicators (especially environmental indicators) on an industry basis.

Understanding intrinsic value

For the continuous development of CSR reporting in China there needs to be greater understanding of its intrinsic value. For companies, such value is expressed in better communication with stakeholders and strengthening the management of environmental, social and governance risks and opportunities. For regulators and investors, such value is reflected in the increasing relevance of ESG data in guiding the market and shaping investment decisions. This is no longer a public relations exercise.

Endnotes

[1] Shenzhen Stock Exchange, "Guidelines on Social Responsibility of Listed Companies", 2006.

[2] Shanghai Stock Exchange, "Notices on Enhancing the Social Responsibility Assumption of Listed Companies", "Guidelines of Shanghai Stock Exchange on Environmental Information Disclosure of Listed Companies", 2008.

[3] SynTao-Sustainability Solutions report, Journey of Value Discovery 2008, December 2008.

[4] SynTao-Sustainability Solutions report, Journey of Value Discovery 2013, October 2013.

[5] Securities Times, "Annual Report of the List of Online Monitoring Data Pollutants of Listed Companies (Abstract)", 2 February 2016.

[6] IPE, "2015 Annual Summary of the List of Online Monitoring Risk of Pollution Sources of Listed Companies", 2 February 2016.

[7] Carbon Disclosure Project, "CDP A List 2017". See: https://www.cdp.net/en/scores-2017.

[8] Carbon Disclosure Project, "Tracking corporate action on climate change". See: https://www.cdp.net/en/research/global-reports/tracking-climate-progress-2017/about

[9] People's Daily Online, "Honour of Kings: Amuse the Public Or 'Frame' The Life"; "Honour of Kings: Strengthening the Supervision of 'Social Games' is Imperative", July 2017.

[10] European Union, Directive 2014/95/EU of the European Parliament and of the Council.

[11] SynTao-Sustainability Solutions, "Journey of Value Discovery 2015", July 2016.

[12] SynTao-Sustainability Solutions, "Substantive Analysis of CSR Reports of the CSI 100", July 2017.

[13] China Responsible Investment Forum, "The Investigation Report on Responsible Investment of the Fund Industry in China (2014)", November 2014.

[14] Guo Peiyuan, "CSR Reports Reach a Plateau: What is the Way for Information Disclosure?", China Financial Information, October 2016.

[15] Xinhua News Agency, "The Law on Soil Pollution Prevention Has Been Incorporated into the Legislation Plan This Year", 9 March 2017.

[16] Ministry of Environmental Protection, "Consultation on the second review draft of the Law on Soil Pollution Prevention ends on 27 January 2018", 7 January 2018. See: http://www.mep.gov.cn/xxgk/hjyw/201801/t20180105_429180.shtml

[17] Ministry of Environmental Protection, "Report on the State of the Environment in China" (multi years).

[18] Working Group on Green Finance, "Establishing a Green Finance System in China", China Finance Publishing House, April 2015.

[19] PBOC, MOF, NDRC, MEP, CBRC, CSRC, CIRC, "Guiding Opinions on Establishing Green Finance System", 31 August 2016.

[20] Ministry of Commerce (MOFCOM), "China Retail Industry Development Report 2016-2017", 3 July 2017. See: https://p.baidu.com/daily/view?id=68948

[21] Ali Research Institute, "Report on Green Consumers in China", August 2016.

[22] Shanghai Securities News, "All A share Companies Incorporated into MSCI Index Will be Evaluated and Assessed for ESG", 26 July 2017.

Interview: 'Enhancing enterprise understanding of ESG'

Li Wen
Expert, China Industrial Enterprises Social Responsibility Research Thinktank,
China Federation of Industrial Economics

What environmental and social risks have a relatively large impact on listed companies in China? What is their impact on the performance of companies?

The largest environmental and social risk is the limited understanding of enterprises towards their role in the area of social responsibility. With the development of the internet and new media, and rising social pressure, stakeholders demand more from enterprises and management's scope of responsibility has widened. When the state has increasingly strict requirements for environmental protection, enterprises should enhance their standards of environmental management, otherwise they will face new risks.

Social risks are mainly those relating to community relationships and supply chain management. The operation of enterprises may affect the nearby community and the general public. Therefore, enterprises need to consider in advance their impact on the community and actively communicate to the public, otherwise public unrest may be triggered and social stability undermined.

Supply chain management relates to the requirements for fair operation and standardised management in a commercial environment in which bribery, security operations and other risks may arise. Whenever environmental or social risks occur, they will likely have an immediate impact on a company's share price. At the same time, they will probably spark public attention and have a negative effect on the company's brand reputation. From a medium and long-term point of view, such risks can influence the reputation and rating of enterprises, increase financing costs and affect the stability of long-term investments of the company in the same or similar high-risk areas.

Are listed companies already aware of these risks? Do you think they can effectively resolve them?

In recent years, while the awareness of environmental and social risks among China's listed companies has risen, it is still not comprehensive or thorough. At a strategic level, their overall planning and control is also inadequate. Resolving these kinds of risks depends on the degree of understanding among listed companies. If their understanding is clear and rational, companies will take effective measures to address these risks. But if their awareness is weak and they do not pay enough attention, most of the measures taken by listed companies will be in emergency mode and will not effectively resolve the problem. Some companies may even take inappropriate measures and trigger new risks.

In terms of the governance structures of listed companies in China, do you think environmental and social risks have become an important issue for discussion in the board of directors?

In my opinion, the topic of environmental and social risks has become an important issue for discussion in the board of directors. But the systematic response to the management of such risks, especially on a strategic level and in respect of management involvement, is not complete.

In many listed companies, the office of the board secretary or the department of investor relations are responsible for communicating with institutional investors, yet they do not understand ESG. The department familiar with ESG issues usually does not talk to investors directly. How can this dilemma be resolved so as to promote the smooth communication between companies and investors?

I think there are many ways to resolve this dilemma. First, the relevant departments, especially personnel in the department of corporate social responsibility (CSR), should actively communicate with colleagues in the office of the board secretary or investor relations and make them aware that efforts to promote ESG, social responsibility and sustainability will be helpful for improving investor confidence, mutual trust and financing. This is where CSR personnel could take the initiative, while workshops could be arranged with external experts providing training on the methodology. Second, the CSR and other departments should overcome their "competence panic" and improve coordination across various departments. It is common for CSR departments in many companies to have limited communication with investor relations departments. The main reasons relate to mindset and the psychological issue of "competence panic". CSR personnel are incapable of explaining responsible investment and related topics to others, so they lack the confidence in communicating about such subjects. In fact, in many companies, the CSR department has an outward facing and international perspective, which is exactly what is needed to manage investor relations in many large listed companies. Therefore, CSR personnel should improve their self-confidence, provide more knowledge and substantial help to those in the investor relations department, and at the same time improve both their own understanding of the relevant subjects and ability to coordinate among departments. The core responsibility of the CSR department remains demonstrating the contribution that corporate social responsibility and ESG factors can make to value creation in listed companies.

A third solution is for listed companies to manage CSR and ESG in a systematic and targeted way, proceed in an unambiguous direction with clearly defined and relevant indicators, and let different departments coordinate through the same system. This requires the concerted effort of both investor relations and CSR departments.

Currently the stock exchanges require or encourage ESG or CSR reports, but the quality of such reports is generally low. How can the report quality be improved?

From an internal point of view, the most important thing is to integrate these reports into the strategic management system and daily operational processes of listed companies. In this way, company executives will attach importance to these reports and establish an incentive mechanism to improve reporting quality and enhance forward momentum.

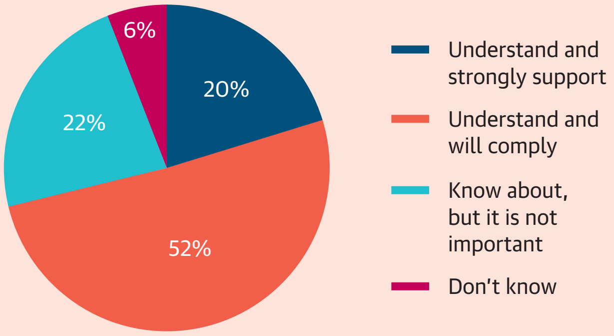
From an external point of view, the attention of the media and research institutions (those with "speaking power") are essential. When ESG reports have become the focus of the media, company executives will of course pay attention to them. Report quality could be improved with the help of ratings agencies. If such agencies set up a rating or ranking of ESG reports, or rated the CSR of listed companies according to the contents of their ESG reports, the results could indicate high, medium and low levels of quality. Listed companies would then become more aware of how important ESG reports were and what standards they would be measured against. Such standards could help to guide listed companies to publish ESG reports of a higher quality.

HKEX ESG guidelines

Fig 4.8

What is your attitude towards the ESG reporting guideline that HKEX has been promoting?

It is interesting to note that most respondents to ACGA's 2017 survey of China listed companies are in broad agreement with Li Wen's comments. More than 70% have a positive attitude towards Hong Kong's new ESG Reporting Guide.



Source: *Adapted from ACGA China Listed Company Perceptions Survey 2017*

4.2 ESG Investing

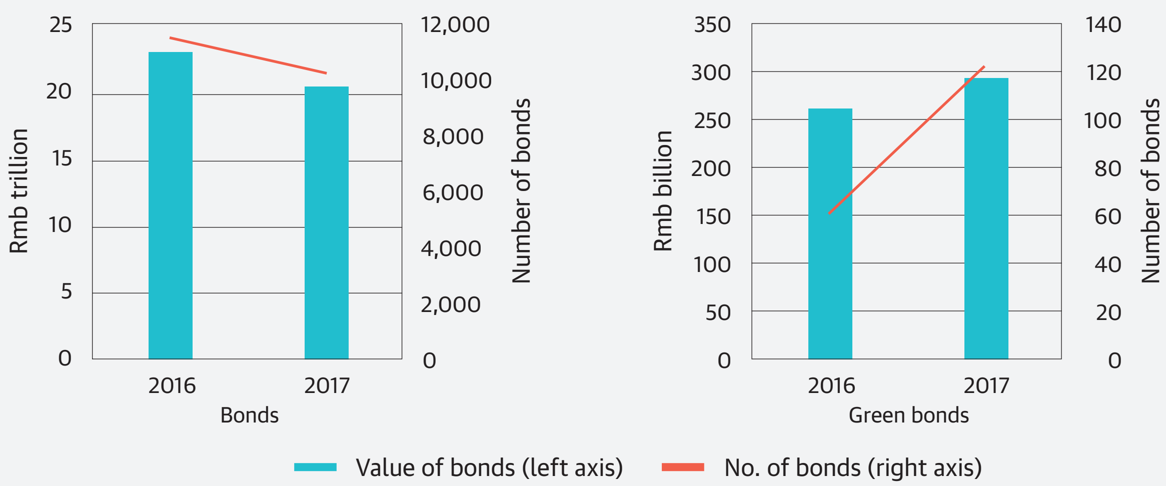
Investment interest in ESG is on the rise, but from a low base. Market opportunities for investment managers are growing and the use of positive and negative screens is increasing. Retail investors with longer time horizons are taking an interest. Green finance has a bright future.

Introduction

Both fund companies and retail investors in China are starting to pay more attention to ESG issues. For the funds, this is a result of national policy encouraging them to examine environmental and social factors in their investment process—part of the wider Five-Year Plan framework—and a natural consequence of the emphasis on green finance in recent years. At the same time, the market for financial products with an ESG theme is on the rise. Figure 4.9 highlights a notable contrast between the national bond market and the green bond market in 2016 and 2017—while sales of bonds fell overall, the number and value of green bonds increased.

China's bond and green bond markets
2016–17

Fig 4.9



Source: *Wind*

Growing awareness of ESG is reflected in annual surveys undertaken by the Asset Management Association of China (AMAC), the peak industry body for investment managers. These show that whereas only 34% of fund companies in 2008 said they considered social responsibility factors in their investment decisions, by 2016 this had increased to just over 59%.[1] In terms of the number of fund companies, the figure rose from 14 to 63 firms over the same period as the overall industry grew (see Table 4.4, overleaf).

Funds typically adopt a dual-screening process that assesses corporate performance using both positive and negative criteria. Positive indicators include such things as protection of employee interests and capacity for innovation. Negative indicators focus on environmental pollution, media monitoring of trust and credibility issues, serious deficiencies in corporate governance structure, and other factors, as shown in Figure 4.10, overleaf.

On the rise

Tab 4.4

Proportion of fund companies in China focusing on social responsibility, 2008-16

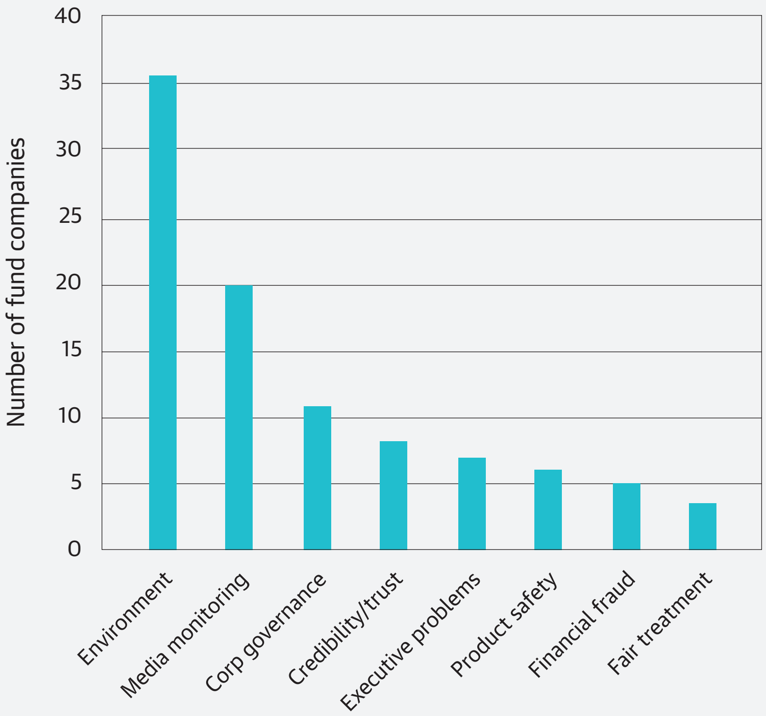
	Sample	Responses	%	CSR/ESG focus	%
2008	41	17	41.50	14	34.20
2009	57	57	100.00	28	49.10
2010	59	59	100.00	41	69.50
2011	68	68	100.00	43	63.20
2012	70	70	100.00	44	62.88
2013	83	83	100.00	46	55.42
2014	92	92	100.00	45	48.91
2015	97	97	100.00	54	55.67
2016	106	106	100.00	63	59.43

Source: *Asset Management Association of China*

Negative screening by China funds

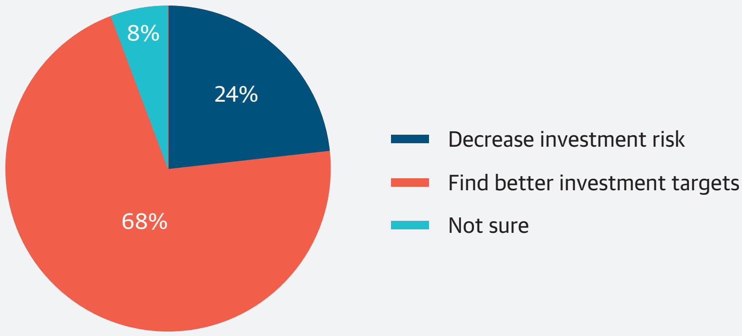
Fig 4.10

Criteria used to screen investments



Note: Number of fund companies (out of 63 respondents)
Source: *Asset Management Association of China*

Why do ESG products bring superior returns? Fig 4.11



Source: *Asset Management Association of China*

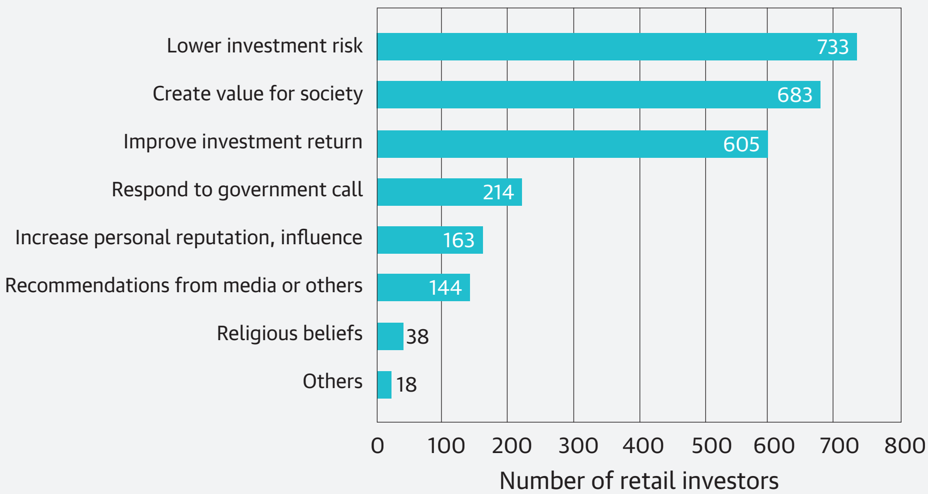
According to AMAC, as of June 2017, there were four socially responsible funds, namely Aegon-Industrial Social Responsibility Balanced Fund, CCB Principal SSE Social Responsibility ETF and Linked Fund, CCB Principal Social Responsibility Balanced Fund, and China Universal Social Responsibility Fund.[2] In addition, there were 59 themed funds focusing on issues such as low carbon, environmental protection, sustainable development, green, corporate governance, pension and so on.[3] AMAC also surveyed its members with ESG funds as to why they felt such an investment approach brought improved returns. A large majority said they believed it produced better investment targets (see Figure 4.11, above). Almost a quarter saw it as reducing investment risk.

Retail catalysts

Awareness is also rising among retail investors. A survey carried out in 2017 of more than 1,000 retail investors found that around 63% of participants said they had basic knowledge of socially responsible investing and green finance, almost 12% claimed a high degree of knowledge, while 23% admitted they knew little or nothing.[4]

In contrast to institutional investors, the primary motive for retail investors to consider ESG factors is to "lower investment risk". This is followed by "creating value for society" and, in third place, "improving investment return", as highlighted in Figure 4.12, below.

Why retail investors consider CSR Fig 4.12



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

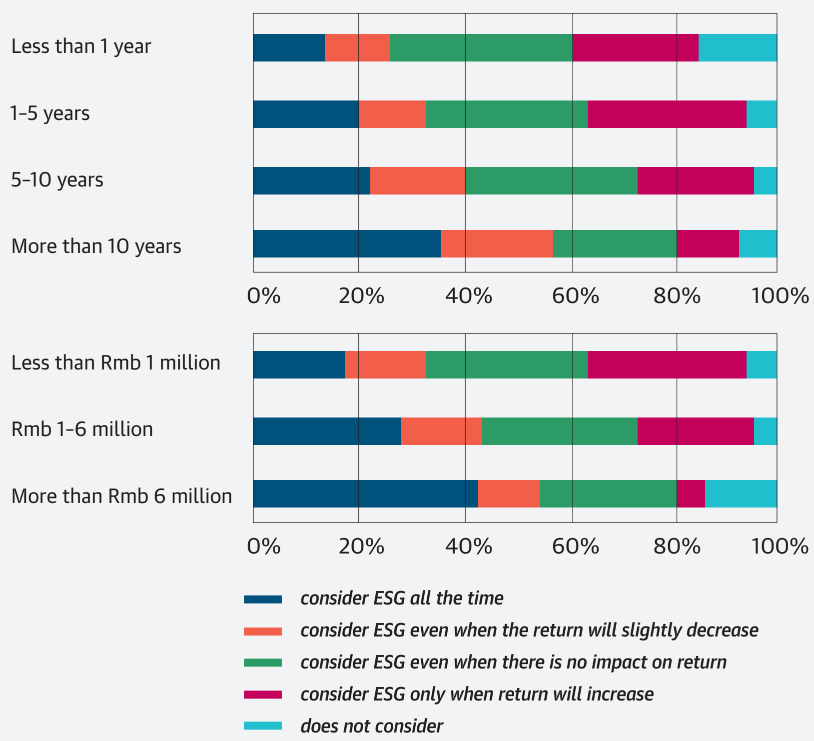
Source: *SynTao Green Finance, Aegon-Industrial Fund*

Retail investors with longer investment horizons were more likely to focus on ESG factors. The propensity to consider ESG factors also rises as investment capital increases (see Figure 4.13 below).

Differing focus on ESG

Investment cycles (years) and investment amounts (Rmb)

Fig 4.13



***Source:** SynTao Green Finance, Aegon-Industrial Fund*

Index investing

The popularity of ESG index investing is also growing in China. The China Securities Index Company, for example, classifies green-themed indices into three categories:

1. Sustainable development, including sub-categories on ESG, social responsibility, and corporate governance;
2. The environmental protection industry, with sub-categories on environmental protection, environmental governance, and new energy; and
3. Environmental ecology, including carbon efficiency and green cities sub-categories.

Up to February 2017, there were 19 green indices and 18 fund products tracking these indices with assets under management of Rmb10.7 billion.[5]

Blossoming
Green indices in China, early 2017

Tab 4.5

Category	Sub-category	Index Name	Short Name
Sustainable Development (including ESG)	ESG	CSI Caitong ECPI ESG China 100 Index	ESG 100
		CSI ECPI ESG China 40 Index	ESG 40
	Corporate governance	SSE 180 Corporate Governance Index	180 Governance
		SSE Corporate Governance Index	Corporate Governance
	Social responsibility	SSE Social Responsibility Index	Responsibility Index
Environmental Protection Industry	Environmental protection industry	CSI China Mainland Low Carbon Economy Index	Mainland Low Carbon
		China Low Carbon Index	China Low Carbon
		CSI Environmental Protection Industry 50 Index	Environmental Protection50
		SSE Environmental Protection Industry Index	SSE EP
		CSI Environmental Protection Industry Index	CSI EP
		CSI Metasequoia Environmental Protection Patents 50 Index	EP Patents
		CSI Water Environment Treatment Index	CS Water ET
	Environmental governance	CSI Environmental Governance Index	Environ-governance
		CSI AEF Ecology 100 Index	Ecology 100
	New energy	CSI New Energy Vehicles Index	New Energy Vehicles
		CSI New Energy Index	CSI New Energy
		CSI Nuclear Energy & Power Index	CSI Nuclear Energy & Power
Environmental Ecology	Carbon efficiency	SSE 180 Carbon Efficient Index	SSE 180 carbon efficient
	Green city	CSI Sponge Cities Index	CSI Sponge Cities

Source: *China Securities Index Company*

Conclusion: Next steps

Although the attention of fund companies on ESG is increasing, and interest in green index investing is gradually rising, the percentage of fund products and indices related to ESG themes remains low. Take public funds for example: the number of publicly offered products exceeds 4,000[6], while the percentage related to ESG is less than 2% and the size of current products is comparatively small. Some industry insiders point out that domestic clients in China (the asset owners) do not yet pay close attention to, or identify with, ESG factors, whereas overseas clients have already developed a mature ESG investment system and continue to improve it.

Insufficient demand for ESG products limits the ability of fund managers to benefit from economies of scale. This directly affects the growth of support services such as consulting, data gathering, rating and index development, which in turn limits the expansion of the market size.

On the other hand, if developments in other markets are any guide, interest in ESG investing seems bound to rise over time in China as the size of the pension market grows and consumer concern for a cleaner environment deepens. Besides designing new products, more fund managers could introduce ESG analysis into their investment research. As a preliminary step, funds could choose specific industries and issues to focus on and accumulate experience gradually.

Endnotes

[1] Asset Management Association of China, "The Social Responsibility Report of Mutual Fund Industry in China (2016)", June 2017.

[2] China Universal Asset Management. See: http://www.chinauniversalasset.com/english/fundinfo/470028/enfundgk.shtml

[3] Asset Management Association of China, "The Social Responsibility Report of Mutual Fund Industry in China (2016)", June 2017.

[4] SynTao Green Finance, Aegon-Industrial Fund, "Ten-year Report on Responsibility Investment in China", September 2017.

[5] Zhao Yonggang, "The Research on Green Finance and Green Stock Indices", February 2017.

[6] Shanghai Morning Post, "The Number of Public Fund Products Exceeds 4,000", 8 March 2017.

Interview: 'Green finance in China is just getting started'

Dr Ma Jun
Chair, Green Finance Committee

What recent progress has green finance made in China?

Recently, China's domestic green finance industry has made rapid progress, becoming the world leader in promoting green finance. One of the key milestones was reached in 2016, when the PBOC and the six other ministries released the "Guiding Opinions on Establishing a Green Finance System". These guidelines strive to accomplish many essential goals—they will execute the tasks of the Government Work Report, promote sustainable development of the economy, establish a sound green financial system, improve the function of the capital market in allocating resources and servicing the real economy, and support and promote the development of an ecological civilisation.

In June 2017, the State Council executive meeting approved piloting green finance in five provinces and autonomous regions including Zhejiang, Guangdong, Xinjiang, Guizhou and Jiangxi.

Specifically, the progress of green finance in China can be found in the following areas:

1. The number of green funds has increased significantly. In recent years, local governments in China have initiated or participated in 50 green funds, and more than 200 green funds have been launched by private capital.
2. Financial subsidies, green guarantee mechanisms and other green finance incentives for green projects are blossoming in various places. Zhejiang, Jiangxi, Guizhou, Guangdong and other regions have allocated specific financial support for green finance programmes.
3. The green bond market has further developed, becoming the largest in the world in 2016; and we have launched 22 green investment funds at the regional level. Green bonds account for 2% of the bond issuance in China, whereas they only make up 0.2% of total bond issuance globally. The target should be 20%, so there is still a long way to go for China and even more so for the rest of the world.

Furthermore, we have created an ecosystem for the market. The Green Finance Committee has published a catalogue for green-friendly projects with 31 categories and specific requirements for each, including key parameters. Second, the PBOC will ask the issuer to go for a third-party opinion to verify the project is genuinely green. China now has 10 verifiers, including the Big Four (about 80% of the market share) and some local firms. This is not a mandatory requirement, but more than 80% of the issued bonds do have this assurance. The verifiers have probably rejected a few projects already, but the issuers tend not to disclose the rejections.

The third part of the ecosystem is disclosure in annual reports by issuers about how they have used the proceeds. These are the three defence lines we put in place to ensure the system is working in the way we designed. For companies exclusively conducting green business such as solar or energy companies, it is not too difficult to monitor. However, if a conglomerate must be monitored, then company process management must also be analysed. Conglomerates are required to have separate accounts for their proceeds from green bonds to ensure they use the funds in the way stated. There are obviously still some problems that we need to face, such as the quality of verifiers. I think the future guideline for verifiers is that they need to at least produce a minimum amount of information to investors, including some key indicators.

4. Financial institutions are carrying out environmental stress tests. The Industrial and Commercial Bank of China (ICBC) has taken the lead in exploring environmental-risk stress testing. Stress testing these scenarios may result in a transfer-pricing mechanism within the bank that supports green projects and stifles polluting investments. The International Institute of Green Finance of the Central University of Finance and Economy also introduced environmental risk analysis methodologies for asset management.
5. New progress has been made in green insurance. The Ministry of Environmental Protection and the China Insurance Regulatory Commission are drafting documents on establishing compulsory environmental liability insurance in high-risk areas. In addition, many insurance companies have introduced a series of innovative green insurance products.
6. Advances have been made regarding disclosure of environmental information by listed companies. To establish a system of mandatory disclosure of environmental information by listed companies, the system will be divided into three steps: We have made a three-year roadmap for mandatory environmental disclosure for listed companies in China. The China Securities Regulatory Commission should lead the drafting of all these documents. Step one is the mandatory disclosure requirement for all the major polluters, which is out already. About 20% of listed companies in China are classified as major polluters. The second step is semi-compulsory disclosure for all listed companies by 2018 and the final step is the mandatory disclosure requirement for all listed companies and bond issuers by 2020.
7. The Green Finance Committee is setting up a green project database in China to serve as a platform for green projects to connect domestic and overseas funds. At present, Xinjiang and Zhejiang have submitted nearly 1,000 green projects, and the Green Finance Committee is organising experts to conduct a preliminary assessment. Green standards will be included in the project library. In the future, the coverage of the green project database could be extended to all pilot areas.
8. We made progress in promoting the greening of the "Belt and Road". In September 2017, the Green Finance Committee along with six industry associations jointly released the "China Foreign Investment Environmental Risk Management Initiative" to guide Chinese financial institutions and enterprises to increase green investment in the "Belt and Road" to avoid pollution and high carbon investment. The Green Finance Committee is also joining forces with the City of London and the Paris Europlace to launch voluntary guidelines for green investment in the "Belt and Road" for Chinese and European investors.

What are the main challenges to developing a green finance market in China? How should these be addressed?

I think we have overcome the biggest hurdle already, which was the lack of policy signals. The Central Party issued a document in 2014 called the "Eco Civilization Reform Plan" which, for the first time, included a statement on establishing a green finance system. This led to the seven-ministry guidelines on green finance. The next step is really about capacity building. I think what we need is to build capacities at the middle management and middle official levels of regulators, companies, banks, and among other asset managers in order to design specific policies and know how to conduct green finance. At present, around 80% of financing in China is still coming from the banking system and 70% of green loans are additional loans which are managed by banks, so each bank has to know how to service green loans and how to analyse the impact of a particular loan finance project on the environment. That capacity is coming out of a system from the China Development Bank (CDB), which spent several million renminbi to build software to quantify the environmental impact of most projects. This kind of capacity is not yet available in many other banks in China, so each bank will need to expend similar resources to develop their own software. However, the Green Finance Committee has been working with CDB and the China Energy Conservation and Environmental Protection Group, which is the biggest green company with 400 subsidiaries, to set up a universal methodology for the industry.

Each bank also has a different approach to their capacity building on green finance. Some of them chose to train all the relevant staff to develop the expertise for analysing green finance projects like the CDB, and some set up a green finance department to deal with these cases like the ICBC.

How long will it take for investors and companies in China to really take ESG factors into account in their decision-making process? What obstacles need to be overcome?

It will take a long time, but there are still a few things that we can do. One avenue is that we can ask companies and investors to refer more to international responsible investment standards, including those from some well-respected international organisations in this field. Signals from the government will greatly influence this. Since most asset management companies in China are still state-owned, they listen to the government very carefully.

The second option involves methodology and capacity building. This applies to not just the people, but also to the model design and the screening process to filter the green companies and projects, among others. What we need is a systematic training programme in which local asset managers can learn from the successful experience of big global asset management companies on how they are doing this and what kind of model they are using.

Although Western countries subscribe to the idea of the fiduciary duty of asset owners, I think it is difficult to promote this concept in China. In terms of green finance development in China, it is not the investors that are telling the asset owners to embrace this idea, but the government, which is also the biggest investor in many cases. Therefore, the situation is very different from the Western markets where pressure mostly comes from investors or the public. The biggest asset owners in China are not being aggressive enough. To start with, maybe we can build some sense of legal responsibility for asset managers to respond to the requirement from asset owners. It will probably take five to 10 years to gradually develop this kind of sense among Chinese asset managers.

The other task is to develop enough high-quality green investment products. We need to have good third-party services and rankings to gauge companies and projects. The Green Finance Committee is working on this with the Asset Management Association of China to soon publish some rankings of listed companies in China according to their green performance.

Many companies and investors are short-term in outlook. Hence, no matter what the government does, sustainability is not the priority for most of the market. How do we fix this?

Most mutual funds are managing public money, so if the public is short-term focused then they have no choice but to be short-term as well. It is just a translation of the preferences of retail investors. They will see that it is not the right way to invest in 10 to 20 years, but changing the mindset of people still requires a lot of education and training. It will be very useful if we can have solid evidence that focusing on the long-term can improve investment performance, but we do not have that yet in China. On the other hand, the government should also be longer-term focused to lead the trend. Both the evaluation and target planning of asset managers need to be long-term focused to make the change.

将晴

Chapter Five

M&A in China

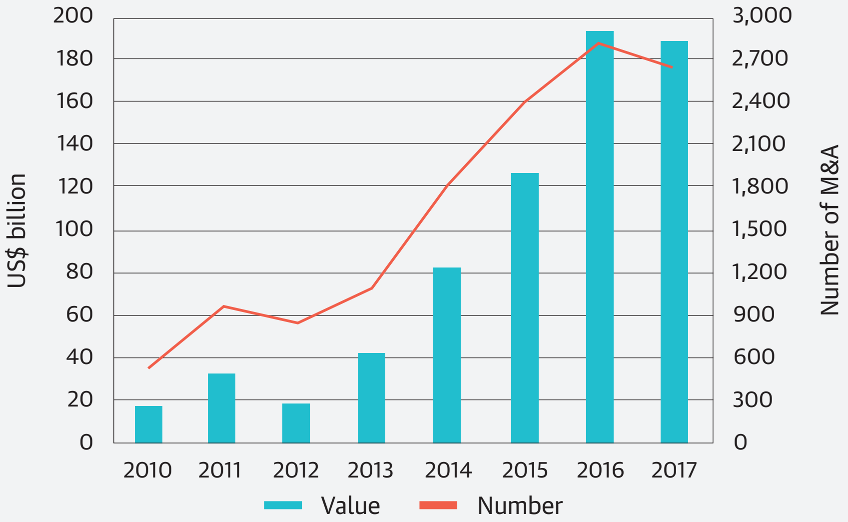
5.1 M&A with Chinese Characteristics

Deregulation over 2014 to 2016 fired up the domestic M&A market, with state enterprises responsible for most deal value. Outbound investment by both state and private firms was also on the rise until the government clamped down on the hyperactive insurance sector in 2017. While the market view of the value of M&A is largely positive, there remain numerous challenges.

Introduction: Local M&A

Following deregulation in recent years, the number and value of mergers and acquisitions in China increased sharply between 2013 and 2016, before easing off slightly in 2017, as Figure 5.1 below shows. In 2014 the State Council released a new policy called "Opinions on Further Optimizing the Market Environment for Enterprise Merger and Restructuring", while in the same year the China Securities Regulatory Commission (CSRC) announced its "Measures for the Administration of the Takeover of Listed Companies". Then in 2016 the CSRC published its "Measures for the Administration of the Material Asset Restructurings of Listed Companies".

Domestic M&A in China
2010–17
Fig 5.1



Source: *Adapted from Zero2IPO Research*

M&A transactions between domestic listed companies in China have certain definable characteristics. One feature is that acquirers seldom undertake a tender offer, although this is possible, but instead negotiate acquisitions by agreement or indirectly. Of the 1,578 cases of significant asset restructurings by listed companies between 1 January 2014 and 31 December 2016, a mere four involved tender offers, according to data from China Stock Market & Accounting Research (CSMAR). One reason for the low percentage of tender offers is the high cost involved: before October 2014 each tender offer required a "non-objection" letter from the CSRC, while the trading cycle from announcement of an offer to expiration usually took more than two months. But a more fundamental reason is that ownership of listed companies is highly concentrated in China and transactions only need to be negotiated between blockholders. This entails lower costs and higher certainty.

China's first successful hostile takeover

On 2 May 2018, an ownership struggle between Hangzhou Zhemin Tianhong Investment Partnership and Zhenxing Biopharmaceutical and Chemical (000403.SZ) was finally settled. As China's first successful hostile takeover bid, the case signals a possible new era in financial market development in the country.

Zhenxing Biopharmaceutical and Chemical (ST Biochemical) is a Shenzhen-listed company primarily engaged in the manufacture and sale of biopharmaceutical products. In 2006, the company was given the label "ST" (meaning "special treatment") by the Shenzhen Stock Exchange in view of its high-leverage and because its largest shareholder, the Zhenxing Group, had not yet followed up on promises to spin-off a loss-making subsidiary, Zhenxing Electronics. In December 2014, ST Biochemical was also punished by the CSRC for not disclosing loan guarantees and certain lawsuits as required.[25] The company thus kept the "special treatment" designation despite being profitable.

On 21 June 2017, only two days after the Zhenxing Group finally compensated ST Biochemical for transferring a remaining 65.22% stake in Zhenxing Electronics, the Hangzhou investment partnership Zhemin Tianhong knocked on the door of ST Biochemical. The latter quickly applied for a temporary suspension, claiming it was in negotiations to acquire another company, Shanxi Kangbao Biological Product, based in Changzhi, Shanxi Province.

On 27 June, ST Biochemical disclosed that a tender offer had been made by Zhemin Tianhong Investment to acquire 27.49% of its shares. Including the 2.51% that Zhemin already owned, this would take its shareholding in ST Biochemical to 29.99%, just below the 30% threshold to trigger a mandatory general offer.

On 7 July, the Zhenxing Group reported Zhemin to the Zhejiang office of CBRC, saying the company had obtained irregular loans of Rmb1.4 billion from China Minsheng Bank. Furthermore, on 14 September, Zhenxing Group initiated litigation against both Zhemin and ST Biochemical for breaching information disclosure rules, suspicious tunnelling and insider trading activities. Yet none of these actions stopped Zhemin.

On 16 August, ST Biochemical announced that its acquisition target had changed from Kangbao to Weikesheng Biotech, based in Inner Mongolia. Meanwhile, many of ST Biochemical's directors were buying shares in the market during this period.

This series of events caught the attention of regulators, with the Shenzhen Stock Exchange issuing multiple letters of concern to the company. Then on 20 September, ST Biochemical announced its asset restructuring plan had been terminated and its shares resumed trading the next day.

The tender offer formally begins

On 1 November, ST Biochemical disclosed details of the tender offer made by Zhemin with an open period of 33 days. Seeing that all other defensive measures had failed, Zhenxing Group sought to bring in a white knight as a last resort. On 29 November, just two weeks after a lock-up period for its 22.61% non-tradable stake in ST Biochemical ended, Zhenxing Group sold an 18.57% parcel of ST Biochemical to Hangyun Jiankang, a subsidiary of the Kaisa Group. The sale price was Rmb43.2 per share, 20% higher than the offer made by Zhemin. At the same time, Zhenxing transferred its remaining 4.04% stake to Shenzhen Cinda under a share-debt swap, with the latter also signing an agreement to delegate its proxy voting rights to Hangyun Jiankang for a year. Thus, Hangyun Jiankang suddenly became the largest shareholder of ST Biochemical with an effective 22.61% stake. »

At this point, things were looking gloomy for Zhemin Tianhong. On the date the share transfer was announced, a large number of shareholders revoked their pre-acceptance of the offer because they believed their shares to be undervalued. According to the Shenzhen Stock Exchange website, the pre-acceptance of Zhemin's offer fell drastically from 24.3% to 8.3% within one day. Moreover, under relevant rules, an acquirer cannot change the terms of a tender offer within 15 days of its expiration unless a competitive offer has been made.[26] An ownership transfer by the largest shareholder does not equate to a competitive offer and the transfer happened with only six days to the expiry of Zhemin's offer.

In the end, Zhemin landed its catch. When its offer expired on 5 December 2017, it received acceptances of 147 million shares from 3,870 shareholders, exceeding the required target of 74.92 million shares by 96.2%. This made it the first successful hostile tender offer in China's financial market.

On 13 April 2018, ST Biochemical announced that all its directors and supervisors had resigned. And on 2 May, the company elected a new board of directors and supervisory board at an extraordinary general meeting. The new board consists of seven members, four of whom were nominated by Zhemin and three by Kaisa. The new chairman was nominated by Zhemin, while both parties nominated one supervisor to the supervisory board.

A second feature is that transfers of control usually involve companies actively looking for a buyer or seller, they are rarely unexpected. This feature is also highly correlated with ownership concentration, since in practice it would be very difficult to take control from a shareholder who owned 30% or more of the voting rights and did not want to sell. Although the number of attempted hostile takeovers has increased in China over the past five years, only one has been successful.

Third, the purposes of M&A are varied. Deals may be done to achieve certain synergies or business expansion goals, or they may be purely for financing needs. Since the listing still needs the approval of the CSRC, the "corporate shell" of a listed company has a high value. This has led to a lot of rent-seeking behaviour around corporate shells, including M&A for the purpose of backdoor listings. A backdoor listing is where a private company takes control of a listed company whose market value is low and assets have been cleared. The buyer then injects assets into the target, becomes a listed issuer itself and then changes the listed company's name. Since this is an obvious form of regulatory arbitrage, the CSRC continues to tighten its rules over the use of such "backdoors".

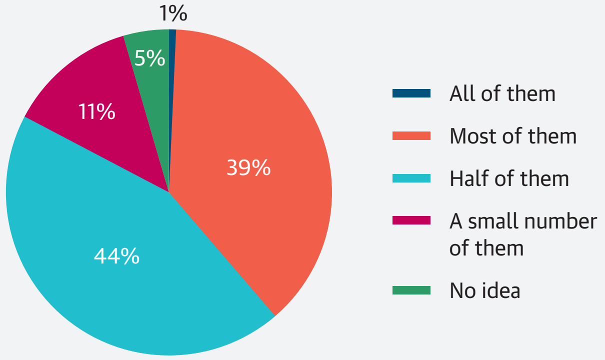
A fourth salient characteristic of the M&A market in China is the active dealmaking between SOEs. According to data from Zero2IPO Research, there were 481 M&A cases among SOEs with a total value of US$36 billion in 2014 alone. More recent data from the *Economic Information Daily*, a state-owned newspaper, showed there were 126 listed SOEs involved in M&A deals with a total value of Rmb854 billion (US$126 billion approx) in 2017. Among these deals, 21 had a value of more than Rmb10 billion and more than half were horizontal mergers among peers in the same industry. In other words, while SOE deals account for a small percentage of all transactions (see Figure 5.1 on page 157), they are responsible for a majority of total value.

Not surprisingly, mergers and acquisitions involving SOEs often have a strong policy imperative. In 2012, for example, SASAC decided to carry out a restructuring and listing of the FAW Group, a state-owned auto manufacturer based in Jilin Province bordering Russia and North Korea. Yet by early 2018, FAW Group had still not completed its integration of subsidiaries and resolved problems of competition between them.

Adding value through M&A

Fig 5.2

How many M&A deals (both domestic and overseas) conducted by Chinese listed companies over the past five years have added value for shareholders?



Source: *ACGA China Listed Company Perceptions Survey 2017*

In another instance, SASAC announced in 2017 that China Hi-Tech Group would be merged into SINOMACH, an SOE in the heavy machinery industry. China Hi-Tech has assets of Rmb70 billion, while SINOMACH is one of the top 500 companies in the world and its main business revenue in 2016 exceeded Rmb200 billion. It would appear that the main driver for the merger was to reduce the number of central enterprises, rather than business reasons. In cases such as this the new entity is said to have been "restructured but not merged", with few synergies expected.

The net result of the recent dealmaking within China is a positive view of the value created by M&A. Our survey of Chinese listed companies showed that 39% of respondents said "most" M&A deals over the past five years had added value for shareholders, while another 44% believed "half of them" had done so, as shown in Figure 5.2, above.

Inbound M&A: Foreign caution

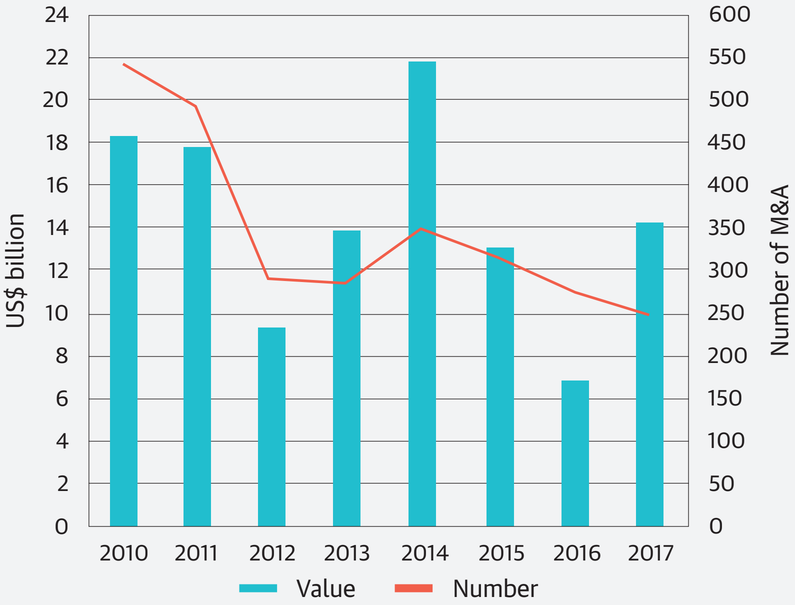
The value and number of M&A deals in China involving foreign capital have fluctuated in recent years, with declines in value in 2011-12 and 2014-16, and a reduction in number from more than 450 per year in 2010-11 to between 250 to 350 in subsequent years, as Figure 5.3 opposite shows. Such deals not only incur high costs in order to satisfy regulatory requirements, but also face challenges posed by China's legal system and cultural integration.

Since the second half of 2016, China has simplified procedures for foreign investment in some areas. In 2017, the Ministry of Commerce (MOFCOM) issued new regulations called the "Catalogue of Industries for Guiding Foreign Investment" and the "Decision on Revising 'Interim Measures for the Recordation Administration of the Formation and Modification of Foreign-Funded Enterprises'". These specified that except for deals where special administrative measures restraining foreign investment applied, other inward investments would only need to be reported to MOFCOM; that is, they would no longer require prior examination and approval.

Meanwhile, following the 2013 introduction of a pilot "negative list" of sectors off-limits to foreign investment in free-trade zones, the special management measures for foreign investment have been simplified and extended to other parts of the country. However, the "negative list" continues to have more restrictions than the "Catalogue of Industries for Guiding Foreign Investment". Since key industries such as finance, health and telecommunications remain highly controlled, the State Council announced its "Several Measures for Promoting the Growth of Foreign Investment" on 16 August 2017. The result is that China is increasing equal treatment of foreign investment and reducing the scope of the "negative list" to further strengthen the openness, transparency and standardisation of the investment environment. Indeed, the negative list has been shortened three times since 2013 and the current fourth list is about half as long as the first version.[1]

Inbound M&A to China
2010–17

Fig 5.3



Source: *Thomson Reuters, China Venture and PwC*

The Boao announcements

Policy changes continued into 2018. At the annual Boao Forum in mid-April 2018 the leadership announced a series of measures to open the financial services sector to greater foreign investment.[2] For example, removing restrictions on the percentage of foreign ownership in banks and financial asset management companies and increasing the upper limit for foreign ownership in securities companies, fund managers and life insurers to 51%. The daily quota for the Stock Connect trading system between Hong Kong and Shanghai, and Hong Kong and Shenzhen, was quadrupled on 1 May 2018—clearly a response to the inclusion of A shares into the MSCI Emerging Markets Index from June 2018. While bold on paper, it will be interesting to see the extent to which the ownership changes make a difference in practice to the structure of China's already well-developed financial system. Then a week later, Beijing announced measures to reduce restrictions on foreign ownership in the auto sector. These included removing ownership restrictions in special vehicles and new energy cars in 2018, followed by commercial vehicles in 2020 and passenger cars in 2022. The two-joint venture limit per foreign investor would also be removed in 2022.

Regulatory challenges

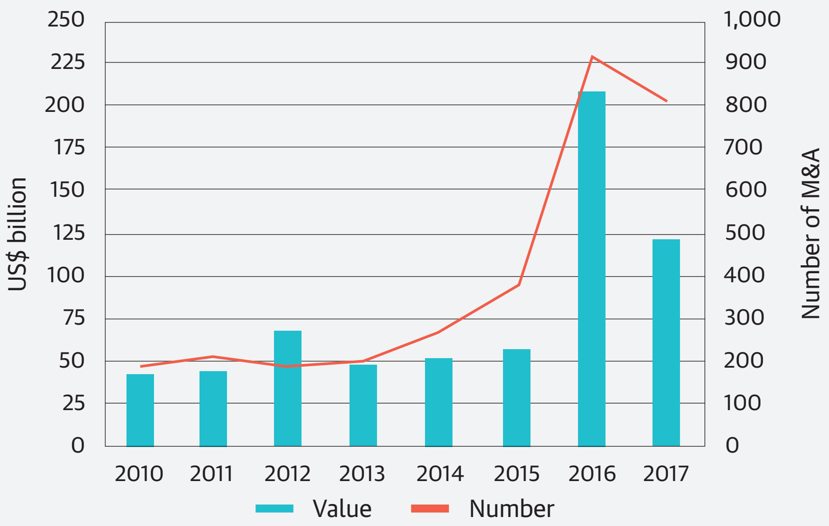
Despite this apparent loosening of the policy environment, foreign-invested enterprises in China continue to face regulatory challenges. A major risk is the interplay between the company law and joint venture law. An important legal principle in China is that "special laws" are superior to "general laws", hence provisions in the special law relating to foreign investment takes precedence over a general law such as the Company Law. For example, the Company Law in China states that the general shareholder meeting is the 'highest organ of authority' in a company[3] and, in theory, provides some level of supervision over the board of directors. In contrast, the Law on Chinese-Foreign Equity Joint Ventures does not require general shareholder meetings and thereby removes a level of supervision. Joint ventures only need a board of directors, which becomes the prime decision-maker.[4] This means complications can arise as a result of the joint venture law's "legal representative" concept, which makes the chairman the legal representative of the company and vests in him sole power over business operations on behalf of the enterprise.[5] In practice, therefore, the chairman will have more power than other directors and may use this to the detriment of the foreign joint venture party. This is a clear example of "regulation with Chinese characteristics" and the conflict between a Western concept (vesting powers in a board of directors) and a Chinese concept (vesting even greater powers in the chairman, with little or no supervision over him).

Outbound M&A: No more salad days?

From 2010 to 2015 the annual value of Chinese overseas investment remained quite steady, then underwent a major surge in 2016 before falling significantly in 2017, as Figure 5.4 below shows. In terms of number of deals, this began rising in 2014, hit a peak in 2016 and dipped the following year. In 2015, China's direct overseas investment exceeded its use of foreign capital in the same year, meaning that China became a net capital exporter.[6] In general, the purpose of overseas M&A is to expand markets, secure resources, export over-capacity, or introduce new technology. There is also evidence of Chinese enterprises acting as financial investors looking for stable returns.

Outbound M&A from China
2010–17

Fig 5.4



Source: *Thomson Reuters, China Venture and PwC*

Private sector swashbucklers

Many of the most colourful overseas investments have been made by aggressive private enterprises. The cash-rich but now-disgraced insurer, AnBang, acquired the Waldorf Astoria Hotel for US$1.95 billion in 2014 and sought to take over Starwood Hotels. Dalian Wanda acquired the American cinema chain, AMC, for US$2.6 billion in 2012, and a US studio, Legendary Entertainment, for US$3.5 billion in 2016—just two of a slew of overseas acquisitions. And the heavily indebted HNA Group of Hainan went on a foreign buying spree between 2015 and 2017, taking substantial stakes in the Hilton hotel group (26%) in late 2016, Deutsche Bank (9.9%) between February and May 2017, and numerous others. To pay off debt, HNA sold its entire stake in Hilton in April 2018 and has been trimming its Deutsche Bank holding. Meanwhile, its efforts to buy Skybridge Capital, founded by President Trump's short-lived White House communications director, Anthony Scaramucci, have been stymied by the US government on the grounds of HNA's complex and opaque ownership structure.

One deal that failed to take off was Anbang's attempted acquisition of Starwood in early 2016. Anbang competed with Marriot Hotels to acquire 100% of Starwood after Marriot had already signed a purchase agreement and was waiting for shareholder approval. Anbang proposed a higher all-cash offer, went through two rounds of bidding, then suddenly withdrew after a third price increase. The reason was reportedly related to financing constraints and the risk of violating CIRC regulations.[7] This case raised questions about the way in which Chinese enterprises negotiate, arrange finance, and manage compliance and credit risk. Yet it is also worth noting that the Anbang consortium included a domestic private equity fund, Primavera Capital, and a US investment fund with deep experience in Asia, J.C. Flowers & Co.

After such an investment boom, it was not surprising that the Chinese state sought to calm enthusiasm in 2017. It strengthened guidance on overseas investments and restricted investments in real estate, hotels, cinemas, entertainment, sports clubs and others, as well as the establishment of equity investment funds or investment platforms without real industrial projects.[8]

State sector constraints

When state enterprises take the lead on overseas M&A, the approach will be different: in addition to a policy orientation in the selection of targets, M&A strategy will be influenced by the need to maintain and increase the value of state assets. One example was the acquisition of Syngenta, a Swiss seed and pesticide giant, by CHEMCHINA on 8 June 2017, the largest overseas M&A to date.[9]

Yet even state dealmaking can be subject to domestic regulatory risk within China. Although regulation has relaxed somewhat since 2014, overseas investments are still examined and approved by SASAC and commercial departments depending on their size and scale, while investments in sensitive countries and industries must be examined and approved by SASAC and the Ministry of Commerce no matter the transaction size.[10] In addition, cash payments are under the supervision of the State Administration of Foreign Exchange.

Backlash from foreign markets

On top of the internal restrictions that Chinese companies have to manage when conducting outbound M&A deals, some have also faced constraints imposed by foreign governments, especially the US. In March 2018, Broadcom's attempt to take over Qualcomm in the US was blocked by President Trump on various grounds, one of which was that the deal could give Huawei, a leading Chinese telecoms company, an advantage in developing its chip-making technology. This is the fifth time that a direct Presidential prohibition has been issued against a deal based on an investigation by the Committee of Foreign Investment in the United States (CFIUS). All of the five directly or indirectly related to China, with three occurring since December 2016 (see Table 5.1 below).

In another case, from January 2016, a Chinese investor called GO Scale Capital announced that it had failed to acquire approximately 80% of Lumileds, a subsidiary of the Netherlands-based giant Royal Philips, as a result of objections from CFIUS. Later, in October 2016, the German government withdrew its initial approval and blocked the acquisition of chip equipment maker Aixtron by China's Fujian Grand Chip Investment Fund. The company later dropped its takeover bid after the former President Obama blocked the deal on security grounds.

History of US blocks on Chinese deals

Tab 5.1

Time	Acquirer	Target	Blocked by President	On the grounds of
February 1990	China National Aero-Technology Import and Export Corporation	Mamco Manufacturing Inc, a US-based aerospace parts supplier	George Bush	National security
September 2012	Chinese-owned Ralls Corporation	Four US wind farms in Oregon near a Navy base	Barack Obama	National security
December 2016	China-based Fujian Grand Chip Investment Fund	German-based Aixtron SE	Barack Obama	National security—potential transfer of US military data to a Chinese acquirer
September 2017	Chinese-backed Canyon Bridge Capital Partners Inc	Lattice Semiconductor Corporation	Donald Trump	National security—potential transfer of intellectual property to a Chinese acquirer
March 2018	Broadcom Inc	Qualcomm Inc	Donald Trump	National security—potential of giving Chinese company Huawei a leading position on 5G development

Source: *Federal Register, ACGA research*

Deals have been blocked not just on national security grounds, but also to protect the primacy of each country's cutting-edge technologies. This trend has been observed in the UK and Europe as well. In 2017, Germany amended its Foreign Trade Regulations to permit investigation of any acquisition over 25% of a domestic company by a non-EU company that could impair public order or security. And in March 2018 the UK government announced that it had expanded investigation of foreign investments to cover the computing hardware and quantum technology sectors in addition to technology that has a military and dual-use purpose. The French government is also planning to expand its investigation of foreign investments to include sectors such as artificial intelligence, energy supply, transport, telecom and public health. It is understood that the perceived threat from China has been identified in each of the cases mentioned above as a driver of the policy change.

> *Foreign scrutiny of Chinese M&A deals is extending beyond traditional national security concerns to protecting cutting-edge technology*

In summary, although overseas M&A transactions by SOEs usually undergo considerable communication with regulators in advance, and even obtain pre-approval, the risk of uncertainty due to policy changes remains. Since private firms find it difficult to have such informal communication with regulators, they generally face more regulatory risk. With the gradual tightening of bank loans and foreign exchange controls, capital risk has become an unavoidable risk factor for those "going out". Moreover, a recent global movement has seen tightened control on foreign investments, which Chinese companies should factor into their valuations of outbound M&A deals. In addition, over the long term, the ongoing internationalisation of China's companies will require further efforts to bridge the gap with global firms in terms of corporate culture, governance, technology and other factors.

Challenges: Takeover rules

In addition to the policy, legal and financial issues enumerated above, the M&A landscape in China is heavily shaped by the nature of takeover regulation itself. This is seen most clearly in the restricted market for corporate control. Despite the high ownership concentration of most listed companies—a natural barrier to any unwanted takeover—dozens of hostile takeovers have been launched since 2013 with the aim of acquiring control over listed companies. Yet only one has succeeded. A prime reason is the current regulatory framework.

Scope of tender offers limited

The wording of takeover rules in China bears some similarities with the system in the UK and Hong Kong. According to the "Security Law" and the "Measures for the Administration of the Takeover of Listed Companies", acquirers have an obligation to make a tender offer if they individually or jointly hold more than 30% of the shares of a listed company.[11] But unlike the UK or Hong Kong, China does not force an acquirer to make an offer for all the shares in a target company. If an acquirer holds 30% and continues to increase his holding, he should acquire not less than 5% more. Meanwhile, the CSRC has provided all kinds of exceptions, including exempting acquirers from making compulsory tender offers.

Lack of clarity in rules

At the same time, Chinese law provides a "non-frustration" rule that stipulates a board of directors shall not interfere in any acquisition.[12] After a tender offer is announced, unless approved by the general meeting, the law reasonably states that a company should not adopt anti-takeover measures such as revising its articles of association, looking for white knights, selling company assets or other defensive tactics. But perversely, this can be interpreted to mean that if a hostile acquirer does not announce a tender offer, or before they have done so, the target company is able to adopt defensive tactics.

Ambiguous position of general meeting

Since the general meeting is the ultimate decision-making authority under law in China, it has the formal power to approve capital increases, remuneration of directors, bond issuances or large asset transactions.[13] In practice, however, this mostly favours the controlling shareholder: although the CSRC trialled certain new voting rights for minority shareholders in 2004[14] , all shareholders are permitted to vote on the adoption of anti-takeover measures. Hence, the general meeting cannot prevent defensive measures that are not in the interests of shareholders as a whole. Meanwhile, in listed companies with dispersed ownership, management cannot rely on the general meeting for support and therefore has few defensive tools under law.

A further issue is that the Company Law does not provide a minimum quorum in percentage terms for shareholder meetings. Even resolutions that require a supermajority vote (two-thirds or more of the votes cast), a low attendance rate among shareholders could still result in a defensive measure being approved. According to publicly available data, the median percentage of votes cast at general meetings of mainboard listed companies in Shenzhen was 43% in 2016. While this may seem quite high, it includes the votes cast by the largest shareholder, who typically owns at least 30% of the company. Hence, the participation of minority shareholders in general meetings is low. Meanwhile, the anti-takeover environment has become more complicated by novel measures created by some controlling shareholders. Some have unilaterally amended their articles of association to protect themselves, as the box story, 'Barbaric articles' on page 166, highlights.

Trading suspensions

A handy anti-takeover weapon is the trading suspension. Once company insiders become aware of a threat to their controlling power, they can immediately apply to have their shares suspended. Minority shareholders lose the opportunity to exit the company, while any hostile acquirer cannot buy. The suspension leads to liquidity risk for investors and causes unforeseen losses. One positive, however, is that this tool will be limited for A share firms included in the MSCI Emerging Markets Index after June 2018: the index provider has indicated that it will exclude any company that suspends its shares for more than 50 consecutive days.

Part of the problem is that, historically, securities law and regulation has lacked clear provisions on the reasons for, and length of, suspensions. Following the stock market collapse in June 2015, when suspensions were rife for a short period, the Shanghai and Shenzhen exchanges developed the "Memo on Trading Suspension and Resumption for Listed Companies", which specified the maximum suspension period for significant issues and stated that listed companies should not abuse suspensions and damage the right to know or the trading rights of shareholders. These rules are based on self-discipline and do not provide full certainty to the market, nor eliminate rent-seeking.

Ignoring the law

Other anti-takeover measures are carried out in apparent direct contravention of the Company Law. For example, the practice of "self-entrenchment" on the part of management: extending the term of directors, refusing to execute minority shareholder proposals, limiting the voting rights of shareholders, and so on. Because people lack confidence in the legal system, they are not utilising their rights to the full and objecting to these unlawful measures. This leaves courts and regulators little room or incentive to initiate enforcement action.

These issues are evident in a case that occured in 2014. The board of Shanghai New Huang Pu Real Estate Company, a Shanghai-listed company, extended the terms of directors and stopped hostile shareholder proposals for interim general meetings to re-elect the board. The board simply refused, saying that "the timing is not appropriate". The shareholders did not file a lawsuit and sold out by mid-2015.[15]

In another case that started in September 2013 and involved two Shenzhen private sector firms, the unlisted Kingkey Group attempted to acquire a listed entity called Kondarl, but the latter's board refused to acknowledge the voting rights of Kingkey Group. Although a court decided the resolution of the board was invalid,[16] Kondarl refused to revise the resolutions of the previous general meeting or call a new general meeting. The court's decision was therefore rendered meaningless and the Shenzhen Exchange could only issue repeated letters of concern—14 of them by September 2016.[17] But things have otherwise not gone well for Kondarl: in April 2018 it announced it could not issue its 2017 annual report and suspended its shares from 2 May 2018.[18]

In some takeovers, hostile acquirers may overlook the need to disclose their substantial ownership (the 5% threshold) as required under the Security Law and the "Measures for the Administration of the Takeover of Listed Companies". According to the Security Law, no voting rights shall be exercised before the correction is made.[19] But courts have different opinions on whether "correction" means the sale of all shares acquired or merely the issuing of an announcement, and whether violating this obligation is considered such a serious breach that the acquisition of the listed company is forbidden. For example, in the battle of control over Oriental Silver Star, the decision of a court in Henan Province in March 2016[20] supported the company's opinion that shareholder rights could not be exercised if the substantial shareholder disclosure obligation had not been met. But in the battle of control for Kondarl, the decision of a court in Shenzhen in February 2018[21] believed that the rights of the acquirer were not affected by the disclosure omission.

In summary, regulatory loopholes and deficient enforcement largely benefit the defenders in any hostile takeover. Companies which dare not to follow the rules can simply close their doors and refuse to acknowledge or allow the rights of minority shareholders to be exercised.

Government intervention

There are also cases where the government has intervened in hostile takeovers because of distrust of a hostile acquirer and a desire to help companies drive out the "barbarians". In such cases, insiders of the target company actively seek government support. In the Vanke case, the central and local governments punished the acquirer, Baoneng Group, while encouraging China Resources, Evergrande and other shareholders to transfer their shares to Vanke's white knight, Shenzhen Metro (see Vanke case study in Chapter 6.4).

Another form of government intervention is the managed transaction. In May 2017, Guangzhou Fund, a financial company under the Guangzhou municipal government, announced a tender offer for 30%

Barbaric articles

One new tactic for defending against the so-called barbarians is to amend the articles of association to make hostile takeovers harder. This occurred in the case of Boya Bio-Pharmaceutical Group, a Shenzhen-listed company formerly known as Jiangxi Boya Bio-Pharmaceutical.

Boya amended Article 83 of its constitution to require any acquirer which holds 5% or more of its shares to disclose this information and their future acquisition plan to the company within three days. The acquirer must also seek the approval of the general meeting for any increase in its shareholding, otherwise the increase will be regarded as hostile and the acquirer will be barred from nominating directors or supervisors and from calling an extraordinary general meeting.

Interestingly, according to the Shenzhen Stock Exchange website, this surprisingly brazen measure was inserted into the Boya's articles in October 2013[27], almost two years before the Vanke saga started. It is still there in its latest version of April 2018.[28]

However, a court in Shanghai recently pushed back against such defensive tactics. On 10 May 2018, the Shanghai Fengxian District People's of the shares of AJ Group, a Shanghai-listed company, with the intention of becoming the controlling shareholder. After the announcement, Guangzhou Fund suddenly withdrew its offer and purchased 7.3% of the shares of AJ Group, thereby becoming the company's third largest shareholder. The reason was that Shanghai SASAC and the Guangzhou government had entered into negotiations to enhance smooth cooperation between the two cities and find a harmonious compromise. Guangzhou Fund revised its offer and the Shanghai side promised to give it a directorship.[22]

Conclusion: Next steps

Despite the problems previously outlined, it is worth remembering that the regulatory framework for hostile takeovers in China was only established in the early 2000s and remains a work in progress. How might it evolve further? Our observations and suggestions follow.

The general meeting will remain a weak protection mechanism

In the UK and certain other developed markets, the shareholder general meeting plays a central role in adjudicating on takeovers. It is unlikely to do so in China for the foreseeable future for several reasons. In companies with concentrated ownership, voting in general meetings will be neutralised by the controlling shareholder, while the absence of an active institutional shareholder base means any anti-takeover measure will more likely be in the interests of the controlling shareholder than shareholders as a whole.

For companies with dispersed ownership, management will be reluctant to use the general meeting to approve defensive measures, such as the introduction of a white knight, because this could easily be countered by a hostile acquirer with a larger percentage of ownership. As the Vanke case showed, the board had limited scope to defend itself, resulting in the company finally choosing to be indirectly owned by the Shenzhen government. Indeed, the battle for control over Vanke was never submitted to the general meeting, possibly because management did not trust the outcome.

A further challenge for China is that it is predominantly a retail investor market. By the end of March 2018 there were 137.5 million individual investors.[23] According to the 2017 statistical yearbook of the Shanghai Stock Exchange, natural-person investor accounts amounted to 99.79% of all accounts in 2016 and the absolute value of their trading, including buying and selling, accounted for 85.62% of the total, leaving institutional investors responsible for only 12.21%. Despite their high proportion of trading, individual investors accounted for only 23.70% of share ownership.[24]

Court announced its decision in the case of *China Securities Investor Services Center (ISC) v Shanghai Hile Bio-Pharmaceutical*, a Shanghai-listed company. ISC sued the company over a clause in its articles that states, "only investors who hold the company shares for 90 days or above could vote for directors". In its decision, the court ruled that there was no requirement under the Company Law for a shareholder to nominate or vote for company directors, thus the term in Hile Bio's articles was declared void.[29]

ISC is a Shanghai-based public shareholder service organisation founded in December 2014. It is directly administered by the CSRC and is a shareholder in more than 3,500 listed companies in China. To May 2018, ISC had initiated 10 lawsuits against companies in order to protect shareholders' interests, with the case against Hile Bio being the first. The ISC flagged that this was the first time a legal decision had been reached on an anti-takeover clause in a Chinese company's articles, and that it would hopefully serve as a precedent.

Given the predominantly short-term focus of most retail investors in China, it is unlikely that many would be interested in voting in a general meeting to determine the strategic direction of a listed company, nor would many have the knowledge and expertise required to make this decision. Institutional investors in China are also known for taking a short-term view. In contrast, UK institutional investors have significant power, their share ownership greatly exceeds individual investors, and they have the capacity to form a view on takeovers.

Exercising voting rights

It is important that shareholders, especially institutional investors, start to exercise their voting rights more actively and in an informed manner. It is well accepted that a larger institutional investor base would be beneficial for China, yet such an outcome will be delayed if institutions seek only short-term returns like retail investors and do not take sufficient interest in governance and voting matters. Indeed, the current drive in China for "responsible investment" requires institutions to think and act more strategically and with a longer term vision of their role in the capital markets. This could also have spin-off benefits for retail investors, who might look to institutions for direction.

Two-tier and independent voting

A form of voting that could be appropriate to China given the prevalence of concentrated ownership is the "two-tier vote". This means that on certain resolutions in company meetings there are two votes: one for all shareholders and one for independent shareholders only, with a majority required in both votes for the resolution to pass. If this were combined with strong conflict-of-interest rules governing who could vote, then companies with dispersed ownership might be more willing to put takeover proposals to a general meeting vote. In such a system, the controlling shareholder and hostile acquirer would both have to recuse themselves from the second vote.

Enhancing communication

There needs to be regular communication between companies and their shareholders, so that the company does not just seek support from shareholders when a takeover is in play. By then it may be too late. Shareholders need to know a company well if they are to make an informed decision when an acquirer comes to the door. Such an ongoing dialogue would also help management better understand, and hopefully trust, their independent shareholders.

Clarifying old rules

Lawmakers, administrators and regulators need to pay more attention to the huge gap between statute law and enforcement. The gap is partially caused by ambiguity in the meaning of laws, such as the stipulation on substantial ownership disclosure that "no voting rights shall be exercised before the correction" (Article 213 of the Security Law). Another reason is incompleteness and error in legislation, such as the lack of a minimum attendance quorum in the general meeting. And there is the possibility of rules being misused to defend against takeovers, such as stock suspensions for a long period.

Resetting mindsets and terminology

In terms of designing a functioning system of takeovers in China, an important issue is the attitude of lawmakers and regulators. Do they wish to mediate or block hostile takeovers? The market for corporate control is regarded as an important mechanism for lowering agency costs and subjecting underperforming companies and management teams to external discipline. Hostile takeovers play an important, if sometimes unwelcome, role in many developed markets around the world. In China, the attitude of regulators, listed companies and society at large is still conservative or even negative about this concept. This may be the primary challenge that the regulation of takeovers should overcome. Indeed, the use of the word "hostile" introduces bias in the discussion against change. A hostile takeover is nothing more than an "uninvited takeover". It is plausible that some acquirers may do a better job of running a company than existing management, especially if the latter is underperforming.

Endnotes

1 Zhong Lun Law, "New Negative List for Free Trade Zones, Usher in New Opportunities for Foreign Investment", 29 June 2017, See: http://www.zhonglun.com/Content/2017/06-29/1140434232.html

2 People's Bank of China, "President Yi Gang Announces Specific Measures and a Timetable at the Boao Forum for Further Opening up China's Financial Sector to the Outside World", 11 April 2018. See: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3517821/index.html

3 Company Law, Article 37.

4 Law on Chinese-Foreign Equity Joint Ventures, Article 6.

5 Regulation on the Implementation of the Law of Chinese-Foreign Equity Joint Ventures, Article 34.

6 Ministry of Commerce, National Bureau of Statistics, and State Administration of Foreign Exchange, "Statistics Communique of China's Foreign Direct Investment in 2015", 22 September 2016. See: http://www.mofcom.gov.cn/article/tongjiziliao/dgzz/201612/20161202103624.shtml

7 Caixin, "CIRC may veto the two overseas M&As by Anbang", 22 March 2016.

8 State Council, "Notice on Forwarding the Guiding Opinions of the National Development and Reform Commission, the Ministry of Commerce, the People's Bank of China and the Ministry of Foreign Affairs on Further Guiding and Regulating the Overseas Investment Direction", General Office of the State Council No. 74 (2017), effective from 4 August 2017.
See notice in Chinese: http://www.gov.cn/zhengce/content/2017-08/18/content_5218665.htm

9 Shanghai Securities News, "The largest overseas M&A comes to the end. CHEMCHINA acquired Syngenta and completed the settlement of the shares", 9 June 2017.

10 State Development and Reform Commission, "Measures for the Administration of the Confirmation and Recordation of Overseas Investment Projects", State Development and Reform Commission No.9 (2014), effective from 8 May 2014, Invalidated on 1 March 2018. Ministry of Commerce, "Measures for the Administration of Overseas Investment ", Order of the Ministry of Commerce No.3 (2014), effective from 6 October 2014. State Development and Reform Commission, "Measures for the Administration of Overseas Investment of Enterprises", State Development and Reform Commission No.11 (2017), effective from 1 March 2018.

11 Security Law (2014) Article 88, "Measures for the Administration of the Takeover of Listed Companies" (2014) Article 24.

12 CSRC, "Measures for the Administration of the Takeover of Listed Companies" (2014), Article 33.

13 Company Law, Articles 37, 39, 121.

14 The CSRC issued a circular in 2004 stating that certain important transactions, such as new share issues and asset restructuring where the acquision price had a premium of 20% or more, required a majority vote of both all shareholders and all public shareholders. There is no resolution in mainland China requiring a vote only of minority shareholders. See: http://www.lawinfochina.com/display.aspx?lib=law&id=3830&CGid=

15 National Business Daily, "Zhong Ke Chuang Proposed for Three Times to Call a General Meeting of New Huang Pu", 16 July 2016.

16 Company announcement, 13 December 2016. See: http://disclosure.szse.cn/finalpage/2016-12-13/1202870921.PDF

17 Sina.com, "The deadlock between Kingkey and Kondarl: three details revealed and 14 letters of concern from regulators", 21 September 2016. See: http://finance.sina.com.cn/stock/2016-09-21/doc-ifxvyqwa3672348.shtml

18 Sina.com, "No results for Kondarl's five-year ownership battle, voting flights in the AGM and a delayed annual report ", 27 April 2018. See: http://stock.jrj.com.cn/2018/04/27025524459658.shtml

19 Security Law, Article 213.

20 Sina.com, "Announcement on the litigation result of Henan Oriental Silver Star ", 24 January 2017. See: https://finance.sina.cn/2017-01-24/detail-ifxzunxf1916357.d.html?wm=3049_0015

21 Sina.com, "Court rules Kondarl cannot disenfranchise Kingkey Group", 10 February 2018. See: http://finance.sina.com.cn/stock/s/2018-02-10/doc-ifyrkzqr1039229.shtml

22 Caixin, "The Result of the Battle of Control of AJ Group: Harmony is Precious", 19 July 2017.

23 China Securities Depository and Clearing Corporation, Monthly Statistical Report, March 2018.

24 Shanghai Stock Exchange, Statistical Yearbook 2017.

25 CSRC Administrative Penalty Decision, No. 104 (2014).
See notice in Chinese: http://www.csrc.gov.cn/zjhpublic/G00306212/201504/t20150403_274636.htm

26 CSRC, "Measures for the Administration of the Takeover of Listed Companies" (2014), Article 40.

27 Boya, article amendment 2013. See: http://disclosure.szse.cn/finalpage/2013-10-17/63162057.PDF

28 Boya, article amendment 2018. See: http://disclosure.szse.cn/finalpage/2018-04-26/1204793449.PDF

29 Investor Services Center, "ISC won the shareholder litigation for the first time", 11 May 2018
See: https://mp.weixin.qq.com/s/1jMrLXZZ27WfMHom9PVsmQ

Interview: 'Strengthening M&A governance'

Vincent Poizat
Senior Manager, Risk Advisory, Deloitte Touche Tohmatsu, Tokyo

What are the reasons behind the value destruction of overseas M&A deals conducted by Chinese companies?

Before examining the case of Chinese companies, we need to better understand value destruction from M&As generally and put this issue into both its global and historical context. The lack of value creation from M&As is a global problem and has always been so. Studies conducted decades ago more or less agreed on a 30% success rate for acquiring companies, with 40% of deals destroying value and the rest being value-neutral. A worrying fact is that the statistics have not improved, despite genuine progress in M&A tools such as valuation techniques, due diligence standards and integration planning. This is partly due to the fact that while notorious serial acquirers from developed markets have improved, the M&A landscape is now heavily populated with inexperienced acquirers, notably from Asian countries such as China, Korea or Japan. An additional factor is that decision-making processes are key—you can improve the tools all you want, but unless you are able to bring everything together the deal tends to end up less than optimal. The governance of M&A processes is thus a critical and universal problem, especially for companies that are less experienced in M&A and less sophisticated in terms of governance, including many mainland Chinese companies.

On top of this, a value-destroying aspect that is seldom considered is the M&A failure rate itself. Academics often look at the value destroyed by successful deals, deals that actually closed. We should also look at origination efforts that didn't bear fruit, deals that went to competitors, or simply deals that did not close. All these carry opportunity costs and strategic costs, including break-up fees, that destroy value. This is extremely relevant to mainland Chinese companies these days as sellers are increasingly doubting their ability to close and have increased the use and rate (10%) of break-up fees. So the picture overall is rather bleak and it is difficult to paint an accurate picture of how much value M&A really destroys, in China or elsewhere. What we have as a guide, though, is the major and clearly visible disasters typically leading to impairment losses or rushed exits at a lower price than previously paid.

Common failures of M&A transactions carried out by mainland Chinese firms include:

Reason 1: Inadequate due diligence

Due diligence is at the core of a good deal: if you don't know what you are buying, not only can you not price it properly, but you also cannot manage it afterwards. It is tempting to say that there is no excuse for poor due diligence, but in reality it is far from easy. Due diligence must be well-focused, well-managed, and its findings must be taken into account later on. So here again, we are talking about M&A processes and very few companies do this right.

To do this well requires a deep knowledge of the target company's market and risks, including regulations, accounting, labour laws and so on, which Chinese companies sometimes lack. Managing due diligence effectively requires good communication with the target, which is always challenging across cultures. Taking findings into account requires a risk-management approach to M&A negotiation, which again is not so strong in China (but to be fair, not just in China). Negotiation processes tend to be surprisingly reactive, as opposed to proactive and strategic. A complicating factor, especially in the case of investments in emerging countries and in sectors such as natural resources, is the availability and quality of data for due diligence. Chinese companies, themselves far less transparent than their Western counterparts, may not fully grasp what data quality to demand from their targets.

Reason 2: Paying too high a price

Here again you could say that there is little excuse: textbooks on valuation are very clear. Of course, valuation in practice is difficult, but not more so for Chinese acquirers than others, so why their higher prices? There are various explanations and they all revolve around inappropriate M&A processes once again: the interference of political considerations, acquiring at all costs, money is not a problem, personal agendas, or wild assumptions on synergies and projections. The truth is that as an acquirer, you can always tweak your assumptions in order to justify a higher price. It is thus absolutely critical that the pricing process be run according to fairly rigid best practices, based on adequate levels of information, and that the offer be approved by a competent and responsible body. This is all lacking at many Chinese companies.

This issue of price is also compounded by strategic rationale: while mature companies often acquire companies in order to leverage their expertise in other markets or by complementing it with new technology, emerging market companies often seek access to businesses that are quite new to them. (Note: The case of the mining boom is a good example. China's economic strategy created a boom in commodity imports, increased valuations of overseas miners, and led to Chinese acquisitions being overvalued.) It is less of a resource-based M&A strategy and more of an aspirational one, so the benefits can be harder to quantify.

On a side-note, but an important one: Chinese companies don't always use M&A advisers very well. They either don't listen to their advice or don't align their advisers' interests with their own. Or they don't use advisers at all, basing origination and execution on relationships with inexperienced "friends" who act as brokers. Managing M&A advisers well requires a long-term partnership approach, which is rare generally in Asia. Advisers in this region are mostly used on a task basis.

Reason 3: Failure to extract value
This is partly linked to the previous reason. If you don't adequately understand what you are buying to be able to price it properly, chances are you cannot manage it either. For example, when too little effort has been spent on evaluating synergies to price them, it is very difficult to implement such synergies. The lack of focus on integration within the M&A process, is a major problem. Chinese companies are at a disadvantage generally when it comes to running overseas businesses, because of national and corporate cultural differences. There have been many instances of severe culture clashes, although I believe Chinese companies are learning. Different cultures face different challenges when it comes to subsidiary management. Some tend to be too hands-off, some others too hands-on (eg, China). Achieving the right balance is difficult, but there is help available.

These are the three top reasons for value-destruction in M&A deals and, as you can see, they are inter-connected and often come with a snowball effect. The root causes of these problems are: first, a strategy that is not value-oriented; second, inadequate knowledge and information, compounded by cultural differences; third, a lack of oversight of the whole M&A process, including integration; and fourth, the lack of transparency at Chinese companies themselves that impact their attitude towards data collection and communication during due diligence, as well as their negotiation style and tactics. There is often no concept of win-win and thus sometimes unfair and unpredictable negotiations, including money being secured after a binding offer during closing period (leaving the deal open to renegotiation or the inability to secure funding). All of this has affected—especially with new capital restrictions and the perception of lack of legal recourse—the reputation of mainland firms as buyers.

That Chinese acquirers tend to not secure the funding for their bids until the last minute is a major problem. Some sellers agree to this only because of the attractive bid they have received. But in the case of a breach of an agreement, it is very difficult to solve this kind of cross-border issue in a local court, hence the seller could end up getting nothing but the minimum break-up fee. This has further impaired the credibility of Chinese acquirers and made it even harder for them to get a bid accepted at a reasonable price the next time, since there is now a premium included in the sale price to compensate for such risks and this sometimes makes financing a (highly priced) acquisition more difficult. It's a vicious circle. This is actually very unfair to many Chinese companies that behave well. The only way to get out of this cycle is for those companies to change their behaviour, follow proper M&A and funding processes, and rebuild the credibility of Chinese companies in overseas M&A markets.

What are the top risks that companies face or tend to dismiss when doing M&A deals? And how to avoid them?

M&A is risky, yet very few companies actually have an M&A risk management function in place. At best, they are aware of risks related to the target and consider that due diligence is enough to identify and assess such risks, and mitigate them later through negotiations. I see three levels of risk, though, and target risk is just one.

As far as target risk is concerned, the nature of risk depends on the target and its sector or market: it can be financial, legal or some other factor; there is no general rule. However, cultural compatibility (or lack thereof) is something that is both crucial and often dealt with rather lightly, as a soft issue. There are cases where acquirers made assumptions before the deal that they could run the company in the same way as they did in China, but only after the deal realised the different working and living cultures in foreign countries. So the valuations they made before the deal were far from the reality they faced. For example, "connections" are worth a lot when you are doing business in China, especially those with local governments and regulators, but they do not automatically transfer to actual value in Western markets.

Where things become more intriguing is when we look at deal execution risk. M&A best practices do exist, yet most inexperienced acquirers seem happy to ignore them. When you choose to take a short-cut and ignore a best practice, you give rise to a risk.

For example, as mentioned before, if you do not spend enough time evaluating synergies, you risk over-paying and being unable to capture value post-transaction. We have developed a register of about 250 M&A best practices and related execution risks that we use in order to guide companies to mitigate and monitor execution risk.

A third level is strategic risk. In some cases, entering the M&A arena with certain target-types in mind already exposes you to risk. For example, when you want to acquire a copper mine and copper prices are at an all-time high, and all smelting companies in the world are following the same strategy, you know that you are exposing yourself to a high risk of overpaying. Or if your investment criteria is unrealistic, you risk spending many years without a deal. Or if they are too vague, you are going to spend a long time looking at a thousand different opportunities without making a decision.

Execution and strategic risks really depend on the company and the sector in which it operates. I cannot really point out things to look out for in general, although there are the usual issues such as paying too much, not integrating smoothly and fast enough and not being able to capture benefits through good subsidiary management.

To avoid these traps, each company should identify where its specific risks lie given its own characteristics and environment. It then needs to implement the appropriate deal review and approval process. Deal review should focus on two key aspects: strategic fit and risk management. The latter includes the monitoring of these key risks that are endemic to the company as well as those related to the approval process (process so far and looking forward, what should be in place) and to the transaction (target risk, proposal risk and if applicable the impact of a risk-appetite framework). Deal review should be based on clear information guidelines and performed by competent people. Deal approval should be systematic, based on deal review and clear investment criteria. Generally, Chinese companies lack such procedures.

Is there a relationship between board diversity and M&A value creation? Is this also a reason behind the high failure rate of deals conducted by Chinese companies?

This brings us to board quality, including diversity. Deal reviews and approvals must of course be run by competent people in a setting that encourages debate and challenge to management. In many countries, including China, we find that boards present three main issues.

For historical reasons, they lack experience in cross-border M&A—sometimes in M&A, sometimes in international business, and usually in both. We try to help boards with specific M&A governance training, but what boards really need is to include people with ex-China experience and M&A expertise.

There is too much uniformity in board member experience, with too few independent directors. This creates a monolithic view on transactions, especially given the typical long-standing relationships among board members. It is no mystery that the boards of best-in-class acquirers also tend to be the most diverse, enabling the gathering of various perspectives on the deal. As M&A transactions are complex and often go beyond simple business and financial considerations (they often include legal, social, cultural, HR aspects and so forth), having people who are sensitive to such diverse aspects really adds value.

There is little constructive debate at board-level or committee-level. This is a complex issue, sometimes very cultural. We have very hierarchical companies, led by a strong CEO or controlled by a powerful shareholder, where directors see their directorship as a badge of honour as opposed to a role to fulfil. Very often, when a deal is presented to the board, approval is more or less an automatic process where directors will align with whoever is the most powerful person in the boardroom. Oversized boards are also an issue as they stifle debate.

In answer to the question: yes, board diversity adds tremendous value to acquisitions. It should be based on both diverse perspectives and the collection of relevant skills, not just having a token foreigner or a woman on the board. For it to work, it is essential that board dynamics be aligned with a more open, argumentative environment.

Guidelines for M&A Best Practices

The following M&A best practices have been provided by Vincent Poizat.

M&A strategy development

M&A strategy should be developed by a carefully assembled team with the right internal connections and insights, so that its intended benefits are clear and capabilities are aligned. Not only should it lead to useful investment criteria but also considerations on risk, process, team, a clear definition of success, alternatives (inorganic or not) in order to capture similar benefits, and a plan detailing when to revise the M&A strategy.

Origination

Target profiles should be specific without being too restrictive, reflect market reality and envisage various possible deal structures. Possible hurdles and risks, derived from market studies, should be taken into account in target profiles. Target searches should generally be exhaustive and highly efficient, leveraging adequately third parties in a professional and ethical manner; deal pipelines must be managed to reflect market reality as well as the acquirer's strategic plans; the proper balance of strategic and opportunistic origination will depend on individual cases. Clear triggers must be set in order to move from research to deal origination phase and information gaps managed with the right level of cautious optimism. Access to in-house expertise should be leveraged in order to identify and assess potential targets. Generally, risk management considerations should be taken into account from origination stage in order to determine further deal review and approval processes, prior to the approach of a target. Such an approach must be planned extensively, eg route, message, potential conflicts of interest, confidentiality requirements.

Launch and transition to execution

Support functions, eg legal, should be involved at an early stage and roles well defined. The deal team should be set up, balancing the right skills, experience, roles and responsibilities in the process and authority. Approval processes should be clear, designed to add value to the deal process, and consistent with the envisaged timetable. Advisers should be secured according to a professional and efficient selection process and be brought on board effectively.

Execution up to the Letter of Intent

Target data collection should encompass all strategically important aspects and be adapted to the stage at which the transaction is at the time of collection, accompanied by adequate communication with the target or seller. Collected data should support an effective review to enable the production of an offer, including assessment of conflicts of interest, bargaining power, ability to close, negotiation strategy and risk management. Pricing should be based on appropriate valuation methods with significant efforts to assess and quantify synergies, including their capture strategy and costs, and should take into account bidding strategy, alternatives to the transaction, seller's objectives etc. The resulting bid should enable a clear negotiation strategy, funding strategy and due diligence. This phase should appropriately leverage third parties as well as in-house expertise while preserving confidentiality.

Execution up to the Binding Offer

Similar best practices apply to this phase, only with more attention to detail and more communication with the target and/or seller. Due diligence must be effectively focused, efficiently managed, and its findings earmarked for future use. The integration team should be involved and its findings taken into account in the offer. A benefit capture plan should start emerging. Pricing becomes not only more detailed but also checked through thorough impairment risk assessment, structuring considerations as well as the optimisation of (secured) funding. Deal terms and conditions should be part of overall risk management. Disclosure requirements should be known and taken into account in the process.

Execution to Definitive Agreement and Closing

Negotiation strategy should include all negotiation items, not just price or terms, and be held in an integrative manner, taking into account cultural differences. There should be a sound strategy for external approvals combined with a closing negotiation that focuses on delivering on original success criteria, with risks adequately managed. Any confirmatory due diligence should be held to the same standards as the previous due diligence investigations, with the integration team increasingly taking leadership. Funding should be secured. Conditions precedent must be clearly established and assessed uncompromisingly before closing. The integration plan should be in place at a reasonable level of detail, based on site visits, regulatory investigations and confidential conversations with key target employees.

Post-transaction

Integration should involve proactive and careful, culture-sensitive communication, a clear and aggressive timeline and clear responsibilities. Synergies should be re-examined early in order to benefit from more candid feedback from target managers, and findings should be taken into account to mitigate potential impairment issues. Monitoring progress is critical and should consider soft factors such as cultural integration, collaboration and employee satisfaction. Reporting should be done regularly and to managers with both responsibility and the means to take corrective action. It should include aspects of risk management applied before and during the transaction. Adequate focus should be put on rewarding the teams for success and on organisational learning in order to optimise future transactions.

公司

Chapter Six

Company Case Studies

6.1 Overview of the Companies

Introduction

This section of our report delves into the governance of five major institutions in China, two state and three private or of mixed ownership. They are Sinopec, ICBC, Vanke, Minsheng Bank and Tencent. Each was chosen because it met one or more of the following characteristics:

- Is a large and influential listed company;
- Has recently faced governance challenges;
- Sets an example for other companies to follow—or, conversely, provides an indication of what not to do.

Each case study contains a description of the corporate governance structure of the company, the range of governance challenges it faces, and makes some concluding remarks.

Sinopec Corp is interesting for a range of reasons: it is one of the better governed central SOEs in China, is comfortable engaging with foreign investors, and was the first to experiment with the new mixed-ownership structure in 2014. It also navigated the new requirement to amend its Articles to incorporate a Party organisation more deftly than most state enterprises. Like all SOEs, Sinopec faces limitations in how it can structure employee remuneration. It is, however, trialling a stock option scheme in two subsidiaries.

ICBC was chosen because it is considered one of the best-governed of the four state banks in China and has taken a leading role in green finance. It was also one of the first banks to develop a performance evaluation system for its board of directors and has a sophisticated risk management system. Its Article amendments on the Party organisation were more extensive than Sinopec's and attracted more votes against. Like the other state banks, ICBC faces challenges in retaining staff due to restrictions imposed around remuneration.

Vanke has been in the news a great deal over the past two to three years because of a bruising hostile takeover bid from a little known insurance to property conglomerate, Baoneng. Vanke eventually won the battle, but perhaps not the war. Its dispersed ownership structure changed significantly with the arrival of a Shenzhen city government enterprise as its controlling shareholder. The Vanke case highlights numerous governance issues in China, both in terms of board practices and takeover regulations.

Minsheng Bank is a rare example of a nationally successful privately owned bank in China. It is competitive and profitable through a strategy of lending to SMEs, the ugly ducklings of the corporate system. Yet Minsheng's success has brought more than its fair share of problems: constant battles for control of its board between existing and new substantial shareholders; a raft of internal control failures; and evidence of managerial misconduct in certain branches. It appears to be on its way to repairing its reputation.

Tencent listed in Hong Kong only in 2004 and is now the largest company by market cap, dwarfing HSBC and China Construction Bank. Its successful online gaming, WeChat messaging and WeChat pay services have made it phenomenally profitable. Yet the market has been asking the company a range of governance questions and, judging by the large votes against certain resolutions at its AGMs, is not wholly satisfied with the answers. Tencent also faces regulatory risks in China linked to gaming addiction and is likely to have to deal with data privacy concerns in other markets.

6.2 Sinopec: Blended governance

Introduction

China Petrochemical Corporation, more commonly known as the Sinopec Group, is one of 97 central enterprises under the supervision of the State-owned Assets Supervision and Administration Commission (SASAC) and is representative of China's wholly state-owned entities. Sinopec Group is the largest oil and petrochemical products supplier and the second largest oil and gas producer in China, as well as being the largest oil refiner and the second largest chemical company in the world. In 2017 it ranked third in the Fortune Global 500. China has three major oil companies, PetroChina, Sinopec and CNOOC, the first two of which have similar business models and development histories.

As a central wholly state-owned enterprise, the Sinopec Group is unlisted. However, it has a major listed subsidiary called China Petroleum & Chemical Corporation (Sinopec Corp) that was formed through a restructuring of the main businesses of the Group. It is a joint-stock enterprise incorporated in China on 25 February 2000 under the sole sponsorship of China Petrochemical Corporation and listed in New York, London and Hong Kong in 2000, and in Shanghai in 2001. Sinopec Corp's main businesses include oil and gas exploration and production, pipeline transportation, marketing, oil refining, production of petrochemicals, and the research and development of technology.

Among China's industrial state enterprises, Sinopec Corp is considered to have a well-formed corporate governance structure and is seen as being fully compliant with regulations in the markets where it is listed. Its ownership structure today includes Sinopec Group with 70.86%, an almost 21% portion held in H shares in Hong Kong, and other corporate shareholders each owning less than 3% of the outstanding share capital.

It is worth noting that Sinopec Group's ownership stake rises to 71.32% once 553 million H shares held by a wholly owned subsidiary, Sinopec Century Bright Capital Investment Ltd, through HKSCC Nominees are included. It is also interesting to see that China Securities Finance Corporation, the 'national team' that heavily bought into the stock market following the 2015 collapse, almost doubled its stake in Sinopec from 1.54% in 2016 to 2.75% in 2017.

Controlling the strategic heights Tab 6.1

Sinopec Corp's shareholding structure, end-2017

	Stake %	Comment
China Petrochemical Corporation (Sinopec Group)	70.86	State shares
HKSCC Nominees *Includes* *BlackRock (8.94% of total H shares)* *Schroders (5.01% of total H shares)* *JP Morgan (1.89% of total H shares)*	20.96	H shares
China Securities Finance Corporation	2.75	
HKSCC Nominees	0.33	A shares
Central Huijin Asset Management	0.27	
Changjiang Securities	0.07	
ICBC SSE 50 Index Fund	0.07	
Bank of Communications – HSBC Large-cap Fund	0.06	
Guotai Junan Securities	0.05	
National Social Security Fund	0.04	

Source: *Sinopec Annual Report 2017, p. 6*

Sinopec is interesting from a governance perspective for several reasons. It was one of the first SOEs to experiment with a new version of mixed-ownership reform in 2014. It is one of the more internationally minded central enterprises and is comfortable engaging with foreign investors. It has reduced the number of former bureaucrats sitting on its board of directors as independents. And it has some of the best CG and sustainability reporting in China. As a large SOE, it shares similar challenges to ICBC. Its business strategy and model is strongly influenced by national economic priorities. In mid-2017, Sinopec Corp was required to amend its articles of association to introduce a Party organisation structure. And it has difficulties creating a more flexible remuneration policy that rewards staff performance.

Governance structure

The key components of Sinopec's corporate governance structure include the Party organisation, board of directors, and supervisory board. It is important to note that there are some material differences between the Group and the Corporation.

Party Organisation – Group

The Group company operates under the leadership of the Party organisation. In accordance with state requirements for SOEs it also has a board of directors, a supervisory board (appointed by State Council, not internally created), and a management level. It does not have general shareholder meetings, while shareholder oversight responsibilities are performed by SASAC directly. In local parlance, SASAC performs the "contributor's responsibilities", approves daily operations and resolves significant issues. It also dispatches external directors and supervisors to participate in the Group's corporate governance. However, SASAC is undergoing an adjustment to its role and responsibilities and some of its functions will be delegated to the Group company.

The members of the Party organisation have overlapping roles in the board of directors and the executive team. Among the six board members of the Group, one also holds a position in the Party organisation. Four of the seven executives are members of the Party organisation.

Governance duality - 1
Tab 6.2
Overlapping Party, director and executive roles
Sinopec Group, June 2018

	Role in Party organisation	Role in parent company
Wang Yupu[1]	Party Secretary	-
Dai Houliang	Deputy Secretary	Director, General Manager
Li Yunpeng	Deputy Secretary	Deputy General Manager
Ma Yongsheng	Member	Deputy General Manager
Ling Yiqun	-	Deputy General Manager
Liu Zhongyun	-	Deputy General Manager
Li Yong	-	Deputy General Manager
Zhao Dong	Member	Chief Accountant
Jiang Liangping	Member, Head of Discipline Inspection Group	-

[1] *Wang Yupu was appointed Party Secretary of the State Administration of Work Safety on 19 September 2017 and he resigned as company chairman on the same day.*
Source: *Company sources*

Party Organisation – Corporation

Sinopec Corp also has a Party organisation that partially overlaps the board of directors, see Table 6.3, opposite. Following the addition of the Party framework into the articles of association in 2017, the relationship between the Party organisation and the board has been more clearly defined. The board of directors should seek advice from the Party organisation when making decisions such as the direction of reform and development, key objectives, and priority operational arrangements of the company. When the board of directors appoints the management personnel of the company, the Party organisation shall consider and provide comments on the candidates for management positions nominated by the board of directors or the president, or recommend candidates to the board of directors and/or the president.

Governance duality – 2

Tab 6.3

Overlapping Party, director and executive roles, Sinopec Corp, June 2018

	Role in parent group and Party organisation	Role in corporation
Dai Houliang	Director, GM, Deputy Sec. of PO	Chairman, President
Li Yunpeng	Deputy GM, Deputy Sec. of PO	Director
Ma Yongsheng	Deputy GM, Member of PO	Director, Senior VP
Ling Yiqun	Deputy GM	Director, Senior VP
Liu Zhongyun	Deputy GM	Director, Senior VP
Li Yong	Deputy GM	Director
Zhao Dong	Chief Accountant, Member of PO	Chairman, Supervisory Board

Sources: *Company sources*

It is worth highlighting the powerful role played by the Discipline Inspection Group within the wider Party organisation in state enterprises. Its reach is wider than that of the supervisory board and internal audit division, which only focus on corporate business issues and the professional performance of personnel. Supervision by the Party organisation, however, covers every aspect of corporate operations as well as the personal life of Party members. For Party cadres, every aspect of life is restricted by the discipline of the Party.

Board of Directors – Group

As of mid-2018, the board of directors at Sinopec Group included six board members made up of one internal director, four external directors, and one employee director. The external directors are selected and appointed by SASAC and make up more than half of the board, which gives the board of directors some objectivity in the decision-making process.

Although the Group was incorporated in 1998, it was not until 2012 that it formed a board of directors following the expansion of a pilot scheme implemented by SASAC to install boards of directors at central state-owned enterprises. The company was regulated from its inception by the State Council, but initially implemented the general manager responsibility system and did not need to set up a board of directors.[1]

After 2012 the directors could exercise their rights pursuant to Article 46 of the Company Law. Problems that existed under the manager responsibility system, such as lack of clarity in decision-making and execution, were largely resolved. However SASAC still performed a number of functions on behalf of the board of directors, such as approving and reviewing significant plans and issues.[2]

Board of Directors – Corporation

After the 2017 annual general meeting held on 15 May 2018, the board of directors at Sinopec Corp increased from eight to 10 members. The new board has four executive directors, two non-executive directors and four independent directors. The directors are nominated by shareholders who individually or collectively hold 3% or more of the voting rights—in practice, SASAC and the Group. The independent directors have backgrounds in economics, finance, investment and academia, and some have sat on the boards of international companies. The group includes some famous names such as Professor Fan Gang, Vice President of the China Society of Economic Reform and a professor at Peking University. He has been a well-known speaker and commentator in China since the 1990s and became an independent director of Sinopec in May 2015.

One significant change came in 2012, when the percentage of independent directors with a government background decreased markedly following a government edict against retired officials becoming independent directors. According to Sinopec reports, the percentage of independent directors with government experience on its first, second, third and fourth boards was high: 66.7%, 75%, 75% and 80%, respectively. But since 2012, no independent director has had a government background. This suggests that the board of directors of the Corporation has become more professional.

Until May 2018, Sinopec Corp did not have a nomination committee, instead delegating these duties to the full board. This decision was a refreshingly pragmatic one based on the realities of being a state-owned enterprise. Since the leaders of large state-owned enterprises are approved by (and registered at) the CPC Central Organisation Department and SASAC, a nomination committee consisting of independent directors to nominate company officers might not provide candidates that satisfy Party requirements. In the interests of a smooth process, the corporation determined that the board of directors should perform the formal nomination duties. On 23 March 2018, the board changed its mind and approved the creation of such a committee.

Supervisory Board – Group

The supervisory board at Sinopec Group is appointed by and answerable to the State Council. It supervises the maintenance and appreciation of state-owned assets in the Group on behalf of the State. Despite the name, the supervisory board mainly performs an inspection and monitoring role. Its main duties include:

1. Monitoring the implementation and execution of relevant laws, administrative regulations, rules and principles in the company;
2. Inspecting the company's finances;
3. Monitoring the company's operations and profit distribution, and overseeing the maintenance, operation and appreciation of state-owned assets;
4. Monitoring the management activities of the enterprise leader, evaluating his/her performance and making proposals regarding bonus and penalties, or appointment and dismissal.[3]

Supervisory Board – Corporation

The supervisory board at Sinopec Corporation consists of eight members, of which there are four internal supervisors (including three employee supervisors) and four from the Group. The number of employee supervisors complies with the regulation that the number of employee representative supervisors should be no less than one-third of the total number of supervisors.[4]

Governance challenges

Concentrated state ownership

The controlling shareholder of Sinopec is China Petrochemical Corporation with a more than 70% share, a sharp contrast to international oil companies in the UK and US where dispersed ownership is the norm. For example, the largest shareholder in BP holds only 28.31% of the shares.

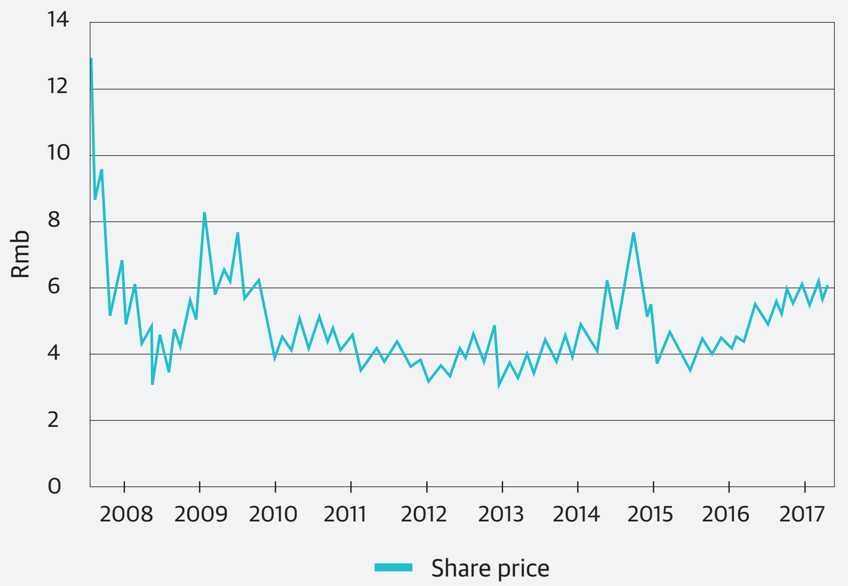
It is well recognised in China that such an ownership structure can lead to problems in corporate governance, such as the major shareholder encroaching on the interests of minority shareholders. One solution adopted to date is "cumulative voting" for the election of directors to ensure that minority shareholder interests are better protected, at least theoretically. In cumulative voting a shareholder has votes equivalent to his shareholding multiplied by the number of directors up for election. The shareholder can concentrate all these voting rights on one candidate or disperse them among several candidates. The directors are determined by the number of votes for each candidate.

How well have Sinopec shareholders done from their investment?

While the annual dividend payout ratio in the past five years has been above 40%, reaching 65% and 118% in 2016 and 2017, respectively, and the dividend yield is a respectable 4.46%, on a 10-year outlook the stock price has yet to regain its highs of January 2008, as shown in Figures 6.1 and 6.2, below, and Figure 6.3, overleaf.

Share price movement
Sinopec Corp, 2008–17

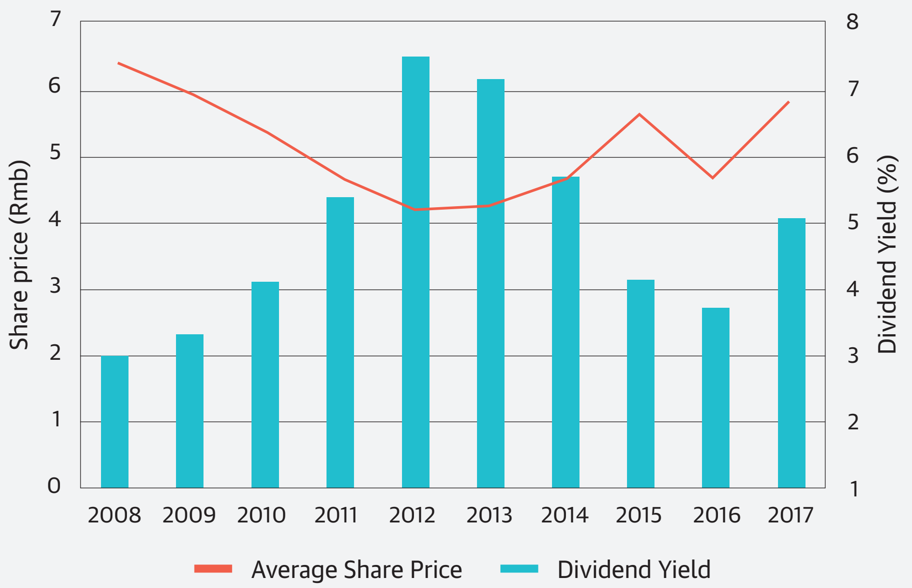
Fig 6.1



Source: *Yahoo! Finance*

Dividend yield vs. average share price
Sinopec Corp, 2008–17

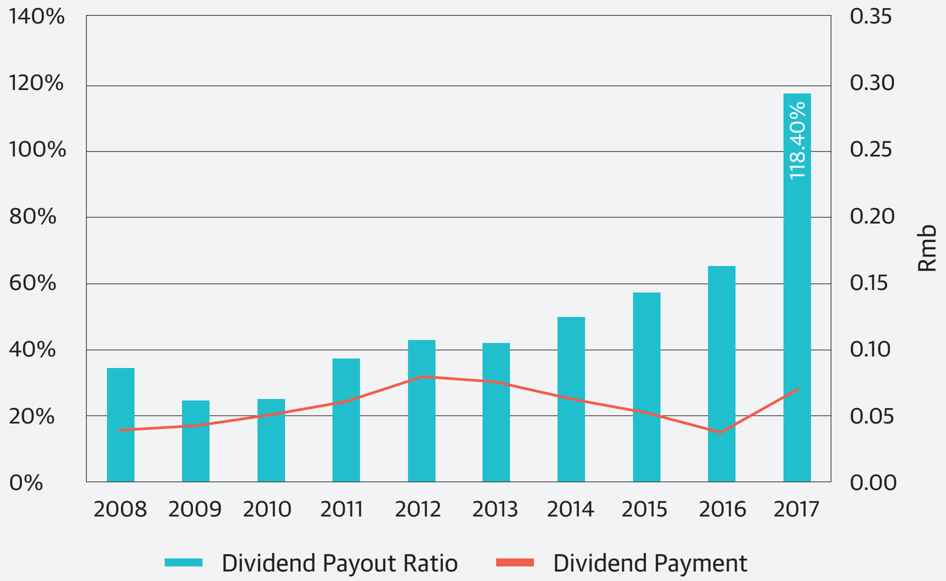
Fig 6.2



Note: Dividend Yield is calculated by total dividend payment divided by average share price of each year.
Source: *Yahoo! Finance*

Dividend payout ratio vs. dividend payment
Sinopec Corp 2008-17

Fig 6.3



Source: *Yahoo! Finance, Sinopec Annual Reports 2008-17*

Mixed ownership reform

In February 2014, Sinopec Corp started restructuring its oil sales business division with a view to embarking on a major experiment in state enterprise reform. In September that year its retail unit, Sinopec Marketing, signed capital raising agreements with 25 investors, including private as well as state financial institutions, private companies, and others.[5] And in 2015 it completed the deal, raising just over Rmb105 billion through a sale of new shares equivalent to 29.5% of the enlarged share capital.[6]

This was a big deal in more ways than one. After reforming the ownership structure, the composition of the board of directors and supervisory board also changed. In December 2015, a new-look Sinopec Marketing announced that it had 11 members on its board of directors, with four being appointed by its parent, Sinopec Corp, and three seats going to the new private investors who held in aggregate slightly less than 30% of the shares. The company also appointed three independent directors to the board, an unusual occurrence in an unlisted entity. The final seat went to a staff representative director, Ye Huiqing, who was also appointed as the board secretary. As for the five members of the supervisory board, the new investors and Sinopec Group each appointed two supervisors.[7]

This new form of "mixed ownership" meant that non-state investors could directly participate in the internal governance of a state-controlled enterprise, with the aim being not only improved operations and governance, but ultimately a spin-off listing in future. In April 2017, the board of Sinopec Corp passed a resolution stating that Sinopec Marketing would become Sinopec Marketing Co., Ltd. and list overseas.[8] At the corporation's June 2017 AGM, shareholders overwhelmingly approved the proposal—with almost 100% of both A and H shares voted giving their support. The listing will take place in 2018 at the earliest, but could be further delayed.

It is hoped that after the listing, minority shareholders will play a more effective role in reviewing related-party transactions—though this in part depends on where the company lists and the specific shareholder rights accorded in that jurisdiction.

Meanwhile, mixed ownership reform in Sinopec Group still faces some challenges. First, the oil industry is strategic in China and reform is harder to undertake. The divisions released by Sinopec for mixed ownership to date have been sales and transportation, both quite straightforward to reform given their remove from oil exploration and the core petroleum division. For the monopoly businesses, such as exploration, drilling and oil production, and petroleum refining, the threshold for capital and technology is high and it is difficult for private capital to participate in China.

Second, the percentage of ownership that the state will open to private investment is limited. Even in Sinopec Marketing for example, only 11 of the 25 investors have private capital behind them and most appear to be financial rather than strategic investors. Despite the reform, the state remains the largest and dominant shareholder.

Third, it is not clear whether the three private-investor directors on the board of Sinopec Marketing will remain in place after the listing. In some ways this could be a positive if they provide continuity and expertise. On the other hand, questions will inevitably be raised as to whether these directors (and their firms) have an unfair information advantage and whether their interests are aligned with other minority shareholders.

Party presence

On 8 June 2017 a proposal to add the Party organisation to the articles of association of Sinopec Corp was approved by domestic and foreign shareholders with votes for totalling 99.96% and with 85% of all shares being voted. This was one of the highest, if not highest, votes in favour of the proposal among H share companies listed in Hong Kong. Indeed, over May to June 2017 the Group company and eight listed companies under its control added the Party framework into their articles based on the requirement of SASAC.[9]

Unlike some central enterprises, such as ICBC, the changes sought by Sinopec were quite minimal—which may go some way to explain the very high vote in favour. In fact, only two concise changes were proposed. First, a new paragraph (Article 9) establishing a "Party organisation and related working organs" with an "adequate level of staffing to handle Party affairs as well as sufficient funding necessary for the activities of the Party organisations". And further: "The Party organisations play the role of the leadership core and political core in the Company."

Sinopec sought approval from shareholders in June 2017 to include its Party organisation in its Articles. But the changes sought were quite minimal.

Second, another new paragraph (Article 110) clarifies the relationship between the Party organisation and the board of directors. While the intent is the same as in other central enterprises, the language is notably softer and more advisory. It says in full, "When making decisions on significant matters such as direction of reform and development, key objectives, and priority operational arrangements of the Company, the board of directors should seek advice from the Party organisation. When the board of directors appoints the management personnel of the Company, the Party organisation shall consider and provide comments on the candidates for management positions nominated by the board of directors or the president, or recommend candidates to the board of directors and/or the president."

What is the rationale for these changes? In the eyes of the Party/government, the broad justification is that they are an integral part of "socialism with Chinese characteristics". That is, they will improve governance through a strengthening of oversight and clearer lines of authority, a closer alignment of interests with state goals, and a more robust framework for addressing corrupt behaviour. A stronger Party organisation is also seen as a positive human resource management tool.

As the Sinopec 2017 Sustainability Report states:

> When making decisions on significant matters such as direction of reform and development, key objectives, priority operational arrangements and appointment of the management personnel, the Board of Directors should seek advice from the Party organisation. The Party organisations and the members of the Party positioned in different departments play the leading role in the decision implementation and motivate the employees, which helps the management [in] the enforcement of the Board decisions. Furthermore, the Party organisations strengthen supervision on the integrity and the duty performance of managers who are also the members of the Party. All of the above mentioned helps promote scientific decision-making, efficient enforcement and effective supervision.[10]

It should be noted that before these changes, the Party already had a leadership presence in Sinopec as in other SOEs. The article amendments formalise its role and arguably reinforce its pre-eminence. While Sinopec shareholders seem reasonably content with the changes, or at least feel there is little they can do about them, one area where governance practices could be enhanced is in corporate disclosure. The new articles outline the broad structure of Party-led governance in a way that is clearer and more detailed than before. What many independent shareholders will be looking for now is greater transparency on what the Party organisation does. What decisions has it been involved in? How does it manage its relationship with the board of directors?

Indeed, as a Hong Kong-listed H share, Sinopec will arguably have a duty under the Hong Kong Corporate Governance Code to make such disclosure. The Code envisages a unitary (ie, single tier) board leading the company—quite different from the system prevalent in China. As the first principle of the Code states, "An issuer should be headed by an effective board which should assume responsibility for its leadership and control and be collectively responsible for promoting its success by directing and supervising its affairs. Directors should take decisions objectively in the best interests of the issuer." While the Party organisation is not new, its formalisation in company articles is new. This is a material development.

Limited incentivisation options

Due to limits set by SASAC on compensation in state firms, Sinopec Corp is restricted in its use of remuneration incentives. While remuneration based on evaluation does play a part in compensation policy, Sinopec Corp does not adopt any equity incentive plan at present. The main reasons include:

- To prevent a "giveaway" of state assets, performance requirements are strict and this leads to complicated qualification models and a diminished incentive effect.
- The evaluation and pricing of state-owned assets is difficult. Large SOEs are diversified and sprawling, making it difficult to evaluate assets and develop a programme. If the price of an incentive award is below the evaluation price of the assets, it will result in an unacceptable dilution of state-owned assets. If the price is above the evaluation price, it is tantamount to a form of fund raising.
- Anyone who develops an SOE equity incentive programme will be reluctant to implement it due to the risk of being held responsible.

Sinopec is trialling stock option incentive programmes in two subsidiaries, Sinopec Shanghai Petrochemical (Shanghai Petro) and Sinopec Oilfield Service Corporation (Oilfield Service), ratified by SASAC. But there are many hurdles to promoting incentive programmes on a wider scale.

Conclusion

As a pioneer of new-style mixed ownership, it will be fascinating to watch in the coming years how far Sinopec Corp is able to extend the Sinopec Marketing model to more subsidiaries and how the more diverse governance of Sinopec Marketing evolves, especially once it is listed. As one of the country's more international central SOEs, it will also be instructive to see if Sinopec Corp is able to provide its broad shareholder base with useful information on the role of the Party organisation. Its shareholders voted strongly in support of this amendment to its articles, implying a willingness to understand more about this unique aspect of corporate governance with Chinese characteristics.

Endnotes

[1] State Council, "Official Reply of the State Council on Some Issues about Incorporating the China Petrochemical Corporation", Letter No. 58 [1998] of the State Council.

[2] SASAC, "Guiding Opinions of SASAC of the State Council on the Establishment of the Board of Directors in Wholly State-Owned Companies (for trial implementation)", Reform No. 229 [2004], article 42, 7 June 2004.

[3] State Council, "Interim Regulations on the Boards of Supervisors in State-Owned Enterprises", Decree of the State Council of the People's Republic of China, No. 283, 15 March 2000.

[4] Company Law, Article 117.

[5] Caixin, "25 Investors Hold Shares of Sinopec Sales Company with High Return Prospect", 14 September 2014.

[6] Securities Daily, "Hundreds of Billions in Private Capital Injected into Sinopec Kick-starting Mixed Ownership Reform", 9 March 2015.

[7] Sinopec Corp, "Sinopec Sales Company Established the Board of Directors and the Supervisory Board", 29 December 2015.

[8] Caixin, "Sinopec Sales Company Announces Listing, May Kick Off in the Second Half of the Year", 28 April 2017.

[9] Sinopec Corp, "'Adding the Party Building into the Articles of Association' of Sinopec Was Approved by Majority Votes", 3 July 2017.Í

[10] Sinopec Corp, "Communication on Progress for Sustainable Development", 25 March 2018, p18.
See: http://www.hkexnews.hk/listedco/listconews/SEHK/2018/0325/LTN20180325077.pdf

6.3 ICBC: Green giant

Introduction

The Industrial and Commercial Bank of China (ICBC) was established on 1 January 1984 as a wholly state-owned commercial bank. It was restructured on 28 October 2005 into a joint-stock limited company and listed on both the Shanghai and Hong Kong stock exchanges a year later. ICBC is one of four major state commercial banks in China and, while its clients are mostly domestic, its revenue and profit make it one of the largest banks globally. From 2013 to 2016 it ranked first in three authoritative lists: *The Banker* magazine's Top 1000 World Banks; the Forbes Global 2000; and the Fortune 500 of Commercial Banks. ICBC was designated a global systemically important bank in 2013 and it has an international presence stretching to 42 countries or jurisdictions.

In terms of ownership structure, ICBC is classified as a centrally managed financial enterprise with Central Huijin Investment Ltd (Huijin), a subsidiary of China Investment Corporation (CIC), acting as its lead shareholder. Huijin is an important state-asset supervision and administration entity that holds major stakes in 18 strategic financial enterprises on the authorisation of the State Council. These enterprises cover banking, securities, insurance and investment subsectors. Huijin is the largest single shareholder of ICBC, with a 34.71% share, just ahead of the Ministry of Finance at 34.6%. The next largest group of shareholders is represented by the H shares custodied by the Hong Kong Securities Clearing Company, a subsidiary of Hong Kong Exchanges and Clearing, followed by a number of much smaller stakes held by a range of mostly domestic financial institutions.

ICBC is interesting for a number of reasons. It is regarded within China as a well-governed lender and seen as a point of reference for other financial institutions. It has one of the more diverse and international boards of any central state-owned enterprise and was the first of the big four banks to institute a board evaluation process. It is considered ahead of the curve on risk management. And it is developing a reputation as a leader in the burgeoning green finance space.

ICBC also faces numerous challenges. As a large domestic institution it must balance national priorities with commercial business decisions. It is refining the relationship between its Party committee, board of directors and supervisory board. And like other SOEs, it is finding talent retention tough due to its rigid remuneration structure. How ICBC addresses these issues could provide a useful marker for comparing corporate governance development in central SOEs in future.

State-led Tab 6.4

ICBC's shareholding structure (as of 31 December 2017)

Company	Stake %
Central Huijin Investment	34.71
Ministry of Finance	34.60
Hong Kong Securities Clearing Company/ HKSCC Nominees	(H shares) 24.29
China Securities Finance	1.12
Ping An Life Insurance Company of China	1.05
Buttonwood Investment Holding	0.40
Central Huijin Asset Management	0.28
China Life Insurance	0.11
Anbang Property Insurance	0.06
Capital Airport Holding Company	0.05

Source: *ICBC 2017 Annual Report*

Governance structure

The key components of ICBC's governance structure include the Party committee, board of directors, and the supervisory board. Each has undergone governance changes in the past year.

The Party Committee

Like other state enterprises, ICBC has a Party committee that approves key decisions and personnel appointments in the bank and leads its overall Party organisation. As an H share listed in Hong Kong, it was one of several dozen SOEs that amended their articles in 2017 to formally incorporate the role of the Party committee in their corporate constitutions (see *Governance Challenges* on page 195).

As in most enterprises, senior Party members have dual roles, or "cross offices", as executive directors or supervisors. Four executive directors including the chairman, president and two vice presidents, as well as the chairman of the supervisory board, are members of the Party committee. The chairman of the board of directors concurrently serves as the secretary (ie, head) of the Party committee, while the president serves as deputy secretary of the committee. They are appointed subject to clearance by the Central Organisation Department of the CPC in Beijing. This department is the lead entity in charge of the appointment, dismissal and evaluation of key personnel in centrally managed financial enterprises.[1] Meanwhile, the chairman of the supervisory board also serves as a deputy secretary of the committee, while the secretary of the Party discipline committee, the key entity supervising cadres employed within the bank, also sits on the Party committee.

Governance duality

Tab 6.5

Overlapping roles between the Party committee, two boards and management in ICBC, end-2017

	Role in Party committee	Role in corporation
Yi Huiman[1]	Secretary	Chairman, Executive Director
Gu Shu[1]	Deputy Secretary	Vice Chairman, Executive Director, President
Qian Wenhui[2]	Deputy Secretary	Chairman, Supervisory Board
Zhang Hongli[1]	Member	Executive Director, Vice President
Wang Jingdong[1]	Member	Executive Director, Vice President
Hu Hao	Member	Vice President
Li Yunze	Member	Vice President
Tan Jiong	Member	Vice President
Wang Lin	Member	Secretary of Party discipline committee

[1] *Sits on both the Party committee and the board of directors.*
[2] *Resigned in January 2018 to join Agricultural Development Bank of China. As at June 2018, both roles remain vacant.*
Source: *ICBC 2017 Annual Report*

Board of Directors

The board has 16 members, including four executive directors, six non-executive directors and six independent non-executive directors. The chairman, as noted, serves a dual role as the secretary of the Party committee and is appointed by the CPC's Central Organisation Department. The five non-executive directors are appointed by Huijin, while the independent directors are selected from a candidate pool made up of recommendations from the main shareholders and the board.

Although all directors must be formally elected by the general shareholder meeting, they do not officially take office until they are approved by the China Banking Regulatory Commission (CBRC). This was made explicit in the announcement of the 2017 AGM voting results: "The meeting elected as non-executive directors of the Bank Mr Ye Donghai, Ms Mei Yingchun and Mr Dong Shi, whose qualification as non-executive directors of the Bank is still subject to approval by the China Banking Regulatory Commission (CBRC) and whose respective term of office as a non-executive director of the Bank will commence on the date when the approval of the CBRC is obtained." In other words, while the company law may state that the general meeting of shareholders is the highest organ of authority within a company, the CBRC not surprisingly outranks it.

ICBC's board is a highly experienced and professional group. The executive directors all have extensive experience in banking, with the chairman and vice chairman serving in ICBC for 33 years and 20 years, respectively, as of end-2017. Of the two other executive directors, one worked as an executive in a number of large foreign banks and used to be the chairman of ICBC (Brazil) and ICBC (US). The other has 24 years of banking experience.[2]

The non-executive directors comprise people with backgrounds in economics and finance, management, policy and academia.

The independent directors are equally diverse and include professionals from economics, finance, auditing, law and regulation, as well as corporate management. As the table on the next page shows, ICBC has a former US Treasury official and a former chairman of the Hong Kong Securities and Futures Commission on its board.[3]

One of the unique aspects of China's system of bank governance is a requirement since 2013 that independent directors must dedicate a set amount of time each year—15 days—to their role. Among the numerous amendments that ICBC made to its articles in 2017 was one stating that independent directors must now work in the bank for 15 days each year, not just for the bank, while the chairmen of the audit, related-party transactions and risk committees must work 25 days (Article 127).

Another article amendment was a new rule limiting the term of independent directors to six years (Article 115), in line with many central SOEs. Previously there was no limit.

Since 2011, meanwhile, ICBC has continuously updated its pool of potential independent directors. Criteria considered include a candidate's overall quality, qualifications and personal willingness.

Diverse expertise

Tab 6.6

ICBC independent directors; selected current and former roles

Or Ching Fai	Chairman CEO Group General Manager Independent director	Hong Kong Association of Banks Hang Seng Bank HSBC Esprit, Chow Tai Fook, TVB
Hong Yongmiao	Ernest S. Liu Professor of Economics and International Studies	Cornell University
Anthony Francis **Neoh**	Former Chief Advisor Former Chairman Independent director	CSRC Securities and Futures Commission, Hong Kong Bank of China, China Life, Link REIT
Yang Siu Shun	Chairman and Senior Partner Independent director Member Member	PwC Hong Kong Tencent 12th National Committee, CPPCC Exchange Fund Advisory Committee, Hong Kong Monetary Authority
Sheila Colleen **Bair**	Former Chairman Independent director Chairman Member	US Federal Deposit Insurance Corporation Thomson Reuters, Banco Santander Systemic Risk Council Chair CBRC International Advisory Council
Shen Si	Deputy General Director, Investigation and Statistics Department Executive Director and Board Secretary Independent Director	People's Bank of China Shanghai Pudong Development Bank China Lending Corporation

Source: *ICBC website, annual reports*

Supervisory Board

The supervisory board of ICBC provides another level of monitoring. Besides the standard functions outlined in the company law (see Chapter 3.3), its responsibilities extend to areas such as risk management and internal control. There are five members on the supervisory board including two shareholder-representative supervisors, two employee-representative supervisors and two external supervisors. The shareholder supervisors are nominated by the supervisory board or shareholders who individually or jointly hold more than 5% of the voting shares of the bank. The employee supervisors are elected by employees. And the external supervisors are nominated by shareholders who individually or jointly hold more than 1% of the bank's voting shares. The appointments of both the shareholder and external supervisors are ratified by the general meeting.

External supervisors are expected to be independent of the company. As the CBRC's "Guidelines on Corporate Governance for Commercial Banks" state, external supervisors "shall not have a relationship with the commercial bank or its major shareholders which may impact their independent judgement."[4] The ICBC articles similarly require that the external supervisors should be independent from the major shareholders of the bank.[5]

Two amendments to the bank's articles made in 2017 affect the supervisory board. One gives it authority to supervise the external accounting auditor (Article 201), a task that should arguably be the sole responsibility of the audit committee of the board of directors. The second allows the supervisory board to decide its own performance evaluation measures and compensation plan, for approval at the general meeting of shareholders after adoption. Directors remain under the oversight of the compensation committee.

One curious aspect of ICBC's supervisory board is the instability of its leadership. In 2015 the chairman resigned for reasons of age.[6] The following year a shareholder supervisor resigned for the same reason.[7] And then in early 2018, the chairman resigned following his appointment as president of the Agricultural Development Bank of China.[8] While the latter departure is understandable, one wonders why the earlier appointments were made if the people were nearing retirement age.

Raising the bar

In recent years, ICBC has progressed in the following key governance areas.

Board performance evaluation

According to the China Association for Public Companies (CAPCO), ICBC was the first listed bank in China to develop a performance evaluation system for its directors in line with CBRC requirements.[9] In 2011 the bank developed its "Evaluation Rules on the Performance of the Directors by the Board of Directors (for trial implementation)", while the supervisory board developed its "Evaluation Rules on the Performance of the Board of Directors, the Executives and its Members by the supervisory board (for trial implementation)".

The intention was to evaluate director performance in terms of compliance with laws and regulations, performance of fiduciary and diligence duties, as well as independence and competence. The plan was for directors to undertake both a mutual and self-evaluation, and to send a draft of their evaluation report to the supervisory board each year. The supervisory board would then assess this report and undertake interviews in order to produce its performance evaluation for delivery at the annual general meeting.

A review of the bank's 2017 annual report shows that its corporate governance report provides quite detailed information on the performance and function of each board committee, director and supervisor attendance, director training and so on. However, there is no information about how the board evaluation was conducted.

Risk management

ICBC has also demonstrated foresight in risk management and internal control. In 2011 it set up the first systematic and quantified risk-bias system in the industry. The development of this system along with a risk-bias management mechanism allows the bank to determine risk-bias across the group. The bank also specifically set up a zero tolerance indicator within the system which prohibits any overstepping of external and internal regulations in the course of doing business. ICBC's efforts in risk management won first prize in technological innovation from the People's Bank of China. The bank is regarded as an international leader within China for being first to develop a world-class risk management system.[10]

Through revisions and updates to its risk management system, ICBC has improved the comprehensive risk management of the group. It has integrated numerous types of risk into the framework, including: country, concentration, asset securitisation, liquidity, bank account, reputation and strategy. In addition it has developed an annual risk management plan which utilises the risk limit control function and has implemented dynamic evaluation of risk management in domestic branches as well as standardising risk reports from overseas branches and their affiliates.[11]

ICBC has also followed best practice in creating a vertically managed internal audit system reporting to the board of directors.[12] The audit committee has an internal audit bureau with provincial subdivisions. Each is responsible for carrying out the internal audit in their jurisdiction.

Green finance

A third area where ICBC is seen as a leader is in its approach to sustainability, climate change and socially responsible lending. It was the first mainland Chinese commercial bank to join the United Nation's Global Compact in 2012 and the first to join the UN Environment Programme Finance Initiative in 2014. Within China, it is a member of the standing council of the Green Finance Committee established under the China Financial Forum. The bank has also been a champion of putting green finance at the heart of the G20's "Business Summit" and advocates for the voice of emerging markets to be heard on topics of green growth and finance. It also conducts quantitative research on green finance and environmental risk.

ICBC's green lending was given a further boost by an amendment to its articles in June 2017 that tasked its strategy committee with examining "green credit strategy, consumer protection strategy and performance of social responsibility in respect of environment, society and governance, and making suggestions to the board of directors" (Article 167).

In September 2017, the bank published a "Green Bond Framework" intended to be a "further elaboration of the Bank's consistent green strategy and will also facilitate the implementation of environmental protection endeavours in accordance with China's National 13th Five-Year Plan".[13] Notably, it invited an independent research institute in Norway, the Center for International Climate Research (CICERO), to publish an assessment of this framework.[14]

Then on 8 December 2017, the board of ICBC decided to amend its "Fundamental Provisions for Corporate Social Responsibility" to better comply with relevant rules and regulations, including the new requirement from the Stock Exchange of Hong Kong on ESG reporting.

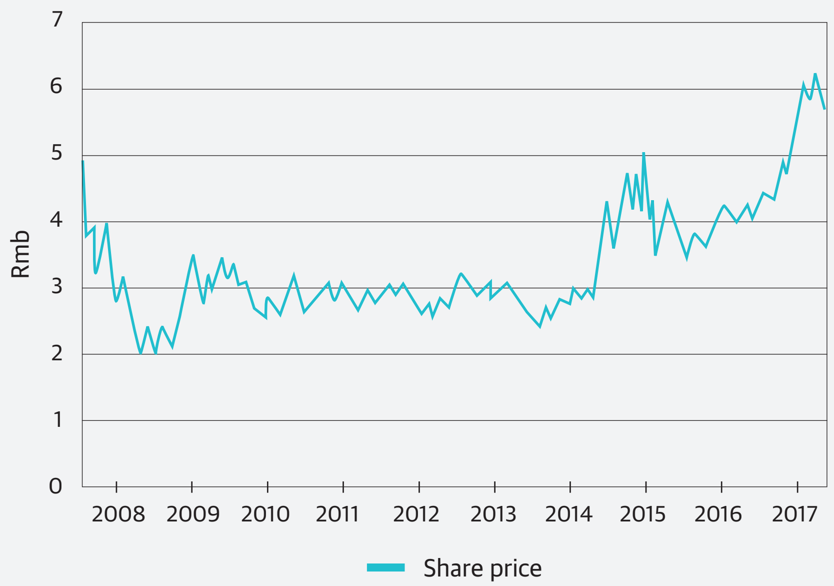
Governance Challenges

Majority vs minority shareholders

Since Huijin is a wholly-owned subsidiary of China Investment Corporation (CIC), and CIC was established by the Ministry of Finance in September 2007, ICBC essentially has one major shareholder owning almost 70% of its shares. The official line is that concentrated state ownership allows for robust supervision and avoids the potential for insider management control that may arise with more dispersed ownership. But the imbalance in ownership raises inherent questions as to whether minority shareholders will always be treated fairly. ICBC tries to improve investor communications and transparency through a number of channels, including performance briefings, roadshows, analyst meetings, its website and hotline. Have its minority shareholders enjoyed good returns? As we can see from Figure 6.4, below, although the share price of ICBC A shares started rising in 2014, it has traded within a relatively limited band for most of the past 10 years.

Trending sideways
ICBC A share price movement, 2008-17

Fig 6.4

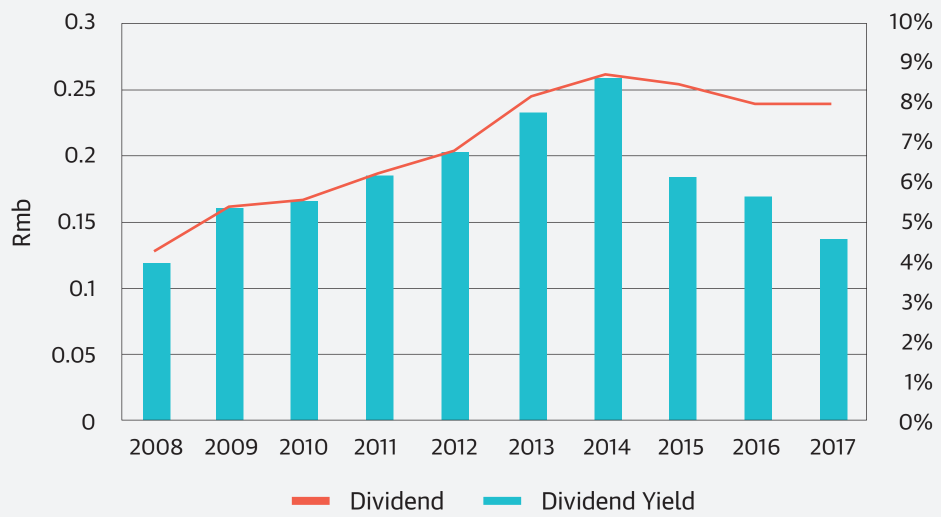


Source: *Yahoo! Finance*

As Figure 6.5, below, shows, ICBC steadily increased its dividend from 2008 to 2014, after which it began to fall into absolute terms and yield (a result of its rising share price).

Dividend history
ICBC A shares

Fig 6.5



Note: Dividend yield is calculated by dividend payment divided by average share price of each year.
Source: *Yahoo! Finance, ACGA*

Explicit risk of national service

As a leading national bank, ICBC focuses on a combination of corporate development and social service. For instance, ICBC directs credit as instructed to assist structural supply-side reforms and advance the rebalancing of industries facing overcapacity issues. In 2016, it decreased its lending to steel and coal, and increased credit support for seven strategic emerging industries as defined by the state. These include: energy conservation and environmental protection, new generation IT, biotech, new energy, new energy vehicles, high-end equipment manufacturing and new materials.

ICBC has also found itself taking debt-for-equity swaps, purportedly to help enterprises optimise their capital structure, but more likely to provide a stay of execution for foundering companies. In 2016, it conducted a debt-for-equity swap for Shandong Gold Group.

More positively, given the difficulty frequently encountered by such businesses when attempting to secure credit, ICBC has increased its support for small and micro enterprises. It has introduced new products such as "entrepreneur credit for small and micro enterprise" and "taxation and finance connect", easing access to credit for smaller companies. In addition, the bank provides credit support for the culture industry and modern agriculture to promote their development.[15]

Party presence

On 27 June 2017, ICBC convened its 2016 annual general meeting by video connection between Hong Kong and Beijing. In line with other H shares, its meeting contained a controversial resolution: approval to amend the articles of association to include detailed requirements for the legal establishment of a Party framework within the group. While the vote was passed by a 93% majority of combined A and H shares, the proportion of H shares in support was much lower: 45% either abstained or voted against the motion.[16]

The revised articles integrated the bank's Party organisation (including its Party committee) into its governance structure, thus formalising responsibilities which had been in place for some time. In theory, the intention behind adding the Party framework into the articles of association is to enhance supervision and decision-making within ICBC, as well as minimise risks with personnel selection and appointment and with the resolution of significant matters. In practice, the degree of involvement of the Party organisation in the group's corporate governance is unclear, which causes uncertainty regarding the final decision-making authority in ICBC. Furthermore, there is insufficient disclosure about the role that the Party committee and organisation plays in significant issues, which increases the risk for investors of information asymmetry.

Party committees shall play the core leadership role, providing direction, managing the overall situation and ensuring implementation of Party rules

Four new articles were added, primarily dealing with the Party organisation. One of the new items, Article 13, states: "In accordance with the relevant regulations of the Constitution of the Communist Party of China and the Company Law of China, organisations of the Communist Party of China (hereinafter the "Party") shall be established; the Party committee shall play the core leadership role, providing direction, managing the overall situation and ensuring implementation. The working organs of the Party shall be established, equipped with sufficient staff to deal with Party affairs and provided with sufficient funds to operate the Party organisation."[17]

Further, Articles 52 and 53 spell out in detail how the Party committee will be structured and what its duties are to be. The chairman of the board must be the secretary of the Party committee, with a deputy secretary assigned to help with "Party-building work". The establishment of new commissions for discipline inspection suggest that the Party role will be more far-reaching than previously.

The specific duties of the Party committee include:

1. Ensuring that the bank implements policies and guidelines of the Party and the State, including adhering to political directives on strategy;
2. Overseeing personnel appointment and performance;
3. Advising on major operational, management and employee issues;
4. Supporting the conventional governance structures in performing their functions, including the general meeting, board of directors and employees;
5. Leading the bank's ideological and political work and running the Party with "strict discipline";
6. Supporting the Party and its members as "pioneers and fine examples" and leading all employees to "devote themselves into [sic] the reform and development of the bank".[18]

This puts the Party committee firmly in charge and superior to the board of directors. While not entirely new, the references to "adhering to political directives on strategy" and advising on "major operational, management and employee issues" provide a clear emphasis of a more top-down, Party-led governance system in the coming years. Where does this leave the board of directors?

Role of the board of directors

The board of directors is the commercial decision-making entity of the bank. Besides fulfilling the obligations under the basic provisions of the Company Law, its responsibilities also include the development of risk management policies and information disclosure.

Unlike in a Western bank, the board does not appoint the chairman or president/CEO. These positions are filled after investigation by the Central Organisation Department of the CPC. The board of directors then formally appoints or dismisses the president and the board secretary. Other executives are appointed and dismissed upon nomination by the president, although these must be approved by the CBRC. The chairman and president are separate posts, avoiding a concentration of power.

The executives of ICBC are responsible for multiple facets of the bank's operations including overseeing the management of the whole bank, implementation of the business plan and investment programme, the development of detailed regulations and systems, the remuneration distribution plan, the performance evaluation plan and financing.

Talent retention

The remuneration of the chairman of the board of directors, the president, the chairman of the supervisory board and other responsible persons in ICBC are strictly defined by state policy. The package consists of basic annual salary, annual performance-related pay and incentive income related to an assessment of the entire period of office. Other executives and shareholder representative supervisors receive a basic annual salary and annual performance-related pay, but part of the latter is deferred. As of the end of 2017, ICBC had not implemented any stock incentive scheme.[19]

Remuneration is tightly controlled so that disparities do not occur among state-owned enterprises in different industries. China's banks, for instance, arguably produce richer profits than they otherwise would due to their state-supported monopoly on credit. The plan which regulates remuneration aims both to avoid abnormally high remuneration for those in successful monopoly businesses and to decrease the distribution gap among central state-owned enterprises, many of which are not financially successful. Consequently the remuneration of bank executives in central enterprises such as ICBC lags far behind that of executives in foreign banks of a similar size.[20]

Besides placing limitations on executive pay, the lack of a meaningful incentive mechanism also results in a serious talent loss from ICBC. The interim reports of listed companies in 2016 showed that there was a trend of resignations in large state-owned banks, such as ICBC, Agricultural Bank of China and China Construction Bank. A total of 18,000 employees left the three banks in the first half of that year alone[21]. ICBC and other state-owned banks face challenges in establishing more reasonable incentive schemes to prevent loss of talent.

Conclusion

Given its prominence in the Chinese banking system and its status as a governance benchmark for other banks and a sustainability leader, it will be instructive to watch the development of ICBC in the coming years. Foreign investors will likely be particularly interested in how the bank develops its green financing capabilities, while they will watch to see if formalising the role of the Party committee in the bank's articles makes a difference to its strategy, operations and treatment of minority shareholders. Greater transparency on this issue, and on other aspects of its governance such as board evaluation and executive remuneration, would be welcome.

Endnotes

1 Sohu.com, "Who Is Controlling China's Financial System?", August 21, 2017. See: http://www.sohu.com/a/166107071_492716

2 ICBC, "Annual Report 2017", p81.

3 ICBC, "Annual Report 2017", p83-84.

4 CBRC, "Guidelines on Corporate Governance for Commercial Banks", No.34 (2013), Article 33.
See: http://www.cbrc.gov.cn/chinese/files/2013/B9DB3F8EF1C64C06A620911FAC61B970.pdf

5 ICBC, "Articles of Association", Article 193.

6 ICBC, "Announcement regarding the resignation of supervisory board chairman", 19 June 2015.
See: http://www.cninfo.com.cn/finalpage/2015-06-20/1201175854.pdf

7 ICBC, "Announcement regarding the resignation of shareholder supervisor", 23 June 2016.
See: http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2016/crA20160624.pdf

8 ICBC, "Announcement regarding the resignation of the supervisory board chairman", 5 January 2018.
See: http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2018/jszA20180105.pdf

9 CAPCO, "Report on Corporate Governance for Listed Companies in China", Beijing: Economy and Management Publishing House, October 2014, p165.

10 China Urban Finance, "Great Momentum, Tempering and Enterprising——ICBC Advancing In-Depth the Transition and Innovation of Comprehensive Risk Management", No.12, 2013.

11 China Economic Net, "ICBC Enhanced Corporate Governance, Improved Core Competition Capability and Actively Performed Social Responsibility", 21 December 2010.

12 ICBC "Annual Report 2017", p98

13 ICBC, "Green Bond Framework", September 2017, p3.
See: http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2017/ICBCGreenBondFramework.pdf

14 CICERO, "Second Opinion on ICBC's Green Bond Framework, 22 September 2017.
See: http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2017/CICEROSecondOpiniononICBCsGreenBondFramework.pdf

15 ICBC, "Social Responsibility Report 2016", p22-29.

16 ICBC Convened General Meeting to Add the Requirements of Party Building into the Articles of Association, People.cn, 29 June 2017.

17 ICBC, "Supplemental Notice of Annual General Meeting for the Year 2016", 12 June 2017, p6.
See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0611/LTN20170611023.pdf

18 ICBC, "Supplemental Notice of Annual General Meeting for the Year 2016", 12 June 2017, p9-10.
See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0611/LTN20170611023.pdf

19 ICBC, "Annual Report 2017", p81.

20 The Beijing News, "The Problem of Remuneration of Bank Executives Is Not the Huge Amount But the Standard", 12 September 2014.

21 Economic Information Daily, "The System Is Rigid and the Talent Loss Increases in SOEs", 29 December 2016.

6.4 Vanke: Shape shifter

Introduction

The entity that would later become Vanke was established in 1984 shortly after China's "reform and opening up" era began. Encouraged by the development of the Shenzhen Special Economic Zone (SEZ), founder Wang Shi transformed himself from a government official selling animal feed into a modern enterprise manager. The company was initially known as Shenzhen Modern Scientific Education Instruments Exhibition & Sales Center and was a subsidiary of a Shenzhen SEZ state-owned development enterprise. It sold office automation and professional photographic equipment. Later that year, following investment from a Beijing-based medical science enterprise, it was renamed Shenzhen Modern Medical Technology Exchange Center and began importing medical devices. In 1986 the Center decided to incorporate as a modern limited company to "break free of the rigidity typical of a state-owned enterprise in business operations and speed up its business development on a large scale", according to the Vanke website.[1] It planned to IPO two years later.

In November 1988 the company duly received permission from the Shenzhen municipal government to restructure into a joint stock company and prepare for an IPO. While the listing did not take place until 29 January 1991, the Center earned the honour of becoming the second listed company on the Shenzhen Stock Exchange, with the stock code 0002—the first was Shenzhen Development Bank. Its name was changed to Shenzhen Vanke, the second word a variation on the Chinese characters "wan ke", which literally means "ten thousand science" but could also be read as "ten thousand clients" because "ke" sounds the same in Chinese as the word for "clients". Then in May 1993 Vanke issued B shares in China to raise finance from overseas investors and became a company with both A and B shares. The B shares were later converted to H shares when Vanke listed on the Stock Exchange of Hong Kong by way of introduction in June 2014. Its H shares at the time accounted for 11.94% of total shares outstanding.

Vanke evolved from a state-owned firm selling photographic equipment to a modern hybrid corporation leading China's burgeoning residential real estate sector. In 2016 it entered the Fortune 500 at 356th place.

Having positioned itself early on as a comprehensive trading company involved in different industries, Vanke diversified into real estate in the late 1980s and intensified this focus in 1993 when it decided to make property development its core business. Over the next 25 years Vanke's progress was nothing short of spectacular and, through both organic growth and acquisition, it catapulted into the top ranks of real estate enterprises in China. By 2016 its annual revenue was Rmb240 billion with a net profit of about Rmb21 billion. In the same year Vanke entered the Fortune Global 500 list for the first time at 356th place, then jumped to 307th place in 2017.

Of equal significance is the company's ownership and management evolution. As Vanke expanded, state ownership steadily diluted—though never completely left—and it became one of the few large listed companies in China with a truly dispersed ownership structure. A genuine hybrid. As a result of management efforts to standardise and modernise operations, Vanke also came to be seen as a standard-bearer for good corporate governance. It ranked first in a 2014 survey of the "100 Listed Companies Most Respected by Investors", conducted jointly by the China Association for Public Companies, the Asset Management Association of China and other organisations.[2] It was ranked 53rd out of 2,510 Asian companies for best investor relations by *Institutional Investor*[3] magazine in July 2017 and came first in the magazine's "All-Asia Executive Team" for the property sector (see Table 6.7, overleaf).

Yet the future shape of Vanke's governance and management remains uncertain following a bruising takeover battle it fought over 2015 to 2017 with an unlisted firm called Baoneng. One of several aggressive insurance-led private conglomerates in China, Baoneng took advantage of relatively liberal rules regarding insurance investment in listed companies to launch a takeover campaign. Vanke's response to this attack surprised many in the market and dented its reputation as a governance leader. By turning to a Shenzhen state enterprise as its white knight, Vanke is now a company with a clear state controller. Wang Shi is no longer on the board and nine of 11 directors have changed. While Vanke's commercial future may be assured, this episode raises some fundamental questions about the nature and direction of corporate governance in China.

The All-Asia Executive Team Ranking of Honoured Companies
Property Sector

Tab 6.7

Rank	Firm	Region	CEO Rank	CFO Rank	IR Professionals Rank	IR Programs Rank
1	**China Vanke**	**China**	**2**	**2**		**2**
= 2	China Resources Land	Hong Kong		3		1
= 2	Link REIT	Hong Kong	1			3
= 4	CapitaLand	Singapore			1	
= 4	CIFI Holdings (Group)	China		1		
6	Longfor Properties	China			2	
= 7	Goodman Group	Australia	3			
= 7	Mirvac Group	Australia			3	

Source: *Institutional Investor, 2017. (Reprinted with permission)*

Control battles

The first wave

Vanke experienced its first control battle in late March 1994 when several major shareholders, led by Junan Securities, proposed four requirements to the company in the form of "A Letter to All Shareholders of Vanke Co., Ltd."[4] These included restructuring its business, increasing exposure to real estate and restructuring the board of directors. Through intensive mediation on the part of Wang, the group of insurgent shareholders was disarmed. Wang also obtained the support of the China Securities Regulatory Commission (CSRC) and eventually won the fight.

Wang's central connections strengthened further in 2000 when China Resources Group, a central state-owned enterprise, bought the 15% stake owned by Shenzhen SEZ Development, the original owner of Vanke. Although arguably big enough to control Vanke, China Resources seldom interfered in the company's operations and management. Over the next 20 years, Vanke maintained a mixed-ownership structure and became a vocal champion for professional management in listed companies. It led by example, with its own management team holding only a small combined ownership stake of around 1%.

The second wave

The second attack proved tougher to repel. On 10 July 2015 a little-known southern Chinese conglomerate called the Baoneng Group disclosed for the first time a substantial ownership stake in Vanke of 5%, purchased in the secondary market. By 16 December of that year Baoneng had increased its stake to 22.45%, substantially more than the 15.29% then held by China Resources, and appeared ready to go further.

The Baoneng Group is an unlisted holding company controlled by billionaire Yao Zhenhua, a native of the distinct Chaoshan linguistic and cultural region in eastern Guangdong Province, close to Fujian Province, where the local dialect is Min Nan Hua not Mandarin or Cantonese. Founded in Shenzhen in 1992, Baoneng's business covers real estate (including shopping malls), insurance and logistics. It owns numerous subsidiaries two of which, Qianhai Life Insurance (Foresea Life Insurance) and Jushenghua, bought the stake in Vanke. Although relatively unknown in the real estate industry, Baoneng, like other private groups in China's burgeoning insurance market, had amassed significant capital in a short space of time from the sale of products such as investment-linked universal insurance and needed to find new investment opportunities. A widely held and rapidly growing firm such as Vanke provided an ideal target. And government regulation tacitly encouraged it: in February 2014 the China Insurance Regulatory Commission (CIRC) amended regulations to allow insurance funds to increase their investment in equity assets (including listed companies) and non-current assets from 25% to 30% of their total assets.[5] Since the average equity investment ratio of the insurance industry at the time was only 10% to 15%, the rule change was interpreted by the industry as a signal that it could rapidly increase its equity investments.

Vanke's initial response was to appeal to China Resources to increase its shareholding, but to no avail. Then on 17 December 2015, the day after Baoneng became the largest shareholder, Wang went on the offensive and stated publicly that Baoneng was not welcome as Vanke's largest shareholder. A few days later, with its share price falling, Vanke announced that its A shares would be suspended pending a significant asset restructuring. This suspension lasted more than six months, which many considered excessive. The H shares listed in Hong Kong were only briefly suspended.

Prior to the suspension, another shareholder slipped onto the register—Anbang, a private insurance conglomerate famous for gobbling up overseas assets. Vanke announced on 8 December 2015 that Anbang had built an ownership stake of more than 5%, which increased to 6.18% two weeks later. In contrast to Baoneng, Anbang expressed its willingness to actively support Vanke's development soon after the acquisition. Then on 24 December 2015, Vanke said it welcomed Anbang as a new major shareholder.

By rejecting Baoneng so strenuously and turning to the local government for support, Vanke's reputation for open governance was questioned.

Cutting a long and complicated story short, on 18 June 2016 the board of Vanke approved a proposal to issue new shares to Shenzhen Metro, a local state enterprise wholly owned by the Shenzhen municipal government, in exchange for a 100% interest in a Shenzhen Metro subsidiary, Qian Hai International (no relation to the Baoneng subsidiary). Vanke hoped Shenzhen Metro would ride in as a white knight and, at the same time, dilute Baoneng. Because it involved a capital increase, the deal needed the support of more than two-thirds of Vanke shareholders in a general meeting. Yet when China Resources, in alliance with Baoneng, stated its opposition to the plan, due to the dilutive effects on its shareholding and other issues, a vote in favour appeared unlikely and Vanke backed down. It is also worth noting that while the board approved the plan some Vanke directors did not support it, including three representing China Resources.

Following the collapse of this deal Wang and other directors criticised China Resources, perhaps unwisely, for effectively siding with Baoneng. For its part, Baoneng made its next move on 26 June 2016, saying that Vanke had become an insider-controlled enterprise and proposed convening an interim general meeting to vote all the directors off its board. When Baoneng never followed through on the threat the market inferred that the central government had intervened with China Resources, leaving Baoneng unsure whether its proposal would succeed.

Complicating matters still further, another Hong Kong-listed mainland property giant, Evergrande, purchased Vanke's shares in the secondary market and built a holding of 14.07% between August and November 2016.

The crackdown

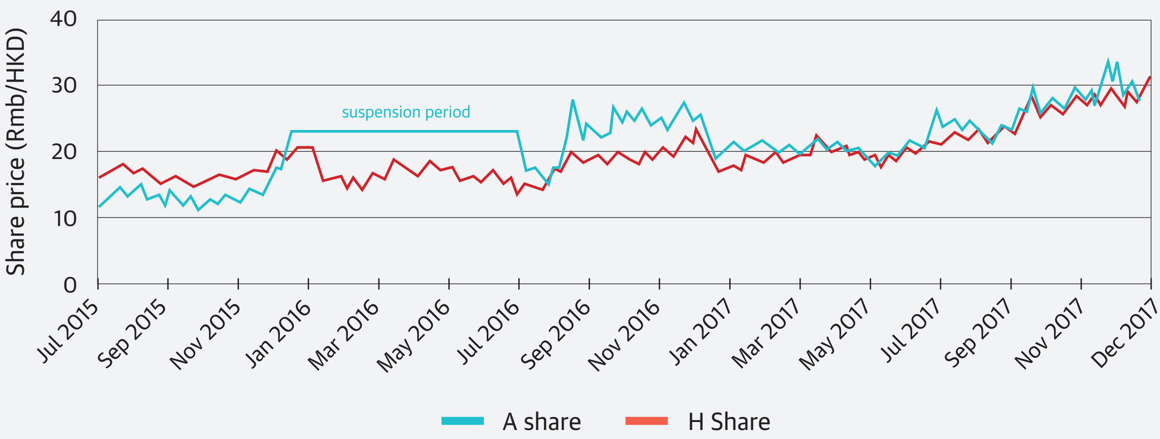
Not surprisingly, the uncertainty and disharmony created by this battle for control displeased regulators in Beijing. Towards the end of 2016 they began cracking down on the purchase of large stakes in publicly listed companies by insurance funds. Liu Shiyu, CSRC chairman, was one of the first to speak, stating publicly in December 2016 that "inappropriately acquired funds" should not be used for hostile leveraged buyouts. At a special meeting of the insurance regulator, the CIRC, then chairman Xiang Junbo called for a strengthening of supervision over the ways in which insurance capital was invested. Equity investment by insurance firms, he said, "should give priority to financial investment and then strategic investment".

In January 2017, the CIRC issued a circular on "Matters Concerning Further Strengthening the Supervision of Stock Investment by Insurance Capital", which prohibited insurance firms and non-insurance persons "acting in concert to jointly acquire listed companies" and required the prior approval of the regulator when insurers purchased shares in listed companies with insurance capital.[6]

Xiang later paid a price for the volatility unleashed by firms under his supervision. In April 2017 the government announced that he was under investigation, and on 29 September 2017 the Supreme People's Procuratorate announced the opening of an investigation into him for suspected bribery.

Share price movement
Vanke, 2015-17

Fig 6.6



Source: *Yahoo! Finance*

Shenzhen Metro rides to the rescue again

With the clear support of the central government, Vanke's ownership saga drew to a close in early January 2017. In a deal coordinated by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) and the CSRC in Beijing, and with the involvement of the Shenzhen municipal government, China Resources transferred its 15.31% holding in Vanke to railway enterprise, Shenzhen Metro, at a price of Rmb22 per share, allowing the latter to become the property company's second largest shareholder. Around the same time, Baoneng formally stated for the first time its intention to be merely a "financial investor", implying it would no longer seek board seats or try to influence management.

After a six-month investigation into Qianhai Life Insurance, the CIRC issued a series of administrative penalties against Baoneng in late February 2017, including prohibiting the development of new universal insurance products. The regulator also revoked the qualification of Yao Zhenhua and barred him from the insurance industry for 10 years.[7] The CIRC also punished Evergrande Life, banning the insurance firm from making stock investments for a year and prohibiting two employees from working in the insurance industry for five and three years, respectively.[8]

On a new track

Tab 6.8

Vanke share register before and after the takeover battles

2015 Shareholders	Stake %	2017 Shareholders	Stake %
China Resources Group	14.89	Shenzhen Metro Group	29.38
HKSCC Nominees	11.90	Baoneng Group funds	25.40
Guoxin Securities-ICBC AM	4.14	HKSCC Nominees	11.91
China Life Insurance (2 funds)	1.40	Anbang Group (subsidiaries)	4.56
GIC Private	1.38	Guoxin Securities - ICBC AM	4.14
Liu Yuansheng	1.21	China Merchants fund	2.99
Merrill Lynch International	1.12	Western Leadbank - CCB fund	2.04
Vanke Labor Union Committee	0.61		
UBS AG	0.54		

Source: *Vanke 2017 Annual Report; ACGA analysis*

Shenzhen Metro's control over Vanke strengthened on 16 March 2017, when Evergrande irrevocably delegated the voting and proposal rights attached to its 14.07% holding to the railway enterprise, giving it an effective voting block of 29.38%. Then on 9 June 2017, Evergrande unexpectedly signed an agreement to transfer all of its Vanke shares to Shenzhen Metro for just over Rmb29 billion. Having paid around Rmb36 billion for the stake, Evergrande booked a substantial loss of about Rmb7 billion.

Board games

The uncertainty surrounding the ownership changes was matched by complications in forming a new board. By 28 March 2017, Vanke had failed to call a general meeting and elect new directors even though the term of the seventeenth board of directors had expired on that day. Company law states that director terms shall not exceed three years[9] and the seventeenth board had been elected on 28 March 2014. Yet it was not until 15 May 2017 that Vanke issued a notice announcing the 2016 annual general meeting would be held on 30 June 2017, the last possible day on which it could be held according to Vanke's articles. The articles state that a general shareholder meeting must be held within six months of the end of the fiscal year.[10]

A further twist came on 21 June 2017 when, at the last possible minute, Vanke received "additional" proposals from Shenzhen Metro to nominate a full suite of 11 director candidates, all of them new apart from two existing executive directors (Yu Liang and Wang Wenjin), and two supervisors. While this proposal was in line with Company Law and the company's articles of association, it left the second largest shareholder, Baoneng, no time to present a competing list of director candidates. Given that Vanke uses the cumulative voting method, which allows in effect for proportional voting, Baoneng could probably have secured two director seats had it put forward candidates. Although Baoneng had already signalled its intention in early 2017 to be merely a financial investor, uncertainties remained as to whether or not it was going to put forward any candidates.

When Vanke finally held its annual general meeting on 30 June, all 11 candidates nominated by Shenzhen Metro were elected and Wang Shi, who had built the company and steered it for 37 years, left the board.

Out with the old

Tab 6.9

Only two executive directors remain on Vanke's new board

2014 Board	2017 Board
Executive directors	
Wang Shi	**Yu** Liang
Yu Liang	**Wang** Wenjin
Wang Wenjin	**Zhang** Xu
Non-executive directors	
Qiao Shibo	**Lin** Maode
Sun Jianyi	**Xiao** Min
Wei Bin	**Chen** Xianjun
Chen Ying	**Sun** Shengdian
Independent directors	
Zhang Liping	**Kang** Dian
Hua Sheng	**Liu** Shuwei
Elizabeth **Law**	**Ng** Kar Ling, Johnny
Hai Wen	**Li** Qiang

Source: *Company reports and announcements*

Yu Liang, the successor appointed by Wang and former president of Vanke, was elected chairman. Meanwhile, Wang Shi was given the title of "Honorary Chairman".

State of play

Vanke may have won the two-year battle for control, but at what cost? It relied on central and local governments' mediation among shareholders and stakeholders, rather than due process of law. It needed the central government to censure a hostile acquirer. And after becoming Vanke's largest shareholder, Shenzhen Metro has become actively involved in the company's governance. While the then chairman of Shenzhen Metro, Lin Maode, said at the 2017 AGM that his firm respected Vanke's corporate culture and operational management, including the company's signature "business partner system"[11], the new controlling shareholder has three of the four non-executive director positions and one of two supervisory committee seats. Although this is similar to the number of directorships and supervisory positions held previously by China Resources, Shenzhen Metro also nominated one further non-executive director from a Shenzhen company and all four independent directors. While it remains to be seen to what extent this affects Vanke's autonomy, one interesting snippet of information points to a possible change of emphasis in management style: the firm now publicises the fact that it has a Party committee and its secretary is Xie Dong, chairman of the company's supervisory committee.

In other ways it seems like business as usual, with some things even appearing to improve. On 5 February 2018, Vanke issued an announcement[12] to adjust the remuneration scheme of its directors and supervisors. It stated that since the company's remuneration scheme for directors and supervisors had not changed for over 10 years and was last approved at the annual general meeting in 2007, the board had decided to double the fees for non-executive directors and supervisors. It also indicated that it was taking a firmer line on the chairman's remuneration: bonus targets would get tougher and the percentage size of the bonus reduced. Meanwhile, the company delivered quite promising numbers in its 2017 Annual Report, published on 27 March 2018—profits were up, though cashflow weakened. And its share price has been doing well.[13]

Indeed, by early 2018 it seemed that the smoke and fire of the Baoneng battle had all but died down. This was until one of the new independent directors, Liu Shuwei, decided to stoke the embers on 30 January with an open letter to the CSRC. Liu asked the regulator to order Jushenghua, a subsidiary of the Baoneng Group that owns part of its stake in Vanke, to immediately liquidate seven asset management plans that had already expired (Jushenghua owns 10.34% of Vanke through nine asset management plans). Liu said she issued the letter in her role as an independent director of Vanke, and was performing her fiduciary duty in order to protect minority shareholders' interests. But the incident proved controversial because Liu's motives were unclear and she did not inform the board before publishing the letter. Moreover, both Baoneng and Vanke quickly issued announcements to clarify that Jushenghua had already signed supplementary agreements with related parties for the nine asset management plans it held and to extend the winding-up periods for the seven mentioned in Liu's letter. All rules and regulations were complied with under the new arrangement. Then on 3 April, Vanke announced that Baoneng had decided to sell the 10.34% stake held through Jushenghua.

Conclusion: Governance questions

The battle for Vanke raises a number of governance and regulatory questions, not only for the firm but for corporate governance in China generally.

What is the future for dispersed ownership in China?

It faces challenges. After restructuring at the end of the 1980s, Vanke transformed from a state-owned enterprise to a largely privately owned enterprise and developed rapidly, establishing a corporate culture that relied upon professional managers. Yet the company's dispersed ownership structure—one of the few of its kind in China—opened it to a takeover threat. Questions have naturally been raised as to the viability of this ownership model in China. While national financial regulators acted quickly to limit the threat posed by an aggressive insurance firm, the end result for Vanke was to become a hybrid state-private firm with a dominant state owner again. It is reasonable to assume that this will have a material influence on management style and strategy. One casualty might be Vanke's vaunted "business partner system", which allowed professional managers including company president, Yu Liang, to voluntarily purchase Vanke shares. It is now uncertain whether this system will continue and, if so, will it be as effective as in the past?

Can the market play a role in arbitrating disputes?

It would appear not. While many believe that Baoneng's failure to take over Vanke was a good thing, since it lacked both the brand power and management reputation of Vanke, it was instructive that Wang turned to the state and not other Vanke shareholders for support. Given the reputation Vanke enjoyed among investors, as reflected in the surveys referenced in the introduction above, one would expect many of them, if not the majority, to support Vanke's existing board and management in any proxy battle for board seats launched by Baoneng. Indeed, many legal experts and financial commentators would have preferred to see Vanke allow market forces to play out.

Yet in Vanke's defence, one factor the company may have taken into account was the swift departure of some large institutional investors shortly after Baoneng arrived. The first to go were GIC of Singapore, Merrill Lynch and UBS, according to Sina Finance. Then once the six-month trading suspension was lifted in early July 2016, Aberdeen Asset Management (now Aberdeen Standard Investments) withdrew completely and Value Partners sold down its shares, according to media reports.[14] China's security market is dominated by individual investors, with institutional investors seldom participating in corporate governance and many lacking the ability to assess which governance strategies are likely to benefit a company. Most investors of all kinds are interested only in short-term gains. In such an environment, one should perhaps forgive Vanke for not trusting in shareholder support. It started as a state enterprise and no doubt carried some of that DNA within it as it grew.

Does China need clearer takeover rules?

A more predictable and minority shareholder-friendly takeover framework would benefit China's capital market and corporate governance development. Several questions arise. First, who should have the power to prevent a takeover? The Company Law provides that the general meeting is the highest authority in a company and management cannot utilise more than 30% of a company's assets without shareholder approval, yet the law contains no explicit procedures for dealing with takeovers.[15] Guidance from the CSRC called "Measures for the Administration of the Takeovers of Listed Companies" provides that shareholder approval must be sought in the event of a tender offer, which kicks in when an acquirer reaches 30% of shares.[16] Yet this was of little benefit to Vanke shareholders since Baoneng had no intention of crossing that line. Indeed, given the nature of company ownership in China, the protection offered by voting in a shareholder meeting is unlikely to counter improper and unreasonable anti-takeover measures. In companies with concentrated ownership, the major shareholder will dominate the general meeting. In companies with dispersed ownership, management can find ways to circumvent the general meeting.

A second question relates to the fiduciary duty and standard of care expected of directors and executives when examining the merits of a takeover deal. Directors may take defensive measures against a hostile takeover in order to protect the long-term interests of the company, or of themselves, or both. The Company Law and administrative regulations are unclear regarding a specific standard of due diligence when defending against a takeover. The law needs to clarify the respective rights of management and shareholders when facing such situations.

Third, the Company Law is somewhat vague about the application of specific rules. For example, Vanke claimed that its 2014 board had not exceeded its three-year term in 2017 because the Company Law has no detailed provision on the exact interval required between general meetings. Article 45 states:

> The term of office of directors shall be specified in the articles of association of the company but each term may not exceed **three** years.

A literal interpretation suggests that there is room for calculating director terms based on the years of general meetings—rather than the exact months and dates. Hence, three years could mean more than 36 months, a nonsensical outcome. For example, following a Q2 2016 annual general meeting, a 2019 annual general meeting could be held as late as Q4 2019, according to this interpretation. The board would then have a term of more than 36 months, as in Vanke's case. This undoubtedly dilutes the provisions of the Company Law.

As the Company Law currently stands, neither a hostile acquirer nor the management of a target company is likely to obtain sufficient support from the rules to achieve their aims. As a result, victory or defeat comes down to the way in which each party utilises informal means. As the Vanke case highlights, a major characteristic of takeovers in China to date is the reliance upon informal coordination by the government and regulators to ensure a speedy and effective defence. Indeed, the Vanke case has left the impression that the government has little trust in the regulating mechanisms of the market. In which direction does China want to develop the market for corporate control? Moreover, both before and after the control battle, a number of other listed companies in China swiftly amended their articles of association to add provisions assisting in the defence against hostile takeovers.

Yet as China's capital market develops, a more robust set of regulations on takeovers will be required. Whatever the ownership structure, the notion that only management or the board can decide how to react is unlikely to be sustainable. China's Company Law decrees that shareholders are at the top of the pecking order, with the shareholder meeting being the highest organ of authority in a company. It is therefore logical to allow all shareholders to vote on takeover offers, as happens in other major markets, and to develop clearer rules on the fiduciary duties expected of directors in these situations.

Endnotes

1 Vanke website, "Vanke Memorabilia 1983-2017". See: http://www.vanke.com/en/about.aspx?type=6

2 No published report is available from CAPCO.
See the following news story: http://finance.people.com.cn/stock/n/2015/0213/c67815-26563389.html.

3 Institutional Investor, July 2017. See: https://www.institutionalinvestor.com/research/7067/Honored-Companies

4 Wang Shi & Miao Chuan, "Wang Shi: Twenty Years with Vanke", 2006, p113-125, CITIC Press.

5 China Insurance Regulatory Commission (CIRC), "Notice on Strengthening and Improving the Supervision of Insurance Fund Applied Ratios" CIRC No. 13 (2014), released on 19 February 2014. See notice in Chinese: http://www.circ.gov.cn/web/site0/tab5168/info3904709.htm

6 CIRC, "Notice on Matters concerning Further Strengthening the Supervision of Stock Investment by Insurance Capital", CIRC No. 9 (2017), effective from 24 January 2017. See: http://www.circ.gov.cn/web/site0/tab5168/info4058265.htm

7 CIRC Administrative Penalty Decision, No. 13 (2017). See notice in Chinese: http://www.circ.gov.cn/web/site0/tab6527/info4060453.htm

8 CIRC Administrative Penalty Decision, No. 14 (2017). See notice in Chinese: http://www.circ.gov.cn/web/site0/tab5168/info4060469.htm

9 Company Law, Article 45, Article 108.

10 Vanke, Articles of Association, Article 60. See: http://www.vanke.com/en/investors.aspx?type=15&id=4264

11 Chen Xiaoying, "Vanke's Core Changes: Yu Liang + Shenzhen Metro, A Long Future Ahead", China Times, June 30 2017.
See: http://www.chinatimes.cc/article/68665.html

12 Vanke, Circular to HKEX, 5 February 2018. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2018/0205/LTN201802051418.pdf

13 Vanke, 2017 Annual Report, 27 March 2018. See: http://www.vanke.com/upload/file/2018-03-27/cd239c08-9dfa-4ffc-a244-2de9fa088c1f.PDF

14 Frederik Balfour, "A $400 Billion Manager Dumps Vanke as Shareholder Fight Heats Up", Bloomberg, 13 August 2016.
See: https://www.bloombergquint.com/china/2016/08/11/a-400-billion-manager-dumps-vanke-as-shareholder-fight-heats-up

15 Company Law, Article 37, Article 99, Article 121.

16 CSRC, "Measures for the Administration of the Takeovers of Listed Companies", Article 33, CSRC No. 108 (2014), effective from 23 November 2014.
See notice in Chinese: http://www.csrc.gov.cn/zjhpublic/zjh/201410/P020141024532445461742.pdf

Interview: 'Hostile takeovers can be good for markets'

Dr Zhang Wei
Assistant Professor of Law, School of Law, Singapore Management University, Singapore

What is your opinion about the Vanke case?

During its acquisition of Vanke shares, Baoneng's objective was to be an active shareholder and obtain membership in the board of directors. What we need to discuss and think about in this case is the appropriate policy regarding active shareholders. We should encourage such shareholders because research shows that their participation in corporate governance is a good thing. In China's capital market, the percentage of retail investors is high and that of institutional investors relatively low, so if active shareholders are able to stand up and strengthen supervision over management, then that is a good thing.

In the Vanke case, another issue concerned the way in which management defended itself. The management, in essence, gained support from the government and the general public through public relations. But they seemed to miss the point by criticising the acquirer for being a private enterprise.

The defender should have proved to shareholders which side would enhance company value and shareholder interests the most. The litigation against Baoneng did not succeed because its substantial acquisition was not illegal. In addition, suspending trading is not a good defence mechanism—it reflects certain "Chinese characteristics" that I will illustrate in detail later.

How do you view the spate of hostile takeovers taking place recently in China?

The first issue is how to think about hostile takeovers. Some hold the view that the market is short-term and hostile takeovers may not be a good thing. Of course, not every hostile takeover is efficient. On average, however, hostile takeovers tend to benefit corporate governance and the efficiency of capital markets. Therefore, a "one-size-fits-all" approach in prohibiting hostile takeovers is not rational.

Of course, in order to protect the long-term strategy and interests of a company, regulations should allow flexibility and permit target companies to use some anti-takeover measures. But is it possible for regulators or courts to investigate the substance of the anti-takeover measures applied and why management chose such measures? Management should be allowed to defend itself against some unfriendly takeovers. But they should first assess how sincere the acquirer is about the takeover. For example, there is a difference between a 30% acquisition target and a 100% one. In the case of a 100% acquisition, the target company will become private and the agency cost will be significantly lower. This kind of acquisition should be encouraged. Of course, it is also permissible to target 30% for a controlling stake.

The second issue is the problem of the hostile takeovers taking place in China. These takeovers are usually not 100% acquisitions, but attempts to gain control, which means the target stake is usually about 30%. This is partly due to the characteristics of the Chinese capital market, in which the "shell" of a listed company is highly valued and the hostile acquirer does not want to allow the company to be delisted. In such cases, the fight for control will result only in a transfer of ownership—the company will continue to have a controlling shareholder. But in companies with dispersed ownership structures, there will be a change from having no controlling shareholder before the takeover to the appearance of one afterwards, which is not necessarily a good thing from a governance perspective and could raise problems for minority shareholder protection. This requires special attention as to whether some new rules should be promulgated.

What are your suggestions for the regulation on hostile takeovers in China?

In respect of the whole market, the competition for corporate control is an important mechanism in corporate governance. At the same time, it leaves room to target companies to adopt defence measures. But such mechanisms should be subject to some restrictions. Either courts or regulators should examine them. However, the attitude of regulators towards hostile takeovers in China is still not clear.

There are different kinds of hostile takeover strategies. The current trend is the appearance of a wave of tender offers. One reason behind this is that the regulation of major acquisitions has become more and more strict and any violation could result in the suspension of voting rights. I have some doubts about this regulatory approach. A tender offer is a common strategy often seen in hostile takeovers. It not only allows some premium to be shared among minority shareholders, but also strengthens the importance of minority shareholders in corporate governance.

Among the different types of defence measures, the suspension of trading has become significant and is especially a feature of the China market. This is in fact an inferior anti-takeover measure. It completely cuts the relationship between information and share price, makes it impossible to transfer information regarding the target company, freezes the liquidity of shares, and thus damages both minority shareholders and the acquirer. At the same time, it also puts an end to the possibility of other competitors entering.

Furthermore, the current rules around suspension of trading are not transparent; they are like a black box. The stock exchanges have no mandatory rules to force a resumption of trading, which leaves space for opportunistic behaviour by company insiders. Therefore, a suspension of trading will not only cause liquidity problems, but also have extremely negative effects from the viewpoint of corporate governance—company insiders can utilise the suspension call to defend themselves against a transfer of controlling ownership without any restrictions.

What are your suggestions for the regulation of listed company governance?

First of all, more attention should be paid to the impact of capital market developments on current legislation. When the regulations on takeovers were put into force in the Company Law and Securities Law, there were few such transactions in the capital market and most were between SOEs. But recent developments have brought new challenges to lawmaking. A second example is the CSRC's stringent regulation on insiders selling shares, which has resulted in controlling shareholders separating the voting rights from profit rights and trading only the latter, rather than selling shares directly. How should regulators react to this?

My second suggestion is that we should carry out a systematic review of the lawmaking process. If the ultimate goal is to protect shareholders, it requires a solid, integrated and comprehensive framework to achieve this goal. For instance, in takeover transactions the voting rights of shareholders and the appraisal rights of dissenting shareholders are both very important. How should voting rights be executed? Does the majority decision rule protect minority shareholders or, on the contrary, company insiders? How should the appraisal rights of dissenting shareholders be executed? How to price the shares? Since hostile takeovers are mainly an involuntary transfer of controlling power in China, the question is then whether the restrictions placed on controlling shareholders under the Company Law, especially those on related-party transactions, are sufficient?

6.5 Minsheng Bank: Repairing its reputation

Introduction

China Minsheng Bank Corporation was founded in Beijing in January 1996 by businessman Jing Shuping (1918-2009) and a group of 15 corporate shareholders, three of which—Shandong Oceanwide Group, Hope Group and China Shipowners Mutual—continue to be major shareholders. It was the first national commercial bank in China not to be wholly state-owned and to be listed on the Shanghai Exchange in December 2000 and the Hong Kong Exchange in November 2009.

Prior to establishing Minsheng, Jing had a background in trust investment and trade policy. He served for a time as chairman of the China Federation of Industry and Commerce and was vice chairman of the Chinese People's Political Consultative Conference until 2002. In recognition of his contribution to industry and commerce, he was awarded the rank of "national leader" in 1993. His goal in founding Minsheng was to introduce market practices into China's banking industry, hence from the start only 15% of the shares were allocated to state enterprises. Jing became the first chairman of Minsheng.

Minsheng ownership in the beginning Tab 6.10

Founding shareholders, 1996

	Stake %
Guangzhou Yitong Group	6.54
China Town and Township Enterprises Investment and Development	6.53
China Coal Industrial Import and Export Company	6.52
China Shipowners Mutual Assurance Association	6.52
Shandong Oceanwide Group Company	6.52
Harbin Linen Mill	6.52
Xiamen Fuxin Group	5.82
Ningbo Economic Construction Investment	5.43
Beijing Vantone Industry	5.37
Hangzhou Unitop Electric	5.07
Kunming Jianhua Enterprise Group	4.35
Shenzhen Advance Development	4.35
Hope Group	3.68
Harbin Shirble Electric-Heat	3.62
Zhengzhou Menda Industrial	2.28

Source: *Minsheng Bank IPO Prospectus*

In the years since, Minsheng has become known in China for its aggressive expansion strategies. Given the inherent difficulty for a private bank to compete with state banks for SOE business, Minsheng has grown through lending to SMEs and acquiring retail banking businesses. Indeed, the strategy is implicit in its name: "min sheng" means "people's livelihood". In July 2017, it ranked 29th in *The Banker* magazine's Top 1000 World Banks and 251st in the Fortune Global 500.

There is a saying that the bank today has "three carriages" (major shareholders): the Hope Group, the Orient Group and the Oceanwide Group. The owners of these three groups—Liu Yonghua, Zhang Hongwei and Lu Zhiqiang, respectively—have been vice chairmen of the bank for an extended period. Despite this stability, the bank has suffered an increasing contest for control in recent years that has resulted in numerous changes to its ownership and board structure.

Minsheng ownership today
As at end-2017

Tab 6.11

	Stake %
HKSCC Nominees (custodian)	18.91
Anbang Group companies	15.54
China Securities Finance (CSF)	4.75
China Oceanwide Holdings Group[1]	4.61
New Hope Liuhe[1]	4.18
Shanghai Giant Life-Tech	3.15
Hua Insurance	3.14
China Shipowners Mutual Assurance Association[1]	2.98

[1] *Founding shareholders*
Source: *Sina Finance*

Table 6.11 , above, shows not only how much the shareholding structure has changed over the past 20 years, but that a majority of shareholders remain privately owned. The aggressive insurance group, Anbang, acquired shares in the secondary market in late 2014 and early 2015, then nominally gained a board seat in quick time: Yao Dafeng, chairman of Anbang Life, was nominated as a director in November 2014 and just before Anbang announced it was a substantial shareholder for the first time. By 30 September 2017, Anbang's stake had risen to 15.54% through three entities and it became the single largest shareholder. But its status and influence within the bank was rapidly undermined by the arrest in June 2017 of Wu Xiaohui, chairman and founder of Anbang, who was placed under investigation for illegal fund raising, corruption and other economic crimes. Events moved ahead even more dramatically in late February 2018 when the government announced that the China Insurance Regulatory Commission and other financial regulators would take over Anbang's operations for one year.

Another noteworthy shareholder is China Securities Finance Corporation (CSF), often called the "national team" by mainland investors following its rapid acquisition of shares after the stock market collapsed in June 2015. Although most of CSF's shareholdings are in SOEs, its shareholding in Minsheng increased from 4.06% to 4.99% in the six months to the end of June 2017, making it the second largest shareholder at the time and raising questions as to why it had raised its stake.

As for the other large shareholders, they are either looking for a long-term return or are strategic investors interested in controlling the bank. Further change came in November 2017 when Huaxia Life Insurance increased its stake to 4.13% and became the second largest shareholder through a formal concert-party alliance with the Orient Group, which owns 2.92%. On 22 January 2018, China Oceanwide Group also increased its shareholding from 6.01% to 6.94%.

Governance challenges

Jing Shuping went to great pains to create an exemplary governance structure for Minsheng in its early days. Under his leadership, for example, the bank was one of only a few listed companies in China to have independent directors in 2000, before the China Securities Regulatory Commission (CSRC) mandated them in 2001. Yet the bank's complicated ownership structure has, not surprisingly, created numerous governance challenges relating to board composition and leadership. Its internal controls have also come under intense scrutiny following a series of failures in recent years.

New independents arrive late ...

Despite a good start in appointing independent directors in its early years, more recent developments in this area have been less positive. In August 2016 Minsheng received a letter from the Beijing Office of the CSRC asking it to "improve its corporate governance structure and speed up the independent directors' election" because three of its independent directors at the time were "no longer performing their duties". Although the three directors, Qin Rongsheng, You Lantian and Ba Shusong, resigned in March, April and July of 2014, respectively, the bank did not replace them until October 2016, when it held an extraordinary general meeting to elect three new candidates: Liu Jipeng, Li Hancheng and Xie Zhichun.[1]

It is interesting to note that despite a clear breach of Hong Kong stock exchange listing rules on the appointment of independent directors—no more than three months can pass before independent directors who resign are replaced—the Exchange has taken no public enforcement action to date.

... and so does the board

Minsheng was also overdue in electing its seventh board of directors and supervisory board. The bank held an EGM on 20 February 2017, two years after the boards' terms had expired. According to company law, a director cannot serve more than three years and neither a company's articles nor its shareholder meeting can override this regulation.[2] While the long delay did not appear to cause Minsheng any operational troubles, and the bank did not disclose why the problem had arisen, a contributing factor could have been that the China Banking Regulatory Commission (CBRC) never approved Anbang's ownership qualification in Minsheng, hence it may have been difficult to elect a new board while the status of the largest shareholder remained uncertain.

Concentrating leadership power

Amidst all the ownership changes, Minsheng fought back by centralising more power in its two key officers. At an EGM in February 2017 it widened the scope of authority of both the chairman and president. Key changes included:

- Removing a restriction on the number of terms the chairman and vice chairmen can serve.[3] The bank's articles previously capped this at two consecutive terms, with a third should the board deem it necessary.
- The chairman can now nominate the president and CFO directly without going through the nomination committee, and he can coordinate this committee (a role previously given to independent directors).
- The president can now nominate not only the vice president, but also the CFO (he shares this power with the chairman) and a number of other key posts including his assistant, chief risk officer and chief information officer.

Management argues that these reforms are necessary to resist the influence of any dominant shareholder. In the same vein, there is a focus on leadership stability. In the February 2017 election, Hong Qi was re-elected chairman of the company despite being slightly beyond the statutory retirement age of 60 years old. Several insiders of the company told *The Beijing News* newspaper that his re-election was designed to stabilise the bank and provide continuity.

Dispersed board

It looks like Minsheng needs all the stability and continuity it can get. As the table below shows, its board composition reflects its unusually dispersed shareholding structure. At least seven major shareholder groups have appointed one or more directors to represent their interests.

7th Board of Directors
Elected 20 February 2017

Tab 6.12

		Nominated by	Stake %
Hong Qi	Executive Director, Chairman	-	-
Lu Zhiqiang	Shareholder Director, Vice Chairman	China Oceanwide	6.94
Zhang Hongwei	Shareholder Director, Vice Chairman	Orient Group + Huaxia Life	7.05
Liu Yonghao	Shareholder Director, Vice Chairman	New Hope Liuhe	4.18
Liang Yutang	Executive Director, Vice Chairman	-	-
Zheng Wanchun	Executive Director, Party Secretary	-	-
Yao Dafeng[1]	Shareholder Director	Anbang	15.54
Tian Zhiping[1]	Shareholder Director	Anbang	15.54
Wu Di	Shareholder Director	Good First Group	1.84
Weng Zhenjie[1]	Shareholder Director	Orient Group + Huaxia Life	7.05
Shi Yuzhu	Shareholder Director	Shanghai Giant Life-Tech + Jinghui	4.97
Song Chunfeng	Shareholder Director	China Shipowners Mutual Assurance Association	2.98
Zheng Haiquan	Independent Director	-	-
Xie Zhichun	Independent Director	-	-
Liu Ningyu	Independent Director	-	-
Peng Xuefeng	Independent Director	-	-
Liu Jipeng	Independent Director	-	-
Li Hancheng	Independent Director	-	-

[1] *Appointments not yet ratified by the CBRC*
Source: *Various, ACGA research*

One noteworthy feature of the bank's board is that while the election of 15 of the 18 directors has been approved by the CBRC, including all the independent directors, the regulator had not yet approved the two Anbang nominees, Yao Dafeng and Tian Zhiping, or Huaxia Life's representative, Weng Zhenjie, as of June 2018. According to banking regulation in China, directors cannot perform their duties until they have been approved by the CBRC—their starting dates begin from this point, not when they were elected by shareholders. Hence the two largest shareholders are effectively not represented on the board—and now Anbang has lost all influence as a private entity.

Another feature worth highlighting: despite being created as a "private bank" in 1996, Minsheng has had a Party committee and a Party disciplinary inspection committee since its early days. Unlike state-owned banks, however, the chairman of Minsheng is not the Party secretary of the company. Instead, this role is taken up by another executive director, Zheng Wanchun. While the role of management in the Party committee is disclosed, that of other board members is not. In fact, the word "Party" is not mentioned in the company's articles.

It is also interesting to note that despite getting an early start on independent directors, their proportion on the board has not risen above 33%. Like most listed companies in China, Minsheng complies with the CSRC regulation of 2001 but does not go beyond it.

Control failures

Fake WMP

On 13 April 2017, Zhang Ying, the president of the Beijing Hangtianqiao sub-branch of Minsheng Bank, was arrested and placed under investigation for fraud. The company made an announcement on 18 April acknowledging the incident and stating that it had "set up a working group to proactively assist the police department in their investigation".[4]

In a later announcement on 28 April, the company added that Zhang and some of her colleagues at the branch had defrauded customers using forged wealth management products (WMP) and bank seals.[5] The bank revealed that "up to now, the amount involved in this case is approximately Rmb1.65 billion, and the initial estimated amount involved will not exceed the number reported by the media and involves over 150 customers". Previously the media had reported that the amount involved could be as high as Rmb3 billion.

In this case victims were tricked into buying a second-hand WMP with a very attractive yield. They were told that the original investors had to cash out of the product for urgent reasons and were willing to forgo the 4.2% yield already accrued, leaving the new buyers with a yield of more than 8% in less than half a year. In addition, the bank staff told investors that this "special product" was only available to loyal customers with more than Rmb10m in their accounts.

However, the funds raised did not appear in the bank's accounts. Instead they were used to cover up a fake loan, which the perpetrators had issued to cover up a default on a commercial note amounting to Rmb3 billion. The fraud was exposed when an investor in the WMP happened to ask a friend who worked for another branch about the product, only to be told it did not exist. The investor told the Beijing branch, which reported the case to the police, who then arrested Zhang.

Ironically, before this case the Hangtianqiao branch used to be one of Minsheng's "star branches" due to outstanding sales performance. In the bank's second announcement it said it would "adopt feasible ways" to refund the principal paid by investors and then "deal with subsequent matters under final judicial judgement". No further details were given.

It is understood that since this case came to light the CBRC has used it as a case study for improving internal controls and compliance practices at other banks. Most of the affected investors have recovered their principal, though some who made large investments are still negotiating with the bank.

Unstoppable "flying contract"

The internal control and audit loopholes in some Chinese banks have also resulted in another common misdemeanour—selling WMPs under the table, a so-called "flying contract" or unauthorised WMP sold by bank staff to earn extra commission. In most cases, the products attract customers by offering guaranteed high returns, while obscuring the associated risks.

The number of cases involving flying contracts has increased significantly in China in recent years. Starting with Huaxia Bank in 2012, other big banks involved have included Agricultural Bank of China and Ping An Bank. The CBRC has taken multiple approaches to deter this misbehaviour, but relevant cases continue to surface.

In the case of Minsheng's fake WMP, some investors were at least aware that the second-hand product was not authorised by the bank. However, they decided to take the risk of buying the product to earn the extraordinary return. This also helps to explain why it is so difficult to eliminate such contracts in the Chinese market: the dominance of retail investors means it will take a lot of resources and a long time to improve the sophistication of the whole investment community.

After the Minsheng case, on 30 March 2017 the CBRC issued Notice 47 on "Double Sales Records" that aimed at cracking down on flying contracts and other misleading sales. At the same time, the CBRC also launched a crackdown on bank staff conspiracies to forge unapproved WMPs.

On 30 November 2017, the Beijing Office of CBRC announced its enforcement decision in this case. The Hangtianqiao branch was fined Rmb27.5m and three former staff including Zhang Ying were banned for life from working in the banking industry.[6] This is the highest fine recorded among more than 500 enforcement actions taken by all the regional offices of CBRC in 2017.

The Hangtianqiao case was not the only offence at Minsheng Bank in 2017. During the first half of 2017, 30 enforcement actions were taken against the bank and its branches across China. Among these actions, 29 were brought by the CBRC and its regional offices and one by a regional office of the People's Bank of China (PBOC). The total fines imposed amounted to just under Rmb200m. According to the CBRC website, no other bank approached these figures over the same period. Some might argue that the fines incurred are negligible when measured against the financial performance of the bank. In the first half of 2017, the bank made Rmb28.1 billion in net profit, up 3.2% compared to the prior year period. For the full year of 2016, its total net profits were Rmb47.8 billion, an increase of 3.8% year-on-year. Despite this apparently passable financial performance, prices of both Minsheng's A shares and H shares fell, by 5% and 9.8%, in the half year to the end of June 2017.

The "radish seal"

A direct result of an inadequate internal control system is the use of forged company seals, an issue that is widespread among financial institutions in China. In 2016 alone more than 22 financial institutions were investigated for the use of forged seals, so-called "radish seals", including Agricultural Bank of China, Ping An Trust, China Guangfa Bank, and Sealand Securities. A wide range of financial institutions were affected in each case and the sums involved ran from millions to billions of yuan.

Forging a company seal is considered a serious breach of criminal law in China and could result in imprisonment of up to 10 years.[9] Yet many people are willing to take the risk because the rewards are high. A great deal can be done with a company seal and they are easier to forge than a signature. Second, many people assume that they will not be caught given their companies' loose internal control systems.

A senior partner of a top-ranked law firm in China made the following comment:

"For foreign investors investing in China, a big difference is that the Chinese market only recognises company seals while the Western market only recognises signatures. Also, the concept of company representative is different in China to that in Western markets. In China, only a seal affixed by the company representative can stand for the company. But in Western markets, every main decision has to be approved and co-signed by the board.

"In some cases this importance of company seals in China has allowed small domestic shareholders (the local management team) to bully large overseas shareholders, since the latter do not have access to the company seal. In extreme cases, the foreign shareholders could not even sell their shares if they wanted to exit without a stamp made by the management."

Managerial misconduct

While not a state-owned bank, the management of Minsheng has close relationships with government officials in China. In January 2015, the Central Commission for Discipline Inspection (CCDI) detained Mao Xiaofeng, the bank's former president, for questioning with regard to the corruption investigation into Ling Jihua, a high-ranking aide to former Chinese president, Hu Jintao. According to *The Beijing News*, Mao had helped the wives of several Beijing top officials obtain "positions" at the bank and take "compelling" compensation for a considerable period of time.

Then in April 2017, Zhao Pinzhang, a former vice president of Minsheng Bank, was reportedly detained at an airport and taken away for questioning. According to *Caixin* financial magazine, the investigation of Zhao may be related to a problematic loan that the bank had provided to a subsidiary of China Railway Construction Corporation. Zhao had been in charge of the bank's credit assessment and risk management departments for many years and had also been the responsible person for accounting in the bank.

More recently, Lin Xiaoxuan, the former chief information officer, was reportedly under investigation by the CBRC for a "serious violation of discipline", a euphemism for corruption. On 6 November 2017, the CCDI announced that Lin had been expelled from the Communist Party for taking bribes and the case had been transferred to the judicial body. Interestingly, although Lin had been appointed by Minsheng as CIO in February 2017, according to the company announcement[7] (no English version), his qualification had only been approved by the CBRC one week before he was caught. It is believed that the investigation into Lin was not related to his role at Minsheng, but to a previous position. He was earlier an executive vice president of the Agricultural Bank of China. Minsheng subsequently dismissed Lin but has yet to disclose who will take over his role.

"Historical fine" by PBOC

On 16 March 2018, PBOC announced its "historical fine" against the Xiamen branch of the bank for breaching settlement rules and online payment services rules.[8] The punishment includes a confiscation of Rmb48.42m, which was the revenue made from these breaches, and a fine of Rmb115m, which is about three times the revenue made. This is the highest fine the PBOC has ever imposed. According to *Caixin*, the Xiamen branch had a "New Payment Settlement Center" that directly connected with 45 online payment platforms, some of which were not even licensed. However, the centre had been providing settlement services to these platforms and helping unlicensed institutions become ordinary payment channels for multiple merchants.

Conclusion

As the first private commercial bank founded in China, Minsheng has created a viable and successful business model capable of competing in a largely state-dominated industry. Yet its very success has made it a target for ownership control battles, leading to a fragmented shareholder base and an ever-changing board. Its missteps in internal controls and fraudulent marketing highlight the need for constant vigilance on the governance side and a need to strengthen board leadership and supervision over management. Despite its reasonable financial performance these incidents have harmed the bank's reputation and share price. For investors, the bet is whether or not the new board can make effective adjustments to the bank's operation and corporate governance to reverse an impaired reputation and regain investor confidence.

From a substantial shareholder of Minsheng, February 2018

"Minsheng is a special bank in China given its business size and the fact that most of its shares are owned by non-state-owned enterprises. However, a coin has two sides. On the one hand, its private-owned nature has put the bank under fewer restrictions and it has more flexibility when conducting business. On the other hand, sometimes we feel its decision-making processes may be too flexible. It is not uncommon for some decisions to be made and revoked in a short period.

"One serious issue is the power struggle among different shareholding groups. Although its performance has improved under the new president, the power struggle saga has impaired the bank's business to a certain extent. It started when Minsheng wanted to further develop its SME business several years ago and then entered an ongoing ownership fight. In the end, the board election was extensively delayed, leaving some business proposals unaddressed.

"One last point is that, while Minsheng is not state-owned, it still subject to the regulation of China Banking Regulatory Committee [CBRC], meaning all its major decisions such as board personnel appointments have to be approved by the CBRC before being effective. To this date, Anbang remains the largest shareholder. But given all the scandals the Anbang group has been involved in over the past few years, it goes without saying that the CBRC will not approve any proposals raised by Anbang. So, despite being the largest shareholder, Anbang has no real voting rights in any major decision in Minsheng."

Endnotes

1. Minsheng, Poll Results of EGM, 30 October 2016. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2016/1030/LTN20161030033.pdf
2. Company Law (2005), Article 45.
3. Minsheng, Poll Results of EGM, 21 February 2017. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0221/LTN20170221021.pdf
4. Minsheng, Company Announcement, 18 April 2017. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0418/LTN201704181306.pdf
5. Minsheng, Company Announcement, 28 April 2017. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0428/LTN20170428225.pdf
6. Beijing Office of CBRC Administrative Penalty Decision, No. 22 (2017). See notice in Chinese: http://www.cbrc.gov.cn/beijing/docPcjgView/D5444947F95244218AE307A534E641FE/26.html
7. Minsheng, Notice on Senior Management Personnel Qualification Approval, 15 August 2017.
See announcement in Chinese: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0815/LTN201708151035_C.pdf
8. PBOC Administrative Penalty Decision, No. 1 (2018).
See notice in Chinese: http://www.pbc.gov.cn/zhengwugongkai/127924/128041/2161421/3499854/index.html
9. Criminal Law (1997), Article 280.

6.6 Tencent Holdings: Two sides to the coin

Introduction

Since its listing in Hong Kong in June 2004, Tencent Holdings (0700) has risen to become the biggest company on the stock exchange: its market cap of HK$3.94 trillion (US$505 billion), as of mid-June 2018, is more than double the next two largest firms, China Construction Bank and HSBC, and over 2.5 times that of China Mobile.[1] Despite the current craze for internet stocks, the restricted nature of China's telecommunications market, and the sheer size of the market opportunity on the mainland, this is still a breathtaking achievement and one that owes much to the firm's strategy and management.

Tencent is also interesting for its governance structure, which remains noticeably different from other internet giants in China. Unlike Alibaba, it does not rely on an artificial "special partnership" arrangement that concentrates control in a small number of senior executives, none of whom own a significant stake in the company. Nor does it rely on a US-listed, dual-class share structure to protect itself, like Baidu, JD.com or Sina. Refreshingly, Tencent has a one-share, one-vote capital structure, with a balance of power between its core founders and a foreign investor, Naspers of South Africa. Since it is listed in Hong Kong, Tencent is required to hold annual general meetings—unremarkable perhaps, except that several mainland issuers in the US, notably Baidu and JD.com, do not have to do so because of exceptions granted to foreign private issuers.

Yet Tencent has also had its share of growing pains. In contrast to the feel-good factor surrounding the firm's business model and share price, the market is starting to ask the company a range of governance questions. Its board structure and composition have changed little since listing in 2004 and votes against some non-executive directors have been material, as have those against the company's share-issuance mandates and stock option plans. Concerns are also rising about certain social and regulatory risk factors. Given its size, importance and diverse shareholding base, how Tencent addresses these issues will be of considerable interest to investors. It could also provide relevant insights into the adaptability and sensitivity of private-sector tech firms in China to international governance expectations.

Ownership and Listing

In one sense Tencent's corporate form is unremarkable and follows a typical Chinese "variable interest entity" (VIE) structure. The original firm, Tencent Computer, began life as a mainland incorporated entity in November 1998. Following investment interest from a South African internet and entertainment group, Naspers, the company restructured its operational structure in late 1999. It formed a BVI holding company, Tencent Holdings Limited, and a wholly foreign-owned enterprise, Tencent Technology, based in China. This contortion was a response to restrictions on direct foreign investment in value-added telecommunications services in China. In 2004, a second wholly foreign-owned enterprise was formed, Shidai Zhaoyang Technology, and Tencent Holdings Limited changed its domicile to the Cayman Islands in preparation for listing in Hong Kong.

Since the two wholly foreign-owned units were not allowed to own or operate internet or other telecommunications value-added services in China, Tencent Holdings carried out these businesses through two mainland companies: the original Tencent Computer and a second firm called Shiji Kaixuan. Both were established and owned by the core founders. Each operating entity had "structured contracts" with the foreign-owned units, Tencent Technology and Shidai Zhaoyang, from which they received software, information consultancy and technical consultancy services in return for their surplus cash. As the 2004 prospectus outlines[2], the operating companies also accorded the foreign units certain other economic rights: the right to buy them out at a nominal price if and when Chinese law allowed; the right to own all key assets, such as intellectual property rights; and a pledge over their entire equity.

Unusual ownership structure

In another respect, however, Tencent Holdings came to market in Hong Kong with one of the more robust and therefore unusual governance structures on the Hang Seng Index and, indeed, among privately owned firms in China:

- Prior to listing, its shares were owned equally by two groups: 12 mainland founders, of which five are referred to as the core founders (50%); and Naspers of South Africa (50%).
- A strong shareholder agreement that allowed the founders to appoint the CEO and Naspers to appoint the CFO.
- Its first post-IPO board comprised two founder executive directors, two non-executive directors representing Naspers, and three independent directors based in Hong Kong. One of the independents was Hong Kong Chinese and the other two were British. In other words, more than half the board were non-Chinese and the independence ratio was 42%.

Unlike many newly listed firms, Tencent did more than just tick boxes to please the Exchange. Whether by design or default, it undertook a range of governance improvement measures before and at IPO:

- Its non-executive directors joined the board well before the IPO: Antonie Roux in December 2002 and Charles Searle in June 2001.
- An experienced Hong Kong company secretary, Lau Suk Yi, was appointed in September 2003.
- All three independent directors were chosen for their business and/or financial acumen. Li Dong Sheng was the chairman of a consumer electronics firm based in Hong Kong. Iain Bruce a veteran auditor/accountant. And Ian Stone came with deep experience in the telecoms and mobile industries.

Why list in Hong Kong with its one-share, one-vote rules rather than NASDAQ where dual-class shares were on offer? In a biography of Pony Ma, the Tencent chairman recounts that six investment banks recommended Hong Kong, four NASDAQ, and three a dual-listing in both markets. The biography claims that Ma chose Hong Kong in order to stand out: at the time Tencent was the only mainland internet firm capable of meeting Hong Kong's stricter listing requirements.[3] Another factor, as Tencent told ACGA, was to be geographically closer to many of the company's main institutional investors.

Ownership update

As we were completing an initial draft of this case study, Naspers informed Tencent on 22 March 2018 that it was selling a 2% stake in the company, taking its ownership from approximately 33.17% to 31.17%. Naspers gave no substantive reason for the sale.

Current Governance

Stability

Tencent's board structure has barely changed in the intervening years. It still comprises two executive directors: Pony Ma as chairman and chief executive and Martin Lau as president. There are still two non-executive directors from Naspers and the independent directors have increased from three to four, with the fourth appointed only in July 2016.

Board and management composition has also been stable: five of the current eight directors, including all three original INEDs, have been on the board since listing. At one point, there were three executive directors, however one of the core founders, Zhang Zhidong, resigned as a director in March 2014 and as chief technology officer in September 2014.

Meanwhile, two other core founders, chief operating officer, Zeng Liqing, and chief administration officer, Chen Yidan, resigned in 2007 and 2013, respectively. All three of the departing core founders have all stayed on in various advisory roles, while Zhang and Chen remain part-owners of the two local operating companies.

Change

Not surprisingly given the growing complexity of its business, Tencent's governance has evolved in various ways. Its board committee structure has grown from just two committees at the time of the IPO—for audit and remuneration—to five today: the original two plus committees for corporate governance, investment, and nomination. While the company follows best practice in some areas—the chairmen of its audit and remuneration committees are independent—this is in fact a requirement of the Hong Kong listing rules.[4] In other areas it does not: in particular its audit committee is not fully independent (one of its members is Charles Searle of Naspers) and its nomination committee is headed by chairman Pony Ma and meets no more than once per year.

More positively, a Shareholder Communication Policy[5] was adopted in March 2012 to ensure that shareholders are provided with "ready, equal, regular and timely access to material information". And unusually for a Main Board-listed company in Hong Kong, Tencent releases unaudited quarterly financial statements which include an income statement, balance sheet, a concise business review/outlook, and a reconciliation between its IFRS-based accounts and non-GAAP results that it believes are useful to investors.[6] While not required under Hong Kong listing rules, the company does this to provide its shareholders with a level of financial information comparable to its US-listed competitors.

Challenges

For those who only know Tencent through its popular games, rocketing share price or omnipresent WeChat, it may come as a surprise to learn that some of its independent shareholders have been signalling concerns about the firm's governance and risk management in recent years.

Votes against directors

As Table 6.13, overleaf, indicates, independent shareholders appear largely happy with the performance of the executive directors they can vote on—despite there being no vote for the re-election of chairman Pony Ma. Yet the votes against one long-serving non-executive director, Charles Searle, have been on the rise, while those against two veteran independent directors, Iain Bruce and Li Dong Sheng, increased markedly in 2015, then dropped significantly for Bruce but not Li in 2018. What also stands out is the relatively high proportion of votes against the newest independent director, Yang Siu Shun, in 2017.

According to market feedback, the votes against Searle were due to his longevity on the board and his membership of the audit committee. Glass Lewis recommended a vote against him in 2017 on the grounds that the audit committee was not fully independent. There were several reasons why

Market concern

Tab 6.13

Tencent AGMs: Votes against directors, 2012–18

Director	Type	2012	2013	2014	2015	2016	2017	2018
Pony **Ma**	ED	*Not subject to re-election*						
Zhang Zhidong	ED	-	1.3%	*Resigned: March 2014*				
Martin **Lau**	ED	-	-	2.2%	-	-	3.1%	-
Charles **Searle**	NED	-	-	4.5%	-	-	7.2%	-
Jacobus **Bekker**	NED	-	2.0%	-	-	2.5%	-	-
Ian **Stone**	INED	-	1.3%	-	-	1.4%	-	-
Iain **Bruce**	INED	2.6%	-	-	26.0%	-	-	3.5%
Li Dong Sheng	INED	3.6%	-	-	27.6%	-	-	23.1%
Yang Siu Shun	INED	*Appointed: July 2016*					13.4%	-

Note: Figures rounded to the nearest decimal point
***Source:** Company announcements*

investors voted against Messrs Bruce and Li. Some had concerns about their long tenures and some followed the advice of proxy advisory firms. For example, Glass Lewis recommended voting against both in 2015 on the grounds that they attended less than 75% of board meetings the previous year and sat on too many public company boards. It also opined that a vote against Bruce was justified because, as chair of the audit committee (at that time), he oversaw the payment of "excessive fees" to external auditor PwC for non-audit services, which amounted to 130% of audit fees.[7] Bruce handed over the chairmanship of the audit committee to Yang Siu Shun in early April 2018, prior to the AGM in mid-May. With non-audit fees at a more acceptable level in 2017—around 23% of total audit and audit-related payments—and full attendance at all board and committee meetings, the votes against Bruce fell in 2018. For Li, however, his attendance at only half the company's four board meetings in 2017 would have attracted strong votes against.

It is also obvious that the board lacks diversity, both in terms of female representation and new expertise, and is quite small for a company that ranks as the biggest on the Hong Kong stock exchange. It must be a challenge for so few directors to shoulder the burden of directing a firm as complex as Tencent. The company's answer is that management support for the board has become more sophisticated, efficient and effective over the years, with a growing support team led by competent officers. There has been stability of personnel here too, with the head company secretary remaining in position since 2003. It also says that it is aware of the need for board refreshment and that this is something the nomination committee and management are working on.

As for Yang Siu Shun, the votes against him would have had nothing to do with tenure. It is possible that his previous role as chairman and senior partner of PwC, the firm's auditor, raised concerns among some shareholders as to his ability to be independent. This would not have been helped by the fact that he was appointed on 1 July 2016, exactly one year and a day since his retirement from PwC on 30 June 2015, thus just meeting the one-year "cooling-off period" for former professional advisers to become independent directors under the Hong Kong Exchange listing rules—a standard that most investors consider antiquated.[8]

Meanwhile, the lack of any right to vote on Pony Ma's appointment is curious. It stems from Article 87(1) of the firm's articles which states that while other directors are subject to re-election every three years by rotation (each time one-third of the board), the "chairman of the Board and/or the managing director of the Company shall not, whilst holding such office, be subject to retirement by rotation or be taken into account in determining the number of Directors to retire in each year". This clause was in the company's original articles of association and again in an amended version approved by shareholders in May 2014. Since shareholders voted to approve the amendments by 99.91%, the company could be forgiven for concluding that either shareholders are not concerned about the issue or they did not read the articles fully. Nevertheless, this approach seems excessively cautious and disenfranchises shareholders from expressing a view on the chairman/CEO's performance. It is certainly not a best, or even good, practice in governance terms.

Votes against share-issuance mandates

As Table 6.14, below, indicates, independent shareholders have been voting strongly against Tencent's annual extension of its "general mandate" to issue new shares on a private-placement basis (ie, to a select number of investors, not all shareholders equally) and at a discount. Shareholders also routinely object to the "reissuance mandate", which allows firms to increase the size of their private placements in any one year by reissuing shares previously repurchased by the company. Votes against both mandates increased in 2018.

Strong opposition

Tab 6.14

Votes against Tencent's new share issue and reissuance mandates as % of total, 2012-18

	2012	2013	2014	2015	2016	2017	2018
Share Issue Mandate	24.3%	24.5%	24.7%	26.8%	25.5%	24.8%	30.1%
Reissuance Mandate	23.6%	24.2%	23.9%	26.0%	24.6%	23.6%	28.4%

Source: *Company announcements*

The consistency of the votes against is not a criticism of the way in which Tencent has applied the mandate. Indeed, it appears to have done so responsibly. Rather they reflect two broad trends in corporate governance in Hong Kong. First, a strong dislike among minority shareholders for the dilutive effects of private placements: rules allow firms to issue up to 20% of their existing issued capital in new shares and up to a 20% discount; and then to increase this by up to another 10% of total capital by reissuing repurchased shares. This is seen as excessive and unfair. Investors understand that issuers sometimes need to raise capital quickly, especially those operating in emerging markets, yet would expect a well-managed firm such as Tencent to voluntarily seek a lower mandate (thresholds of 5% to 10% in any one year are acceptable to most institutional investors). This is what many other blue chips in Hong Kong have done. Tencent, however, regularly asks for the usual 20% and the additional 10%.

Second, these voting trends reflect the fact that international proxy advisory firms, namely ISS and Glass Lewis, annually recommend voting against the two mandates in Hong Kong and a large number of institutional investors follow their advice.

One point worth highlighting is that if voting was restricted to independent shareholders only, Tencent's general mandate resolutions would regularly fail (as they would for the majority of listed companies in Hong Kong). Indeed, the effective independent vote against increased substantially in 2018. Table 6.15, overleaf, shows why.

Unfortunately, apart from some leading blue chips and a few mid-caps, listed companies in Hong Kong do not take the large votes against their general mandates seriously. While most do not use the full 20% in any one year, let alone the additional 10%, they continue to seek the annual extension because 'that is what the rules allow' and 'that is what we have always done'. Since the issue is an ongoing source of frustration for institutional shareholders, and since large firms such as Tencent are unlikely to need the full 20%—which amounts to more than US$100 billion at mid-February 2018 share price levels—voluntarily reducing the requested size and discount to a more acceptable 10% is an easy win for both sides.

No mandate from minorities Tab 6.15

Voting on Tencent's new share issue mandate, 2017-18

	2017	2018
Total shares eligible to be voted at Tencent AGM	9,477,483,498	9,503,686,366
Total shares voted on new share issue mandate	7,455,346,853	7,058,433,963
Less combined shares of controlling shareholders	3,978,709,400	3,780,731,100
Total votes remaining of other shareholders	3,476,637,453	3,277,702,863
Votes against	1,852,473,311	2,122,734,678
Votes against as percentage of total votes remaining	**53%**	**65%**

Note: Percentages have been rounded.
***Source:** Company announcements, ACGA calculations*

Employee share ownership

Like most tech and internet firms, Tencent has been a strong believer in the use of stock options to attract and retain talent. Prior to its IPO in June 2004 it adopted a broad-based share award scheme covering 256 employees. By 2017, the company had created five schemes, the first two of which had already expired. It has been an active dispenser of options, bringing considerable wealth to thousands of its employees. In July 2017 alone it dispensed 17,870,595 new options to 10,800 "awarded persons".[9]

While this strategy has helped the firm attract and retain high-quality talent, the market clearly has concerns about the size and scope of such schemes. In 2017 the vote against the company's latest share award scheme reached almost 19.3%. The size of the scheme amounted to 4% of total shares —up from 2% in 2007 and 3% in 2009. As a company announcement states, if all options under the previous and new schemes were exercised, they would amount to 7.96% of total existing shares.[10] This is not an immaterial figure. Is it too high? Not according to Hong Kong listing rules, which allow up to 30% of a company's issued capital to derive in aggregate from outstanding stock options.[11] Yet many institutional investors consider the HKEX threshold itself too high and clearly have concerns about Tencent's awards. Many investors would prefer a 10% cap, and want to see awards linked to performance targets. They are also looking for companies to explain their performance metrics.

Proxy advisory firms also had their concerns. Glass Lewis recommended a vote against in 2017 on the grounds that the scheme covered an "excessive range of participants", including customers, suppliers, consultants and advisers as well as directors and employees, and the lack of any explicit performance targets. (The actual Tencent AGM circular referred to employees, executives or officers, directors, and "any consultant, adviser or agent of any member of the Board, have contributed or will contribute to the growth and development of the Group or any Invested Entity".[12])

Institutional investors also worry about the dilutive effect of big employee share ownership schemes, both in terms of their impact on earnings per share (since new shares are issued to satisfy the option awards) and on the voting influence of independent shareholders (the broader the scheme, the bigger the group of loyal employee-shareholders). There is a danger that over time management bolsters its position and the market's ability to discipline gradually weakens. Given Tencent's high public float, however, the risk of the latter happening is commensurately lower.

INED compensation

Related to the issues above is another somewhat unusual feature of Tencent's governance: its practice of awarding stock options to independent directors. By Hong Kong standards, the four INEDs receive high fees of between HK$750,000 to HK$1.1m per year each—though some might argue that these are modest in relation to the size and growth of the firm and the heavy workload that each director must bear (a downside of having a small board). Yet the lion's share of their compensation comes in stock options and here Tencent has been extremely generous. According to the 2017 annual report, Iain Bruce had 72,500 options at the beginning of the year and received another 20,000. Ian Stone had 72,500 options and also received another 20,000. For Li Dong Sheng, the comparable figures were 36,250 and 10,000. Yang Siu Shun received 11,474 options in his first month and another 10,000 in March 2017, the same month as the other independent directors received their awards but still less than a year into his first term.

Many governance mavens view stock ownership by INEDs as a positive, believing it makes them more diligent as directors by aligning their interests with the success of the company. Indeed, Messrs Bruce and Stone are both long-term owners of substantial parcels of stock in Tencent—a tangible sign of their confidence in its future. In contrast, some others see share ownership by INEDs as a negative, believing it undermines their independence by tying their fortunes too closely to management. Yet there is broad consensus among both groups that granting stock options complicates the relationship with management and creates a perception that the independence of INEDs has been, or will be, compromised. We do not believe that this is necessarily the case with Tencent's independent directors, since by all accounts they work extremely hard, are highly competent and opinionated, and have the respect of management. Yet it is a question the company may need to address more directly in future. It is certainly not a practice that investors would like to see adopted more broadly in other listed companies.

One place to start would be the annual report. Tencent could, for example, explain why it believes that giving options to independent directors does not undermine their independence. The directors' report for 2017 contains numerical details but no narrative explanation—as in previous years. Nor is it clear what role the remuneration committee plays in determining these share awards. The company says that no individual is involved in determining his own remuneration, yet two of the four independent directors sit on the committee and one chairs it.

Emerging Risks

Beyond the questions raised by the market about Tencent's governance, the company faces a number of other related risks.

Regulatory risk

The rise of the internet and social media has led to growing concerns around the world about cybersecurity, data privacy and the negative impact of high screen time. New government regulation could have a marked impact on the business models of service providers. For example, in China, gaming addiction among teenagers has become an issue of concern for the government, parents and shareholders seeking to invest responsibly. Tencent has addressed this issue in public statements and in its 2016 annual report under the heading, "Healthy Environment for our Users", where it briefly stated: "To safeguard the physical and mental health of online game users and adolescents, we have implemented the real-name system and anti-addiction system in accordance with the regulatory requirements of the PRC and strengthened the promotion of healthy gaming and anti-addiction through various channels."[13] Its 2017 annual report went into some more detail, highlighting efforts made in that year to help parents monitor the gaming habits of their children and the introduction of a new anti-addiction system for "Honour of Kings", one of its most popular games. While the additional information for 2017 is welcome, investors would almost certainly appreciate a more thorough explanation of these measures and their effectiveness.

New regulation could impact Tencent's overseas businesses as well. While its operating assets and other investments in China far exceed those outside, it has substantial operations and investments in North America, Europe and other parts of Asia. As its 2016 annual report highlights, more than Rmb111 billion of its total Rmb396 billion in operating assets and investments are outside China—and these numbers are growing swiftly, especially in Europe.[14] The respective figures for 2017 were approximately Rmb173 billion and Rmb555 billion.[15] Although the company has a large and professional legal department to handle such risks, the rapid evolution of regulatory and social norms will likely be a challenge. For example, there is a growing focus in the US and Europe on what are called "digital rights", the right to individual freedom and privacy in the online world and the extent to which internet and telecoms firms respect such rights. A 2017 index of 22 large ICT firms, carried out by a non-profit research initiative called Ranking Digital Rights, placed Tencent third from the bottom of the internet and mobile firms surveyed.[16] The 2018 index produced the same result. Baidu came last in both years.[17]

Key man risk

With Pony Ma continuing in his dual role as chairman and CEO, it is fair to ask whether one person can do both jobs in a company as large and complex as Tencent. The 2016 annual report explains, rather obscurely: "In view of the ever-changing business environment in which our Group operates, the Chairman and Chief Executive Officer must be technically sophisticated and sensitive to fast and rapid market changes, including changes in users' preferences, in order to promote the different businesses of the Group. The Board thus considers that a segregation of the role of the Chairman and Chief Executive Officer may create unnecessary costs for the daily operation of the Group."[18] It is not clear what these costs might be and this explanation for a combined role is not very informative. Meanwhile, the 2017 annual report contains exactly the same paragraph.[19]

Board composition risk

While the company may be working on refreshing its board, the process appears to be slow. It is notable that the Nomination Committee met only once in each of 2016 and 2017. Indeed, the language on board composition in its corporate governance reports for the two years is virtually identical. The message is that the current balance between executive and non-executive directors is "reasonable and adequate". [20]

VIE risk

After a flurry of concern in 2013 to 2014 about the prospect of the Chinese government closing down VIE structures, the discussion has gone quiet. No policy direction has been forthcoming and the market has assumed that China's dominant tech firms are too big to touch. Yet the risk has not entirely gone away: Tencent's 2016 and 2017 annual reports state that while the firm's legal advisers are of the opinion that its structured contracts do not violate current mainland law, there are "substantial uncertainties regarding the interpretation and application of the currently applicable PRC laws, rules and regulations. Accordingly, the PRC regulatory authorities and PRC courts may in the future take a view that is contrary to the position of the Company's PRC legal advisers concerning the Structure Contracts."[21]

Conclusion

Tencent has had a dream run since listing in 2004 and through a combination of factors, including internal expertise and leadership and external technological developments and mainland government economic policy, has risen to dominate the Hang Seng Index in a short space of time. In sharp contrast to this success, the market is signalling to Tencent that it has broad concerns about the firm's governance, in particular board composition and its share award schemes, and is worried about wider risks. While Tencent may be working internally to address these issues, its corporate reporting sends a mixed message as to whether it is taking investor concerns seriously. On the one hand, its 2017 annual report provides more substance on environmental, social and governance risks. On the other, the direct copying of governance-related information from one annual report to the next is not befitting of the biggest and most successful company on the Hang Seng Index. As the firm's business grows in China and internationally, a more sensitive ear to stakeholder concerns would be beneficial.

Endnotes

1. HKEX website (12 June 2018). See: http://www.hkex.com.hk/Market-Data/Securities-Prices/Equities?sc_lang=en
2. Tencent Holdings Limited, Prospectus, June 2004, p68-77.
3. Leng Hu, "Ma Huateng & Tencent", LID Publishing Ltd, London, 2017, pp45-46.
4. See HKEX Listing Rules 3.21 (audit committees) and 3.25 (remuneration committees).
5. Tencent, "Shareholders Communication Policy", March 2012. See: https://www.tencent.com/attachments_en/ShareholdersCommunicationPolicy.pdf
6. Tencent, "2017 First Quarter Results", 17 May 2017. See: https://www.tencent.com/en-us/articles/8003431495014482.pdf
7. Glass Lewis, Proxy Paper on Tencent Holdings, published 22 April 2015. (Provided to ACGA by Glass Lewis and quoted with permission.) See also Tencent, Annual Report 2014, p71 for the fees paid to PWC.
8. See HKEX Listing Rule 3.13 (3).
9. Tencent circular, "Issue of New Shares Pursuant to Share Award Scheme", 10 July 2017. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0710/LTN20170710836.pdf
10. Tencent AGM Circular, 10 April 2017, p8.
11. HKEX Listing Rules, Note (2) to Rule 17.03(3).
12. Tencent AGM Circular, 10 April 2017, "Definitions", p1. See: http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0410/LTN201704101137.pdf
13. Tencent Annual Report 2016, p98.
14. Tencent Annual Report 2016, p163.
15. Tencent Annual Report 2017, p178.
16. Ranking Digital Rights, "Corporate Accountability Index 2017", March 2017. See: https://rankingdigitalrights.org/index2017/
17. Ranking Digital Rights, March 2018. See: https://rankingdigitalrights.org/index2018/
18. Tencent Annual Report 2016, p70.
19. Tencent Annual Report 2017, p76.
20. Tencent Annual Reports 2016, p71 and 2017, p76.
21. Tencent Annual Reports 2016, p55 and 2017, p60.

Chapter Seven

CG Diagnostics

7.1 Diagnostic Questions

60 questions for assessing corporate governance in China

The following questions are intended as a handy starting point for investors who wish to assess the governance of Chinese listed companies:

Ownership and Capital Structure

1. What is the ownership structure of the company? Is there a controlling shareholder? What percentage stake do they own and has this increased/decreased over time?
2. Who are the next four to five largest shareholders?
3. Is the company an SOE, POE or of a mixed-ownership form?
4. If the company is an SOE, does it have any private individuals or entities among its top 10 shareholders? Do these private shareholders have any influence in the company?
5. If the company is a POE, does it have any state enterprises among its top 10 shareholders? Do these state shareholders have any influence in the company?
6. Who are the principal institutional investors on the shareholder register? Are they long-term investors?
7. Does the company have a one-share, one-vote capital structure?
8. If the company has a dual-class share structure, what specific investor safeguards has it put in place? Do any of these safeguards exceed the regulatory minimum?

Governance Structure and Accountability

9. Is there clear accountability for each governance body inside the company (including the Party organisation/committee, the board of directors, board committees, the supervisory board and management)?
10. How were the individuals on these committees and boards appointed? To whom are they primarily accountable?
11. How does the Party organisation/committee work with the board of directors, the supervisory board and management?
12. Has the company made any public disclosure about the role of the Party organisation/ committee? Is it useful to investors?
13. Are the roles of chairman and CEO separate? If not, why not?

Board Composition and Functions

14. What is the composition of the board of directors (ie, between executive, non-executive, and independent non-executive directors)?
15. Does the company distinguish clearly between executive, non-executive and independent non-executive directors, or does it only label them “independent” and “non-independent”?
16. Does the company meet or exceed the minimum one-third independence requirement? If it exceeds, is this due to having a small board or a conscious effort to expand the number of independent directors?

17. How were the directors, especially independent directors, nominated and appointed? What role does the nomination committee play in the process? Is it fully independent of both management and the controlling shareholder?
18. Is there a mechanism to allow minority shareholders to nominate a director? Has this mechanism ever been used in practice?
19. How does the board of directors develop the company's strategy? What role do non-executive directors, especially independent directors, play in this process?
20. How does the "skills matrix" of the board compare against the company's strategy and operations? That is to say, does the company have a board that fully understands its business risks and opportunities?
21. Has the company provided training to directors to fill any gaps in expertise or knowledge?
22. Do the non-executive directors, in particular the independent directors, meet at least once a year without executive directors present?
23. Does the company have a succession plan in place for both the board and management? How are the two plans determined?
24. What are the main governance duties and responsibilities of the board secretary?
25. Besides managing the board, does the board secretary perform any other duties or responsibilities within the enterprise?

Supervisory Board

26. What is the composition of the supervisory board (ie, between shareholder-appointed and employee-elected supervisors; and between internal supervisors who work within the enterprise and external supervisors who do not)?
27. Are any of the external supervisors truly independent of both management and the controlling shareholder?
28. How were the supervisors nominated and appointed? Could a minority shareholder nominate a supervisor?
29. What are the main functions of the supervisory board? How does it add value?
30. Does the supervisory board truly "supervise" the directors, or would it be more accurate to say that it monitors and audits them?
31. How does the supervisory board ensure it does not duplicate the work of the audit committee in areas such as financial accounts and internal audit?
32. Are there any obvious obstacles for supervisors to challenge the board of directors or management?
33. Has the supervisory board ever used its powers to call a shareholder meeting or initiate litigation against directors or management?

Remuneration

34. Is there any incentive scheme for directors and managers that links remuneration to company performance?
35. How does the remuneration of management compare to the industry average (including SOEs and POEs)?
36. If the company has adopted a share award/stock option scheme, does it set an upper limit on the percentage of outstanding shares that can be issued? (Note: Many institutional investors would oppose, for reasons of dilution, schemes greater in aggregate than 10% of issued capital.)

37. Is the share award scheme restricted to employees of the listed company? Or does it include non-executive directors, employees of affiliated companies, suppliers, advisers and any others?
38. Is the issuance of shares or options under the share award scheme linked to any corporate or individual performance targets?
39. Does the company give stock options to independent directors? If so, how does it manage the potential conflicts of interest that arise?
40. What role does the remuneration committee play in deciding or advising on executive, director and employee pay? Is it fully independent of both management and the controlling shareholder?

Audit

41. Has the company set up an internal audit department? Does this department report directly to the audit committee? Is the person in charge of internal audit appointed and evaluated directly by the audit committee?
42. Is there at least one meeting a year between the audit committee, internal audit (if there is one) and the external auditors without executives present? What issues were raised in this meeting and how were they resolved?
43. What major questions have the internal/external auditors raised with the audit committee in the past two years and how were they resolved?
44. Has the company provided meaningful, "non-boilerplate" disclosure in its annual report or website about the work of its audit committee over the past year? (See Chapter 3.6 for a guide to the types of disclosure we consider useful.)
45. Are all members of the audit committee financially literate?

Shareholder Relations

46. Have there been any disputes between the major shareholders of the company? If so, how have they been resolved?
47. Does the company meet its minority shareholders on a regular basis? Who within the company is usually tasked with this responsibility?
48. Would the company be open to allowing its directors to meet shareholders?

ESG/Sustainable Development

49. Does the company's strategy incorporate sustainable development, corporate social responsibility (CSR) and environmental, social and governance (ESG) elements? That is, does it view these issues as potential risks that need to be managed and/ or as generators of new business opportunities? Or are they dealt with more as regulatory compliance matters?
50. What role does the board of directors play in setting and overseeing sustainability strategy?
51. Does the company's CSR/sustainability/ESG report include any key performance indicators? How are these indicators decided?
52. Does the company's CSR/sustainability/ESG report follow any international reporting standard or template? Is the report audited or reviewed by a qualified third party?
53. Has the company and its subsidiaries or associates ever appeared in the violation database of the Institute of Public and Environmental Affairs?

M&A Governance

54. What standard procedures does the company follow when conducting an M&A deal (inbound or outbound)?
55. How do the board and management identify and manage the multiplicity of risks arising during the process?
56. What is the company's track record for creating value from M&A? Can the company provide examples where it has succeeded or failed? Is there a regular follow-up assessment after each deal?
57. Does the company have a strategy for defending itself against hostile takeovers?

Related-Party Transactions

58. How does the company investigate, approve and disclose significant related-party transactions?
59. What related-party transactions has the company undertaken in the past three years?
60. Does the company have a related-party transaction committee that is independent of the management and controlling shareholder?

附录

Annexes

Annexes

Biographies of Lead Authors and Editors

Jamie Allen

Mr Jamie Allen is the founding Secretary General of ACGA, which was incorporated in Hong Kong in 1999. He is a published author and has more than 30 years' experience as a writer, editor and analyst covering Greater China and East Asia from Hong Kong. Prior to ACGA, he ran his own consulting firm and carried out customised economic research for multinational clients in Asia. From 1992 to 1995, he was editor of Business Asia for the Economist Intelligence Unit and a contributor to The Economist magazine from 1994 to 1996. From 2001 to 2007, he served on the Public Shareholders Group formed by the Hong Kong Securities and Futures Commission. From 2006 to 2010, he served on the Listing Committee of the Stock Exchange of Hong Kong. He has served on the Operations Oversight Committee of the Financial Reporting Council since July 2013.

In 2017, he received an International Corporate Governance Network Lifetime Achievement Award and a Regional CG Recognition Award from the Minority Shareholder Watchdog Group of Malaysia. He is a graduate of the Australian National University, Canberra, where he received a BA (Hons) in political science and Chinese language. He studied Mandarin Chinese in Taiwan from 1983 to 1984.

Nana Li, CFA

Ms Nana Li is Senior Research Analyst for ACGA, joining the Association in February 2014. Her primary responsibilities include researching corporate governance developments in Hong Kong and China, covering these markets for our bimonthly members' publication, *Asia Regional Briefing*, and assisting with other specialised financial- and accounting-related research. She is the primary author of the China and Hong Kong chapters of *CG Watch* in 2016, and is the project manager and one of the main authors of the ACGA China Corporate Governance Report 2018.

Besides her research work, Ms Li assists ACGA's advocacy and educational work, giving presentations in Hong Kong, China and other parts of the region. In 2017 she gave speeches at the Shanghai and Shenzhen stock exchanges, Shenzhen Asset Management Association and the ACGA 2017 Annual Conference in Mumbai. She has assisted with the organisation of ACGA's annual conferences since 2014 as well as ACGA member delegations to different Asian markets. She was a primary organiser of the 2017 China Responsible Investment Forum in Tianjin, the first event ACGA has co-organised with the Asset Management Association of China and China Association for Public Companies.

A native of Hangzhou, Ms Li holds a Bachelor of Commerce (Distinction) from the University of New South Wales, Australia, with major in Finance and Accounting. She also holds a Master of Finance (Dean's Honours List) from the University of Hong Kong. In August 2017, she became a CFA charterholder.

Biographies of Contributing Authors

Dr Guo Peiyuan

Dr Guo is general manager of SynTao and chairman of SynTao Green Finance. He focuses on research and practice of corporate social responsibility (CSR) and socially responsible investment (SRI), with abundant experience in research, training and consulting services. SynTao has become a leading CSR consulting company in China with offices in Beijing, Shanghai, Guangzhou, Shenzhen, Chengdu and Washington DC. SynTao Green Finance is a founding member of the Green Finance Committee of the China Society for Finance and Banking. It is also the first CBI approved green bond verifier from China.

Dr Guo teaches at Tsinghua and Beijing Normal universities and holds a PhD in Management from Tsinghua University. He has worked with more than 100 companies, governments, and social organisations in China and abroad. He has been a judge for multiple CSR awards.

Lin Zhaowen (Maggie Lin)

Ms Lin is a corporate governance consultant at the International Finance Corporation (IFC). She served as a corporate governance officer during 2008 to 2015 with the IFC, mainly responsible for assessing corporate governance risks and formulating mitigating strategies for IFC investment clients in East Asia and the Pacific.

Ms Lin holds a Bachelor of Laws and a Bachelor of Engineering from Tsinghua University and a Master of Laws from the University of Bristol, UK. She also serves as the senior research fellow of the China Enterprise Reform and Development Society.

Dr Zhang Zhengjun

Dr Zhang is the founder and CEO of King Parallel Consulting. He leads King Parallel's SOE and corporate strategy practice. His areas of expertise include SOE reform, strategic management and corporate governance, with over 15 years of SOE reform consulting, and 20 years of strategic management consulting.

Dr Zhang was a core member of the OECD Asia SOE Governance Network, as well as a shareholder responsibility committee member at the ICGN. Currently he is an an expert at the economic group of the China Real Estate Association, a senior research fellow of the China Enterprise Reform and Development Society, and an advisory committee member of Morrow Sodali.

Formerly he was chief of the SOE division as well as Senior Research Fellow at the Development Research Centre of the State Council in China for 11 years. He holds a PhD in management from Nanjing University and a post-doctoral certificate from Renmin University of China. He was a visiting fellow of the OECD, Stockholm School of Economics and the NLI Research Institute.

Dr Zhou Chun

Dr Zhou is an Assistant Professor at Zhejiang University Guanghua Law School. Her research focuses on corporate law, securities regulation and comparative corporate governance. Dr Zhou's work has been published in academic journals including the *Law Review, Journal of Securities Law* and *Northern Law Review.* Her current research interests include hostile takeover regulation and the fiduciary duties in the asset management industry in China.

Dr Zhou received her LLB and PhD from Peking University Law School and her LLM from Columbia Law School. While studying at Columbia University, she was the editor of *Columbia Journal of Asia Law* and was named a James Kent Scholar.

Media Partner

FTChinese is the *Financial Times'* Chinese-language website, providing unrivalled news and information to China's top business executives and decision makers. The FT's international team of journalists has access to senior corporate executives and politicians both in China and around the world, making it a must-read for China's business leaders.

Supporting organisations – International

Brunswick Group helps its clients navigate the interconnected financial, political and social worlds to build trusted relationships with all their stakeholders. A global partnership, with 24 offices in 14 countries, Brunswick operates as a single profit centre allowing it to respond seamlessly to its clients' needs globally.

BSR is a global not-for-profit organisation that works with its network of more than 250 member companies and other partners to build a just and sustainable world. From its offices in Asia, Europe, and North America, BSR develops sustainable business strategies and solutions through consulting, research, and cross-sector collaboration.

The Council of Institutional Investors (CII) is a US not-for-profit and non-partisan association of pension funds, other employee benefit funds, endowments and foundations. It is a leading voice for effective corporate governance, strong shareholder rights and vibrant, transparent and fair capital markets. CII promotes policies that enhance long-term value for US institutional asset owners and their beneficiaries.

The International Corporate Governance Network (ICGN) is led by investors responsible for assets under management in excess of US$34 trillion. It is an authority on global standards of corporate governance and investor stewardship. Its members are based in more than 45 countries. ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies worldwide.

The International Finance Corporation (IFC) is the largest global development institution focused on the private sector in emerging markets. It works with more than 2,000 businesses worldwide, using its capital, expertise, and influence to create markets and opportunities in the toughest areas of the world.

Supporting organisations – China

The American Chamber of Commerce in Shanghai was founded in 1915. It is a non-profit, non-partisan business organisation. Its mission is to enable the success of its members and strengthen US-China commercial ties through its role as a service provider of high quality business resources and support, policy advocacy and relationship-building opportunities.

King Parallel is one of China's leading boutique consultancy firms. It provides solutions for government, investment holding companies and enterprises to effectively manage change, such as strategy and business model design, organisation transition, financial advisory, mixed-ownership reform and board evaluation.

PwC is a network of firms in 158 countries with more than 236,000 employees who are committed to delivering quality in assurance, advisory and tax services. In 2017, PwC firms provided industry-focused assurance, consulting and deals, and tax services for 419 of the companies in the Fortune Global 500.

SynTao Green Finance is a professional consultancy in China, focusing on providing green finance solutions and responsible investment services. With both international perspectives and rich local experience, it provides ESG data analysis and rating, green bond verification, research and consulting in responsible investment and green finance.

Valueonline is an innovative enterprise that specialises in compliance software development and one-stop financial compliance delivery services. Valueonline provides professional services to most listed companies in China. It offers a compliance management platform and trustworthy business consulting team, which fills in for the absence of service management in the RegTech field.

Wind has been the market leader in China's financial information services industry since its founding in 1994. In China, Wind serves more than 90% of financial institutions including hedge funds, asset management firms, securities companies, insurance companies, banks, research institutions, and government regulatory bodies. Abroad, Wind serves 70% of Qualified Foreign Institutional Investors (QFII).

Foreign Institutional Investor Perceptions Survey

ACGA Foreign Institutional Investor Perceptions Survey (Sample Questionnaire)

In confidence when completed

	Question	Response
1	Are you positive about the investment potential of mainland China's A share capital market over the next five to 10 years?	Yes, No, Neutral, No view
2	Did you agree with MSCI's recent decision to include 222 A shares in its emerging markets index?	Yes, No, Neutral, No view
3	Do you favour investing in privately owned companies (POEs) above state-owned companies (SOEs) in China?	Yes, No, No view
4	How would you rate the system of investor protection in China compared to developed markets in Asia-Pacific (ie, Australia, Hong Kong, Japan and Singapore)?	Higher, Similar, Lower, No view
5	Do you consider the quality of corporate governance in overseas listed mainland companies (i.e. Hong Kong, New York, Singapore) is superior to A shares on average?	Yes, No, No view
6	Do you consider the level of investor protection offered to shareholders of mainland companies listed in the United States is superior to comparable firms in Hong Kong?	Yes, No, About the same, No view
7	If your answer to Q6 was: *'Yes',* please list the measures that make the biggest difference in the US. *'No',* please list the measures that make the biggest difference in Hong Kong. *'About the same',* please list the relative strengths of each market.	Free text
8	How would you rate the quality of corporate reporting and disclosure (on financials, CG, ESG) of China A share firms compared to developed markets in Asia-Pacific (ie, Australia, Hong Kong, Japan and Singapore)?	Higher, Similar, Lower, No view
9	In five years time, how would you rate the quality of corporate reporting disclosure (on financials, CG, ESG) of China A share firms compared to developed markets in Asia-Pacific (ie, Australia, Hong Kong, Japan and Singapore)?	Higher, Similar, Lower, No view
10	For your investment process, do you consider it essential to do significant additional analysis on the corporate governance of China A share firms?	Yes, No
11	Do you understand the system of corporate governance applied in mainland China?	Yes, No, Somewhat
12	Does the individual holding the position of chairman influence your decision to invest in the following firms? A share SOEs and A share POEs.	Yes, No, Somewhat Free text (to provide justification)
13	Does the Chinese government intervene in the decision-making process of the following firms? A share SOEs and A share POEs.	Yes, No, Somewhat Free text (to provide justification)
14	Do independent directors add value to boards in China?	Yes, No, Somewhat, No view
15	If your answer to Q14 was *No*, are there common problems?	Free text
16	Do supervisory boards add value to corporate governance in China?	Yes, No, Somewhat, No view
17	If your answer to Q16 was *No*, are there common problems?	Free text
18	Does the Party committee in listed companies have a clear and accountable role?	Yes, No, Somewhat, I am not aware of the Party committee
19	Have you ever tried to engage with China A share firms, either SOEs or POEs?	Yes, No
20	If your answer to Q19 was *Yes*, were there common challenges?	Free text
21	How would you rate the degree of difficulty in engaging with such firms?	Very difficult, somewhat difficult, not difficult
22	Did any of your engagements lead to constructive outcomes?	Yes, No
23	Would you like to tell us more about your experience in engaging with Chinese listed companies?	Free text

[1] *Mandatory question*

ACGA Foreign Institutional Investor Perceptions Survey (Sample Questionnaire)

In confidence when completed

	Question	Response
24	Name	Free text
25	Email address	Free text
26	Job title[1]	Free text
27	Company name	Free text
28	In which region are you based?	Africa, Asia, Australia/New Zealand, European Union, Middle East, UK, US, Other (please specify: free text)
29	What is your firm's total global AUM (in US$)[1]	Free text
30	What percentage of your global AUM is invested in China equities listed overseas (ie, in Hong Kong, New York, Singapore)?	<1%, 1-10%, 10%-20%, 20%-50%, >50%
31	What percentage of your global AUM is invested in China A shares?	<1%, 1-10%, 10%-20%, 20%-50%, >50%
32	How do you invest in China?[1]	Through QFII, Through Stock Connect, Both of the above, We don't invest in China, Other (please specify: free text)

[1] Mandatory question

China Listed Company Perceptions Survey

ACGA China Listed Company Perceptions Survey (Sample Questionnaire)

In confidence when completed

	Question	Response
1	Are you positive about the investment potential of mainland China's A-share capital market over the next five to 10 years?	Yes, No, Neutral, No view
2	Did you agree with MSCI's recent decision to include 222 A shares in its emerging markets index?	Yes, No, Neutral, No view
3	How relevant do you think is the relationship between good corporate governance and good company performance?	Highly relevant, Somewhat relevant, Not relevant, No view
4	Do you consider the quality of corporate governance in overseas-listed mainland companies (ie, in Hong Kong, New York, Singapore) is usually superior to A shares on average?	Yes, No—they are similar, No—the quality of domestic listed companies is better, No view
5	Do you consider the quality of corporate governance in privately-owned enterprises (PoEs) is usually superior to state-owned enterprises (SoEs) on average?	Yes, No—they are similar, No—the quality of domestic listed companies is better, No view
6	In your opinion, do you think the corporate governance standards of mainland unlisted companies will have a significant impact on their ability to list?	Yes, No, No view
7	In your opinion, do you think investors are doing significant additional analysis on the corporate governance of China A-share firms in order to make their investment decisions?	Yes, No, Other (please specify: free text)
8	What is your attitude towards the ESG reporting guideline the HKEx has been promoting in recent years?	Understand and strongly support, Understand and will comply, Know about—but it is not important to me, Don't know about it
9	Do you agree that as the volume of pollution increases, listed companies will face more risks due to environmental factors?	Yes, No—the risk is the same, No—the risk has decreased, No view
10	Do you think independent directors add value to boards in Chinese companies?	Yes, Yes—but not as expected, No, No view
11	Do you think supervisory boards add value to corporate governance in Chinese companies?	Yes, Yes—but not as expected, No, No view
12	How many M&A deals (both onshore and offshore) conducted by Chinese listed companies over the past five years do you think are creating value for their shareholders?	All of them, Most of them, Half of them, A small portion of them, No idea
13	Do you think IR is the only group in your company that is responsible for talking to shareholders?	Yes, No, No view, Other (please specify: free text)

[1] *Mandatory question*

ACGA China Listed Company Perceptions Survey (Sample Questionnaire)

In confidence when completed

	Question	Response
14	Name	Free text
15	Job title[1]	Free text
16	Email	Free text
17	Company name	Free text
18	Where is your company listed? (multiple choice)[1]	Mainland China, Hong Kong, Singapore, Australia/New Zealand, United States, United Kingdom, Other (please specify: free text)
19	How long has your company been listed?[1]	<1 year, 1-≤5 years, >5-≤10 years, >10-≤20 years, >20 years
20	What is the market cap of your company (Rmb)?[1]	<100m, 100m-≤1 billion, >1-≤5 billion, >5-≤10 billion, >10 billion
21	What is the ownership type of your company?[1]	SOE, POE, mixed ownership (please specify: free text)

[1] *Mandatory question*

Asian Corporate Governance Association
Room 1801, 18th Floor, Wilson House
19-27 Wyndham Street, Central, Hong Kong SAR

+852 2160 1788 | www.acga-asia.org

ISBN 978-988-78682-2-4