CHINA LAW UPDATE

TRANSFORMATION, CHALLENGE, AND OPTIMIZATION: THE ESG EVOLUTION OF CHINESE CORPORATE GOVERNANCE

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I. INTRODUCTION

Environment, Society, and Governance ("ESG") is a new framework to evaluate how an organization manages its risks and opportunities according to environmental, social, and governance criteria.[1] It is a response to various societal problems emerging from rapid industrialization, such as pollution and counterfeits. ESG criteria can help investors avoid investment losses when companies engaged in risky or unethical practices which are held accountable. Nowadays, the notion of ESG has been adopted by more and more investors, entrepreneurs, and regulators from all across the world.

Meanwhile, as corporations have become the major entities as well as driving forces in economic development, the governance of corporations turns out to be a critical topic and the quality of corporate governance highly influences the quality of economic growth. Since climate change and low-quality governance put trillions of dollars in public and private assets at risk, regulators and scholars start to discuss measures that companies should take to address these challenges. An important consensus is that ESG has become an unignorable component of corporate governance.[2]

This Note mainly focuses on how this ESG-transformative tendency influences Chinese corporate governance. Part II of the Note traces back to the emergence of the ESG concept in China and how Chinese legislators and regulators begin to respond to its integration with corporate governance; then in Part III, we analyze how this ESG transformation works through internal and external mechanisms from both theoretical and empirical perspectives; In Part IV, we discuss external and internal challenges for Chinese ESG corporate governance; and in Part V, we propose potential solutions borrowed from overseas practices.

[1] *See* Andy Green, *Making Capital Markets Work for Workers, Investors, and the Public: ESG Disclosure and Corporate Long-Termism*, 69 CASE W. RES. L. REV. 909 (2019).

[2] *See* UNEP Financial Initiative, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (Freshfields Bruckhaus Deringer, October 2005), https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.

II. A BRIEF HISTORY OF CHINESE ESG CORPORATE GOVERNANCE

A. The Emergence of ESG Concept in China

China has experienced very rapid growth for over four decades. While domestic infrastructure and industrial output witnessed rapid growth, the amount of carbon emission, however, is growing even faster. This extensive urbanization and industrialization led to the severe problem of pollution, and further, volatile climate change, which constitutes a long-time threat to the sustainable growth of Chinese economy. Thus, an ESG transformation is urgently needed. In China, ESG transformation is officially raised and confirmed by the address of the leadership and the strategic plan of the central government. President Xi Jinping announced new climate targets at the UN General Assembly in 2020, committing to peak carbon emissions before 2030 and to achieve carbon neutrality before 2060.[3] This commitment indicates the strong determination of the Chinese leadership to push forward the ESG transformation of the Chinese economy. The 14th Five-Year Plan (2021–2025) (the Plan) for National Economic and Social Development of the People's Republic of China (PRC), as the United Nations Development Program commented in its policy brief, underscores the sustainability of the Chinese economy and the greening of all economic sectors.[4]

With official support, Chinese legislators joined their counterparts in the EU and the US to add ESG elements to the national legal system. One of the examples is that the green principle has been enshrined in the Civil Code of the People's Republic of China (the "Civil Code"). Under this principle, combined with secondary regulations and administrative guidelines, China established a responsibility system to guarantee green development. The expansion of environmental liability and the obligation to protect the ecological environment could be detected in the Civil Code which signifies an eco-friendly approach to Chinese civil law.[5] This is a response to the political advocation of ESG from the top, and further, a clear indication that ESG has become an indispensable element of the Chinese legal system.

It is noteworthy that the discussion of the ESG concept in China primarily highlights the "E" field of ESG transformation, which is particularly emphasized by the top leadership. Thus, the majority of Chinese ESG regulations are relevant to eco-requirements or eco-liabilities. This special attention complies with the top leaders' determination to reform the national development mode.

[3] See *China Headed Towards Carbon Neutrality by 2060*, UN NEWS (Sep. 21, 2021), https://news.un.org/en/story/2021/09/1100642 (last visited Sep. 30, 2022).

[4] *See* UNDP, *Issue Brief - China's 14th 5-Year Plan: Spotlighting Climate & Environment* (Jul. 23, 2021), https://www.undp.org/china/publications/issue-brief-chinas-14th-5-year-plan-spotlighting-climate-environment (last visited Sep. 30, 2022).

[5] *See* Tiantian Zhai & Yen-Chiang Chang, *The Contribution of China's Civil Law to Sustainable Development: Progress and Prospects*, 11 SUSTAINABILITY 294 (2019).

B. The Development of Chinese ESG Legal and Regulatory Regime on Corporate Governance

Despite being a recent concept, the idea of ESG has long been adopted in the Chinese legal and regulatory system, particularly in the area of corporate governance, and can be traced back to the revision of the Company Law of the People's Republic of China (the "Company Law") in 2005. The 2005 revision added an Article 5, which stipulates that a company shall act in good faith and bear social responsibilities obligating Chinese companies to take account of ESG factors in their day-to-day operations. Simultaneously, Articles 46 and 47 of the 2005 Company Law further require directors to be in charge of the plans for operation and investment[6] and shoulder fiduciary duties.[7] Thus, ESG issues become the responsibility of company directors and an important topic in Chinese corporate governance.

At first, ESG elements are additional requirements for companies of specific forms or in specific sectors. Regulators mainly focused on listed companies and financial institutions, with consideration of their substantial impact on the national economy. In 2012, the former China Banking Regulatory Commission formulated the Guidelines for Green Credit, an ESG regulation on the operation and governance of Chinese financial institutions. As required by this guideline, the board of directors and the council of banks should be responsible for formulating the green credit development strategy, examining and approving the green credit goal and the green credit reports submitted by the senior management, and supervising and evaluating the implementation of the green credit development strategy of the institution.[8] Pursuant to the Code of Corporate Governance of Listed Companies (2018 Revision), a listed company shall actively implement the concept of green development, integrate the requirements for ecological environmental protection into the corporate governance process and actively perform the social responsibilities in community welfare, disaster relief, poverty alleviation, and other respects.[9] In recent years, the ESG requirement of corporate governance begins to generalize. Companies, in addition to those publicly traded or licensed financial entities, are urged by regulators to incorporate ESG elements into their governance structure as well. One piece of evidence is that all Chinese companies are now required to establish their management of law-based disclosure of environmental information. According to the Measures for the Administration of the Law-based Disclosure of Environmental Information by Enterprises, a newly issued regulation on the

[6] *See* Gongsi Fa (公司法) [Company Law] (2005 Revision) (promulgated by the Standing Comm. Nat'l People' s Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 47, CLI.1.60597 (Chinalawinfo).

[7] *See id.*, art. 148.

[8] *See* Lüse Xindai Zhiyin (绿色信贷指引) [The Guidelines for Green Credit] (promulgated by the China Banking Regulatory Commission, Jan.29, 2012, effective Jan.29, 2012) art. 7, CLI.4.168015 (Chinalawinfo).

[9] *See* Shangshi Gongsi Zhili Zhunze (上市公司治理准则) [Code of Corporate Governance of Listed Companies] (promulgated by St. Council, Sep. 30, 2018, effective Sep. 30, 2018), art. 87, CLI.4.322372 (Chinalawinfo).

disclosure of environmental information, Chinese companies are subject to law-based requirements to disclose environmental information.[10] To satisfy such law-based requirements with respect to the disclosure of environmental information, companies shall establish and improve the rules for the management, standardize work procedures, define work responsibilities, establish accurate environmental information management ledgers, properly preserve relevant original records, conduct statistical analysis, and collect environmental information in a scientific manner.[11] That is to say, since then, ESG concern has become an obligatory factor in commercial activities in China. Accordingly, a proper form of corporate governance to mitigate ESG risks and improve business performance under ESG restraints turns out to be a necessity for Chinese enterprises.

III. THE ESG-TRANSFORMATION IN CHINESE CORPORATE GOVERNANCE

Accompanied by the development of ESG regulatory regimes, Chinese companies began to transform their corporate governance systems. This ESG transformation could be considered in two aspects: external mechanisms (how companies tackle outsiders, such as shareholders, stakeholders, and the regulatory authority) and internal mechanisms (how companies manage themselves).

External mechanisms are in the demand of those outside an organization and serve the objectives of entities such as regulators, investors, trade unions, and financial institutions. Typically, companies are required to report their operation status and critical financial information to external stakeholders. Meanwhile, internal mechanisms always serve the internal objectives of the corporation and its internal stakeholders, including employees, managers, and shareholders. These objectives include smooth operations, clearly defined reporting lines, and performance measurement systems. Internal mechanisms include oversight of management, independent internal audits, the structure of the board of directors into levels of responsibility, segregation of control, and policy development.[12] The following paragraphs of this part will deliberate how Chinese companies change their internal and external corporate governance mechanisms under the ESG notion.

A. ESG-Transformation in External Mechanisms

The external mechanisms of corporate governance in China at first just followed the pattern of Western countries, which promoted and protected the interests of its shareholders with the belief of "shareholder primacy theory."

[10] *See* Qiye Huanjing Xinxi Yifa Pilu Guanli Banfa (企业环境信息依法披露管理办法) [Measures for the Administration of the Law-based Disclosure of Environmental Information by Enterprises] (promulgated by Ministry of Ecology and Environment, Dec. 11, 2021, effective Feb. 8, 2022), art. 5, CLI.4.5112674 (Chinalawinfo).

[11] *See id.*, art. 4.

[12] *See* Stuart L. Gillan , *Recent Developments in Corporate Governance: An Overview*, 12 J. CORP. FIN. 389 (2006).

Since one hundred years ago, Western scholars tend to believe that the corporation was only a vehicle to promote and protect the interests of its shareholders, and the interpretation of corporate law should reflect the abovementioned theory. The spirit of this theory had been applied in practice like *Dodge v. Ford Motor Co.* (1919) whereunder ESG was a completely voluntary concept.[13]

However, the external mechanisms gradually exposed some limitations regarding their scope of supervision and protection under the adjustment of society's interests, which bolstered the transformation of the external mechanisms, and furthermore, the essence of ESG. With the boom of some corporations, their domination of the economy and society had given them a disproportionate political influence. These corporations, which enjoyed oligopolistic economic power, dangerously distorted the value-discovery function and the fundamental price mechanism of the market-oriented economy. They determined the production and prices of products, which led to a lack of free competition in the marketplace. As a result, some reformers in America have called for a review of the corporate system to hold large public corporations and entrepreneurs accountable not only to shareholders but to society as a whole. They held that the government should intervene in large public corporations for promoting the corporations to advocate ESG, including the concept of "urban disease," and reflections on the Vietnam War, mixed with feminism, student movements, and socialist thinking.[14] The earliest discussion of the necessity of ESG-related information in China can be traced back to the initial period of reform and opening up. Here are some views reflecting the different facets of "ESG":

From the perspective of "E," some scholars like Liu Hongqi stressed that the development of an enterprise's production should comply with the ecological law and pay attention to environmental protection.[15] From the perspective of "S," Professor Xu Chunhou proposed that enterprises are the "cells" of the social and economic "body," which have an inescapable responsibility to society.[16] At the same time, Professor Wang Qiucheng also appealed that enterprises should take social responsibility.[17] From the perspective of "G,"

[13] *See* Milton Friedman, *The Social Responsibility of Business Is to Increase Profits*, NEW YORK TIMES (Sep. 13, 1970), at 17, https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html. *Also see* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668, 1919 Mich. LEXIS 720, 3 A.L.R. 413.

[14] *See* C. A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century*, 51 KANSAS L. REV. 77, 83-86 (2002).

[15] *See* Liu Hongqi (刘洪岐), *Baohu Huanjing Fazhan Shenchan* (保护环境, 发展生产) [*Protect the Environment and Develop Production*], 5 HUANJING BAOHU (环境保护) [ENVIRONMENTAL PROTECTION] 12 (1980).

[16] *See* Xu Chunhou (徐淳厚), *Shilun Shangye Qiye de Shehui Zeren* (试论商业企业的社会责任) [*A Discussion on Social Responsibility of Business Enterprises*], 9 JINGJI ZONGHENG (经济纵横) [ECON. REV. J.] 44 (1987).

[17] *See* Wang Qiucheng (王秋丞), *Shangye Qiye de Shehui Zeren* (商业企业的社会责任) [*Social Responsibility of Business Enterprises*], 2 JIANGSU SHANGYE GUANLI GANBU XUEYUAN XUEBAO (江苏商业管理干部学院学报) [J. JIANGSU INSTITUTE OF COMMERCE] 21 (1987).

Wu Jinglian, who is a Chinese economist, suggested that an enterprise shall clearly delineate the respective rights, responsibilities and interests of shareholders, directors, and managers, thus forming a relationship of check and balance among them.[18]

More and more public attention and market practices in China on ESG issues rise an urgent need for regulators to rethink the external mechanisms, which were supposed to force corporations to consider the interests of non-shareholders when making business judgments, and help stakeholders utilize the disclosed information to urge the corporation to implement ESG responsibility. Chinese regulators have enhanced and optimized ESG regulations on external mechanisms, which can be seen from the following aspects:

Firstly, the concept of ESG is directly stipulated in the relevant laws of China in the form of "examples + details" through the phrase "Social Responsibility." In accordance with Article 5 of the Company Law revised in 2018, "[w]hen conducting business operations, a company shall comply with the laws and administrative regulations, social morality, and business morality. It shall act in good faith, accept the supervision from the government and the general public, and bear social responsibilities." Article 86 of the Civil Code stipulates: "In business activities, a for-profit legal person shall comply with business ethics, maintain the safety of transactions, receive government supervision and public scrutiny, and assume social responsibilities." The Company Law (Second Review of Revised Draft) divides Article 5 of the Company Law into Articles 19 and 20, further clarifying the connotation of corporate social responsibility.[19]

Secondly, the specific content of ESG has been directly institutionalized into a series of legal provisions. The Company Law has promoted the implementation of responsibility based on information disclosure from self-discipline to more binding corporate compliance. For example, for the discourse mechanism between enterprises and stakeholders, a series of legal systems have emerged around the protection of minority investors, such as cumulative voting rights, dissenting shareholders' right to repurchase their shares, and shareholding representative litigation, etc. For the protection of employees' interests and their enthusiasm, a bunch of measures such as the system of trade union organization, worker representatives, and worker assembly, are designed.

Thirdly, starting with the Guidelines for the Governance of Listed Companies issued in 2002, China has continuously promoted the disclosure of ESG-related information. At present, with the comprehensive promotion of corporate ESG responsibility in China, the preparation and release of ESG responsibility reports have also become a trend. According to the statistics from Yi Dong, the number of Chinese A-share listed companies disclosing ESG reports has

[18] *See* Wu Jinglian (吴敬琏), *Shenme Shi Xiandai Qiye Zhidu* (什么是现代企业制度) [*What Is the Modern Enterprise System*], 1 GAIGE (改革) [REFORM] 17 (1994).

[19] *See* Gongsi Fa, *supra* note 6, arts. 18, and 19.

increased from 22 in 2007 to 1147 in 2021, and the disclosure of ESG reports by Chinese A-share listed companies is in a stage of leapfrog development.[20]

B. ESG-Transformation in Internal Mechanisms

1. New Roles of Directors. In corporate governance, directors believed to bear fiduciary duties to the corporation, are significant participants in the internal mechanism. Thus, the transition of the corporate purpose influences the role of directors. An influential theory called the "multi-fiduciary model", calls for taking account of the varied interests of multiple corporate constituencies in decision-making.[21] Particularly for the listed companies, which always have dispersed ownership structures and stronger social influences, directors shall be encouraged to serve the joint interests of all stakeholders who comprise the corporation by coordinating different demands of any single stakeholder group, including the shareholders.[22] Nowadays, directors may pay attention to the ESG fiduciary duty when they make crucial business decisions such as corporate investment and merger and acquisition.

In practice, to meet this transformative demand on the directorship, Chinese companies begin to innovate the form of the board. It can be witnessed that more and more listed companies have established specific committees to be responsible for ESG issues. According to the Work Plan for Improving the Quality of Listed Central State-owned Enterprises issued by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC), directors of state-owned enterprises will be responsible for corporate ESG issues and all listed central state-owned enterprises will establish specific committees for ESG issues and publish ESG annual reports.[23] It means that over 350 Chinese listed companies will renew their boards under the ESG-transformative trend.

2. Participation of Institutional Investors and Their Fiduciaries. Under the traditions of securities law, fiduciaries of institutional investors, such as pension fund trustees, asset managers, and equity investment advisors, shall in principle put their clients' or beneficiaries' interests before their own.[24] In the ESG era, taking ESG factor into account, the general responsibility of institu-

[20] Statistics are from Yi Dong database (易董), http://www.easy-board.cn/new/IPOPortalSite.html (last accessed Sept. 30, 2022).

[21] *See* Jeffrey Nesteruk, *Law, Virtue, and the Corporation*, 33 AM. BUS. L. J. 473 (1996).

[22] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[23] SASAC (国务院国有资产监督管理委员会), Tigao Yangqi Konggu Shangshi Gongsi Zhiliang Gongzuo Fang'an (提高央企控股上市公司质量工作方案) [Work Plan for Improving the Quality of Listed Central State-owned Enterprises (SOEs)], May 27, 2022, http://www.gov.cn/xinwen/2022-05/27/content_5692621.htm.

[24] *See* Green, *supra* note 1.

tional investors and specifically their fiduciaries may incorporate the following content:

Basically, corporate ESG performance shall be one of the criteria for institutional investors to decide on their investment. Today many institutional investors favor ESG funds or those companies pursuing ESG goals, not for moral reasons or a prosocial willingness to sacrifice profits, but because ESG is thought to provide sustainable long-term value or higher returns for shareholders.[25] To fulfill their diligent responsibility of maximizing the returns of their clients, institutional investors shall conduct value-enhancing ESG research. In addition, there is an obligation for institutional investors to reduce the ESG risk. Fraud, self-dealing, and environmentally illegal conduct do occur and could lead to harsh penalties. Even though institutional investors may be exempted from the direct penalty, their investment in the corporate may suffer a reverse. Thus, as the manager of clients' assets, fiduciaries of institutional investors may fail to fulfill their fiduciary duty.

Bearing ESG fiduciary duties urges institutional investors to more actively participate in corporate governance, or in other words, rational apathy is replaced by a more ESG-active approach. This participation is always conducted in the way of supervision or evaluation. For example, the United Bank of Switzerland ("UBS") has put forward ESG Risk Radar for Chinese banks. The Risk Radar is a simple risk assessment matrix in which the sector analysts identify ESG factors they deem most material to sectors and companies, and consider the financial impact in terms of likelihood, impact, and timing. To link ESG risk factors with financial impact, UBS offers a further elaboration on the assessments and makes explicit connections between these risk factors and companies' key value drivers, based on the insights of their analysts.[26]

IV. CHALLENGES FOR THE ESG OF CHINESE CORPORATE GOVERNANCE

A. *External Challenges: Non-uniformity of ESG Standards*

Firstly, the Chinese government has already established an ESG disclosure framework but failed to enact clear disclosure standards, and the non-uniformity of disclosure standards in the market makes it difficult to compare different companies under the same dimension. The type of ESG information that needs to be disclosed is not clear, which is easy to produce a "masking effect" and makes it even more difficult for stakeholders to effectively supervise the disclosure based on an ambiguous benchmark. For example, the three-tier classification standard in the SynTao Green Finance's report does not explicitly involve any indicators like the disclosure of executive incentives and

[25] *See* Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2563-64 (2021).

[26] *See* Grant McCasker, *ESG Risk Radar China Banks*, GLOBAL RESEARCH AND EVIDENCE LAB OF UBS 1-2 (2022).

corporate risk management (see Table 1).[27] On the contrary, in June 2022, the China Enterprise Reform and Development Society took the lead in drafting and jointly launched Guidance for Enterprise ESG Disclosure (T/ CERDS 2-2022), which clearly requires the disclosure of executive incentives and corporate risk management. Whether these disclosure standards are scientific or not, which one is more reasonable for companies to be in conformity with, and whether similar indicators in different standards can be compared have not been directly responded to by the Chinese government.

TABLE 1. THE THREE-TIER CLASSIFICATION STANDARD IN THE SYNTAO GREEN FINANCE'S REPORT[28]

Primary Indicators	Secondary Indicators	Tertiary Indicators
E	Environmental management	Environmental management system, management objectives, employees' environmental awareness, energy and water conservation policies, green procurement policies, etc
	Environmental disclosure	Energy consumption, energy conservation, water consumption, greenhouse gas emissions, etc
	Negative environmental events	Water pollution, air pollution, waste pollution, etc
	Employee management	Labor policy and employee training
	supply chain management	Supply chain responsibility management, supervision system, etc
	customer management	Confidentiality of customer information, etc
S	Community management	Community communication, etc
	Product management	Fair trade products, etc
	Public welfare and donation	Enterprise foundations, donations and public welfare activities, etc
	Social negative events	Negative events of employees, supply chain, customers, society and products
G	Business ethics	Anti corruption and bribery, reporting system, tax transparency, etc
	Corporate governance	Information disclosure, independence of the board of directors, executive compensation, diversity of the board of directors, etc
	Negative events of corporate governance	Negative events of business ethics and corporate governance

Secondly, the ESG disclosure and supervision mechanism is in dearth of industrial pertinence. On the basis of the serial ESG disclosure regulations adopted by the Securities Supervision Commission, Shenzhen Stock Exchange and Shanghai Stock Exchange, there has been industrial pertinence to some

[27] *See* An Guojun (安国俊) et al., *Tanzhonghe Mubiao Xia ESG Tixi Dui Ziben Shichang Yingxiang Yanjiu—Jiyu Butong Hangye de Bijiao Fenxi* (碳中和目标下ESG体系对资本市场影响研究——基于不同行业的比较分析) [*Study on the Impact of ESG System on Capital Market under Carbon Neutral Target—A Comparative Analysis Based on Different Industries*], 3 JINRONG LILUN YU SHIJIAN (金融理论与实践) [FIN. THEORY & PRAC.] 52 (2022).

[28] Statistics are from SynTao Green Finance's Report.

extent for Environment (E) disclosure: the key emission companies identified by the environmental protection department or its major subsidiaries should disclose environmental information; while other companies are not obliged to prepare and disclose separate environmental responsibility reports (which is encouraged nevertheless), they should fully explain the reasons behind the non-disclosure of environmental information. However, there is no industrial pertinence shown in current Chinese disclosure rules for social responsibility (S) and governance (G). The lack of industrial pertinence may increase the burden of disclosure, which means useless procedures and costs of corporations. For example, environmental information disclosure might be the priority of the manufacturing industry, while the governance arrangement seems to be more important for credit agencies. What's more, the forced unifiable disclosure demand may cause a higher "crash risk." As China's current disclosure policy on ESG is voluntary, enterprises may abuse this encouragement to cover up the whitewash of problems in corporate operations, which undoubtedly increases the risk of a sudden plunge in the stock price.[29]

B. Internal Challenges: Lack of Incentive for ESG Governance and Compliance

For commercial entities, establishing ESG inner governance and compliance system usually means more employment, lower operating efficiency, and thus extra financial burdens. Hence, the promotion of ESG requires an expected return from investors or consumers to sustain. However, there is no theoretical or empirical consensus on whether ESG governance and compliance are financially beneficial to companies.

On the one side, some researchers have indicated that compliance of ESG is beneficial to the finance of enterprises. For instance, An Guojun et al. believe that the performance of ESG can promote the stock price of enterprises.[30]

On the other side, some researchers argue that the cost incurred from compliance with ESG cannot be covered by the revenue generated. In the meantime, the impact on the stock price of enterprises varies among different industries while the statistics of the ESG information disclosure of listed companies in China are not enough to give a decisive conclusion.[31]

V. SOLUTIONS FROM OVERSEAS EXPERIENCES

In order to cope with aforementioned challenges, after the examination of overseas practices, a suggestion raised by this Note is that the government, industries and corporations should work together to build an ESG information

[29] *See* Shi Tiantao (施天涛), *Gongsi Fa Di 5 Tiao de Lixiang Yu Xianshi: Gongsi Shehui Zeren He Yi Shishi?* (《公司法》第5条的理想与现实：公司社会责任何以实施?) [The Ideals and Realities of Article 5 of the Company Law: How Can Corporate Social Responsibility Be Implemented?], 5 QINGHUA FAXUE (清华法学) [TSINGHUA UNIV. L. J.] 78 (2019).

[30] *See* An et al., *supra* note 27.

[31] *See id.*

disclosure regime which is categorized but inherently uniform within each industry, and on this basis, improve the incentive for ESG governance.

A. External Mechanism: The Uniformity of ESG Information Disclosure Within the Industry

On the one hand, uniformity is an effective means to alleviate external challenges. For instance, Nasdaq conducted an internal study of the current state of board diversity among Nasdaq-listed companies based on public disclosures, which is highly related to the ESG information disclosure, and found that current reporting of board diversity data was not provided in a consistent manner or on a sufficiently widespread basis. As such, it is convincing that investors are not able to readily compare board diversity statistics across companies. Accordingly, Nasdaq proposes to require each of its listed companies to implement its board diversity rules: (i) providing statistical information regarding diversity among the members of the company's board of directors under the proposed Rule 5606; and (ii) having, or explaining why it does not have, at least two "diverse" directors on its board under the proposed Rule 5605(f)(2). The board diversity rules stipulate compulsory disclosure obligations regardless of the merits of the disclosed reasons. These rules are expected to alleviate the adverse impact of non-uniform ESG standards to some extent.

On the other hand, the uniformity shall be within the scope of the industry or enterprises running similar businesses. Just as mentioned above, the unitary disclosure rule may increase the risk of corporate collusion. To meet the objective of diversity, the Nasdaq board diversity rule provides flexibility for Smaller Reporting Companies and Foreign Issuers by including two female directors and for companies with five or fewer directors by including one diverse director.

B. Internal Mechanism: Enhanced Obligations of Directors

Directors of companies are urged by legislators and regulators to make critical assessments of the environmental and social influences of business decisions made by the company. The best example is the newly revised French law which stipulates exactly how French companies are expected to manage ESG risks. The so-called "Duty of Care" law, which also came into effect in 2018, imposes a "duty of care plan" on directors to disclose, manage, and prevent ESG-related risks. A care plan shall identify and mitigate environmental, health, safety, and corruption risks throughout the supply chain, which includes those of their subsidiaries, subcontractors, and suppliers, in France and abroad.[32] Failure to comply with the law or to implement such a plan may incur

[32] *See* Adina Ponta, *Directors' Duty of Loyalty and Care in Light of New European Perspectives*, 2 REVISTA ROMANA DE DREPT AL AFACERILOR 17, 36 (2018).

a fine in an amount up to € 30 million. Concretely, the boards of French companies are required to publicly disclose the followings:[33]

> "(i) a risk mapping aimed at identifying, analyzing and classifying the risks;
>
> (ii) procedures for regular evaluation of the situation of subsidiaries, subcontractors and suppliers;
>
> (iii) appropriate actions in order to mitigate the risks and prevent serious harm;
>
> (iv) a warning mechanism and a compilation of all the reports and alerts related to the existence and materialization of such risks;
>
> (v) mechanism for monitoring the measures taken and an evaluation of their efficiency."

Scholars acclaim that this enhancement of the ESG obligation of directors is a landmark of the ESG concept integrated into corporate and commercial legal regimes and may lead to a progressive movement of ESG wave in the business world.[34] A persuasive example is the French oil and gas giant Total has remarkably improved its human rights and environmental performance in developing countries and emerging markets since the launch of the new law according to recent academic research.[35]

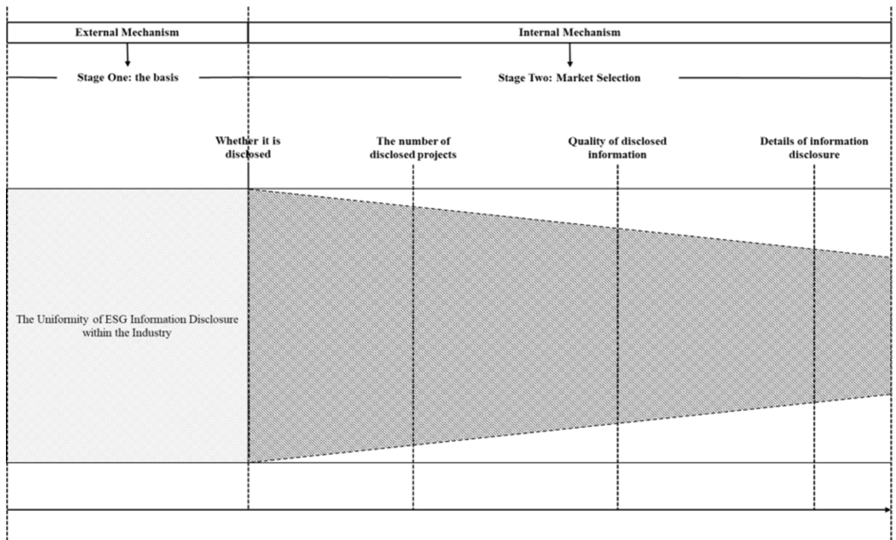
To summarize, a hypothetical ideal ESG corporate governance model seems to be a two-stage system from our perspectives. As Figure 1 shows, in the first stage, the external mechanism based on a uniformed ESG information disclosure within industries obligates companies to shoulder the ESG responsibility, to avoid corporate behaviors damaging the basic rights and interests of stakeholders and public interests. Specifically, it at least includes the implementation of environmental laws and regulations, consumer protection, and the handling of labor relations. Then, guided by corporate law and regulatory guidelines, directors of companies will be in charge of which, when, and how ESG issues should be solved and disclosed. In the stage of the internal mechanism, based on the external system under the unified ESG standard within industries, the market can give full play to its role based on directors of companies: it does not require the compulsory disclosure of listed companies within an industry, but once the unified standard is measured, it can self-evaluate the "advantages and disadvantages" of listed companies.

[33] Sandra Cossart et al., *The French Law on Duty of Care: A Historic Step Towards Making Globalization Work for All*, 2 BU. & HUM. RIGHTS. J. 317, 319 (2017).

[34] *See id.*, at 322.

[35] *See* Almut Schilling-Vacaflor, *Putting the French Duty of Vigilance Law in Context: Towards Corporate Accountability for Human Rights Violations in the Global South*, 22 HUM. RTS. REV. 109 (2021).

FIGURE 1. A HYPOTHETICAL IDEAL ESG CORPORATE GOVERNANCE MODEL



VI. CONCLUSION

With policy support and regulatory pressure, Chinese ESG corporate governance is rapidly progressing. Directors of Chinese companies begin to take ESG factors into their decisions on corporate operations, known as internal issues of companies. In addition, more and more Chinese companies intentionally disclose ESG-related information to external stakeholders—investors, regulators, suppliers, and media. Both the internal and external mechanisms of Chinese ESG corporate governance have experienced a transformation. Meanwhile, the absence of standard uniformity and financial incentive disappointingly impedes further improvement.

To solve these problems, possible solutions may still rely on an optimization of the external and internal mechanisms of corporate governance. Overseas practices suggest that Chinese legislators and regulators may uniform the disclosure standard of ESG information, and leave the autonomy of deciding how to disclose it to the directors. To monitor directors' decision-making processes, an ESG obligation shall be imposed on directors who should face civil, administrative, or even criminal penalties for any failure to comply with ESG requirements.