US CHINA
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ESG Standards with Chinese Characteristics

ESG or "Environmental, Social, and Corporate Governance" are three core factors in evaluating an investments' impact and sustainability. While skeptics abound, it is undeniable that ESG will continue to play an exponentially important role in the ways we allocate our capital. Investors will always have choices, but it is becoming increasingly apparent that institutional investors will be forced by Trustees to embrace sustainability. Thought leaders from Larry Fink to Jamie Dimon are compelling us to rethink whether an exclusive focus on the return on capital is appropriate in a world facing enormous challenges such as the climate crisis, gender, and racial inequality. Companies and investors alike are being asked to focus on stakeholder versus shareholders, and ESG advocates will argue that an optimal return on capital and the sustainability/ethics of investment need not be mutually exclusive over the long haul.

This trend is global and increasingly complicated in China. Not only do investors have to assess traditional metrics such as environmental sustainability, but the impact of the Chinese Communist Party's (CCP) non-democratic rule adds layers of complexity.

A recent US-China Series Virtual Forum on ESG standards, their applicability to Chinese firms, and the risks and benefits for investors exposed to Chinese politics featured:

Isaac Stone Fish — CEO, Strategy Risk

You will know Isaac as a WSJ columnist, author, and regular on US-China Series with hs focus on the CPP's use of soft power. His new firm, Strategy Risks, is centering on ESG with Chinese Characteristics. We concentrate our discussion around how and should investors assign risk to companies with links to the CPP and the military. We discuss the role of dual-use technologies and use Xinjiang as a test case of where to draw the line. There is an immense level of ambiguity regarding Xinjiang, affecting not only Chinese firms but global organizations due to cotton exports.

It is clear that ESG will and should be an ever-important input into the investment process and that ESG with Chinese characteristics needs to be taken into account for any investment in the world's second-biggest economy. Two different categories of risk come into play in China. The economic risk involved is more similar to that found in other countries. Political risk, however, is radically different because of the differences in the Chinese Communist Party and its governance. There are no easy answers to the ways we should define ESG in China

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Risk Assessment in China: A Background

Isaac Stone Fish: *Strategy Risk* provides data on the exposure of global companies to Beijing across a series of metrics. Our work also serves philanthropies, nonprofits, institutional investors, and others, helping them assess the risk involved in equities linked to China.

ESG rankings in the United States have been inadequate, informing its role as an assessor of liability, as well as being applicable in measuring political exposure to China. As capitals from Washington to Tokyo implement more regulations and restrictions on business with Chinese companies, there is value in a system that could quantify this exposure for investors.

Define risk to Beijing. Do connections to the Communist Party add risk to an ESG framework, or do other elements play a role?

Isaac Stone Fish: The liabilities involved in Chinese-linked investments come in the form of exposures and risks, as follows:

- Exposure to the Communist Party plays into a company's business, such as issues of revenue in China and Taiwan; supply chain; social network analysis; and Xinjiang.
- Risk operates as a derivative of exposure: more significant exposure to Beijing results in higher fluctuations in perceptions from the Party.

How could an investor weigh economic versus political risk?

Isaac Stone Fish: Politics dominates in China on both the macro and micro levels. On a macro level, risks include how the Party can improve or hurt a particular asset class or stock and how this company is connected to Beijing.

Risk operates on a micro level when an American company, for instance, wishes to build a factory in the small province of Anhui, the US equivalent of Arkansas or Mississippi. If this venture involves partnering with a Chinese firm with deep ties to the United Front Work Department — an important Leninist organization that aims to strengthen the Party's friends and weakens its enemies; or if a board member is politically active — then there may be liabilities in that American company's standing in the US. Perhaps this firm will be scrutinized by politicians who are sensitive to US firms cooperating with Chinese political entities.

Recently, Ant Financial has been a significant example of risk: one must keep in mind, "What early warning signs of political and economic risks that could influence investment decisions?" In Ant's case, political liabilities linked to Jack Ma's standing within Chinese authorities — rather than financial fundamentals — derailed its IPO. The evaluation of political and economic risks is at once complicated, intriguing, yet maddening.

By Paul Krake

In advising investors, are risk assessments scaled in a formulaic way, or are they anecdotal in attempting to minimize risks?

Isaac Stone Fish: A combination of both approaches tends to be the most successful when communicating with portfolio managers and board members. It is vital to not advocate for a hardline prohibition of investing in China but instead highlighting the political risks involved and the hedge positions to manage risk. And even if exposure to China may be unavoidable, some areas — such as Xinjiang-related issues — to which companies certainly have an incentive to minimize exposure.

Examples of exposure to the Chinese Communist Party abound, from the revelation of Jack Ma's membership in the Party to everyday facial recognition software that could be derived from uses in Xinjiang. Where is the line drawn for exposure to Beijing?

Isaac Stone Fish: The question of where to cut off a country with whom there are tense relations is an old one. From an investor's perspective, the important thing is to gauge how US regulatory moves are headed. In light of current events, anything associated with Xinjiang should be a red line for companies. More broadly speaking, connections with the Chinese military also present themselves as risks, such as Poly Group, which is China's second-largest military defense company and the world's third-largest art auction house.

Moreover, there are some quite prominent companies that are entangled with US financial institutions. It is essential to have contingency plans if companies such as Tencent and Alibaba are seen as too problematic due to possible relationships with Beijing.

Chinese Specific Risks and ESG Standards

Are ESG frameworks involving China more difficult compared to other countries, and if so, should China have a lower ESG score by default because of the involvement of the Chinese government?

Isaac Stone Fish: Generally speaking, companies linked to China should have a lower ESG score because of connections to the Party. In terms of actual risk, the opaque nature of the Communist Party means that it is challenging to know the intricacies of the relationships between US corporates, Chinese corporates, and the Party. This is the most crucial black box on these companies' performance into which few have insight.

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Are US companies being held at a higher standard in a traditional ESG evaluation, and do Chinese companies benefit as their embedded risks are often overlooked?

Isaac Stone Fish: It is an arbitrage opportunity, given that laws and regulations do not reflect current needs. In certain instances, US authorities have acted on CNOOC, a major Chinese oil company, which the Biden administration will continue to sanction for its connection to the People's Liberation Army (PLA). Given the organization of the Communist Party, a broad definition of PLA connections would result in thousands of Chinese companies being highlighted for their military links.

The double standards for the US versus Chinese companies stem from several reasons, most notably transparency: an issue such as forced labor in the US supply chain of a major company would be a major scandal. Yet Chinese companies are much less transparent, and it is a possibility that understanding the operations of respected companies such as Alibaba or Tencent — and their possible involvement in issues such as Xinjiang — would raise red flags for US regulators.

Discuss the differences between disclosure and transparency for Chinese firms versus US-domiciled companies and where improvements can be made.

Isaac Stone Fish: The possibility for improvement is complex, and for the rankings that *Strategy Risk* creates, transparency is the only "positive": the more information, the better. There is one caveat: corporate transparency could be narrowly-focused on certain aspects while missing other important factors, such as political links.

This sort of double standard, on the other hand, for US firms is seen in the fact that they can openly discuss political relationships with the government. A partnership with the Pentagon, for instance, is disclosed, while information on cooperation with the Chinese Communist Party is far less transparent.

This is especially true for SOEs in their connections to Beijing: China Mobile's links to authorities are more opaque than that of private companies such as Huawei.

Approaches to Mitigating Risk

With Huawei as an example of a blanket ban, what are the challenges of risk mitigation policies compared to blanket bans?

Isaac Stone Fish: The challenges and benefits depend, as there are very different incentives in mitigations and bans for the public and private sectors. Some key points:

- The government wants to avoid mistakes and scandals, and the private sector wants to move fast and disrupt existing industries in the process. The challenges and benefits of risk mitigation shift between the perspectives of regulators and investors.
- Small- to medium-sized investors find little reason to deal with the politics of Beijing: investments in state-owned enterprises do not promise much greater returns than private Chinese companies. But a firm like Blackrock — if it decided to divest from state-owned Chinese companies — could face political backlash and financial repercussions.
- From the perspective of the US government as a regulator, this is a challenging question, and responses have shifted over time. From the 1980s to the 2000s, cooperation was preferred for reasons including a common adversary in the Soviet Union and hoped that economic liberalization would lead to political liberalization.

Now there is a shift as the US needs to decide how to deal with a country that is simultaneously an economic bright spot and the US's most significant geopolitical competitor. Yet this has to be done so with a focus on Beijing and the Communist Party, and not the Chinese people.

Given the disparity between listing requirements in China and the US, could one solution be for the Security Exchange Commission (SEC) to create an even playing field by requiring Chinese companies to make themselves available for audits?

Isaac Stone Fish: This would have happened already if it were a viable and straightforward solution. But US financial institutions would lobby against such a proposal for both the potential damage to their interests, as well as pressure from Beijing on their operations. On the other hand, Chinese financial markets have liberalized in allowing US financial firms to participate, and this has helped individuals like Steven Schwartzman and Ray Dalio become more vigorous advocates for Beijing in the United States.

What is social network analysis, and how is it applicable to China?

Isaac Stone Fish: In looking at nodes and connections between people in institutions, we have noted that the Chinese Communist Party, including the United Front and other party organizations, emphasize the value of networks in spreading Party ideals and pushing back against anti-Party view-points.

One example is WeChat, which is a powerful tool that both connects hundreds of millions of Chinese people but also allows the Party to have access to information being spread on networks, and the ability to clamp down on negative opinion.

What is the infrastructure surrounding board members who are representatives of the Party, and why is it a cause for concern?

Isaac Stone Fish: The concern is that board members who belong to the Party do not drive shareholder value. The assumption is that board members chosen by companies are more efficient than individuals who prioritize the Party over the company, even if they may be very competent.

The other issue transparency. When it is uncertain why an individual is on a board in an American company — for instance, Netflix or Tesla — much more information can be had that allows for better investment decisions, while that information is much more difficult to obtain for Chinese companies.

Attempting to ascertain how and why board members are appointed becomes intensely complicated. An appointment could occur because the Communist Party felt that the company was moving in a different direction; or, the person in question is a fig leaf for the company to move in directions that are against the wishes of the Party.

Should the valuations of Chinese equities be automatically discounted because of these embedded risks?

Isaac Stone Fish: Investors may downplay embedded risks and look at China's growth and its positive fundamentals, which are higher than the US — if the numbers are accurate — but hidden risks should make investors cautious about the Chinese stock market.

At the same time, those risks may already be baked into Chinese equity prices. It is possible that Chinese equities should be trading at much higher valuations but is not doing so because of the risk factors, either political or economic ones, that are baked in.

Environmental Risks

As the US, UK, and EU are harmonizing ESG standards, could China be part of global efforts on those standards? If the "environment" part is likely to converge, what about "social" and "governance"?

Isaac Stone Fish: When it comes to ESG standards, the "E" or environment part is easiest for Beijing, given general perceptions that China's cooperation is needed to fight climate change. This is despite my personal view is that pushing Beijing would yield better results for the climate.

Some key points:

- Under the environment standard, both governments and businesses in China and the US are aligned on issues of carbon reliance. In contrast, "S" and "G" standards (social and corporate governance, respectively) will never be the same in China as they are in the United States.
- There are worries that the increasing influence of Chinese companies in the ESG space will dilute the standards upheld in the US. And it is concerning that Beijing's influence in

these issues — and achievements of environmental goals — could be done in conjunction with social and human rights issues, such as Xinjiang.

The growing influence of the Communist Party over private and public businesses would necessarily reduce ESG scores, especially the "S" and "G" elements. And Chinese firms, realizing the benefits of having ESG policies, see some of their scores increasing because they are transparent on specific narrow metrics that fulfill ESG criteria.

China has taken the lead in the global climate agenda. Does it deserve more credit with regards to the environment, and should Chinese companies score more highly than US companies on environmental standards?

Isaac Stone Fish: China may have set out long-term goals for reducing its carbon emissions, but investors should be wary of believing in grand pronouncements. Stereotypes that the Communist Party and Chinese people are master planners are often misguided as their faults are similar to everyone else. This includes five-year plans, which see a sizeable gap between promises and realities. It is impossible to predict China's ability to stick to carbon reduction plans, particularly as it could hurt the Chinese economy.

And, Beijing needs to be held accountable at high standards when it comes to climate change initiatives. Chinese is the world's largest emitter by far, and there is a big difference between rhetoric and reality. But certainly, Beijing has done more on areas like EVs compared to the United States and Europe.

Are there sectors of the Chinese economy that look relatively clean from an ESG standpoint versus other sectors that need wholesale change?

Isaac Stone Fish: For investors, it would be advisable to look at Chinese companies that will pose regulatory risks in the United States and provide a guide to the political ramifications of a particular asset. As opposed to a firm that can provide an in-depth understanding of a particular equity, *Strategy Risk* supplies guidance on the individuals, their political positions, and relationships that could influence any investment decision.

Conclusion

It is clear that ESG will and should be an ever-important input into the investment process and that ESG with Chinese characteristics needs to be taken into account for any investment in the world's second-biggest economy. Two different categories of risk come into play in China. The economic risk involved is more similar to that found in other countries. Political risk, however, is radically different because of the differences in the Chinese Communist Party and its governance.

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