C/M/S/ Hasche Sigle
Rechtsanwälte Steuerberater

XETRA | DEUTSCHE BÖRSE GROUP

Corporate governance matters
The role and perspectives of the private equity industry in China

White paper

Contents

3 Foreword

Part 1: Corporate governance study

4 Executive summary
5 A high priority for GPs
6 Corporate governance – high on the agenda of PE managers
8 Experience with corporate governance – an improving trend
9 From the GP's perspective
10 Setting the legal and contractual framework of corporate governance
12 Enforcing the GP's rights within a corporate governance scheme
13 Reporting about corporate governance
14 The LP's role
15 Scope for improvement
16 Environment, Social, Governance aspects and Corporate Social Responsibility
17 Conclusions

Part 2: Overview of the regulatory framework

18 Legal framework
18 PRC Company Law
18 Other statutory laws
19 Foreign-Invested Enterprises
19 Listed Chinese companies
20 Corporate governance overview
20 General shareholders' meeting
21 Board of Directors
21 Supervisory board
21 Senior management
22 Articles of Association
22 Contractual rights
22 Terms
23 Enforceability

Foreword

Dear readers,

It is a great pleasure for us to present to you our third white paper, which was prepared on the basis of fact gathering within our "China Europe Private Equity Roundtable" network.

The roundtable was established in 2009 as a joint effort of Deutsche Börse and CMS in order to initiate a regular and open dialogue between the European and Chinese venture capital and private equity industry on capital market topics.

This time we picked a sensitive subject: the role of corporate governance in Chinese private sector companies – particularly from the perspective of pre-IPO investors.

It is a good moment to address the importance of a value creating corporate governance methodology. The times when fund-raising was rather easy due to the upside potential created by the hype of the IPO markets for Chinese companies appear to be over.

Instead, the IPO markets for small and mid-size businesses from China are closed for the time being, and the returns on investments are far below expectations. In addition some egregious examples of fraudulent behaviour have made international investors more circumspect.

As a consequence confidence and trust, not only in the financial performance of Chinese (private sector) companies but also in the corporate governance culture, will have to be rebuilt or, at the very least, repaired.

In this study corporate governance is not looked at primarily as a legally structured framework but rather as a behavioural or cultural pattern.

If the private sector industry and the fund managers investing in these businesses are looking for overseas capital, the rules of international capital markets will apply. Moreover, these standards will increasingly be implemented in the Chinese domestic stock markets.

Therefore, an open attitude towards transparency, protection of minority shareholders and management oversight needs to be adopted. In addition legal compliance, environmental protection and corporate social responsibility are likely to gain traction – also in new growth markets – as these principles are widely incorporated into the statutes of international investors.

In the first part, the study reflects the sentiment of market participants of the European and Chinese Private Equity industry investing in Chinese private sector companies.

The second part contains some considerations regarding the legal framework.

Our special thanks go to Wang Xuwen, associate with CMS in Frankfurt, who summarised the legal aspects for this white paper, and to Karl Olbert of Olbert Consult who conducted the interviews with the market participants.

Sincerely yours,

Volker Potthoff Alexander von Preysing

Our study

The following report is in two sections.

- First we discuss the role and significance of corporate governance on the basis of interviews with market participants.
- In the second part, CMS gives an overview of the relevant regulatory framework in China.

Part 1: Corporate governance study

Executive summary

- In China corporate governance is less a formal, contractual regime; rather, it stands for the creation of trust among stakeholders.
- In these more challenging times where access to funding is harder to come by, corporate governance is particularly high on the agenda for the PE/VC industry.
- Corporate governance is return-enhancing and an important tool with which GPs can add value to their investments.
- PE/VC managers who adhere to stringent corporate government standards differentiate themselves from their competitors and are therefore better able to attract investors.
- Despite the trend for better corporate governance, there is still a long way to go, and further improvements will need more time.
- The corporate legal framework and available contractual arrangements in China are generally considered sufficient by PE/VC managers to exercise the necessary influence on companies and their managers.
- The prospect of a future IPO is not seen as reason enough to motivate management to adopt corporate governance standards. Business owners and management should take personal responsibility for corporate governance decisions and use it as an opportunity to achieve better results.
- Hence, better education in the area of corporate governance is needed and a change of mindset is necessary.
- Many GPs would welcome a more rigorous approach to corporate governance by LPs. This would help support those who already have good corporate governance track records and generally improve standards of corporate governance within the private sector more quickly.
- Corporate governance is strengthened by the adoption of ESG/UN PRI standards.
- Now that the first big wave of fundraising is over and many LPs are invested, the rules of the game will change. GPs looking to raise new money are likely to find it more difficult to do so.
- The differentiating role that corporate governance exhibits will contribute to and accelerate the consolidation process within the private equity industry in China.

A high priority for GPs

In last year's report we wrote about how private equity managers and investors work out the valuation of target companies. This year we want to discuss how private equity managers implement and execute corporate governance in their target companies. In doing so we concentrate on investments in private rather than state-owned businesses.

GPs do not see corporate governance merely as a system of checks and balances or as a way to improve transparency. Rather they regard it as an art, a correct way of conducting business, or a broad means of influence which can also include ethical standards.

Corporate governance is not a topic that should only be discussed in the context of listed equity. It is really a much broader issue and can concern virtually everybody engaged in a business who is confronted with stakeholders.

Corporate governance – high on the agenda of private equity managers

Return-enhancing
Private equity managers investing in China generally take their corporate governance responsibilities very seriously (as we shall see there are also many exceptions). The interviews we conducted indicate that GPs see corporate governance as critical and by no means as window-dressing with little substance behind it.

First of all there is a strong business case for corporate governance, as capital markets pay a premium for companies with good practices and procedures, hence the GP can have a positive impact on the company's valuation and its exit options. The private equity manager's mandate is to optimise the return of the capital allocated by the LPs. The GPs have to make sure that the company is managed in a professional manner and relevant standards, regulations and laws are adhered to. This is also a fiduciary obligation towards their investors.

This value-adding process, facilitated by the PE/VC managers, begins at the due diligence stage when deliberating over the investment and evaluating the deal, i.e. before the money flows, and not just at the time of exit.

Rising competition for capital and in businesses
Private equity managers, and private business owners in China alike, are confronted with an increasingly competitive market. In particular, competition for capital is rising – investors are becoming more demanding – as is the trading environment for most of the companies in their underlying businesses. Global competition is also increasingly a factor.

Impact of global value chains
Globalisation affects businesses however remote or small. More and more smaller enterprises are integrated into global value chains and have to adapt their standards and requirements accordingly. This quickly becomes evident if there is an accident, perhaps due to a lack of proper safety requirements during food preparation or while at work. Such a mishap can swiftly lead to high damages or even casualties, and the news about it will spread in seconds all over the world. The potential risks, including loss or damage to reputation, have become an increasing concern for private equity managers. They have to manage this risk properly in the companies they invest in. Thus global value chains become de facto drivers of international standards, which will also affect the corporate governance schemes of both investors and the companies invested in.

Methodology

- The first part of the study is based on an analysis of a series of extended interviews carried out over recent months with relevant, experienced market participants.
- We selected tier 1 private equity managers from China as well as from Europe mainly exposed to the private sector in China. This screening of the market was based on long-standing experience, regular visits, and on-the-ground knowledge. We also interviewed large European investors, including funds-of-funds managers and institutional investors.
- The interviewees expressed their personal views and remained anonymous unless they agreed to be quoted in this study. The interviews were conducted partly in China and partly on the phone.
- In addition to more than 20 interviews we had numerous other conversations about the topic. We also conducted a panel discussion about corporate governance in Shanghai, China, in September of this year.

ESG – impact of environmental, social and governance aspects

ESG is increasingly a trend within the industry. Ever more asset managers and investors in equities, bonds and real estate, including private equity investors, have become signatories to the UN PRI – Principles for Responsible Investment. By April 2013 there were 1,200 signatories, representing USD 35 trillion of assets under management, http://www.unpri.org/about-pri/about-pri/.

Contributing to financial stability

The OECD Principles of Corporate Governance (2004) reiterate the importance of these standards (http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf). The OECD points out that policy makers are now more aware of the positive impact corporate governance has on the stability of financial markets, investment and economic growth.

As the foreword to the OECD Principles of Corporate Governance says: "Companies better understand how good corporate governance contributes to their competitiveness. Investors – especially collective investment institutions and pension funds acting in a fiduciary capacity – realise they have a role to play in ensuring good corporate governance practices, thereby underpinning the value of their investments."

The situation in China

The private sector in China is developing quickly and gaining weight in the overall economy, which still has a substantial amount of state-owned companies. The private equity industry plays a vital role in financing private entrepreneurial activities. In many cases these are first generation enterprises with the founder being the CEO and still playing a central role. The entrepreneurs are self-confident and have been successful in a difficult and increasingly competitive – often local – environment.

Companies want to grow further and may consider the involvement of a private equity manager, especially as private banks do not play a major role in financing private sector entrepreneurial activity in China.

While the entrepreneurs know their respective businesses very well, they might not be aware of the consequences of bringing in third party equity capital investors into their businesses. In particular, they often lack the specific knowledge and expertise in business management and technology that capital markets require, factors which can be crucial when trying to steal a march in an increasingly competitive global market.

From the entrepreneur's point of view the contribution of private equity is mainly that of financing further growth, whereas additional involvement of the GP in the day-to-day business is often seen as a constraint, particularly when it leads to the business owner having less autonomy or flexibility, as is the case when the CEO still holds the majority of the company.

"The entrepreneurs used to have their behavioural patterns and decision-making processes which might be based on intuition rather than facts – contrary to what you would expect from a professional well-educated business manager," notes a Chinese GP manager in Beijing.

In our interviews we wanted to find out more about current practice among private equity managers and how they add value to their investments through the means of corporate governance. There are two chief concerns for any GP investing in China: understanding people and managing relationships. This can be more important than contracts. How can corporate governance help? Business owners, GPs and LPs alike, want to add value to their investments, each of them with their respective means, talents, objectives and agendas. Satisfying these not-always-aligned interests to the benefit of all parties is by no means easy.

Experience with corporate governance – an improving trend

Corporate governance in emerging capital markets is generally seen as difficult and in China experience is rather mixed. That said, GPs there do work hard to introduce corporate governance and often try their best to adopt international standards and best practice.

But the task is difficult because Chinese GPs are often only minority shareholders. Many managers and business owners do not understand that corporate governance is actually in their own interest when approaching capital markets; and, even more so when facing stiff international competition. Often tensions arise over business matters. These could also be differences in approach. The GPs, for example, are accustomed to making capital expenditure decisions based on facts, statistics and scientific logic, whereas others may be relying more on personal experience, intuition and gut instinct, or "flying by the seat of their pants" as one GP candidly described it.

Sometimes the business owner is unable to access comprehensive and reliable data.

In such situations conflicts may have to be resolved. These could also be of a cultural nature.

"The Chinese entrepreneurs have less respect for formality and corporate governance rules [than in the West] and want flexibility," says Zhen Gao, managing partner at Mandarin Capital Partners in Beijing.

It is hard to accept a GP as a partner who restricts entrepreneurship. Hence, for the entrepreneurial community at least, better and more pertinent education and training is required. However it takes time for this to develop.

"Only a few people can see the direct impact of corporate governance. Changing people's behaviour needs work and strong commitment."

Frankie Fang, managing director at LGT Capital Partners in Hong Kong

"Only a few people can see the direct impact of corporate governance. Changing people's behaviour needs hard work and a strong commitment," says Frankie Fang, managing director at LGT Capital Partners in Hong Kong.

A broad, general assessment from interview partners of the standard of corporate governance in the respective companies showed a level of 5 to 6 in comparison with an international "Western" measure of 10. However this is an improvement on the 2-3 of a few years ago. One reason cited for this better corporate governance is the impact of the financial crisis in 2008.

"CG is evolving as a practical matter. The locals treat everyone equally. Those who will cheat do not distinguish between foreigners and locals," says a Shanghai-based GP.

However it was also mentioned in the interviews that there are a lot of GPs who do not really understand the concept of corporate governance as required by international capital markets.

From the GP's perspective

GPs have various challenges in mind when thinking about the corporate governance of those companies they invest in.

First they have to set up the necessary corporate structures in the company, for example boards of directors, committees etc, and ensure that these entities work effectively and properly. This leads to a more democratic set-up within the corporation, and, at the same time, it puts the business owner or management in a new and more responsible position.

On the basis of these new structures, the GP will exercise influence on the company, exchange or add key personnel – for example the CFO – introduce international accounting practices and systems, increase transparency, set ethical standards, and support and control the business on a day-to-day basis.

Finally the GP will focus on those issues which help to secure the financial commitment they undertook with the company. It should be noted that these issues could be in conflict with other minority shareholders' rights.

Setting the legal and contractual framework of corporate governance

The main legal and contractual framework of corporate governance in China is provided by the Company Law in China (2006), the articles of association of the individual companies as well as contractual arrangements, in particular the shareholders' agreement. **➜For a comprehensive overview of the legal framework, see pages 18-23**.

Most GPs feel that these means and tools offer a company sufficient help to fulfil the necessary requirements for a proper governance scheme. However the GPs drew attention to the following ongoing issues:

- setting up appropriate boards and committees
- diversity and independence (of boards and committees)
- ability to work efficiently with boards and committees
- regularity of management meetings
- dialogue with management
- detailed reporting systems (for both management and GP)
- punctuality and detail
- appropriately qualified people
- sensible management incentives
- transparency of salaries
- accurate and professional accounting
- control-and-risk-management systems
- payments and expenses

The following regulations were mentioned most frequently in the interviews:

- veto rights
- right to a seat on the board
- right to appoint senior managers
- right to hire CFOs
- right to change the articles of association
- right to liquidate and dissolve a company
- right to information
- right to approve budgets, expense control and capital expenditure

In addition, business systems have to be set up to ensure the right policies, procedures and ethical standards are in place, for example sales and marketing procedures in a pharmaceutical company.

Young, fast-growing companies, in particular, need the support and professional guidance of good GPs. Here expense control is vital.

Contracts and GPs

- Some GPs would say, actually, you do not need any contractual arrangement. If you have a contract that governs the rights of the GP, then this will basically serve as a template for discussion with the business owner. The written contract can also be used as evidence to third parties.

- Some GPs might demand from a business owner something that another GP would not. Fewer requests might be less troublesome – and sometimes it is the GPs who care less about corporate governance who will complete the deal in this highly competitive market.

In order to protect his financial commitment a GP can force the other shareholders to sell the company, even if he is only in a minority position, the so-called drag-along clause. Whereas with a tag-along clause, the GP has the right – but not the obligation – to have his shares purchased on the same terms as the majority shareholder.

A GP can also create a downside protection for his investment by stipulating that the business owner has to buy back the shares from the GP at a certain price. Alternatively, the business owner is granted additional shares by the GP in the case of good performance.

Some GPs will not have preferential voting rights but will negotiate a right to put the entire company up for sale if required, as an entire company is generally worth more than just a stake in the company.

However, the real challenge for the key decision makers appears to be whether they were able to promote and support corporate governance rather than merely agreeing on it in a contract. GPs highlight the importance of managing people and relationships, regardless of what your rights might be. Many companies are in remote parts of the country, far away from the offices of the private equity manager. This represents an additional challenge. "However, here you need finesse and courtesy in order to manage the people," says Martin Mok, partner at EQT Partners in Hong Kong.

Enforcing the GP's rights within a corporate governance scheme

The main motivation for a business owner to accept a corporate governance regime is the prospect of a future IPO for the company which will, in turn, lead to higher financial returns and prestige for the entrepreneur. Nevertheless discussions, disagreements, even disputes about implementation, happen considerably more frequently than one might expect.

A GP who has established a corporate governance framework, and then encounters a problem exercising the desired influence or control over the company, needs to weigh up all the options carefully.

In general the contractual rights are not deemed to be easily enforceable. Most GPs will refrain from going to court, as they see their chances there as limited. "You will not win in court in China, but with the contractual agreement you have a guideline at hand to discuss the case, but not to exercise the control. You have a framework in case some dispute arises," notes a senior GP based in Hong Kong.

One GP proposed to bring a case to the attention of the government, rather than going to court. Only one interviewee would consider going to court after consulting their legal adviser.

"Usually I do have a very diligently negotiated contract. However normally this is never looked at. If you have to look back at the contract, then the situation is already bad," says Martin Mok, partner at EQT Partners in HK.

Consequently other options have to be discussed, for instance, mediation or the use of arbitration courts. GPs and management have to negotiate or persuade in order to solve a problem.

"If you have to look back at the contract, then the situation is already bad."

Martin Mok, partner at EQT Partners in Hong Kong

"Better are good ethics and trust in management and a clear understanding. This is more essential than legal remedies."

Bin Sun, vice president, at CICC PE in Beijing

"In almost every single situation we run into various issues, then we have to work them out. We will talk to the chairman and/or CEO frequently. All of us have these conversations and it is a case of learning through experience," says a GP located in Shanghai.

"This might look very good on paper. The private equity firm has to earn the trust of the company on top of any legal document," says Joseph Chang, head of the Hong Kong Office at SCM Strategic Capital Management AG, Zurich.

Reporting about corporate governance

- GPs interviewed do not publish a comprehensive corporate governance report for their LPs. This is not a priority. One reason given is that it would be too labour intensive. However, corporate governance related issues will often be mentioned in the respective sections of the reporting documents for the LPs covering the individual portfolio companies.
- One fund-of-funds manager emphasised that he is preparing a dedicated corporate governance section this year as part of his regular reporting to investors.

One way to put pressure on the management is if the GP is already preparing to replace a key player. "If you have a back-up employee it is easier to discipline the board and shareholders, notes Martin Mok.

However, the rights are typically somewhat limited – rarely will a CEO be fired, because the enforceability is not there and the CEO is generally in a stronger position.

The personal background of the chairman or CEO can also make the implementation of corporate governance easier. It could be considered an advantage, for example, if he or she has been educated abroad or has lived in an international city or generally has a more cosmopolitan outlook.

There are also measures which might not be made public, otherwise this would mean a loss of face for the entrepreneur. The GP might get control of the company stamp or 'chop', for example, or have a joint bank account or the requirement to co-sign certain financial transactions.

One option suggested in the interviews was that foreign courts might be used to handle conflicts where their law was applicable.

If you have a majority stake, you can exercise control more easily and change the management if necessary. "If your ownership stake is extremely high, above 40%, your chances increase," argues a GP from Shanghai.

Ultimately, the parties have to find an appropriate alignment of their interests. The business owner should understand that corporate governance is really for their benefit, regardless of the outcome of any potential IPO.

"You are setting the rules and you can fight the battle; but, better are good ethics and trust in management and clear understanding of each other. This is more essential than legal remedies," says Bin Sun, vice president at CICC PE in Beijing.

"Chinese corporates are beginning to rely more on professional managers. They cannot go back to the old days," says Zhen Gao, managing partner at Mandarin Capital Partners in Beijing.

The LP's role

"Our reputation is for asking uncomfortable questions of GPs, a relationship alone is not enough," observes one LP located in Zurich.

The LP has a contractual relationship with the GP (a LPA or Limited Partner Agreement).

LPs and GPs generally report a good experience of corporate governance. However the LP has no direct influence on the portfolio companies of the private equity fund. Hence his position is weak in comparison with that of the GP – he may have a seat on the advisory board of the private equity fund but no board seat in the respective companies. Therefore the LP cannot exercise any direct influence or control over a portfolio company. The LP has no proactive role.

"In a company there were sometimes dynamics which we did not know about. Only in retrospect did we receive the information, then we could check whether everything went the correct way – for instance, how much was paid to the CEO," notes an LP based in Zurich.

"From an LP you should not expect true experience, generally he knows little about what the GP is doing. He only has a seat on the advisory board of the fund. Only if he co-invests will he know more about what is going on," the same LP adds.

Not many LPs are fully prepared for co-investments, and the GP requires a quick turnaround when presenting a co-investment to an LP. But the decision-making process can be very slow, as is the case with a public pension fund for example. Unless there is a dedicated co-investment team, the internal approval process tends to drag on.

The LPs have a strong interest – often a fiduciary duty – in safeguarding an investment. Utimately, however, LPs are investing in funds, which they might not be able to control. Therefore it is of the utmost importance that the LP has sophisticated due diligence procedures in place to ensure that the GP has an excellent corporate governance policy and track record. Just before investing in a fund is a time when the LP is in a strong position relative to the GP.

"The GP must have a good protocol in place, how they will govern; later, there is nothing much we can do."

Joseph Chang, head of Hong Kong office at SCM Strategic Capital Management AG, Zurich

"The GP must have a good protocol in place, how they will govern; later, there is nothing much we can do," says Joseph Chang, head of the Hong Kong Office at SCM Strategic Capital Management AG, Zurich.

In particular the LP will find out through their own due diligence process how the GP implements corporate governance. This will become clear by observing how they select an investment target and by looking at how they structure the deal in order to achieve optimum corporate governance post investment.

Often examples of investments being positively or negatively impacted by corporate governance and compliance issues are given. Some LPs will check the corporate governance culture in the private equity company itself. They want to know how they govern themselves, how the GP ensures his business and his shareholders are properly capitalised, what the stake of the management is in the company, what the incentives are and whether there is a clear separation between the investment team and other entities. This will include background checks of the key players within a private equity company, including their criminal record, which will be conducted by specialist companies. Important is the involvement of excellent audit companies and the use of international accounting standards.

Some LPs require a fraud detection manual for investments in the Asia region.

An increasing number of LPs put an emphasis on ESG – Environmental, Social, Governance related aspects, which is reflected in their questionnaires to the GPs.

Funds-of-funds managers often present themselves as ESG-compliant to their investors.

However GPs believe LPs could be doing a lot better on due diligence. They say that many LPs are not aggressive enough when it comes to asking questions of their GPs. They also believe they should request more information about the economics of the team and about who receives carried interest. Finally, GPs perceive most LPs to be too shy or too polite.

Scope for improvement

- Most respondents feel that it will take time for the necessary corporate governance changes to filter through.

- Benchmarking corporate governance structures and methods is seen as a big challenge. A lot of corporate governance mechanisms are treated as commercial secrets, which neither GPs nor management would like to share with outsiders. Furthermore, any general benchmark is hard to set. You could do worse than learn from the corporate governance practices of a well-run international company, or consult the relevant global corporate governance bodies. This information could then serve as a benchmark.

- Many GPs had their doubts as to whether it was possible to find suitable benchmarks which accurately reflect the areas of most importance and concern. Benchmarks are too frequently seen as a mere checklist or reference.

Zhen Gao, managing partner, Mandarin Capital Partners, Beijing

- Better education for business owners and management was seen as important. Zhen Gao, managing partner at Mandarin Capital Partners in Beijing, suggested corporate governance classes "where the classmates are all private entrepreneurs and they would share their experiences".

- Leading by example is seen as the most relevant and effective way of improving corporate governance in the country. The best solution would be to find a high profile corporate personality in China who stands for high standards of corporate governance, a fact which helped them to achieve their wealth or prosperity, "the richest man in China".

Environmental, Social, Governance aspects and Corporate Social Responsibility

So that our study could be comprehensive and with an eye on future developments, we also discussed the growing influence of corporate social responsibility (CSR) and environmental, social, governance (ESG) policies and corporate social responsibility for GPs when investing in companies in China. What we found, however, is that there is no consistent approach to this.

Some see CSR as completely different to corporate governance, choosing to demonstrate instead the company's commitment to social issues. Some see it as an offshoot of corporate governance and begin with test cases in one or two of their own companies.

However CSR is certainly not to be underestimated because it can have a positive impact on the value of a company. Some GPs pointed out that this is a subject they should pay more attention to but still have much to learn about.

Corporate governance is seen as a core business tool for the GP – both as a means of generating money and of ensuring that the right processes are in place. Whereas CSR, on the other hand, is seen as less important from a financial point of view.

"If corporate governance is a subset of ESG, you would belittle CG," says Martin Mok, partner at EQT Partners in Hong Kong

Sometimes CSR is only seen as part of the investment guidelines, comparable with avoiding the use of child labour or discouraging the production of alcohol.

However, high level international investors are increasingly interested in ESG and CSR and want to see their principles implemented in the investment policies of their service providers, for instance in the pharma sector, where ethical sales procedures have been advocated. These investors care about their reputation. If the GP does not comply he will not be selected.

Some GPs we interviewed are signatories to the UN PRI – Principles for Responsible Investment, which aim to integrate environmental, social and governance concerns into the decision-making processes of institutional investors. "From the very beginning we incorporated ESG in our business and signed the UN PRI principles. On a GP level we implement ESG in our day-to-day work. When we do our investments we implement ESG through our due diligence process but also later, post investment, CG is a part of it. We benchmarked ourselves and we work together with ESG consultants," says Min Lin, partner at NewQuest Capital Partners, Hong Kong.

"We have an holistic approach to ESG. For our investors ESG plays an ever increasing role."

Robert Collan, investment manager private equity at Unigestion Asia Pte. Ltd., Singapore

"When we do our investments we implement ESG through our due diligence process but also later, post investment, CG is a part of it."

Min Lin, partner at NewQuest Capital Partners, Hong Kong

"We have an holistic approach to ESG. For our investors ESG plays an ever increasing role," notes Robert Collan, investment manager private equity at Unigestion Asia Pte. Ltd., Singapore.

"ESG is becoming increasingly important; it is a key concept for all our clients. They want to make sure that everybody will follow ESG. GPs have to show us how they deal with ESG in the invested companies," adds Joseph Chang, head of Hong Kong Office at SCM Strategic Capital Management AG, Zurich.

Conclusions

Corporate governance in China matters and will become even more important in the future, especially as the private sector is increasingly seeking capital from abroad. There is a strong business case for corporate governance, as it improves the valuation of companies and can also lead to higher investment performance.

A GP with a well established corporate governance track record has a competitive advantage in the market, especially against a backdrop of constrained investment returns. The GP can positively differentiate himself from his competitors and attract sophisticated long-term investors. This will contribute to consolidation within the PE industry in China.

There should be no conflict between GPs and business managers on corporate governance. The latter should see it less as a constraint or complicating factor and more as a useful and efficient way of adding value to their businesses.

The companies and their management need to take personal responsibility for corporate governance, rather than merely fulfilling the requirements of the GP. This would entail a change of mindset on behalf of the business owner community, and there is also clearly a need for better education on corporate governance issues. GPs need to be accepted as equal partners and a culture of self-governance should prevail. This will inevitably take time to establish itself.

In general, global capital is becoming more discerning. After the first big wave of fund raising in China, the balance of power has shifted from the GP towards the LP. However more pressure from investors is necessary to ensure that corporate governance standards continue to improve. Many GPs would welcome this development.

Managing people and relationships is crucial in China, regardless of what the contractual rights might be. There is a different approach to contracts than in the West. In China, contracts provide a basis for further discussions and serve as proof vis-a-vis third parties.

With so many LPs already invested and becoming more demanding, it is likely that the rules of the game will change and it will become more difficult for GPs to launch new PE/VC funds in the future.

Part 2:
Overview of the regulatory framework

In general, Chinese companies are subject to three main corporate governance constraints: (I) legal requirements; (II) the company's constitutional document, i.e., articles of association (the "AoA"); and (III) contractual obligations.

I. Legal requirements

A. Legal framework

China's corporate governance legal framework comprises a wide range of laws, regulations, administrative rules and self-disciplinary guidelines.

1. PRC Company Law

For both non-listed and listed companies, the most important statutory law is the PRC Company Law (promulgated in 1993 and amended in 2005, "Company Law"), which provides for the foundation of the corporate governance system in China and establishes the legal framework for the two most common company types in China – limited liability company ("LLC") and company limited by shares ("CLS"). While the CLS is the required corporate form for listed companies, most private companies are LLCs, mainly due to the lower registered capital requirements. The table below sets out the main features of the LLC and CLS.

2. Other statutory laws

The corporate governance legal framework set out in the Company Law is supplemented by several important basic statutory laws, including the PRC Criminal law (amended in 2006), which sets out criminal liability on disclosure breaches, non-disclosure of major information, insider trading, leakage of insider information and manipulation of markets, as well as the Law on State-Owned Assets of Enterprises (2009), which provides for stricter corporate governance for State-Owned Enterprises ("SOE").

Comparison of requirements for an LLC and CLS in China

Requirements	LLC	CLS
Minimum registered capital	RMB 30,000 (RMB 100,000 for one-shareholder company; certain sectors require higher capital) Registered capital not divided into shares	RMB 5 million Registered capital divided into shares of equal value
Number of shareholders	At least one but no more than 50	At least 2 but no more than 200 promoters, half of whom must reside in China
Board of directors	3-13 members	5-19 members
Supervisory board	At least 3 members	At least 3 members
Listing availability	An LLC must be converted into a CLS in order to be publicly listed	

In addition, the PRC Accounting Law (2000) lays out requirements regarding accounting practices, special provisions on companies' accounting procedures, accounting supervision, accounting offices, accounting personnel, and legal liability.

3. Foreign-Invested Enterprises ("FIEs")
FIEs are extensively regulated by the Chinese authorities and are subject to separate laws and rules, including the Law on Wholly Foreign-Owned Enterprises, the Law on Sino-Foreign Equity Joint Ventures, the Law on Sino-Foreign Cooperative Joint Ventures, their respective implementing rules, and the Interim Provisions on the Establishment of Foreign-Invested Companies Limited by Shares, as well as the Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (the so-called "M&A Rules").

These laws or regulations generally set out corporate governance rules for FIEs, including restrictions on foreign shareholdings in an FIE depending on certain businesses or industries, restrictions on transfer of equity or interest in the FIEs, as well as matters that must be adopted by unanimous approval of the board of directors of the FIE. For example, transfer of any equity in a Chinese joint venture requires a statutory consent right and right of first refusal by all the other shareholders or joint venture partners. Theoretically, such rights could be waived in the joint venture contract. But, in practice, a transfer of equity or interest in a Chinese joint venture requires amendments to the joint venture contract and the AoA, as well as approval by the Ministry of Commerce (MOFCOM) or its local counterpart.

4. Listed Chinese companies
Listed Chinese companies must comply with additional corporate governance laws, rules and guidelines. These include the Securities Law (2006), which governs, among other things: securities issuance and transactions, listing of securities, disclosure of information, prohibited transactions, acquisition of a listed company, as well as the Chinese Public Company Corporate Governance Code 2002 (the "China CG Code"), which is considered the main benchmark of whether or not a listed Chinese company has a sound corporate governance structure.

Unlike the OECD Corporate Governance Principles, which are adopted on a voluntary basis, Chinese-listed companies are subject to a certain constraint of compliance with the China CG Code, as the China Securities Regulatory Commission ("CSRC") can order any listed company that experiences major corporate governance problems to introduce remedial measures.

Other major regulations and rules for Chinese-listed companies include the Regulations on Listed Companies' Information Disclosure (2007), Guidance on Listed Companies' Articles of Association (2006), Rules on Listed Companies' Shareholders' Meetings (2006), as well as the Guidance on the Establishment of the System of Independent Directors in Listed Companies (2001). In addition, Chinese companies that are listed on the Shanghai Stock Exchange or the Shenzhen Stock Exchange must also comply with their respective listing rules.

Furthermore, if a Chinese company wants to list on a large foreign stock exchange, such as the NYSE, NASDAQ, or Deutsche Börse, it needs to obey additional listing requirements or foreign laws, which may entail higher corporate governance standards than the existing Chinese laws. As an IPO is still one of the main exit channels for PE investors in Chinese companies, implementation of a corporate governance system complying with these international standards could be difficult for the PE investor.

➜For a list of important laws and regulations on China's corporate governance, please see the Annex to this report on page 23

B. Corporate governance overview

The chart below shows an overview of corporate governance structures of non-listed (either LLC or CLS) and listed Chinese companies (CLS only).

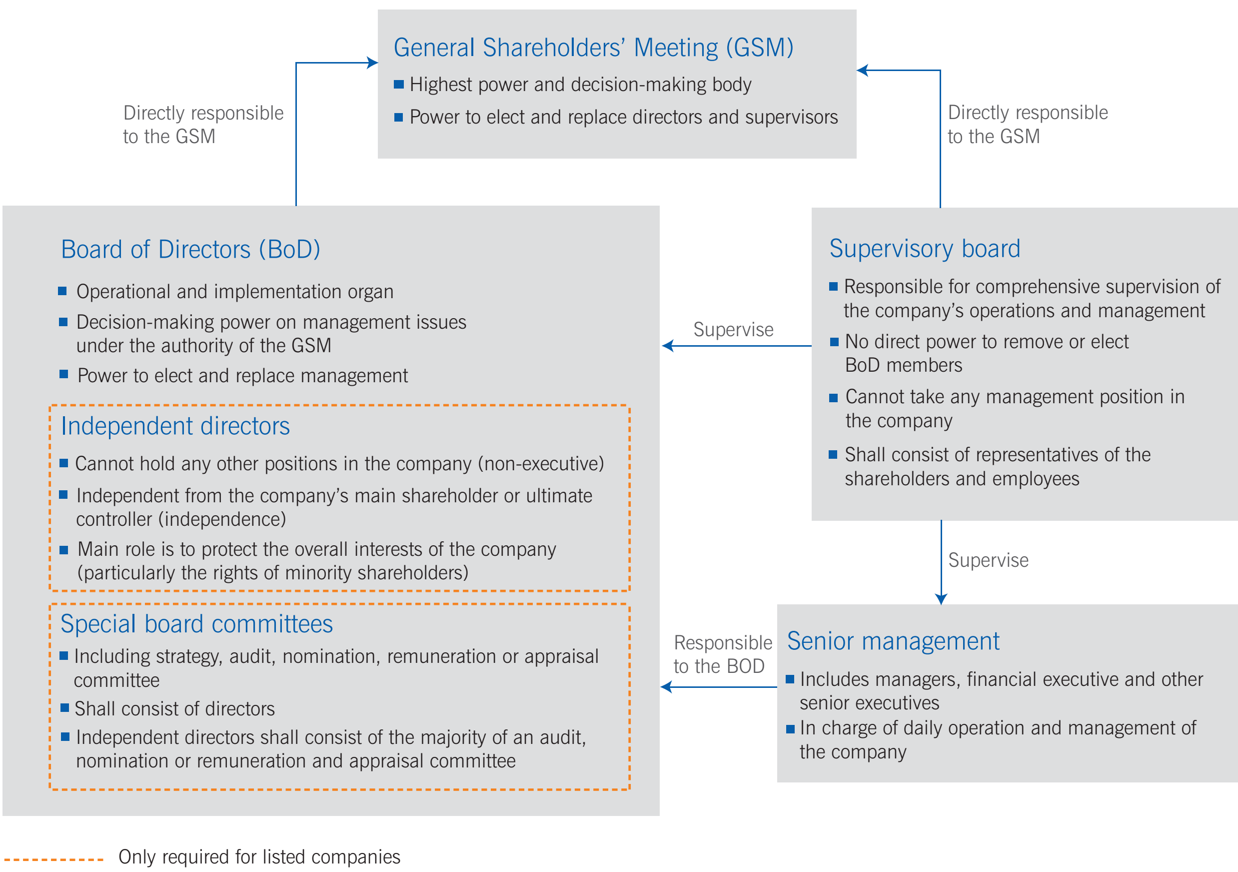
1. General shareholders' meeting

As the power and decision-making organ of a Chinese company, the general shareholders' meeting ("GSM") can determine major issues within the business, including: (i) amending the AoA, (ii) changes in registered capital; (iii) mergers, divisions, dissolution and change in corporate forms; and (iv) electing and replacing directors and supervisors and deciding on their remuneration.

The adoption of items (i) (ii) and (iii) requires at least a two-thirds majority vote. At the general shareholders' meeting, the shareholders of an LLC shall vote according to their respective percentage of capital contribution in the company unless the AoA provides otherwise, while the principle of "one share, one vote" shall be followed by the shareholders of a CLS.

All shareholders in a Chinese company can inspect the company's AoA, board minutes, financial statements and company accounts. Minority shareholders also have corporate governance rights, including the right to convene an interim shareholders' meeting or submit proposals to the

Corporate governance structures for Chinese companies



agenda of the shareholders' meeting (including proposing candidates for the BoD).

2. Board of Directors (the "BoD")
Unlike other jurisdictions, such as Germany, the BoD members of Chinese companies can only be appointed or removed directly by the GSM, and not by the supervisory board. The BoD, which is directly responsible to the GSM, is the most important operational and implementation organ of the company, and can determine management issues under the authority of the GSM. Directors are subject to a duty of care and a duty of loyalty to the company. Any breach of such a duty could give rise to civil, administrative or even criminal liability.

Listed Chinese companies are also required to have independent directors, who shall account for no less than one-third of the members of the company's BoD. Independent directors under Chinese law are similar to "non-executive" board members under the OECD Principles. Independent directors shall not hold any other positions (in particular a management position) in the company and shall be independent from the main shareholders, the ultimate controller, or other entities that have significant influence over the company. This means they do not assume executive roles in the management of the company and are capable of making independent and objective judgments. They are, however, responsible for protecting the overall interest of the company and, in particular, the rights of minority shareholders.

In addition, listed Chinese companies can set up special board committees, including a strategy committee, audit committee, nomination committee, remuneration committee or appraisal committee based on resolutions of the GSM. These committees oversee daily operations, often in comparatively independent fields, and consult and give input to the BoD on important company decisions.

In particular, independent directors shall consist of the majority of an audit committee, nomination committee or remuneration and appraisal committee. Therefore, the special committee is essentially an extension of the independent director system and can improve the independence and effectiveness of the BoD's operations and also help to control risks.

3. Supervisory board
Although China has adopted a quasi two-tier structure of board governance, designed loosely on the German corporate governance system, Chinese supervisory boards do not have the same strong controlling or powers of supervision over the BoD as the supervisory boards (Aufsichtsrat) in Germany do. For example, the supervisory board does not have the direct power to remove or elect the members of the BoD; it only has the right to "propose" such a removal to the GSM.

The supervisory board is responsible for the comprehensive supervision of the company's operations and management, in particular in relation to financial matters. If the company is being run inappropriately or inefficiently, the supervisors may investigate with the assistance of an accounting firm. To ensure independence of the supervisory board, the supervisors may not concurrently take the office of director or senior executive. Each supervisory board shall consist of representatives of the shareholders and employees.

In practice, Chinese supervisory boards are generally considered to be "phantoms" or "formalities" and most companies set up the supervisory boards just to meet minimum statutory requirements. There are several reasons for this. Firstly, as a matter of law Chinese supervisory boards are mostly entitled to "proposal/suggestion" powers rather than "decision-making" powers as in the German legal system. In practice, the roles of supervisory boards, in particular for listed companies, sometimes overlap with the roles of independent directors. Therefore, some academics have asked whether it is still necessary to have the system of supervisory boards or if a powerful independent director system similar to that in the US is sufficient. Some believe that companies should be free to choose whether they want to have an independent director system or a supervisory board in place.

4. Senior management
Senior management of Chinese companies is defined under the company laws to include managers (and vice manager), chief financial officers, as well as other senior executives as set out in the company's AoA. They are elected by and responsible to the BoD and in charge of

the daily operation and management of the company. However, for many Chinese companies, their founders normally serve as the company CEO while concurrently being the chairman of the BoD as well as the company's major shareholder. Therefore, the power of such a CEO in the company is significantly enhanced by his or her role in the BoD, as well as by his or her majority shareholding in the company.

The China CG Code requires that directors and management of listed companies must complete a performance evaluation organised by the remuneration and appraisal committees. Companies are also required to regularly disclose the remuneration of directors and senior managers to shareholders.

II. Articles of Association

The Articles of Association ("AoA") of a Chinese company are the company's constitutional document. The provisions of the AoA are binding on the company, its shareholders, directors, supervisors and senior managers. Violations of the rules of the AoA by a director, supervisor or senior manager may give rise to civil, administrative or even criminal liability. The Company Law allows a Chinese company to set out in its AoA more detailed rules or provisions regarding certain corporate governance matters, which may be used to the advantage of PE investors to strengthen their control over the target company.

For example, Chinese companies may adopt a cumulative voting mechanism in their AoA, which allows a shareholder to have the number of votes that equal (x) total number of shares held by such shareholder multiplied by (y) the total number of directors to be elected, which may be used to vote on one or more candidates.

Such a voting method gives a minority shareholder(s) a greater chance of appointing the directors/supervisors they want. According to the China CG Code, any listed company with a single shareholder who holds more than 30% of the company's equity shall adopt the cumulative voting system in its AoA. Without additional contractual protection, minority investors can only passively rely on favourable provisions in the company's AoA (if any), such as a cumulative voting system when electing directors or supervisors.

III. Contractual rights

A. Terms

It is essential for PE investors in China, who usually hold minority interests in the target companies, to strengthen their shareholders' rights. One way they can do so is by imposing contractual constraints on the company, the existing shareholders, or the co-investors.

It is not unusual therefore for private equity investors to negotiate aggressive, pro-buyer terms in the contract (even when there is a relatively small minority stake), in order to exercise control over the company's management and business as well as to ensure flexible exit options.

1. Representatives on the Board of Directors

It is vital for PE investors to have control in the BoD. Often PE investors ask for the right to appoint one or more board representatives to the BoD. Such representatives are normally granted veto rights over material matters, including over AoA amendments and major business decisions or financial-related issues. Usually this comes after an extensive negotiation.

However, it should be noted that under the PRC Criminal Law, a director, supervisor or officer may be subject to criminal liability, even for crimes committed by the company, if he or she is the "manager directly in charge" or "person directly responsible" for the management of the matter with respect to which a specific crime act was committed by the company. The risk of personal liability is more acute for a director or officer who is also the chairman of the board, executive director or legal representative of the company, or who otherwise serves in a senior management capacity such as general manager of chief financial officer. Some private equity investors avoid the risk of personal liability by appointing representatives to the board who have no management role within the company.

2. Information rights

PE investors usually ask the company to allow the investor and its authorised representative to inspect the books and records of the company. They can also make copies and extracts and have full access to all of the company's property and assets. In addition, any director of the company may request the company to provide information relating to its business and financial position. This information can be made available to any shareholder by the director.

3. Restrictions on share transfer

PE investors normally ask for additional restrictions on the transfer of shares by other shareholders, such as a "right of first offer", which ensures the investor is the first party to be offered the shares before such shares are sold to any third party, and/or a "tag-along right", entitling the PE investor to sell their shares to the third-party buyer together with the selling shareholders on a pro-rata basis. In some growth equity investments, the investor would require that the controlling shareholder shall not sell their share in the target company until a certain period after a successful IPO.

4. Exit mechanism

The most common exit mechanism for PE investors is still the IPO. In order to secure a "back-up" exit channel, some PE investors might negotiate a "drag-along" right, which gives the investor the right to "force" the other shareholders to sell all of their shares in the target company (together with the investor) to a designated third party. Such a right, although rather aggressive from the perspective of the company, ensures that the investor can sell all of the shares in the company to a third party, even if he or she only has a minority stake in the target. Some PE investors ask for redemption rights in the case of a failed IPO or material breach by the company or other shareholders. In such a scenario, the company is required to repurchase the shares from the investor at a price favourable to the investors.

5. Other

An investor may wish to seek co-signatory rights over the target's bank account, in which case an independent third party (normally a bank) will ensure that the funds of the target are not released other than for the purposes agreed by the investor. Such a right, however, is generally unacceptable to the target company as it imposes a material burden on the funds necessary for the operation of the target business.

B. Enforceability

In practice, the implementation or enforcement of such contractual rights can be difficult, largely due to the ultimate owner of the company not willing to share his/her "fiefdom". In cases where disputes arise between the investors and the company founder or CEO, the investor would usually resort to settlement or negotiation with the company rather than litigation or arbitration. This is due to the time it would take to bring such complex disputes to court or arbitration in China and also reflects the uncertainty of winning any such ruling. In addition, if the PE investor is well-known or influential in the market, Chinese companies may prefer to resolve disputes in an amicable way to reduce the risk of any loss of reputation.

Annex

Major laws and regulations on China's corporate governance

1. PRC Company Law (2006)
2. PRC Criminal Law Amendment No.6 (2006)
3. PRC Law on the State-Owned Assets of Enterprises (2009)
4. PRC Securities Law (2006)
5. PRC Accounting Law (2000)
6. Law on Wholly Foreign-Owned Enterprises (2000)
7. Law on Sino-Foreign Equity Joint Venture (2001)
8. Law on Sino-Foreign Cooperative Joint Venture (2000)
9. Interim Provisions on the Establishment of Foreign-Invested Companies Limited by Shares (1995)
10. Provisions on Change in Equity Interest of Foreign-Invested Enterprises (1997)
11. Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investor (2009)
12. The Code of Corporate Governance of Listed Companies (2002)
13. Regulations on Listed Companies' Information Disclosure (2007)
14. Guidance on Listed Companies' Articles of Association (2006)
15. Rules on Listed Companies' Shareholders' Meetings (2006)
16. Guiding Opinions on the Establishment of the System of Independent Directors in Listed Companies (2001)
17. Provisions on Strengthening the Protection of the Rights and Interests of Public Shareholders (2004)
18. Rules Governing the Listing of Stocks on the Shanghai Stock Exchange (2012)
19. Rules Governing the Listing of Stocks on the Shenzhen Stock Exchange (2012)

Published by
Deutsche Börse AG
60485 Frankfurt/Main
Germany
www.deutsche-boerse.com

CMS Hasche Sigle
60325 Frankfurt/Main
Germany
www.cms-hs.com

November 2013