BACKGROUND

As Mainland China and Hong Kong operate under a one-country, two-systems arrangement, we take great care in considering the differences and coherence needed for the governance systems to function in both. In our engagement work, we take into account the interconnectedness of the two systems and how they influence corporate behaviours. Major similarities and differences of the two systems are highlighted in Graph 1. Mainland China largely follows the German civil code BGB and its locally incorporated companies have a dual board structure consisting of a board of directors and a supervisory board. This remains the same when the companies list in Hong Kong. The Company Law and the Securities Law provide the foundation for drawing up and developing the corporate governance framework in Mainland China. The Code of Corporate Governance for Listed Companies was issued in January 2002, by the China Securities Regulatory Commission (CSRC) and the State Economic and Trade Commission. The Code is legally binding and applies to all listed companies in Mainland China.

Over the past 20 years, the progress made by domestic capital markets in Mainland China has reflected the country’s economic development. The reform of share ownership in Chinese companies aimed at bringing in private sector investment has encouraged competition and more business-oriented behaviours among state-controlled companies. For example, boards are now setting business targets and creating incentive schemes for management. Private enterprises have grown significantly and a major shift has occurred in the profile of those who own tradable securities. A domestic institutional investment community has emerged. In 2011, the CSRC published an assessment on corporate governance developments in China, which acknowledged that, given China’s concentrated ownership structure, potential conflicts of interest between majority and minority shareholders are a core corporate governance issue. We strongly support the efforts made by the regulators in strengthening the corporate governance frameworks in Mainland China and the commitments by companies to treat all shareholders equitably and take into account the interests of all stakeholders. We are pleased to see the China Institute of Finance and Capital Markets, a think tank affiliated with the CSRC, advocating green finance, with lending priorities to low-carbon economy projects and businesses and restrictions on lending to high risk sectors that may lead to environmental degradation and pollution.

Despite positive momentum to improve environmental, social and governance standards in Mainland China and in Hong Kong, we feel the following areas are in need of further improvements: the quality and diversity of boards, the protection of minority shareholders and the disclosure of related party transactions. Special attention should also be paid to their effective implementation and enforcement. Corporate governance in China may further improve through engagement from foreign institutional investors. We welcome opportunities where we can contribute with international best practice examples that could apply in Mainland China and Hong Kong.

Under a separate legal system, Hong Kong-incorporated companies follow common law and have a one-tier board structure. The board comprises executive directors, non-executive directors and independent non-executive directors. In Hong Kong, the first formal corporate governance initiative was launched in 1992, when the Hong Kong Stock Exchange (HKEx) introduced the Corporate Governance Project to enhance and promote a higher standard of corporate governance for local issuers. Influenced by international developments, the HKEx introduced its first Code of Best Practice in 1993. This served as a non-mandatory guideline for companies to devise their own codes of board practices. In 2005, the HKEx replaced the Code of Best Practice with the Code on Corporate Governance Practices. This led to a new set of listing rules requiring companies to include a corporate governance report in their annual reports. The comply-or-explain approach was adopted. However, we are mindful that this approach can be misused. Companies can use the same boilerplate explanation to justify compliance over an extended period of time. We expect an honest and thorough explanation that reflects the changing circumstances faced by the company over the reporting period especially when it comes to explaining committee structures that deviate from best practices and the independence of directors that serve beyond the recommended nine-year limit.

Figure 1 Corporate Governance Overview in Mainland China and Hong Kong

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Mainland China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Framework</td>
<td>German Civil Code</td>
<td>English Common Law</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Control system of listed companies</th>
<th>Mainland China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of directors</td>
<td>Three-year term, can serve consecutive terms</td>
<td>Three-year term, can serve consecutive terms</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Supervisory board</th>
<th>Mainland China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors</td>
<td>At least one third independent</td>
<td>At least one third independent</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Audit committee</th>
<th>Mainland China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent directors</td>
<td>At least one third independent</td>
<td>At least one third independent</td>
</tr>
</tbody>
</table>

---

We believe that transparency and consistency in reporting are required, especially given the differences of the two-systems model. With regard to financial reporting, we are pleased to see that the Chinese government has made a public commitment to move towards a single set of global accounting standards and has made significant progress in the convergence of the local accounting standards with the International Financial Reporting Standards (IFRS). We pay particular attention to the accuracy and robustness of the financial accounting of Chinese companies. We also encourage Chinese companies whose securities are traded on the HKEx to opt for IFRS for financial reporting to meet the expectations of international investors and stakeholders.

Following the introduction of Corporate Social Responsibility (CSR) reporting requirements in 2008, all Mainland China-listed companies now report annually on their CSR activities. Aside from disclosure on employee rights and environmental protection, CSR can at times be segregated from a company’s core activities. A notable proportion of CSR reports is philanthropic in nature, which distinguishes it from the environmental, social and governance (ESG) reporting in Hong Kong. Companies therefore should not treat their CSR reports, which are compliant in Mainland China, as an equivalent to Hong Kong ESG reports that link material ESG issues to potentially material financial impacts in core business activities, even though there may be some overlap in the topics covered.

We recommend Mainland Chinese and Hong Kong-listed companies adopt the recommendations of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD). We expect companies to provide the relevant disclosures in their annual financial filings, including the determination of the materiality of other information included in their filings. If companies do not report fully against the recommendations of the TCFD, they should explain their reasons for not doing so.

Whether it is financial, CSR or ESG or integrated reporting, the objective of all reports should be to enable investors to conduct global peer and historical comparisons, with consistency in data and presentation. We recommend companies that are already producing CSR reports in Chinese to consider producing English versions for international investors.

**SHAREHOLDING STRUCTURES**

**Mainland China**

China is undergoing a reform of its ownership structures, therefore attracting private sector capital and diversifying and internationalising the shareholding structure of its state-owned enterprises (SOEs). For this process to proceed smoothly, we recommend enhanced transparency in the appointments of board members and senior executives, independent third party board evaluation, improvements in investor access to board members, as well as the protection of minority shareholders. We are concerned about opaque and abrupt changes to executive management at companies that do not have a robust nomination and selection process in place.

We place great importance on observing state policy expectations and objectives in our engagement activities. We are firm supporters of relevant ESG initiatives that relate to, for example, climate change, environmental protection, improvements in health and safety systems, as well as the introduction of codes of ethics and anti-bribery and corruption policies.

**Hong Kong**

Hong Kong’s listing rules require a minimum free float of 25% for most companies, which is why families or founders often retain the control of listed companies. A good number of these families or entrepreneurs are advocates of sustainable and responsible companies. Through common interests on issues such as employee relations and environmental sustainability, we aim to gain better access to family members and to understand how they see the future of the company alongside their own interests.

In relation to governance, our discussion focuses on succession planning, board structure and the appointment of independent non-executive board directors. In particular, we encourage companies with a combined chair/CEO or a dominant shareholder to consider appointing a lead independent director. The main roles and responsibilities of a lead independent director are as follows:

- Represent the interests and views of minority shareholders on the board
- Chair meetings of independent non-executive directors
- Consolidate the views of other board directors and act as a constructive counterweight to executives and major shareholders on the board
- Manage committees and government investigations (if any) as a non-executive but informed party of the company

Given the number of related party transactions and investigations into bribery and corruption connected to the government and senior executives, a suitably qualified lead independent director can add transparency and rigour to the governance process of companies.

China’s Company Law requires SOEs to establish a party committee to facilitate party activities and the implementation of government policies. In 2015, the China Communist Party issued a directive, which requires SOEs to specify in their articles of incorporation (AOI) the legal status of the party committee and how party activities will be...
facilitated. However, the directive also sets out the rights of company boards to make material decisions, elect and appoint management and personnel, design remuneration, as well as the rights of the management to independently run the company. In addition, no regulations explicitly grant the party committee the authority to override a legitimate board, and the board has full discretion over how the articles are altered to reflect the requirements of the directive. We will only support proposed amendments to AOIs that assure protection of the board’s and management’s authorities while legitimising the presence of the party committee within the company’s governance structure.

SHAREHOLDER ENGAGEMENT
We support Hong Kong’s Principles of Responsible Ownership7.

Engagement with shareholders is an important part of responsible ownership or stewardship as it is also referred to. To be effective, we believe stewardship must be seen by companies and investors as an ongoing relationship rather than a procedure to be followed when things go wrong or close to the AGM to secure votes. It should involve dialogue between directors and investors on strategy, risk management and other material issues affecting the long-term health of the company and on how a company’s specific governance arrangements and practices are tailored to best meet its needs.

LEAD INDEPENDENT DIRECTOR
The access of minority shareholders to the board outside of AGMs is a distinguishing feature of companies with better governance standards. It is particularly important when a company has a dominant or controlling shareholder. We recommend companies appoint a lead independent director, especially if it is family or state dominated or where the role of chair and CEO are combined. The lead independent director should act as a counterweight to the board chair, lead the group of independent directors and function as a link between them and the executive directors. The lead independent director should also play a key role in board evaluation and shareholder engagement.

BOARD COMPOSITION
The listing rules in Mainland China and Hong Kong require at least one third of the board to be independent. We recommend that companies consider whether their directors have the knowledge, expertise and cultural understanding to effectively challenge executive decisions, with the objective of creating a more effective board.

We expect companies in Mainland China and Hong Kong to have nomination committees that are majority independent. In particular, we do not like to see the chair of the company be a member of the audit, nomination or remuneration committees. This is in line with the Code of Corporate Governance for Listed Companies in China and the provisions of the Code on Corporate Governance Practices in Hong Kong. We expect the highest level of independent representation on the boards and committees of listed subsidiaries or companies with controlling shareholders to ensure an appropriate level of accountability to minority shareholders among the directors.

We also advocate an independent board evaluation, if the company has yet to conduct one. If it has, it should adopt the best practice of undertaking such evaluation at least every three years so that it can benefit from expert opinions on how to improve its board composition and efficiency.

We suggest that the remuneration for non-executive directors reflect the time, expertise and resources required for proper board oversight.

We expect the company to explain the reasons for nominating candidates, taking into account concerns that investors might have. These can include independence and tenure, particularly where directors have been on the board for more than nine years, which goes against the recommended practice of the HKEx, or where they have been on the board with a group of directors for a long time or if a director’s capacity to fulfil his or her obligations is declining. We regard directors sitting on the boards of more than five listed companies as over-boarded. Unless a company can demonstrate how the individual is able to manage the workload or if the director can explain how he or she is improving local governance practice, we will recommend voting against the over-boarded director.

Mainland China
An independent director should serve on the board of no more than five listed companies8. We expect the director and the company to provide, for example in relevant documentation related to elections and re-elections, evidence that the director has enough time and energy to effectively perform his or her duty as an independent director. We also expect attendance records to be made available; if attendance falls short of 75% of board or committee meetings during the year. An adequate explanation and plan with remedial action should also be disclosed.

Hong Kong
The same principles apply to the appointments of directors in Hong Kong. Exceptions to our preferred limit may be considered when the business is a complex group of companies and the company clearly articulates the benefits of having its directors sit on multiple boards within the group.

DIVERSITY
As Chinese companies expand their customer bases and operations overseas, we assess diversity at their board and management levels to ensure that the leadership team has a suitable combination of talents. We expect boards to be made up of at least 20% women by 2020. According to a study by Corporate Women Directors International, a Washington-based research group, women make up 12.4% of board seats at the top 500 companies, and 30% board seats at the top 500 companies in North America, where over one fifth of board members at the 500 largest public companies are women9. Progress has been stagnating in Hong Kong, according to a study by Community Business, a Hong Kong based non-government organisation. As members of the 30% Club, we support the 30% Club Hong Kong campaign to increase the percentage of women directors on company boards to 20% by 2020, working

---

9 https://www.ft.com/content/1b0d7abe-33ff-11e7-bce4-9023f8c0fd2e?mhq5j=e6
towards a long-term goal of 30% for all companies in the Hang Seng Index. We recommend voting against the nomination committee chair at companies that have no female board members unless a credible plan to introduce female talent is available, and if the nomination chair is not accessible for dialogue with shareholders.

We expect companies to explain how they take into account the different dimensions of diversity, such as gender, ethnicity, nationality, skill sets and experience, on their board and in their management to improve the long-term performance of the company.

REMUNERATION

Mainland China

Executive pay in Chinese state-owned enterprises is considered to be significantly lower than at their global peers. We advocate that the total remuneration package of executives reflect their contributions, abilities and responsibilities, with incentives and accountability closely aligned.

Mainland Chinese companies have started introducing incentive schemes for their senior management. We have long held the view that the best means of aligning the interests of executives and shareholders is through significant share ownership maintained over long periods of time. We encourage companies to consider creating a clear and simple incentive scheme with key performance indicators that reflect primarily strategic goals, together with operational and personal objectives. A comprehensive remuneration plan should cover all key staff and focus on the long-term success of the company.

Hong Kong

Similar to Mainland Chinese companies, we expect companies in Hong Kong to create a simple incentive plan with improved disclosure on performance-linked indicators and assessment criteria. Companies should note that we are more likely to support incentive schemes through significant share ownership maintained over long periods of time. We encourage companies to consider creating a clear and simple incentive scheme with key performance indicators that reflect primarily strategic goals, together with operational and personal objectives. A comprehensive remuneration plan should cover all key staff and focus on the long-term success of the company.

RELATED PARTY TRANSACTIONS

Related party transactions (RPTs) are an important issue, particularly for minority shareholders, and require thoughtful consideration. We encourage companies to provide disclosure of any RPTs before the minimum required notice period ahead of a vote on them to ensure that any questions from shareholders can be adequately answered. While we appreciate the provision of information on the nature and rationale of RPTs by companies, we recommend further disclosure on how the transactions are monitored over the approval period, the response to any breaches of the conditions set and the process of reporting should any irregularities be discovered.

Mainland China

Due to capital account restrictions, many Chinese companies have set up subsidiaries outside of China to hold and manage foreign currencies required for business transaction purposes. We expect RPTs, especially finance-related transactions to be accompanied by detailed disclosure on the rationale of the use of the connected party, the terms of the agreement and the audit and assurance mechanisms put in place to ensure that the transaction is conducted in a fair and transparent manner over the agreement period, not only during the initial phase. We expect a thorough review mechanism to be in place should any irregular activities be noted by the auditor. We may also seek further information from companies on finance-related transactions ahead of AGMs. When AGMs involve shareholder approvals of these transactions, companies should dedicate sufficient time and resources to communicate with shareholders ahead of the meeting date. We generally do not support financial guarantees provided to related entities if they are not significantly majority-owned by the company and there is no strong evidence that the guarantee is necessary for the business to continue to operate.

Hong Kong

Related party transactions are often referred to as continuing connected transactions (CCTs). They involve the provision of goods, services or financial assistance, which is carried out on a continuing or recurring basis and is expected to extend over a period of time. Due to the nature of CCTs, the pricing policies, settlement methods and other terms of the transactions may be different from those with independent third parties. We expect companies that have CCTs to have an RPT policy in place and that continued or one-off transactions be independently verified to show demonstrable benefits to the company. Companies should be able to convince investors about their ability to monitor the proper implementation of these policies.

We normally recommend voting against such financing arrangements especially if they include a deposit facility by the connected party or parties of the company. However, we will consider supporting such an arrangement if a company can convincingly argue that the services provided are unique in nature and not available from another third party.
NON-AUDIT FEES
We normally recommend voting against the auditor if the non-audit fee exceeds 50% of the total fee payable to the external auditor. Companies should be able to articulate how they categorise audit and non-audit related fees and be consistent over time.

SHARE ISSUANCE
Hong Kong’s listing rules allow companies to seek authorisation to issue up to 20% of share capital other than as a rights issue under the general issuance mandate. These shares may also be issued at a discount of up to 20% of the market price.

Companies may repurchase up to 10% of their issued share capital per year and often seek authorisation to re-issue all repurchased shares under the share re-issuance mandate.

While we respect the flexibility that companies require in managing their share capital, they rarely fully utilise the general share issuance allocation that they seek for shareholder approvals at AGMs. We therefore strongly advise a self-imposed target of general share issuance, including the re-issuance of shares of 5% as best practice and no more than 10% of the shares in issue. These should be issued at no more than a small discount, with 10% as an absolute maximum. In addition, we recommend that the company clearly disclose the rationale for the placement, the number and percentages of issued shares issued in earlier placings, whether the funds from those placings have been used as intended, the discount at which the shares were issued, as well as details of the actual placements, including criteria for selecting these, in the proxy materials for the next AGM to keep shareholders adequately informed on a continuous basis.

PRE-EMPTION RIGHTS
Our support for waiving pre-emption rights above 10% depends on a case-by-case assessment of the particular circumstances of a company. We are more likely to support smaller listed companies in an industry that is experiencing accelerated pace of development and dynamic change.

CORPORATE SOCIAL RESPONSIBILITY
We believe that companies cannot flourish in the long term unless they have a purpose that brings benefits to society. Furthermore, we are of the opinion that the effective management of risks and opportunities associated with material environmental and social matters can result in long-term financial benefits to the companies concerned and is therefore an important driver of sustained value. We expect a meaningful CSR or sustainability programme to be closely connected to the company’s business strategy and the impact of its activities.

While we encourage companies to undertake activities for the benefit of local communities, we expect a reasonable explanation on the decisions made regarding any charitable contributions and activities and how they are related to the business and its stakeholders.

MANAGEMENT OF ENVIRONMENTAL AND SOCIAL RISKS AND OPPORTUNITIES
Environmental matters
Companies should be aware of and have appraised the risks and opportunities arising from the environmental impact of their own activities and those of others and be supportive of public policy efforts to help manage the key environmental impacts of their business.

This should include specific policies and actions in the following areas:

- **Climate change**
  - Including the impact of the company’s own greenhouse gas emissions and those related to its supply chain, products and services

- **Water-related risks**
  - Including the impact of water use in areas that are water-stressed, access to clean water, together with the risks from intense weather events, such as flooding

- **Environmental pollution and waste management**
  - Including pollution of the air, water and soil and the opportunities to improve waste management and resource efficiency by reducing demand, re-using products, recycling materials or otherwise recovering value prior to safe disposal as a last resort

- **Land use**
  - Including the appropriate use of agricultural land, policies against deforestation, actions against illegal logging and forestry footprint disclosures where practical

Social matters
Licences to operate are increasingly affected by the reputation of companies, including their performance on human rights. We support the UN Guiding Principles on Business and Human Rights and the UN Global Compact. We expect companies to use the UN Guiding Principles Reporting Framework to disclose how they manage human rights issues that are salient to their business.

Companies should ensure that to the extent relevant to their business and operations, including their suppliers and potential uses of their products, they are aware of and take effective measures in the following areas:

- **Human and labour rights**
  - Compliance with all legal requirements and the duty to respect all internationally recognised human and labour rights
  - Human rights due diligence assessments, especially if the company operates in areas with indigenous communities or in disputed regions
  - Monitoring and avoidance of human trafficking, child and forced labour along the entire supply chain. Companies with a global turnover of more than £36 million and any operations in the UK are required to produce a statement about their business in line with the UK Modern Slavery Act

Conduct and culture

Development and maintenance of the highest standards of conduct towards all stakeholders, including employees, customers, suppliers, government, regulators and the wider public across all markets, together with a culture that ensures the highest standards of integrity and a respect for others inside and outside of the company.

Human capital management

Employees are a company’s most valuable asset and businesses should therefore develop human capital management strategies and accompanying objectives that seek to develop their employees to fulfil their potential in support of maximising long-term value through a positively engaged, committed and talented workforce. We encourage companies to provide qualitative contextual information describing their approach, as well as annual disclosure of the key performance indicators they use to manage their human capital. These should include the company’s total number of employees, annual turnover and total recordable incident and lost time injury frequency rates.

Bribery and corruption

- Development of an ethical culture and a robust policy that recognise the corrosive impact of bribery and corruption on the company and wider society
- Demonstration of effective training and other procedures to provide adequate measures against bribery and corruption
- Evidence of a well-tested and robust whistleblowing and grievance system for employees, stakeholders and the public to report on suspected cases

Cyber security

Ability to provide evidence of a culture with risk awareness and management relating to cyber security, such as data privacy, information security, business continuity plans and the prevention of frauds and crimes.

Sustainable Development Goals

We expect companies to assess the relevance of each UN Sustainable Development Goal (SDG) to their business and to consider how best to incorporate those which may be material into their business models and strategies. We encourage companies to report on how they support the SDGs and to engage with civil society to find out how best to respond to them.

Task Force on Climate-related Financial Disclosures

We welcome the recommendations of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures. As a representative of long-term shareholders, we expect companies to assess and report on possible future climate change risks, not just those that have already emerged. Therefore, we expect companies to respond positively to the recommendations and to report against them. For companies in sectors where the risks from climate change are most material, this should include identifying potential material issues by testing the performance of their strategies against a range of low-carbon scenarios and demonstrating that these are effectively monitored and managed.

Tax

We expect companies to:

- Comply with all tax laws and regulations in all countries of operation
- Recognise the importance of taxation to the funding of good public services on which they and their stakeholders rely and the importance of their commitment to pay their fair contribution
- Ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence
- Disclose the taxes paid by or collected by them in each country.
HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices
London | New York | Singapore

Contact information

Hermes EOS
Christine Chow +44 (0)20 7680 2378 christine.chow@hermes-investment.com

For more information, visit www.hermes-investment.com or connect with us on social media: LinkedIn, LinkedIn, LinkedIn

Disclaimer
This communication is directed at professional recipients only. The activities referred to in this document are not regulated activities under the Financial Services and Markets Act. This document is for information purposes only. It pays no regard to any specific investment objectives, financial situation or particular needs of any specific recipient. No action should be taken or omitted to be taken in reliance upon information in this document. Any opinions expressed may change.

This document may include a list of Hermes EOS Limited ("HEOS") clients. Please note that inclusion on this list should not be construed as an endorsement of HEOS' services. HEOS has its registered office at Lloyds Chambers, 1 Portsoken Street, London, E1 8HZ.

EOS00117 0002351 Global 12/17