GOVERNANCE

February 2021 Issue 318

Board reviews: the governance box of chocolates

‘Nevertheless, there is an opportunity to look at board reviews in a different way – one influenced by what good governance looks like in a purpose-led corporate world of the 21st century rather than driven by legacies of previous corporate failure.’

Chris Stamp

ESG in quoted SMEs: Closing the gaps

‘The evidence is clear: the time for seeing ESG as a passing fad is over. It is now high on the agenda for most investors and boards, and that includes some that were highly sceptical no more than twelve months ago.’

Filipe Morais and Jenny Simnett

Content

News 3 **The future of the AGM**
Four out of five FTSE 350 companies opted to hold their 2020 AGMs ‘behind closed doors’ with no external participants allowed to attend and ask questions to the board, other than by email, according to a new report by ShareAction

International 4 **More trust placed in business**
The 2021 Edelman Trust Barometer indicates that the Covid-19 pandemic has prompted a wave of mistrust in all institutions including government, business and the media. The annual survey of more than 33,000 people across 28 countries asked respondents how much they trusted various institutions

Global News 5 **CEO compensation trends**
The ethics of diversity

Features 6 **Board reviews: the governance box of chocolates**
Chris Stamp, Founder Member of The Board Effectiveness Guild, presents the Guild’s view of the current state of board reviews and argues for a rigorous discussion about how to make them more meaningful

8 **ESG in quoted SMEs: Closing the gaps**
Filipe Morais and **Jenny Simnett** report on research commissioned to examine the reality of ESG adoption in smaller quoted companies

10 **What really happened to Ant Group’s IPO?**
Lyndsey Zhang reviews China’s suspension of Ant Group’s initial public offering in 2020, explains the role recent regulation reform in China played in the suspension and examines the suspension’s impact on China’s corporate governance development

Editorial Board

Jamie Allen
Secretary General, Asian Corporate Governance Association

David W. Anderson
President, The Anderson Governance Group

Philip Armstrong
Adviser, Governance, Gavi Alliance

Kit Bingham
Partner & Head, Chair & Non-Executive Director Practice, Odgers Berndtson

Peter Butler
Founder Partner, GO Investment Partners

Richard Davies
Managing Director, RD:IR

Stephen Davis
Associate Director, Harvard Law School Programs on Corporate Governance & Institutional Investors

Michelle Edkins
Managing Director, Global Head of Corporate Governance & Responsible Investment, Blackrock

Alison Gill
Director, Bvalco Ltd

Sandra Guerra
Founder Partner of Better Governance, Brazil

Paul Lee
Independent Advisor on Stewardship Matters

Robert McCormick
Partner, CamberView Partners LLC

Alan McDonnell
Principal, Good Governance Solutions Ireland

Paul Moxey
Visiting Professor in Corporate Governance at London South Bank University

Liz Murrall
Director, Corporate Governance and Reporting, IA

Sean O'Hare
Founder, Boardroom Dialogue

Chris Pierce
CEO, Global Governance Services Ltd

François Siegwart
Managing Partner, EMC Gestion de Fortune

Geof Stapledon
Vice President Governance for BHP Billiton

Cas Sydorowitz
Global Head of Activism and M&A, Georgeson

Kerrie Waring
Executive Director at ICGN

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

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

icsa
The Chartered **Governance** Institute

20%
discount for registrations until **28 February**

Embracing a green and sustainable recovery

ESG SUMMIT

After the events of the last year, stakeholder scrutiny on strategies around environmental, social and corporate governance (ESG) is at an all-time high. With a lack of global standards around ESG, the best way to improve your own initiatives is to learn from other organisations successes, challenges and visions for the future.

From carbon footprints and supply chains to diversity and equality, join our panel of experts as we explore:

- organisational purpose and values, and how these need to be continuously aligned with changing stakeholder expectations
- risks and opportunities linked to implementing ESG strategies
- economic benefits of sustainable organisations
- and much more

Sign up for an exciting agenda, split over two days, with speakers confirmed from organisations such as Coca-Cola European Partners plc and UN Global Compact Network UK.

21 and 22 April 2021
08.30–13.30 BST | Virtual conference

Discover the full programme and book your place at
icsa.org.uk/ESG-Summit

News

The future of the AGM

Four out of five FTSE 350 companies opted to hold their 2020 AGMs 'behind closed doors' with no external participants allowed to attend and ask questions to the board, other than by email, according to a new report by ShareAction. The Report, *Fit-for-purpose? The future of the AGM*, sets out a bold new vision for the AGM of the future. It also addresses how companies, shareholders, stakeholders and policy-makers can play their part in making the AGM of the future the backbone of corporate governance and investor stewardship.

Current situation

Even before the current crisis, company AGMs had shortcomings. Many FTSE 100 companies held AGMs with few attendees present and occasionally with no questions. Institutional investors, who generally own over 90% of company shares, are frequently absent.

At the other end of the spectrum, some AGMs suffer from heated exchanges and unmet expectations as the major, but brief, forum for contact between shareholders, stakeholders and company employees. Even the value derived by boards has not always been clear and many AGMs have entrenched style and content.

According to ShareAction (a charity building a movement for responsible investment):

- The AGM of the future sees companies and their boards creating a purposeful, on-going, values-based AGM process, through which they will gather insight and input from shareholders and stakeholders.
- A revamped agenda will facilitate structured and respectful multi-lateral dialogue during the meeting.
- Shareholders will be able to hear, challenge and discuss the views of stakeholders impacted by corporate activity.
- AGMs will take a hybrid format, with both in-person and virtual attendance possible, transforming it into a genuinely accessible event. Companies will support participants to attend virtually, should they not have the means to do so.
- The new values-based purpose for AGMs will empower stakeholders to speak up and share their experiences, better informing shareholders when holding companies and boards accountable for their impacts. A focus on values will help companies develop practical and sustainable solutions to their greatest challenges.

Companies and investors

ShareAction say AGMs in future will be one of the most important dates in CEO and executive leadership team diaries and will provide an enhanced role for non-execs, in particular those with specific responsibility for the environment, workforce and/or community. Non-exec board members will be far more engaged in shareholder and stakeholder interactions throughout the year. This will involve a greater demand on non-exec time, with governance consequences such as potentially increased pay and greater scrutiny on overboarding and skill sets. This will also result in a commensurate increase in their confidence – and that of shareholders and stakeholders – that their responsibilities are being fulfilled.

In the future, institutional investors will increasingly participate in the AGM process through an ESG lens. They will attend AGMs far more regularly and will work collaboratively, where possible, to ensure that there is a visible and vocal investor presence at as many AGMs as possible. Investors will embrace the value of AGMs and be transparent about their engagement with them.

Stakeholders

The AGM of the future will invite a wider range of stakeholders affected by company activity including: workers; trade unions; suppliers; communities directly and indirectly affected by corporate activity; and customers and users.

Companies will take an active interest in stakeholder input, collaborating, encouraging participation in the AGM process and recognising the benefits of aligning stakeholder, shareholder and company views to business outcomes. Companies will take active and enthusiastic ownership over the process, proactively engaging with stakeholders, to ensure that AGMs of the future are well-attended and genuinely useful.

Investors of the future will recognise their natural interest in supporting stakeholder attendance and voice. They will spend more time listening directly to stakeholders, as well as to what companies tell them through established engagement channels.

Engagement and communication

The AGM of the future will be positioned as the culmination of year-long transparent, on-going dialogue between companies, stakeholders and shareholders and the start of the next cycle – whilst also engaging with the multi-year time horizons of many ESG issues.

Companies should look to make available to shareholders and stakeholders information to enable them to come to a well-informed position on the company's Companies Act 2006, s 172 responsibilities. Annual and sustainability reports should talk more about the challenges companies face.

The AGM will be a vibrant, cost-effective forum which delivers value to both stakeholders and shareholders and enables boards of directors to deliver the long-term sustainable success of the company.

For the full Report go to: https://bit.ly/3aOqC1t

International

More trust placed in business

The *2021 Edelman Trust Barometer* indicates that the Covid-19 pandemic has prompted a wave of mistrust in all institutions including government, business and the media. The annual survey of more than 33,000 people across 28 countries asked respondents how much they trusted various institutions.

When asked who they trusted to do the right thing, 59% of respondents said business; 57% the government; 56% NGOs; and 50% the media. When respondents were specifically asked which institutions had performed well or very well during the pandemic, only 47% said the media; 46% said business; 43% pointed to government; and 41% said NGOs. Trust in national health authorities and the World Health Organisation has also fallen.

Role of business

Business emerged as the most trusted institution (61%) and is the only institution deemed ethical and competent. Business outscored government by 48 points on competency and is approaching NGOs in ethics. In 18 of the 28 countries business is more trusted than the government, followed by NGOs and then the media.

There is a clear public expectation that business will not focus only on its own interests at times of global uncertainty but will take an active role in restoring trust. Business gained trust by proactively developing vaccines in record time and finding new ways to work. Trust continues to move local, respondents placing even higher reliance on ‘my employer’ (76%) and ‘my employer CEO’ (63%). Communications from ‘my employer’ is the most trusted source of information (61%), more so than national government (58%), traditional media (57%) and social media (39%).

Disinformation

The global ‘infodemic’ has driven trust in all news sources to record lows, with social media and owned media the least trusted; traditional media saw the largest drop in trust. Fifty-nine per cent of people said most news organisations are more concerned with supporting an ideology or political position than informing the public, whilst 61% said the media is not doing well at ‘being objective and non-partisan’. Indeed, a majority of respondents believe that government leaders, business leaders and journalists and reporters are purposely trying to mislead people by saying things they know are false or are gross exaggerations.

According to the Report, only a quarter of people practice good ‘information hygiene’ – practices which allow them to evaluate information, avoid echo chambers and share only information which they know is reliable. However, 55% of respondents said that increasing their media and information literacy was more important to them now than last year. Fifty-three per cent of respondents believed that business should take an active role in providing accurate information.

> ‘… people are more likely to place their trust in their local community and business leaders to whom they feel personally connected and who they view as trustworthy, employers particularly so.’

Transformational change

CEOs are under a weight of expectation to drive social change. Eighty-six per cent of respondents expect CEOs to speak out publicly on societal challenges such as the impact of the pandemic, societal issues, job automation and problems facing local communities. Over two-thirds also ‘expect CEOs to step in when the government does not fix societal problems’. However, CEO credibility is at an all-time low in several countries and the mistrust in what they are saying is so acute that honest and authentic communication will be key.

People feel more empowered to demand change: 50% of the employees questioned said that they are more likely now than a year ago to voice objections to management or engage in workplace protests. Around two-thirds believe in the power of consumers and employees to force businesses to change.

Social purpose

Following the devastating health and economic impacts of the pandemic, the *Trust Barometer* found heightened awareness on key social issues such as access to healthcare and education, climate change and poverty. People are looking to business, particularly their employers, to embed a sense of social purpose at the heart of their organisations and lead on societal issues, such as upskilling workers and racial justice. It has also led to new expectations of business expanding its remit into unfamiliar areas, such as providing and safeguarding information.

Existing relationships

Trust in societal leaders such as politicians, journalists and religious leaders has continued to fall. In fact, the survey shows that there is no room for complacency, even in the business sector. Trust is declining across all business sectors and trust in CEOs as a group has also declined by 3% over the last year. However, people are more likely to place their trust in their local community and business leaders to whom they feel personally connected and who they view as trustworthy, employers particularly so.

For more information go to: https://bit.ly/2MD2t65

Global News

CEO compensation trends

'As proxies are filed in early 2021, it is expected that 2020 overall S&P 500 CEO actual total direct compensation (TDC) will decrease, potentially by 3–4%, due to many companies underperforming during the Covid-19 pandemic and lower bonuses', according to Pay Governance LLC. There will, however, be some variation with companies in strong performing industries likely seeing increases in compensation. 2020 actual pay was balanced by steady base salaries and long-term incentive (LTI) grants, as most companies had strong financial performance at the time awards were granted, typically in Q1.

Compensation projections assume successful global rollout and broad usage of the Covid-19 vaccine but do not account for additional major market shocks. In 2021, companies will want to strike a balance between having competitive executive pay and meeting public, investor and proxy advisor expectations that companies exercise restraint in light of the pandemic's continued disruption.

Median CEO target pay is expected to increase in early 2021 in low single digits due to some companies providing 'supplemental LTI grants' to partially offset for lost value for performance share plans that were impacted and mostly worthless due to the financial repercussions of the pandemic. Executives in industries with favourable economic conditions and higher growth (eg technology and bio-technology) are likely to see more significant pay increases, while those in slow-growth or hard-hit industries may see no increases or a continued fall in pay.

Historical CEO pay increases have been supported by historical total shareholder return (TSR). In fact, annualised pay increases have been nine percentage points lower than TSR performance. Individual CEO pay increases will continue to be closely tied to overall company performance and peer group compensation increases; it is notable that S&P 500 TSR was +18% in 2020, primarily driven by large-cap technology companies.

The use of performance share plans seems to have peaked, with 94% of S&P 500 companies employing them, while restricted stock has cemented its position with 69% prevalence. Stock options have continued their steady decline but are still prevalent at 50% of companies. In 2021 there could be an increase in stock option and restricted stock usage due to the Covid-19 pandemic and companies struggling to set long-term goals in their performance share plans.

The ethics of diversity

Directors must prioritise diversity of thought and life experience says the Institute of Business Ethics in a new report. The Report, *The Ethics of Diversity*, examines the case for delivering real boardroom diversity and inclusion and makes recommendations to embed genuine diversity of thought and life experience at board level.

2020 saw the issue of diversity take a prominent role for companies of every size and type. Even before Covid-19 there was a growing need for boards to better connect to a wider range of stakeholders amidst rapid changes to the expectations and skills requirements for boards.

Boards need to be truly representative of the communities they represent in a much more connected world and their actions need to lead to sustainable change at board level and across the organisation. An ethical business needs to listen to the diverse voices of its stakeholders, and its board needs to reflect them, if they are to meet not only their ethical obligations but also their business potential. Board appointments that are not representative of the company's employees, customers or supplier base will not bring different perspectives necessary to counter groupthink.

The power and impact of employee networks is key and boards should be aware of the issues being discussed and understand how they inter-relate. Employee networks need to be part of a more holistic diversity and inclusion strategy with open communications across the organisation which reaches board and executive level.

Report recommendations include:

- understand and explore the diversity of thought and experience on the board;
- ensure that diversity and inclusion is an organisational, strategic and commercial imperative;
- review all board and executive committee nomination and succession planning processes;
- look critically at individual roles assigned to board members;
- learn from improving gender diversity and from other sectors;
- actively listen, understand and respond to company stakeholders;
- communicate aims and milestones internally and externally;
- learn from a more challenging board evaluation; and
- see diversity and inclusion as an opportunity for long-term change.

By being genuinely inclusive, boards can demonstrate their understanding that diversity means more than meeting targets on gender and ethnicity and that it is about embracing, embedding and valuing different experiences of directors.

Feature

Board reviews: the governance box of chocolates

Chris Stamp, Founder Member of The Board Effectiveness Guild, presents the Guild's view of the current state of board reviews and argues for a rigorous discussion about how to make them more meaningful.

Board reviews have come into the spotlight following the publication of a long-awaited report into their effectiveness. We suggest that board reviews have become like a box of chocolates – a comfort to mask stark realities and a luxury that promises much but only sometimes gives you what you want. To move forward, a more rigorous discussion is needed about how board reviews can be meaningful in the 21st century.

It is 18 years since the idea that boards should undertake an annual self-evaluation exercise was introduced into the UK Corporate Governance Code and ten years since the Code requirement was extended to include an externally-facilitated review every three years (for FTSE 350 companies at least).

Last month, The Chartered Governance Institute published its long-awaited Report[1] into independent board evaluation prepared at the request of the UK Government. You do not have to read too far into the Report before you realise that its purpose is not to give a glowing endorsement of the state of independent board evaluation. So, why is this potentially valuable element of the corporate governance framework not working as well as originally hoped? We suggest that there are a number of reasons some of which, but by no means all, are addressed in the Report.

> 'The Report acknowledges this issue in places but does not make much effort to address this issue by building on the FRC's useful advice on externally facilitated board evaluations (which would have been an obvious area for the Institute to focus its review).'

'They've got these chocolate assortments, you like some and you don't like others. And you eat the ones you like and the only ones left are the ones you don't like so much?'[2]

The analogy of a box of chocolates comes to mind as an appropriate metaphor for this process which we choose to call 'board effectiveness reviews'. And therein lies the first problem: there are different views on what the process should be called. The Institute argues that it is a 'board performance review' rather than a 'board evaluation'. It doesn't like 'evaluation' because it implies that the process is an assurance exercise measured against objective standards.

We would argue that 'performance' is no better as a term because performance is contextual (ask any teacher) and the Institute has not really addressed how performance is to be assessed. To be effective, a board has to adapt its performance to its context and therefore good performance in one year is not a barometer to effectiveness in another – just look at some of the stars of recent years who have performed less well in the pandemic-affected economy of 2020. Board effectiveness is a more enduring quality which requires the reviewer to take a broader, more relevant perspective.

And it's not just about terminology, it's about preferences as well. Too many boards, and particularly Chairs, have singular views of what they want these reviews to be – sometimes out of expediency, sometimes out of favouritism, sometimes out of a desire to secure the right outcome. The Report acknowledges this issue in places but does not make much effort to address this issue by building on the FRC's useful advice on externally facilitated board evaluations[3] (which would have been an obvious area for the Institute to focus its review). Instead, it suggests eight *Principles of good practice for listed companies using external board reviewers* which, with one exception (Principle 5), are no more than restating the common sense of many current reviewers.

'Life is like a box of chocolates, you never know what you're gonna get'[4]

To be fair to many listed company boards, as the Institute notes, the quality of board effectiveness review services has not always been good and their reputation has been tarnished as a result. Again as the Institute notes, there is evidence that this is rapidly improving but it has taken time. Among the early movers in the board review marketplace were the head-hunters, some of whom initially saw board reviews as a way of creating demand for their recruitment practices. The Code now requires disclosure of any connections that the board reviewer has with the company but the sense of self-interest sometimes remains. Beyond this, the issue for boards is sometimes simply that the exercise just seems a complete waste of time, particularly ones which result in long tables of questionnaire output and analysis which do not offer any new insight. This is a quality issue rather than a self-interest issue. The Report rightly seeks to address both these issues but it does not really get to grips with the fact that, at the heart of the process, there needs to be serious traction between the reviewer and the board being reviewed. Getting this traction requires three things: good engagement about the process, good definition of the areas to be considered within the review and good dialogue about the findings. These need to work together to deliver the best outcome.

Feature

‘… there needs to be serious traction between the reviewer and the board being reviewed. Getting this traction requires three things: good engagement about the process, good definition of the areas to be considered within the review and good dialogue about the findings.’

Good engagement: The Report makes much of the process by which board reviewers should engage with companies. Plenty of disclosure and process is suggested but it is all up front, before the engagement commences. The scope of a review cannot be fully developed without the reviewer finding out what is going on with the board, the company, its stakeholders and, yes, its performance. Some of this can form part of the pre-engagement discussion but it can only be done properly and fully as part of the initial stage of the project. Only after this piece of work has been completed can the scope of the review be crystallised so that there is clarity about what the reviewer is going to focus on in their interviews, observation or even questionnaires.

Good definition: Whilst there are often a number of topics that should always be considered in every board review because they are fundamental to effective governance, the context of the company has to be a primary consideration in identifying the issues to be probed in the review. The Code is not helpful in this regard by ambiguously making board reviews the prerogative of the nominations committee and over-emphasising board composition as the central purpose of such reviews. Such emphasis seems to downplay really important considerations such as the board’s engagement with strategy or risk which are central to any board’s effectiveness.

Good dialogue: The Report devotes useful attention to the dialogue between the reviewer and the board, and disclosure of the outcomes from the process. Requiring companies to report fully on the findings and outcome of the process may help encourage dialogue but it does not mandate it. It is for this reason that Principle 5 of the Institute’s *Principles of Good Practice*, which requires signatory companies to provide reviewers with an opportunity to present their findings to the whole board, is actually very helpful.

‘Everyone knows the boat is leaking, everyone knows the captain lied … everyone wants a box of chocolates.’[5]

As with many aspects of the Code, board reviews were introduced in response to a corporate governance failure. The 2003 Code changes were the consequence of Enron and other corporate failures and the 2010 changes were prompted by the global financial crisis. The Government’s approach which gave rise to the Institute’s review was the direct result of the corporate failures of Carillion, BHS and others. Corporate failure has been the defining narrative for the evolution of board effectiveness reviews or put another way, it gives the corporate world a sense of comfort that it has taken action to avoid previous failings. But is this not simply shutting the stable door after the horse has bolted?

The Institute observes that the purpose of reviews is ‘to provide reassurance that the board takes its responsibilities seriously’ rather than ‘assurance as to the future performance of the board and the company’. Either way, there is a truth that needs to be acknowledged – board reviews will never be the remedy for poor corporate performance – neither historic nor prospective. A good board review will probe important issues and should be able to give stakeholders a sense that the board is engaging well with its duties; beyond that, nothing is guaranteed. Nevertheless, there is an opportunity to look at board reviews in a different way – one influenced by what good governance looks like in a purpose-led corporate world of the 21st century rather than driven by legacies of previous corporate failure.

If there is a fundamental point that the Institute seems to have missed in its Report, this seems to be it. Bob Garrett recently discussed the future role of company boards within this context of corporate purpose and made the point that s 172 of the Companies Act has been in place to ensure that directors act in the interests of all stakeholders since 2006[6]. But he notes, it has rarely been used to require directors to account for how they account for stakeholder interests in their decision-making. This is now changing with new reporting requirements. However, until robust legal and shareholder remedies are enforced, there is no point in board effectiveness reviews being expected to be the stick for driving responsible board behaviours. A better approach, therefore, would be to re-position board effectiveness reviews to support boards in becoming more effective decision-makers in the context of a broader stakeholder dialogue. The additional processes and guidelines of the Institute’s new Codes of Practice do not do much to help this repositioning and board effectiveness reviews look destined to remain a governance box of chocolates.

The Board Effectiveness Guild is a group of independent board reviewers who have come together to enhance the value of the board effectiveness reviews by sharing best practice and contributing to the wider debate on excellence in corporate governance.

https://theboardeffectivenessguild.co.uk/

1. *Review of the effectiveness of independent board evaluation in the UK listed sector*, The Chartered Governance Institute, 2021
2. *Norwegian Wood*, 2011, Haruki Murakami
3. *Guidance on Board Effectiveness*, FRC, July 2018, p 30
4. *Forrest Gump*, 1986, Winston Groom
5. *Everyone knows*, 1988, Leonard Cohen
6. *What are company boards for now?* Bob Garrett, RSA, 26 June 2020

Feature

ESG in quoted SMEs: Closing the gaps

Filipe Morais and **Jenny Simnett** report on research commissioned to examine the reality of ESG adoption in smaller quoted companies.

Among the many repercussions of the global pandemic, one is that ESG factors have been brought into sharper focus for governments, boards and investors. According to a recent survey by ISS ESG, the responsible investment arm of Institutional Shareholder Services, the percentage of investors who say they would pay a premium for securities issued by companies with a higher ESG rating has increased from a pre-Covid 34.9% to 41.3% today.

The World Economic Forum (WEF) is advising boards to focus on six sustainability-related priorities in 2021, and these include 'aligning strategy and capital allocation with drivers of long-term value creation' and 'internaliz[ing] material ESG factors in enterprise risk management'. For KPMG, 2021 is a year in which boards will have to 're-evaluate the company's focus on ESG and corporate purpose'. Furthermore, two initiatives, one from the Big Four and one a joint effort from five leading ESG standard-setting bodies, aim to accelerate the creation of a harmonised set of sustainability standards and disclosure requirements. The evidence is clear: the time for seeing ESG as a passing fad is over. It is now high on the agenda for most investors and boards, and that includes some that were highly sceptical no more than 12 months ago.

Most of the ESG initiatives making headlines concern global investors and large iconic companies. This is to be expected, given the scale and global reach of many of these players and their capacity to deliver a multiplying effect throughout the global economy. Small and Medium Enterprises (SMEs), on the other hand, are rarely part of this conversation. But, according to the House of Commons Business Statistics in 2020, SMEs represent 99% of all UK businesses, contribute 52% of all turnover and 79% of all UK employment. And let us not forget that, in so many cases, today's SME turns out to be tomorrow's large company.

A team from Henley Business School was commissioned by the Quoted Companies Alliance (QCA) and Downing LLP to examine the reality of ESG adoption in quoted SME firms. This unique survey of 100 quoted companies and 50 investors, which included 30 in-depth interviews with business leaders and asset managers, revealed three fundamental prevailing mind-sets among companies and four critical ESG gaps that need to be addressed.

Three ESG mind-sets

ESG as a tool for managing strategic risk. Many companies use ESG predominantly as a risk and legitimation tool. For these companies, what drives ESG is regulatory compliance and pressure from investor, social and environmental groups. They ask themselves: How can we protect ourselves from environmental, social and governance risks? How can we prevent such factors from undermining our existing competitive advantage and position? This is a compliance mind-set, one of protecting the *existing* business. Here, no fundamental changes are made to the business model. Rather, the *existing* business model is made more resilient – at best; at worst, the company indulges in a substantial amount of greenwashing.

ESG as a source of sustainable competitive advantage. For an increasing number of companies, ESG is seen as a shift in how the company competes and grows. ESG factors are integrated into the business model and indeed become increasingly central to it. The drivers of ESG integration in these companies are clients, customers, suppliers – competitors, even – and some types of investors. ESG is strongly embedded within the company's purpose and business operating culture. For some companies in this category, this remains an aspiration and they are still building the necessary knowledge and capabilities to execute it.

> 'There is a notable lack of resources being allocated or hired by companies for ESG implementation, and an apparent lag between understanding, discussion and action.'

ESG as a fashion: a distraction from growth and unnecessary regulatory creation. In the third and final category are companies that see ESG as a fad. For them, it is not the company's role to be overly concerned about social and environmental factors. Governance, surely, is simply the pursuit of shareholder value maximisation. These businesses do not see any relationship between ESG factors and long-term performance or resilience. They might pay lip service to the idea or do the bare minimum to be seen as politically correct. The dominant belief system within these companies forecloses any exploration of ESG opportunities.

Regardless of which mind-set comprises the point of departure, fundamental gaps have been observed in how ESG is being managed. These are discussed next.

Knowledge gap

These days, ESG is a familiar concept: a quarter of all companies began to acknowledge its value in the last 24 months. However, most are interpreting it narrowly and applying it in a piecemeal fashion – in a siloed way or on a per-project basis. Last year, ESG made its way up the corporate agenda, not least because the Covid-19 pandemic acted as a catalyst, focusing companies on the environment, stakeholders and governance.

Feature

The most familiar and well-entrenched of the three 'ESG' pillars is 'G for governance', with knowledge of the 'E for environment' pillar mostly customised by sector – but often defaulting to carbon emissions from business travel or office energy consumption and recycling. The 'S for social' pillar is most often interpreted as diversity and the gender pay gap, and has been further driven by regulation, with Covid-19 also highlighting employee welfare. However, other stakeholder groups, such as supply chain partners, customers or competitors, are largely neglected here.

Only 23% of companies claim a high level of ESG knowledge, with 63% rating their knowledge as moderate and 8% saying they had no knowledge at all. Larger companies are more likely to know more about ESG, with real estate, construction, aerospace and engineering being the most knowledgeable sectors, as a consequence of their roles in building and manufacturing. Investors interpret ESG to be indicative of quality and sophistication in company operation, board and management.

Both companies and investors agree that ESG impacts long-term financial performance and sustainability, but companies don't appear to know how to measure it convincingly. Investors want to see more of the company story with evidence-based metrics.

Leadership gap
Companies lack clear accountability for, and ownership of, ESG; where such things exist, they are often diffused and dependent on personal interest. The board as a whole 'owns' ESG in 44.6% of cases, with 38% declaring ownership by executive leadership. In some companies, there is a sharing of role between the board and Chair, and in others it falls to the CEO or CFO to implement ESG.

Unsurprisingly, investors want clear board and CEO accountability. Employees, customers, suppliers and competitors are often the internal drivers in smaller companies but here we tend to see an emphasis on just one pillar. Founders rarely drive ESG. External drivers consist primarily of government policy and regulation or watchdog and industry regulators. While investors are not the primary external driver of ESG, for many of them ESG is a major influence on their decisions whether to invest or divest, focusing on either materiality and financial performance, or stewardship and sustainability. The conclusion is that market forces are more powerful drivers of ESG for competitive advantage than investors.

Execution gap
There is a notable lack of resources being allocated or hired by companies for ESG implementation, and an apparent lag between understanding, discussion and action. Of the companies surveyed, 62% claim that ESG is integral to their strategy and vision, but piecemeal approaches are in evidence, with key projects such as diversity or customer service built into strategy and therefore merely 'ticking the box'. Companies see ESG execution as fashionable – and therefore optional – whereas investors see it as an imperative for quality, reputation and credibility. Investors would like companies to define ESG more broadly and customise it to their businesses, but companies are still perceiving it as a compliance exercise and providing little quantification in their communications to stakeholders. Distinct sectoral differences are evident in terms of ESG maturity and the degree of integration: the real estate, construction, retail, travel and leisure sectors are clearly ahead in most ESG activities.

Disclosure gap
You can't communicate ESG effectively if you don't fully understand it. Uncertainty about how to communicate ESG to their stakeholders is how 31% of companies feel, but as many as 52% of investors claim that is how their portfolio companies might be characterised. Annual reports and company websites are the most popular vehicles for disclosure of ESG, but larger companies will also make use of investor meetings and roadshows.

The use of standards, such as the UN Sustainable Development Goals, Global Reporting Initiative or Sustainability Accounting Standards Board, is generally low among SMEs, who claim that they are unsuitable for their businesses or irrelevant. The sectors most interested in standards are real estate, construction, retail, food, travel and leisure. The quality of ESG disclosure is deemed by investors to be low-level and formulaic, even when companies have easy access to data on energy consumption and carbon emissions.

Investors would like to see a clear narrative, with evidence, pertaining to the business and customised to growth, risk, stakeholders and board independence. This ESG narrative should include consistent year-on-year progress on targets with explanations of shortfalls and with ESG as a wrapper on the company story. However, companies appear to lack confidence in the quality of the ESG information they are meant to be disclosing. This is particularly noticeable in smaller companies, with environmental data perceived as being of the poorest quality, and corporate governance and leadership the best.

ESG and sustainability will soon become a critical component of competitive advantage and the licence to operate, and one that companies – even SMEs – cannot afford to ignore. The time to act is now.

Dr Filipe Morais is a Lecturer in Governance and Programme Director of the MSc in Management for Future Leaders at Henley Business School. He is an Independent Member of the Ratings Ratification Committee at Risk Insights (Pty) Ltd.

Ms Jenny Simnett is a Doctoral Researcher in corporate governance at Henley Business School and a non-executive director and committee Chair at Tower Hamlets Community Housing.

Feature

What really happened to Ant Group's IPO?

Lyndsey Zhang reviews China's suspension of Ant Group's (Ant) initial public offering (IPO) in 2020, explains the role recent regulation reform in China played in the suspension and examines the suspension's impact on China's corporate governance development.

Last summer, Ant was on the verge of its highly anticipated IPO – the world's largest with a $312bn valuation – and was seeking to raise a $34.4bn dual listing in Shanghai and Hong Kong. Despite the tension between the US and China, many American tier-one investment banks and institutional investors had taken part in this iconic transaction with other global players. Fewer than two days before Ant's shares were due to begin trading, China's regulators suspended Ant's IPO. The news shocked the financial world, and left many speculating about what really happened and what the future holds.

Background

Ant (originally 'Ant Financial' until June 2020) was launched by Alibaba in 2012 as a micro-loan solution provider for Chinese small businesses (small like ants). Back in 2012, Small and Medium-sized Enterprises' (SMEs) threshold for receiving loans from Chinese banks was about $1m, which ruled out finance possibilities for most Chinese SMEs. Ant filled this gap with an average loan size of RMB8,000 (about $1,200), with the smallest financing amount around RMB324 ($50). Ant extended its lending business to individual consumers in 2014. In 2019, the smallest credit limit offered by Ant was RMB45 ($7).

With the vast amount of consumer data generated by small businesses on Alibaba's platform, and Alibaba's advanced algorithms, Ant is able to analyse borrowers' profit margins, transaction histories and affordability and make decisions simultaneously regarding finance terms, including loan amounts, interest rates and payback periods. And the process enabled Ant's micro-loan business to have a default rate of 1% (much lower than the worldwide average of 3.9% in 2018 according to S&P Global Ratings). In contrast with the complicated application process and documentation required for receiving traditional bank loans, Ant offers a user-friendly financing process – offering customers the ability to apply via smartphone and receive cash if the application is approved. The entire process only takes a borrower about three minutes, with no human bankers involved. In addition to its micro-loan business, Ant also sells insurance, investment products and financial technology to enterprises.

To pave the way for its IPO, Ant significantly expanded its international business in 2019 – acquiring London-headquartered payment company WorldFirst to establish a European profile, investing aggressively in Asian and South American countries and establishing payment channels with 35,000 merchants in the US. The large transaction volume from Alibaba's e-commerce platform (Taobao and Tmall), coupled with the growth of overseas consumer activity driven by Chinese tourists and students and the wide acceptance of Alipay by overseas merchants, made Ant the largest Fintech in the world and precipitated its Asian IPO in January 2020.

In early November of the same year, Chinese regulators halted Ant's IPO. In late December, regulators ordered Ant to return to its roots as a payment service provider and revamp its business sectors like insurance and money management, which need to comply with regulations from different industries. Moreover, regulators mandated Ant to improve its corporate governance because allowing Ant to cut corners in complying with regulations weakened the company's board functions. Regulators also launched an anti-trust investigation into Alibaba, which owns one-third of Ant.

In January of this year, Ant submitted a plan to restructure itself into a financial holding company directly under the administration of China's central bank. At the time of writing, the plan is likely to be finalised before China's Lunar New Year holiday in the middle of February. The timing of the suspension was dramatic, but regulatory reforms that led to the decision have been decades in the making. Let's take a brief look at what reforms in particular played a role.

China's recent regulatory reforms in new sectors

China's economic reforms in the past decades have slowly opened its capital market to foreign investors. And reforms aimed at establishing a better-regulated investment environment have been a priority for regulators in recent history. Digital business boomed in the 2010s, leading China to develop regulatory reforms targeting these new industries. Some of these recent reforms played an important part in Ant's IPO suspension.

Online payment and mobile payment

While Ant has had a reputation as the largest Fintech in the world since early 2019, the company has tried to position itself as a technology company in order to lighten the regulatory pressure from China's new online payment and mobile payment regulations, including the following:

- The Measures for the Administration of Online Payment Business of Non-Bank Payment Institutions (Measures) issued by People's Bank of China (PBOC) in 2016 requires non-bank payment platforms to standardise the processes for client registration, credit worthiness evaluation, risk management systems, client data usage notifications and data protection.
- In 2018, PBOC established the Online Settlement Platform for Non-Bank Payment Institutions as a centralised

Feature

- clearinghouse. All mobile payment transactions must be settled at the centralised clearinghouse.
- China's new rules for financial-holding companies issued in September 2019 and effective from 1 November 2019, require large companies holding two or more financial businesses with 85% or higher debt to asset ratio to register with authorities and secure at least RMB5bn ($731m) for their financial businesses (like online payment and lending).

After suspending Ant's IPO, China's regulators made it clear that Ant is not a technology company.

IPO application processing time
In order to attract more homegrown innovative technology companies and biotech companies, and to help these companies obtain global capital, China launched a new STAR Market (STAR) overseen by the Shanghai Stock Exchange (SSE) in the second half of 2019. STAR took aim at major stock market reforms including speeding up the IPO process. Compared with SSE's regular IPO application processing time of an average of six months, STAR showcased its efficiency by approving Ant's IPO application in 26 days. Under pressure from STAR's quick approval, Hong Kong Exchanges followed suit with a timely IPO application process. Regardless of the outcome of Ant's IPO, STAR successfully demonstrated how an IPO application can be fast-tracked on a Chinese stock market.

Anti-trust rules
Immediately after pulling back Ant's IPO, the State Administration for Market Regulation drafted a series of new anti-trust laws in November to stop anti-competition in the internet sector and protect consumers. The new anti-monopoly rules will apply to China's internet giants – Alibaba, Tencent, Pinduoduo, JD.com and Meituan. Although these big companies have been praised during the Covid-19 pandemic for minimising the disruption of Chinese society, the widespread use of exclusivity agreements by one of Alibaba's e-commerce platforms and food delivery service company Meituan have pushed regulators too far by transgressing these new anti-trust laws. By enforcing these laws, China made a timely intervention that has prevented these Chinese multi-nationals from getting out of control.

These are the reforms that were front and center in Ant's suspended IPO. But maybe more important than the story behind the suspension is the story of how it will impact China's business development, particularly in the area of corporate governance.

Impact on China's corporate governance development
Historically, corporate governance improvements follow catastrophic business failures: The 2002 Enron scandal led to creation of the Sarbanes-Oxley Act; the 2008 financial collapse led to the Dodd-Frank Wall Street Reform and Consumer Protection Act. In the same vein, China's new internet sector anti-trust rules, together with China's regulations on online and mobile payments, will likely stimulate risk management integration into Chinese companies' corporate governance practices in these areas.

Regulation compliance
Ensuring business activities stay compliant with local regulations is one of the basic functions of a corporate board. When compliance is compromised, the effectiveness and quality of board functions needs to be reviewed and reevaluated. Although It could be very challenging for new technology companies due to a lack of well-functioning regulations, any business strategy that navigates existing regulations should never be content with a corporate governance culture based on simply sustaining itself. As Ant's story has shown, regardless of the complexity or lack of sophistication in China's regulations, staying compliant is the responsibility and obligation of any corporate citizen; this explains the regulator's request for Ant to improve its corporate governance practices.

Consumer data safety governance
One significant governance risk exposed by Ant's operation is the immense quantity of consumer data stored on Ant's platform. As of March 2020, the company boasted 1.3 billion annual active Alipay users and had a transaction volume of over RMB118trn ($18trn) in China, RMB622bn ($95bn) overseas, for the year ending on 30 June 2020. China's recent regulations on online and mobile payments in 2016 and 2018 require payment service providers to implement risk management mechanisms to protect consumers' data, a reform that is in line with global discussion regarding the relationship between cyber security and corporate governance.

Mitigating potential systemic risks
Financial system stability is the foundation of a sound economy. The fact that Ant's online lending model provided unsecured credit to consumers and small businesses raised concerns of 'systemic risks' for China's financial system. Suspending Ant's IPO not only prevented Ant from becoming a monopoly, it also established a framework for other financial institutions to manage risk and thwart fraudulent and illegal transactions.

Narrowing the anti-trust enforcement gap between China and the US
Due to a huge consumer market and a rising middle class in the past few decades, Chinese multi-nationals have learned to grow domestically before expanding into the international market, leveraging the domestic market for further global growth. China's regulators have drawn suspicion from the global business community for allowing unfettered growth of Chinese companies at home due to their flexible regulation system. With this suspension, China has shown it's willing to enforce its anti-trust laws. This mirrors what we are seeing in

continued on page 12

GOVERNANCE
www.governance.co.uk

Subscription form

Please complete this form and send by mail to:

Subscriptions Department Governance Publishing and Information Services Ltd
The Old Stables, Market Street,
Highbridge, Somerset, TA9 3BP, UK

Tel: +44 (0) 1278 793300
Email: info@governance.co.uk
Website: www.governance.co.uk

(Please tick one)

- ☐ Yes! I would like to subscribe to Governance for one year
- ☐ Or save with a 2 year subscription

Governance international subscription costs:

	£UK	Euro	US$
1Yr	325	450	490
2Yr	585	790	855

Governance can accept cheques in other currencies but an administration fee of £15 will be charged.

☐ I enclose a cheque/bankers draft for
Currency Value
☐ Please invoice me
Specify currency:
Order reference:
Title:
First name:
Surname:
Position:
Company/Organisation:
Address:
Postcode:
Email:
Tel:
Fax:

continued from page 11

the US, as big tech companies like Google, Facebook and Amazon face greater scrutiny and anti-trust investigations.

Conclusion
Whether Ant's IPO suspension sows more confusion over China's regulatory practices or signals a step toward genuine reform remains to be seen. Either way, this incident is a warning to all Chinese technology companies to remain compliant and to beware regulators' intolerance toward cutting corners.

China's anti-trust enforcement is sure to shake other Chinese internet giants like Tencent, Meituan and JD.com and may possibly hurt China's economy and investors' interest and faith in Chinese companies for the time being. However, in the long-term, a well-regulated economic environment is essential, especially as China's economy – the second largest in the world – transitions to the digital era and plays a greater role in the global economy. If China suspended Ant's IPO to demonstrate its commitment to a higher standard of regulations, it may have come just in time – not only to prevent systemic and credit risks, but also to sustain and strengthen Chinese companies and the country's entire economy.

Lyndsey Zhang is a business strategist, entrepreneur and founder of BoardEpoch and Boardroom&Beyond, and a thoughtful adviser on corporate governance for Board of Directors around the world. Her company specialises in producing inspiring podcast episodes and educational articles sharing only the best corporate governance practices and ESG strategies and promoting leading companies in today's global ESG movement. www.boardroomandbeyond.com She can be reached at: Lyndsey.zhang@boardroomandbeyond.com

Index

Organisations
FRC 6
Henley Business School 8
ICSA: The Chartered Governance Institute 6
Institute of Business Ethics 5
ShareAction 3
World Economic Forum 8

People
Bob Garrett 6
Filipe Morais 8
Jenny Simnett 8
Chris Stamp 6
Lyndsey Zhang 10

Companies
ISS 8
KPMG 8
Pay Governance LLC 5

Designed and printed by WithPrint
Riverside Studio, Gills Lane, Rooksbridge, Somerset, BS26 2TY
www.with-print.co.uk

ISSN 1358-5142

© Governance Publishing 2021. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without written permission of the copyright holder.

Governance Publishing and Information Services Ltd
The Old Stables, Market Street, Highbridge, Somerset TA9 3BP, UK
Tel: +44 (0) 1278 793300
Email: info@governance.co.uk Website: www.governance.co.uk