BSR

Sustainable Investment in China 2009

September 1, 2009

www.bsr.org

About this Report

Sustainable Investment in China 2009 is the third in a series of reports which investigates and provides recommendations for the development of sustainable investment (SI) in emerging economies. This report, which focuses on the SI market in China, has been commissioned by the International Finance Corporation (IFC) and prepared by BSR. The first two reports in the series covered Brazil and India, and were prepared by TERI-Europe. As with the previous reports, this report focuses on “sustainable investment,” defined as domestic and foreign investment in the country’s publicly listed companies using strategies that take environmental, social, and governance (ESG) issues into consideration. The report also briefly covers sustainable investment by private equity investors.

The report is based on literature review as well as interviews with individuals. The authors would like to thank the interviewees for their review of this report for accuracy. Any errors that remain are those of the authors.

Please direct comments or questions to Adam Lane at alane@bsr.org.

DISCLAIMER
BSR maintains a policy of not acting as a representative of its membership, nor does it endorse specific policies or standards. The views expressed in this publication are those of its authors and do not reflect those of BSR members.

In addition, investment products and organizations referenced in this report are for illustrative purposes only and should not be construed as investment advice. Investors should perform their own due diligence on any potential investments.

ABOUT IFC
IFC, a member of the World Bank Group, creates opportunity for people to escape poverty and improve their lives. We foster sustainable economic growth in developing countries by supporting private sector development, mobilizing private capital, and providing advisory and risk mitigation services to businesses and governments. Our new investments totalled US$16.2 billion in fiscal 2008, a 34 percent increase over the previous year. For more information, visit www.ifc.org.

IFC’s Sustainable Investing Team. For the past four years, IFC's Sustainable Investing team has delivered technical and financial support for projects that aim to mobilize sustainable capital flows into emerging markets. The goal is to increase the volume of mainstream investment that uses ESG analysis as a standard practice in their investment decision.

IFC’s approach is twofold:

» To catalyze capital market flows into sustainable investment, IFC works to (a) promote the business case for sustainable investment by drawing lessons from IFC’s own portfolio, (b) establish frameworks to identify and assess new sustainable investment opportunities, and (c) develop new financial products (e.g. Sustainability indices); and

» To support fund managers investing in sustainable companies, IFC works (a) with private equity funds in IFC’s portfolio to assist them to establish ESG analytical processes, and (b) with capital market actors to improve the enabling environment for the market to recognize and value sustainability in corporate valuation.

IFC is committed to continue its work in partnership with key market actors to improve the enabling environment and address barriers to sustainable investment in emerging markets. In order to do this, IFC's work is centered in three areas: policies and standards, knowledge management and investment vehicles. The Sustainable Investing team is part of IFC's Environment and Social Development Department, and benefits from the generous financial support of IFC and the Governments of Japan, the Netherlands, Norway, Canada, South Africa and Switzerland. For more information, please visit the Sustainable Investing website at www.ifc.org/sustainableinvesting.

ABOUT BSR

A leader in corporate responsibility since 1992, BSR works with its global network of more than 250 member companies to develop sustainable business strategies and solutions through consulting, research, and cross-sector collaboration. With six offices in Asia, Europe, and North America, BSR uses its expertise in the environment, human rights, economic development, and governance and accountability to guide global companies toward creating a just and sustainable world. Visit www.bsr.org for more information.

Table of Contents

Acknowledgments

All Pensions Group Asset Management Asia	Y. K. Park
Asian Corporate Governance Association	Jamie Allen
Association for Sustainable & Responsible Investment in Asia	Wai-Shin Chan
Bank of China Investment Management	Daixi Yu
CCB-Principal Asset Management	Jun Xu
Carbon Disclosure Project	Sue Howells
Changjiang Pension Insurance Co., Ltd	Weisha Li
China Banking Regulatory Commission	Yanfei Ye
China Center for Market Value Management	Guofang Liu
F&C Management Ltd	Alexis Krajeski
Fortis Investments	Florian Sommer
Generation Investment Management LLP	David Y Yeh
Global Reporting Initiative	Sean Gilbert
Gold Stone Investment Limited	Jianguo Cui
Guosen Securities Co., Ltd	Ping Wang
IDFC Global Alternatives (Hong Kong) Ltd	Melissa Brown
Industrial Fund Management Co., Ltd	Zhao Xin, Zhaoyang Liu
Mercer	Helga Birgden
Japan Research Institute	Eiichiro Adachi
Ministry of Environmental Protection of China	Dongfang Feng
National Council for Social Security Fund	Weihua Wang, Zhongxin Liu, Yuyin Zhan
New Horizon Capital	Cher Teck Quek, Hao Song
Principles for Responsible Investment	Narina Mnatsakanian
Robeco	Min Lu
Shanghai Stock Exchange	Danian Situ
Shenzhen Stock Exchange	Jiahang Fei
Sumitomo Trust & Banking	Akira Inoue
Tsing Capital	Don Ye, Yan Zhu
UNEP Finance Initiative	Susan Steinhagen

Glossary of Abbreviations

ADB	Asian Development Bank
ADRs	American Depository Receipts
AGM	Annual General Meeting
AMC	Asset Management Company
ASrIA	Association for Sustainable & Responsible Investment in Asia
AUM	Assets under Management
Cap	Capitalization
CBA	China Banking Association
CBRC	China Banking Regulatory Committee
CDP	Carbon Disclosure Project
CFA	Chartered Financial Analyst
CIRC	China Insurance Regulatory Commission
COP	Communication on Progress
CSI	China Securities Index Co. Ltd.
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
DFI	Development Finance Institutions
DJSI	Dow Jones Stock Index
EA	Enterprise Annuity
EGM	Extraordinary General Meeting
EIA	Environmental Impact Assessment
ESG	Environmental, Social and Governance
ETF	Exchange Traded Fund
FDI	Foreign Direct Investment
GAC	General Administration of Customs
GDP	Gross Domestic Product
GEM	Growth Enterprise Market
GHG	Greenhouse Gas
GRI	Global Reporting Initiative
ICBC	Industrial and Commercial Bank of China
IFC	International Finance Corporation
ILPA	Institutional Limited Partners Association
IPE	Institute of Public and Environmental Affairs
IPO	Initial Public Offering
JRI	Japan Research Institute

LPs	Limited Partners
MEP	Ministry of Environmental Protection
MOFCOM	Ministry of Commerce
NaCSSeF	National Council for the Social Security Fund
NDRC	National Development and Reform Commission
NPI	Non-Profit Incubator
NPL	Non-Performing Loan
NSSF	National Social Security Fund
OFDI	Outward Foreign Direct Investment
PBOC	People’s Bank of China
PE	Private Equity
PRI	Principles for Responsible Investment
QFII	Qualified Foreign Institutional Investors
SAFE	State Administration of Foreign Exchange
SAM	Sustainable Asset Management
SASAC	State-owned Assets Supervision and Administration Commission
SEPA	State Environmental Protection Administration
SI	Sustainable Investment
SME	Small and Medium Enterprises
SOE	State-Owned Enterprise
SRI	Socially Responsible Investment
SSE-CGI	Shanghai Stock Exchange Corporate Governance Index
SSF	Social Security Funds
STB	Sumitomo Trust & Banking
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNEP-FI	UNEP Finance Initiative
UNGC	United Nations Global Compact
VC	Venture Capital
WRI	World Resources Institute

Executive Summary

Over the past three decades, China has made remarkable strides in economic development, maintaining a GDP growth average of nine percent a year and lifting more than 400 million people out of poverty.[1] China is determined to ensure the sustainability of its economic and social development as it enters the 21st century, which it envisions in terms of a "harmonious society." To this end, sustainable investment has an important role to play, not only as a means of risk mitigation for the financial system, but also as a powerful lever for influencing corporate behavior and helping to improve ESG performance. However, the potential of sustainable investment as a positive force for broader economic performance remains underdeveloped.

Mainstream investors in China have limited awareness and capacity related to ESG issues. Most domestic market participants have not yet moved from the "what and why" to the "how." Confusion over terminologies obscures the differences between sustainable investment and environmental thematic investment. Skepticism prevails regarding the business case for ESG integration and statistical evidence of SI financial returns. The lack of human resources—analysts and researchers trained to perform both ESG and financial evaluation—limits institutional investors' competencies to execute sustainability-oriented investment.

Despite the undeveloped status of the market, there are encouraging cases showing that a small number of market pioneers and innovators are exploring ways to integrate ESG factors into investment, and inventing homegrown methodologies which align with material issues at the country level, though these efforts generally remain at a very early stage. There are examples in different segments of the investment market:

» In the mutual fund sector, AEGON-Industrial Fund Management Co. Ltd offered the first, and so far only, socially responsible investment retail fund in China in May 2008. The fund has adopted a positive screening approach and developed a set of criteria to assess corporate and environmental sustainability. Specific ESG criteria that are particular to the Chinese market include a special emphasis on relationships with government, tax payment and legal compliance.

» In private equity, Tsing Capital, a leading Chinese private equity firm focused on clean technology, has performed ESG audits and engaged with investees on ESG challenges.

» In the pension fund sector, the National Social Security Fund of China (NSSF), the country's largest pension fund with total assets of US$82 billion, lists "responsible investment" as one of its four core investment principles and has expressed interest in learning more about responsible investment practices from overseas.

» The Shanghai Stock Exchange (SSE) and China Securities Index Co., Ltd. launched China's first ESG index—the Social Responsibility Index—in August 2009, selecting 100 SSE-listed stocks with good CSR performance based on their customized rating system.

The central question is whether these developments are merely a flash in the pan or rather, the early signs of a growing market in sustainable investment. The

---

[1] McKinsey Quarterly, "China's Green Opportunity", May 2009, (http://www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/Chinas_green_opportunity_2364 accessed 30 June 2009)

increase in strategic management of corporate social responsibility by Chinese companies, the strong reform of ESG-related regulation by the Chinese government, and the progress on ESG transparency reinforce the latter view. However, unless the growing interest in SI can be effectively translated into investor capacity and action, and garner broad popular support, SI may ultimately stay on the margins or even fade away. To ensure continued development of SI, there are a number of steps that the business community and the Chinese government should consider. They are:

» **The formation of a China Sustainable Investment Working Group (CSIWG)** to provide a platform for cooperation among the SI community and for a communication mechanism to help define and envision SI in China, and to jointly work on solutions that can fill the gap between current needs and future plans.

» **Enhancing ESG disclosure and research** targeting mainstream investors, which are a much broader audience than SI investors alone. A higher quality and quantity of ESG data on companies, along with robust ESG research intermediaries and easy access to ESG research information, could accelerate the progress of mainstreaming ESG approaches.

» **Increasing ESG education** should include integration of sustainability issues into key training programs, aiming to build broad-based buy-in and expertise on sustainable investment and corporate social responsibility.

China has an opportunity to further leverage the role of sustainable investment to significantly benefit the country and its business community. With rising awareness and understanding of ESG among mainstream investors, requirements for transparency would increase, which would lead to better corporate governance and ultimately, more successful companies. The market would reward the most innovative companies that address the country's most critical sustainability challenges, and financial resources would be more efficiently allocated. With the right incentives and commitments from government, and large mainstream investors on board, sustainable investment could flourish and lend support to yet another of China's transformations.

1. Introduction

Objectives

This report has been prepared by BSR for the International Finance Corporation (IFC) as part of the Sustainable Investing Program of IFC's Environment & Social Development Department. The report has the following objectives:

- To determine the current state of development of sustainable investment in China by measuring a number of market indicators; and
- To identify and recommend feasible interventions to stimulate the development of this important market.

This report forms part of a wider IFC project that includes similar assessments of the sustainable investment markets in Brazil and India. This report on China has been prepared by BSR's Beijing office with support from key members in New York and Hong Kong as well as input from Meng Liang, a senior researcher of People's Bank of China (the Central Bank of China). The sources of information include comprehensive desk research as well as extensive interviews and stakeholder discussions in Beijing, Shanghai, Shenzhen and Hong Kong conducted by the team over the period April–July 2009.

Scope

"Sustainable investment" is defined here as domestic and foreign investment in China's listed companies using strategies that take environmental, social and governance issues into consideration. These strategies include negative screening, positive screening, best-in-class, and shareholder activism, as well as "integrated" approaches such as engagement and non-financial risk auditing/analysis.

Although the term "sustainable investment" can mean different things, in this report it is defined as domestic and foreign investment in China's listed companies using strategies that take environmental, social and governance issues into consideration. These strategies include negative screening, positive screening, best-in-class, and shareholder activism, as well as "integrated" approaches such as engagement and non-financial risk auditing/analysis (these terms are explained below).

Stocks included	Stocks not included
A Shares	B Shares
ADRs	H Shares
	Other Chinese stock listings

The focus of the report is on China's A-share market, which consists of CNY-denominated shares listed on the Shanghai or Shenzhen Stock Exchanges, or through ADRs. B shares (listed on the Shanghai and Shenzhen Stock Exchanges with trading in foreign currencies), H shares (listed on the Hong Kong Stock Exchange) or shares of Chinese companies listed on Nasdaq, NYSE, or other exchanges are not included.

In addition, the report includes a section which describes the current status of sustainable investment in private equity (PE) in China. However, the total sustainable investment amount estimated by BSR does not include any PE investment.

The report does not cover other segments of the sustainable credit market such as ESG-related banking products, adoption of the Equator Principles, or micro-finance.[2]

[2] While only one Chinese bank has adopted the Equator Principles, many have developed social and environmental risk management systems as a result of China's Green Credit policy and several are

A SNAPSHOT IN TIME

This report must be seen in the context of the global financial crisis that unfolded during 2008 and 2009 following the emergence of problems in the US sub-prime mortgage market in 2007.

The authors have done their best to present an accurate and balanced 'snapshot' of China's sustainable investment market in this fast-changing and turbulent environment, and to frame conclusions and recommendations that will be accurate for the next 1-3 years. The BSR team has sought to use the most up-to-date data available, but acknowledges that some of the information and corresponding analysis contained in this report may have an unavoidably short shelf life in these exceptional circumstances.

EXCHANGE RATES USED

Unless otherwise stated, the exchange rate used in this report is CNY 6.834 to US$1 (the rate prevailing as of March 30, 2009).

EXPLANATION OF TERMS

Explanation of terms used in this reports are divided into two categories as following:

Sustainable Investment Terms	
ESG integration	The explicit inclusion by asset managers of environmental, social and governance (ESG) risk into traditional financial analysis.
Negative screening	The exclusion investment approach where negative criteria and/or filters are applied (i.e. avoidance of investment in risky companies or industries or countries).
Positive screening	Investment approach which seeks to invest in companies with better environmental or social performance. This approach normally scores companies based on their responsible business practices and over-weights companies who demonstrate environmental or socially responsible leadership and underweights companies with evidence of irresponsible practices.
Best-in-class	Investment approach where the leading companies with regard to ESG criteria from each individual sector or industry group are identified and included in a portfolio.
Thematic investment	Investment approach which focuses on a subset of equities which are related to a particular ESG issue (i.e. focus on sectors such as clean-tech, carbon-trade, water, energy, etc.).
Shareholder activism	A way in which shareholders can influence a corporation's behavior by exercising their rights as owners, often through use of proxy voting to influence corporate boards to promote shareholder resolutions focused on social responsibilities or governance issues and/or developing a dialogue with top management to solve a specific problem.
Engagement	Approach applied by fund managers to encourage more responsible business practices, which mainly takes the form

active in promoting sustainability-related financial services and banking products in areas such as alternative energy.

	of dialogue between investors and companies on issues of concern. Engagement may extend to voting practices and include shareholder activism.
General Financial Terms	
A shares	Shares listed on the Shanghai or Shenzhen Stock Exchange with trading in CNY.
B shares	Shares listed on the Shanghai and Shenzhen Stock Exchanges with trading in foreign currencies.
H shares	Mainland company stocks listed on the Hong Kong Stock Exchange.

Structure of the Report

To provide important context for the rest of the report, Chapter 2 begins with a brief overview of China's development profile, economy and stock markets (Shanghai and Shenzhen), along with a summary of the regulatory and policy framework. Chapter 3 adds to the context for sustainable investment in China with a short discussion of ESG issues in China.

Chapter 4 analyzes sustainable investment activity by different types of market participants, focusing primarily on Chinese mutual funds, Chinese pension funds, Chinese insurance companies, foreign investors and private equity.

Chapter 5 analyzes the enabling environment for sustainable investment in China including the role of ESG disclosure, sustainability indexes, sustainability research organizations, relevant networks and associations, and civil society organizations.

Chapter 6 concludes with a summary of the major challenges and proposes a number of recommendations for stakeholders in China's sustainable investment market.

2. Country Overview

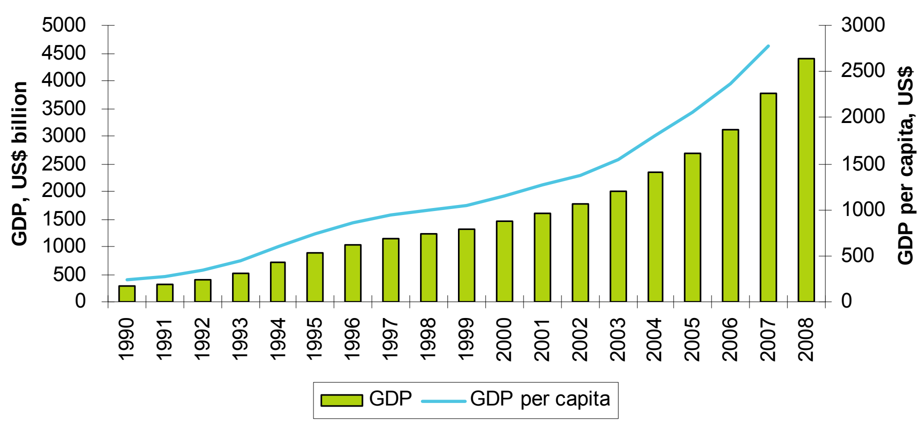
This chapter provides an overview of China's development profile including basic economic structure, capital markets, and the regulatory and policy framework for environmental, social and governance issues. There is significant potential for the development of a strong market for sustainable investment in light of China's economic status and regulatory landscape—the country's strong economic development and increasingly stringent regulation of social and environmental impacts combine to create fertile ground for the development of sustainable investment.

Economy

In 1978, the Chinese economy ranked 10th in the world in terms of Gross Domestic Product (GDP), and with a per-capita GDP of only US$190, was one of the least-developed countries in the world. Only three decades later, China has become the third-largest economy in the world (or second-largest in terms of purchasing power parity),[3] though on a per-capita basis it is ranked just 104th in the world. This economic growth has been largely driven by trade – in 2004, China overtook Japan to become the third-largest trading nation.

CHINA'S CONTINUING GDP GROWTH
China's economic growth has become one of the main drivers of the global economy. According to World Bank statistics, during 2003 – 2005, China contributed 13.8% of global economic growth, 2nd only to the U.S at 29.8%. By 2008, after several years of rapid growth, China's GDP in monetary terms reached CNY30.07 trillion (US$4.4 trillion), an increase of 9% over the previous year, and a total share of more than 20% of global GDP. By 2007, per-capita GDP was equivalent to US$2,771, propelling China from a low-income country to a lower-middle income country, as defined by the World Bank.

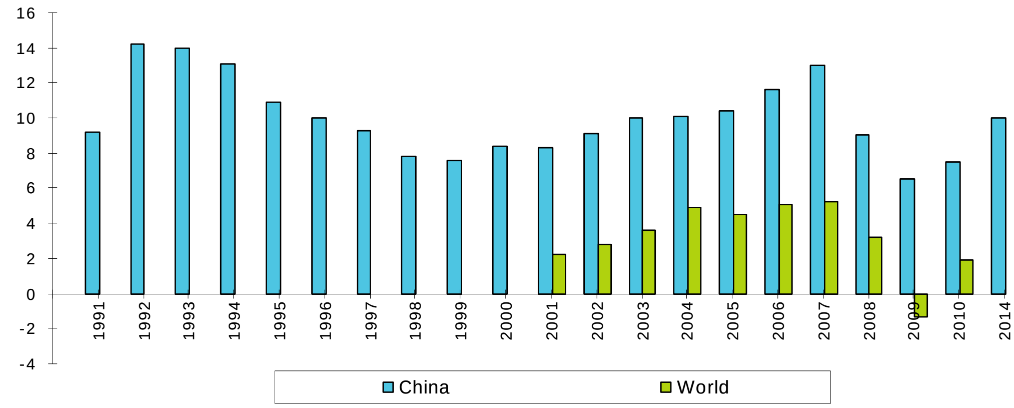
Figure 2.1: GDP and GDP per capita of China



Source: CEIC DATA

[3] World Bank, "World Development Indicators Database", revised 24 April 2009, (http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP_PPP.pdf accessed 20 July 2009)

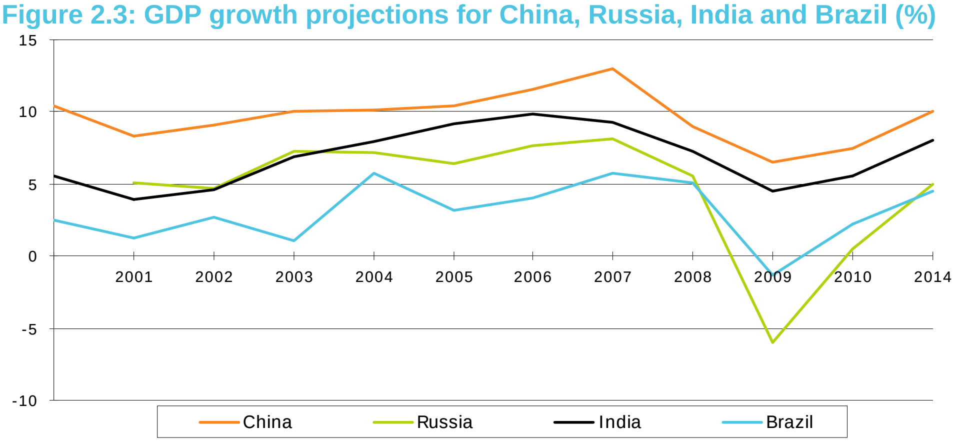
Figure 2.2: China and World GDP Growth Projections (%)



Source: CEIC DATA and World Bank

China's growth is estimated to continue at a brisk pace leading other emerging markets (see Figure 2.3) despite the current economic crisis, driven largely by government spending and policy measures to boost domestic consumption.

Figure 2.3: GDP growth projections for China, Russia, India and Brazil (%)

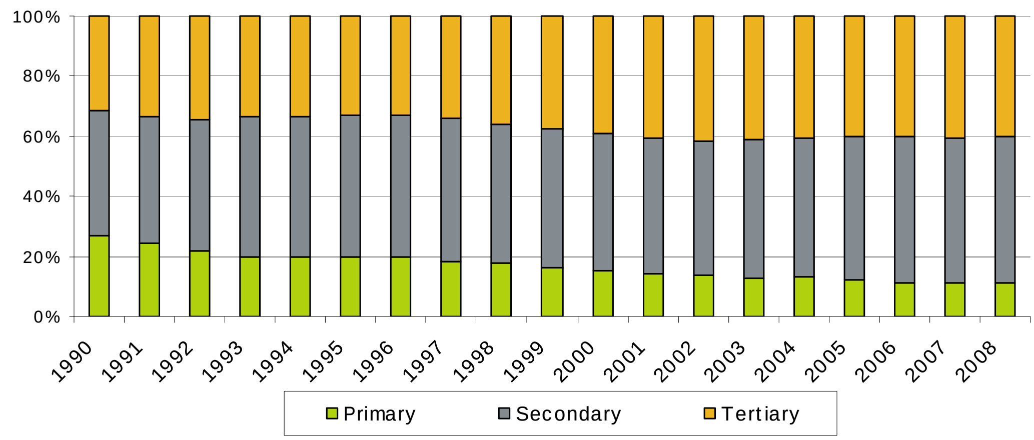


Source: World Bank

SECTOR BREAKDOWN

The importance of the primary industry (production and extraction of raw materials) to the country's GDP continues to decline while the secondary (manufacturing) and tertiary (service) industries continue to increase. In 1990, the ratios of the primary, secondary and tertiary industries' proportion of GDP was 27.1%, 41.3% and 31.5%, respectively, while in 2008, the ratios were 11.3% (down 15.8%), 48.6% (up 7.3%) and 40.1% (up 8.6%), respectively. This shows the process of China's economic industrialization and changing economic structure, with service industries becoming increasingly important, second only to manufacturing.

Figure 2.4: Breakdown of China's Industrial Sectors



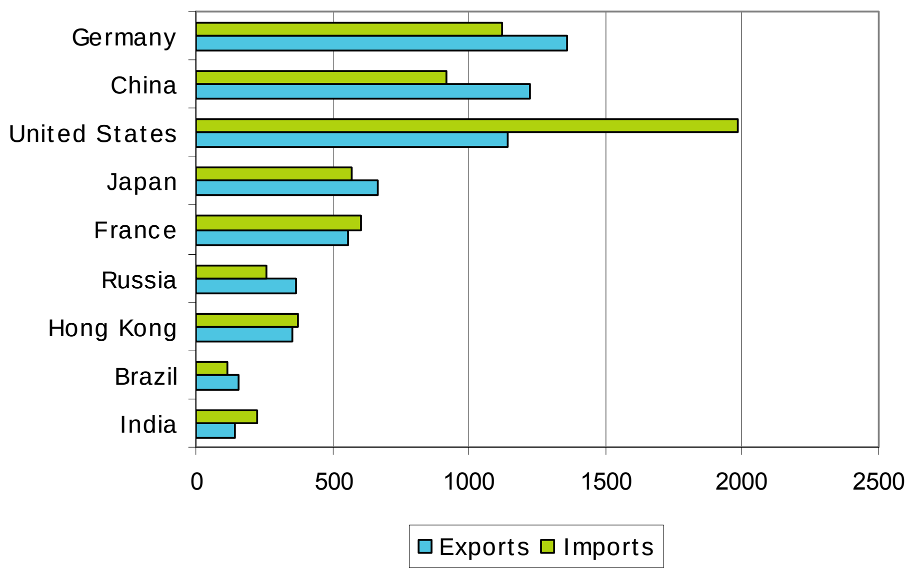
Source: CEIC DATA

China's government has placed even more attention on taking advantage of the Chinese people's high saving rates with efforts to stimulate domestic consumption.

RELIANCE ON INTERNATIONAL TRADE

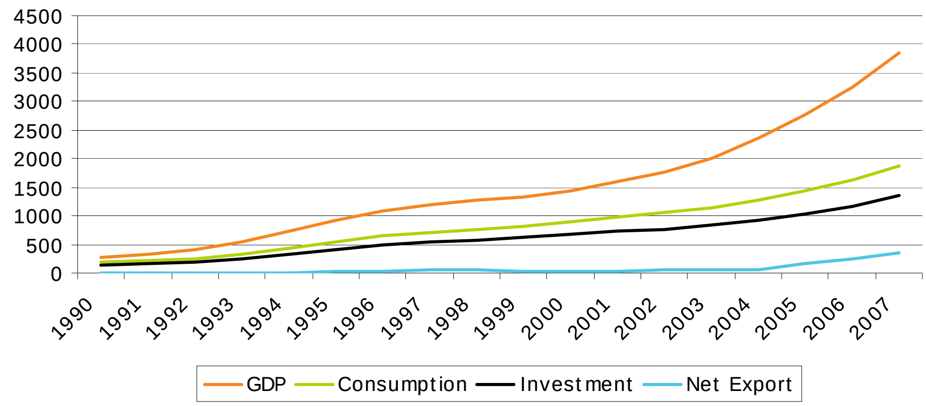
China continues to have a healthy balance of payments, but the economy is over-reliant on trade and international export. With depressed international demand during the recent economic crisis, the Chinese government has placed even more attention on taking advantage of high saving rates with efforts to stimulate domestic consumption.

Figure 2.5: Exports and Imports for Selected Countries (US$ billion), 2007



Source: CIA World Factbook

Figure 2.6: GDP, Consumption, Investment and Net Exports (US$ billion)



Source: CEIC DATA

The ratio of consumption to GDP has declined to 49% as economic growth depends more heavily on investment and net export, despite government attempts to boost consumption. Although the economic crisis lessened demand for Chinese exports, China's economy is likely to continue to be over-reliant on exports for the foreseeable future, as the country's industrialization process continues.

Table 2.1: Ratios of Consumption, Investment and Net Export to GDP (selected years)

	Consumption	Investment	Net Export
1995	58.1%	40.3%	1.6%
2000	62.3%	35.3%	2.4%
2005	51.8%	42.7%	5.4%
2006	49.9%	42.6%	7.5%
2007	48.8%	42.3%	8.9%

Source: CEIC DATA

CHINESE DOMESTIC SAVINGS CONTINUE TO RISE

The rapid rate of economic growth has increased the fiscal strength of the government. In 1978, China's foreign exchange (Forex) reserves were only US$167 million, but by 2008, these had grown to US$1.946 trillion, the largest in the world.

Table 2.2: Gross Deposits and Growth in Gross Deposits in China (selected years)

Year	Deposits (US$ billion)	Growth in Deposits
2000	1811.6	13.81%
2004	3532.7	16.04%
2008	6821.8	19.73%

Source: CEIC DATA

At more than one trillion dollars, China's gross domestic savings was the third highest in the world in 2005.

Chinese gross domestic savings continue to be high. China's population saves more as a percentage of GDP than almost any other country, with only one major economy, Saudi Arabia, saving more. At more than one trillion dollars, China's gross domestic savings total was the third-highest globally in 2005, and is likely even higher in 2009. Even when broken down per capita, savings are still fairly high–and growing fast.

Table 2.3: Comparison of Domestic Savings among China, India, Brazil and Russia, 2005

	Total Domestic Savings (US$ billion)	Gross Domestic Savings (% of GDP)	Gross Domestic Savings per Capita (US$)
China	1,096 (2nd)	49 (7th)	839.949 (71st)
India	240 (12th)	30 (39th)	218.724 (103rd)
Brazil	199 (13th)	25(53rd)	1,065.682 (64th)
Russia	263 (9th)	34 (26th)	1,839.445 (52nd)

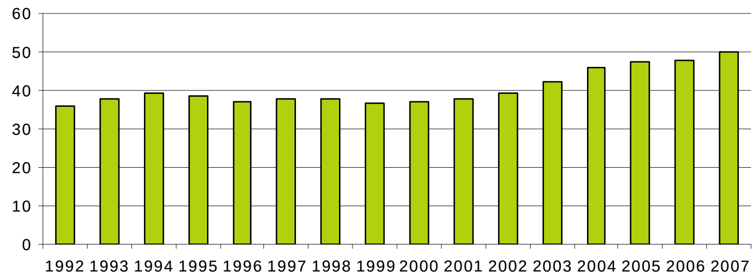
Source: World Bank, World Development Indicators

The surge in savings since 2002 has been driven as much by corporate savings as by household savings. The corporate savings ratio increased from 37.5% in 1998 to 49.9% in 2007.[4]

The household savings rate for Chinese citizens continues to be high (and the total amount continues to increase) for a number of reasons, such as a fear of not being able to afford future healthcare costs, and expectations for pension and private education expenses, as well as culture, tradition and family structure.[4] Many citizens estimate potential future costs to be much higher than they are likely to be.[5] Of domestic savings, 86% are kept in low-yielding bank deposits which, between 1996 and 2006, earned an average return of just 0.5% a year after inflation.[6] McKinsey analysts estimated that if real returns on savings increased to 1%, consumers would gain $10 billion annually and thus have more disposable income. Such low interest rates encouraged individuals to seek higher returns in equities and real estate, fuelling the stock market bubble of 2007 (when individuals made up 51% of the stock market)[7] and a boom in real estate prices. However, with recent stock market losses due to the financial crisis, individuals may return to the safety of bank deposits.

[4] Zhou Xiaochuan, Speech at a Conference hosted by the Central Bank of Malaysia, Kuala Lumpur, 10 February 2009, (http://www.pbc.gov.cn/english/detail.asp?col=6500&id=179 accessed 20 July 2009)
[5] Orr, Gordon R, "Encouraging Consumer Spending in China", December 2004, (http://www.mckinseyquarterly.com/Encouraging_consumer_spending_in_China_1555, accessed 20 July 2009)
[6] Farrell, Diana and Lund, Susan, "Putting China's Capital to Work", May 1, 2006, (http://www.mckinsey.com/mgi/mginews/chinacapital.asp, accessed 30 July 2009)
[7] CSRC, "China Capital Markets Development Report", January 2008

Figure 2.7: China's Domestic Savings Ratio (% of GDP)



Source: National Bureau of Statistics of China

86% of domestic savings are kept in low-yielding bank deposits earning, between 1996 and 2006, an average return of just 0.5% a year after inflation.

Various analysts and observers expect China's economy to grow at around 6-8% over the next two years. If government policies, stimulus packages and longer-term strategies perform as planned, and barring additional global shocks, the economy is expected to grow steadily for the medium-to-long term. Though the proportion of savings to GDP is likely to decline (in part due to government policy encouraging more consumption), the total amount of household savings is expected to continue to grow and thus the prospects for increased bank savings and investments in equities are good.

CHINA'S SHARE OF INWARD CAPITAL DECLINES AND OUTWARD CAPITAL INCREASES

China is still an attractive destination for FDI. Foreign businesses initially flocked into China to manufacture exports for overseas, but now they are increasingly targeting the domestic market.

China is still an attractive destination for foreign direct investment (FDI). Foreign businesses initially flocked into China with plans to manufacture exports for overseas, but now they are increasingly targeting the domestic market and high individual savings rate. Government policies have been supportive and provided tax incentives to foreign investors. China ranks above other emerging markets in the World Bank's *Ease of Doing Business* annual ranking (below).

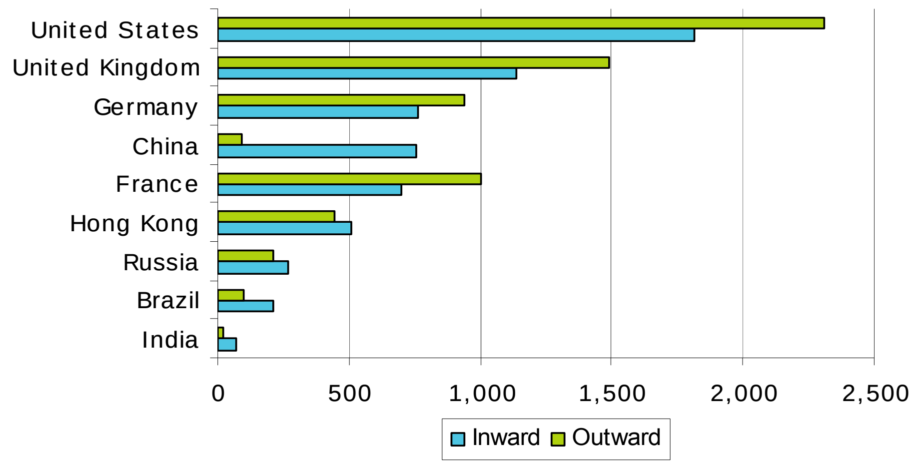
Table 2.4: Ease of Doing Business Ranking for Selected Countries, 2009

Country	Rank
China	83
Russia	120
India	122
Brazil	125

Source: World Bank

Over the last 20 years, China has attracted a sizable proportion of the total global stock of FDI, pushing it into the top 5 global destinations for FDI. However, China's share of new FDI has been declining recently due to excessive liquidity, tighter government regulation, and stricter macro-economic controls. Additionally, as the costs of labor have gradually risen, particularly in coastal areas, capital has tended to flow either to inland China or to other countries.

Figure 2.8: Total Stock of FDI (US$ billion) on January 1, 2008



Source: CIA World Factbook

Table 2.5: FDI in Selected Countries/Areas (US$ billion)

Country/Area	2005	% share	2006	% share	2007	% share
World	958.7	100%	1411.0	100%	1833.3	100%
Developed Countries	611.3	63.8%	940.9	66.7%	1247.7	68.1%
Developing Countries excluding China	244.0	25.5%	340.3	24.1%	416.2	22.7%
China	72.4	7.6%	72.7	5.2%	83.5	4.6%
Russia	12.9	1.3%	32.4	2.3%	52.5	2.9%
Brazil	15.1	1.6%	18.8	1.3%	34.6	1.9%
India	7.6	0.8%	19.7	1.4%	23.0	1.3%

Source: CEIC DATA

China is also the leading destination for portfolio equity investments, with a significant amount of private equity investments entering the country especially in 2006, when the inflow totaled over four times as that of India. As other emerging markets become more attractive investment destinations, China's share is expected to declined.

Table 2.6: Top 4 Portfolio Equity Destination Developing Countries (US$ billion)

Country	2002	2003	2004	2005	2006	2007e
China	2.2	7.7	10.9	20.3	42.9	35.0
India	1.0	8.2	9.0	12.1	9.5	34.0
Brazil	2.0	3.0	2.1	6.5	7.7	26.2
Russia	2.6	0.4	0.2	-0.2	6.1	14.8

Note: e =estimate
Source: World Bank, Global Development Finance 2008

In line with the government's new 'Go Global' strategy, between 2000 and 2006, OFDI increased by an average of 116% a year, making the current total the 6th largest among developing countries and 18th largest in the world.

China's stock of Outward Foreign Direct Investment (OFDI) is still low compared to total OFDI stocks, accounting for just 0.6% of global OFDI at the end of 2006. However, in line with the Chinese government's new 'Go Global' strategy, OFDI increased by an average of 116% a year between 2000 and 2006, so the current total is now the 6th largest of developing countries and 18th largest in the world.[8] Since 2006, China's OFDI has continued to increase and attracted substantial attention, as has the Official Development Assistance which the OECD estimates to be more than twice as large as China's OFDI. Chinese companies are expanding globally, led by State-Owned Enterprises (SOEs), particularly those in the natural resources sector, and are moving predominantly into developing countries, which received 95.3% of China's OFDI total by the end of 2006.

Table 2.7: China's OFDI flow

	1982-89 (average)	1990-99 (average)	2000-06 (average)	2004	2005	2006
Amount (US$ million)	453	2,328	6,938	5,498	12,261	17,634
As share of global OFDI (%)	0.4	0.8	0.8	0.6	1.5	1.5
Rank in the world	22	22	23	22	17	18
As ratio of China's GDP (%)	0.1	0.3	0.3	0.3	0.5	0.7

Source: OECD Investment Policy Reviews - China 2008: Encouraging Responsible Business Conduct

Table 2.8: China's OFDI Stock

	1990	1995	2003	2004	2005	2006
Amount (US$ million)	4,455	17,768	33,222	44,777	57,206	75,026
As share of global OFDI (%)	0.2	0.6	0.4	0.4	0.5	0.6
Rank in the world	25	21	25	27	24	23
As ratio of China's GDP (%)	1.1	2.3	2.0	2.3	2.5	2.9

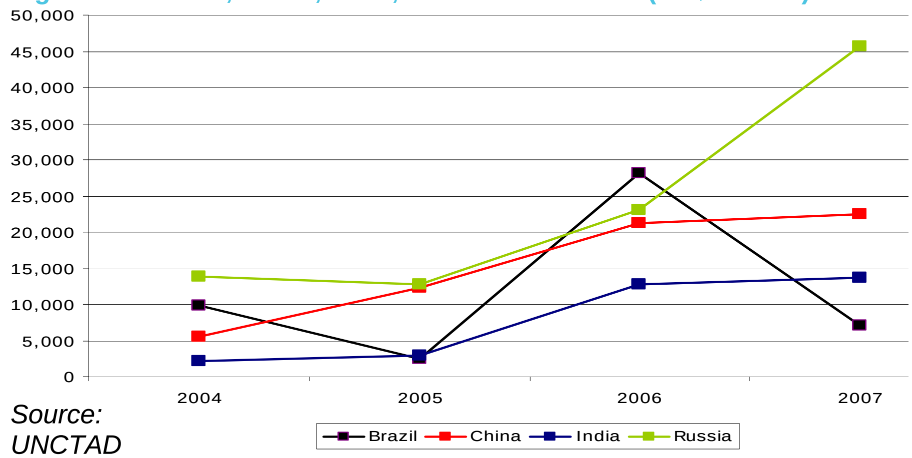
Source: OECD Investment Policy Reviews - China 2008: Encouraging Responsible Business Conduct

Though China's dramatic increase in OFDI has resulted in much media and political attention, it is not unique–other key emerging markets, particularly Russia, have also seen a high-speed increase in OFDI flows. Russia's overall stock of OFDI (US$255 billion) is around twice that of Brazil's (US$130 billion), and these are both far ahead of both China's (US$96 billion) and especially India (US$29 billion).

[8] OECD, "OECD Investment Policy Reviews - China 2008: Encouraging Responsible Business Conduct", 2008, (http://www.oecd.org/document/40/0,3343,en_33873108_36016481_41735656_1_1_1_1,00.html, accessed 30 July 2009)

Total stock, 2007 (US$ billion)	
Russia	225
Brazil	130
China	96
India	29

Figure 2.9: Brazil, China, India, Russia OFDI flows (US$ million)



Source: UNCTAD

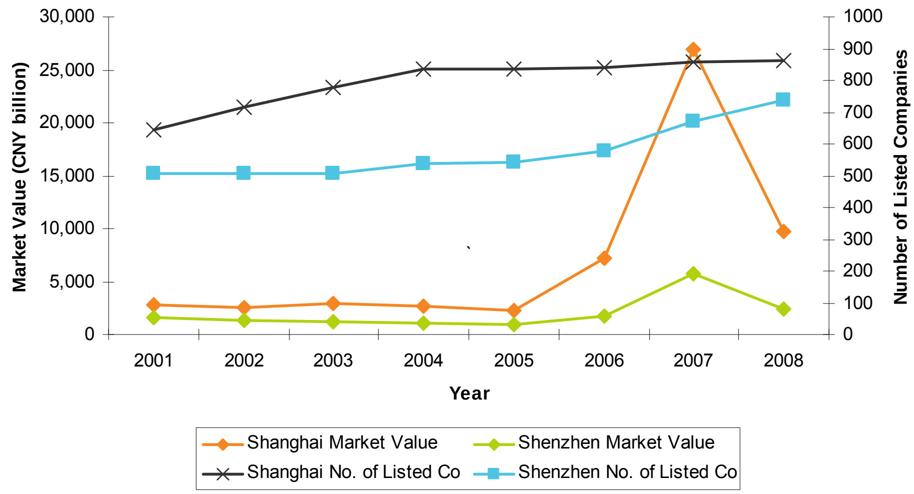
Securities Market

CHINA'S STOCK MARKETS

On November 26, 1990, the Shanghai Securities Exchange was officially established as the first of its kind in China, and the Shenzhen Securities Exchange opened the same year. Non-tradable shares reform[9] from April 2005 to September 2006 created a bull market of overwhelming size. By 2007, the market capitalization of both the Shanghai and Shenzhen Securities Exchanges exceeded the national GDP aggregates for the first time. However, the situation changed quickly with the sub-prime mortgage crisis in the US and the downturn of the European, American, and global economies. The Chinese stock markets plunged drastically, with the total market value of stocks declining from 133% of GDP in 2007 to 40.4% in 2008. By way of comparison, before the financial crisis the US and UK stock markets were valued at over 150% of GDP, while Germany was around 50% and Japan 80% of GDP.

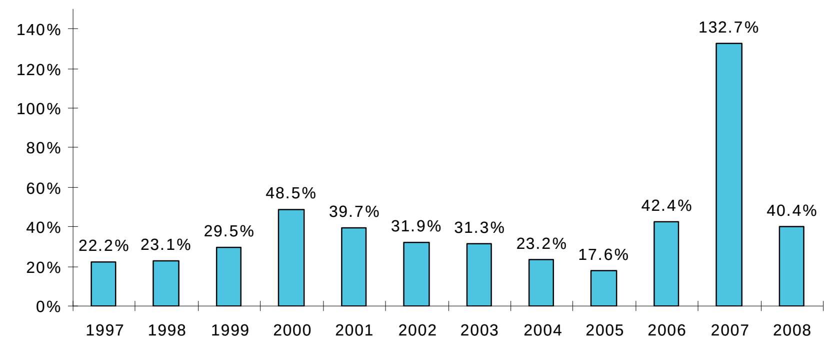
[9] Non-tradable shares is a distinct feature of the ownership structures in China's stock markets. These shares entitle the holders to exactly the same voting and cashflow rights assigned to the holders of tradable shares but the shares cannot be traded publicly. Non-tradable shares have been typically held by the State and serve the purpose of keeping the government in control of State-owned enterprises that were floated on the market. However, this ownership structure restricted the listed companies ability to improve their management. Various levels of government entities controlled these companies and had power over the appointment of key managers, thus making management responsible not to the investors, but to bureaucratic powers. The government soon noticed the problem, and initiated the reform to float non-tradable shares in 2005.

Figure 2.10: Market Value and Number of Listed Companies on Shanghai and Shenzhen Stock Exchanges



Source: Shanghai Stock Exchange, Shenzhen Stock Exchange

Figure 2.11: China's Stock Market Value/GDP



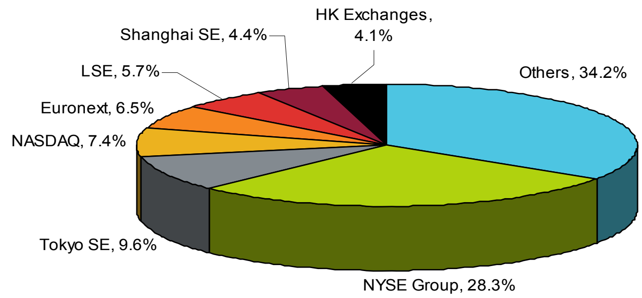
Source: The 2008 Chinese Financial Market Development Report

The Shanghai Exchange has now overtaken Hong Kong in market capitalization, to be the 6th largest Exchange globally.

As of August 2009, the overall market capitalization of the Shanghai and Shenzhen Exchanges was US$2.74 trillion, but non-tradable shares still accounted for half of the markets, approximately US$1.36 trillion[10]. The Shanghai Exchange is larger then the Shenzhen Exchange, which tends to be more geared towards manufacturing and SMEs. The Shanghai Exchange has now overtaken Hong Kong in terms of market capitalization, to become the 6th largest exchange globally.

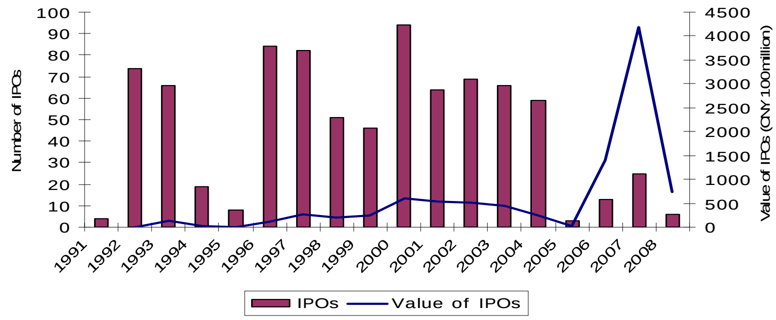
[10] CSRC, "Securities Market Statistics Table – August, 2009" (http://www.csrc.gov.cn/n575458/n4239016/n7828263/n11147943/n11359293/11360334.html accessed 1 Sept. 2009)

Figure 2.12: Distribution of Stock Market Capitalization in Global Stock Exchanges, 2008



Source: International Financial Market Development Report

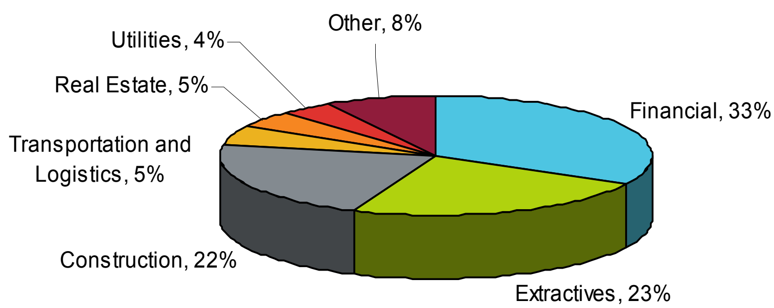
Figure 2.13: Number and Value of IPOs on Shanghai Stock Exchange



Source: Shanghai Stock Exchange

China's stock exchanges are heavily dominated by stocks in three sectors: financial, extractives, and construction—sectors which directly profit from China's strong economic growth, and where many stocks are still partially State-owned. The market capitalization of these shares makes up over 78% of the market.

Figure 2.14: China's Stock Exchanges Market Capitalization by Sector



Source: PBOC, China Financial Market Development Report, 2008

The GEM is characterized by easier access making it more conducive for SMEs to obtain finance. The GEM will provide a further option for IPOs for smaller companies and will provide another investment channel, particularly in green-tech stocks.

SHENZHEN'S NEW SECOND BOARD WILL PROVIDE ALTERNATIVE INVESTMENT CHANNELS

China will soon introduce a Growth Enterprise Market (GEM) board at the stock exchanges, now that the development of relevant regulations has almost been completed. The GEM board, also known as the Second Board Market or the second stock exchange, is an effective supplement to the main-board market.

Companies listed in the GEM are mostly those in the high-tech sector with high growth, but they are usually newcomers and small in size. The GEM is characterized by easier access, making it more conducive for SMEs to obtain finance. For investors, risks in the GEM market are higher than those in the main board, but this market also offers the potential for higher returns. The GEM will provide a further option for IPOs for smaller companies and will provide another investment channel for investors, particularly in green-tech stocks. The GEM should also increase market liquidity.

DOMESTIC ENTERPRISES LISTING OVERSEAS
Starting in 1993, blue chip Chinese companies have successfully listed on the Hong Kong Stock Exchange, the New York Stock Exchange and others. Most of the listed companies were SOEs. As of August 31 2009, there were 148 companies[11] listed on the Hong Kong Stock Exchange, so-called H shares, with a market capitalization of US$5138 billion.

Regulatory and Policy Frameworks

There has been tremendous reform of ESG-related regulation over the past five years leading to higher standards for businesses and improved enforcement.

The ESG regulatory landscape is a combination of social, environmental and governance laws and financial regulation that affect the environment in which firms and investors operate. There has been tremendous reform of ESG-related regulation over the past five years, leading to higher standards for businesses and improved enforcement. In addition, more and more financial regulations have been leveraged to support the efforts on ESG improvement. Environmental issues in particular are increasingly at the top of the agenda for joint efforts across various government agencies, though governance and social standards have also evolved with far more specific regulations to push for further regulatory framework reform.

EVOLVING ENVIRONMENTAL AND SOCIAL POLICIES/REGULATIONS
A large number of new polices on environmental and social (E&S) issues have been formulated in recent years. A relatively comprehensive and high level E&S regulatory framework has gradually been formed, which has created the impetus for corporate ESG improvement, as well as the development of a market for sustainable investment. Table 2.10 describes several milestone policies and laws instated by the Chinese government.

Table 2.9: Key Environmental and Social Policies/Laws

Policies /Laws	Description	Data
Signing of the Rio Declaration on Environment and Development	Signing the Rio Declaration was one of China's first steps toward sustainable development. Subsequently, China issued its 21st Century Agenda in 1994, and in 1996, sustainable development was officially declared as the national development strategy.	1992
Outline of the Eleventh Five-Year Plan (2006-2010) on National Economic and Social Development	The National Development and Reform Commission (NDRC) issued the *Outline of the Eleventh Five-Year Plan* (2006-2010) which clearly put forward legally binding targets of lowering energy consumption per unit of GDP by 20% and reducing the emissions of major pollutants by 10% by 2010, the first such national-level target.	March 2006

[11] PBOC statistics

National Eleventh Five-Year Plan for Environmental Protection	The *National Eleventh Five-Year Plan for Environmental Protection* outlines ten key environmental protection areas in eight key sectors. It is a guiding document for directing the economic, social and environmental development of China and is therefore a milestone in the history of environmental protection in China. The NDRC also developed three major systems focusing on statistics, monitoring and performance in order to deliver on the energy intensity reduction and pollution emissions reduction goals. These systems and targets extend down to the local level and form part of the performance evaluation of government leaders and SOE corporate managers.	November 2007
Labor Contract Law	National People's Congress [NPC] drafted the *Labor Contract Law* through a process of consultation that included multiple revisions. The final version emphasizes the protection of worker rights and endows enforcement power to workers themselves through statutory labor contracts.	January 2008
Energy Conservation Law	The *Energy Conservation Law* determined, in legal terms, energy conservation as a national policy with the establishment of a system to define responsibilities and evaluate performance.	April 2008
Law on Mediation and Arbitration of Labor Disputes	The *Law on Mediation and Arbitration of Labor Disputes* formulated by the National People's Congress focuses on the procedural features of the mediation and arbitration of labor disputes with the aim of further protecting employees' rights.	May 2008
Law on Prevention and Control of Water Pollution	The *Law on Prevention and Control of Water Pollution* stipulates, in legal terms, the importance of prevention and control of water pollution in the plan for national economic and social development, and reinforces the power of environmental protection authorities in China.	June 2008
Regulations on Civilian Building Energy Conservation and the Rules and Regulations on Public Institution Energy Conservation	Issued by the State Council in order to strengthen the management of energy-saving in residential buildings, reduce their energy consumption while in use, and improve their energy usage efficiency as well as boost energy saving by public institutions.	October 2008
White Paper on China's Policies and Actions for Addressing Climate Change	This White Paper on climate change provided a progress report on the 2007 targets and was released by the State Council Information Office.	October 2008
Circular Economy Promotion Law	The *Circular Economy Promotion Law* emphasizes the reduction of resources consumption and waste generation in the process of production,	January 2009

	distribution and consumption. The law indicates that relevant industries should adopt energy-saving and low-consumption technologies and improve their facilities, and confirms that the government will prioritize the development of industries that enable the effective utilization and economic use of resources.	

Government agencies are required to disclose 17 categories of environmental protection information covering areas of policies, standards, licensing process and administrative approvals, as well as a list of businesses that violate waste discharge policies.

INCREASE IN TRANSPARENCY

ESG disclosures provide crucial information about company performance and management qualities that allows investors to understand (and thus price in) risks related to their investments. China's ESG transparency and disclosures are lower than international standards, but recent trends driven by government regulation demonstrate significant reform. Key milestones include:

» With MEP's new regulation on disclosure of environmental information, the general public gained access to information on corporate environmental practices

» Establishment of information-sharing mechanism between environmental protection authority and financial institutions

» Extensive national and local guidelines encourage non-financial information disclosure by large Chinese companies

Access to Business Environmental Information

In May 2008, in an effort to increase transparency regarding environmental issues, China implemented the *Provisional Measures on Disclosure of Environmental Information*. The measures allow the general public increased access to environmental information from both government agencies and businesses. Government agencies are required to disclose 17 categories of environmental protection information covering policies, standards, licensing processes and administrative approvals, as well as a list of businesses that have violated waste discharge policies. On the business side, any company found to be in violation of local or national waste discharge policies is required to disclose specific environmental performance data such as waste discharges and operational status of environmental protection systems, in addition to publishing action plans for environmental emergencies. The new measures also encourage all businesses to voluntarily disclose additional environmental performance data.

The most noticeable changes brought about by the new measure include a significant increase in the number of businesses publicly identified for not complying with environmental laws and the growing public attention paid to these companies. Selected cities in Shandong and Hubei provinces, for example, have published lists of noncompliant companies on a daily basis. The Institute of Public and Environmental Affairs (IPE, a local environmental NGO – see Chapter 5), together with more than 10 other civil society organizations, has written letters to some of these noncompliant companies, asking them to release environmental performance data as required by law. Through the media, these activities have garnered significant attention from the public and local investors.

Information Sharing Mechanism between Environmental Protection Authority and Financial Institutions

Information exchange between MEP, the Central Bank, and the China Banking Regulatory Committee (CBRC) has also improved environmental transparency. The Central Bank has gradually integrated environmental information provided by

CBRC has urged all commercial banks in China to review and weigh each applicant's environmental history before granting credit applications, in order to mitigate risks.

MEP into a corporate credit database since 2003,[12] creating a resource which enables financial institutions to review companies' environmental records. This type of environmental information has become an important non-financial data resource within the credit system. CBRC has also urged all commercial banks in China to review and weigh each applicant's environmental history before granting credit applications, in order to mitigate risks. This effort, as part of the well-known "Green Credit Champion" program in China, has further improved use of environmental information.

Non-financial Information Disclosure

The promotion of non-financial information disclosure and sustainability reporting has been supported extensively by both national and local governments. Guidelines issued by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), the stock exchanges, business associations and even local government agencies are all advocating for improved sustainability reporting as an important way for companies to disclose their ESG information and allow public supervision. These reports can provide useful information to investors. The following are some of the key milestones in this evolution:

- On September 25, 2006, the Shenzhen Stock Exchange formally issued and put into effect its social responsibility guidelines for listed companies. The guidelines explicitly state that as members of society, listed companies should assume their responsibilities to protect the rights and interests of their employees, shareholders, creditors, suppliers and consumers. The Shenzhen Stock Exchange called for listed companies to establish and evaluate their social responsibility systems according to the guidelines, and to publish social responsibility reports.

- On January 4, 2008, SASAC issued the *Guidelines to State-owned Enterprises Directly under the Central Government on Fulfilling Corporate Social Responsibilities*, which instructed 150 leading state-owned enterprises (SOEs) to issue sustainability reports.

- In May 2008, the Shanghai Stock Exchange (SSE) issued the *Notice of Improving Listed Companies' Assumption of Social Responsibilities* and the *Guidelines on Environmental Information Disclosure by Listed Companies*, which encouraged listed companies to produce social responsibility reports. On December 31, 2008, the exchange issued the *Notice of Doing a Better Job for Disclosing 2008 Annual Reports*, requesting that companies in the SSE Corporate Governance Sector[13], those issuing foreign capital stocks listed abroad, and financial companies should disclose reports on their fulfillment of social responsibilities. By May 12, 2009, 290 SSE-listed companies had released social responsibility reports, of which 282 were making this disclosure for the first time, demonstrating that listed companies are attaching increased importance to their social responsibilities.[14]

[12] China Daily, "PBOC Launches Green Scheme", January 10, 2007, (http://english.mep.gov.cn/News_service/media_news/200712/t20071217_114439.htm accessed 20 July 2009)

[13] The companies in the SSE Corporate Governance Sector are the ones listed in SSE Corporate Governance Index (see section of "SSE Corporate Governance Index" in chapter 5 for more information).

[14] China Securities Index Co., Ltd, "SSE CSR Index to be Launched in Mid-year", May 12, 2009, (http://www.sse.com.cn/en_us/cs/about/news/en_news_20090512a.html accessed 20 July 2009)

In addition to national regulations, local governments and government-oriented business associations are also encouraging ESG information disclosure. Selected initiatives include:

» Following the November 2007 CBRC-issued *Recommendations on Strengthening Large Commercial Banks' Social Responsibilities*, which encouraged banks to issue sustainability reports, the China Banking Association (CBA) published guidelines for Chinese banks on implementing their corporate social responsibility (CSR) work in January 2009.[15] The guidelines apply to commercial and policy banks as well as credit cooperatives and financial asset management companies. The scope of CSR includes economic, social and environmental responsibilities, as well as accountability for environmental and social sustainable development and accountability to communities and other stakeholders. Key environmental commitments include setting up specialized environmental protection departments, research on incorporating the Equator Principles into the banks' own guidelines, educating clients about environmental impact assessment (EIA) procedures and green credit program compliance, and conducting independent investigations and audits of client projects. The guidelines also call for integration of CSR principles into banks' business structures, governance, and assessment mechanisms, as well as public disclosure of a third-party-verified annual sustainability report each June.

» In July 2007, the Environmental Protection Bureau of Shandong Province commissioned Qingdao Technological University to draft the *Corporate Environmental Report Preparation Guidelines for Shandong Enterprises*.

» The China Federation of Industrial Economies teamed up with ten other industrial associations and published the *Social Responsibility Guidelines for Industrial Enterprises and Associations in China*, explicitly laying down eight basic components of corporate sustainability.

» In June 2008, China National Textile & Apparel Association released the *China Sustainability Reporting Guidelines for Apparel and Textile Enterprises* (the CSR-GATEs) and plans to launch the Sustainability Report Evaluation System for Chinese Textile and Apparel Enterprises in 2009 following the implementation of CSR-GATEs.

GREEN FINANCIAL POLICIES

China is taking a leading role in using financial means to support improvements in corporate environmental performance. The following five policies illustrate how market mechanisms and financial means are being used for boosting energy saving and emissions reduction in line with national sustainable development objectives.

Green credit policy requires all commercial banks to conduct strict environmental screening for loans, to implement industry policies, and to restrict lending to companies with high energy consumption and high pollution

» Green credit policy. In July 2007, SEPA (now MEP), the People's Bank of China (PBOC) and China Banking Regulatory Commission (CBRC) jointly issued the *Opinions on Implementing Environmental Protection Policies and Laws to Prevent Credit Risks*. Following that, CBRC issued the *Notice on Preventing and Controlling Loan Risks from High-energy Consumption and High Pollution Industries* and the *Guiding Principle for Energy Saving and Emissions Reduction Based Credit Issuance*, requiring all commercial banks

[15] See information in China Banking Association website, (http://www.chinacba.net/Article/ShowArticle.asp?ArticleID=6445 accessed 20 July 2009)

to conduct strict environmental screening for loans, to implement industry policies, and to restrict lending to companies with high energy consumption and high pollution.

In addition to policy formulation, the government agencies have collaborated with each other and with external international institutions such as IFC to jointly promote "green credit" practices by building the information infrastructure and capacity of Chinese banks. The key initiatives included: (1) integrating environmental information into the corporate credit database of PBOC and establishing a nationwide 'blacklist,' which included 38 companies classified as high environmental risk as of November 2008;[16] (2) localizing the Equator Principles to the Chinese industrial context; and (3) providing trainings for commercial banks and associated workshops and seminars as an opportunity for banks to exchange experiences.

The response by commercial banks to this campaign has been positive. Major domestic banks have started to experiment with ESG integration and have released public reports detailing their relevant environmental financing policies, procedures and activities. ICBC in particular displayed a level of sophistication by introducing a veto system into environmental risk management. In addition, some banks began to create innovative financial products to address China's key environmental issues. IFC teamed up with the Industrial Bank of China, the Bank of Beijing, and the Shanghai Pudong Development Bank to launch the China Utility-based Energy Efficiency Program (CHUEE), which aims to accelerate energy efficiency penetration in China by providing loans and guarantees to commercial, industrial, institutional and multi-family residential users who upgrade their energy-using systems.

A system of environmental pollution liability insurance has been established on a trial basis.

» Green insurance policy. In February 2008, SEPA and the China Insurance Regulatory Commission (CIRC) jointly promulgated the *Guiding Principles for Liability Insurance on Environmental Pollution*, which established a system of environmental pollution liability insurance on a trial basis. Pilots are to be conducted in key industries and regions, and environmental risk-based catalogs for insured enterprises or facilities of key industries, as well as standards for compensation of damages from environmental pollution, will be established.

The green securities policy requires companies in certain sectors to pass more stringent environmental criteria before being allowed to list.

» Green securities policy. In February 2008, SEPA issued the *Guiding Principles for Strengthening the Supervision and Management in Environmental Protection of Listed Companies*. The green securities policy requires companies in certain sectors to pass more stringent environmental criteria before being allowed to list (IPO). The guiding principles for green securities, with the environmental protection inspection system and environmental information disclosure system at the core, were designed to contain the excessive expansion of industries with high levels of energy consumption and pollution, prevent capital risks, and encourage listed companies to continuously improve their environmental performance.

» Green trade policy. In February 2008, SEPA published the first batch of catalogs of high pollution and high environmental risk products (or "Double-H" Product Catalogs) for 141 categories of 6 industries. In addition, the

[16] Matisoff, Adina, "The Green Evolution: Environmental Policies and Practice in China's Banking Sector", November 2008.

Ministry of Commerce (MOFCOM) and the General Administration of Customs (GAC) jointly published the 2008 edition of the *Catalogue of Prohibited Commodities in the Processing Trade* based on the policy for restricting high-energy-consuming, high-polluting, and resource-intensive enterprises and products.

» Pollution discharge exchange policy. Pollution discharge exchange systems have existed for many years in China, and the national government has engaged in a series of pilots. The *Decision on Implementing the Outlook on Scientific Development and Strengthening Environmental Protection* issued in 2006 stated that “Regions and organizations, where conditions permit, may practice the exchange of rights for pollution discharge, such as sulfur dioxide.” Although the government has not yet developed a nationally unified standardized document on the exchange of rights for waste discharge, local governments in Hubei, Changsha and Chongqing have piloted projects to allow the exchange of waste discharge rights.

3. Key ESG Issues

With China's rapid pace of development, businesses in China face urgent environment, social and governance (ESG) challenges that may impact their ability to operate successfully. In this section, while acknowledging that these issues are complex and vary by geographic area and by sector, BSR seeks to identify and describe a set of ESG issues facing companies operating in China and the relevent themes related to investors.

A Challenge for Business: A World of ESG Indicators

To identify a list of potentially important ESG challenges, BSR reviewed a representative selection of global ESG performance and disclosure guidelines and tools created either by multilateral institutions or the Chinese government (see box).

ESG Performance and Disclosure Guidelines and Tools

- OECD Principles of Corporate Governance
- UN Global Compact
- IFC Performance Standards on Social and Environmental Sustainability
- The Equator Principles
- Global Reporting Initiative
- China's National Climate Change Program
- Guideline on CSR for State Owned Enterprises: Guidelines on Fulfilling Social Responsibility by Central Enterprises
- Dow Jones Sustainability Index
- FTSE4Good

Although these guidelines and tools present different perspectives on how companies should address and disclose ESG risks and opportunities, at their core, they focus on a common set of ESG issues. These core ESG issues are synthesized below.

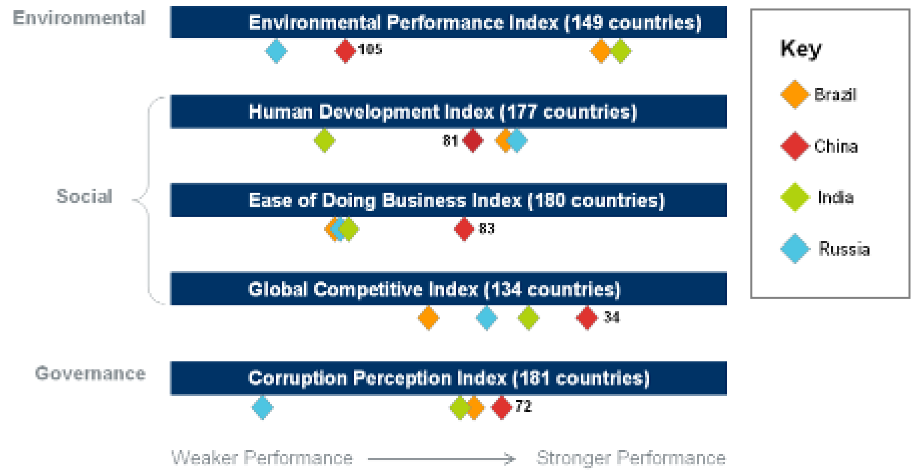
Environmental	Social	Governance
» Energy use and climate change » Water scarcity and pollution » Air quality	» Labor and working conditions » Poverty » Health » Education » Community development	» Disclosure and transparency » Bribery and corruption » Corporate ethics

These issues are all important for the sustainability of global development, and many have a direct impact on continued Chinese development and the success of Chinese businesses. These ESG issues will have variable impacts on companies in China depending on industry and company performance, and also vary in terms of urgency. The following sections will review key themes and factors that may help distinguish the importance of these issues for successful development at both a corporate and national level.

ESG Issues and their Impact on Chinese Development

Although it is difficult to assert which issues have the most significance for China, BSR has used a set of globally-recognized country-performance indicators as a proxy for overall country performance as shown in Figure 3.1.

Figure 3.1: China's ESG Performance



Sources: Various (See Appendix 1)

Figure 3.1 shows that China's performance is generally better than, or comparable to, Brazil, India and Russia in four of the five indicators. The major exception is environmental performance. Each of the 3 major challenges and 5 indices are explained in more detail in Appendix 1.

Common ESG Themes in China

There are four themes, broadly focused on openness and responsiveness, that warrant investor attention when assessing corporate performance on ESG issues:

THEME #1: RESPONSIVENESS TO THE GOVERNMENT'S ESG POLICIES
In Western ESG models, being responsive to stakeholder concerns is fundamental to developing a good ESG management approach. In China, the most important stakeholder for large companies is frequently the Chinese government. With the important role that the Chinese government plays as regulator and even major investor, in the case of many listed State-Owned Enterprises, it is vital that companies operating in China position themselves ahead of the curve when it comes to government policies on ESG issues. Newly minted laws are in many ways 'directional edicts' that the government uses to steer businesses in a certain direction. If the law is a high priority for the government, enforcement mechanisms are later strengthened. Those companies overtly in breach of the law may be penalized very publicly, and used as an example to encourage others to comply. Thus, the degree of sensitivity that businesses in China have towards new ESG regulation can greatly benefit or impede business success.

A prime example of this can be seen with the Chinese Labor Contract Law (LCL). Serious dicussion of this regulation began in 2006, and the law's formal release followed in 2008. Companies that were aware of the negotiations and had an opportunity to share their views with the government about policy implementation—and at the same time better prepare themselves for the new law—were much better off than their counterparts who did not participate in the discussion process.

THEME #2: SUSTAINABILITY REPORTING AND USEFULNESS TO INVESTORS

Many large Chinese companies, particularly listed companies (290 in Shanghai and 88 in Shenzhen as of May 20, 2009),[17] have begun to release public sustainability reports, in part due to the role of the Chinese government in encouraging increased disclosure of information related to sustainability. However, the quality of sustainability reports still needs to be improved to increase their usefulness to investors, even though investors are not the primary intended readers. Key considerations in this regard are:

» Quality of sustainability reporting: The quality of Chinese sustainability reports is improving, but still is not up to international standards.[18] Common shortfalls include a lack of data and future goals. Low quality is often due to insufficient understanding of what a good sustainability report entails—particularly for an audience of investors (see box), and insufficient internal data collection systems, as well as a limited desire to disclose data publicly.

» Accountability of sustainability reporting: Unlike financial reports, there are no legal standards related to disclosure and very few non-financial reports in China have been assured to verify their information and contents (according to Corporate Register's database, only four were assured in 2007).

» Usefulness to investors: Sustainability reports are not primarily written for investors. Reports are often intended for a wide variety of stakeholders, each interested in slightly different information, e.g. consumers might be more interested in philanthropy or product safety and government might be more interested in energy efficiency or tax payment. A good quality sustainability report helps investors understand that the company is aware of its key risks, but even with a good quality report, investors will need additional information specific to their analysis. For international investors, sustainability reports are particularly useful as they have few other sources of ESG information on Chinese companies available in English.

Finding a Chinese company that is willing to dislose its material risks—and its subsequent plans for improment—is a clear signal that its commitment to open dialogue oni these issues goes beyond checking boxes against a set of standards.

Though the reports are useful, they may not speak directly to ESG risk for investors. With the great importance placed on presenting and maintaining a clean reputation, it is rare to find a Chinese company voluntarily admitting to missteps and potential risks. Although companies all over the world tend to take a defensive stance towards ESG risks and only portray the positive, in China, an overly optimistic representation of CSR performance is all too common. As Chen Ying of the Chinese Enterprise Confederation once slyly noted in a review of a Chinese sustainability report, "The only fault in this report is that there are no faults."[19] Finding a Chinese company that is willing to disclose its material risks—and its subsequent plans for improvement—is a clear signal that its commitment to open dialogue on these issues goes beyond checking boxes against a set of standards. In addition to the reasons for which any company might choose to not disclose risks, there are also strong cultural reasons for Chinese companies to be overly cautious.

[17] Information from the web pages: http://paper.cnstock.com/paper_new/html/2009-05/12/content_69849038.htm, http://www.szse.cn/main/aboutus/bsyw/39739798.shtm accessed 20 July 2009
[18] SynTao, "A Journey to Discover Values, 2008," November 2008
[19] China Mobile, "China Mobile Communications Corporation 2008 CSR Report", March 2009

Making Sustainability Reports More Useful for Investors

In preparing sustainability reports, companies can structure their disclosures aimed at investors around three key building blocks. These are:

CEO or Chair of the Board Statement. This should explain:

- » The company's ESG strategy and key ESG priorities, and
- » How market trends and issues link to the company's ESG strategy and key ESG priorities.

Discussion of Risks and Opportunities. This should:

- » Identify key ESG risks and opportunities facing the business, and
- » Discuss the implications of these risks and opportunities for business strategy and financial performance.

Provision of Performance Data. This should:

- » Highlight key achievements, failures, and performance against ESG targets in the reporting period, and
- » Be standardized and comparable through time and across companies.

Source: Reaching Investors –communicating value through ESG disclosures (GRI, 2009)

THEME #3: INTERNATIONAL ESG ADAPTATION

When Chinese companies go abroad, they need to manage ESG issues in other cultural contexts—for example, where populations are not as homogeneous as China, where the government may no longer be the most important stakeholder, and where different ESG topics will vary in local importance. In an industry like mining, for example, neglecting to deal appropriately with local concerns has in some instances halted basic operations. Stories describing local citizens' attempts to stop Chinese mining operations through protests and other means are becoming more common. Key cases include Shougang Steel, whose offices in Peru were burned down in April 2007 by workers who had developed health problems;[20] Sinopec, whose license was withdrawn after illegal exploration in a national park in Gabon,[21] and China Non-Ferrous Mining Corporation, whose poor health and safety record and treatment of workers in Zambia led to riots and strikes.[22] Assessing whether Chinese management at senior and even middle management levels have some capacity for managing both ESG and traditional business decisions across cultures is a key indicator of potential future financial performance.

Capacity for managing both ESG and traditional business decisions across cultures is a key indicator of potential future financial performance.

THEME #4: THE CHINA MULTIPLIER

To paraphrase Chinese Premier Wen Jiabao, "Any small problem multiplied by 1.3 billion [China's population] becomes a big, big problem. And any wealth generated by growth, when divided by 1.3 billion, becomes very, very small per capita." Extending Premier Wen's metaphor, investors should be aware that ESG challenges—however small they may seem on the scale of one single business, have the potential in China to grow into issues of massive, nationwide concern. In one example, there was a highly publicized encounter in 2003 when a farmer

[20] Bloomberg, "China Defies Peru Rescue of Miners Afflicted With Lung Disease" July 23 2008, (http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aa.E5XOgp1Bs accessed 20 July 2009)

[21] Agence France Presse, "China's Sinopec provokes conservation uproar in Gabon" September 28, 2006,(http://www.uofaweb.ualberta.ca/chinainstitute/nav03.cfm?nav03=51093&nav02=43782&nav01=43092 accessed 20 July 2009),

[22] Dow Jones Newswires, "Zambia's miners paying high price for copper boom" October 12, 2005, (http://www.minesandcommunities.org/article.php?a=501 accessed 20 July 2009)

named Xiong Deming asked Premier Wen Jiabao (during an official visit to her village) for help in recovering unpaid wages owed to her husband, a migrant worker in the construction industry. The event sparked a series of policies and enforcement measures related to on-time payment of workers, and even the *Labor Contract Law* described earlier could be seen as a not-so-distant outcome of this incident.

ESG Impact on Specific Industries

For investors to make any meaningful analysis of how sensitive Chinese companies are to ESG risks *and* opportunities will require that investors create industry-specific analytical tools suited to assessing companies operating in China.

ESG issues do not impact all companies equally. Certain ESG issues will be highly relevant for companies in the light manufacturing sector, such as labor relations, while other issues like climate change impacts and energy use will hold more weight for a company in the automotive industry. Each industry—and ultimately each company—is presented with a unique set of ESG risks and opportunities. For investors to make any meaningful analysis of how sensitive Chinese companies are to ESG risks *and* opportunities will require that investors create industry-specific analytical tools suited to assessing companies operating in China.

Table 3.1 shows all of the industry sectors represented on the Shanghai and Shenzhen Stock Exchanges in descending order based on total market capitalization.

Table 3.1: Top 20 Industry Sectors Represented on the Exchanges, May 1 2009

Shenzhen Stock Exchange (CNY)			
		# of Listed Securities	**Total Market Capitalization**
1	**Manufacturing**	**508**	**2,186,781,921,862**
2	**Machinery**	**139**	**611,289,576,845**
3	**Metals & Non-metals**	**76**	**506,859,502,218**
4	**Petrochemicals**	**94**	**376,977,460,507**
5	**Real Estate**	**35**	**293,980,977,308**
6	**Food & Beverage**	**30**	**204,987,990,206**
7	**Pharmaceuticals**	**46**	**186,005,246,120**
8	**IT**	**44**	**177,532,634,619**
9	**Wholesale & Retail**	**34**	**172,473,266,534**
10	**Financial Services**	**7**	**165,398,721,856**
11	Mining	12	143,359,949,036
12	Electronics	49	128,161,524,981
13	Social Services	31	115,009,659,664
14	Utilities	25	114,448,781,685
15	Transportation	21	86,234,403,840
16	Conglomerates	31	79,106,749,814

17	Textiles & Apparel	37	73,309,503,638
18	Paper & Printing	18	61,328,234,091
19	Agriculture	16	44,326,954,036
20	Construction	12	35,509,256,041

Shanghai Stock Exchange (CNY)			
		# of Listed Securities	**Total Market Capitalization**
1	**Financial Services**	**20**	**38,108,220,000,000**
2	**Mining**	**24**	**36,960,070,000,000**
3	**Manufacturing**	**490**	**26,833,270,000,000**
4	**Machinery**	**136**	**8,591,550,000,000**
5	**Transportation**	**50**	**8,246,750,000,000**
6	**Metals & Non-metals**	**76**	**6,456,760,000,000**
7	**Utilities**	**43**	**5,366,060,000,000**
8	**IT**	**55**	**3,551,280,000,000**
9	**Petrochemicals**	**85**	**3,452,720,000,000**
10	**Construction**	**24**	**3,059,680,000,000**
11	Real Estate	38	3,023,780,000,000
12	Wholesale & Retail	63	2,914,480,000,000
13	Food & Beverage	36	2,668,750,000,000
14	Pharmaceuticals	54	2,415,170,000,000
15	Conglomerates	44	2,406,630,000,000
16	Social Services	25	1,347,050,000,000
17	Textiles & Apparel	42	1,285,360,000,000
18	Electronics	29	835,830,000,000
19	Agriculture	23	806,950,000,000
20	Other Manufacturing	13	619,510,000,000

Sources: Shanghai Stock Exchange, Shenzhen Stock Exchange

The above data shows the primary sectors listed on the stock exchanges. With a sectoral focus, ESG materiality studies can be tailored to each industry. Though not within the scope of this report, this type of work is beginning to be conducted in China with early results from several groups, including IFC, ASrIA, and Mercer.

Figure 3.2: Report Conclusions: Sectoral Issues

	Key Drivers				Key Impacts		
Investment Themes	**E**	**S**	**G**	**Financial Dynamics**	**Costs**	**Opportunities**	**Both**
Auto							
Air pollution	✓	✓		Higher costs, reduced revenue opportunities	✓		
Meeting tougher emissions standards	✓			Higher costs	✓		
Building new alliances	✓		✓	Improved margins			✓
Technology and innovations	✓			Improved margins			✓
Banking							
Corporate control & governance			✓	Consolidation provides economies of scale			✓
The technology bet			✓	Higher capex needed			✓
Asset quality & sustainable risk assessment	✓		✓	Improved credit quality			✓
Sustainable financial products	✓	✓		New revenue opportunities		✓	
Metals & Mining							
Rising EHS standards	✓	✓		Higher costs	✓		
Community investment		✓	✓	Higher costs	✓		
The energy appetite	✓			Margin pressure, incentives for energy efficiency			✓
Globalization and transparency			✓	More competitive pressures			✓
Oil, Gas & Petrochemicals							
Deregulation: a prerequisite			✓	More market incentives			✓
EHS: higher standards & costs	✓	✓		Higher costs but more stable margins			✓
Cleaner fuels a key constraint	✓			Premium pricing for clean fuels		✓	
Meeting the supply challenge	✓		✓	Growth but higher costs			✓
Power							
Energy efficiency	✓			More stable returns			✓
Regulatory risk		✓	✓	Higher costs	✓		
Cleaner fuels	✓			Higher costs	✓		
Pricing in the environmental costs	✓			Improved incentives for renewables			✓
Pulp, Paper & Timber							
Rising regulatory risk	✓	✓	✓	Higher costs	✓		
Sustainable supply	✓			Higher costs	✓		
Forest standards	✓	✓		Higher costs but more market access			✓
Technology & carbon sequestration	✓			New revenue opportunities		✓	
Supply Chain							
Rising labour & environmental standards	✓	✓		Higher costs	✓		
Competiting on codes and standards			✓	More market incentives			✓
Export market access			✓	More market incentives			✓
Strategic engagement		✓		More market incentives			✓
Technology							
Toxics and takeback	✓	✓		Higher costs to gain market access			✓
Transparency			✓	Higher cost of capital	✓		
Industrial policy			✓	Fewer subsidies	✓		
IPR			✓	Higher cost to develop and protect IPR			✓

Source: ASrIA, Taking Stock, Adding Sustainability Variables to Asian Sectoral Analysis. February 2006.

An understanding by investors of the material ESG issues that affect the market and their portfolio stocks is crucial. Investors need to be able to understand the risks and opportunities that will affect their stocks and factor those into their investment criteria. The work done by organizations such as ASrIA is helping investors understand these issues and the impacts on their portfolio.

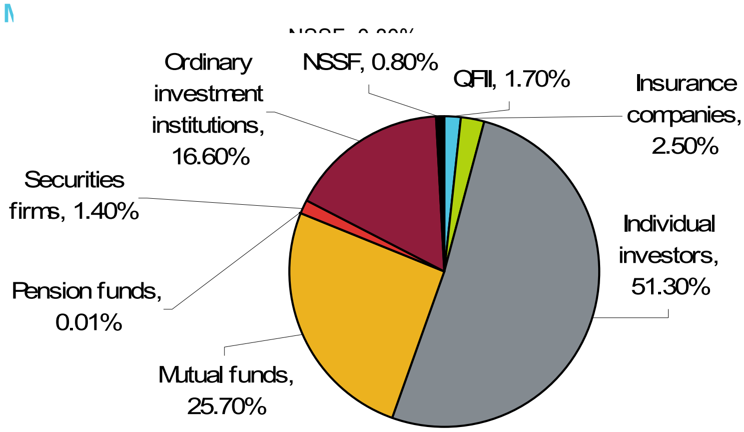
4. Sustainable Investment Activities

This chapter examines the state of key institutional investors in the China equity market and their activity related to sustainable investment. Overall, there is minimal systematic ESG integration into investment decisions at this time, though there are strong signs of initial progress.

Overall, there is minimal systematic ESG integration into investment decisions at this time, though there are strong signs of initial progress.

Due to the limited scope of this study, mainstream investors have not been comprehensively investigated, but key existing and upcoming sustainable investment (SI) funds and cases of systematic integration of ESG into investment in specific sectors and industries have been identified. A recent report by Mercer, *Gaining Ground*, provides more extensive information on mainstream investors, and estimated that for China (including Hong Kong), the stock of SI-labeled funds was US$14.9 billion and investment that integrates ESG totaled US$10. 4 billion.[23] For SI investment in the A share market, our team conducted initial r

F ck
M



Sources: CSRC, China Capital Markets Development Report

Individual investors account for 51.3% of the total China stock market.

The stock market structure in China is quite different than most other countries, as individual investors account for 51.3% of the total market and institutional investors play a relatively limited role (see Figure 4.1).[24] In comparison, individual investors are only 24.4% of the Brazilian market and 13.1% of India's.[25] Though individuals may still play an important role in the SI market in China in the long term, we have chosen to focus on institutional investors, especially ones with a focus on risk management and long-term performance, as they will be integral to the development of China's SI market. In the long run, institutional investors which have a long-term 'buy and hold' approach are likely to be the main players in the market. This is in part because the Chinese government has determined that individual investors' dominance constrains the healthy development of the market, so it has been promoting the development of institutional investors and encouraging them to engage in long-term investment practices. These market developments align strongly with the development of SI in China.

[23] Mercer, "Gaining Ground – Integrating ESG Factors into Investment Processes in Emerging Markets", March 2009, and BSR interview with Mercer
[24] CSRC, "China Capital Markets Development Report", January 2008
[25] TERI & IFC, "Sustainable Investment in India 2009" and "Sustainable Investment in Brazil 2009"

The Chinese government has determined that individual investors' dominance constrains the healthy development of the market, so it has been promoting the development of institutional investors and encouraging them to engage in long-term investment practices.

The relative size of China's stock market participants is shown in Figure 4.1. Mutual funds play an important role, making up 26% of the market. The role of pension funds and insurance companies is still limited (0.8% and 2.5% respectively), but expected to grow. The influence of foreign investors is small, as a result of Chinese government investment quotas that limit them to 1.7% of the market. The following section gives more detailed information on each of these investor types and their sustainable investment activities.

Mutual Funds

MARKET OVERVIEW

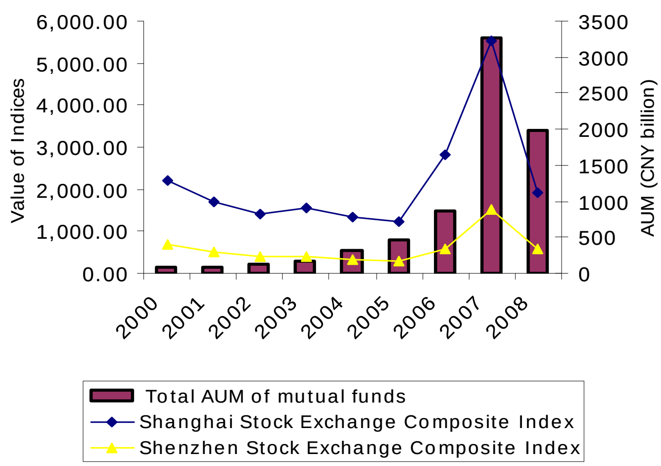
Mutual funds have experienced explosive growth over the last decade, as a result of Chinese government efforts to develop the sector. *Rules on the Establishment of Joint Venture Fund Management Companies* took effect in July 2002, when there were only 15 fund management companies, and by the end of 2008, there were 61 fund management companies of which 33 were joint ventures. The fierce competition between domestic companies and joint ventures has helped improve the compliance and efficiency of the industry.

The total assets under management (AUM) has increased from CNY10.7 billion in 1998 to CNY1.98 trillion in 2008, growing at an average annualized rate of 68% despite a drop of almost 40% during the global economic downturn last year.

In addition to the increase in the number of fund management companies, the total assets under management (AUM) has similarly increased from CNY10.7 billion in 1998 to CNY1.98 trillion in 2008, growing at an average annualized rate of 68% despite a drop of 39.6% during the global economic downturn last year. This growth is inextricably linked with the strong performance of China's A-share stock markets. As expected, there is a positive correlation between AUM and the Shanghai and Shenzhen Stock Exchange Composite Indexes (Figure 4.2).

By the end of 2007, there were 364 retail funds from domestic and joint venture mutual fund management companies. Of these, 329 are open-end funds with CNY3.04 trillion AUM, around 92.9% of the total AUM. The 34 closed-end funds have CNY232.1 billion AUM; their proportion of the total dropped from 18.96% in 2006 to 7.09% in 2007. As of 2007, the total AUM of retail funds made up 26% of the total market capitalization (cap),[26] and mutual funds established themselves as significant players in the A share market.

Figure 4.2: Comparison of Mutual Funds AUM and Shanghai and Shenzhen Stock Exchange Composite Indices, 2000-2008



Source: CSRC

[26] CSRC, "China Capital Markets Development Report", January 2008

Among the 61 mutual fund management companies in China, ChinaAMC, Harvest and Boshi are the top 3 fund management companies, with AUM greater than CNY100 billion each.

There are 61 mutual fund management companies in China (see Appendix 3), and the top 3 are ChinaAMC, Harvest, and Boshi, with AUM greater than CNY100 billion each. Table 4.1 lists the top ten management companies in China, which account for 49.3% of the total mutual fund market.

Table 4.1: Top 10 China Mutual Fund Managers by AUM

Rank	Mutual Fund Management Companies	AUM		Nature of Ownership	Year of Operation
		CNY bln	USD bln		
1	**China Asset Management Co.**	**188.86**	**27.64**	**Chinese**	**11**
2	**Harvest Fund Management Co.**	**137.51**	**20.12**	**JV**	**10**
3	**Boshi Fund Management Co.**	**125.75**	**18.40**	**Chinese**	**11**
4	China Southern Fund Management Co.	102.83	15.05	JV	11
5	E Fund Management Co.	87.63	12.82	Chinese	8
6	ICBC Credit Suisse Asset Fund Management Co.	75.23	11.01	JV	3
7	Da Cheng Fund Management Co.	70.73	10.35	Chinese	10
8	Hua An Fund Management Co.	70.16	10.27	JV	11
9	GF Fund Management Co.	66.28	9.70	Chinese	6
10	Yinhua Fund Management Co.	52.43	7.67	Chinese	8

Note: JV = Joint Venture
Source: Morning Star Statistics (December 2008)

STATUS OF SUSTAINABLE INVESTMENT

Although SI in the mutual fund sector in China is still nascent, there is great momentum and increasing interest in the sector. Key sustainable investment activities are:

» The first SI fund – Industrial Social Responsibility Fund by AEGON Industrial Fund Management Co., Ltd (hereafter referred to as AEGON Industrial) performed well, and its records showed that it outperformed the market benchmark by 32% from its inception in May 2008 to the end of 2008.

» A second SI fund will be launched by the end of 2009 by CCB Principal Asset Management Co., Ltd (hereafter referred to as CCB Principal), and will passively follow the forthcoming Shanghai Stock Exchange CSR index.

» Some mutual funds have started to incorporate ESG factors into their investment process and take an active engagement approach on corporate governance issues for risk management purposes.

The growth of SI in China is driven more by industry competition than by external demand. Mutual funds have a strong desire to explore ways to differentiate themselves from their competitors through a variety of investment methodologies, changing their branding, and investing in different market segments.

The growth of SI in China is driven more by industry competition than by external demand. The majority of clients, namely pension funds and insurance companies, have a relatively limited knowledge of SI, so requests for SI products are limited. However, mutual funds have a strong desire to explore ways to differentiate themselves from their competitors through a variety of investment methodologies, changing their branding, and investing in different market segments. This incipient desire for differentiation led AEGON Industrial to launch its Social Responsibility Fund. CCB Principal, under the same competitive pressures, will soon launch the first SI Index Exchange-Traded Fund (ETF) in China. Both of the asset managers are relatively small players, ranking in the second tier (top 10-20) of the mutual fund market in terms of AUM.

Apart from these two funds, there are other mutual funds which do not position themselves as SI funds but do incorporate ESG factors into their investment analysis. Their rationale is that this approach strengthens their risk management, especially after recent ethical scandals such as the Sanlu case[27] in 2008, which inspired Chinese investors to consider non-financial risks. The Bank of China's Sustainable Growth Fund is one of these funds,[28] as it incorporates CSR information disclosure and corporate governance into its investment analysis template. The fund's analysts score the two elements alongside every other financial calculation and assessment for each of the fund's candidate companies. In other words, a systematic approach to integrating ESG criteria into mainstream mutual fund investing is emerging. Besides ESG integration in investment analysis, some firms have taken active approaches to engagement in the corporate governance of their investees. For instance, Bank of China's Sustainable Growth Fund voted against a proposal regarding related-party transactions at Qingdao's Haier during the company's board meeting. Although the action did not change the result of the vote, since the fund has a limited share in Haier, it attracted the attention of Haier's senior management and inspired subsequent changes in corporate governance.

There are other mutual funds which do not position themselves as SI funds but do incorporate ESG factors into their investment analysis. Their rationale is to strengthen their risk management.

The initial SI approaches taken by Chinese SI retail fund managers are (1) positive screening, such as that employed by AEGON Industrial; and (2) passive investment, such as CCB Principal's fund which will follow the CSR index. Unlike western SI investors who commonly use negative screening and engagement approaches,[29] the initial methods in China seem focused on positive screening. Even though CCB Principal's SI fund passively follows the CSR index founded by Shanghai Stock Exchange and China Securities Index, the index is inclined to weight ESG performance of listed companies according to their social contribution (discussed in Chapter 5) rather than based on negative factors.

Most Chinese mutual funds use in-house analysts, which is partly due to the lack of ESG research institutions in China. Most Chinese mutual funds interviewed expressed little interest in taking a questionnaire approach to glean information directly from listed companies because of concerns about the integrity of information, survey fatigue and the methodology itself.

To conduct ESG research and analysis for investment purposes, most Chinese mutual funds use in-house analysts, which is partly due to the lack of ESG research institutions in China. The main sources for analysts are information from the public domain, i.e. corporate-disclosed information, media channels, and authorized websites. Most Chinese mutual funds that we interviewed expressed little interest in taking a questionnaire approach to glean information directly from listed companies because of concerns about the integrity of information, survey fatigue and the methodology itself. Leading ESG criteria that funds use tend to focus on legal compliance, including compliance with environmental and labor regulations.

There is currently only one retail SI mutual fund product available to investors in China (US$375million as of March 31, 2009), although there are more funds that

[27] A milk contamination scandal in 2008: the irresponsible but legal behavior of Sanlu company caused contamination of powdered milk products, which led to kidney stones in more than 6,200 infants and incited public outrage.

[28] Bank of China Sustainable Growth Fund stated to the BSR team during an interview that they do not position themselves as an Social Responsible Investment (SRI) fund.

[29] 2008 survey results from Responsible Investor shows that 40% of SRI assets invested use a negative screening approach, and 43% use an engagement approach.

have started to integrate ESG factors into their investment processes, and there is at least one new domestic fund launching soon.

Industrial Social Responsibility Fund

In May 2008, the Industrial Social Responsibility Fund was launched by AEGON Industrial, which is a joint venture between Industrial Securities (51%) and AEGON International N.V. (49%), one of the world's largest life insurance and pension groups, based in the Netherlands. According to its prospectus, the Fund invests 65 to 95 percent of its proceeds in stocks and the remainder in bonds. As the first SI retail fund in China, the Industrial Social Responsibility Fund has attracted a great deal of attention among the investment community. The following sections will describe its genesis, development, investment strategy, and performance.

Investment Strategy

Although the concept of SI is relatively easy to adopt, different approaches must be scrutinized and a methodology must be selected and refined. Mr. Xin and Mr. Liu, fund managers of AEGON Industrial, adapted an SI methodology to the Chinese context and now implement it in management of the Fund. Their specific methodology is a standard positive screening process which rates listed mainland companies based on four categories of performance—economic responsibility, sustainability responsibility, compliance responsibility and business ethics—and then selects the companies with the highest comprehensive score to form their core stock pool. The Fund's Investment Committee then selects stocks from the pool to use in its portfolio. Like most international SI approaches, the Fund integrates broad consideration of non-financial factors into its core investment decisions. The main difference from international SI funds is that it uses information in the public domain to assess companies, whereas the investment research methodology of international investors is more diversified and relies on third party research institutions and/or sending questionnaires to potential investees.

AEGON Industrial has ESG criteria that are specific to the Chinese market. Figure 4.3 illustrates the investment framework and the investment priority parameters. It is interesting to note that compliance with the law, especially the tax law, and cooperation with government are highlighted by the Fund. The following paragraphs describe each of the four categories and the parameters.

» **Economic responsibility**: From the Fund's perspective, good economic returns form the very foundation of a sustainable company. The parameters include three basic standards for a good company: (a) financial performance (assessment indicators include PEG ratios,[30] EBIT,[31] growth), (b) products/services quality and competitiveness (including safety of products/services, product return and repair rate, accuracy of product advertisements); and (c) corporate governance (including independent board of directors, risk management system, information disclosure policies, balance of majority and minority shareholders).

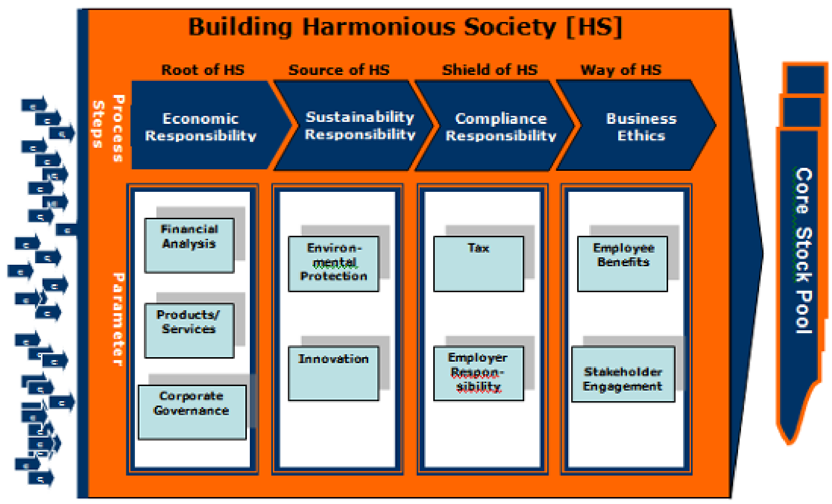
If a company outperforms the industry average in terms of energy use, greenhouse gas (GHG) emissions, and other indicators, it will gain extra points and be more likely to be an investment target.

» **Sustainability responsibility** focuses on environmental protection and innovation. For environmental protection, the Fund first checks whether companies comply with national and local environmental laws and

[30] The PEG ratio (Price/Earnings to Growth ratio) is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share (EPS), and the company's expected growth.
[31] Earnings before interest and taxes (EBIT) is a measure of a firm's profitability that excludes interest and income tax expenses.

regulations, and then evaluates their measures and budget to deal with environmental protection and energy efficiency. If a company outperforms the industry average in terms of energy use, greenhouse gas (GHG) emissions, and other indicators, it will receive extra points and be more likely to be an investment target. The Fund also looks at companies' incentive mechanisms to encourage innovation, the quantity and quality of intellectual property (IP), and the financial and human capital investment in R&D.

Figure 4.3: Investment Framework of Industrial Social Responsibility Fund



Source: AEGON INDUSTRIAL Fund Management Co., Ltd

» **Compliance responsibility** focuses on two areas: tax law and labor law. Investee companies should fulfill their tax payment responsibilities and have sound human resources management and record systems for employees. The companies' social security payments for employees, tax payments and other related issues are taken into account when the Fund selects companies for its stock pool.

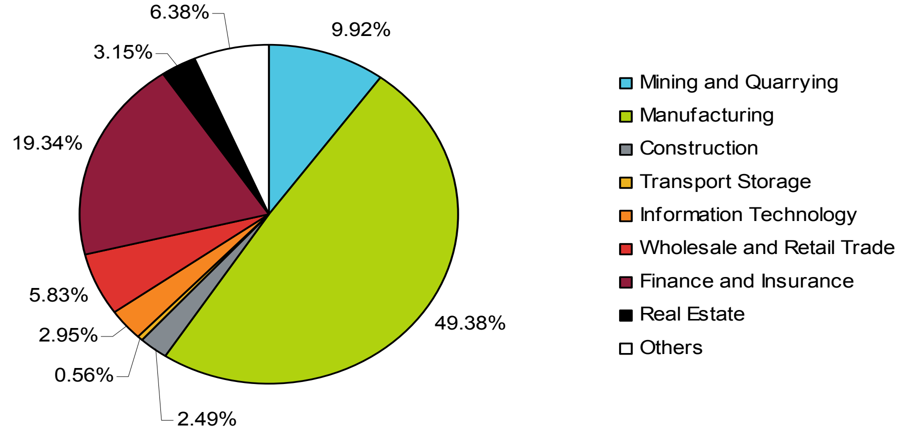
» **Business ethics** includes employee benefits and stakeholder engagement. The Fund considers treatment of employees and protection of employee rights to be the primary internal ethical responsibilities of a company, and stakeholder engagement to be its primary external ethical responsibility. For employee benefits, the Fund emphasizes employee training, relationship with employees, and incentive structures linked to employee performance. For external stakeholders, it looks for participation in strategic government plans (such as a company's contribution to the "Western China Development strategy," or investment in sectors that the government has encouraged for development). In addition, it examines a company's relationship with local communities.

<u>Fund's Portfolio</u>

Figure 4.4 shows the portfolio of the Fund by sector. The largest sector is manufacturing, accounting for almost 50% of the portfolio, followed by the financial sector, which makes up approximately 20%. The other 30% covers a diversified mix of sectors including construction, transportation, IT, mining, real estate, wholesale and retail. The Fund's largest investments in individual stocks generally have a long-term investment horizon. For instance, the Fund has

invested in China Merchants Bank since its launch, and the bank has represented at least 4% of the fund's total AUM for over a year, according to the Fund's quarterly reports.

Figure 4.4: Portfolio of Industrial Social Responsibility Fund by Sector, March 31, 2009



Source: Quarterly Report of Industrial Social Responsibility Fund, Q1 2009

Capital Raised and Performance to Date

There was some early skepticism about the Fund's ability to raise capital. Zhou Liang, head of China research for Lipper, a Reuters company, said that "it remains unclear whether the fund will be successful in China because most domestic investors focus on financial returns rather than social responsibility." [32] Another analyst suggested that the fund would "probably meet a hard sell due to the stock market slump which has hit overall mutual fund sales." However, the Fund sold about 1.388 billion shares at a unit price of CNY1 per share in early 2008, when the economy was sluggish. Furthermore, it raised another 1 billion shares to increase its AUM by 190% as of May 6, 2009, propelling it into the top 5 stock funds in terms of AUM growth in 2009.[33]

Table 4.2: Performance of Industrial Social Responsibility Fund

	3 months	6 months	1 year	Since Inception[34]
Industrial Social Responsibility Fund	19.60%	63.11%	41.79%	26.90%
Benchmark Yield (80%× Citics S&P 300 Index + 20%×Citics S&P treasury index)	19.83%	54.57%	13.13%	-10.53%
CSI 300 Index	26.27%	74.20%	13.41%	-20.02%

Source: Industrial Social Responsibility Fund 2009 Q2 Report and Calculation of CSI 300 Index

Table 4.2 compares the Fund's performance with its own benchmark index and the CSI 300 (an index commonly used as a market benchmark, containing 300

32 "China Plans 1st Socially Responsible Mutual Fund", (http://www.enn.com/business/article/32661 accessed 20 July 2009)
33 Shanghai Evening Post, "Social Responsibility Fund's Size Increase to 190%", May 9th, 2009
34 Data as of December 31, 2008

listed companies in the Shanghai and Shenzhen Stock Markets). Although the market was sluggish, and CSI 300 had a negative 20.02% return, the Fund gained 26.9% from April 30, 2008 (its inception) to June 30, 2009 outperforming its benchmark and the market average (CSI 300) by 37.43% and 46.92% respectively.[35]

Giving and Receiving

As the first SI retail fund in China, the team of the Industrial Social Responsibility Fund has made a substantial contribution to the SI field. In addition to methodology development, the Fund has put great efforts into SI promotion and education. Mr. Xin and his team translated and published Amy L. Domini's book, *Socially Responsible Investing: Making a Difference and Making Money*, to systematically introduce the history and development of sustainable investing in western countries to the Chinese public. In addition, Mr. Xin reviewed and translated materials from the Social Investment Forum and other leading perspectives to promote SI concepts. The Fund has also offered trainings to its own staff to increase their acceptance and expand their knowledge of SI.

As a result of these efforts, AEGON Industrial has gained a reputation as a pioneer in the field of Chinese SI mutual funds. Its endeavors have been recognized by the CSRC, which specifically mentioned the Fund's practices in a notice to the mutual fund industry and encouraged other mutual funds to learn from AEGON Industrial to further enhance corporate social responsibility. The Fund has also had strong support from AEGON International, their foreign shareholder, which arranged trips for the team to go to the UK to study and share experiences with its sister company.

CCB-Principal Social Responsibility ETP Fund

CCB-Principal Asset Management Co. Ltd. is a young mutual fund management company jointly established by China Construction Bank (65% share), the Principal Financial Group (25% share), and China Huadian Group (10% share) in September 2005. It has recently devoted itself to SI research and will launch its new offering, the Social Responsibility ETP Fund, to the public in the near future.

The ETP fund methodology quantitatively measures listed companies' environmental impacts linked with their intrinsic value for investment.

Research on SI Methodologies

In cooperation with Renmin University, the National Development and Reform Commission (NDRC) and the Ministry of Environmental Protection (MEP), CCB-Principal Asset Management sponsored and developed a new methodology called "Environmental Cost" (EC). This methodology quantitatively measures listed companies' environmental impacts linked with their intrinsic value for investment. The methodology details have not yet been disclosed to the public, but it is likely that the data comes from the public domain and the MEP, which has a master list of corporate environmental survey results and compliance status. CCB-Principal also established an associated database which stores the environmental data and EC of all Chinese publicly listed companies.

The Shanghai Stock Exchange and the China Securities Index leveraged the EC methodology to create a "Corporate Social Contribution per Share" (SC), which is found below. Net Income, Taxes, Salary and Interest Expenses represent a company's economic contribution to society; Community Investment symbolizes its contribution to the local community; and Environmental Investment includes the company's investment in environmental protection, energy efficiency and GHG emission reductions. A company's social contribution is calculated by adding these together and subtracting EC.

[35] Authors' calculation based on CSI index, and performance of Industrial Social Responsibility Fund

$$SC = \frac{\text{Net Income + Taxes + Salary + Interest Expenses + Community Investment + Environmental Investment} - \text{EC}}{\text{Total Number of Shares}}$$

Portfolio of the 150 lowest PSC companies outperformed the market benchmark by 14% annually with a lower volatility.

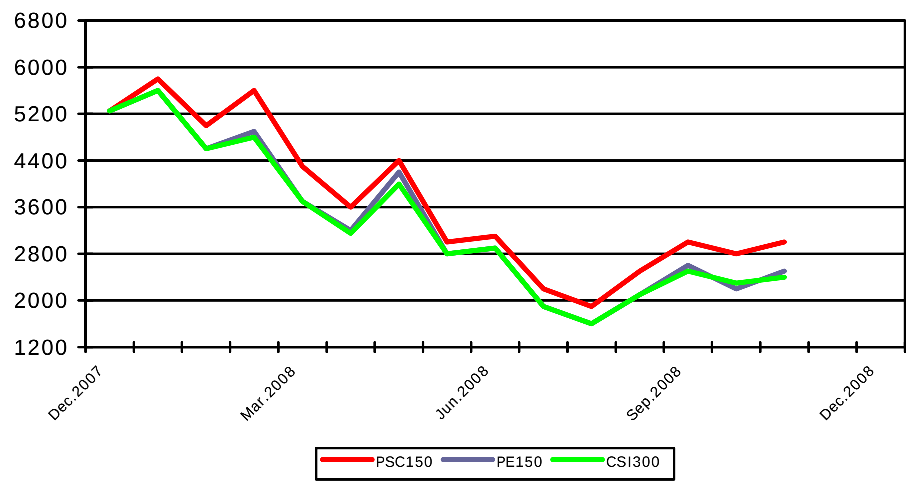
CCB-Principal ran a trial which calculated the ratios “Price to Social Contribution (PSC)” and “Price to Earnings (PE)” (Table 4.3) of each listed company, and found that the portfolio of the 150 companies with the lowest PSC (PSC150) outperformed the PE150 (the portfolio of the 150 companies with the lowest PE) which is the traditional value investing approach. It also outperformed the CSI300 market benchmark by 14% annually, and exhibited lower volatility (Figure 4.5).

Table 4.3: Social Contribution Approach vs. Traditional PE Approach

	Traditional PE Approach	SC Approach
Stock Value	PE = Price/Earnings	PSC = Price/Social Contribution
Profitability	ROE (Return on Earnings)= Net Profit/Net Asset	SCOE (Social Contribution on Earnings)= Social Contribution/Net Asset

Source: Presentation of CCB-Principal

Figure 4.5: Performance Comparisons between PSC150, PE150 and CSI 300 Indexes



Source: Xu Jun, Presentation on CCB-Principal, May 2009

Following the successful results of this trial, CCB-Principal plans to launch an SI Index Fund. The Fund will passively follow the SC-adjusted Social Responsibility Index which was offered by China Securities Index and Shanghai Stock Exchange from August 5, 2009. CCB-Principal expects that companies which address both economic and social interests will provide investors with stable long-term returns.

Pension Funds

MARKET OVERVIEW

Similar to pension systems in other emerging markets (such as India), China's pension system is immature and lags behind the country's overall economic development. Only 21% of the population is entitled to receive pension benefits[36] and many rural residents do not have access to even basic pension schemes. Migrant workers are also limited by their inability to transfer their pension plans from the provinces where they work to their hometowns when they return. The total size of pension funds is still relatively small compared with the expenditures that will be needed to cope with the country's aging population. In addition, the current pension system restricts the type of investment asset classes and the investable amounts or percentage 'ceiling' for each asset class, and also places limits on the number of asset management companies entitled to manage investments. This means that the role of pension funds in the capital market is still limited, which currently restricts their importance as a long-term investor and stabilizing force in the market.

The role of pension funds in the capital market is still limited, which restricts their importance as a long-term investor and stabilizing force in the market.

However, China has been undertaking major reforms in its pension system. According to many estimates, Chinese pension funds will emerge as some of the largest in the world. As this happens, the Chinese pension funds will increase their influence in the capital market, and could also become a significant group of SI investors.

Current Pension System

Since 1997, China's pension system has undergone major reforms. The Chinese government has laid out a conceptual "three-pillar" system to gradually replace its SOE-financed retirement system, which was a relic of the centrally planned economy.

The three-pillar system consists of the following elements:

1. Basic benefits provided through mandatory defined contributions, including pooling component to which enterprises contribute, and individual accounts to which employees contribute
2. A supplementary benefit to be provided by voluntary contributions from enterprises in sound financial condition;
3. A benefit based on individual pensions and savings.

Mechanisms serving different purposes have been developed in line with this system, including (1) social security funds, (2) enterprise annuities, and (3) individual savings. This research will focus on the first two mechanisms, which are of greater relevance to SI.

Social Security Funds

Social Security Funds (SSF) aim to provide basic pension benefits for individuals, and are based on mandatory defined contributions. This system in China is highly decentralized. Local authorities collect enterprise and individual contributions and manage these funds, and then provide basic benefits to subscribers within their jurisdiction. Based on the *Financial Regulation on Social Security Funds*, local authorities are not allowed to use the funds to make any equity or portfolio investments, and can only put the funds into bank deposits or use them to purchase government bonds.

[36] "Five Categories of Social Securities Funds' Income Increase by 26.7% in 2008", May 20, 2009, (http://news.hexun.com/2009-05-20/117880984.html, accessed 20 July 2009)

According to the *Statistical Communiqué on Labor and Social Security Undertakings* (2007), the combined local SSF funds reached US$158 billion (CNY1.081 trillion) in 2007, an increase of 25.1% over 2006. Although local SSFs presently have a balanced account, China's increasingly elderly population structure suggests that there will be tremendous pressure on local SSFs in the future, and a large implicit pension gap.[37] To address this issue, the National Social Security Fund (NSSF) was established in September 2000 with funding from the central government to serve as a supplemental adjustment tool and a reserve to cover future social security expenditures.

NSSF was established and initially entrusted with US$2.93 billion (CNY20 billion) in December 2000, and serves as a supplemental adjustment tool and a reserve to cover future social security expenditures.

NSSF was established and initially entrusted with US$2.93 billion (CNY20 billion) in December 2000. The central government administers NSSF through the National Council for the Social Security Fund (NaCSSeF). NaCSSeF manages its own bank deposits and purchases treasury bonds through the primary market. It also outsources investment in stocks, corporate bonds, financial institution bonds, and other fixed-income instruments in the secondary market to external specialized investment managers. The domestic and foreign asset management companies contracted by NaCSSef for investment management are listed in Table 4.4.

Table 4.4: Asset Managers for NSSF

Domestic Asset Managers	Foreign Asset Managers
China Southern Fund Management	State Street Global Advisors
BOSERA Funds	Alliance Bernstein
Penghua Fund Management	AXA Rosenberg
Changsheng Fund Management	T. Rowe Price
Harvest Fund Management	JANUSINTECH
ChinaAMC	Allianz
E Fund Management	UBS
China Merchants Fund	INVESCO
GUOTAI AMC	Black Rock
China International Capital Corporation Limited	PIMCO

Source: NSSF website

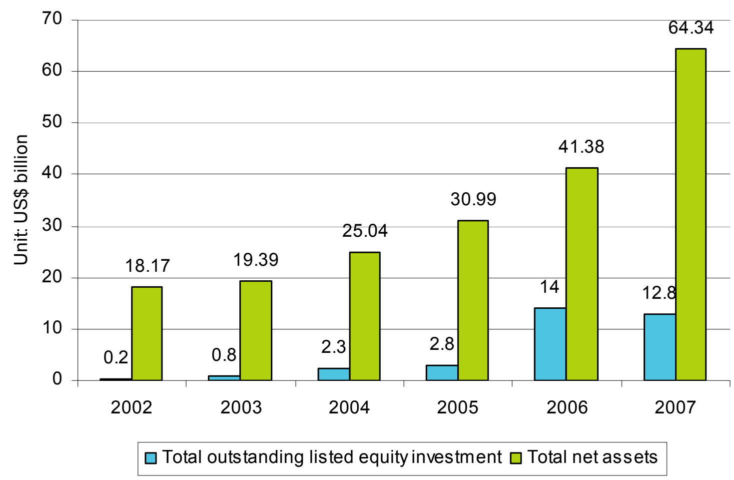
NSSF's investment in stock markets remains small both in absolute amount and in market share. However, rapid expansion of NSSF total net assets and investment in stock markets suggests increasing momentum.

NaCSSeF's investment policies are set out in the *Provisional Measures on Investment Management of NSSF*, jointly issued by the Ministry of Finance and Ministry of Labor and Social Security and adopted at the first annual meeting of NaCSSeF in December 2001. According to the provisional measures, NSSF can invest no more than 40% of AUM in stocks and investment funds, no less than 50% in bank deposits or treasury bonds, and no more than 10% in corporate bonds and financial institution bonds. At the end of 2008, NSSF's holdings were over US$82.29 billion (CNY562.4 billion), with about 20% held in domestic portfolio investments and 5% in foreign portfolio investments.[38]

[37] ADB, Technical Assistance to China, (http://www.adb.org/Documents/TARs/PRC/tar_prc_34096-03.pdf, accessed 20 July 2009)
[38] BSR interview with NSSF, May 22, 2009

NSSF's investment in stock markets remains small both in absolute terms (US$12.8 billion at the end of 2007) and in market share (0.8% at end-2007),[39] so it has a relatively limited influence on the market at this point. However, Figure 4.6 shows the rapid expansion of NSSF total net assets and investments in stock markets from 2002 to 2007, which suggests an increasing momentum that is likely to continue.

Figure 4.6: Total Net Asset and Total Outstanding Listed Equity Investment by the NSSF, 2002-2007

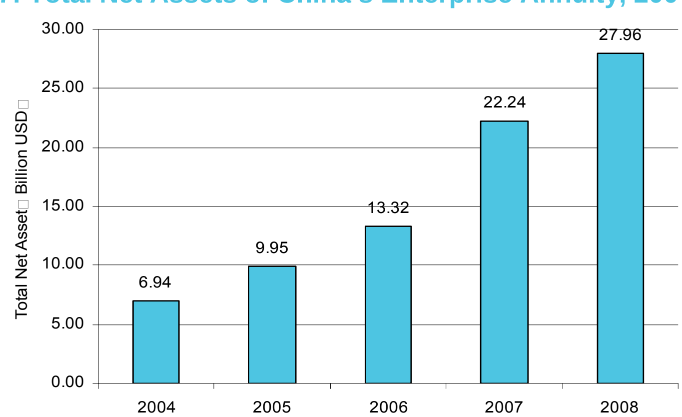


Source: NSSF Annual Reports, 2002-2007

Enterprise Annuity (EA)

Enterprise Annuity is a supplemental pension plan authorized by the Chinese government which provides further financial security for employees beyond basic social security funds. According to the *Statistical Communiqué on Labor and Social Security Undertakings* in 2008, approximately 33,000 companies in China had established EA plans, covering 10.4 million employees. The total amount of EA increased to US$27.96 billion (CNY191.1 billion) in 2008. Figure 4.7 shows the growth of the EA market, which has averaged 43% annually over the past five years.

Figure 4.7: Total Net Assets of China's Enterprise Annuity, 2004 to 2008



Source: Statistical Communiqué on Labor and Social Security, 2002-2008

[39] Authors' calculation based on NSSF's 2007 Annual Report

EA investment policies are set out in the *Trial Measures on the Management of Enterprise Annuities Funds*, jointly issued on May 1, 2004 by the Ministry of Labor and Social Security (MOLSS), China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). The *Trial Measures* require an EA plan to appoint a licensed trustee, custodian, administrator, and fund manager (Table 4.5 lists all government-approved EA licensees and Figure 4.8 describes their roles). The *Trial Measures* also stipulate investment allocation with no more than 30% holding stocks and mutual fund products, no less than 20% in bank deposits and monetary market funds, and no more than 50% in treasury bonds, corporate bonds and financial institution bonds. Under this rule, EAs could make maximum equity investments of US$8.4 billion in 2008.

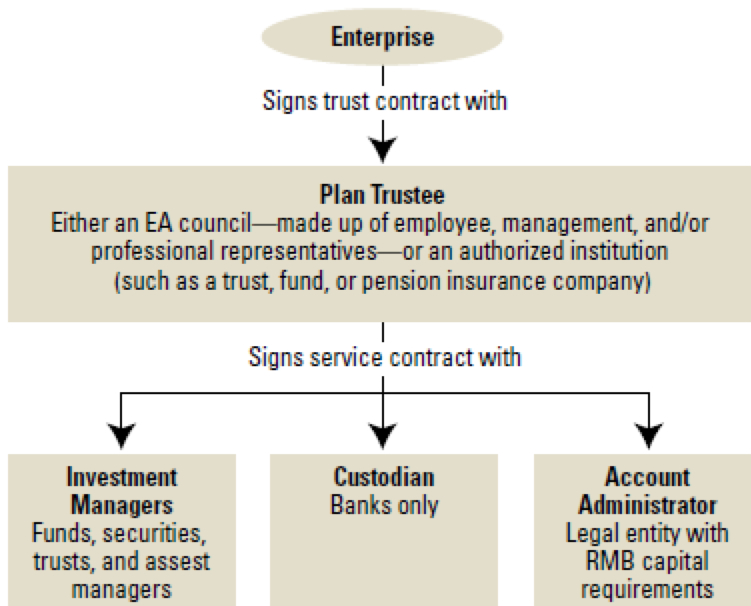
Table 4.5: Enterprise Annuity Licensees

License Type	Institution	
EA institutional trustees	CITIC Trust and Investment	Shanghai International Trust
	Huabao Trust Corp.	Changjiang Pension Insurance
	Ping An Pension Insurance	China Life Pension Insurance
	Tai Ping Pension Insurance	Taikang Pension Insurance
	China Merchants Bank	China Construction Bank
	Zhongcheng Trust and Investment Corp.	Industrial and Commercial Bank of China
EA custodians	Bank of China	Bank of Communications
	China Construction Bank Corp.	China Everbright
	Industrial and Commercial Bank of China	CITC Bank
	Agricultural Bank of China	Shanghai Pudong Development Bank
	China Minsheng Bank	
EA account administrators	Bank of Communications	China Everbright
	China Merchants Bank	China Life Insurance Co. Ltd
	China Pacific Life Insurance	CITIC Trust and Investment
	Industrial and Commercial Bank of China	Huabao Trust Corp.
	Shanghai Pudong Development Bank Co. Ltd	New China Life Insurance Co.
	Taikang Life Insurance Co.	China Construction Bank
	China Minsheng Bank	Bank of China
	Taikang Pension Insurance Co. Ltd	China Life Pension Insurance Co. Ltd
	Ping An Pension Insurance Co.	Changjiang Pension Insurance Co.
EA investment managers	Boshi Fund Management	China Asset Management
	China Life Insurance Assets Management	China International Capital Corp. Ltd
	China Merchants Fund Management	China Southern Fund Management
	CITIC Securities Co.	E Fund Management
	Fortis Haitong Investment Management	Fullgoal Fund Management

	Huatai Asset Management	Harvest Fund Management
	Ping An Pension Insurance	Tai Ping Pension Insurance
	Guotai Fund Management	Yinhua Fund Management
	ICBC CS Fund Management	Guang Fa Fund Management
	PICC Fund Management	Taikang Fund Management
	Changjiang Pension Insurance	

Source: China Enterprise Annuity Net

Figure 4.8: Enterprise Annuity Account Management in China



Source: Forest 2007

Although EA investment has shown tremendous growth in recent years, it is still far behind the original expectations of a US$14.63 billion (CNY100 billion) annual increase and total value in 2010 of US$147 billion (CNY1 trillion). The reasons behind this shortfall include inconsistent tax policies and weak incentive structures.

Summary of Pension System Components

The Chinese pension system is evolving rapidly, but still requires further reform in order to fully develop. The restrictions on equity investment are expected to be loosened in the future, and the growth of pension funds is estimated to be enormous. These developments would further solidify the role of pension funds in the capital market.

The current equity investment landscape is summarized as follows:

- Local SSF is not allowed to make any equity investment;
- NSSF can make no more than 40% equity investment, equal to US$33 billion at the end of 2008; and
- EA can make no more than 30% equity investment, equal to US$8.4 billion at the end of 2008

STATUS OF SUSTAINABLE INVESTMENT

Our project team conducted extensive interviews with asset owners who are entitled to make equity investments on behalf of the pension system, namely EA institutional trustees and NaCSSeF. The key findings regarding their sustainable investment status are summarized in Table 4.6:

Table 4.6: Sustainable Investment Status of Key Pension Trustees

	SI Interest	SI Know-how	SI Practices	UN PRI[40] Signatories	Assets in Equity Investments (%, net asset in US$)
NaCSSef	Strong	Medium	Limited	No	40%, 33bn
EA Trustees	Weak	Low	Limited	No	30%, 8.4bn

EA trustees have limited interest in SI and none of them have joined the UN Principles for Responsible Investment (PRI) or related associations. In contrast, NaCSSef has a strong interest in SI. It has expressed interest in learning more about responsible investment practices from overseas and has highlighted responsible investment as one of its four core principles (the others being long-term investment, professional investment, and safety-oriented investment). These four principles are linked, but have different emphases. NaCSSef's rationale behind responsible investment is that there is a correlation between economic development and pension fund growth, so NaCSSef has a responsibility to take a large-scale and long-term investment focus to facilitate the healthy development of China's economy. Overall economic growth will then be a basic and fundamental source of NSSF's growth. In terms of stock markets, NaCSSef also understands its role as a stabilizing force for the stock markets—as NSSF's investment in the stock market increases, the priorities affecting the yield of NSSF will shift from investment to the overall development of the stock markets. Thus, NaCSSef has continued promoting investment in stock markets and uses its own professional, standardized investment approach as a demonstration for other institutional investors.

EA trustees have limited interest in SI and none of them have joined the PRI or related associations. In contrast, NaCSSef has a strong interest.

Although NaCSSef shows a strong commitment to SI, its understanding of the field is not very robust and it has not yet developed formal SI approaches. EA trustees have even less awareness of SI, and their practical knowledge is very limited.

Looking toward the future, NaCSSef has expressed strong interest in pursuing SI,[41] and EA trustees have not expressed any particular resistance to SI. However, further education and detailed knowledge about SRI are needed to change mindsets and increase the technical capacity of pension funds to pursue the adoption of SI.

[40] See UN PRI section in chapter 5 for more information

[41] BSR interview with NSSF, May 22, 2009

Insurance companies can now invest up to 5% of their total assets into the stock markets, depending on asset structure, quality and internal control system. The investment is limited to A shares only.

Life and Property Insurance

MARKET OVERVIEW

There are 65 life insurance firms registered in China, with 34 (52%) foreign-owned and 31 (48%) domestically owned. There are also 49 property insurance firms, with 16 (33%) foreign-owned and 33 (67%) domestically owned. These are listed in Appendix 4.

On February 17, 2005, the China Insurance Regulatory Commission (CIRC) and the China Banking Regulatory Commission (CBRC) began to allow insurance companies to invest in stock markets, but only through nine insurance asset managers (listed in Table 4.7). Since March 2009, insurance companies have been able to invest directly in stock markets. Insurance companies can now invest up to 5% of their total assets into the stock markets, depending on asset structure, quality and internal control system. The investment is limited to A shares only.

Table 4.7: Approved Insurance Asset Managers in China

1	PICC Asset Management Co., Ltd
2	Taikang Asset Management Co., Ltd
3	China Life Asset Management Co., Ltd
4	China Pacific Assets Management Co., Ltd
5	Huatai Asset Management Co., Ltd.
6	Tai Ping Asset Management Co., Ltd
7	PingAn Asset Management Co., Ltd
8	New China Asset Management Co., Ltd
9	China Reinsurance Asset Management Co., Ltd

At the end of 2005, total insurance assets were CNY1.522 trillion (US$222 billion) but at that time, investment was limited to bank savings and bonds. Since then, these funds have grown rapidly, as shown in Table 4.8.

Table 4.8: Growth of Insurance Companies' Investments,[42] 2005-2009

Year end	Total assets (CNY billion)	Total assets (US$ billion)	Investments (CNY billion)	Investments (US$ billion)
2005	1,522	222	889	130
2006	1,973	288	1,179	172
2007	2,900	424	2,020	295
2008	3,341	488	2,246	328
March 2009	3,543	518	2,217	324

Source: CIRC website

[42] Investments including stock market and non-stock market investments

CIRC does not have a policy for sustainable investment, but BSR's interviews with insurance fund managers reveal that when they make an investment decision, they usually consider the company's profitability, the development trend of the industry, corporate governance and whether the investment target is in compliance with the government environmental policy.

STATUS OF SUSTAINABLE INVESTMENT

Based on CIRC data, the total assets of China's insurance firms reached CNY3.543 trillion (US$518 billion) as of March 30, 2009. As a result, total insurance funds that can be invested in the stock market are estimated at CNY177 billion (US$25.9 billion).

CIRC encourages insurance companies and insurance fund managers to follow cautious, safe and value-added principles when investing in the stock markets. CIRC does not have a policy for sustainable investment, but BSR interviews with insurance fund managers found that when they make an investment decision, they usually consider the company's profitability, the development trend of the industry, corporate governance and whether the investment target is in compliance with government environmental policy. Insurance companies and insurance fund managers are required to follow national industrial and environmental policy, and in practice they do consider governance and environmental performance when selecting stocks in order to avoid risk. They do not consider a company's social performance, however, because they say it is difficult to measure the social performance of a company.

Some insurance companies and insurance fund managers also make themed investments, such as investing in new energy industries. They do not invest in gambling, tobacco and alcohol industries even though they don't have a negative screening policy. Opportunities for sustainable investment are being created by the Chinese government's strong support for environmental protection, energy conservation, pollution reduction and initiatives to combat climate change, which are providing funding and a supportive policy environment for the establishment and growth of companies in these fields.

Foreign Investment in Listed Equity

GENERAL OVERVIEW

Foreign Investment in Chinese mainland companies can be made in three primary forms:

- » Stocks listed on mainland Chinese stock exchanges (Shanghai or Shenzhen)
- » American Depository Receipts (ADRs) of mainland Chinese stocks
- » Chinese stocks listed on the Hong Kong Stock Exchange (H-shares) or on other overseas stock exchanges (New York, London, Singapore, etc)[43]

Due to the research scope of this project, we focus on the first two categories and do not cover Chinese stocks in overseas markets. However, it should be noted that overseas markets are an important investment channel for international SI funds as they represent a bigger market (due to the restrictions on foreign investors in the A share market explained below), and are easier to invest in, in part because of greater use of English and more detailed information disclosure. Many mainland Chinese companies are listed in Hong Kong (sometimes as a dual listing, in addition to their A share listing) and thus international investors commonly invest in mainland companies through the Hong Kong exchange.

The overall trend is to further open up the Chinese capital markets to foreign investors. As part of this trend, the State Administration of Foreign Exchange (SAFE) in 2008 announced it will increase the total QFII investment quota from US$10 billion to US$30 billion.

Foreign Investment in Mainland Chinese Stock Exchanges

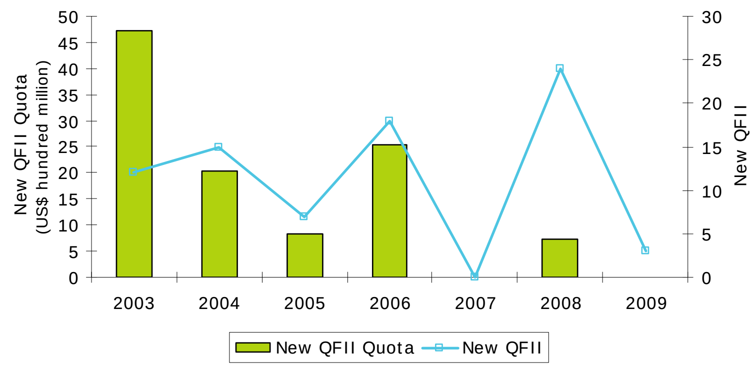
The Qualified Foreign Institutional Investor (QFII) scheme was launched in late 2002 to open up CNY-denominated A shares on the Shanghai and Shenzhen Stock Exchanges to foreign investors. The scheme requires foreign investors to apply for licenses and investment quotas from Chinese authorities in order to buy or sell A shares. The detailed rules are set up in the *Temporary Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investors*, which was published in 2002, and the *Regulation on Domestic Securities Investment by Qualified Foreign Institutional Investors*, which came into effect in 2006. The quota for foreign investors is relatively small (normally less than US$500 million per institutional investor), but the overall trend has been to further open up the Chinese capital markets to foreign investors. The State Administration of Foreign Exchange (SAFE) announced in 2008 that it will increase the total QFII investment quota from US$10 billion to US$30 billion and in September 2009, SAFE proposed lifting the limit on foreign investment from $800 million to $1 billion which indicates further reforms might be expected in the future to support the market.

As of July 2009, there are 85 institutions holding QFII status, each with an investment quota approved by SAFE. In early 2008, the combined quota of the 58 QFIIs at that time was US$10.8 billion (see Appendix 5), and estimates of total QFII investments as of July 2009 were around US$13 billion, approximately 1.7% of the total stock market. Figure 4.9 shows the growth in both number of QFIIs and value of their investments from 2003 to 2008.

---

[43] According to statistics from CSRC and Zero2IPO, there are over 230 Chinese companies listed overseas, predominantly in the US and UK, but also in Singapore, Frankfurt and other locations. 159 Chinese companies with a market capitalization of US$112.15bn are listed in Hong Kong (H shares, as of January 1, 2009), 111 on the Main Board and 42 on the GEM (Growth Equity Market). Source: Zero2IPO.,http://www.zero2ipo.com.cn/en/n/2009-1-16/2009116151801.shtml, and CSRC, http://www.csrc.gov.cn/n575458/n4001948/n4002195/n4003695/n4003785/n4003890/10389249.html

Figure 4.9: Total Quota and Number of QFII, by Year*



* There is a lack of data on the value of new QFII quotas given in 2008 and 2009, though estimates are that their quotas are low, around US$50m each
Source: CSRC

Table 4.9 lists the top 10 QFII in China in terms of their investment quota and year of operation. The largest quotas are held by companies who received the earliest approvals and have had their quota increased in subsequent years. The full list of QFII is available in Appendix 5.

Table 4.9: Top 10 Qualified Foreign Institutional Investors

QFII investment is small, but it has brought competition to the market and played an important role in transformation in Chinese investors' sophistication, improved risk management, and strengthened the global clout of Chinese capital markets.

	QFII	Investment Quota (US$ million)	Start Time
1	UBS AG	800	5/23/2003
2	Citigroup Global Markets Limited	550	6/5/2003
3	Fortis Bank SA/NV	500	9/29/2004
4	Credit Suisse (Hong Kong) Limited	500	10/24/2003
5	Nikko Asset Management Co., Ltd	450	12/11/2003
6	Deutsche Bank AG or Deutsche Bank Aktiengesellschaft	400	7/30/2003
6	Morgan Stanley & Co. International Ltd	400	6/5/2003
8	The Hongkong and Shanghai Banking Corporation Limited	400	8/4/2003
9	Nomura Securities Co., Ltd	350	5/23/2003
10	ING Bank N.V.	350	9/10/2003

Source: CSRC

Although the size of QFII investment is small, it has brought competition to the market and played an important role. SAFE reports that the QFII system has facilitated a transformation in Chinese investors' sophistication, improved risk management, strengthened the global clout of Chinese capital markets and helped optimize corporate governance.[44]

[44] Xinhua News Agency, "Quota in QFII triples to US$30b", December 10, 2007, (http://www.china.org.cn/english/business/234999.htm accessed 20 July 2009)

__ADRs of Mainland Stocks__

International investors can invest in Chinese companies listed through American Depository Receipts (ADRs) that are traded on the NYSE or other US markets. As of March 16, 2009, although there are 158 Chinese ADRs (with a total ownership value of US$35.741 billion), only 20 of them are Shanghai or Shenzhen stocks (the rest are Hong Kong or other stock markets), most are not regularly traded, and of those 20, their ownership value is very low. For A shares, ADR activity is so small that it does not warrant further analysis in this report. This is in marked contrast to Brazil, for example, where Brazilian ADRs are an important avenue for investors.

STATUS OF SUSTAINABLE INVESTMENT

Although 26 of the 85 QFIIs in China are signatories to the PRI, there is limited information about how these PRI signatories are integrating ESG factors into their operations or investment decisions in China.

There is insufficient information to estimate the amount of foreign investment in the Chinese stock market which has a strong ESG focus. Although 26 of the 85 QFIIs in China are signatories to the PRI, there is limited information about how these PRI signatories are integrating ESG factors into their operations or investment decisions in China. However, several investors who are well-known for their SI approach, such as the Bill & Melinda Gates Foundation, Yale University, Stanford University and Norges Bank, may also be applying SI principles to investment in Chinese A shares.

Fund management for QFIIs is normally run from headquarters and/or regional hubs rather than by staff in China, which makes it even harder to obtain statistics and data. However, looking at mainstream investment behavior, foreign investment in mainland stock markets is characterized by high portfolio turnover. This means that foreign investors generally have shorter-term investment time horizons, and implies that longer-term risks such as environmental and social risks usually receive limited consideration. Fortis's SI investment[45] in the A-share market is the only hard data that the BSR team has obtained verifying SI investment by QFII. Several companies with the largest QFII allowances told BSR that their SI investment in A shares is either very low or zero.

Fortis SI Investment in A Shares

Fortis is one of the few QFIIs with regional/global SI products investing in A shares. Their SI research centre has 12 analysts managing their SRI funds. They currently hold 4 A share stocks in their portfolio, in part through their Green Tiger Fund (which invests in green technology stocks in Asia). Of the 1,800 stocks that qualify for their SI investment, around 40 are Chinese (including A and H shares, ADRs, and overseas listings).

Fortis' Green Tiger fund is a typical thematic investment that is becoming more popular among international investors, particularly after China's latest economic stimulus package (US$221 billion of which is related to the environment), which presents opportunities for companies in sectors that will benefit from the stimulus package.

Except for the upcoming launch of STB's SI fund (see page 60), BSR is not aware of any China-specific QFII SI retail funds. However, based on conversations with QFII and others who invest through QFII, it is likely that there are global funds, emerging market funds, or Asian funds (such as Fortis') participating in SI in China. Due to the low QFII quota, such SI is likely to be low. The authors also expect that any SI investment through ADRs is also negligible

[45] BSR telephone interview with Fortis, May 15, 2009

due to the limited amount of stocks available, how rarely they are traded, and lack of further information.

ESG Engagement
International investors interviewed by BSR noted several challenges in engaging with Chinese investees, including cultural and language barriers and lack of proxy voting services. Despite these challenges, a few investors have begun to engage directly with Chinese companies on ESG issues. Engagement is primarily with companies listed in Hong Kong, although the interaction takes place with company head offices in mainland China. The engagement approach mainly tends to take the form of written advice (e.g. recommending that companies pay attention to key ESG risks that the investor has identified), but some international investors such as F&C (who currently invest in mainland Chinese companies listed in Hong Kong or overseas, but not A shares, as they are not QFII) actively visit China to meet with companies. Overall, the response to engagement is lower than in other emerging markets.

A number of international investors are actively voting at annual general meetings (AGMs) and extraordinary general meetings (EGMs) of Chinese companies, in many cases following up with companies e.g. if they vote against the Board, to explain their rationale for opposing a resolution.

F&C Engaging on ESG issues with Chinese Companies

F&C runs reo® (responsible engagement overlay), a shareholder engagement and corporate governance service. Through reo®, F&C uses its influence as a major asset manager to encourage better management of ESG risks by companies, where this can benefit shareholder value. F&C translated its Corporate Governance Operational Guidelines on ESG and reporting into Chinese and sends it to all Chinese companies they invest in. In addition, F&C visited China in 2008 and met with representatives of 15 companies, government bodies and local sustainability experts. In total, F&C engaged 24 Chinese companies in 2008 on environmental, social and governance issues. This reflects engagement above and beyond their annual mailing to all companies in their portfolios and their voting-led engagement letters. In 2008, five Chinese companies changed corporate sustainability practices on a total of ten occasions following engagement by F&C.

Companies that provide advice to these investors, such as RiskMetrics Group, are increasingly active. In 2009, for example, RiskMetrics produced voting recommendations for over 800 mainland Chinese companies. Demand for such research has increased exponentially over the past two years.[46] A number of international investors are actively voting at annual general meetings (AGMs) and extraordinary general meetings (EGMs) of Chinese companies, in many cases following up with companies—for example, if they vote against the Board—to explain their rationale for opposing a resolution.

Future Trends
Although the current landscape of foreign investment under SI mandates seems limited, the scenario may change in the near future as international SI funds show strong interest in Chinese stocks and the QFII quota expands. In particular, the leading SI Japanese investor – Sumitomo Trust & Banking (STB) – will soon launch its China SI retail fund which will add US$50m to the stock of foreign SI in China's A-share market.

[46] BSR telephone interview with RiskMetrics, June 10, 2009

Sumitomo Trust & Banking (STB) to Launch China SRI (Social Responsibility Investment) Retail Fund

Sumitomo Trust & Banking (STB) is one of the leading SI fund managers in Japan. In 2007, it began to consider offering a China SI fund to Japanese investors. The bank worked with Japan Research Institute (JRI) (see page 81 as its primary research partner to analyze and evaluate Chinese listed companies in 2008. With extensive preparation, they plan to establish a US$50m fund which will be invested in A shares at the end of 2009 (they received QFII status in June 2009).

The investment process will consist of two main steps: (1) screening the potential target companies against ESG and financial criteria, and forming a 200-company stock pool by the best-in-class method; then (2) evaluating corporate performance, long-term strategy and valuation among the stock pool, and then structuring the investment portfolio. It not only identifies top ESG performers but also identifies companies with high-level ESG risks. The information mainly comes from questionnaire responses, on-site visits and publicly disclosed information. Further engagement with Chinese companies has not yet been decided.

Private Equity & Venture Capital

In addition to public equity investment, private equity investment is also an important channel for SI.

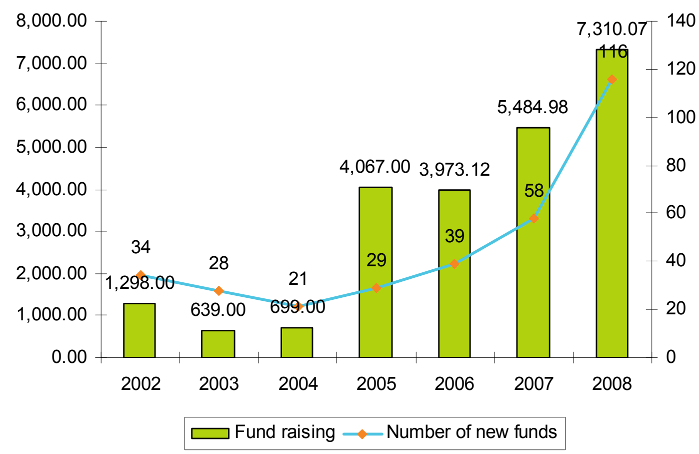
Chinese government's positive attitude and preferential policies toward VC and PE facilitate dramatic increase in this sector.

MARKET OVERVIEW

Policy Background

Figure 4.10 shows the dramatic increase in venture capital (VC) fundraising since 2004, which is due to the Chinese government's positive attitude and preferential policies toward VC and other form of private equity (PE). The revision of China's *Partnership Law* in 2007 and the *Notice regarding the Tax Policy to Facilitate the Development of Venture Capital Investment Enterprise* were particularly important. The former made substantial improvements to the 1997 *Partnership Law*, effectively removed legal barriers to structuring a PE/VC fund in the form of a limited partnership, and allowed foreign natural persons and foreign legal persons to invest in domestic limited partnerships. The latter notice provided tax incentives allowing VCs to deduct 70% of the investment amount of SME high-tech enterprises from taxable income. This is subject to a number of conditions; for example, the investment must last for at least two years.

Figure 4.10: VC Fundraising in China, 2002-2008 (Unit: US$ million)



Source: Zero2IPO, Venture Capital Annual Report, 2008

Although the first batch of PE/VC funds in the market were established by the Government, foreign PE/VCs now dominate. By 2007, foreign VCs were raising 82 percent of all new VC funding by value.

Domestic versus Foreign PE/VC

Although the first batch of PE/VC funds in the market was established by the Chinese government, foreign PE/VCs now dominate. The first government VC was established in Shenzhen in late 1985; after that, governments at all levels have invested directly in PE/VCs as majority shareholders. Based on industry statistics, domestic VC funds in 2006 raised 37.2% of their funding from the government, SOEs, and public institutions (see Figure 4.11)

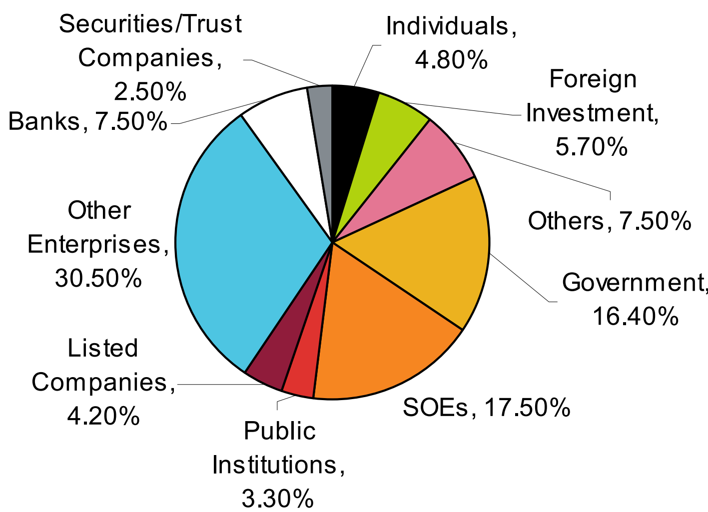
The first foreign PE fund, International Data Group, entered the Chinese market in 1992. By 2007, foreign VCs were raising 82% of all new VC funding by value, with only 13% coming from domestic VC funds (Table 4.10). Foreign PE/VCs are also more active investors. In 2007, foreign VC investment accounted for 89% of total new investment in the market, according to Zero2IPO, a leading Chinese service provider in PE and VC sectors.

Table 4.10: Number of New VC Funds Started in China, and Amount of Capitalization, by Domestic and Foreign Origin, 2007

Origin of VC funds	Number of new funds	Capitalization		
		Value (US$ millions)	Average per fund (US$ millions)	Share of value (percent)
Domestic	25	1106.21	44.25	13
Foreign	29	6886.72	237.47	82
Joint Venture	4	437.71	109.43	5
Total	**58**	**8430.64**	**145.36**	**100**

Source: World Bank, "Promoting Enterprise-Led Innovation in China", April 2009

Figure 4.11: Sources of Funding for China's Domestic VC



Source: Wang, Wang, and Liang, China Venture Capital Development Report, 2007

Snapshot of Current Market

The recent global financial turmoil has affected the PE/VC sector in China through falling asset values, which have led investors to readjust asset allocation and reduce their use of PE/VC. On the transaction side, with acquisition activities almost nonexistent and initial public offerings (IPOs) at a near standstill, PE/VCs have struggled to exit from their investments.

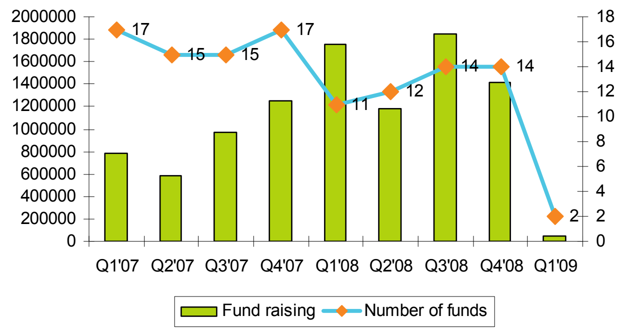
Fundraising Trends

Only two funds achieved a final close in Q1 2009. They raised US$500 million, down 96.5% from the previous quarter.

Global PE fund-raising hit a low of US$45.9 billion in Q1 2009, the smallest amount since 2003. Only 79 funds managed to raise capital worldwide.[47] In mainland China, only two funds achieved a final close in Q1 2009. They raised US$500 million, down 96.5% from the previous quarter. Figure 4.12 compares the fall-off in Q1 2009 after significant growth in 2007 and 2008.

[47] "PE fund-raising in 2009 lowest since 2003", April 2009, (http://www.expressindia.com/latest-news/PE-fundraising-in-2009-lowest-since-2003/443725/ accessed 20 July 2009)

Figure 4.12: PE Fundraising in China by Quarter, 2007-2009

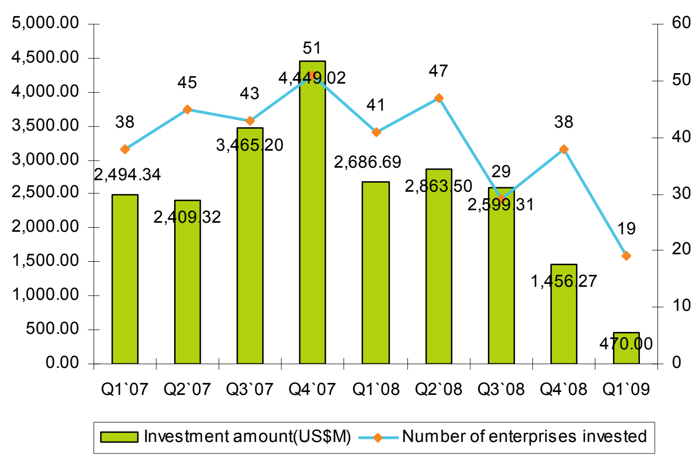


Source: Zero2IPO, China PE Report Q1 2009, 2009

<u>Investment Trends</u>

According to Zero2IPO, fund investment plummeted 82.5% year-on-year, to US$470 million in the first quarter of 2009. The total number of investment projects also plunged from 38 in Q4 2008 to 19 in Q1 2009 (see Figure 4.13). In terms of investment sectors, 82.7% of total investment volume in Q1 2009 went to traditional industry and 12.8% to the service sector, indicating an increase in traditional industry investment.[48]

Figure 4.13: Comparison of Total PE Investment Volume, 2007-2009



Source: Zero2IPO, China PE Report Q1 2009, 2009

<u>Exit Trends</u>

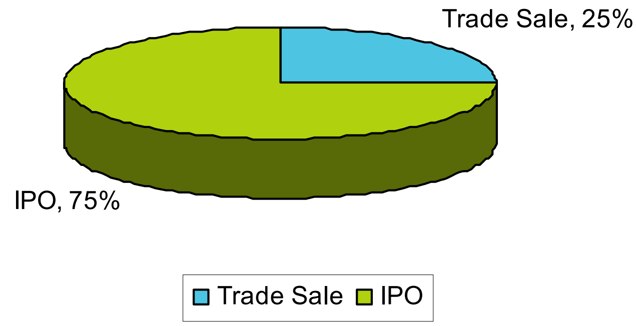
The total number of PE fund investment exits shrank by 50% year-on-year, and hit an all-time low of just 4 exits in Q1 2009. This is partly due to the sluggish domestic and foreign stock markets. The main exit option was still initial public offering (IPO), accounting for 75% of exits, with trade sale accounting for the remaining 25% (see Figure 4.14). In 2008, there were only 24 exits compared to 70 in 2007.[49]

---

[48] Zero2IPO, "China PE Report Q1 2009", 2009.

[49] Zero2IPO, "China PE Report Q1 2009", 2009

Figure 4.14: PE Exit Methods in 2009 Q1



Source: Zero2IPO, China PE Report Q1 2009, 2009

PE/VCs in China are in an excellent position to make sustainable investments and engage with investee companies on their ESG issues. They tend to hold substantial ownership position in corporations and thus have better access to and influence over investees, and are often staffed with seasoned and high-quality professionals who have returned from overseas.

STATUS OF SUSTAINABLE INVESTMENT

Like other emerging markets, PE/VCs in China are in an excellent position to make sustainable investments and engage with investee companies on ESG issues. In particular, they tend to hold substantial ownership position in corporations and thus have better access to and influence over investees, and are often staffed with seasoned and high-quality professionals who have returned from overseas.

The first point is an advantage held by every successful PE/VC fund, as they are essentially business partners with their investees and typically make important business decisions together in areas including corporate governance, high-level HR management, strategic planning, and key operational activities such as product development, management systems, and supplier and buyer relationships. As a result of this joint decision-making process, PE/VC firms have opportunities to influence the integration of ESG factors into investee strategy and management. In addition, the relatively long investment horizon of PE/VC funds allows them to monitor and guide ongoing improvement of investees' ESG performance.

The second point is regarding human capital. PE/VCs in China, whether of domestic or foreign origin, have lured a large number of expatriate Chinese professionals back. These returnees have brought back knowledge, know-how, and a broader base of experience. For instance, Mr. Ye Dong, a returnee from Silicon Valley, set up the first clean-tech PE fund in China in 2001, and became a sustainable investment pioneer in this area. With these high-quality human resources, there is greater potential for PE/VCs in China to "green" the market.

The existing sustainable investment activities of PE/VCs in China can be divided into three main topics:

- ESG integration – a process-focused sustainable investment approach which incorporates assessment of portfolio companies' ESG management and engagement over adoption of sound ESG management into the investment process;
- Clean tech investment – a product-focused sustainable investment approach in which PE/VC investments focus on the clean-tech sector that develops environmentally beneficial products and services;
- Impact-oriented investment – an impact-focused sustainable investment approach in which VC funds target SMEs or social enterprises with the

primary target of making an environmental, social, or economic impact, and a secondary goal of making a return on investments.

Quotation from PE/VCs About ESG Screening: "The assumption is that the current laws and regulations should take care of it, and legal compliance is enough."

About Non-Financial Aspect Audit:
"ISO certification won't mean anything, if the company can't even keep their toilet clean."

ESG Integration

ESG integration so far has not become mainstream for PE/VCs in China. Based on BSR's research, few Chinese PE/VCs have formal investment policies or a systematic process to deal with sustainability-related risks. Most of their efforts still focus on legal compliance screening. Their information sources heavily rely on legal compliance records from local governments, industry codes and public news. One of the interviewees stated that "the assumption is that the current laws and regulations should take care of it, and complying with statutory requirements is enough."[50] In addition, the majority of PE/VCs in China do not have in-house environmental and social expertise, and do not hire external qualified consultants either (except for some specific sectors, such as biofuels).

Though ESG integration is not widespread amongst PE/VCs, the Chinese market does not lack for pioneers who are forward-thinking and consider SI as a way to identify well-managed companies that understand risk and will have strong performance over the long term. Some of these pioneers are people who have returned from overseas and experienced the growth of SI markets in overseas countries, and are now attempting to incorporate SI practices into their work in China. Other PE pioneers have been motivated to incorporate non-financial factors into the investment process through the efforts of Development Finance Institutions (DFI) and sustainability-oriented family offices (professional entities set up to manage the investments, business affairs and philanthropic interests of high net-worth families), including IFC, Asian Development Bank (ADB), and LESS (a Hong Kong-based family office). These organizations have made significant efforts by providing catalyst investments to sustainability-oriented funds as limited partners, and engaging the funds to adopt environmental and social standards for their investments. IFC also developed tools, resources and guidance for PE funds to implement a Social and Environmental Management System (SEMS), which is available free online.[51]

The extent to which ESG has been integrated by these Chinese pioneers varies greatly. Some apply ad-hoc environmental and social indicators in their due diligence process, and many of these indicators are developed in anticipation of evolving regulations, such as the indicator which is linked to high-energy-consuming equipment, selected in part because of possible increased government regulation to limit the use of equipment with high energy consumption levels. Some PEs assess their prospective clients' ESG performance based on general perceptions of company performance, such as one example from a PE general partner who said that "ISO certification won't mean anything, if the company cannot even keep their toilet clean."[52] Others have developed sophisticated SI policies, E&S auditing systems and investee engagement schemes. By practicing these approaches in their investment process and receiving a premium when exiting from investee companies, they realized that value could be created by mitigating ESG risks and enhancing investees' ESG practices. One role model in this regard is Tsing Capital (see box).[53]

[50] BSR interview with an anonymous PE.
[51] http://www.ifc.org/ifcext/sustainability.nsf/Content/SustainableFinance_PrivateEquityFund
[52] BSR interview with New Horizon Capital in July 2009.
[53] Fei Yang, "Tsing Capital: Doing Well by Doing Good", January 14, 2009, (http://www.21cbr.com/html/magzine/2009/200901053/citizen/200901/12-2714.html accessed 20 July 2009) and BSR interview with Tsing Capital, May 5, 2009

Tsing Capital

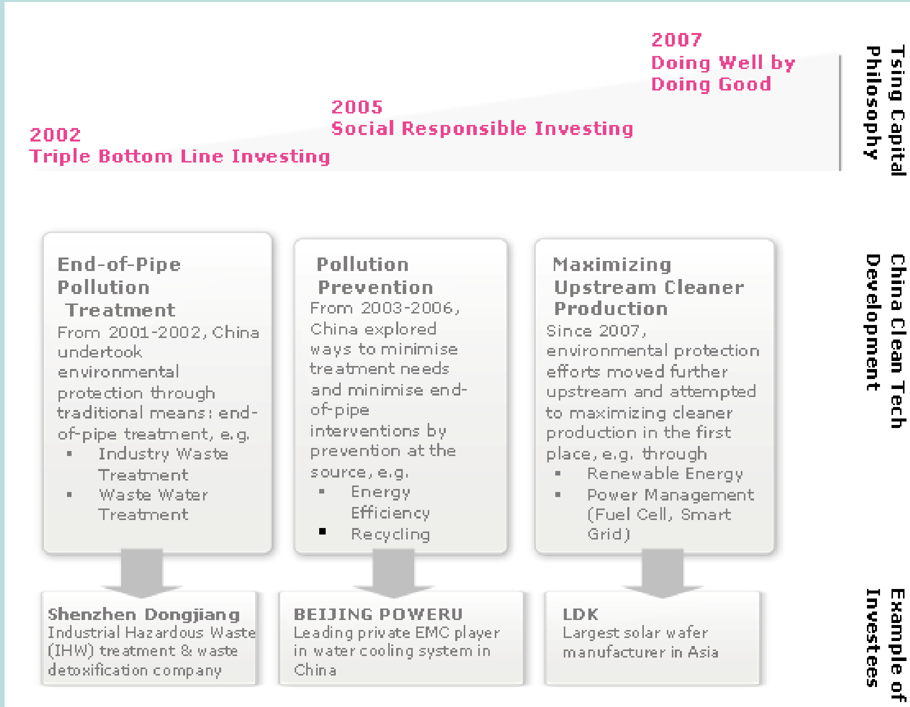
Tsing Capital, an investment arm of Tsinghua Holding (a subsidiary of Tsinghua University), was founded in 2001. Since its inception, it has managed three clean tech funds - China Environment Fund I (2002), II (2004) and III (2008), which have invested in around twenty Chinese companies in sub-sectors such as wastewater treatment, energy efficiency, solar photovoltaic cells and wafers, and solid waste recycling. The limited partners (LPs) of Tsing Capital broadly fit into four categories, namely DFIs, family offices, multinational corporations, and international institutional investors. Some of the LPs are renowned socially and environmentally active organizations including IFC, ADB, LESS, Robeco, and Calvert Ventures.

Having established its first sustainable investment fund 8 years ago, Tsing Capital was the market pioneer in China and is now a sustainable investment leader. Their capacity for leadership has been demonstrated through their investment philosophy, practice and impact.

(1) Philosophy: a thought leader on sustainable investment in the country
(2) Practice: integration of ESG considerations into the entire investment process
(3) Impact: three-digit financial return demonstrating the viability of a sustainable investment business model

Mr. Ye Dong, the founder and managing partner, noted a change in investment philosophy from being a passive adopter of standards to actively advocating for new standards. When Tsing Capital started its first fund in 2002, it followed international sustainable investment trends on “Triple Bottom Line Investing,” with encouragement from its LPs. As the company developed a deeper understanding of sustainable investment, they internalized ESG considerations into the company with buy-in from staff. Tsing Capital then started proactively advocating for the concept of social responsible investment in China starting in 2005. Two years later, Tsing Capital had established a philosophy, “Doing Well by Doing Good,” and shared its perspectives and experiences with the domestic investment community. Each of these three steps was ahead of the market at the time, and as a consequence, Tsing Capital has built up a reputation as a leader in the investment community.

The changes in Tsing Capital’s philosophy are reflected in the progression of its three investment funds, which also echo the development of China’s environmental sector, and are shown in the following diagram. The investment flowed first into pollution treatment industries, then energy efficiency, and now the scope has been enlarged to the entire clean technology sector. This transformation traced the increase in environmental awareness in China from a focus on end-of pipe treatment to pollution prevention and then to maximizing upstream aspects of clean production.



In terms of investment practice, Tsing Capital integrates ESG factors into the entire investment process (see diagram below), from due diligence to monitoring and engagement. Moreover, unlike other PEs, Tsing Capital not only focuses on corporate governance but also social and environmental factors. According to Tsing Capital's investment policy, a social and environmental (S&E) audit is required for due diligence on each candidate company and passing this audit is a prerequisite for next-step appraisal. A wide range of social and environmental issues are covered by this assessment. Specific social criteria include employee work time, occupational health and safety, child labor, salary and benefits, employee promotion opportunities, job creation, and community engagement. Environmental standards including utilization of water, land, energy, and environmental impacts. Tsing Capital also uses the audit to help the company identify strengths and weaknesses in order to develop action plans for further improvement.

After an investment had been made, Tsing Capital requires investee companies to disclose related S&E information in addition to financial data. It closely monitors and guides the companies' S&E performance. In addition, Tsing Capital works proactively with companies to ensure they maintain and improve their performance. In some cases, S&E technical assistance is provided to enhance the companies' capacity, including ESG trainings, facilitating the establishment of S&E management systems, and specific S&E projects. Tsing Capital views S&E technical assistance as one of its key value-added services to investees, and believes that the overall value of the investees will be increased as a result of improvement on S&E issues.

The impact of Tsing Capital on the investment community and the public has also been substantial. With double-digit returns for its first fund and triple-digit returns for its second fund, Tsing Capital has demonstrated a business case for sustainable investment in China. Its outstanding financial performance provides evidence that the goal of maximizing profit does not have to conflict with a responsible investment approach; to the contrary, an ESG risk adjustment approach has the potential to produce optimal returns over the long term.

Through its investments, Tsing Capital also claims to indirectly contribute to emission reductions of 7 million tons of carbon dioxide, generation of 8,000 megawatts of renewable energy, and over 10 thousand job opportunities annually. The fact that Tsing Capital measures and tracks the broader environmental and social impacts of its investments demonstrates an awareness of the role that financial institutions can potentially play in society.

Clean Tech Investment

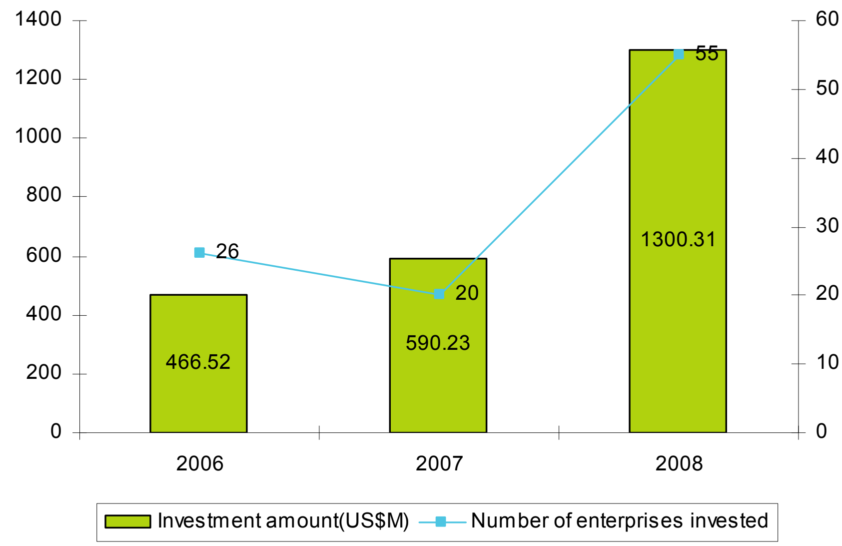
Increasing energy prices and the risk of serious, irreversible impacts from global climate change have led to a worldwide boom in clean energy investment. In 2006, global investment in clean energy reached US$100billion (45% higher than in 2005), with just over US$70 billion in new investments, and $30 billion in merger and acquisition or buyout transactions. The clean energy market is expected to grow rapidly in the coming years: the United Nations Environment Program (UNEP) projects a US$1 trillion market in clean energy financing and a US$2 trillion global market for Greenhouse Gas (GHG) emission trading by 2020.[54]

PE/VC's investment in Chinese clean tech companies rose from US$467 million in 2006 to US$1.3 billion in 2008, an annualized growth rate of 67%.

Although clean tech investment in China is still small compared with the global market, the rate of growth is very fast, partly due to immense market demand in China. PE/VC investment in Chinese clean tech companies rose from US$467 million in 2006 to US$1.3 billion in 2008, an annualized growth rate of 67% (see Figure 4.15). The investments cover 9 sub-sectors: new energy, water/wastewater treatment, air/environmental protection, new materials, solid waste treatment, energy efficiency, energy storage, new agriculture, and green building (see Figure 4.16). New energy makes up the lion's share of investments, with 69.8% of total investments and a total of US$907 million.[55]

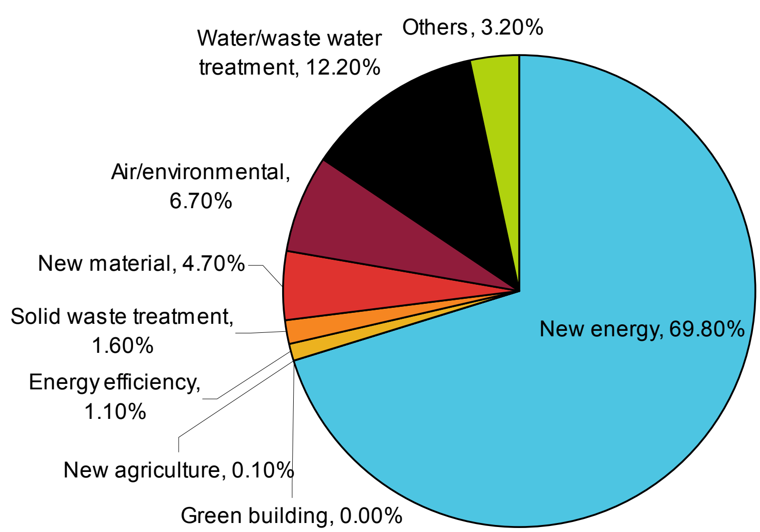
[54] ADB, "Proposed Equity Investment in Asian Clean Energy Private Equity Funds", March 2008, http://www.adb.org/Documents/RRPs/REG/41922-REG-RRP.pdf
[55] Zero2IPO, "China Clean Tech Report", 2009

Figure 4.15: Investment in the Chinese Clean-tech Sector, 2006-2008



Source: Zero2IPO, China Clean Tech Report, 2009

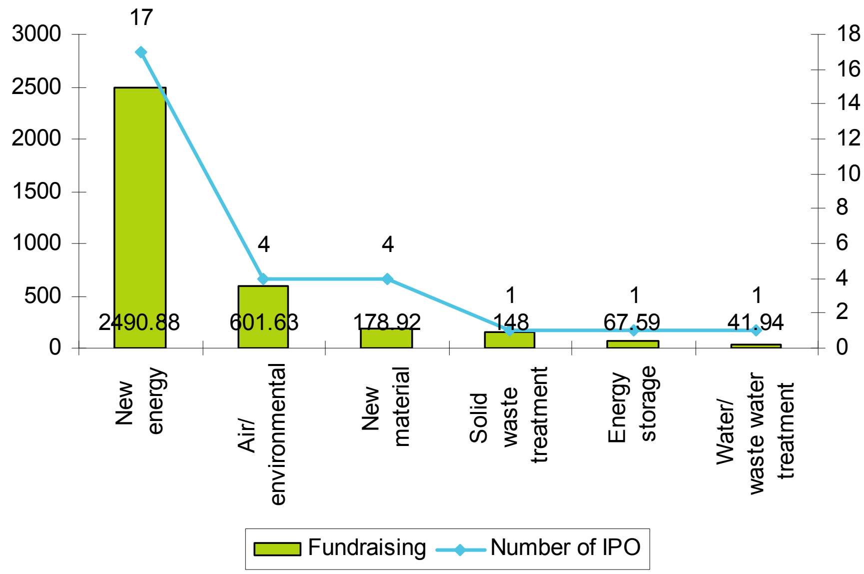
Figure 4.16: Investment in Clean Tech Enterprises by Sector



Source: Zero2IPO, China Clean Tech Report, 2009

On the exit side, 28 Chinese clean tech companies have gone through IPOs since 2006, 17 of which were backed by PE or VC. As with fundraising, most stock market IPOs have also come from the new energy sector (see Figure 4.17).

Figure 4.17: Clean Tech Enterprise IPO by Sector



Source: Zero2IPO, China Clean Tech Report, 2009

A Joint-Venture Sustainable Investment Private Equity Fund[56]

Sumitomo Trust & Banking (STB) is one of the leading SI fund managers in
In March 2009, Robeco and TEDA International Holding Corporation announced plans to offer a new joint-venture vehicle, The Robeco TEDA Sustainable Private Equity Fund. The fund will be the first CNY-denominated, sustainability-focused, cross-border, joint-venture equity fund. By leveraging the advantages of both TEDA and Robeco, the fund aims to link advanced international environmental technologies with growing demand in the Chinese market. The fund's approach is to invest in global leaders as well as Chinese companies developing such technologies and products suited to the Chinese market.

Impact-Oriented Investment

China is a partner of the New Ventures program of the World Resources Institute (WRI), which aims to "promote sustainable growth in emerging markets by supporting and accelerating the transfer of capital to businesses that deliver social and environmental benefits at the base of the economic pyramid."[57] Since its inception in 1999, the New Ventures program has set up local centers in five emerging markets, including Brazil, Mexico, China, Indonesia and India, with program headquarters in Washington, DC.

In China, the program acts as a bridge between investors and leading enterprises in the clean technology, biodiversity, renewable energy, and

---

[56] Robeco, "Robeco and TEDA International Holding Corporation announce Investment Management Joint Venture", March 23, 2009, (http://www.robeco.com/eng/press/period/pr/2009/03/joint_venture_robeco_teda.jsp accessed 20 July 2009)

[57] "About New Venture", (http://www.new-ventures.org accessed 20 July 2009)

sustainable forestry industries. New Ventures China's team evaluates candidate enterprises and selects 'Star Enterprises' for a portfolio. It then provides one-on-one consultation and holds seminars to build their capacity. In the past five years, over 300 Small and Medium-sized Enterprises (SMEs) participated in capacity-building or finance-matching events in China.[58] The New Ventures China program mentored 48 SMEs in China, and helped more than 15 enterprises to leverage over US$150 million in investments and loans.[59] Table 4.11 illustrates some Chinese companies which have received help from New Ventures.

Table 4.11: Investment Sought and Received of New Ventures Portfolio China, As of 1 June 2009

Company Name	Sector	Investment Sought (US$)	Investment Received (US$)
Green Circle Company	Green Consumer Goods, Clean Cosmetics & Nutraceuticals	4,500,000	484,000
Jiangsu Ruikang Tea Company	Sustainable Agriculture, Aquaculture, Food	N/A	484,000
King Vegetable Company	Sustainable Agriculture, Aquaculture, Food	1,000,000	12,000
Xi'an Xincheng Science & Technology Development Co.	Green Chemicals	1,200,000	363,000

Source: New Ventures website[60]

In the last two years, a number of organizations have started to look for so-called social enterprises in China for which they can provide funding and support. These enterprises (or in some cases, just entrepreneurs) are small-scale, and the funding for them is generally less than US$50,000. Most of the organizations active in this space in China (such as the British Council or NPI) are not looking for returns on their investments and see it more as a philanthropic contribution to building up the capacity of charitable organizations. However there are some, such as LGT Venture Philanthropy, SOW Asia and Avantage Ventures that are looking for a return on some, if not all, of their investments. Currently, though such organizations talk about financial investments, their strategies are more akin to loans than investments, as they rarely take any ownership stake or a share of investee profits.

[58] Data on New Ventures China website, (http://www.new-ventures.org.cn/intro.html, accessed 12 June 2009)
[59] Data on New Ventures website, (http://www.new-ventures.org/index.cfm?fuseaction=noticia&IDnoticia=111; http://www.new-ventures.org.cn/intro.html accessed 1 June 2009).
[60] Data on New Venture website, (http://www.new-ventures.org accessed 1 June 2009)

Distressed Asset Management Companies

AMCs are now permanent profit-oriented financial institutions that compete with investment banks in some services. They still continue to hold large numbers of these assets and are tasked, by the government, with realizing value from the assets.

In 1999, the Chinese government started transferring approximately US$205 billion in non-performing loans (NPLs) from the four biggest Chinese banks to four newly created Asset Management Companies (AMCs), in order to clean up the banking system. Bank of China's NPLs were transferred to Dongfang, China Construction Bank's to Cinda, Industrial and Commercial Bank's to Hurong, and Agricultural Bank's to Great Wall. In 2003, another US$120 billion was transferred and the AMCs began to sell some of the better-quality assets.[61]

Unlike in the US (1990-1995) or Sweden (1992-1997), where the priority of such operations has been to liquidate the assets, the AMCs are now permanent profit-oriented financial institutions that compete with investment banks in some services. They continue to hold large numbers of these assets and are tasked, by the government, with realizing value from the assets (especially to pay the interest on the long-term bonds used to buy the assets). These four AMCs dominate the market for distressed assets, but there are other smaller players.

Cinda Asset Management Company, one of the four AMCs, has shown interest in understanding the relationship between ESG and the assessment and valuation of assets

Cinda Asset Management Company, one of the four AMCs, has shown interest in understanding the relationship between ESG and the assessment and valuation of assets, though there is limited awareness at present. Given the sizeable amount of AMC assets, even initial steps in this direction could have an impact, and thus future experiments in this field should be encouraged. Collaboration between international and domestic distressed-asset companies could be a good way to help Chinese AMCs with ESG integration and improving the quality of their assets.

ADM Capital from Hong Kong is one of the leaders in managing distressed assets in Asia, demonstrating particularly strong awareness of ESG issues throughout their investment process:

- During the initial company assessment before deciding to do further research,
- During the detailed due diligence stage, including use of external specialist consultancies,
- During the investment evaluation stage, using a risk categorization approach,
- During the investment documentation signing stage, with agreements with investees on what areas of their business will be improved,
- During their ongoing monitoring of investments, board representation, and reporting to investors.

Having invested approximately US$500m in Mainland China, ADM Capital's focus is on turning around their assets in 2-3 years and adding value to the investee companies - an important part being ESG improvements. Indeed they have a proven track record in enhancing the ESG performance of most of their assets. With an investor base comprised of the Asian Development Bank and other development finance institutions (in some instances as co-investors in specific deals), ADM Capital has had exposure to, and in many cases training on, such institutions' advanced EHS frameworks and standards. Their focus on EHS is also supported by other ethically-minded organizations such as university endowments and the firm's Partners whose donations support the ADM Capital Foundation.

[61] "Really Bad Banks: China's Asset Management Companies", March 2009, (http://seekingalpha.com/article/125105-really-bad-banks-chinas-asset-management-companies accessed 20 July 2009)

5. Supporting Infrastructure

There are a number of factors that affect how difficult it is for investors to identify and assess prospective companies, and that improve the quality of companies (from an SI perspective). The main enabling factors include: government policy, corporate transparency and ESG disclosure practices, indices that identify companies according to certain ESG criteria, and research institutes that assess companies. Organizational support comes from global and national networks and associations that play a role in supporting SI, and development finance institutions which provide catalyst sustainable investments. Finally, there are a number of civil society organizations which play an increasingly important role.

Government Policy

As Chapter 2 showed, the Chinese government has established a number of regulations and policies to encourage sustainable development. Many of these norms, especially the ones covering ESG disclosures and green listing rules, are leading-edge and compare favorably with international best practice. However, China can still learn from other countries, particularly on specific sustainable investment policies such as pension fund investment and tax incentives. To build on the high quality of its laws, China should direct efforts to tackling its bottleneck problems—legal enforcement and policy implementation—which undermine the effectiveness of regulations and weaken the market.

Table 5.1 illustrates international best practices that governments are using to implement innovative policies and support the development of sustainable investment. In turn, a growing sustainable investment market also supports government agendas by:

- Making longer-term investments which increase market stability and encourage more responsible ownership; and
- Making investments in companies that are actively contributing to sustainable development, and also not investing in companies that are in breach of the law or negatively impacting the country's sustainable development.

Table 5.1: Best Practices Using Regulations to Support SI Internationally

	Best Practices Using Regulations to Support SI Internationally
U.K.	In 2000, the 1995 *Pension Act* was amended to require pension funds to disclose the ways in which they integrate (if at all) environmental, social and ethical factors in their investment strategy.[62] The *Trustee Act* (2000) requires that charity trustees must make sure investments are 'suitable' not only financially, but also with regard to the charity's stated aims, including "applying relevant ethical considerations as to the kind of investments that are appropriate for the trust to make." The *Companies Act* of 2006 mandates that companies listed on the London Stock Exchange disclose in their annual Business Review information on environmental, workplace, social and

[62] Other countries, such as Germany, Spain and Sweden have since adopted similar legislation.

	community matters "to the extent that they are important to understanding the company's business."
France	France was the first country to require companies to report on non-financial information in 1977, when it mandated that companies employing more than 300 people must report annually on 134 issues relating to employees and the workplace. These were expanded in 2001 to mandate that publicly listed companies include a report on social and environmental issues in their annual reports. The employee savings law of 2001 requires that companies offer at least one solidarity fund (a fund that invests in activities related to employment, social issues and housing). The 2001 *Law on Public Pension Reserve Funds* requires disclosure on how investment policy guidelines have addressed social, ethical, and environmental considerations.
Norway	The Norwegian Government Pension Fund defines the Norwegian responsible investment market in terms of its guidelines and investment approaches. The fund's guidelines are based on a combination of engagement, negative screening, and exclusion. It serves as a role model for other asset managers and investors in Norway and abroad. These asset managers and investors have adopted similar policies and practices and often join in collaborative engagement, as well as following the Norwegian Government Pension Fund's exclusion recommendations.
Belgium	A law prohibiting the direct and indirect financing of the manufacture, use and possession of anti-personnel mines and munitions was approved by the Belgian Parliament in March 2007.
Malaysia	In 2006, tax incentives were put in place, such as tax exemptions through 2016 for Islamic banks and funds. As a result, nearly 20% of bank assets are compliant with Islamic law (*sharia*), which shares some similar ethical principles with SI.
New Zealand	The New Zealand Superannuation Fund's mandate is set out in the *New Zealand Superannuation and Retirement Income Act 2001*. The Guardians of the fund must ensure the fund is invested in a manner consistent with "avoiding prejudice to New Zealand's reputation as a responsible member of the world community." The legislation does not provide any guidance as to what this means - that is left to the Guardians to decide, but the Guardians' annual report should include information on compliance with this principle.

Source: Eurosif, Domini Social Investments, SIF

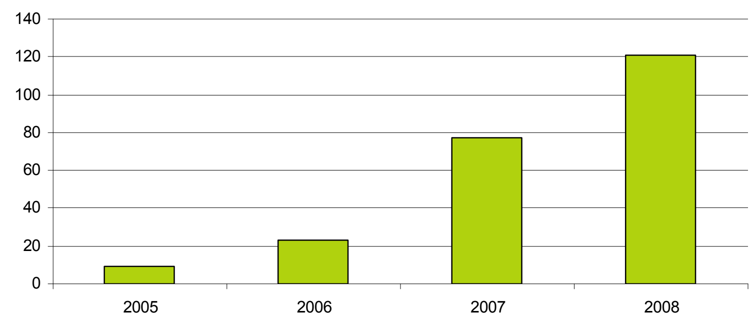
Non-Financial Information Disclosure

Sustainability reporting has become commonplace among large Chinese companies. Figure 5.1[63] shows that the number of sustainability reports increased from 9 in 2005 to 121 in 2008, though the quality of reports varied greatly. The rise in reporting is largely driven by government regulation and promotion (see Chapter 2), and state-owned enterprises account for over half the sustainability reports published in China in 2008. Although there are no statistics yet available on sustainability reports published in 2009, the number of reports is

[63] SynTao, "A Journey to Discover Values", 2008

expected to double or triple in number over the previous year, due to mandatory disclosure requirements by the Shanghai and Shangzhen Stock Exchanges. Global Reporting Initiative (GRI) guidelines are increasingly used by Chinese companies, and are regarded as a good tool to improve the quality of reporting.

Figure 5.1: Number of Sustainability Reports by Enterprises in China



Source: SynTao, A Journey to Discover Values, 2008

In addition to sustainability reporting, some leading Chinese companies even proactively approach their stakeholders and share their ESG strategies and request stakeholder feedback and participation. The case of China Mobile (see box) provides a good example of reaching out to investors.

China Mobile Outreach to Investors

In the fall of 2006, China Mobile (listed in Hong Kong) invited more than 30 analysts from Goldman Sachs, Morgan Stanley, Merrill Lynch and other leading investment firms to tour the Chinese countryside. The tour included a chance to see China Mobile's Rural Information Terminals (which provide information about market prices, weather forecasts, and crop management to rural customers) in action. After this, analysts more commonly noted the benefits that the system provides China Mobile's rural users, and how that aligns with the company's growth strategy in rural areas.

Source: Wang Jianzhou, "Mobile Phones: Bridging the Digital Divide", 2009

There are a few international initiatives which collect ESG information from Chinese companies and distribute them in the public domain. Their goal is to use the information to motivate investors, government and business to take action to address global sustainability issues. This mechanism also supports investors who want to make informed investment decisions while preventing ESG risks. However, their progress in China is still limited. The following are two cases.

Carbon Disclosure Project [64]
The Carbon Disclosure Project (CDP) is an international initiative which advocates for business to disclose information related to their carbon emissions. For a company to demonstrate awareness, measurement, and management of its carbon risks is a general indicator of good risk management, and thus could influence investment decisions. With the current financial crisis, investors are looking at risk management even more than before, and with the new focus on climate change and energy efficiency in China, this is one issue that is likely to

[64] BSR interview with CDP, May 21, 2009.

make progress before other environmental or social issues. It is important to note that CDP is about disclosing specific performance data. The concept is that once a company has made the first step and are aware and measuring, they will move to the second step, which is to actually reduce their climate impact and manage climate-related risk. However, it is important to differentiate between disclosure and performance, and worse-performing companies are probably less likely to disclose information.

CDP China – Questionnaires Completed

- China Shenhua Energy Co Ltd
- Foxconn International Holdings Ltd (subsidiary of Foxconn)
- Great Wall Motor Co Ltd
- Huaxin Cement Co Ltd (subsidiary of Holcim)
- Industrial and Commercial Bank of China

In 2008, two Chinese financial institutions (China Investment Corporation and Industrial Bank of China) became the first signatories to the CDP. The response rate to the 2008 CDP Questionnaire, sent to 100 Chinese companies, was surprisingly low, with only 5 questionnaires completed and 20 companies which submitted other information. With more effort being made in the future to educate companies on the importance of good carbon management and the usefulness of the initiative, CDP expects an improved response rate in 2009 and even more in 2010 once CDP establishes a presence in China.[65]

CDP also runs a Supply Chain Program which is active in China. Through this program, buyers encourage their suppliers to respond to the questionnaire, with the long-term goal of reducing carbon emissions in supply chains, which is an area of increasing importance to many global companies. Nine out of 40 suppliers responded to the request from buyers, motivated by the relationship and the interest in potential cost savings from management of carbon emissions.

Chinese companies still have some way to go to integrate the Compact's principles and get used to disclosing information.

United Nations Global Compact

The United Nations Global Compact (UNGC) is a United Nations initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies, and to report on their implementation. The UNGC began working in China in 2001, but it was after the 2005 UNGC Global Summit in Shanghai that interest really increased. The UNGC requires participants to submit Communications on Progress (COP) explaining how they are integrating the UNGC’s 10 principles. However, as of May 2009, of the 214 companies to have participated in the initiative since 2000 (including those who are deemed inactive and those delisted), only 27 had submitted a Communication on Progress (COP), and only 15% of companies required to submit a COP (of the 102 companies participating in UNGC for longer than two years) had done so. This is quite low, compared to the global average of 56%. More recent participants seem to be take the initiative more seriously, as evidenced by 12 COP submissions from among the 112 participating companies not yet required to submit them. Participants may also benefit from increased activity within the local network (for example, 50 companies attended the first Global Compact Progress and Value workshop in China in April 2008). However, there is still substantial room for improvement in how Chinese companies to integrate the Compact's principles and learn to disclose information.

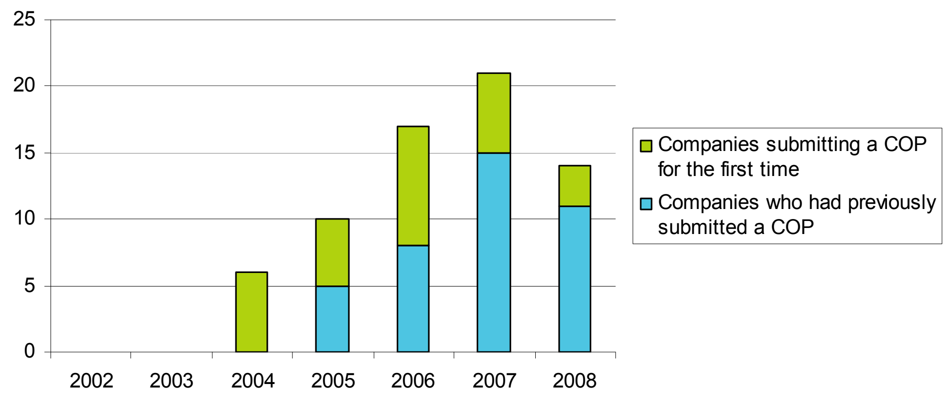
[65] Carbon Disclosure Project, “Carbon Disclosure Project Report 2008 –China 100 Executive Summary”, 2008

Table 5.2: UN Global Compact Participation by Chinese Companies

Category of UNGC participation	No.
Active Participants (112 participants within the last 2 years, 15 participants who joined earlier and have submitted COPs)	127
Non-Communicating Participants (did not submit COP for 1 year):	48
Inactive Participants (did not submit COP for 2 years):	18
Delisted Participants (did not submit COP for 3 years):	21
Total	214

Source: United Nations Global Compact

Figure 5.2: Number of COPs Submitted by Chinese Companies



Source: United Nations Global Compact

Sustainability Indices

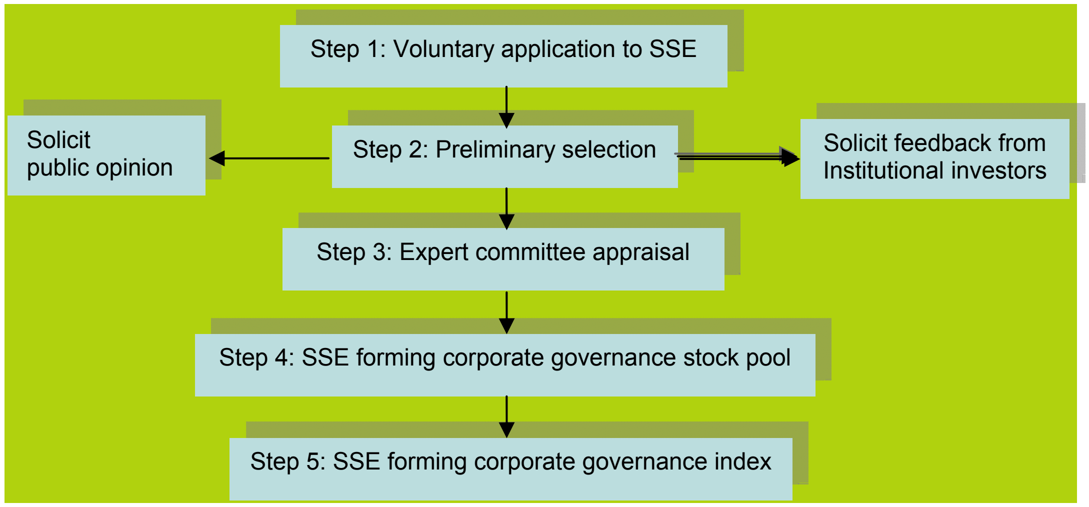
Publicly listed companies can voluntarily apply to join the Corporate Governance Index. After the public screening, an expert committee will further evaluate the companies and select the companies with the best governance practices to join the index.

SHANGHAI STOCK EXCHANGE CORPORATE GOVERNANCE INDEX
The Shanghai Stock Exchange (SSE) and China Securities Index Co. Ltd. (CSI) jointly launched the SSE Corporate Governance Index (SSE-CGI) on January 2, 2008, as a step towards improving the corporate governance of China's listed companies and promoting the healthy long-term development of the capital market. As of May 31, 2009, the index included 230 companies.[66]

The Index constituent appraisal methodology is set out in a *Notice on Selection Method of the SSE Corporate Governance Board*, issued on October 9, 2008. Publicly listed companies can voluntarily apply to join the Corporate Governance Index. Their application information will be made public, in order to solicit both feedback from both the general public and institutional investors. After the public screening, an expert committee will further evaluate whether applicants meet corporate governance criteria and select the companies with best governance practices to join the index. The criteria mainly consist of assessments of governance structure, internal control systems, incentive mechanisms and employee management systems.

[66] Xu, Yuhai, "Stable Performance of Listed Companies," May 25, 2009, (http://www.cs.com.cn/gz/04/200905/t20090525_1954252.htm accessed 20 July 2009)

Figure 5.3: SSE Corporate Governance Index Appraisal Process



Source: Liu Zhong, Presentation on China Securities Index Co., Ltd, May 2009

CSI will adjust the index annually each July, after the re-selection of SSE corporate governance board constituents between May and June. If a constituent of the index fails to meet the criteria before the next adjustment time, it will be excluded as soon as practicable. For example, Chongqing Road and Bridge Company Ltd. was deleted from the index on February 18, 2009 after the SSE punished the company for illegal transactions.[67]

The stated objectives of the Index are to encourage listed companies to actively manage their social end environmental risks and opportunities, to provide investors with a new investment benchmark, and to "popularize the concept of social responsible investment."

SHANGHAI STOCK EXCHANGE SOCIAL RESPONSIBILITY INDEX

Building on the success of SSE-CGI, Shanghai Stock Exchange and China Securities Index launched the first sustainability index in China – SSE Social Responsibility Index (SSE-SRI, securities code: 000048) on August 5, 2009. Based on its own rating system, the Index selects 100 leading sustainability companies from within SSE-CGI, which is comprised of 230 companies which were selected for good corporate governance practices. The stated objectives of the Index are to encourage listed companies to actively manage their social end environmental risks and opportunities, to provide investors with a new investment benchmark, and to "popularize the concept of social responsible investment."[68] The selection process consists of three key steps:

- » Eliminate the bottom 20% companies with the lowest average daily trading volume from the 230-company universe, based on the previous 12-month record prior to the beginning of the evaluation process;
- » Rank the remaining companies based on Social Contribution per Share (SC) and select the top 100 companies (see section "Social Responsibility ETF Fund" of Chapter 4 for more details); and
- » Screen those 100 companies and remove any with significant CSR violations.

Similar to SSE-CGI, the SSE-SRI provider also requires that any constituents of the SSE Social Responsibility Index which violate ESG standards in a significant matter will be excluded from the index subsequently, even outside of the Index's re-evaluation time each July. The SSE claims that the index's average SC of CNY2.42 and average earning per share of CNY0.69 in 2008 were both higher

[67] A notice on Shanghai Stock Exchange website, (http://www.sse.com.cn/sseportal/ps/zhs/ggxx/zsjbxx.jsp?indexCode=000019&x=13&y=6 access 20 July 2009)
[68] Shanghai Stock Exchange Press Release, August 5, 2009

than the overall average of all Shanghai Stock Exchange-listed stocks. On August 4, the Index closed at 1.198.69 points, an increase of 19.87% over the base day of June 30, 2009. CCB Principal plans to offer an Exchange-Traded Fund to follow this index, to be launched in late 2009.

Since the key selection criteria for the SC methodology have not been fully disclosed, it is difficult to analyze how the index weights ESG factors. However, the index portfolio composition provides some clues on sector and company preferences, as well as divergence with SSE-CGI (see Appendix 7 for full component list of SSE-CGI and SSE-SRI). Some large-capitalization stocks are conspicuously absent from SSE-SRI. The three largest banks in China (and globally) – Industrial and Commercial Bank of China, China Construction Bank, and Bank of China, as well as Aluminum Corporation of China, one of the biggest extractive companies in Shanghai Stock Exchange, are all missing from the universe of SSE-SRI.

Due to the current structure of the index, its performance will largely determined by the top 10 weight companies, which makes up about 62% of the total index.

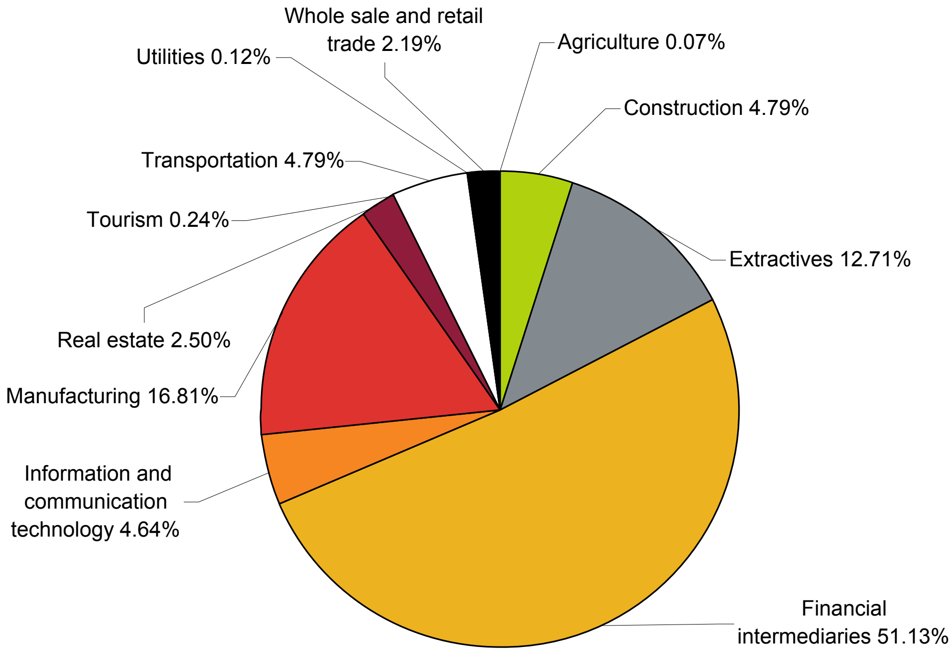
Apart from the capitalization preference, the SSE-SRI has a highly concentrated structure, shown in Table 5.3, which shows the top 10 weighted companies in SSE-SRI, and Figure 5.4, which shows the industry breakdown. The financial sector is much more heavily represented than other industries, with 7 financial services institutions in the top 10 companies by weight, equivalent to 51.13% of the entire index. Manufacturing (16.81% of total weight) is the second largest industry, with 45 companies, or nearly half of all companies in the index. The third largest sector is extractives, which accounts for 12.71% of total weight, and has two companies—China Shenhua Energy Company and PetroChina—in the top 10 list by weight. Due to the current structure of the index, its performance will largely be determined by the top 10 companies by weight, which make up over 62% of the total index. The 7 financial service institutions account for 82% of the top 10, so financial sector growth is critical for the performance of the index.

Table 5.3: Shanghai Stock Exchange Social Responsibility Index – Top 10 Constituents

No.	Company	Industry	Index Weight (%)
1	China Merchants Bank Co., Ltd	Financial intermediaries	8.98%
2	Bank of Communications Co., Ltd	Financial intermediaries	8.14%
3	Citic Securities Co., Ltd	Financial intermediaries	7.35%
4	Ping An Insurance (Group) Company of China, Ltd	Financial intermediaries	7.34%
5	China Minsheng Banking Corp., Ltd	Financial intermediaries	6.92%
6	Shanghai Pudong Development Bank Co., Ltd	Financial intermediaries	6.23%
7	Industrial Bank Co., Ltd	Financial intermediaries	6.18%
8	China Shenhua Energy Company Ltd	Extractives	5.57%
9	China United Telecommunications Corporation Limited	Information & communication technology	2.90%
10	PetroChina Company Limited	Extractives	2.56%
			SUM: 62.16%

Source: China Securities Index Co. Ltd.

Figure 5.4: Shanghai Stock Exchange Social Responsibility Index – Sector Breakdown



Source: China Securities Index Co. Ltd.

TEDA ENVIRONMENTAL INDEX

TEDA Group, with support from the Shenzhen Stock Exchange, launched the TEDA Environmental Index on January 2, 2008. The Index consists of 40 listed companies selected from ten sectors, including utilities, chemical, manufacturing, construction, durable consumer products, metallurgy, information and communication technology, and energy. The selection criteria focus on corporate environmental performance and governance.

DOW JONES SUSTAINABILITY INDEX

The Dow Jones Sustainability Indexes (DJSI) are a cooperation of Dow Jones Indexes, STOXX Limited and SAM Group (who operates the company). Sustainable Asset Management (SAM), ranked among the leading investment groups worldwide in this field, has compiled one of the world's largest sustainability databases and analyzes more than 1,000 listed companies every year. SAM is not a QFII, so does not invest in A shares at this time.

The DJSI World Index is reviewed quarterly and annually to ensure that the index composition accurately represents the top 10% of leading sustainability companies in each of the DJSI sectors. The annual review methodology selects the leading sustainability companies from a universe of the 2,500 largest global stocks (as listed in the DJ World Index), which is also reviewed annually.

In 2008, 36 Chinese companies listed in Hong Kong were invited to fill out the questionnaire in order to be included in the DJSI World Index. In 2008, less than 5 Chinese companies responded to the questionnaire request and only one, China Mobile, was rated high enough to be listed on the DJSI World Index. In 2009, 36 Chinese companies will again be invited to fill out the DJSI questionnaire. It should be noted that China is not eligible for the DJSI Asia Index, which only focuses on developed markets.

With more international sustainability research institutions entering the Chinese market, especially joint ventures such as JRI's program, the knowledge and experience of SI research will be gradually introduced to China, helping build local capacity and expertise. So far, apart from JRI's two Chinese research partners, there is no local capacity for SI research.

Independent Sustainability Research Institutions

In recent years, international sustainability research institutions have begun to enter the Chinese market, although market demand for sustainability information is still limited. There are no specialist domestic research institutions as of yet, though there are signs that some research organizations will start to develop this capacity (e.g. the two partners of Japan Research Institute). The international pioneers include:

- Reputex: set up an office in Shanghai in 2006;
- Japan Research Institute (JRI): conducted extensive research on mainland-listed companies with two Chinese partners in 2008;
- RiskMetrics: opened an office in Beijing in April 2009.

Apart from these institutions which have offices in China, other institutions researching Chinese companies through overseas offices include EIRIS, Responsible Research and others. Where research operations are off-shore, data collection and analysis will continue to be challenging. Local knowledge, understanding, and presence are all central to developing research that is both rigorous and credible.

With more international sustainability research institutions entering the Chinese market, especially joint ventures such as JRI's program, the knowledge and experience of SI research will be gradually introduced to China, helping build local capacity and expertise. So far, apart from JRI's two Chinese research partners, there is no local capacity for SI research.

REPUTEX

As a specialist ESG research agency in China, RepuTex has several related indices covering China as part of Asia or Global indices, as well as a Responsible China index which is not publicly available. The company has research available for a number of Chinese companies (in Asia, their coverage includes listed companies in the CSI 300, the HSCI and the MSCI Developed World Index). RepuTex's research methodology in China was initially funded by the IFC and covers a range of criteria and indicators in the four categories of Corporate Governance, Environmental Impact, Social Risk and Workplace Practices. Research is predominantly based on publicly available materials. Information on demand (i.e. their client base) for services is not publicly disclosed.

> In June 2008, RepuTex released the RepuTex China Top 10, a best-in-sector list based on the CSI 100, identifying China's leading companies based on their effective management of environmental, social, governance and workplace risks. RepuTex found that the CSI 100 cohort has a moderate level of sustainability performance, and notes that while sustainability risks are being considered, there is still significant opportunity for improvement. The overall universe (CSI 100 Index) average RepuTex Sustainability Rating was low, "BB".

JAPAN RESEARCH INSTITUTE[69]

In 2008, the Japan Research Institute, Limited (JRI) collaborated with Sumitomo Trust & Banking (STB) to screen Chinese listed companies based on their CSR performance, using a modified version of an established research methodology used for Japanese SI funds. JRI worked with two Chinese research partners to

[69] BSR interview with JRI, May 20 2009

modify the questionnaire for the Chinese context, and the final version is made up of 70 questions in following categories:

- Governance (18 questions)
- Protection of employees' rights and interests (14 questions)
- Protecting profits and rights of suppliers, customers and consumers (12 questions)
- Contribution and communication to local community (8 questions)
- Environmental performance (18 questions)
- Social issues (including employee rights and stakeholder engagement) make up 48% of the total questions, which reflects the emphasis of the JRI methodology.

JRI received an 18.8% response rate (309 of 1,645 companies) to their questionnaire, which was sent to all listed companies in Shanghai and Shenzhen and Chinese companies listed in Singapore and Hong Kong. 294 companies listed in mainland China returned the questionnaire, though the Chinese researcher partners had to call each company an average of 4 times to persuade companies to fill out the forms. JRI also conducted further research based on publicly available information, and developed a qualitative assessment to accompany the score that each company received based on questionnaire responses. The top 200 companies will form the stock pool for the fund manager of STB (see page 60).

JRI's Key Lessons from the Exercise

Challenges with the questionnaire:

- It was important to make phone contact before sending the questionnaire.
- It was important to explain socially responsible investment and the purpose of the survey.
- Chinese companies are not familiar with answering questions from others except governments.
- There is no focal point in companies to answer this kind of survey.

Challenges with information-gathering:

- There is little information about companies who did not answer the questionnaire.
- There are increasing numbers of sustainability reports, but it is hard to get negative information.
- Verifying the quality of information is difficult.

RISKMETRICS

RiskMetrics, who recently acquired Innovest Strategic Advisors, opened an office in Beijing in April 2009 in response to increasing interest from mainland-Chinese fund managers for all types of non-traditional financial research, including corporate governance and sustainability.

The office is not yet focusing on ESG-specific research, but with an established global reputation, client base, and methodology, they will be well-placed to provide such research as the market develops. From their other offices, RiskMetrics has researched at least 40 of the largest Chinese companies for environmental and social risk, but this is small compared to the 800 A shares (and growing) which they research and engage with for governance and other risk-related products. This reflects the fact that governance is much more mainstreamed into investment managers' decision-making, and that the governance models are more sophisticated with around 5 years more experience than ESG.

EIRIS

EIRIS, one of the largest sustainability research firms, researches Chinese companies listed in Hong Kong that are part of a major global large / mid cap index, as well as covering other Chinese companies for clients on a customized basis. In 2006, EIRIS released *Broadening horizons for responsible investment: an analysis of 50 major emerging market companies*[70], which found that the overwhelming majority of companies in the study have shown evidence of addressing at least some environmental, social and governance issues in their public disclosures, with some making significant efforts. Though only two companies in the publication were Chinese (both listed in Hong Kong), the study found that some countries such as China have yet to produce strong evidence of performance on sustainability issues (ranking 13th out of the 14 countries).

RESPONSIBLE RESEARCH

Established in 2008 with offices in Singapore and Hong Kong, Responsible Research provides independent research on ESG issues of listed Asian companies. The research is targeted at global mainstream and responsible investors. The company has a thematic approach to building coverage, with a pipeline of around 10 reports to be completed this year. They have already completed 2 research reports covering Asia, each with coverage of about 15 Chinese companies, and they hope to extend this coverage to over 200 Chinese companies by the end of the first year of operations.

Responsible Research's client base is mostly US and European asset managers who are comfortable rewarding independent research through commission-sharing agreements and who have their own internal ESG screening processes. Global competitors in the ESG research space tend to have very limited coverage of Asian companies and issues and the investment banks have mostly cut this area of research.

Responsible Research's methodology is fairly robust; within each sector they develop specific sectoral ESG benchmarks on reporting for each company covered. They also provide in-depth qualitative analysis of issues and provide detailed company case studies. Where possible, the analysts speak with each company they research in order to overcome the lack of information available publicly and build relationships with the companies to get as much quality information as possible.

TRUCOST

Trucost Plc, headquartered in the UK, is an environmental research organization which helps companies and investors understand the environmental impacts of business activities. Trucost provides data and analysis on company emissions and natural resource usage. It presents these in financial as well as quantity terms, providing the basis for an improved dialogue between companies, investors and other stakeholders. Over the past 8 years, Trucost has built a

[70] Tozer, David, "Broadening Horizons for Responsible Investment: an Analysis of 50 Major Emerging Market Companies", September 2006

database of the environmental impacts and disclosures of over 4,000 companies, including 156 Chinese companies.

BLOOMBERG

Bloomberg is one of the leading providers of financial information to the financial community and thus the recently announced launch of a groundbreaking ESG data service for its customers in 2009[71] is likely to support the integration of ESG data into the data which mainstream investors look at when analyzing companies. Bloomberg plans that its clients will be able to use its data terminals to access all publicly-available ESG data from 2,000 to 3,000 companies, with the aim of providing ESG information that will influence mainstream analysts.[72]

Networks and Associations

No local business associations or networks promote sustainable investment yet, but many of them promote CSR in general, such as China Enterprise Confederation and China Banking

There are currently no local business associations or networks that specifically promote sustainable investment, but many of them promote CSR in general, such as China Enterprise Confederation (which is the local contact point for the UN Global Compact), and China Banking Association (which promotes social responsibility among Chinese banks).

Most international initiatives have yet to focus on China, though two key ones (UNEP FI and PRI) both plan to do more in China by the end of 2009. Chinese institutions are naturally cautious about Western initiatives, particularly those that seem to require commitments (although neither initiative is binding). Past experience has shown that China prefers to develop its own initiatives or standards if possible, albeit often based on international efforts. There is potential for domestic industrial associations (such as Beijing PE Association or the Insurance Industry Association) or stakeholder networks to lead the promotion of sustainability investment and take the initiative in localizing relevant guidelines and principles. The main benefits of these initiatives are likely to be raising awareness about the materiality of ESG factors and encouraging Chinese institutional investors to integrate ESG issues into their investment decisions and ownership practices.

PRI

Past experience has shown that China prefers to develop its own initiatives or standards if possible, though these are still often based on international efforts.

The UN-backed Principles for Responsible Investment (PRI), developed for and by institutional asset owners, provide a voluntary set of aspirational guidelines for integrating environmental, social and corporate governance (ESG) factors into investment decisions and ownership practices in a way that is consistent with fiduciary duty.

Currently the PRI Initiative consists of approximately 530 signatories, totaling US$18 trillion in assets under management. PRI signatories include many of the world's largest and most respected institutional investors, such as CalPERS, PREVI, NYCERS, PGGM, TIAA-CREF and ABP. Investors are increasingly recognizing that ESG issues are relevant and material to financial performance, particularly over the long term, and need to be integrated into investment decision-making and ownership practices.

[71] Vaceare, Amie, "Live from Ceres Conference: Corporate Sustainability Report and Beyond," April 15, 2009, (http://www.greenbiz.com/blog/2009/04/16/ceres-CSR-and-beyond accessed 20 July 2009)
[72] Lubber, Mendy S., "Is ESG data going Mainstream?" May 6, 2009, (http://blogs.harvardbusiness.org/leadinggreen/2009/05/is-esg-data-going-mainstream.html accessed 20 July 2009)

The PRI has been successful in promoting responsible investment worldwide and if Chinese fund managers and asset owners join the PRI, it will be an important step. Of course, in order to have an impact on the market, Chinese signatories would have to follow through on their commitment with concrete actions.

There are no Chinese signatories to the PRI yet, though a number of international signatories are present in China through their local subsidiaries, such as HSBC. The PRI plans to focus its outreach efforts on China starting in Q4 2009, and have already begun engaging with some Chinese investors. Once several Chinese asset owners and investment managers sign, the PRI Secretariat could establish a local investor network to support signatories in their implementation of the principles in China, by sharing best practices and providing local language support.

UNEP FINANCE INITIATIVE (FI)

UNEP FI is a unique public-private partnership between UNEP and the global financial sector. Approximately 180 institutions, including banks, insurers, and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance through regional activities, a comprehensive work program, training programs, and research. The signatory base of UNEP FI is predominantly from the banking sector, and only around 20% of signatories are asset managers, but many of the bank members have asset management arms. There is an asset management working group representing approximately US$3 trillion in assets under management, which aims to mainstream the integration of ESG factors into investment analysis, decision-making and ownership practices.

UNEP FI currently has three signatories from mainland China: Bank of Shanghai, China Industrial Bank and China Merchants Bank.

UNEP FI currently has three signatories from mainland China: Bank of Shanghai, Industrial Bank of China and China Merchants Bank. The Initiative invited a team of Chinese representatives to join its biennial roundtable that was held in Melbourne, Australia in 2008. UNEP FI has recently recruited Chinese-speaking staff in 2009 to step up efforts to engage with the current signatories and reach out to more potential signatories in 2010, and will also enlist the help of current international signatories with recruitment, particularly those in the Asia Pacific Task Force.

ASRIA

The Association for Sustainable & Responsible Investment in Asia (ASrIA) is a non-profit membership association dedicated to promoting corporate responsibility and sustainable investment practices in the Asia Pacific region. ASrIA is a primary source of information on the development of sustainability investment in Asia for many international investors. ASrIA also provides training, organizes events and conducts research across the region.

ACGA

The Asian Corporate Governance Association (ACGA) is a non-profit membership association dedicated to promoting substantive improvements in corporate governance in Asia through independent research, advocacy and education. ACGA engages in constructive dialogue with regulators, institutional investors and listed companies on key corporate governance issues and works towards making improvements. In terms of advocacy work, ACGA has not focused as much on China as it has on other Asian markets, mainly due to resources and the fact that it has been heavily engaged in Japan, Taiwan, Hong Kong and Singapore.

ACGA has been researching and writing about corporate governance developments in China since 1999 and has organized several events there. It will be holding its 9th annual conference in Beijing in November 2009 (the third to be held in Mainland China). ACGA believes that education and information-sharing may be more effective than advocacy, and this year will produce a manual for Chinese companies that provides case studies and country-specific examples related to building effective boards of directors. Two of its members are Chinese (Shenzhen Development Bank and China Universal Asset Management).

EMERGING MARKETS DISCLOSURE PROJECT

Of the seven countries analyzed in the report of the Emerging Markets Disclosure Project, South Africa leads in disclosure, while China has the greatest room for improvement.

The Emerging Markets Disclosure Project is an international initiative to improve sustainability disclosure in emerging markets. It is a collaborative effort led by the US Social Investment Forum US (SIF US), Calvert and IFC with the support of KLD Research & Analytics, Inc., ASrIA, the Global Reporting Initiative (GRI), PRI, and the General Board of Pension and Health Benefits of the United Methodist Church. Phase I of the project included a benchmark report on the current state of sustainability reporting in several emerging markets, including China. Of the seven countries analyzed in the report, South Africa leads in disclosure, while China has the greatest room for improvement. Phase II resulted in a sign-on statement endorsed by 28 global institutional investor signatories and 15 affiliated supporters encouraging emerging market companies to use GRI reporting standards and to improve sustainability reporting. Phase III, which began in May 2008 and will run through December 2009, is focused on outreach to corporations operating in several countries to promote greater sustainability disclosure, but does not include China at this time.

CFA INSTITUTE

CFA launched a new companion manual to the Corporate Governance manual: *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors*, which reflects increasing importance of ESG factors as indicators for assessing corporate values.

CFA Institute is the global, not-for-profit association of investment professionals that awards the CFA (Chartered Financial Analyst) and CIPM (Certificate in Investment Performance Measurement) designations. The CFA course is becoming increasingly popular in China, with 19,700 registrations in 2009 (an increase of 25% over 2008), and as part of the Level II course includes *The Corporate Governance of Listed Companies: A Manual for Investors*.[73] The course also includes corporate governance as a part of the CFA exam. In Level III, the course includes further discussion of corporate governance, including incentives, structures and recommendations. Overall, it gives a useful framework and education about governance to financial analyst candidates. In July 2008, the Institute launched a new companion manual to the Corporate Governance manual: *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors*,[73] which reflects the increasing importance of ESG factors as indicators for assessing corporate values.

EQUATOR PRINCIPLES

The Equator Principles are the financial industry benchmark for determining, assessing, and managing social and environmental risk for project financing greater than US$10million. Once adopted by banks and other financial institutions, the Equator Principles commit the adoptees to refrain from financing projects that fail to follow the processes defined by the Principles. Industrial Bank of China is the only Chinese financial institution that has joined so far, although its project finance portfolio is relatively small.

[73] CFA website, (http://www.cfapubs.org/toc/ccb/2005/2005/6, accessed 12 June 2009)

Development Finance Institutions

IFC is, first and foremost, an investment organization demonstrating that responsible investment is feasible and brings financial returns. Since its first investment in 1986, IFC has mobilized more than $4 billion in funds for 160 projects in 24 provinces in China.[74] IFC has invested in 6 Chinese banks and insurance companies and has provided capacity building and knowledge transfer to them and other financial institutions. Of particular note is the Industrial Bank of China,[75] which was the first (and so far, only) institution to adopt the Equator Principles and sign up to the UNEP FI. IFC has also invested in a clean-tech PE Fund (Tsing Capital Fund) that has achieved impressive financial and social returns.

IFC has been working with MEP and CBRC to localize the Equator Principles, IFC Performance Standards, and World Bank Environmental, Health, and Safety Guidelines and their guidance notes,[76] helping to integrate these standards into Chinese government policies. As part of IFC's global carbon finance program, it facilitates access to carbon markets for China and other developing countries by providing Carbon Delivery Guarantees and purchasing credits for Dutch funds (although the Dutch funds recently closed). IFC has also signed agreements with Chinese companies such as Deqingyuan Agriculture Scientific, and Shenzhen PhasCon to reduce GHG emissions.[77] IFC's Corporate Governance Program trains government and stock exchange officials and other intermediaries, who in turn provide training to listed companies to improve their corporate governance. Globally, IFC has also funded the development of a comprehensive and user-friendly web-based tool that will enable private equity investors to assess sustainability risks and opportunities associated with each stage of the investment process.

Apart from IFC, a number of other development finance institutions are active in China, and use their own cases to demonstrate sustainable investment in China for domestic investors, in particular the Asian Development Bank (ADB) and DEG, the German development finance institution. DEG has made 75 investments in China since 1985, ranging in value from 5 million to 30 million Euros each, of which around one-third are equity investments with a maximum equity share of 30%. Their investments must meet strict ESG criteria. DEG is also able to engage very closely with companies, spending a great deal of time and financial resources on due diligence and providing technical support on ESG issues. Though traditional equity investors are unlikely to be able to spend as much time or effort in the research process, many equity investors will invest in companies that have received development financing because of this assurance. This plays a role in encouraging responsible investing, and in educating investors.

---

[74] IFC website, (http://www.ifc.org/ifcext/eastasia.nsf/Content/China accessed 12 June 2009)

[75] The Industrial Bank of China was runner-up in the FT Sustainable Banking Awards' Sustainable Deal of the Year in 2007, as a result of successful implementation of an energy efficiency financing program and related products to help SMEs purchase energy saving equipments and reduce their emissions

[76] IFC website, (http://www.ifc.org/ifcext/sustainability.nsf/Content/Highlights_November2008_ChinaGreenCredit accessed June 12 2009)

Civil Society

Chinese civil society plays three critical roles in supporting sustainable investment in the country. Civil society organizations provide third-party information to investors, monitor companies and act to put pressure on unsustainable companies, and engage with government authorities. Due to the challenge posed by limited public disclosure of information in China, the role of information disclosure and monitoring by civil society is more important than in other countries, and can serve as an important means to corroborating information. International investors have to rely on such information from civil society organizations, in particular in China, where there is limited other third-party information available in English. There is no Chinese version (and few Chinese companies covered by the English version) of labor watch websites which are widely used by international investors, but both Friends of the Earth and Greenpeace release English-language newsletters covering Chinese companies, which are targeted at the international investment community.

Relevant civil society organizations in China reviewed for this report are predominantly in the environmental and labor arenas. Those in the labor field have been providing information on supply chain labor problems for more than ten years, but this information and related activities have been targeted at consumers, rather than investors. Where civil society organizations have done advocacy work targeting investors, they have mostly focused on investors in US or European businesses with labor problems in their supply chain (such as the campaign to educate investors in Nike), although there are a few instances of advocacy focused on investors with mainland Chinese holdings (such as that of Henan Rebecca case).[78]

Although Chinese investor relations departments have not been open to engaging with civil society organizations, environmental NGOs have become increasingly active on investment issues in China.

Although Chinese corporate investor relations departments have not been open to engaging with civil society organizations, environmental NGOs have become increasingly active on investment issues in China. In 2007 they began to engage with the financial industry, and now they are predominantly focusing on the Green Credit policy due to recent regulatory developments, greater opportunities for success, and easier targets (banks, rather than investors, of which just a handful dominate the market). However, there is also work on the investment side, particularly with the support of two international civil society organizations, Greenpeace and Friends of the Earth, which have been driving this work: the former focused on doing fieldwork and providing research to investors, and the latter building capacity among local civil society organizations.

FRIENDS OF THE EARTH US

Friends of the Earth US (FOE-US) have over 13 years of experience engaging with the financial industry and, recognizing the importance of Chinese financial institutions globally, in May 2007 published *Time to Go Green - Environmental Responsibility in the Chinese Banking Sector* followed by *The Green Evolution - Environmental Policies and Practice in China's Banking Sector* in November 2008 in partnership with the NGO BankTrack. Their China Sustainable Finance program, which seeks to improve the environmental standards of Chinese financial institutions, has three priorities:

Engaging with international investors, particularly international financial institutions, to work with Chinese financial institutions to improve their

[78] William Baue, “Human Rights Site Spotlights Bank Investment in Chinese Manufacturer Linked to Forced Labor”, 25 August 2005 (http://www.socialfunds.com/news/article.cgi/1788.html accessed 27 July 2009)

environmental standards and involve Chinese NGOs in creating finance policies. FOE-US releases a bi-monthly newsletter (Sustainable Finance in China), which follows developments in sustainable banking in China. It is sent to 700-800 people, including bankers from international public and private banks, as well as some Chinese banks and financial regulatory departments. It also goes to civil societies (international and Chinese) and individuals interested in financial advocacy. The newsletter is accompanied by some shareholder activism around specific Chinese companies, encouraging international investors such as IFC and Citigroup to provide environmental risk management training to their strategic Chinese partners.

Training and capacity building for local civil society organizations. The first training, hosted by the Chinese NGO Green Watershed, was in May 2008 (more are planned) and they have prepared materials in Chinese to help Chinese civil society organizations engage in financial advocacy. The trainings and materials cover the basics of financial advocacy, case studies of how financial advocacy has been used internationally, and how it can be employed in China using the Green Credit and Green Securities policies. Supporting specific campaigns, such as the one against Gold East using the 14-day consultation period for civil society stipulated by the Green IPO requirements (see box).

GREENPEACE CHINA

Greenpeace publishes a quarterly newsletter, Green Investment, which is targeted at the finance community, including asset managers and banks. Because Greenpeace has an office in Hong Kong, it has direct access to the finance community in Hong Kong as well as in the EU and US, and the organization utilizes the newsletter to engage with the industry on a regular basis. It has had to overcome initial investor concerns about interaction with environmental NGOs, but now international investors recognize the value and credibility of the information Greenpeace provides. The organization’s investigative reports and perspective on regulatory trends and policy development now contribute to investors’ risk assessment and due diligence. Greenpeace does not provide customized research but plans to release the newsletter in Chinese and distribute it to more Chinese investors.

Greenpeace has also had some success engaging with the Hong Kong authorities, for example by hosting a seminar with the Hong Kong Stock Exchange due diligence department on how to factor environmental issues into due diligence and IPO processes, particularly for companies from the forestry sector. Greenpeace has played a leading role in supporting local environmental NGOs’ campaign against Gold East (see box), and plans to extend its work from the forestry sector into the energy sector.

Public Participation in an IPO Listing: The Case of Gold East

In August 2008, Gold East Paper Company, a subsidiary of Asia Pulp & Paper (APP) registered in Jiangsu Province, applied to MEP for approval to list shares on the Chinese stock market (as required by the 2007 Green Securities policy related to new IPOs for 13 high polluting/emitting industries). During the ten-day public evaluation period, six well-known Chinese NGOs raised objections to the company's IPO, citing its "shocking environmental record" and providing evidence from its operations in Hainan and Yunnan showing it violated pollution laws and illegally destroyed forests. MEP subsequently required the local environmental protection bureau to redo the Environmental Audit and examine the reported incidents. In March, another ten-day public consultation was held and finally in June 2009, ten months later, the MEP issued the approval of Gold East 's environmental audit, allowing the company to apply to the Chinese securities regulator for listing.

The civil society organizations were successful in delaying the application and drawing investor, public and governmental attention to the company's environmental issues. MEP has demonstrated impressive transparency in reporting details of the case on its website.

Source: Greenpeace, Friends of the Earth US and MEP website

WWF CHINA

WWF's 'China for a Global Shift' Initiative involves supporting responsible finance through research (such as co-producing the first high-level government analysis on sustainable development and China's banking sector with the People's Bank Of China), meetings (such as the 'Finance, Environment and Development Forum' in May 2009) and advice (such as that provided to the Export Import Bank). Their impressive access to government officials is likely to enable their agenda to move forward.

GREEN WATERSHED

A current challenge for civil society groups like Green Watershed is the struggle to get recognition equal to the international NGOs that get first access to relevant events or give training or presentations.

Green Watershed has been actively engaging with MEP as part of the Green Credit Policy, is driving the China Green Banking Innovation Award[79] (see box below) and is driving the opposition to Gold East's IPO listing (see box above). In addition, it plans to adapt Western activist techniques in China where appropriate, including buying shares in relevant companies and attending their AGMs to raise questions as legitimate shareholders, or seeking to engage companies as part of their sustainability reporting process when they want endorsements from civil society. A current challenge for civil society groups like Green Watershed is the struggle to get recognition equal to the international NGOs that get first access to relevant events or to give training or presentations; one reason for this is that international NGOs are considered less sensitive than domestic NGOs by the government and businesses.

GLOBAL ENVIRONMENTAL INSTITUTE

The Global Environmental Institute is one of the first international NGOs to originate in China. It is able to engage with the government to provide feedback on policy, though to date this has been mostly related to the environmental impact of Chinese companies operating overseas.

[79] Friends of the Earth US, "Eight Chinese NGOs Announce Green Banking Innovation Award", July 26th, 2008, (http://www.banktrack.org/show/news/eight_chinese_ngos_announce_green_banking_innovation_award accessed 20 August 2009)

NGOs Building Capacity and Awareness to Support the Green Credit Policy

The focus of Chinese environmental NGOs on the Green Credit policy is providing an opportunity for them to increase their understanding of the financial industry and gain experience and credibility, particularly in the eyes of the government and financial institutions themselves. The program broadly has three components:
1) Training for local civil society organizations, and often training for banks;
2) The China Green Banking Innovation Award, sponsored by the Economic Observer. The jury is comprised of nine local environmental organizations, which helps to build the legitimacy of the award and also of civil society organizations in China. The jury developed 10 criteria and researched 30 banks for the first award in 2008 before declaring Industrial Bank of China the winner. In 2009, Industrial Bank was again the winner and in late 2009, the detailed evaluation of all the banks will be publicly released; and
3) A white paper for the Chinese banking industry which will be released at the end of 2009.

INSTITUTE OF PUBLIC AND ENVIRONMENTAL AFFAIRS (IPE)

Utilizing publicly available information, IPE, a domestic NGO, manages an online database (www.ipe.org.cn) that shows 40,000 records of companies breaking environmental regulations, and lists environmental discharge information for more than 640 businesses in a searchable format, providing a powerful source of information for investors and other stakeholders. IPE has also led the establishment of a 'Green Choice' initiative with 21 other civil society organizations in an effort to influence consumer choice.

More than 50 Companies have contacted IPE to explain the violations listed in the database, and over 20 have accepted third-party inspections under the supervision of local civil society organizations in an effort to demonstrate their commitment and capacity to improve. In August 2008, IPE launched the Green Choice Alliance Supply Chain Management System, which seeks to measure an enterprise's environmental performance as a whole by also measuring the environmental performance of its supply chain.

IPE is working to encourage environmentally compliant companies to voluntarily publish additional environmental performance data, with the view that voluntary disclosure will require business to take a proactive stance on environmental management. IPE has developed an Enterprise Information Disclosure Form, with a list of specific chemicals, that allows enterprises to consistently collect and report data over time. Collecting this data will not only allow them to comply with local and national environmental laws, but will also allow them to benchmark and improve their environmental performance.

The current potential for NGOs to provide extensive information to investors is still low, due to the nascent status of civil society in China.

THE LIMITED ROLE OF NGOS IN INFLUENCING INVESTORS

The potential of NGOs to influence sustainability investment in China should not be overestimated. Investors utilize information from NGOs as one of many sources of information, and usually want to be made aware of any risks in order to then do additional research in that area themselves, rather than rely on information from the NGO. In China, in particular, the current potential for NGOs to provide extensive information to investors is still low, due to the nascent status of civil society in China.

In 2005, a NGO, focusing on labor rights and working conditions, posted an article from a reputable newspaper alleging that the Chinese firm Henan Rebecca Hair Product Company used forced labor, as well as responses from banks implicated through investment for their clients. [80] The case shows that because QFIIs often only act as brokers, they do not take directly responsibility for their investments, which makes it harder for NGOs to influence the real investors.

There has been almost no interaction between civil society and domestic investors yet, but this is expected to increase due to the efforts of Greenpeace, Green Watershed and others.

With a supportive legal environment and public and government support, environmental civil society organizations are making impressive progress in the financial arena, and are demonstrating they can be a force to reckon with. The ability of civil society to work with the media will affect how much pressure can be applied to both businesses and investors, but so far there has been limited progress in being seen as a legitimate stakeholder with investors, and engagement with media and government is limited. There has been almost no interaction between civil society and domestic investors yet, but this is expected to increase due to the efforts of Greenpeace, Green Watershed and others. It is hard to draw conclusions regarding engagement with international investors (including Hong Kong), which has had some impacts.

[80] William Baue, "Human Rights Site Spotlights Bank Investment in Chinese Manufacturer Linked to Forced Labor" , 25 August 2005, (http://www.socialfunds.com/news/article.cgi/1788.html accessed 27 July 2009)

6. Challenges and Opportunities for Development of the Sustainable Investment Market

China is determined to ensure the sustainability of its economic and social development. To this end, sustainable investment has an important role to play, not only in mitigating risks for the economic and financial system, but also as a means of allocating resources to entities with better ESG performance.

Over the past three decades, China has made remarkable strides in economic development, maintaining a GDP growth average of 9 percent per year and lifting more than 400 million people out of poverty.[81] China is determined to ensure the sustainability of its economic and social development as it enters the 21st century. To this end, sustainable investment has an important role to play, not only in mitigating risks for the economic and financial system, but also as a means of allocating resources to entities with better ESG performance.

As this report has noted, there are a number of challenges that must be overcome to effectively channel the growing interest in SI into a mainstream market. Based on interviews with market participants in different segments of the investment market and stakeholders in government, academia, and industry associations, BSR identified seven major challenges which are summarized below, followed by recommendations on how to address these challenges.

Challenges in Sustainable Investment

CHALLENGE #1: CONFUSION OVER TERMINOLOGIES

The first battle for promoting SI in China is the question of nomenclature. Terms such as Socially Responsible Investment (SRI), Responsible Investment (RI), Sustainable Investment (SI), and Green Investment (GI) are all used by the Chinese investment community. However, people tend to use these terms as if they are synonymous, or interpret them freely depending on the occasion or audience. This is linked to a limited understanding of the terms themselves and a lack of consensus on definitions. Examples from BSR interviews and focus group meetings include:

» "SI is environmental sector investing."

» "No. SI is an approach that systematically and holistically looks at where ESG factors can add value or mitigate risk across investment portfolios and integrates these criteria into the investment process. In short, it identifies good companies for investment and often includes methodologies of ESG analysis/auditing, ESG performance scoring and shareholder engagement."

» "No, I don't agree. Exclusion screening which excludes some industries or companies based on investors' criteria should be counted as SRI or SI too, as that approach is also good for society's sustainable growth."

» "Our investment looks at environmental and governance factors but not social. We believe in the long-term risks in these areas. We should be counted as SI."

» "We have around 4 ESG indicators beyond a traditional stock selection process. Are we SRI?"

Without clear definition, people would tend to ask what SI is and why it is important; and the government would be skeptical to promote it in China.

This debate illustrates the significant differences in perspective among different investors over simple definitions and terms.

Direct Chinese translations of the English terms help to introduce western concepts, but what do these mean in a Chinese context? The terms are used

[81] McKinsey Quarterly, "China's Green Opportunity", May 2009, (http://www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/Chinas_green_opportunity_2364 accessed 20 July 2009)

without clear definitions, and confusion within the investment community, the government and the public slows the potential for adoption of SI principles. One government official pointed out in a meeting that, “Without a clear definition, people would tend to ask what SI is and why it is important; and the government would be skeptical to promote it in China.” The lack of consensus on terminology and lack of widely accepted Chinese nomenclature slows uptake. Discussion, debate and research on the terms and concepts should be encouraged, and the understanding of sound SI methodologies is important in clarifying the appropriate Chinese terminology.

CHALLENGE #2: SHORT-TERMISM

A fund manager stated that “long-term means overnight, for so many investors in China”.

One common area of agreement among interviewees was that the mentality of investors in China is still dominated by an emphasis on short-term results, which works against ESG integration. One senior PE practitioner with 15 years of experience in China said, “nobody [referring to PE/VC practitioners] really wants to spend time to build a new business with their sponsors,” although PE/VCs are supposed to play that role. Also, “investors try to enter some sectors or companies quickly, ride the tide of market expansion, then get out of the business quickly. That’s the universal investment philosophy in China.” For secondary market investment, there is an even shorter-term focus. A fund manager stated that “long-term means overnight for so many investors in China.” Short-termism is linked to the mindset that financial returns are prioritized over all other considerations. A clean-tech investment manager admitted during an interview with BSR that “this is profit-driven. We do this not because we love clean-tech.” Though there are exceptions, ethics and social impact are normally considered as lower priorities compared with financial return.

Some institutional investors argued that short-termism is not purely their fault, and that major Chinese entrepreneurs are also focused on the short term. As a McKinsey analysis reported in 2007, “there are still significant free-rider problems and a risk for those companies that wish to deploy higher ‘international norms’ (for example, with respect to child labor) that they will lose out to less scrupulous competitors. There are still strong ‘race to the bottom’ pressures”.[82] “People want to have quick money, rather than a business lasting for a hundred years. So why should they bother with energy-efficient equipment retrofits?” an interviewee shared with BSR.

The problem of short-termism should be addressed, and one first step could be to change the way that fund manager performance is measured. A study on long-term investing found that “long-term value investors will always be disadvantaged as long as their performance is measured against stock price.”[83]

CHALLENGE #3: QUESTIONABLE BUSINESS CASE

Drawing on international experience, financial institutions which choose to adopt sustainable investment strategies do so for many reasons: to manage risks in order to achieve better financial performance over time, to seize business opportunities in fast-changing environmental and social landscapes, to act in accordance with ethical principles, and to address societal challenges. To find

[82] Jeremy Oppenheim, Sheila Bonini, Debbey Bielak, Tarrah Kehm and Peter Lacy, “Shaping the New Rules of Competition: UN Global Compact Participant Mirror”, McKinsey & Co., July 2007, p. 21.
[83] Lydenberg, S., 2007. Long-term investing: a proposal for how to define and implement long-term investing.

ways to develop the Chinese sustainable investment market, it is crucial to explore these incentives.

When BSR interviewed domestic investors, many of them emphasized the business value of SI, but were also quite skeptical. Investors want to know whether there is actually a positive correlation between the environmental and social performance of Chinese companies and their financial performance.

When BSR interviewed domestic investors, many of them emphasized the business value of SI, but were also quite skeptical. Investors want to know whether there is actually a positive correlation between the environmental and social performance of Chinese companies and their financial performance. Organizations such as UNEP FI and SAM cite numerous international academic and brokerage firm studies that qualitatively and quantitatively show a positive association between the adoption of ESG criteria and enhanced financial performance. However, many investors feel that this empirical data is not relevant to the Chinese situation. One anonymous interviewee in China pointed out that there are low risks for non-compliance with environmental and social standards in China (partly due to issues associated with law enforcement), and an ESG-integrated investment approach may conflict with China's development model which to date has been achieving economic development with relative disregard for the high environmental and social costs.

A report from Mercer echoes that point and cites the perspective that "as a 'world factory' with incentives to pursue profits at any cost, corporate management may elect to operate in the 'grey areas' or take legal risks that would not be tolerated in other emerging markets."[84] Undoubtedly, fostering a just market environment and a shift from a heavily growth-oriented economic model to a more environmentally and socially friendly path are fundamental steps in creating incentives for investors to take SI approaches.

Creating a just market environment and shifting the economic development model would involve many different reforms. These include increasing the risks for illegal behavior of companies, strengthened law enforcement, improved pricing of natural resources, and government intervention in cases of market failure.

CHALLENGE #4: LIMITED ESG INFORMATION

Most companies still lack the capacity and experience to collect and disclose detailed ESG information and there is limited high-quality information from third parties such as civil society.

The amount and quality of ESG information from Chinese companies which is in the public domain is very limited. The concept of releasing corporate ESG information is still foreign to many companies, and stakeholder pressure and government regulations on disclosures have only recently begun to play a role. Most companies still lack the capacity and experience to collect and disclose detailed ESG information, and there is limited high-quality information from other groups such as civil society or government. In addition, the responsiveness of companies' investor relations departments to surveys or direct questions is also low.[85] Of the 100 companies which received questionnaires from the Carbon Disclosure Project (CDP) in 2008, only 5 companies actually completed them.

Most international SI funds are still managed from centrally located investment centers. The ability to provide answers to the types of questions that international investors ask is somewhat limited; many of the issues, in particular human rights, are not on the radar screen for Chinese companies, and language is another barrier.

[84] Mercer, "Gaining Ground – Integrating Environmental, Social and Governance Factors into Investment Processes in Emerging Markets," March 2009

[85] Japan Research Institute presentation at TBLI Conference Asia 2009,

CHALLENGE #5: LACK OF FUNDING SOURCES FOR SI

Pension funds, insurance companies, and certain types of international investors (such as endowment funds, retirement funds, and family offices) generally have longer investment horizons than ordinary investors. Their longer-term investment behaviors require them to consider longer-term risks associated with potential investee companies, including environmental and social risks.

However, these institutional investors currently play a relatively limited role in the sustainable investment market and their investment in stock markets is restricted. As shown in Figure 4.1, stock exchanges have limited funding from insurance companies, pension funds, and institutional investors. Only 2.5% of market share is from insurance companies, 0.8% from NSSF, 0.01% from pension funds, 2.57% from mutual funds, and 1.7% from QFII. China's investment regulations, introduced in a previous section, put ceilings on the proportion of assets these institutions can allocate to stock markets. For instance, enterprise annuity funds can make no more than 30% equity investment. International investors can only make investment within their limited QFII quotas. It will be hard to develop a sustainable investment market if long-term institutional investors' participation in stock exchanges is restricted to such limited influence on the market. In addition, domestic family offices, foundations and endowments are essentially absent from the market thus far.

Allowing China's nascent institutional investors to eventually make unlimited equity investments, and increasing the quota for QFII investment would be two ways to expand sources for SI and strengthen long-term investors' influence in the market.

CHALLENGE #6: ABSENCE OF ESG RESEARCH INSTITUTIONS FOR CHINA SI MARKET

International sustainability research agencies overseas do not currently provide extensive research coverage of A share stocks.

Presently, there are no domestic research companies specializing in ESG analysis. Chinese SI investors currently rely on in-house analysts to conduct such research, normally on a part-time basis. The international ESG research companies have been exploring the China market, but progress has been slow, and the market is limited. A Chinese mutual fund manager commented that "the international ESG research company we met in China is not localized. If they only tell us the carbon emissions of listed companies, it does not solve the materiality issues we have in China."

International sustainability research agencies based overseas also do not currently provide extensive research coverage of A-share stocks. These research agencies often restrict their research to components of the MSCI World or the Dow Jones Total Stock indexes. Less than 100 of the 2,700 components of the MSCI World are Chinese (many of which are listed overseas or in Hong Kong). The limited research coverage of A-share stocks affects the ability of international SI investors to make investments in mainland Chinese markets. International SI investors are more focused on H shares, in part because H shares are more commonly researched by analysts and provide more English-language disclosures.

The domestic SI market currently lacks human resources, who understand both ESG materiality issues and the financial evaluation methodologies.

CHALLENGE #7: A LACK OF EXPERIENCED PRACTITIONERS

The domestic SI market currently lacks professional personnel who understand both ESG materiality issues and financial evaluation methodologies, and apart from some internal courses (such as CFA's ESG manual), there is no domestic training available on relevant topics. Therefore, domestic practitioners have limited sources to build SI knowledge and skills. International SI investors have relatively more experience on ESG analysis, but lack personnel who understand the Chinese market and associated ESG issues. QFIIs have analysts in China, but almost none have SI experience.

Recommendations

The three broad recommendations are:

» Forming a China SI Working Group
» Enhancing ESG research and disclosure
» Increasing ESG education

Some of these challenges can be overcome in the relatively short term, but others, like changing investors' corporate attitudes to ESG and market infrastructure, will take several years. To tackle these challenges, individual market intervention solutions have been collected through extensive discussion with market participants. Analyzing these solutions, three strategic long-term approaches crystallize; namely, connecting people, researching ESG issues, and educating. BSR has developed the three approaches into three concrete strategies – forming a China SI working group (CSIWG), enhancing ESG research and disclosure, and increasing ESG education. (see Figure 6.1)

Figure 6.1: Challenges, Solutions and Recommended Strategies

Challenges	Solutions
#1 Confusion over terminology	•Create awareness •Communicate SI understanding and experience
#2 Short-termism	•Change value measurement system •Change incentive structure
#3 Questionable business case	•Monitor and measure ROI of ESG improvement •Change resource pricing system •Build broad-based buy-in of sustainable investment knowledge and value
#4 Limited ESG information	•Increase ESG disclosures •Link ESG research with ESG information
#5 Lack of funding source	•Increase quota for QFII •Remove investment ceiling for institutional investors
#6 Lack of ESG research institutions	•Encourage ESG research •Introduce international research methodologies
#7 Lack of experience practitioners	•Provide Chinese investment practitioners with education about extra-financial analysis •Provide ESG education for future business leaders in China through integrating ESG courses into undergraduate and MBA courses

Recommended Strategy

- **China SI Working Group**
- **ESG Research & Disclosure**
- **ESG Education**

Forming the CSIWG will provide a platform for cooperation among the sustainability investment community and for communication to help define and envision sustainability investment in China, and to jointly work on solutions that can fill the gap between present needs and future vision. Enhancing ESG disclosure and research capacity primarily targets mainstream investors, which are a broader audience than sustainability investment investors alone. Higher quality and quantity of ESG data on companies along with robust ESG research intermediaries and easy access to ESG research information could accelerate the progress of mainstreaming ESG approaches. Finally, increasing public education about ESG, including integrating sustainability issues into key training programs, aims to build broad-based buy-in (and expertise) on sustainable investment and corporate social responsibility.

The following sections will illustrate each of the recommendations in detail with objectives, key partners required, and 3-year phased action plans so as to provide a road map for promoters of sustainable investment.

Formation of China Sustainable Investment Working Group (CSIWG)

Plan for Formation of CSIWG	
Overall Objectives	» Foster cooperation amongst China's sustainable investment community and introduce international experiences and lessons to China to accelerate progress » Provide a direct communication platform and develop synergy among asset owners, asset managers, research institutions, civil society organizations, and government agencies » Identify systemic constraints and engage with policy makers/ industry leaders to address them
Challenges Addressed	#1: Confusion over terminologies #2: Short-termism #5: Lack of funding Sources for SI
Possible Partners	» Government agencies: CSRC, MEP, Shanghai Stock Exchange, Shenzhen Stock Exchange, NSSF » Private sector: representatives from mutual funds, insurance institutions, QFIIs, research institutions » International organizations: IFC, ASrIA, UN PRI, UNEP FI, GRI, CDP, BSR
Phase 1	» Establishment of CSIWG with a secretariat » Recruiting key members for its steering committee » Discussing and determining goals and work plans
Phase 2	» Awareness raising, knowledge sharing and activities to develop the sustainable investment environment, e.g.: » Sustainability indexes » Mutual fund sustainability investment products and practices » Insurance industry sustainable investment practices
Phase 3	» Identification of systemic constraints and engagement with policy makers/industry leaders to address them. Topics could be: » Allow China's existing but nascent institutional investors to ultimately make unlimited equity investments

	» Increase the quota for QFIIs and make mainland A shares easier for international investors to invest in » Promote the sustainable investment policies and practices of pension funds and enterprise annuity funds
Sample measurement indicators	» Number of participants for CSIWG » Number of participants in workshops/conferences » Regulatory changes in line with CSIWG recommendations » Number of new sustainability investment products stimulated by CSIWG

CSIWG would seek to facilitate China's burgeoning but fragmented SI community, and provide a direct communication platform to help interested parties envision a sustainable investment market and to jointly work on solutions that can fill the gap between the current market and future scenarios. As listed above, the three key goals of the working group are (1) development of an sustainable investment community; (2) development of synergy among parties in the sustainable investment value chain; (3) tackling systemic constraints.

Achieving the three goals requires CSIWG to engage the various entities active in the SI value chain: policymakers, voluntary disclosure initiatives, ESG research organizations, and SI-oriented asset managers and asset owners.

To achieve these three goals requires CSIWG to engage the various entities active in the sustainable investment value chain which include policymakers, voluntary disclosure initiatives, ESG research organizations, and SI-oriented asset managers and asset owners. In China, the role of government is of primary importance. Their involvement in CSIWG will largely drive and motivate the private sector and academic institutions. Government authorities could use the communication platform to gain feedback on their existing or upcoming policies. The structure of the working group will largely determine its impact and efficiency. Thus, the working group can include a wide range of sustainability investment stakeholders, but should be led by a relatively small steering committee. To balance various interests accordingly, the steering committee chair could be shared by a national-level government agency, a representative from the private sector and an international organization.

A draft action plan is provided, though it could be adjusted according to the initiators' objectives, and stakeholder feedback. The draft action plan has three phases:

(1) Phase I: Establishment of the CSIWG
(2) Phase II: Awareness raising and knowledge sharing
(3) Phase III: Identification of systemic constraints and engagement with policy makers/industry leaders.

Phase I is largely about structuring the CSIWG and recruiting key partners for its steering committee. The key tasks are listed in the table above. The initial establishment of the working group may take 3-6 months.

In Phase II, a number of the activities can start to build understanding among the working group participants, to raise awareness and to enhance market infrastructure. The steering committee could choose sustainable investment topics which are strategic and will have strong impacts on the promotion of sustainable investment markets. The suggested topics from BSR are:

» ***Sustainability index***: International experience shows that a sustainability index is a critical mechanism for development of sustainable investment in secondary markets. Conferences/workshops that bring domestic index providers together with international experts, investors, index constituency and government bodies could allow a better understanding of the role and value of a sustainability index; and at the same time, build capacity for current and future sustainability index providers through direct communication with international index providers and local users and clients.

» ***Mutual fund sustainability investment products and practices*:** The sole existing Chinese sustainable investment mutual fund has had impressive performance in its short history, and this business case is the best reason for other sustainable investment funds to be established. CSIWG will be in a good position to profile successful sustainable investment mutual funds and organize information-sharing activities, and possibly bring international mutual fund sustainable investment product leaders to the workshop to transfer their knowledge and experiences.

» ***Insurance industry sustainable investment practices:*** Working closely with insurance companies to identify their knowledge gaps, then developing a pool of tools and knowledge for their use should be helpful. CSIWG could publish and disseminate (in Chinese) the tools and knowledge guide which may consist of research comparing sustainable investment methodologies, reviewing impacts of sustainable investment, and highlighting best practices in sustainable investment or financial returns of sustainable investment funds. Insurance Industry Associations should be engaged as partners for the initiative.

In the long run, China's long -term institutional investors, such as pension funds and insurance companies, will likely emerge as the main source of funding for sustainable investment.

In subsequent awareness-raising activities after Phase II, Phase III could focus on identifying systemic constraints and engaging with policy makers/industry leaders to address them.

» ***Allow China's existing but nascent institutional investors to ultimately make unlimited equity investments:*** In the long run, China's long-term institutional investors, such as pension funds and insurance companies, will likely emerge as the main source of funding for sustainable investment. Successful cases in other countries have shown the leading role of pension funds and insurance companies in the sustainable investment market. It is common for these institutional investors to use sustainable investment approaches to ensure their long-term investment return and also fulfill their fiduciary responsibilities. The stringent regulatory limits placed on institutional investors' ability to invest in Chinese equities is, therefore, not conducive to the development of the market, and changes should be considered. CSIWG could serve as a platform to allow direct dialogue between the public and private sector to address this issue and identify possible solutions.

» ***Increase the quota for QFIIs and make mainland A shares easier to invest in for international investors:*** Similarly, foreign investors should be allowed to invest more in the Chinese stock exchanges, and the process of applying for Qualified Foreign Institutional Investor status should be further streamlined. Working with international indices to include A shares in their universe would also open up the market to more investors.

» ***Speed up the development of fiscal incentives such as green taxes:*** There is likely some kind of market failure when the social return on environmental and social practices can be very high yet the financial return relatively low, and vice versa. To deal with this, government intervention is both necessary and important. China has proposed instituting some fiscal incentives, including green taxes, tariff rebates, etc. On May 25th, 2009, the State Council issued *Opinions on Deepening the Economic Reforms*, which reiterated the importance of speeding up the reform of environmental taxes and fees. The MEP and Ministry of Finance (MOF) are jointly developing tax reduction sector catalogues and consumer taxes on products with large environmental footprints, which will benefit green sub-sectors. In addition, MEP also works with MOFCOM to leverage environmental evaluation measures to decide tariff rebates for exporting companies[86] The development of such evaluation systems could be a solution towards further improving enterprises' environmental and social behavior. Some existing tax incentive approaches for stimulating high-tech sector investment (see page 61 about the *Notice regarding the Tax Policy to Facilitate the Development of Venture Capital Investment Enterprise)* could be used as models for similar approaches in the green-tech and climate change sectors.

Indicators have been proposed above, but can be adjusted once the CSIWG's structure and work plan is finalized.

ESG Disclosure and Research Enhancement

Plan for Enhanced ESG Disclosure and Research	
Overall Objectives	» Increase the quality and quantity of ESG disclosures » Address absence of quality, practical ESG research and shortage of ESG research expertise in China » Reduce transaction costs for investors to access ESG research » Link ESG research with corporate ESG disclosures
Challenges Addressed	#1: Confusion over terminologies #3: Questionable business case #4: Limited ESG information #6: Absence of ESG research institutions for China SI market
Possible Partners	» Top Chinese research institutions » Sell-side research entities » RiskMetrics, EIRIS, KLD » UN PRI, Enhanced Analytics Initiative (EAI) » CDP, UN Global Compact, IPE
Phase 1	» Establish a network of investors, key disclosure-related initiatives and companies. » Improve ESG disclosure » Organize seminars to share with businesses about investor perspectives on ESG issues and engage them to improve quality and quantity of ESG information disclosure » Collaboration with voluntary disclosure initiatives such as, CDP, UN Global Compact, IPE and sector disclosure standards such as sustainability reporting guidelines for the banking sector, and Shanghai and Shenzhen exchanges sustainability reporting guidelines
Phase 2	» Develop China ESG Research Database Initiative » Develop a proposal for establishment of a web-based China ESG Research Database (seed funding for the first three years and self-sustaining in the future) » Identify grant funding or sponsorship to support the first three-year operation and activities

[86] Chinanews, "China Will Accelerate to Establish Security Reviewing Mechanism for Foreign Merger and Acquisition", May 27th, 2009, http://www.fdi.gov.cn/pub/FDI_EN/News/Investmentupdates/t20090527_106451.htm

	» Identify appropriate organization to run the database
Phase 3	» Leverage the online database to promote ESG research among academic institutions and sell-side research » Identify top 10 areas that investors are most interested in but that lack research on extra-financial factors » Develop sample ESG research focusing on material issues in Chinese context » Establish ESG research awards to encourage related research and share good research submission through the on-line database » Review existing international SRI research organizations and share a comparative analysis of their methodologies with domestic research organizations » Link ESG research with corporate disclosure through continued business-investor-researcher events, research and initiatives
Sample measurement indicators	» Number and quality of ESG research reports on Chinese companies » Download rate of ESG research papers » Quality of business disclosure of ESG information

The lack of voluntary disclosure in China of suitable quality and the absence of high-quality practical ESG research on Chinese companies present major challenges.

Improving the quantity and quality of ESG disclosure is the first step, and is necessary for investors or researchers to be able to gather information on companies. Improving ESG research is the second step, to help investors evaluate companies, and is necessary for mainstreaming ESG investing. The combined lack of voluntary disclosure in China of suitable quality, and the absence of high-quality practical ESG research on Chinese companies present a major challenge. The lack of suitable skilled staff to gather, evaluate, and disclose information is another significant barrier to the successful mainstreaming of ESG. The recommended ESG disclosure and research enhancement initiative aims to encourage ESG disclosure and the development of robust ESG research through grant-funded/sponsorship incentives, and tackle the challenges that investors face in terms of access to ESG research, as well as linking ESG research with corporate information disclosure to promote transparency on ESG issues.

Similar to the first recommendation, Phase I focuses on establishment of an "umbrella" platform of investors, disclosure-related organizations and businesses. To engage with business for better ESG disclosure would help the market in the long term, as their input will ensure that disclosure initiatives are feasible, while investor input will ensure that such initiatives are useful. Seminars to share researcher and investor perspectives on ESG issues with companies would also be conducive. Collaboration with voluntary disclosure initiatives will include CDP, UN Global Compact, IPE and sector disclosure standards such as sustainability report guidelines for the banking sector, and Shanghai and Shenzhen Stock Exchange reporting guidelines. Such collaboration could include promotion of these initiatives, training on how to respond to them and improvement of the initiatives.

In Phase II, a platform designed for mainstream investors will be established, using an easily accessible and usable web format. This would allow broad access to qualified ESG research, effectively promoting additional research and more extensive application. The name of the website is tentatively proposed as the “China ESG Research Database.” An appropriate organization should be appointed to run the database, which should have access to the China research community and sell-side institutions, as well as a good understanding of ESG and investment.

Phase III will promote ESG research among research organizations and sell-side institutions. Steps could include:

- Identify top 10 areas that investors are most interested in but that lack research on extra-financial factors
- Develop sample ESG research focusing on material issues in Chinese context
- Establish ESG research awards to encourage related research, and share good research submission papers through the online database
- Review existing international SRI research organizations and share a comparative analysis of their methodologies with domestic research organizations

Phase III will also link ESG research with corporate information disclosure. With support from ESG research entities, some disclosure standards could be improved and be more effective in the Chinese context.

Increasing ESG Education

Plan for Increasing ESG Education	
Overall Objectives	» Build broad-based buy-in of sustainable investment knowledge and value » Provide Chinese investment practitioners with education about extra-financial analysis » Provide ESG education for future business leaders in China through integrating ESG courses into undergraduate and MBA courses » Provide ESG knowledge to general public
Challenges Addressed	#1: Confusion over terminologies #3: Questionable business case #7: A lack of experienced practitioners
Possible Partners	» Securities Association of China, China Banking Association » Top universities in China » Financial media » Financial education organizations
Phase 1	» Introduce CFA’s ESG module to the Securities Association of China and China Banking Association who organize licensing examinations for securities and banking professionals respectively, and integrate ESG courses into these professional licensing examinations » Collaborate with ILPA and promote SI-oriented practices among PE’s Limited Partners
Phase 2	» Benchmark ESG courses in top-ranked international universities and identify best practices » Incorporate sustainability-related courses into

	undergraduate or MBA/EMBA courses
Phase 3	» Train financial media and financial education organizations about ESG issues and sustainable investment » Outreach to general public through the media, opinion leaders and possible awards
Sample measurement indicators	» Adoption of ESG into financial professional licensing examination » Number of universities teaching sustainability issues » Number of media articles about sustainable investment

Greater ESG education seeks to raise awareness among financial practitioners, future business leaders, and the general public.

Human resources are critical for the development of the SI market in China. There would be more financial practitioners applying sustainable investment practices if they better understood the material ESG issues in their potential investments and the various ESG analysis tools which could help them make informed investment decisions. There would be higher-performing companies (according to ESG criteria), if more entrepreneurs were aware of the challenges and opportunities that ESG issues bring to their business. There would be larger amounts of sustainable investment if the general public understood investment impact in terms of addressing environmental and social challenges. Greater ESG education seeks to raise awareness among financial practitioners, future business leaders and the general public.

Chinese financial professionals primarily use traditional financial analysis at present, but a range of research shows that ESG factors ultimately affect the valuation of equity investments. To help mainstream Chinese investors adopt ESG approaches, Phase I of the action plan is to introduce financial practitioners to non-traditional factor analysis, and equip them with the relevant skills. Existing organizations or curricula can be modified for use in China, such as the CFA's Manual (*Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors).* The Securities Association of China and China Banking Association, which organize two of the most important financial professional licensing examinations, could be key target partners, as they can reach Chinese financial practitioners in the most effective way. In addition, asset owner awareness and perspectives on ESG issues are also important for asset managers to adopt sustainable investment practices. Working with influential asset owner associations such as Institutional Limited Partners Association (ILPA China) and raising awareness among asset owners could be a strategic move and should be included in Phase I.

Besides financial sector education, ESG education for future business leaders in other sectors is also important for the SI market, and thus is the focus of Phase II. This could be done through incorporating sustainability-related courses into undergraduate or MBA/EMBA courses, whose students often go on to careers in the financial sector as well. A benchmarking of ESG courses in globally top-ranked universities and best practice documentation could be undertaken to help Chinese universities learn from existing successful programs.

Phase III aims to raise awareness among the general public, who currently own around half of listed shares. To effectively reach the large population in China of individual investors (or potential investors), training financial media/mass media and leveraging opinion leaders could be potential options. The media plays a critically important role in awareness-raising because of the huge influence it wields in society. Different sustainability issues may be raised in different types of media. For the mass media, general topics such as business impacts on environment and society or investment's role in addressing societal challenges should be addressed. For financial media, there should be more specific topics such as investment risks and opportunities in the context of climate change and water scarcity, studies on the market premium of good ESG performers, or case studies on specific sustainable investment funds.

The media can also play a role in profiling sustainable investors and highlighting best practice of sustainable investors by coverage of awards such as the FT Sustainable Banking Awards, the ESG Leaders Awards, or the Capital Markets Award for Sustainable Investment & Banking. There are currently no awards focused on sustainable investment in China.

The goals of this phase are to educate media, to raise awareness of the importance and function of sustainable investment, and ensure that media effectively influences the general public and investors. The involvement of influential opinion leaders would also increase the impact of public education efforts.

Appendix 1: China's ESG Profile

A. Environmental Challenges

Of the three major ESG areas, environmental performance is where China falls shortest. The greatest environmental challenges are related to environmental pollution and energy use and climate change.

ENVIRONMENTAL POLLUTION

China has industrialized far more quickly than other developed countries, which has caused major environmental impacts, particular in terms of air and water pollution due to manufacturing, extractive industries, and transport. The Ministry of Environmental Protection (MEP) has estimated that environmental problems cost the state US$200 billion every year, equivalent to approximately 10% of GDP. A joint report by World Bank and the State Environmental Protection Administration (SEPA), *China's Loss from Environmental Pollution: Economic Forecast on Physical Damages*, also calculated the damage from environmental pollution to public health. In March 2008, SEPA was promoted in rank to the Ministry of Environment Protection (MEP), which has been widely interpreted as sign of an ambitious national environmental policy and intentions to strengthen environmental enforcement. In May 2008, the *Measures for Disclosing Environmental Information* were released, stipulating that environmental protection agencies should be obligated to disclose environmental information and encouraging enterprises to publish information on their environmental performance.

ENERGY USE AND CLIMATE CHANGE

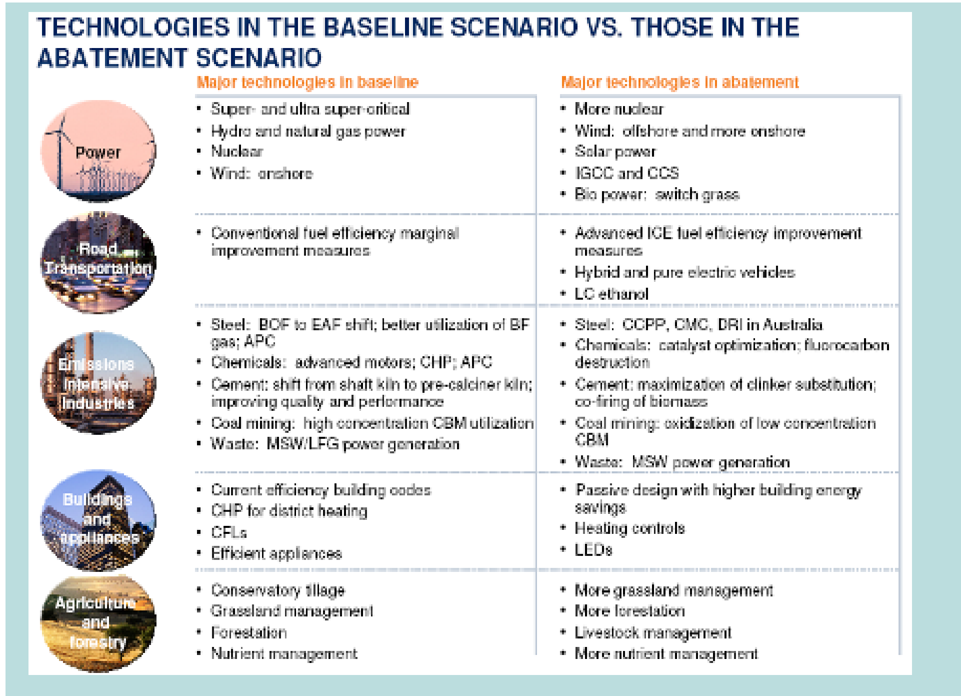
China's rapid development has resulted in a dramatic increase in demand for electricity which is predominantly dependent on China's cheap and abundant coal resource, and has direct implications for global climate change. China does seem to be making substantive efforts to improve at the national policy level, such as the National Climate Change Program which was announced by the State Council in June 2007. Led by Premier Wen Jiabao, the program sets up goals, principles and steps for dealing with energy and emissions issues.[87]

McKinsey Study: "China's Green Revolution"

China's Green Revolution is a detailed review of economically pragmatic strategies that can foster environmental sustainability in China. The study reviewed energy security, greenhouse gas reductions, pollution curbs, and land and ecosystem conservation. The authors identified and analyzed six areas that could improve China's environmental performance over the next 20 years: (1) "Green Power" - Replacing Coal with Clean Energy; (2) "Green Fleet" - Comprehensively Adopting Electric Vehicles; (3) "Green Industry" - Managing Waste in High-Emission Industries; (4) "Green Buildings" - Designing Energy Efficient Buildings; (5) "Green Ecosystem" - Restoring and Preserving China's Carbon Sink; and (6) "Green Mindset" - Rethinking Urban Design & Consumer Behavior. From the same study, the figure below illustrates opportunities for technical progress on environmental protection in five key industries:

---

[87] The Chinese Government, "Notices on Addressing Climate Change Challenges", , (http://www.gov.cn/zwgk/2007-06/08/content_641704.htm accessed 20 July 2009)



TECHNOLOGIES IN THE BASELINE SCENARIO VS. THOSE IN THE ABATEMENT SCENARIO

	Major technologies in baseline	Major technologies in abatement
Power	• Super- and ultra super-critical • Hydro and natural gas power • Nuclear • Wind: onshore	• More nuclear • Wind: offshore and more onshore • Solar power • IGCC and CCS • Bio power: switch grass
Road Transportation	• Conventional fuel efficiency marginal improvement measures	• Advanced ICE fuel efficiency improvement measures • Hybrid and pure electric vehicles • LC ethanol
Emissions Intensive Industries	• Steel: BOF to EAF shift; better utilization of BF gas; APC • Chemicals: advanced motors; CHP; APC • Cement: shift from shaft kiln to pre-calciner kiln; improving quality and performance • Coal mining: high concentration CBM utilization • Waste: MSW/LFG power generation	• Steel: CCPP, CMC, DRI in Australia • Chemicals: catalyst optimization; fluorocarbon destruction • Cement: maximization of clinker substitution; co-firing of biomass • Coal mining: oxidization of low concentration CBM • Waste: MSW power generation
Buildings and appliances	• Current efficiency building codes • CHP for district heating • CFLs • Efficient appliances	• Passive design with higher building energy savings • Heating controls • LEDs
Agriculture and forestry	• Conservatory tillage • Grassland management • Forestation • Nutrient management	• More grassland management • More forestation • Livestock management • More nutrient management

Indicator 1: China's Performance in the Environmental Performance Index (EPI)

EPI was released by the Yale Center for Environmental Law & Policy and the Center for International Earth Science Information Network (CIESIN) at Columbia University, in collaboration with the World Economic Forum and the Joint Research Centre of the European Commission. The EPI categories include environmental health (environmental burden of disease, water and air pollution effects on humans) and ecosystem vitality (air and water pollution effects on ecosystems, biodiversity and habitat, productive natural resources, climate change).

Table 7.1: China's Performance in the EPI

	Brazil		China		India		Russia	
	2008	2006	2008	2006	2008	2006	2008	2006
Ranking (out of 149 countries)	34	34	105	94	120	118	28	32
Score	82.7	77	65.1	56.2	60.3	47.7	83.9	77.5

Source: 2008 Environmental Performance Index (EPI)

B. Social Issues

Socio-economic performance in China has been strong, particularly given China's rapid rate of economic growth. The PRC has made tremendous progress in poverty reduction in recent years. Twenty years ago, it was among the world's poorest countries, with 80% of the population living on incomes of less than $1 a day and only one-third of all adults able to read or write. Now, only about 7% of the population between 15 and 25 years old is illiterate, and the PRC's high life expectancy and low infant mortality rates are envied by much richer nations.

However, serious challenges remain. Increasing income disparities will be one of China's major issues in the coming years. According to the UNDP's 2007/2008 *Human Development Report on China*, the poorest 20% of China's population accounts for 4.3% of all consumption, while the richest 20% accounts for 51.9%. This inequality in income has ramifications for social stability.

Income disparity is particularly apparent between rural and urban areas. With more than 700 million people in the countryside, China is making an effort to increase rural incomes. In October 2008, the Communist Party issued what Xinhua News called a landmark policy, the *Decision on Major Issues Concerning the Advancement of Rural Reform and Development* that allows farmers to lease their contracted farmland or transfer their land-use rights to boost the scale of operation for farm production and provide funds for them to start new businesses. The policy is meant to help double the per-capita disposable income of rural residents from 2008 levels to more than US$1200 by 2020.

In order to address income inequality and other profound social issues, the government is continuing to implement legal reforms which increase opportunities for affected groups to participate in policy reform, such as the *Labor Contract Law* and upcoming *Trade Union Law* which allow migrant workers to advocate for their labor rights.

Finally, a variety of politically sensitive areas still present challenges, particularly where international expectations differ. These require careful navigation by all actors as they often present challenges for investors working towards global standards.

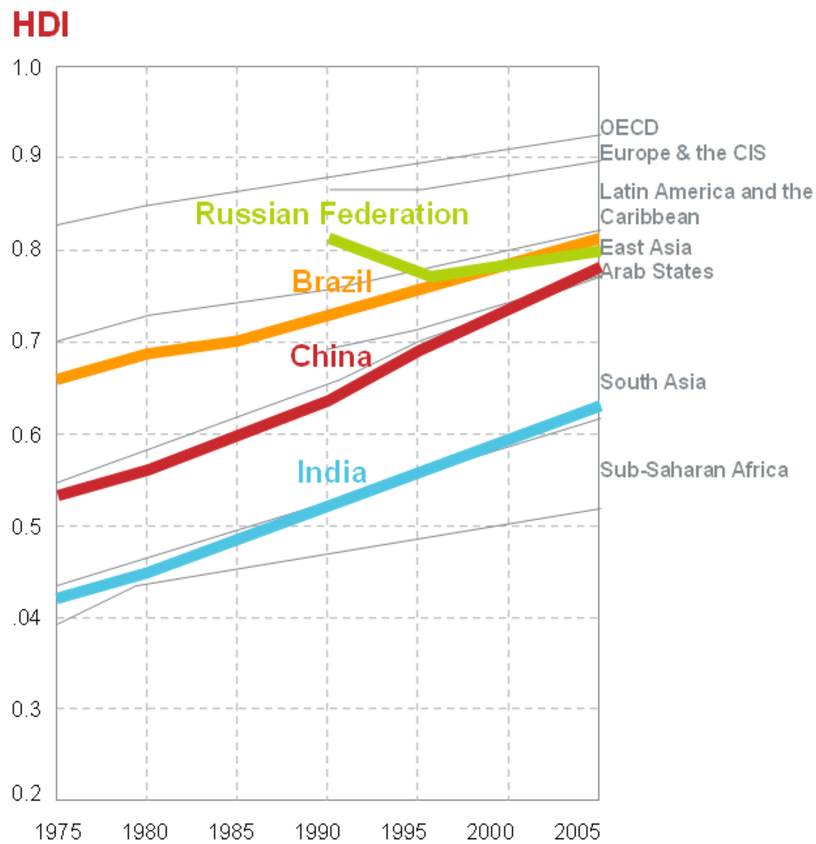
Indicator 2: China's Performance in the Human Development Index (HDI)
The HDI combines normalized measures of life expectancy, literacy, educational attainment, and GDP per capita for countries worldwide. It is a standardized means of measuring human development—a concept that, according to the United Nations Development Programme (UNDP), refers to the process of widening the options of persons, giving them greater opportunities for education, health care, income, and employment. The basic use of HDI is to evaluate a country's development and growth.

Table 7.2: HDI for Selected Countries

	Brazil	China	India	Russia
Ranking (out of 177 countries)	70	81	128	67

Source: Human Resource Development Report 2007/2008

Figure 7.1: HDI Growth for Selected Countries



Source: Human Resource Development Report 2007/2008

Indicator 3: China's Performance in the Ease of Doing Business Index
The Ease of Doing Business Index is an indicator created by the World Bank, in which higher rankings indicate better, usually simpler, regulations for businesses and stronger protections of property rights. Empirical research funded by World Bank to justify their work claims to show that the effect of improving these regulations on economic growth is strong. The Ease of Doing Business index is meant to measure regulations directly affecting businesses and does not directly measure more general conditions such as a nation's proximity to large markets, quality of infrastructure, inflation, or crime. A nation's ranking on the index is based on the average of 10 subindices: Starting a business, Dealing with licenses, Hiring and firing workers, Registering property, Getting credit, Protecting investors, Paying taxes, Trading across borders, Enforcing contracts, and Closing a business.

Table 7.3: Ranking for Selected Countries in Doing Business Index

	Brazil		China		India		Russia	
Year	2009	2008	2009	2008	2009	2008	2009	2008
Ranking (out of 181 countries)	125	126	83	90	122	120	120	112

Source: Doing Business 2009 report, The World Bank Group

Indicator 4: China's Performance in the Global Competitiveness Index
The Global Competitiveness Report is a yearly report published by the World Economic Forum. The report "assesses the ability of countries to provide high levels of prosperity to their citizens, [which] in turn depends on how productively a country uses available resources." A Global Competitiveness Index assesses institutions, policies, and factors that affect the "sustainable current and medium-term levels of economic prosperity." Variables include: Institutions, Accountability, Macroeconomy, Health and primary education, Higher education and training, Market efficiency, Technological readiness, Business sophistication, and Innovation.

Table 7.4: Ranking for Selected Countries in Global Competitiveness Report

Year	2008-2009		2007-2008		2006		2005		2004		2003		2002	
Country	rank	score	rank	score	rank	score	rank	score	rank	score	rank	score	rank	score
Brazil	72	3.99	72	3.99	66	4.03	65	3.69	57	4.05	54	/	46	/
China	34	4.57	34	4.57	54	4.24	49	4.07	46	4.29	44	/	33	/
India	48	4.33	48	4.33	43	4.44	50	4.04	55	4.07	56	/	48	/
Russia	58	4.19	58	4.19	62	4.08	75	3.53	70	3.68	70	/	64	/

Source: The Global Competitiveness Report

C. Governance in China

Reviewing Transparency International's Corruption Perceptions Index, governance in China scores on par with its BRIC counterparts India and Brazil, and significantly higher than Russia. Further information on corporate-specific governance that is related to the SI market in China is provided in Chapter 5.

ESG in China, a JP Morgan Report that reviews governance issues in China, breaks down governance into 3 components: business ethics, corporate governance structures, and transparency and reporting. Their analysis is reviewed below.

Business ethics:	Corporate governance:	Audit & financial reporting:
The government recognizes the detrimental social and macroeconomic effects of bribery and corruption, and has begun prosecuting official and executives more forcefully in line with its policy. It will likely tackle sectors with a direct link to human health more heavy- handedly as the recent product safety scandals have shown.	The introduction of a corporate governance index will only help to alleviate concerns over a lack of independent oversight and minority shareholder rights if existing governance regulations are better enforced. Listings may be conditional on companies' environmental and governance performance.	Investors are prepared to pay a premium for well-governed companies. Irregular and opaque disclosures run contrary to investors' desire for accountability and transparency. The government will likely enforce new standards in our view.

Source: JP Morgan, ESG in China, 2008

INDICATOR 5: CHINA'S PERFORMANCE IN THE CORRUPTION PERCEPTIONS INDEX

Since 1995, Transparency International has published an annual Corruption Perceptions Index (CPI), which ranks countries according to the perception of corruption among public officials. The organization defines corruption as "the abuse of entrusted power for private gain."[88] It is a composite index which draws on corruption-related data from expert and business surveys carried out by a variety of independent and reputable institutions. The CPI reflects views from around the world, including those of experts who are living in the countries evaluated.

Table 7.5: Ranking for Selected Countries in Corruption Perception Index

Year	2008		2007		2005		2003		2001	
Country	**Score**	**Rank**	**Score**	**Rank**	**Score**	**Rank**	**Score**	**Rank**	**Score**	**Rank**
Brazil	3.5	80	3.5	72	3.7	62	3.9	54	4	46
China	3.6	72	3.5	72	3.2	78	3.4	66	3.5	57
India	3.4	85	3.5	72	2.9	88	2.8	83	2.7	71
Russia	2.1	147	2.3	143	2.4	126	2.7	86	2.3	79

Source: Corruption Perceptions Index

[88] Transparency International website, (http://www.transparency.org/about_us accessed 20 July 2009).

Appendix 2: Estimated Stock of Sustainable Investment in China

<table>
<tr><th colspan="2">Market Participant</th><th>Total AUM (US$ billion)</th><th>Estimated Stock of Investment in Chinese Equities (US$ billion)</th><th>Estimated stock of SI (US$ billion)</th><th>SI Investments % of Total Investment</th><th>Potential for SI market development short to medium term</th></tr>
<tr><td colspan="2">Domestic: Mutual funds</td><td>294.73</td><td>294.73</td><td>3.32</td><td>0.011%</td><td>High</td></tr>
<tr><td rowspan="2">Domestic: Pension funds</td><td>NSSF</td><td>82.29</td><td>33</td><td>0.33</td><td>1%</td><td>Medium/ High</td></tr>
<tr><td>Enterprise Annuity</td><td>27.96</td><td>8.4</td><td>0.08</td><td>1%</td><td>Medium/ High</td></tr>
<tr><td colspan="2">Domestic: Insurance</td><td>518</td><td>26.9</td><td>0.26</td><td>1%</td><td>Medium</td></tr>
<tr><td colspan="2">International: QFII</td><td>13</td><td>13</td><td>0.13</td><td>1%</td><td>Medium</td></tr>
<tr><td colspan="2">International: ADR</td><td>n.a.</td><td>n.a.</td><td>0</td><td>0%</td><td>Low</td></tr>
<tr><td colspan="2">TOTAL</td><td>971.83</td><td>411.63</td><td>4.12</td><td>1%</td><td></td></tr>
</table>

Source: BSR estimates

Domestic Mutual Funds
Based on interviews and research, BSR takes a conservative approach and estimates that around 1% of AUM of the mutual fund sector are invested with consideration of ESG factors. Adding this 1% (US$2.94 billion) to the amount of the one current available SI fund (US$375 million as of March 31, 2009), the total amount is US$3.32 billion.

Domestic Pension Funds
Based on the analysis in Chapter 4 which describes limited SI implementation among pension funds, BSR conservatively estimates that 1% of NSSF and EA investments are in sustainable investments, equivalent to US$0.33 billion and US$84 million respectively.

Life and Property Insurance
SI funds are estimated at 1% of total assets, or CNY1.77 billion (US$0.26 billion).

Foreign Investment
BSR conservatively estimates that SI comprises less than 1% of the US$13 billion in QFII investments, or US$130 million in total. We do not estimate any SI ADR investments are in the A share market.

Appendix 3: List of Mutual Funds

No.	Fund Name	Assets Under Management (Billion CNY)	Assets Under Management (Million USD)	Nature of Ownership	Years of Operation
1	Guotai Asset Management Co., Ltd	32.3	4.73	Chinese	11
2	China Southern Fund Management Co., Ltd	117.63	17.21	Joint Venture	11
3	China Asset Management Co., Ltd	202.38	29.61	Chinese	11
4	Hua An Fund Management Co., Ltd	71.96	10.53	Joint Venture	11
5	Boshi Fund Management Co., Ltd	132.13	19.33	Chinese	10
6	Penghua Fund Management Co., Ltd	47.25	6.91	Joint Venture	10
7	Changsheng Fund Management Co. Ltd	25.04	3.66	Chinese	10
8	Harvest Fund Management Co. Ltd	120.91	17.69	Joint Venture	10
9	Da Cheng Fund Management Co. Ltd.	77.99	11.41	Chinese	10
10	Fuligoal Fund Management Co. Ltd	48.95	7.16	Joint Venture	10
11	E Fund Management Co. Ltd	110.15	16.12	Chinese	8
12	Baoying Fund Management Co. Ltd	12.04	1.76	Chinese	8
13	Rongtong Fund Management Co. Ltd	47.61	6.97	Joint Venture	8
14	Yinhua Fund Management Co. Ltd	49.05	7.18	Chinese	8
15	Great Wall Fund Management Co. Ltd	38.31	5.61	Chinese	7
16	Galaxy Fund Management Co. Ltd	12.71	1.86	Chinese	7
17	ABN AMRO TEDA Fund Management Co. Ltd	21.11	3.09	Joint Venture	6
18	UBS SDIC Fund Management Co. Ltd	26.29	3.85	Joint Venture	6
19	WanJia Asset Management Co. Ltd	9.78	1.43	Chinese	6
20	Golden Eagle Fund Management Co. Ltd	2.04	0.30	Chinese	6

21	China Merchants Fund Management Co. Ltd	35.8	5.24	Joint Venture	6
22	Fortune SGAM Fund Management Co. LTD	54.34	7.95	Joint Venture	6
23	Morgan Stanley Huaxin Fund Management Co. LTD	2.08	0.30	Joint Venture	6
24	GTJA Allianz Fund Management Co. LTD	6.78	0.99	Joint Venture	6
25	Fortis Haitong Investment Management Co. LTD	35.37	5.18	Joint Venture	6
26	Changxin Fund Management Co. LTD	21.64	3.17	Chinese	6
27	First-trust Fund Management Co. LTD	14.27	2.09	Chinese	6
28	China Nature Asset Fund Management Co. LTD	5.18	0.76	Chinese	6
29	Invesco Great Wall Fund Management Co. LTD	57.2	8.37	Joint Venture	5
30	GF Fund Management Co. LTD	82.45	12.06	Chinese	5
31	AEGON-INDUSTRIAL Fund Management Co. LTD	31.26	4.57	Joint Venture	5
32	CITIC Fund Management Co. LTD	10.22	1.50	Chinese	5
33	Lion Fund Management Co. LTD	42.53	6.22	Chinese	5
34	SYWG BNP Paribas Asset Management Co. LTD	12.57	1.84	Joint Venture	5
35	Zhonghai Fund Management Co. LTD	19	2.78	Chinese	5
36	Everbright Pramerica Fund Management Co. LTD	33.74	4.94	Joint Venture	5
37	Huafu Fund Management Co. LTD	5.06	0.74	Chinese	5
38	China International Fund Management Co. LTD	69.74	10.20	Joint Venture	5
39	Orient Fund Management Co. LTD	8.09	1.18	Chinese	4
40	Bank of China Investment Management Co. LTD	23.07	3.38	Joint Venture	4
41	Soochow Asset Management Co. LTD	8.66	1.27	Chinese	4

42	Franklin Templeton Sealand Fund Management Co. LTD	17.52	2.56	Joint Venture	4
43	Tianhong Asset Management Co. LTD	4.54	0.66	Chinese	4
44	AIG-Huatai Fund Management Co. LTD	19.56	2.86	Joint Venture	4
45	New Century Fund Management Co. LTD	1.26	0.18	Chinese	4
46	China Universal Asset Management Co. LTD	45.54	6.66	Chinese	4
47	ICBC Credit Suisse Asset Fund Management Co. LTD	49.24	7.21	Joint Venture	3
48	Bank of Communications Schroder Fund Management Co. LTD	44.51	6.51	Joint Venture	3
49	CITIC-Prudential Fund Management Co. LTD	8.06	1.18	Joint Venture	3
50	CCB Principal Asset Fund Management Co. LTD	31.56	4.62	Joint Venture	3
51	Huashang Fund Management Co. LTD	7.84	1.15	Chinese	3
52	HSBC Jintrust Fund Management Co. LTD	5.8	0.85	Joint Venture	3
53	Yimin Asset Management Co. LTD	8.06	1.18	Chinese	3
54	CHINA POST & CAPITAL Fund Management Co. LTD	37.57	5.50	Chinese	3
55	First State Cinda Fund Management Co. LTD	7.82	1.14	Joint Venture	3
56	Lord Fund Management Co. LTD	4.77	0.70	Joint Venture	3
57	Lombarda China Fund Management Co. LTD	3.03	0.44	Joint Venture	3
58	KBC-GOLDSTATE Fund Management Co. LTD	3.98	0.58	Joint Venture	2
59	AXA SPDB Investment Management Co. LTD	1.38	0.20	Joint Venture	2
60	ABC-CA Fund Management Co. LTD			Joint Venture	1
61	Minsheng Royal Fund Management Co. LTD			Joint Venture	1
	Total	**2086.72**	**305.34**		

Appendix 4: List of Life Insurance and Property Insurance

Life Insurance Firms

Chinese-owned	Foreign-owned
Reward Health Insurance Co., Ltd	Huatai Life Insurance Company Ltd
PICC Life Insurance Co., Ltd	Cathay Insurance Company Limited
Guohua Life Insurance Co., Ltd	Platinum United Metlife Insurance Co., Ltd
China Life Pension Co, Ltd	Samsung Air China Life Insurance Co., Ltd
Changjiang Pension Insurance Co., Ltd	Zhongxin Grand Oriental Person's Life Insurance Co., Ltd.
Yingda Taihe Life Insurance Co., Ltd	Shin Kong & HNA Life Insurance Co., Ltd
Taikang Pension Insurance Co., Ltd	King Dragon Life Insurance Company Ltd
Happy Life Insurance Co., Ltd	Sino-US MetLife insurance Co., Ltd
Sunshine Life Insurance Co., Ltd	Sino-French Life Insurance Co., Ltd
Ping An Life Insurance Co., Ltd	Allianz China Life Insurance Co., Ltd
New China Life Insurance Co., Ltd.	AXA-Minmetals Assurance Co., Ltd
Taikang Life Insurance Company	CITIC-Prudential Life Insurance Company Ltd
Taiping Life Insurance Co., Ltd.	China CMG Life Insurance Company Ltd
Minsheng Life Insurance Co., Ltd	John Hancock Tianan Life Insurance Co., Ltd
Sino Life Insurance Co., Ltd	General China Life Insurance Company Ltd
Kunlun Health Insurance Co., Ltd	Manulife-Sinochem Life Insurance Co., Ltd
China Life Insurance Co., Ltd	Manulife-Sinochem Life Insurance Co., Ltd
China Pacific Life Insurance Co., Ltd	Pacific-Aetna Life Insurance Company Ltd
Ping An Annuity Insurance Co Ltd.	American International Assurance Company, Ltd.
Union Life Insurance Co., Ltd	Haier New York Life Insurance Co Ltd
Taiping Pension Co., Ltd	ING Capital Life Insurance Company Ltd
Ping An Health Insurance Co, Ltd	Aviva-COFCO Life Insurance Co., Ltd
PICC Health Insurance Co Ltd	AEGON-CNOOC Life Insurance Company Ltd

Huaxia Life Insurance Co. Ltd	CIGNA and CMC Life Insurance Company Ltd
Dragon Life Insurance Co., Ltd	Nissay-SVA Life Insurance Company Ltd
Sinatay Life Insurance Co., Ltd	Heng An Standard Life Insurance Company Ltd
Jiahe Life Insurance Co., Ltd	Skandia–BSM Life Insurance Company Ltd
Great Wall Life Insurance Co., Ltd	

Property Insurance Firms

Chinese owned	Foreign owned
PICC Property and Casualty Co Ltd	AIG General Insurance Company China Limited
China Continent Property & Casualty Insurance Co Ltd	The Tokio Marine & Nichido Fire Insurance Company (China) Limited
China Export & Credit Insurance Corporation	Winterthur Swiss Insurance
China United Insurance Holding Company	Sun Alliance Insurance (China) Limited
China Pacific Property & Casualty Insurance Co., Ltd	Chubb Group of Insurance Companies
Ping An Property & Casualty Insurance Co., Ltd	Mitsui Sumitomo Insurance Group Holdings Inc.
Huatai Property Insurance Company Ltd	Samsung Fire & Marine Insurance
Tianan Insurance Company Ltd	Allianz Insurance Company
Dazhong Insurance Company Ltd	Sompo Japan Insurance Inc.
Hua An Insurance Company Ltd,	Liberty Mutual Ins. Group
Yong An Property Insurance Company Ltd.	Groupama
Taiping Insurance Company Ltd	Zurich Insurance (Taiwan) Ltd
Min An Insurance Co (China) Ltd	Hyundai Insurance (China) Company Limited
Bank of China Insurance Company Limited	General China Insurance Co Ltd
Alltrust Property Insurance Company Ltd	Aioi Insurance Company (China) Limited.
Anbang Property & Casualty Insurance Company Ltd	Cathay Insurance Company Limited
AnHua Agricultural Insurance Company Ltd	Heng An Standard Life Insurance Company Ltd
Shanghai Anxin Agricultural	Skandia–BSM Life Insurance Company

Insurance Co., Ltd.	Ltd
Sunshine Property and Casualty Insurance Co., Ltd.	Sino-US MetLife insurance Co., Ltd
Sunlight Agricultural Mutual Insurance Company	Sino-French Life Insurance Co., Ltd
Du-Bang Property & Casualty Insurance Co., Ltd	Huatai Life Insurance Company Ltd
Bohai Property Insurance Company Ltd	Cathay Insurance Company Limited
China Huanong Property & Casualty Insurance Co., Ltd.	
China Life Property and Casualty Insurance Co Ltd	
Ancheng Property & Casualty Insurance Co., Ltd	
Chang An Property & Liability Insurance Co Ltd	
Guoyuan Agricultural Insurance Co., Ltd.	
Ding He Insurance Co Ltd	
Yingda Taihe Property Insurance Co.,Ltd	

Appendix 5: List of Qualified Foreign Institutional Investors (QFII)

No.	QFII Name in English	Investment Quota (US$ hundred million)	Time of Authorization
1	UBS AG	8	5/23/2003
2	Nomura Securities Co., Ltd.	3.5	5/23/2003
3	Morgan Stanley & Co. International Limited	4	6/5/2003
4	Citigroup Global Markets Limited	5.5	6/5/2003
5	Goldman, Sachs & Co.	3	7/4/2003
6	Deutsche Bank AG or Deutsche Bank Aktiengesellschaft	4	7/30/2003
7	Hongkong and Shanghai Banking Corporation Limited	4	8/4/2003
8	ING Bank N.V.	3.5	9/10/2003
9	JPMorgan Chase Bank	1.5	9/30/2003
10	Credit Suisse (Hong Kong) Limited	5	10/24/2003
11	Standard Chartered Bank (Hong Kong) Limited	0.75	12/11/2003
12	Nikko Asset Management Co., Ltd.	4.5	12/11/2003
13	Merrill Lynch International	3	4/30/2004
14	Hangseng Bank	1	5/10/2004
15	Daiwa Securities SMBC Co., Ltd.	0.5	5/10/2004
16	Lehman Brothers International (Europe)	2	7/6/2004
17	Bill & Melinda Gates Foundation	1	7/19/2004
18	INVESCO Asset Management Limited	2.5	8/4/2004
19	ABN AMRO Bank N.V.		9/2/2004
20	Société Générale	0.5	9/2/2004
21	Templeton Asset Management Ltd	N.A.	9/14/2004
22	Barclays Bank PLC	0.75	9/15/2004
23	Dresdner Bank Aktiengesellschaft	0.75	9/27/2004
24	Fortis Bank SA/NV	5	9/29/2004
25	BNP Paribas	2	9/29/2004
26	Power Corporation of Canada	0.5	10/15/2004
27	Calyon S.A.	0.75	10/15/2004
28	Goldman Sachs Asset Management International	2	5/9/2005
29	Martin Currie Investment Management Ltd	1.2	10/25/2005
30	Government of Singapore Investment	1	10/25/2005

	Corporation Pte Ltd		
31	AIG Global Investment Corp	0.5	11/14/2005
32	Temasek Fullerton Alpha Investments Pte Ltd	1	11/15/2005
33	JF Asset Management Limited	1.5	12/28/2005
34	The Dai-ichi Mutual Life Insurance Company	1	12/28/2005
35	DBS Bank Ltd.	1	2/13/2006
36	AMP Capital Investors Ltd.	2	4/10/2006
37	Scotia Bank or The Bank of Nova Scotia	1.5	4/10/2006
38	KBC Financial Products UK Limited	1	4/10/2006
39	La Compagnie Financière Edmond de Rothschild Banque	1	4/10/2006
40	Yale University	0.5	4/14/2006
41	Morgan Stanley Investment Management Inc.	2	7/7/2006
42	Prudential Asset Management (Hongkong) Limited	2	7/7/2006
43	Stanford University	0.5	8/5/2006
44	GE Asset Management Incorporated	2	8/5/2006
45	United Overseas Bank Limited	0.5	8/5/2006
46	Schroder Investment Management Limited	2	8/29/2006
47	HSBC Investments (Hongkong) Limited	2	9/5/2006
48	Shinko Securities Co., Ltd	0.5	9/5/2006
49	UBS Global Asset Management (Singapore) Ltd	2	9/25/2006
50	Sumitomo Mitsui Asset Management Company, Limited	2	9/25/2006
51	Norges Bank	2	10/24/2006
52	Pictet Asset Management Limited	1	10/25/2006
53	Trustees of Columbia University in the City of New York	1	3/12/2008
54	Prudential Asset Management Co., Ltd.	0.75	4/7/2008
55	Robeco Institutional Asset Management B.V.	1.5	5/5/2008
56	State Street Global Advisors Asia Limited	N.A.	5/16/2008
57	Platinum Investment Company Limited	N.A.	6/2/2008
58	KBC Asset Management N.V.	N.A.	6/2/2008
59	Mirae Asset Investment Management Co., Ltd	N.A.	7/25/2008
60	Pictet Asset Management Limited	N.A.	8/5/2008
61	Caisse de dépôt et placement du Québec	N.A.	8/22/2008
62	President and Fellows of Harvard College	N.A.	8/22/2008
63	Samsung Investment Trust Management Co.,	N.A.	8/25/2008

	Ltd.		
64	Alliance Bernstein Limited	N.A.	8/28/2008
65	Oversea-Chinese Banking Corporation Limited	N.A.	8/28/2008
66	First State Investment Management (UK) Limited	N.A.	9/11/2008
67	DAIWA Asset Management Co.	0.5	9/11/2008
68	Shell Asset Management Company B.V	N.A.	9/12/2008
69	T. Rowe Price International, Inc.	N.A.	9/12/2008
70	Société Générale Asset Management SA	N.A.	10/14/2008
71	Credit Suisse	N.A.	10/14/2008
72	UOB Asset Management LTD	N.A.	11/28/2008
73	ABU Dhabi Investment Authority	N.A.	12/3/2008
74	Allianz Global Investors Luxembourg S.A.	N.A.	12/16/2008
75	Capital International Inc.	N.A.	12/18/2008
76	Mitsubishi UFJ Securities Co., Ltd.	N.A.	12/29/2008
77	Hanwha Investment Trust Management Co., Ltd	N.A.	2/5/2009
78	Emerging Markets Management, L.L.C.	N.A.	2/10/2009
79	DWS Investment S.A.	N.A.	2/24/2009
80	Woori Bank Co., Ltd	N.A.	5/4/2009
81	Bank Negara Malaysia	N.A.	5/19/2009
82	Lloyd George Management (Hong Kong) Limited	N.A.	5/27/2009
83	Templeton Investment Counsel, LLC	N.A.	6/5/2009
84	BEA Union Investment Management Limited	N.A.	6/18/2009
85	The Sumitomo Trust & Banking Co. Ltd	N.A.	6/26/2009

Appendix 6: Review of Major Reforms in China

Price Reform

China's price reform was one of the important components of economic restructuring in the country. Boosting price reform was the key in realizing the transformation of the economic operation mechanism. Price reform and ownership reform were two of the major projects in China's economic reform.

For a long time, China was a shortage economy with market commodities constantly in short supply. Through over ten years of effort, prices in the total commodity retail sales, the total sales of industrial production materials and the total value of purchased agricultural products and by-products were basically determined by the market. In 2006, the ratio of prices of these three areas was as high as over 92%. The official implementation of the *Price Law* on May 1, 1998 brought China's price reform and behavior into the legal system, which was also a demonstration that the price system had improved.

Share-holding System Reform

From 1978 to 1992, attempts to reform China's state-owned enterprises (SOEs) were made on three occasions, but they were not completely successful.

The first phase from 1978 to 1983 was focused on expanding the independent rights of the enterprises, including for production and sales, profit retention and personnel affairs. Problems arose at the end of this period when there was increasingly poor performance in the accomplishment of production and financial tasks delegated by the state. The second phase from 1983 to 1987 was the period when two measures were implemented. First, revenue shifted from the collection of profits from SOEs to the levy of taxes, or what was then called, "Replacement of Profit by Tax." Second, fiscal funds were no longer appropriated to SOEs without compensation and SOEs needed to apply for loans from state banks, what was then called, "Replacement of Appropriations by Loans."

The third phase from 1997 to 1992 focused on the implementation of the measures for the "Contractual System." The corporate contractor was obliged to achieve certain amounts of profits and taxes. Due to the shortage of scientific standards for computing the contractual base number, the quota of profits and taxes to be accomplished was not scientifically based and it also served as the stimulus for short-term behavior. As a result, some contractors would not make provisions or made less provisions for depreciation and changed depreciations into profits.

After 1992, the share-holding system reform began to be back on the normal track. The share-holding system reform included two different reforms, the corporate equity system reform and the establishment and improvement of securities markets. For this report, only the corporate system reform is discussed. The share-holding system reform was actually started from Deng Xiaoping's South China Inspection Tour in 1992. In the *Resolution on Several Issues on Establishing the Socialist Market Economic System*, it was announced that SOEs must establish the "Modern Enterprise System" and that "the corporate share-holding system is conducive to establishing the modern enterprise system." Following many years of hard work, 30 Chinese companies were ranked among the top 500 enterprises by the US-based Fortune magazine.

Renminbi Exchange Rate System Reform

The Renminbi (RMB) exchange rate system has been in a process of constant development and improvement. Generally, it can be divided into the following four stages of historical development:

A. 1978-1985: RMB was pegged to a basket of world currencies. During this period, the RMB exchange rate fluctuated greatly, and over just three years, the exchange rate of RMB to the US dollar depreciated from US$1 : CNY1.5 to US$1 : CNY3.2. This basically eliminated the overvaluation of the RMB and indirectly promoted the recovery of export to foreign countries.

B. 1986-1993: The system of adjustable and fixed exchange rates of RMB pegged to the US dollar was adopted.

C. 1994-July 2005: The single and managed floating exchange rate system based on market supply and demand was officially determined. The RMB exchange rate system during this period was characterized by the policy of pegging to the US dollar and compulsory buying and selling of foreign currency. The exchange rates were maintained at between 8.28 and 8.27 for a long time during this stage.

D. July 2005 to present: The managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies was adopted.

There are two objectives for the next phase of reform of the RMB exchange rate regime; first is gradually liberalizing RMB convertibility under the capital account, and second is gradually realizing RMB convertibility and then when conditions are ripe, bringing about internationalization of the RMB.

Accession to the WTO

On November 15, 1999, the bilateral agreement on China's accession to the WTO was signed between China and the United States. On May 29, 2000, the bilateral agreement on China's accession to the WTO was signed between China and the EU. On December 6, 2001, China officially joined the WTO.

After its accession to the WTO, the Chinese government, according to the WTO rules, abided by the extensive commitments it made upon entering the WTO and made major adjustments to its trade systems and policies.

1. Changes in the legal system. After joining the WTO, China developed, amended and abolished over 3,000 laws, administrative statutes and sectoral rules from 1999 to 2007. As a consequence, the transparency in the policies of the Chinese government was greatly enhanced. The *Law on Administrative Licensing and Administrative Legality* developed in 2003 put forward strict and specific requirements for transparency in government behavior.

2. Trade in goods. China's average tariffs were reduced from 15.3% at the time of accession to 9.8% in 2007. By the beginning of 2005, most of China's commitments to tariff cuts had been fulfilled. By January 1, 2005, China had abolished all non-tariff barriers such as import quotas, import licenses and specified bids, according to the agreed timetable. On July 1, 2004, the Chinese government fulfilled its commitment to open foreign trade through the abolishment of the procedure for the approval of foreign trade rights and the

implementation of the system of foreign trade rights operations registration six months ahead of schedule.

3. Service trade. In the banking service sector, China introduced multiple major policies, such as the licensing of eligible foreign-funded banks to conduct Renminbi business for Chinese citizens. In the insurance service sector, foreign-funded insurance companies, starting from December 11, 2004, may provide insurance services at any location in China, and China opened all services, except relevant legal insurance services, to foreign insurance companies.

Development of Private Equity Funds in China

It is generally believed that the earliest private equity fund in China was started from the industrial investment fund established overseas in the mid-to-late 1990s. During the same period, the state also promulgated a series of policies and laws in order to boost and standardize the development of private equity funds in China, including the *Measures for the Management of China Industrial Investment Funds Established Overseas* in 1995, the *Interim Measures for the Management of Venture Capital Enterprises* in 2005, the *Measures for the Management of Strategic Investment by Foreign Investors in Listed Companies and the Regulations on Foreign Investors' Acquisition of Enterprises within China* in 2006. In addition, the amended *Company Law* lifted the restrictions on quotas for overseas investment by Chinese enterprises, and the amendment of the *Partnership Enterprise Law* officially marked the form of limited partnership enterprise. All this created an ideal legal environment for establishing private equity funds in China, especially domestic funds.

Over the past years, the promulgation of the *Trust Law*, the amendments of the *Company Law* and the *Securities Law* and the recently amended *Partnership Enterprise Law* have basically eliminated legal barriers to the establishment and operation of private equity funds.

Appendix 7: Portfolio Composition of Shanghai Stock Exchange Corporate Governance Index (SSE-CGI) and Social Responsibility Index (SSE-SRI)

Industry	SSE-CGI Constituents	SSE-SRI Constituents	SSE-SRI Index Weight
Manufacturing	Dongfeng Automobile Co., Ltd		
	Baoshan Iron & Steel Co., Ltd.	●	2.12%
	Hisense Electric Co., Ltd	●	0.14%
	Zhengzhou Yutong Bus Co., Ltd.	●	0.25%
	Phenix Optical Co., Ltd.		
	Tbea Co., Ltd		
	China—Kinwa High Technology Co., Ltd.		
	Shanghai Aerospace Automobile Electromechanical Co., Ltd		
	Beijing Tiantan Biological Products Co., Ltd.		
	Guangdong Shengyi Sci.Tech Co.,Ltd.		
	Shanghai Fosun Pharmaceutical (Group) Co.,Ltd.	●	0.56%
	Anhui Quanchai Engine Co.,Ltd.		
	Kaile Technology Co., Ltd.(Hubei)		
	Liaoning SG Automotive Group Co., Ltd	●	0.10%
	Guangzhou Pharmaceutical Co.,Ltd.	●	0.07%
	Yabao Pharmaceutical Group Co., Ltd.	●	0.13%
	JiLin Sino-Microelectronics Co.,Ltd		
	WanXiang Doneed Co.,Ltd.		
	Anhui Jianghuai Automobile Co.,Ltd		
	Jilin Jien Nickel Industry Co.,Ltd.	●	0.65%
	Hangzhou Silan Microelectronics Co.,Ltd.		
	Tianjin Benefo Tejing Electric Co.,Ltd.		
	Shanghai Zhixin Electric Co., Ltd		
	Jiangsu Jiangnan High Polymer Fiber Co.,Ltd.		
	Xiamen Tungsten Corp.	●	0.18%

	Beijing AriTime Intelligent Control Co., Ltd.		
	Zhejiang Xinan Chemical Industrial Group Co.,Ltd	●	0.46%
	Shanghai Highly (Group) Co., Ltd.		
	Guangzhou Shipyard International Company Limited	●	0.23%
	Anhui Heli Co.,Ltd.	●	0.15%
	Maanshan Iron & Steel Co.,Ltd. (MAS C.L.)		
	Shanghai Jielong Group Industry Co.,Ltd.		
	Long March Launch Vehicle Technology Co.,Ltd.	●	0.33%
	Nanjing Chemical Fibre Co.,Ltd.		
	Sdic Zhonglu Fruit Juice Co.,Ltd.	●	0.07%
	Hefei Rongshida Sanyo Electric Co.,Ltd.		
	Mayinglong Pharmaceutical Group Stock Co.,Ltd.		
	Zhejiang Hangmin Co.,Ltd.		
	Shandong Bohui Paper Industry Co.,Ltd.		
	Harbin Pharm Group Sanjing Pharmaceutical Shareholding Co.,Ltd		
	Jiangzhong Pharmaceutical Co.,Ltd.	●	0.12%
	Qingdao Haier Co.,Ltd.	●	0.56%
	Bright Dairy & Food Co.,Ltd.		
	Fujian Longxi Bearing (Group) Co.,Ltd.		
	Aeolus Tyre Co.,Ltd.		
	Wolong Electric Group Co.,Ltd.	●	0.15%
	Baoding Tianwei Baobian Electric Co.,Ltd.	●	1.03%
	Tianjin Tasly Pharmaceutical Co.,Ltd.	●	0.20%
	Changyuan Group Ltd.		
	Black Peony (Group) Co.,Ltd.		
	Wuhan Iron and Steel Co.,Ltd.		
	Jinxi Axle Co.,Ltd.	●	0.07%
	Fujian Nanfang Textile Co.,Ltd.		
	Baoji Titanium Industry Co.,Ltd.	●	0.26%
	Tongwei Co.,Ltd.		

	Liuzhou Chemical Industry Co., Ltd		
	Jiangxi Copper Co.,Ltd.	●	0.99%
	Zhejiang Longsheng Group Co.,Ltd	●	0.37%
	Markor International Furniture Co.,Ltd.	●	0.10%
	Shandong Huatai Paper Co.,Ltd.	●	0.21%
	Zhejiang Hisun Pharmaceutical Co.,Ltd.	●	0.18%
	Zhejiang Yankon Group Co.,Ltd.	●	0.08%
	Shandong Nanshan Aluminum Co.,Ltd.	●	0.35%
	Grinm Semiconductor Materials Co.,Ltd		
	Shanghai Belling Co.,Ltd.		
	NanZhi Co., Ltd.(Fujian)		
	Xining Special Steel Co.,Ltd.		
	Inner Mongolia Baotou Steel Rare-Earth Hi-Tech Co.,Ltd.	●	0.50%
	Laiwu Steel Corporation	●	0.18%
	Yunnan Yuntianhua Co.,Ltd.		
	Beijing Tongrentang Co.,Ltd	●	0.22%
	Citychamp Dartong Co.,Ltd.		
	Beijing Double□Crane Pharmaceutical Co.,Ltd.	●	0.34%
	Handan Iron & Steel Co.,Ltd.		
	Sany Heavy Industry Co.,Ltd.	●	0.94%
	Anhui Wanwei Updated High-Tech Material Industry Co.,Ltd.		
	Zhejiang Guyue Longshan Shaoxing Wine Co.,Ltd		
	Beijing Wandong Medical Equipment Co.,Ltd		
	Jinan Iron &Steel Co.,Ltd.	●	0.41%
	Youngor Group Co.,Ltd.	●	0.73%
	Beiqi Foton Motor Co.,Ltd.	●	0.36%
	Zhejiang Dongri Co.,Ltd.		
	Saic Motor Co.,Ltd.		
	Guizhou Redstar Developing Co.,Ltd.		
	Chengde Xinxin Vanadium and Titanium Co., Ltd.		
	TDG Holdings Co.,Ltd.		
	Yantai Wanhua Polyurethanes Co.,Ltd.	●	0.77%

	Anhui Xinke New Materials Co.,Ltd		
	QingHai HuaDing Industrial C0.,Ltd		
	Shanghai Zijiang Enterprise Group Co.,Ltd.		
	China Animal Husbandry Industry Co.,Ltd.	●	0.19%
	Henan Yuguang Gold & Lead Co.,Ltd.	●	0.38%
	Zhejiang Feida Environmental Science &Technology Co.,Ltd.		
	Nanchang Changli Iron & Steel Co.,Ltd.		
	Keda Industrial Co.,Ltd.	●	0.19%
	Jiangsu Yangnong Chemical Co.,Ltd.		
	Shandong Homey Aquatic Developme nt Co.,Ltd.		
	Zhuzhou Times New Materials Technology Co.,Ltd.		
	Henan Rebecca Hair Products Co.,Ltd.	●	0.19%
	Tangshan Sanyou Chemical Industries Co.,Ltd.		
	Nantong Jiangshan Agrochemical Chemicals Co.,Ltd	●	0.07%
	Sichuan Changhong Electric Co.,Ltd.	●	0.37%
	Shanghai Mechanical & Electrical Industry Co.,Ltd.	●	0.28%
	Tuopai Yeast Liquor Co.,Ltd.		
	Tsingtao Brewery Co.,Ltd.	●	0.35%
	Henan Zhongfu Industry Co.,Ltd	●	0.38%
	Tiandi Science & Technology Co.,Ltd.		
	AnYang Iron & Steel Lnc		
	Jiangsu Kanion Pharmaceutical Co.,Ltd.	●	0.16%
	Guizhou Wire Rope Co.,Ltd.		
	Bgrimm Magnetic Materials & Technology Co.,Ltd.		
	Beiren Printing Machinery Holdings Limited		
	Xinjiang Guannong Fruit & Antler Group Co.,Ltd.		
	Shanghai Diesel Engine Co.,Ltd.		
	Shanghai Electric Group Co.,Ltd.		
Transportation	China Shipping Development Co.,Ltd.	●	0.48%

	Sinotrans Air Transportation Development Co.,Ltd.	●	0.15%
	Guangshen Railway Co.,Ltd.		
	Tianjin Port Holdings Co.,Ltd.	●	0.54%
	Daqin Railway Co.,Ltd.		
	China COSCO Holdings Co.,Ltd.	●	1.83%
	Air China Limited		
	Hainan Shipping Haisheng Co.,Ltd.		
	Jiangxi Changyun Co.,Ltd.		
	Yingkou Port Liability Co.,Ltd.	●	0.17%
	China Railway Tielong Container Logistics Co.,Ltd.		
	Rizhao Port Co.,Ltd.		
	Henan Zhongyuan Expressway Co.,Ltd.		
	Fujian Expressway Development Co.,Ltd.	●	0.18%
	China Southern Airlines Co.,Ltd.		
	Shanghai International Port (Group) Co., Ltd		
	Anhui Expressway Co.,Ltd.		
	Guangzhou Baiyun International Airport Co.,Ltd.	●	0.22%
	Nanjing Tanker Corporation		
	Shanghai Pudong Road & Bridge Construction Co.,Ltd.		
	Shenzhen Expressway Co.,Ltd.		
	Cosco Shipping Co.,Ltd.	●	0.41%
	Ningbo Marine Co.,Ltd.		
	Zhongchu Development Stock Co.,Ltd.		
	Jiangsu Lianyungang Port Co.,Ltd.		
	Guangshen Railway Co.,Ltd.		
	Jiangxi Ganyue Expressway Co.,Ltd	●	0.37%
	Dazhong Transportation (Group) Co.,Ltd.	●	0.44%
Information and Communications Technology	China United Telecommunications Co.,Ltd.	●	2.90%
	Tsinghua Tongfang Co., Ltd	●	0.54%
	Tiancheng Co., Ltd of Taiyuan University of Technology		
	Jiangsu Hengtong Photoelectric Stock Co., Ltd.		

	Founder Technology Group Corp.		
	Shanghai Baosight Software Co., Ltd		
	Baosheng Science and Technology Innovation Co.,Ltd.	●	0.08%
	Insigam Technology Co.,Ltd.		
	Neusoft Corporation	●	0.25%
	Beijing C&W Technology Co.,Ltd.		
	Fiberhome Telecommunication Technologies Co.,Ltd	●	0.16%
	Aisino Co.,Ltd.	●	0.31%
	China Spacesat Co.,Ltd.	●	0.17%
	UFIDA Software Co. Ltd	●	0.23%
Financial Intermediaries	Shanghai Pudong Development Bank Co., Ltd	●	6.23%
	China Minsheng Banking Co.,Ltd.	●	6.92%
	Citic Securities Co., Ltd.	●	7.35%
	China Merchants Bank Co., Ltd	●	8.98%
	Pingan Insurance (Group) Co.,Ltd.	●	7.34%
	China CITIC Bank Co.,Ltd.		
	China Construction Bank Corporation		
	Bank of Communications Co.,Ltd.	●	8.14%
	Haitong Securities Co.,Ltd.		
	Bank of China Limited		
	China Life Insurance Co.,Ltd.		
	Industrial and Commercial Bank of China Limited.		
	Industrial Bank Co.,Ltd.	●	6.18%
	China Pacific Insurance (Group) Co.,Ltd.		
Whole Sale and Retail Trade	Cntic Trading Co., Ltd	●	0.08%
	Sinochem International Corporation	●	0.45%
	Xiamen C&D Inc.	●	0.51%
	Minmetals Development Co.,Ltd.	●	0.46%
	China National Medicines Co.,Ltd.	●	0.25%
	Xiamen International Trade Group Co.,Ltd.	●	0.24%
	Shanghai Jinfeng Wine Co.,Ltd.	●	0.20%
Energy	Chongqing Three Gorges Water Conservancy And Electric Power Co.,Ltd.		

	Guangxi Guidong Electric Power Co.,Ltd.		
	Nanhai Development Co., Ltd		
	Chongqing Fuling Electric Power Industrial Co.,Ltd.		
	Beijing Jingneng Thermal Power Co.,Ltd.		
	Shanghai Chengtou Holding Co., Ltd.		
	GD Power Development Co.,Ltd.		
	Datang International Generation Co.,Ltd.		
	Yunnan Wenshan Electric Power Co.,Ltd.		
	Sichuan Guangan AAA Public Co.,Ltd.		
	Top Energy Co.,Ltd.(Shanxi)		
	Shenyang Jinshan Thermoelectric Co.,Ltd.	●	0.12%
	Huaneng Power International, Inc.		
	Huadian Power International Co.,Ltd.		
	Guangzhou Development Industry (Holdings) Co.,Ltd.		
	Sichuan Chuantou Energy Co.,Ltd.		
	Shenergy Co.,Ltd.		
	China Yangtze Power Co.,Ltd.		
	SDIC Huajing Power Holdings Co.,Ltd.		
Extractives	Shanxi Lanhua Sci-Tech Venture Co.,Ltd	●	0.60%
	Yunnan Chihong Zinc & Germanium Co.,Ltd.	●	0.56%
	Shanghai Datun Energy Resources Co.,Ltd.		
	Offshore Oil Engineering Co.,Ltd		
	China Shenhua Energy Company Limited	●	5.57%
	Shanxi Lu'an Environmental Energy Development Co.,Ltd	●	0.99%
	PetroChina Co.,Ltd.	●	2.56%
	Aluminum Corporation of China Limited		
	Yanzhou Coal Mining Co.,Ltd.	●	0.54%
	Zijin Mining Group Co.,Ltd.		
	Kailuan Energy Chemical Co.,Ltd.	●	0.66%
	Jinduicheng Molybdenum Co.,Ltd		
	Western Mining Co., Ltd.		

	China Coal Energy Company Limited	●	1.21%
	Jinduicheng Molybdenum Co.,Ltd		
Construction	Shanghai Construction Co. Ltd		
	Beijing Urban Construction Investment& Development Co.,Ltd.		
	China Railway ERJU Co.,Ltd.(CREC)	●	0.46%
	China Gezhouba Group Co.,Ltd.	●	0.50%
	Shanghai Pudong Road& Bridge Construction Co.,Ltd.		
	CRBC International Co.,Ltd.	●	0.08%
	Changjiang & Jinggong Steel Building (Group) Co.,Ltd	●	0.11%
	Sinoma International Engineering Co.,Ltd.	●	0.26%
	China Railway Group Limited	●	1.65%
	China Railway Construction Co.,Ltd.	●	1.47%
	Shanghai Construction Co.,Ltd	●	0.26%
Real Estate	Beijing Vantone Real Estate Co.,Ltd	●	0.28%
	Nanjing Chixia Development Co., Ltd.		
	Shanghai Industrial Development Co.,Ltd.		
	Beijing North Star Co.,Ltd.		
	Beijing Airport High-Tech Park Co.,Ltd.		
	Gemdale Corporation	●	1.63%
	Huafa Industrial Co., Ltd	●	0.59%
	Poly Real Estate Group Co.,Ltd.		
	Tianjin Reality Development(Group) Co., Ltd.		
	Suzhou Hew District Hi-Tech Industrial Co.,Ltd.		
	Huayuan Property Co.,Ltd.		
Business Service	Jinling Hotel Co.,Ltd.		
	China Sports Industry Group Co.,Ltd.		
	China Cyts Tours Holding Co.,Ltd.	●	0.24%
	Shandong Expressway Co.,Ltd.		
	Shanghai DaZhong Public Utilities (Group) Co.,Ltd		
Entertainment	Beijing Gehua CATV Network Co.,Ltd.		
Others	Jilin Yatai(Group) Co.,Ltd.		

	Silver Plaza Group Co.,Ltd.		
	Shanghai Tianchen Co.,Ltd.		
	Guangxi Wuzhou Zhongheng Group Co.,Ltd.		
	Ningbo United Group Co.,Ltd.		
	Shanghai Zhangjiang Hi-Tech Park Development Co.,Ltd.		

Source: Shanghai Stock Exchange[89] and China Securities Index Co., Ltd

[89] Shanghai Stock Exchange Website, August 13, 2009 http://www.sse.com.cn/sseportal/webapp/datapresent/queryindexcnp?indexCode=000019&indexName