CORPORATE GOVERNANCE IN CHINA

Scores for Chinese companies cluster around the median relative to global peers, VIEs and SOEs have distinct governance risks

September 2017

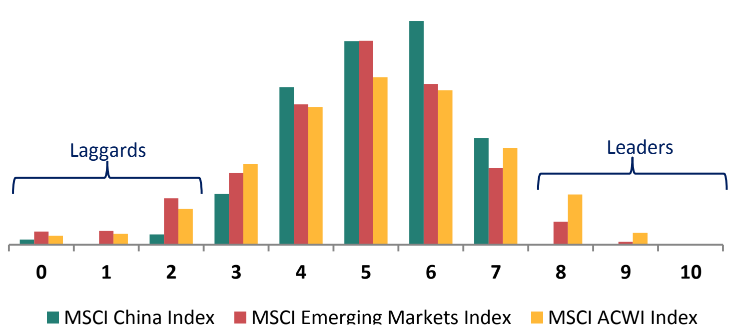
CHINA IN CONTEXT

Recognition of the importance of corporate governance principles has a long history in China. China's first corporate governance code was introduced by the China Securities Regulatory Commission (CSRC) in 2001, ahead of many APAC peers, and updated further in 2011. In August 2016 a review of this code was announced by the Chairman of the CSRC, and other legislative reforms are also under review. As more and more global investors consider investing in Chinese equities, the importance of these efforts to adopt and adhere to global standards of good corporate governance can only continue to grow. Our report examines the many opportunities – and risks – presented by current corporate governance practices in China, based on the expectations of these potential investors.

The expectations of global investors regarding the governance of publicly traded companies have been guided by the adoption of corporate governance codes and standards across virtually all global markets, beginning with publication in the UK in 1992 of "Financial Aspects of Corporate Governance", more widely known as the "Cadbury Report". According to Cadbury, "The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place," and "The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting." These core principles have been used to inform the definition of good corporate governance ever since.

Contents

CORPORATE GOVERNANCE SCORE



Top 5 Scores

China Shenhua Energy Co Ltd	7.2/10
China Merchants Bank Co Ltd	7.2/10
China Telecom Corporation Ltd	7.2/10
Sun Art Retail Group Ltd	7.1/10
Lenovo Group Ltd	7.1/10

Bottom 5 Scores

Alibaba Group Holdings Limited	0.0/10
CTRIP.COM International Ltd.	1.6/10
JD.COM Inc.	2.1/10
Netease, Inc.	2.7/10
Huaneng Renewables	2.8/10

This report is based on the 149 constituents of the MSCI China Index as at 11 September 2017. Some references are made to other Chinese companies in coverage.

KEY FINDINGS

- China adopted its first corporate governance code in 2001, ahead of many APAC peers, and with updates in 2011 and 2016. As China's market becomes more accessible to global investors, corporate governance practices will likely face increased comparison to global standards. This report examines the opportunities and risks to minority shareholders presented by current corporate governance practices in China.
- In aggregate, constituents of the MSCI China Index cluster more around the median score on corporate governance relative to constituents of the MSCI ACWI Index. Key areas of concern include pay and board issues (no independent chair, no independent board majority), controlling shareholder and related party transaction conflicts, and limited shareholder protection rights. Regulatory oversight differences between A-share (Mainland China) and H-share (Hong Kong) listings, in some cases for the same company, contribute additional layers of risk and complexity.
- Companies employing variable interest entity (VIE) structures are large (16 companies with constituent weights on the MSCI China Index of 12% as of 1 August 2017) and show generally strong returns. But VIE governance structures are often tilted to favor the founder and ownership risk is increased due to legal uncertainties.
- In contrast to private enterprises, over the past five years shareholder returns at Chinese state-owned enterprises (SOEs) have underperformed the MSCI China Index. The Chinese State has undertaken a multi-pronged reform program aimed at improving returns, but the possibility of misalignment between the strategic interests of the state and those of minority shareholders remains a key governance risk.

MARKET CHARACTERISTIC | VARIABLE INTEREST ENTITIES

Despite being some of the largest, most discussed companies in China, four of the bottom five governance assessments for constituents of the MSCI China Index utilize a variable interest entity ('VIE') structure.

Under current Chinese legislation, foreign investors are not permitted to invest directly in Chinese companies that operate in key industries, e.g., internet, education and telecommunications.

RISK – GOVERNANCE STRUCTURE FAVORS FOUNDERS

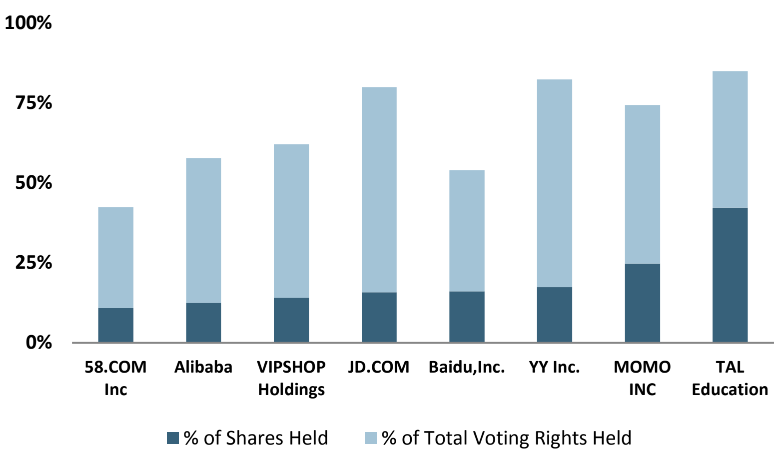
- Many VIEs retain founder involvement. Due to the nature of the contractual relationships and the associated risks, the reputation and equity commitment held by the founder is often key to an IPOs success.
- Founders typically use three primary tools to maintain a tight grip on the control of the listed SPV – a dual share class structure granting them superior voting power; incorporation in a management-friendly jurisdiction; and dominating the board, often via the key role of Chairman while retaining executive powers.

CAPITAL AND OWNERSHIP STRUCTURE

Dual Share Classes with Unequal Voting Rights

Among the 12 VIEs that are founder firms, eight utilize dual class share structures with the share class held by the founders carrying superior voting rights. This arrangement has allowed the founders to reduce their capital investment while maintaining control of the company. With this dual class share structure not permitted in Hong Kong,[1] these eight companies are listed on U.S. stock exchanges as a foreign private issuer.

Figure 1 | Disparity between Founder Ownership and Voting Rights at VIEs



Source: MSCI ESG Research. Data as at 27 July 2017

[1] This approach is not viable on Hong Kong Exchanges & Clearing (HKEX) as a result of the opposition to dual class shares by the Securities and Futures Commission in October 2015 which aborted an earlier consultation to allow dual class shares to be listed on HKEX. In June 2017, HKEX started a consultation with a view to allowing dual class shares on a new board http://www.hkex.com.hk/eng/newsconsul/hkexnews/2017/170616news.htm.

DEPRIVATION OF SHAREHOLDER PROTECTION RIGHTS

The VIEs are typically incorporated in the Cayman Islands with some utilizing the Cayman Islands 'Exempt Companies' provisions. Two provisions are of particular concern – the absence of legal requirement to hold AGMs and setting the requisition threshold for an EGM at an excessively high level. Hong Kong Listing rules specifically require the holding of AGMs.

- **Last AGM …**

Two VIEs have taken advantage of the flexibility under the 'Exempt Companies' regime to avoid the holding of AGMs.

	Baidu	JD.com
Last AGM >>	2008	None since 2014 IPO

In their respective Articles of Association, **Alibaba**, **Baidu** and **JD.com** have taken advantage of the Cayman Islands 'Exempt Company' provisions to impose unusually high thresholds to request an EGM.

- **EGM Threshold versus Aggregate Voting Rights of Minority Shareholders**

	Baidu	JD.com	Alibaba
EGM Threshold >>	50%	33.3%	33.3%
Aggregate Voting Rights of Minority Shareholders >	30.8%	20.0%	45.2%*

**Those shares not held by the executive officers (10.6%), Softbank (29.2%) or Yahoo (15.0%).*

Given the size of the respective controlling interests at Baidu and JD.com, the minorities are left unable to take remedial action through convening an EGM. At Alibaba, some 75% of minority shareholders would need to collaborate to request an EGM, a near impossible task.

MARKET CHARACTERISTIC | STATE OWNERSHIP

In contrast to VIEs, which dominate the MSCI China Index in terms of capitalization but represent a small number of companies, about 90 companies in our dataset (59.7%) are State-owned.

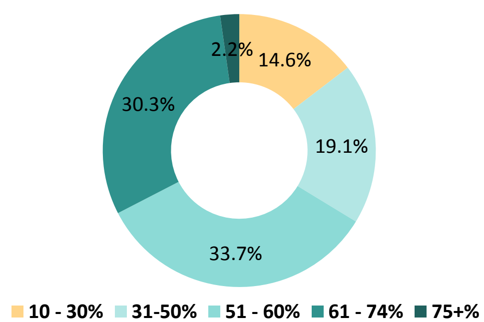
ORGANISATION OF STATE OWNED ENTERPRISES

In China, some 102 central state-owned enterprises (SOEs) are supervised by the State-owned Assets Supervision & Administration Commission (SASAC). SASAC appoints and provides training to the directors of these central SOEs. It decides on their remuneration and sets profit targets for these SOEs. There are also local SOEs supervised by local bureaus of SASAC in the various different provinces/municipalities.

HOW MUCH EQUITY IS HELD BY THE STATE?

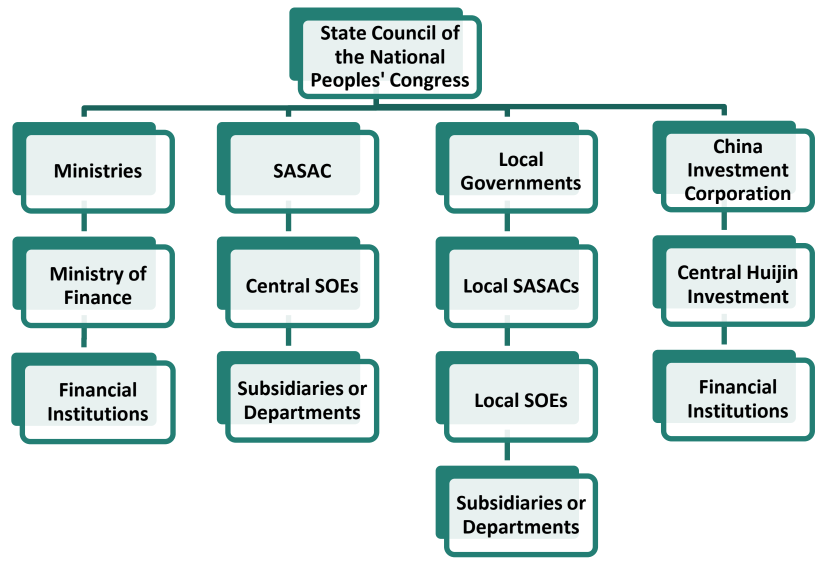
The state typically holds a majority stake (MSCI ESG Research and local regulations both utilize 30%+ of the voting rights as the threshold for a majority stake).

Figure 2 | Percentage of State Holdings at MSCI China Index SOEs



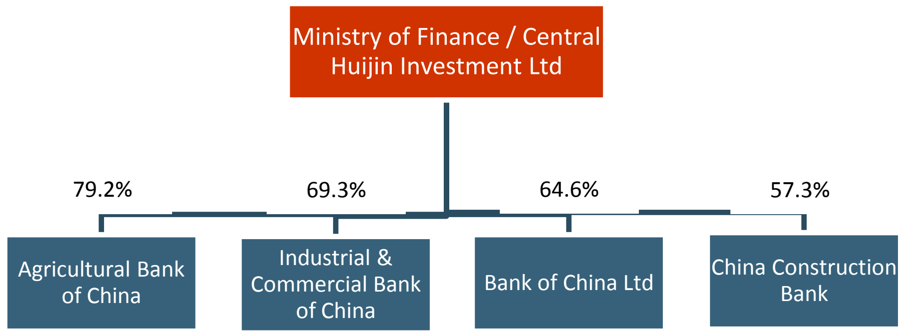
Source: MSCI ESG Research. Data as at 27 July 2017

Figure 3| Relationship between Chinese Government, SASAC , SOEs, Huijin and MOF



Source: MSCI ESG Research

Figure 4 | Common Control in Banking Sector



Source: Company Annual Reports.

RISK – MISALIGNMENT OF INTERESTS IN SOE FIRMS

- Shareholder returns at Chinese SOEs underperform relative to both other MSCI ACWI Index SOEs and other MSCI China Index constituents, given possible misalignment of interests within SOEs.
- The SOE reform program represents an effort to address this possible misalignment in the long term. The previous 2013-14 reform initiatives have shown limited progress to date. SASAC set three key goals for listed SOE companies in 2017, a sign of continued focus on the SOE reform process.
- One of the SOE reform tracks is to make boards more autonomous. In general Chinese SOE boards include government representatives and sector expertise, but most boards do not have a majority of independent directors, while 75% of Chairman roles are executive positions.

2013-14 SOE REFORM INITIATIVES

Since the November 2013 third plenum of the Central Committee of the CCP, SOE reform has been on the agenda for the Chinese government. However, instead of wholesale financial reform, the SOE reform process has been one of incremental changes, using the various approaches below.

One of the themes of SOE reform has been to change state control from *management of company* to *management of capital*.

- *Management of Capital*: establishing state-owned capital investment and operation companies, transferring the equities in SOEs from SASAC to these companies.
- *Mixed ownership reform*, allowing non-state capital to share ownership of SOEs together with SASAC-controlled state-owned parents, with a view to sharing board control with non-state interests.
- Giving company *boards more autonomy* to make decisions, segregating party control and management/board control under the legal framework.
- *Mergers in strategic sectors* including railways, telecommunications, energy (e.g., coal and power companies), shipping and steel.
- *Increasing dividend payouts* by SOEs.

In our June 2015 report "China's Economic Transformation: A New Era of ESG Opportunity," we highlighted that the new round of SOE reform would aim to enhance corporate efficiency through mixed ownership and incentivized pay. However, progress has been limited to date.

Increasing Dividend Payments

In 2014 MOF raised the ratio of profits to be handed over by SOEs to the government. More than 120 SOEs administered by the central government would pay 5 percentage points more of their profits.The plan divided the SOEs into five categories that would be required to pay between zero and 25 percent of after-tax profits as a dividend to the government.[2]

Figure 5 | Required Dividend Payments at SOEs

Required % of Post-Tax Profit as Dividends to the State	Applicable Companies
25%	China National Tobacco Corporation
20%	14 companies, including energy companies such as China Petrochemical Corporation and telecom carriers such as China Mobile
15%	70 companies, including railway-related companies such as China Railway Engineering Corporation and resources companies such as Aluminum Corporation of China
10%	30+ firms, including nuclear energy and culture companies

Source: MOF data (www.mof.gov.cn)

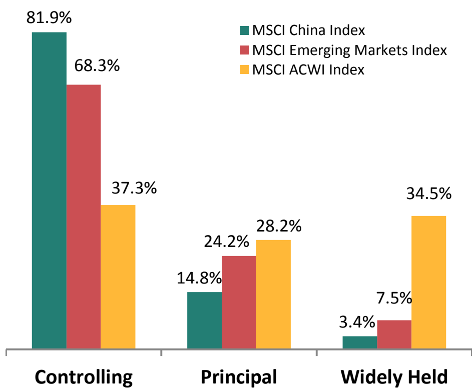
[2] http://www.globaltimes.cn/content/858820.shtml

OWNERSHIP SNAPSHOT

Governance risks vary widely depending on the nature of the company's ownership, the separation of ownership and management, and the design of the capital structure and its impact on shareholders' voting rights.

Largest Owner Classification

Concentrated ownership dominates in China, where 81.9% of MSCI China Index constituents include a shareholder or shareholder group, often the State itself, who controls 30% or more of the voting rights,



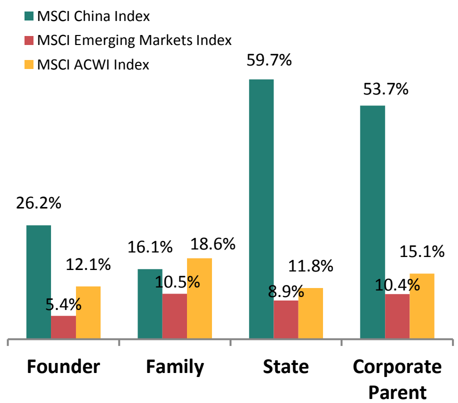
Controlling – Largest shareholder or shareholder group holds 30% or more of the voting rights.

Principal – Largest shareholder or shareholder group holds between 10% and 30% of the voting rights.

Widely Held – No shareholder or shareholder group holds more than 10% of the voting rights.

Key Owner Types

Most Chinese firms are state-owned at 59.7%, often controlled by other state companies via intermediate holding companies. At 26.2%, founder firms are the next most significant group, and many of these are VIEs (variable interest entities, see page 3).



Founder – Founder serves as Chairman or CEO

Family – Family hold 10% or more of the voting rights and maintain at least one board seat

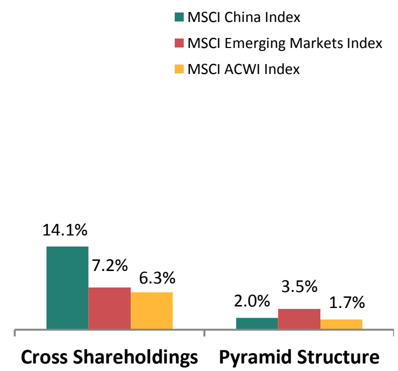
State – State directly or indirectly controls 10% of the voting rights

Corporate Parent – Issuer is a subsidiary (30% or more) of a corporate, which itself may be listed

**Owner types may overlap or separate owners may be of different types at a company*

Complex Ownership Structures

Few MSCI China Index constituents are party to cross shareholdings or positioned at levels 3 or below in a stock pyramid, although the pyramidal nature of many of the SOEs (state owned entities) is noted.

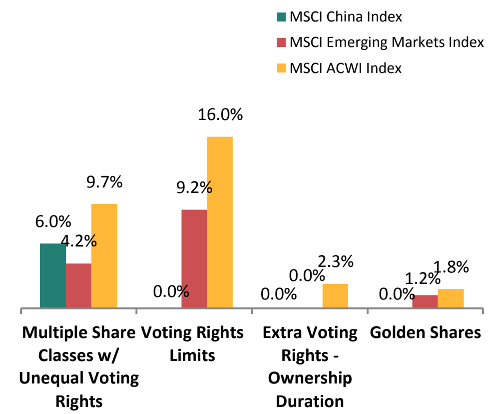


Cross Shareholdings – Two or more entities hold at least 0.5% of shares in each other, or via a circular or more complex cross-shareholding arrangement.

Pyramids – Control is exercised through a chain of non-controlled companies, which ultimately results in a shareholder gaining voting power that is misaligned with their economic interests.

Control Enhancing Structures

Companies with unequal voting rights are generally listed on US exchanges (variable interest entities, see page 3). In a market where 81.9% of companies are controlled, such control enhancing structures are not really needed, and yet they are employed anyway.



Multiple Share Classes with Unequal Voting Rights (or no voting rights for one class) or classes which carry different rights to vote on director appointments.

Voting Rights Mechanisms include ceilings on ownership or voting rights, voting rights limits based on nationality, or additional voting rights accruing depending on ownership duration.

Golden Shares – Government veto rights for transactions or changes to governing documents.

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