GOVERNANCE

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Governance across the board

'The often shocking responses to these survey questions and interviews expose high levels of ignorance about the role of the independent director and what governance even entails, amongst the public, policy-makers and even among directors themselves.'

Gerry Brown

China companies' VIE structure

'The VIE structure has provided a workaround structure or shortcut for Chinese companies to access foreign capital over the past 30 years. However, Chinese companies need to understand the risks of the VIE structure and disclose the risk properly for the awareness of investors.'

Lyndsey Zhang

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Publisher
Lesley Stephenson
Tel: +44 (0) 1278 793300
Email: lesley@governance.co.uk

News Editor
Katharine Jackson
Email: katharine.jackson@governance.co.uk

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News

Annual reporting in 2019–20

UK companies have 'adapted well' to the recent overhaul of corporate reporting requirements but need to demonstrate the link between intention and action more explicitly, according to EY's latest review of 100 FTSE 350 annual reports for 2019–20, the first affected by the overhaul of corporate reporting requirements.

The Review, *Annual Reporting in 2019–20: From Intent to Action*, explores key aspects of narrative reporting including: meaningful reporting; purpose and culture; managing risk and viability; UN Sustainable Development Goals (SDGs) and climate change; stakeholder engagement and Companies Act 2006, s 172; and workforce engagement and diversity.

Meaningful reporting

Some companies took the opportunity in their 2019–20 annual reports to rethink their reporting in light of the FRC's new 2018 UK Corporate Governance (UKCG) Code and the Miscellaneous Reporting Regulations (MRR). Companies still seem largely focused on meeting all provisions of the 2018 Code: 61% complying with all provisions and 80% with all but one provision. There were some good explanations for specific cases of non-compliance and explanations of plans for compliance in the following year. Most companies, however, provided little evidence of how they applied the Principles and ended up repeating the Principles as statements of fact. While progress continues to be made in the strategic report, governance reporting mostly remains boilerplate. However, companies have improved their KPI disclosures, with many now including more non-financial metrics and there were examples of meaningful reporting.

Purpose and culture

Eighty-six per cent of companies now articulate a purpose, though very few articulate the link to their business strategy. Some companies have started making the purpose narrative an integral part of their story and the expectation that a company's purpose should benefit all its key stakeholders has now become mainstream. As lockdowns progressed, the narrative on how companies were realising their purpose for the benefit of society began to shift from explaining how companies earmarked funds to support society to detailing how they were contributing to fighting the virus in the context of their business.

Culture has moved up the board agenda and the majority of companies make some reference to how culture is monitored. However, very few discuss exactly how they do this or the resulting actions. The vast majority attempt to describe their culture in a compelling way by setting out their values, but too often descriptions become boilerplate. Companies have been making progress in explaining how culture helps to protect value but struggle to articulate how culture supports the achievement of their strategic objectives.

Managing risk and viability

The vast majority of companies only make generic references to emerging risks when describing their risk management processes, however, an increasing number are disclosing specific emerging risks. The most common ones relate to environmental and technology issues, followed by geopolitical issues. Some companies disclose climate change as both a principal and an emerging risk. In line with investors' expectations, companies have started to explain how Covid-19 impacted their risks and how management responded.

Climate change and SDGs

The majority of companies most affected by climate change now acknowledge that it forms a material risk or opportunity for their company, but there has been limited progress in improving the quality of climate-related disclosures. More than half of companies are disclosing climate change targets and 56% reference SDGs in their ARAs. Not all companies, however, explain the actions they have taken, or plan to take, to meet their commitments.

Stakeholder engagement

Some companies clearly explain who was involved with engagement and some disclose more about the impact of stakeholder engagement. However, 45% do not clearly identify principal decisions or provide any narrative to illustrate how stakeholder considerations affected decisions taken. Most companies focus on stakeholder considerations rather than addressing broader factors, such as long-term consequences of decisions and their impact on a company's reputation and standing.

Workforce engagement

Some companies clearly define their workforce, however many disclosures focus on processes around workforce engagement. It is more important for companies to give insights into the engagement outcomes and the impact of those outcomes on board decisions. Insightful disclosures clearly explain the engagement mechanisms in place and why they were chosen.

Fifty-six per cent of companies disclose broader aspects of their board diversity (beyond gender diversity), the most frequently reported metrics being nationality, tenure and age. Surprisingly, only 12% report the ethnic diversity of their board. Some also report transparently on board diversity policy, however reporting of broader diversity and inclusion below board level remains limited to policies and commentary on initiatives.

For the full Review go to: https://go.ey.com/2GnfEVd

International

European 2020 AGM season

The 2020 annual general meeting (AGM) season was substantially affected by both the Covid-19 pandemic and the implementation of the Shareholder Rights Directive II (SRD II) across the EU, according to Georgeson's *2020 AGM Season Review* of eight major European markets (the UK, the Netherlands, Germany, Spain, France, Switzerland, Italy and Denmark).

The Review found that restrictions on physical attendance during the pandemic, as well as legislative or regulatory challenges in permitting the swift move to alternative 'virtual meetings', impacted voting in over 80% of AGMs held across seven of the eight markets (excluding Denmark) and at least 90% or more of AGMs that took place in the UK, France, Germany, Switzerland and Italy. The pandemic also prompted many corporate boards to announce temporary reductions in executive pay as well as cancelling, postponing or reducing dividend payments.

Impact of Covid-19

The Covid-19 outbreak had a major impact on the 2020 AGM season. Many AGMs were postponed, live voting rights restricted (across the seven main European markets 79.6% of AGMs had live voting rights restricted, both physically and virtually) and changes were made to dividend and remuneration proposals. In Italy shareholders were barred from attending AGMs and could only attend by granting a proxy to an appointed representative who would act for all shareholders. In the Netherlands the government stipulated that, where attendance at the meeting was barred, shareholders had the right to follow the meeting via electronic means and submit questions on agenda items up to 72 hours before the meeting. In Switzerland from mid-March onwards, shareholders were also banned from attending AGMs and were given the choice to exercise their voting rights in writing, electronically or through a proxy.

Executive remuneration

Executive remuneration was amongst the most contested resolutions in the majority of the markets despite a 9% overall reduction in contested votes since 2019. Some boards took steps to apply temporary changes to executive pay, without regulatory intervention, ranging from salary reduction, elimination of annual bonuses to suspension of dividends. The countries with the highest percentage of public companies announcing a temporary reduction in executive pay were: France (70%), UK (44%) and Germany (33%), whilst in Denmark no public companies announced a reduction in executive pay.

Swiss companies saw the highest level of contested remuneration proposals amongst the countries reviewed. Across the FTSE 100, UK companies experienced nearly three times more votes on remuneration policy in 2020 than 2019 (though saw the lowest level of opposition to remuneration

'The pandemic also prompted many corporate boards to announce temporary reductions in executive pay as well as cancelling, postponing or reducing dividend payments.'

reports since 2015). However, there was a 50% decrease in the proportion of remuneration policy votes receiving more than 10% shareholder opposition. There was also a 43% reduction in the proportion of remuneration report votes that were contested. In France, there was a significant increase (nearly 75%) in the total number of remuneration proposals. The proportion of all remuneration proposals that were contested with 10% or more shareholder opposition decreased by 30%.

Shareholder Rights Directive

The introduction of the SRD II across the EU meant that executive remuneration continued to be a flash point for investors. The market most affected by this change has been the Netherlands. In 2020 every company in the Netherlands held a vote on executive remuneration, whereas only a third of companies held votes in 2019. Germany delayed SRD II implementation until the 2021 AGM season and in 2020 remained the only major European market without a mandatory annual remuneration vote.

Dividend distribution

Another clear impact of the pandemic was on distribution of dividends. Most companies across Europe were impacted by lockdowns and, as a result, profit distributions have seen major disruption. Many companies chose to cancel, postpone or reduce their expected dividend distribution. The three countries with the highest percentage of public companies that did so were: France (70%), Spain (51%) and UK (49%), with Switzerland the lowest (20%).

Director elections

Director elections remain an area of focus and negative votes. However, across the eight European markets covered, there was a calibrated 24% decrease in contested director elections from 2019. The Review also shows that the vast majority of resolutions that received high levels of opposition from investors were also opposed by proxy advisors.

The 2021 AGM season is likely to continue to be affected by the pandemic, social and environmental issues as well as SRD II. Measures taken by companies this year and emphasis on matters such as executive pay moderation will have a long-term impact.

For the full Review go to https://bit.ly/3cRJeOA

International

Board oversight of diversity, equity and inclusion

As boards continue to discuss the importance of dismantling systemic and institutional racism, many are looking at the board itself and the management team to understand where they can help create a more diverse and inclusive environment throughout the organisation, focussing on the organisation's diversity, equity and inclusion (DEI) goals.

A recent NACD *Briefing, Board Oversight of Diversity, Equity, and Inclusion to Combat Racism*, aims to help boards: understand their role in dismantling systemic racism; provide oversight of the CEO and management's efforts on DEI; and consider frameworks and metrics to evaluate progress on achieving DEI goals. Boards that plan to publicly support issues of inclusion and equity need to reflect those values internally, from board recruitment to committee work and ongoing board dynamics. They must focus on diversity in the executive team, considering not only where they source director candidates from but also the actual skills needed in the boardroom, to create a list of board-ready, diverse candidates.

Executive team diversity
Boards should bring new talent into the boardroom and ensure new directors are fully engaged. The following actions are effective in combatting systemic racism in the boardroom:

- requiring recruiters to provide a diverse list of candidates for all board and management searches;
- analysing boardroom demographics to understand minority representation;
- undertaking a serious review of the board's culture and level of inclusivity; and
- building the talent pool by engaging in proactive succession planning for the board and management team, ensuring diverse candidates across the organisation.

Role of the CEO
CEOs have a crucial role in DEI and must be committed to change. Directors should push their CEOs to truly create and embrace diversity by:

- clearly mapping out the board's expectations for diversity throughout the company;
- making diversity a goal tied to the CEO's compensation plan, using quantitative metrics alongside qualitative assessments;
- considering using employee engagement surveys and tracking organisational demographics, as a quantitative measure of success on the CEO's DEI strategies; and
- making DEI a regular board agenda item, requiring updates on DEI initiatives.

Frameworks supporting DEI
In order to make diversity a measurable goal the metrics needed from senior management should be clearly articulated. Frameworks can be helpful in achieving this, as well as in showcasing board commitment on DEI to shareholders. Possible frameworks include: a People, Purchasing, and Philanthropy (PPP) Framework or a Paradigm for Parity Framework.

A PPP Framework focuses on an inside-out approach, the primary emphasis being on internal people operations. There should be a complete people strategy integrating diversity from the ground up and the importance of focusing on employees and other stakeholders during conversations around DEI should be stressed. The second element looks at the organisation's allocation of resources, primarily through its purchasing power. It encourages companies to consider with whom it is conducting business. Philanthropic contributions are the last element of a DEI strategy. Directors should work with management to understand where the organisation is spending to support minority populations and initiatives.

The Paradigm for Parity Framework uses a five-point action plan to address gender equality in organisations, focusing on uncovering unconscious biases, evaluating and targeting diversity throughout the company and ensuring performance is the key factor for promotion.

Data is also important in improving DEI, particularly for discussing progress on achieving diversity with the management team. Including an executive compensation dashboard can result in increased diversity. Publishing the information in the dashboard in the annual report can provide investors and other stakeholders with evidence of transparency and accountability for expanding diversity within the company.

Oversight of DEI
The following actions, taken from each of the frameworks, are key in providing oversight of DEI practices:

- address the organisation's own internal DEI practices, ensuring the board understands the company's DEI performance, including recruiting, retention, promotion and pay practices at all levels of the organisation;
- present a clear strategy to address any DEI gaps;
- consider publicly disclosing a breakdown of corporate employees by race/ethnicity, job function, roles and responsibilities;
- conduct and present a pay equity audit focusing on minority employees;
- work with management to define a goal for the organisation's engagement with third-party, minority-owned organisations; and
- understand management's philosophy for corporate giving and ensure that the philosophy reflects the company's values.

Diversity is now a priority for boards and organisations. Directors who want to effect a change have an opportunity to drive progress by using frameworks, metrics and holding management accountable.

For the full Report go to: https://bit.ly/3nb2mvA

Global News

Director conduct guidelines in Malaysia

New director conduct guidelines to strengthen board governance and oversight in listed issuers and their subsidiaries have been issued by the Malaysia Securities Commission (MSC). The Guidelines set out the duties and responsibilities of boards in company group structures and the requirements for the establishment of a group-wide framework, with an emphasis on oversight of group performance and the implementation of corporate governance policies. Three core areas are covered in the Guidelines: conduct requirements for directors; maintaining proper records and accounts; and group governance.

Conduct requirements for directors – directors are to ensure that they act in the best interests of the corporation whose boards they sit on, even if they have been appointed as a representative of a shareholder. They must exercise reasonable care, skill and diligence and ensure that there is a full discussion of decisions.

Maintaining proper records and accounts – directors must seek to ensure that accounting records and other records are kept for proper preparation and audit. This also extends to records of subsidiaries. If records are kept overseas, MSC may request that directors produce those records in Malaysia and recommend how those records are to be kept in Malaysia.
Group governance – A listed corporation and its directors must ensure that there is: an adequate group-wide framework for co-operation and communication between a listed issuer and its subsidiaries to enable it to discharge oversight, governance and risk management responsibilities; a group-wide framework on corporate governance which must include the establishment of a code of conduct and ethics and policies and procedures on anti-corruption, whistleblowing, managing conflict of interest, managing material sustainability risks and board diversity including gender diversity; and an adequate group-wide framework for co-operation and communication on strategy, risk (including material sustainability matters) and financial and non-financial matters. A subsidiary of a listed corporation and its directors must provide any relevant information requested by the listed corporation to enable the board to oversee the performance of its subsidiaries effectively, including assessing non-financial performance of the group.

The Guidelines are applicable to directors of Malaysian listed corporations and directors of subsidiaries of a listed corporation whether incorporated in Malaysia or otherwise, came into effect on 30 July 2020, with the exception of the Guidelines on group governance which will come into effect on 1 January 2021.

The full Guidelines can be found here: https://bit.ly/3hrFeF2

Updated guidance about directors' duties in UK

The Chartered Governance Institute has published practical guidance for directors of companies, primarily quoted public companies but equally applicable to private companies, about their general duties under the Companies Act 2006, including an additional section on the new s 172 reporting requirement. Practical guidance is offered to directors and gives examples of how the key factors in s 172 might be considered in decision-making.

All large UK companies are required to publish a s 172(1) statement on their website and in the annual report, which shows how directors have discharged their duty under s 172. The information contained in the statement should focus on matters that are of strategic importance to the company, and will depend on the circumstances, size and complexity of the business, but is likely to include: the issues, factors and stakeholders the directors consider relevant under s 172(1) (a) to (f) and how they have formed that opinion and the primary methods used to engage with stakeholders in order to understand the issues they need to consider.

Boards must demonstrate how, in relation to the company's decisions and strategies, the directors have had regard to: the longer-term consequences of board decisions; the interests of the company's employees; relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; safeguarding the company's reputation; and the requirement to act fairly between members of the company. The board should also be able to demonstrate how a company has undertaken effective engagement with material stakeholders.

The statement will need to be included within the Strategic Report but a statement on the factors relating to employee engagement and regarding business relationships will need to be included in the Directors' Report, or cross-referenced to the statement in the Strategic Report.

Directors will have obligations and responsibilities beyond the general statutory duties covered in the Guidance. Directors must act in accordance with their company's constitution and companies may, through their Articles of Association, go further than the general duties by placing more onerous requirements on their directors. If directors breach their duties, they could face civil action and, in some cases, criminal sanction.

The Guidance can be downloaded at: https://bit.ly/2GfyFIU

Global News

Disclosure requirements for asset managers

New European rules on sustainability-related financial disclosures (SFDR) in the financial sector will come into force from March 2021. The new regulatory framework is intended to drive sustainability in an effort to make EU financial markets more sustainable. It comprises two key aspects: the EU Taxonomy Regulation and the Regulation on Disclosures. The new rules will have a wide scope and will impose ESG requirements for a broad range of financial services participants, including investment firms and fund managers (which will include non-EU fund managers), that market funds in the European Economic Area under the National Private Placement Regime.

Taxonomy Regulation

The Taxonomy Regulation aims to establish an EU-wide classification system intended to provide companies and investors with a framework to identify the degree at which their economic activities can be considered to be environmentally sustainable. It will establish a common language and a classification tool to help investors and companies make informed investment decisions as to what can be considered environmentally sustainable economic activities. The majority of the provisions of the Taxonomy Regulation will apply from 31 December 2021.

SFD Regulation

The SFDR requires investors and asset managers to disclose how they integrate ESG factors into their risk processes. The disclosure requirements are wide-ranging (50 sustainability measures, of which 30 are mandatory) and disclosure is prescriptive. As part of their duties towards investors and beneficiaries, companies in scope will have to integrate ESG factors into their investment decision-making processes.

Companies and advisers will be subject to additional disclosure obligations when the financial product promotes environmental and social characteristics, or has sustainable investment as part of its objective or has a reduction in carbon emissions as its objective. At product level, sponsors will be required to review their whole portfolio and consider a range of complex metrics to ensure compliance.

The majority of the SFDR provisions will apply from 10 March 2021. Further guidance is expected at the end of 2020 that will set out in more detail how the disclosures should be made. Unless the transitional period is extended beyond 10 March 2021, when the SFDR takes effect, the requirements under it will not apply in the UK.

Virtual board meetings in Australia

'More than half of company directors expect virtual meetings to replace face-to-face meetings only occasionally on an ongoing basis', according to a survey, *Governance through a crisis*, by the Australian Institute of Company Directors and the Governance Institute. Forty-one per cent of respondents said board meetings had become more frequent, 34% said board meetings had become shorter after moving to a virtual platform and 42% said they would meet virtually 'frequently' going forward.

Main challenges in moving online include the impact on boardroom dynamics and security of digital platforms. Key benefits arising from virtual meetings include: increased participation resulting from the removal of physical and geographical barriers to attendance; greater diversity of stakeholders attending; and significant cost savings.

Virtual meeting protocols

Though organisations have largely had a positive experience with virtual meetings, a key challenge is the disruption to boardroom dynamics and the impact this can have on director-director and board-management relations. This is compounded by the challenges of trying to read body language to pick up non-verbal cues, as well as the lack of informal conversations that can help build relationships, provide insights and generate ideas. This becomes even harder if the board has new members and there is no pre-existing relationship.

Virtual meetings underscore the importance of an effective Chair and require greater discipline and focus from all attendees. The Chair has a vital role in running through important virtual meeting protocols at the start of each meeting, establishing the ground rules upfront and regularly reviewing their effectiveness. Directors and executives need to bear in mind how their behaviour has to change in order to support the flow of meetings.

Security of platforms

Forty-three per cent of respondents revealed that the security and stability of virtual platforms has presented the greatest governance challenge. Organisations have also discovered that the move to virtual platforms is heavily reliant on directors' home IT systems and directors' competence both working with, and trouble-shooting, virtual meeting technology. The move to the home office environment and remote working has also had implications on data security for many organisations. There is certainly a role for technology in promoting agility and getting boards together quickly. Organisations should also consider how technology could have a positive impact on director recruitment and board diversity.

Feature

Governance across the board

Based on a landmark survey of the health, sports, charities and universities sectors **Gerry Brown** looks at how governance can be improved for the benefit of society as a whole.

Our society depends on its institutions being well-governed. But today, in the UK and around the world, we are facing a crisis of governance. And that was before Covid-19 (sadly) threw these problems into even sharper relief. In nearly every type of institution, private, public or third sector, we see a rising tide of scandals and failures. Indeed, the institutions we depend on are letting us down.

What is to be done? These scandals and mis-steps keep happening – as we argue in our new book *The Independent Director in Society* – because independent directors and Chairs of boards are failing to discharge their duty; or even, in some cases, understand what that duty is. Our analysis of the present situation along with our recommendations and conclusions are based on extensive original research including interviews and surveys conducted by Henley Business School involving thought leaders, key executives and staff across four important but often under-investigated sectors – health care, universities, sport and charities. The often shocking responses to these survey questions and interviews expose high levels of ignorance about the role of the independent director and what governance even entails, amongst the public, policy-makers and even among directors themselves.

This state of affairs has implications for us all. It is not just the institutions themselves, but the wider economy which could suffer. Historically, Britain has enjoyed a reputation for good governance (and abiding by legal agreements), one of the factors that made Britain an attractive place for international firms to invest and international organisations to locate offices. But if the present situation carries on and governance standards continue to slide, that reputation will be lost. That could lead to a loss of competitiveness for the entire nation, especially post-Brexit (however that eventually turns out).

Before we go any further, there is a sharp distinction between governance and management, and the role of the former is not always fully appreciated. The day-to-day running of these institutions is the task of the *executive* team and the managers who report to them. They prepare budgets, execute strategy, deliver products and services to clients and customers, and do all the myriad things any organisation must do in order to carry out its mission.

Governance, on the other hand, is about oversight. Managers and executives come and go, but governance structures are permanent. It is the independent directors – sometimes also known as non-execs, governors or trustees, depending on the type of institution – who are the real custodians of the organisation. Their task is to ensure that the organisation stays focused on its mission, balances the interests of its stakeholders and works to the benefit of all. Theirs is the ultimate responsibility. If the organisation has a failure or breaks down in some way – a human or financial scandal, perhaps, or a case of corruption, or a breach of regulations or procedures that puts people's lives in danger – it is up to the independent directors to put things right. It is also part of their role to ensure that these failures do not happen in the first place.

'Equally, issues and solutions from one sector can cross-pollinate or apply to others and to government or policy makers.'

If we are to place matters of governance centre stage, we felt we needed to survey, analyse and discuss the opportunities, problems and solutions to the governance crisis right across society rather than just narrowly focus upon the business sector. Bringing a joined-up approach and broad perspective to these important sectors of society showed – despite the very different environments, opportunities and challenges each sector faces – that they also have many issues, behaviours and problems in common. The same problems require, in many cases, the same solutions. Sometimes they don't. Equally, issues and solutions from one sector can cross-pollinate or apply to others and to government or policy-makers.

We believe that there are at least two important answers to the Gordian Knot of good governance problems. The first lies in the realm of policy. We argue against the traditional but worthy panacea of more legislation. Mainly because every sector already has a code of governance and, at heart, these codes are broadly fit for purpose. However, a review needs to be undertaken to give them back their teeth and also make them truly fit for purpose in the 21st century. Among the bold recommendations for policy *The Independent Director in Society* sets out is a recommendation that directors (or trustees, or governors; titles change from sector to sector, but the role remains the same) in the third sector in particular should be paid for their work. This may be surprisingly controversial in many quarters, but we are adamant that this measure – among others – will improve the quality of governance by encouraging a more diverse range of candidates to put themselves forward for directorships.

Our second answer lies with independent directors themselves. Urgent improvement is needed in standards of thought and action as well as the calibre of these directors.

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Above all, directors need to develop an independent mindset that will enable them to make better, more accurate decisions. As the research we conducted shows, that mindset is clearly lacking in many cases. Independent directors who are capable, empowered, engaged and actively supported are required to steer organisations in the right direction, for the benefit of all their stakeholders. There are many elements to creating this culture, including selection, training and education for directors, and support from Chairs and executive teams, but most of all directors themselves must recognise their responsibilities in a complex and volatile world.

But what are the recommendations for policy-makers arising from our landmark survey of the health, sports, charities and universities sectors? Too often, independent directors and boards face an uphill struggle in their quest to be more effective and make real impact. We have seen how in the NHS, in particular, governments have sometimes actively interfered with boards and made their work more difficult, compromising their independence. In many other cases boards of vitally important organisations have been left to sink or swim at times when government intervention might have been timely and helpful. If we are to resolve the crisis of governance and end the damaging stream of collapses and scandals, then boards and directors need more support from government and regulators if they are to fulfil their remit and make the kind of social impact we all need and expect of them.

Drawing upon the differences and similarities revealed, my co-authors Professor Andrew Kakabadse and Dr Filipe Morais (both of Henley Business School) and myself tried to define what independent directors and Chairs of boards *should* do – generally and in each specific sector – as well as where the gaps are between present practice and what is needed. Across all sectors – health, university, sports and charity – our key general findings include:

- The challenges facing boards and independent directors are formidable and have never been greater.
- Boards are failing to be effective.
- Training for directors is sparse to the point of non-existence.
- There is a serious lack of diversity.
- The consequences of board and independent director ineffectiveness are dreadful for society.
- Understanding of digital economy issues and grasp of data are poor.
- Directors themselves are failing to perform their duties.
- Regulatory exhaustion is increasingly common.

Of course, boards do not exist simply to perpetuate the organisation, or themselves. Impact is their *raison d'etre*. Boards exist to ensure the organisation is well run and delivers the goods and services that stakeholders need. If the board does not do so, then it is failing in its purpose. To deliver impact, directors need to carry out those twin duties of compliance and stewardship, control and engagement. Once again, these are the two faces of the same coin.

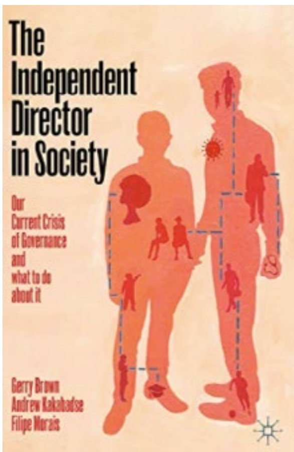
> 'Independent directors who are capable, empowered, engaged and actively supported are required to steer organisations in the right direction, for the benefit of all their stakeholders.'

Control ensures that organisations are run responsibly; engagement ensures that they are run well. Together, they drive the organisation forward so that it meets the needs of the people.

It should go without saying – but, sadly, actually often needs re-iterating – that independent directors are society's unsung heroes. They have no public image or face, and there is widespread ignorance about what they actually do. They rarely receive credit when things go well, although society is all too happy to blame them – often with good reason – when they do not. Many are underpaid, or receive no pay at all for the service they give. Yet without them, the vitally important institutions that serve society and bring benefit to us all would collapse. We need to recognise the role that they play, and we need to give them the support and assistance they deserve so they can carry out their role more fully. Investing in support for independent directors will be repaid many times over, in the forms of more efficient and effective institutions, contributions to tax income, a prospering economy and a healthy, happy society.

The time to begin reforms and end the crisis of governance is now.

Gerry Brown is Chairman of private equity firm Novaquest Capital Management and is also the co-author (with Andrew Kakabadse and Filipe Morais) of 'The Independent Director in Society: Our Current Crisis of Governance & What To Do About It' which is published in the UK this month by Palgrave Macmillan.



The Independent Director in Society

Gerry Brown
Andrew Kakabadse
Filipe Morais

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Feature

China companies' VIE structure

Lyndsey Zhang reviews the history of Chinese companies' VIE structure, the structure's potential risks as seen in the case of Alibaba and the Chinese Government's approach to fix the VIE loophole.

In the past three decades, Variable Interest Entity (VIE) structure has become a widely used business structure for Chinese companies accessing overseas capital. I remember that when I worked in Hong Kong between 2015 and 2017 establishing VIE structure was one of the 'must have' steps Chinese companies took when setting up subsidiaries in Hong Kong. In the global market, VIE is still an unsolved mystery. But because its impact on the market is not as visible as other hot Chinese business topics like related-party transactions and auditor independence, it remains as powerful as it is hidden.

What is VIE structure?

VIE structure is a unique business structure in which investors do not have direct ownership but have controlling interest of the entity through special contracts. The contracts specify the services and purpose of the agreements, and the percentage of profits allocated to each party, but do not provide direct voting rights to the controlling party. VIE structure comprises the following (see Figure 1):

VIE: In the case of overseas-listed Chinese companies, a VIE refers to a company that is incorporated in China and owned by individuals who are Chinese citizens (usually the founders).

OLOE and WFOE: The Overseas Listed Offshore Entity (OLOE) is typically a shell company domiciled in the Cayman Islands. OLOE often incorporates a Wholly Foreign Owned Enterprise (WFOE) in China that holds material assets and conducts operations on behalf of the overseas-listed company. An OLOE generates revenue mainly through its ownership of WFOE. And the WFOE captures profits of the VIE through a series of contracts between the WFOE and the VIE. The contracts (loan agreements, technical services agreements) give WFOE the rights to VIE's residual profit. Additionally, the VIE and its owners will sign a power of attorney or proxy agreement to grant WFOE voting rights at VIE shareholder meetings.

Technically, OLOE shareholders don't own the VIE, but have contractual rights to the VIE's profit and will be able to conduct voting rights through its WFOE. An OLOE can operate its business through more than one VIE. We often refer to the entire set of relationships as a 'VIE structure'.

Brief history of VIE structure

VIE structure emerged in China primarily for two reasons. First, the Chinese Government has forbidden foreign investments in certain sectors, though regulators have increased the number of acceptable foreign investments over the years. Investments in industries like telecommunications, e-commerce, education and media were still restricted as of June 2019. Second, Chinese authorities have complicated the approval process for overseas fundraising, making it extremely hard for private companies to access offshore capital.

VIE structure was designed in the 1990s to avoid the approval process and bypass the foreign investment restrictions. In 1993, Ping An Insurance in Shenzhen used a VIE structure to simplify its government approval process in order to obtain strategic investment from Morgan Stanley. After China's leading online media company (also with a VIE structure) Sina.com's successful Nasdaq IPO in April 2000, hundreds of State-owned and private Chinese companies followed. As of October 2018, 92% of Nasdaq-listed and 64% of NYSE-listed Chinese companies took advantage of the VIE structure. Out of the 11 Chinese IPOs in the US between November 2019 and January 2020, six were structured as VIEs due to China's foreign investment restrictions and two were structured as VIEs for other reasons.

VIE structure itself has evolved in the past two decades. VIEs have been consolidated into OLOE's financials since the SEC started requiring off-balance controlling entities to consolidate their balance sheets in early 2000s (after the Enron scandal).

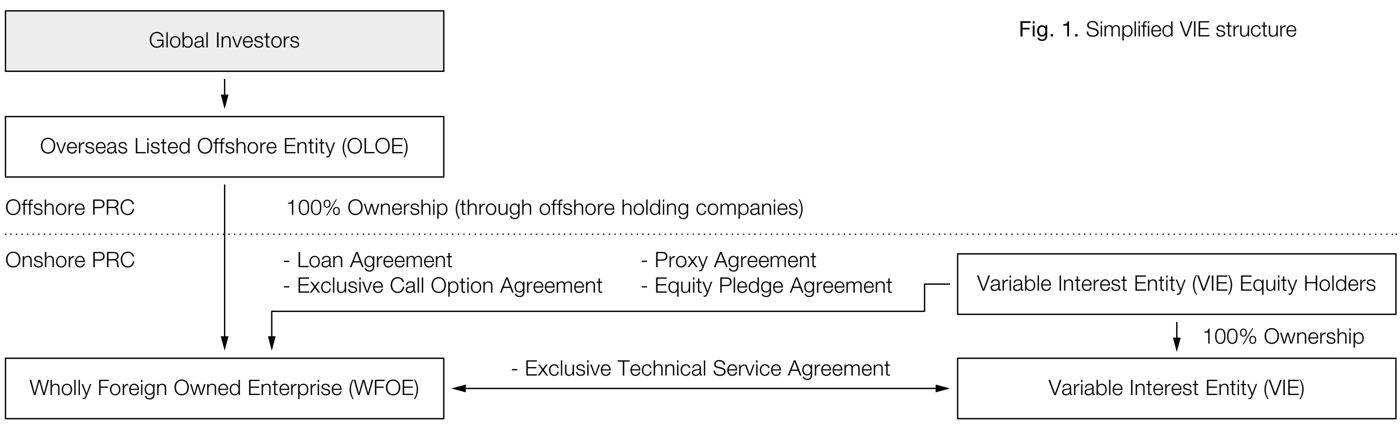

Fig. 1. Simplified VIE structure

Feature

Since VIEs naturally favour founders, in order to protect investors' interests, some VIE agreements include conditions that even factor in the risks associated with a founder's marital status.

VIE structure risks

When companies use a VIE structure to evade China's regulations, they enter a gray area in Chinese contract law. And the complicated relationship between different entities under a VIE structure exposes VIEs to the following risks:

- *Legal uncertainty:* The question over whether VIE agreements are legal is their biggest vulnerability. According to current Chinese law, a contract written to avoid regulation requirements is void and the courts will not enforce it. The special contracts enabling global investors' controlling interest of VIEs are technically not valid. In addition, Chinese authorities can choose to close the loophole at any time by banning or restricting VIE structures, which could leave global investors in limbo.
- *Investors' fragile ownership:* The fact that global VIE investors are only shareholders of the shell company leaves investors out of decision-making processes unless agreed otherwise. The most severe example is the Alipay spin-off controversy between Alibaba and its partners Yahoo and Softbank in 2011. When the Chinese Government tightened regulations for online payment businesses, Alibaba decided to transfer ownership of its online payment platform, Alipay, to a private company owned by founder Jack Ma. As Alibaba's strategic partners, Yahoo and Softbank were not part of the decision because of Alibaba's VIE structure. Yahoo and Softbank's dispute became a warning to global investors.
- *Founders' risk:* the VIE structure also jeopardises founders' interests. According to MSCI's September 2017 *Corporate Governance in China* report, Alibaba was one of the five lowest Chinese companies on the MSCI China Index Corporate Governance Score ranking list due to its VIE structure. Alibaba's stock price rose four times from USD68 per share upon its 2014 IPO to USD290 per share in September 2020. Compared with its eight-fold increase in revenue from USD9bn 2014 to USD72bn 2020, it's clear that Alibaba's VIE structure has had a significant, adverse impact on its stock price due to investors' lack of confidence. Alibaba's founders' group was not able to profit fairly from the disproportionate correlation between stock price and company performance.

China's regulation development and its impact on the VIE structure

Like many other unique events during China's economic reform in the past three decades, the VIE structure was formed at a time when China's economic growth exploded, its desire and demand for global expansion accelerated rapidly and regulation development lagged behind. Sophisticated companies like Alibaba learned to communicate their VIE risk with investors by disclosing the significant uncertainty and addressing potential financial consequences in SEC reports since 2018. But it is widely accepted that VIE, as a transitional structure, needs a regulatory solution to close the loophole. In this new decade, it's worth asking: 'What has been done so far and what solutions are Chinese regulators considering now?'

2015 Draft Foreign Investment Law (FIL): The 2015 Draft Foreign Investment Law initiative was the first regulation to clearly state that the VIE structure cannot be used to circumvent foreign investment law, with the exception of foreign companies ultimately controlled by Chinese citizens. The exception accommodated companies like Alibaba and Baidu that were founded and are owned by Chinese citizens. But companies like Tencent were excluded despite their Chinese founding, because Tencent's shares are not controlled by its founders. The 2015 version was later withdrawn.

2019 new FIL: Global investors were disappointed and surprised when the most recent FIL (effective 1 January 2020) did not address the VIE structure. As a result, S&P Global Ratings concluded that China would back off efforts to restrict VIEs and updated its risk assessment for VIE structured Chinese companies; the Hong Kong Stock Exchange revised its guidance to continue to permit VIE structures.

Negative lists: Since July 2017, the Chinese Government has implemented a nationwide negative list approach with annual updates. The negative list defines prohibited and restricted industries for foreign investors. The list gets shorter each year, opening up more areas for foreign investment and lifting caps for foreign ownership in certain industries. The trend of shortening the negative list will attract more foreign investment. At the same time, by prohibiting fewer industries, China will help reduce the necessity of VIE structures.

It's highly unlikely that China will suddenly ban VIEs without notice or justification. Most well-known Chinese multinational companies today are structured as VIEs. These VIEs are major contributors to China's GDP growth, job opportunities, tax revenues and global expansion. Harming VIEs would cause financial chaos and economic disruption to China.

China has been taking a gradualist approach to economic reform and corporate governance development in the past 30 years. The approach has proved successful in comparison with the Russian 'rush approach,' for example. According to Jing Leng's *Corporate Governance and Financial Reform in China's Transition Economy* (2009), with a gradualist strategy, countries tend to lack well-functioning or out-of-date regulations, which means regulation development always lags behind. It appears that Chinese regulators are taking the same strategy to fix VIEs as they steadily and continuously relax foreign investment restrictions.

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China's 2019 FIL still needs work, but it establishes the principles necessary to create a more equal environment for foreign investors, to simplify the approval process for foreign investments entering and exiting China's market, and to better protect foreign investors' interests. Most reforms of current FIL still need detailed provisions for practical implementation and these reforms are foundational to fixing VIEs. Therefore, leaving the VIE structure as a grey area could be a practical decision which indicates that the Chinese Government is still working to improve these foundations and is unlikely to prohibit or restrict VIE structure in the near future.

Conclusion

The VIE structure has provided a workaround structure or shortcut for Chinese companies to access foreign capital over the past 30 years. However, Chinese companies need to understand the risks of the VIE structure and disclose the risk properly for the awareness of investors. Those companies not on the negative list need to re-evaluate the risk and benefits before choosing VIE structures. The VIE structure will not remain a regulation grey area forever. When Chinese regulators are ready to close the VIE loophole, companies on sound legal footing will be more resilient regardless of the regulatory change.

Lyndsey Zhang is the founder of BoardEpoch Inc. and podcast host of Boardroom&Beyond. Her company specialises in comprehensive culture transformation, governance optimisation and strategic engagement for companies with cross-culture connections. Lyndsey is also an accomplished speaker and writer on international corporate governance issues. www.boardroomandbeyond.com www.linkedin.com/in/lyndsey-zhang

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