

# Corporate Governance Principles

**Mainland China and Hong Kong**

Our expectations of  
Mainland China and  
Hong Kong-listed companies

**EOS at Federated Hermes  
2023**



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## **Corporate Governance Principles: Our expectations of China and Hong Kong publicly-listed companies**

**2023**

### **INTRODUCTION**

EOS at Federated Hermes is a stewardship service provider representing a broad range of long-term institutional investors. EOS clients seek to be active stewards of their beneficiaries' assets by being active owners of shares or debt of the companies in which they invest. EOS engages with our clients' investee companies around the world to promote long-term, sustainable returns to investors, their beneficiaries, and other stakeholders.

These Principles express our expectations of board directors and companies across a number of important strategic and governance topics, focusing on areas which will inform the policies which guide our voting recommendations for 2023.

This document is not exhaustive. More detail on our expectations, particularly on environmental and social topics, can be found in our Public Engagement Plan,<sup>1</sup> which is updated annually.

### **COMPANY PURPOSE, CULTURE AND ETHICAL LEADERSHIP**

The board must set and find effective ways to oversee the values of the organisation, that must be founded on ethical integrity. Ethical considerations must underpin every decision made by the board. For example, the board must ensure that its CEO has the highest ethical standards and must not accept any lapses in that expectation during the CEO's time in office or beforehand, performing sufficient due diligence and having strong contractual provisions to enable the board to take sufficient action, including clawing back pay and dismissal for cause, should unethical behaviour come to light.

The board must ensure that a system exists to take multiple different soundings of the culture and micro-cultures in different parts of the organisation and guarantee that both the board and management take action to improve the culture where it is not aligned with the board's expectations. This should include robust and accessible whistleblowing systems together with a demonstrable commitment to protect those that use such systems.

It is our strong belief that companies can only create and preserve long-term, good quality returns for investors if they provide goods and services that sustainably solve societal needs. To achieve this, we expect companies to be guided by a purpose that serves not only shareholders, but also other stakeholders, society and the environment. Achieving this purpose will, in turn, require a healthy culture and an emphasis on ethical values across the organisation. The pursuit of a stakeholder-inclusive purpose in support of long-term societal interests will then help protect the long-term interests of the savers and pensioners – current and future – invested in companies, who require sustainable financial returns and an economy, society and environment

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<sup>1</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)

which can provide a secure future. This will require review of those critical ESG-related issues of concern to the company and its stakeholders, such as climate change or human rights, through an ethical lens.

A clear and meaningful business purpose should enable business leaders to identify the right things to do in the short term, in order to fulfil their purpose over the long term. This is critical in a time of crisis – such as that caused by the Russia Ukraine conflict and cost of living crisis – when difficult trade-offs arise, particularly between shorter-term financial returns and maintaining strong relationships with key stakeholders, including government, the workforce, customers and supply chains.

It remains vital that boards and executive teams continue to consider their key stakeholders and their organisation's purpose, and make decisions that best support sustainable returns over the long-term. Companies need to be able to explain their decisions affecting key stakeholders. This includes the most difficult decisions, such as redundancies, but also how they allocate capital, including dividend payments and share buybacks.

We expect boards to consider and disclose capital allocation policy in the context of a company's purpose and long-term strategy. We are concerned that buybacks and similar diversions from re-investment in key stakeholders may be chosen to improve the share price or other related metrics over the short-term but are not always the best use of capital to support the creation of long-term, sustainable returns.

### **Stewardship and engagement**

Investors must act as responsible stewards and promote long-term sustainable returns on investment through constructive engagement with companies and their directors. All substantive correspondence from major institutional investors' representatives should be shared promptly with all board members to help directors fulfil their role to safeguard the interests of all shareholders. Our experience has shown that dialogue between companies and committed, long-term investors on strategy, finance, risk management and material environmental, social and governance (ESG) issues can improve the governance and performance of companies. Developing relationships of trust with long-term shareholders can be invaluable for boards, and we expect chairs and independent directors to make themselves available for investor engagement, beyond opportunities at formal shareholder meetings.

We expect companies to engage with long-term investors across a range of asset classes, including different types of corporate debt, in addition to their shareholders. Companies should now recognise that the expectations of debt investors are similar to those of long-term shareholders and substantially aligned in relation to governance, long-term strategy, capital allocation and environmental and social matters. Debt investors now expect accountability and constructive dialogue on opportunities and risks which might enhance or impair earnings and cashflow.

## ENDORSEMENT OF LOCAL CODE

We endorse the Hong Kong Stock Exchange's (HKEX) reporting guidance<sup>2</sup> and support the amendments to the Corporate Governance Code and related listing rules<sup>3</sup> that came into effect on the 1<sup>st</sup> July 2020. In particular, we support the expectation that the company issue a statement setting out the board's consideration of ESG issues, as well as the requirement to disclose significant climate-related issues which have impacted or may impact an issuer.

To align with the amended code in Hong Kong and the guidance, we expect companies to:

- Disclose the policy and procedure by which they identify board director candidates.
- We expect the board to demonstrate that it has considered a broad range of candidates who are outside the board's usual circle of contacts.
- Have a nomination committee with clear responsibility for evaluating the performance of the board. The responsible directors should also conduct an annual assessment of the diversity profile of the company and progress towards achieving the diversity objectives set. For companies without a nomination committee, we will consider voting against the chair of the board.
- Have a diversity policy with measurable objectives, rather than one which just states the aspiration to have a diverse board with different skills and expertise. Companies should be able to demonstrate progress towards these objectives and communicate this through disclosure and engagement with shareholders and their representatives.
- Prepare a skills matrix of the current and desired skills, experience and other attributes that the board requires.

## BOARD COMPOSITION AND EFFECTIVENESS

Boards should ensure they comprise members with strong ethics and diverse skills, experience, perspectives and psychological attributes, as well as sufficient independence and strength of character to challenge, as well as advise and support executive management teams. They should ensure overall composition and individual membership of the board is frequently reviewed and refreshed, and that directors are elected and re-elected by shareholders on a regular basis to ensure accountability. Biographies for all directors should be provided to shareholders, indicating which are considered independent and the particular attributes that they bring to the board. This should be accompanied by an analysis of how the board as a whole displays the necessary skills, independence, diversity and other attributes to meet the company's evolving needs.

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<sup>2</sup> [Appendix 27 Environmental, Social and Governance Reporting Guide | Rulebook \(hkex.com.hk\)](#)

<sup>3</sup> [Update No. 128 | Rulebook \(hkex.com.hk\)](#)

## Effectiveness

Disclosure of measurable aspects of boards, such as those outlined below, are important but insufficient indicators of a board's functionality.

Engagement with board directors provides a valuable opportunity for investors to sufficiently assess how well a board is functioning. Our white paper, *Guiding Principles for an Effective Board*,<sup>4</sup> highlights the factors that we consider to be most important in determining board effectiveness, focusing on the human, relational, and behavioural elements that are more difficult to assess.

They can be summarised as follows:

- Genuine independence, diversity and inclusion support directors' ability to effectively question long-held assumptions and mitigate the risk of groupthink.
- The role of the chair should be held by an independent director to support the overall conditions for board effectiveness, which includes setting and enforcing the expectations for a board culture that is based on mutual respect, openness and trust, and encouraging diverse voices and behaviours of independent thinkers.
- How the board allocates its time spent in board meetings and between board meetings is equally important. We expect a board to maximise the time spent on strategy and other forward-looking activities during structured board meetings, committee work, site visits and engagement with stakeholders.
- The board's relationship with the CEO should ideally be characterised by transparency, trust and constructive collaboration, and the board should build relationships with the wider workforce through formal and informal channels.
- A commitment to continuous improvement should be encouraged and supported through regular board evaluations, and disclosure should strike a balance between transparency and confidentiality.

## Evaluation

We expect boards to be committed to continuous improvement and therefore to be constantly reflecting on their performance. We encourage boards across markets and corporate structures to conduct regular evaluations with the goal of enhancing board effectiveness. When conducted with this intention, and not simply as a compliance exercise, the evaluation process offers a unique opportunity for the board to pause, reflect and optimise its performance. The board should embrace the evaluation process as an opportunity to recalibrate focus, identify skills gaps on the board, highlight the need for succession, and raise concerns related to performance and culture.

Furthermore, conducting regular board evaluations signals to investors that the board is open to constructive criticism and willing to improve. We recommend that independent external board evaluations are conducted at least once every

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<sup>4</sup> <https://www.hermes-investment.com/wp-content/uploads/2020/04/guiding-principles-for-an-effective-board-april-2020.pdf>

three years, with internal evaluations conducted in the interim years. The board should implement an action plan and a clear timeline for addressing the points raised in the evaluation. Disclosure should demonstrate how the board has taken the necessary steps to enhance performance and provide reassurance to investors about the quality of the board evaluation.

### **Communist party committee**

We will only support proposed amendments to the Article of Incorporation which assure protection of the board's and management's authorities, while legitimising the presence of the party committee within the company's corporate governance structure.

### **Weighted voting rights**

We may recommend voting against the nomination committee chair or lead director to express our concerns about weighted voting rights structures. If there are no such committees or individuals, we may not support the re-election of the chair. We encourage issuers with multiple-class share structures to adopt one-share-one-vote. We are unlikely to support the issuance of shares with reduced or no voting rights, or capital raising and share buyback exercises that discriminate against minority shareholders.

### **Chair/CEO separation**

In line with the Hong Kong Stock Exchange's corporate governance code, we expect separation of the roles of the chair and chief executive. The division of responsibilities between the chair and chief executive should be clearly established and set out in writing. We may recommend voting against the election or re-election of a combined chair and CEO, executive chair or the promotion of a former CEO to chair unless: it is a temporary arrangement with a published, time-bound transition plan; there is a compelling justification for the move such as the sudden loss of the CEO; the appointment is balanced by the presence of independent and effective non-executive directors including a lead or senior independent director with the skills and character to challenge the chair so that no one individual has overriding powers of decision; or the appointment is of a CEO to the role of chair and the candidate has spent at least two years not employed by the company between such roles.

### **Independence and tenure**

On all boards, we expect a strong core of independent directors, including an appointed lead independent director, to ensure that stakeholder interests are protected, to exercise objective judgement and, if necessary, to act as agents for change. This group should play an important role in guiding the boards' decision-making and in the recruitment and nomination of directors. It should be empowered to meet independently, including before and after board meetings, and should do so in practice. It should be granted unfettered access to members of management, information and resources as required.

The listing rules in mainland China and Hong Kong require that at least one third of the board be independent. We are concerned about board independence in Hong Kong, especially when there are too many long tenured independent

directors and executive directors on the board. We encourage companies to aim for 50% independence rather than stopping at one third to comply with requirements.

Ensuring sufficient levels and quality of independence is particularly important for founder-led companies, those with executive or non-independent chairs, significant shareholder representatives on the board (which we believe can be useful and justified, provided minority shareholder interests are protected) or significant management representation on the board. For Chinese and Hong Kong companies with a primary listing in the US, we expect at least half of the board directors to be independent. This applies to all companies with foreign private issuer status.

We consider the overall composition of boards and recognise the value that long serving directors can contribute. However, too many directors serving concurrently can increase the risk of groupthink and complacency. We expect a healthy mixture of tenures on boards, including regular board refreshments. Companies should provide the rationale for nominating candidates, taking into account concerns that investors might reasonably have. These might include independence and tenure, particularly when directors have been on the board for more than nine years or more than six years for Hong Kong and China<sup>5</sup> respectively; if 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 may be perceived to be declining.

Minority shareholder access to board members, other than at annual general meetings, is a necessary feature of companies with good governance standards. The main roles and responsibilities of a lead independent director are:

- Leading the group of non-executive directors and functioning as a link between them and the executive directors
- Consolidating the views of other board directors and acting as the main, constructive counter-weight to the chair, executives and major shareholders on the board
- Chairing meetings of non-executive directors
- Playing a key role in board evaluation and shareholder engagement
- Representing the interests and views of minority shareholders at board meetings
- Ensuring that all directors are sufficiently well-informed to perform their duties
- Managing government investigations (if any) as a non-executive but informed director of the company.

Given the track record of related party transactions and investigations into bribery and corruption, a suitably qualified lead independent director can introduce transparency and rigour to the governance process of companies, and help set the expected cultural and behavioural tone from the top. They can also

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<sup>5</sup> [http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231\\_189696.html](http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231_189696.html) (Chinese only)



help introduce or maintain effective anti-bribery and corruption systems and controls.

### **Committees**

We expect companies in Mainland China and Hong Kong to have fully independent audit committees and majority independent nomination and remuneration committees with independent chairs. We also expect that committees should not include any executives as members. This is in line with the provisions of the Amended Code on Corporate Governance in Hong Kong. We expect the highest level of independent representation on the boards and committees of all listed companies, including listed subsidiaries or companies with controlling shareholders, to ensure an appropriate level of accountability to minority shareholders among the directors. We expect companies in China to disclose committee memberships at the time of election.

### **Director attendance and commitment**

We expect board directors to be able to devote sufficient time to fulfil their duties, including to build and maintain a good understanding of the company and to fully absorb and be able to challenge the information presented to them by management. As a broad guideline, we do not support directors holding more than five directorships at public companies<sup>6</sup> and, in this context, we consider a non-executive chair role to be roughly equivalent to two directorships and, at complex companies, other committee chair roles, in particular the chair of the audit and risk committee, may be considered more burdensome than a typical non-executive directorship.

We expect companies to provide, for example in relevant documentation related to elections and re-elections, evidence that a 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 be disclosed.

Whether a director may be over-committed depends on a range of factors beyond the number of other roles they hold, including the size and complexity of the company and additional responsibilities, such as being a committee chair. We consider that certain industries such as banking (due to its business model and regulatory complexity) and businesses with large and/ or complex operations will require site visits and therefore more time commitment.

We expect companies to encourage their executives to take on a non-executive role (but not normally more than one) outside their own company to assist in their development, bring current experience to boards and to build a pipeline of future board directors. However, we do not expect executives to hold more than one non-executive role. This applies to directorships in both commercial and non-profit making institutions. We may make an exception if these organisations are part of a conglomerate, but we expect companies to be able to explain any conflicts of interest that may exist due to multiple directorships in subsidiaries,

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<sup>6</sup> Also required by China's Establishment of Independent Director Systems by Listed Companies Guiding Opinion: [http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231\\_189696.html](http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/ssgs/gszl/201012/t20101231_189696.html) (Chinese only)

the competing objectives that might be present, and clarification on how director remuneration is calculated for these multiple roles.

### **Succession planning**

Effective succession planning at the board and senior management level is essential for safeguarding the ability of companies to deliver long-term returns. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change such as impending retirement. It should include consideration of the current and future required diversity of skills, experience and other attributes required at board and senior management level, including the need for any candidate to demonstrate the highest levels of ethical integrity. Robust succession planning also can help to counter the tendency of many boards to over-pay current executives relative to the senior executive labour market and peers.

Overseen by the board, senior management should create a pipeline of suitable candidates from within the organisation to become senior managers and executive directors. Similarly, the board should identify suitable candidates for independent directors.

### **DIVERSITY, EQUITY AND INCLUSION**

There is a growing body of evidence that supports the link between more diverse company leadership and financial performance.<sup>7</sup> We believe improving diversity, equity and inclusion performance creates enduring value by improving decision-making, attracting talent, enhancing workforce satisfaction and stimulating insight and innovation.<sup>8</sup>

In 2023 we will continue tightening our voting policies and thresholds on diversity, as we believe most companies need to improve their diversity towards representation of all groups throughout all roles and levels. Boards should seek diverse composition in its broadest sense to support high-quality debate and decision-making, considering diversity of skills, experience, networks, psychological attributes and characteristics (including, but not limited to, race, ethnicity, gender, sexual orientation, age, disability, nationality and socioeconomic background). Boards should give careful consideration to how they can find members from outside of their typical networks and the breadth of attributes or perspectives that may be valuable to their decision-making. Where boards have made insufficient progress on critical dimensions of diversity, including racial and ethnic or gender representation at either board or senior management level, we will recommend opposing the re-appointment of relevant responsible directors.

We expect boards not only to address their own diversity, but that of the whole organisation and its impacts on stakeholders; and to provide meaningful disclosure assessing progress against complex challenges. In 2023, we will hold boards accountable for more effective oversight of inclusive culture and diversity across all levels of the company's workforce and effects on the ecosystem upon

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<sup>7</sup> For example, The 30% Club has compiled a list of studies examining the benefits of gender diversity <https://30percentclub.org/initiatives/investor-group>

<sup>8</sup> [Delivering growth through diversity in the workplace | McKinsey](#)

which the company's long-term health depends, including suppliers, customers and communities. When developing director voting recommendations, we will take into account a range of considerations. From a workforce perspective, these may include, but are not limited to, diversity of named executive officers, senior executive team members and talent pipeline; the existence of a thoughtful diversity, equity and inclusion strategy, targets and action plan rooted in rigorous analysis of underlying problems that incorporates employee survey data; and a board-driven process for evaluating management's inclusion performance and issues surrounding all strands of diversity across the employee lifecycle.

### **Racial or ethnic inequity**

We welcome the steps taken by companies around the world to acknowledge and commit to addressing racial or ethnic inequity, in the workforce and beyond.

The definition of race and ethnic minorities is often contextual. There are 55 different ethnic minority groups officially recognised in Mainland China, but the nation remains homogenous with over 90% of its citizens belonging to the Han Chinese group. In Hong Kong, there is also a mix of ethnic minorities including Filipino, Indonesian, White, Indian, Nepalese, Pakistani, Thai, Japanese and other Asian, representing around 8% of Hong Kong's population. Following the Race Discrimination Ordinance<sup>9</sup>, we encourage companies to identify any areas of biases and discrimination in hiring and promotion. Companies should set priorities towards cultural integration. This is expected to create a more inclusive corporate culture.

As a start, we expect companies to:

1. Discuss how they see the inclusion of minorities within their organisation in terms of ethnicity, religion and language and how diversity reflects their key stakeholders, namely customers, employees and suppliers.
2. Start collecting, as a minimum, data on the ethnic composition of the workforce by seniority. We encourage companies to consider publishing these and other relevant data annually, including pay gaps/ratios, with a narrative explanation of what the figures mean and a brief, timebound, action plan to address shortfalls. Data should be used internally to prompt further investigations so that underlying drivers can be understood and acted on. Many companies will have a global footprint with a workforce spread over different geographies. In markets where data collection is restricted by law, companies should find alternative ways of monitoring their diversity and inclusion efforts. This could for example include anonymous staff satisfaction and engagement surveys.
3. Follow the guidance of the National Minorities Policy. We encourage companies to identify the area of biases upon hiring and work toward cultural integration and cultivating corporate culture to reduce the risk of discrimination from biases.

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<sup>9</sup> 第 602 章 《種族歧視條例》 - [Cap. 602 Race Discrimination Ordinance \(elegislation.gov.hk\)](http://elegislation.gov.hk)



## Gender equality

Advancing gender equality in company leadership and throughout organisations also remains critically important, with many companies around the world still falling far short of equal representation. We continue our global support for initiatives like The 30% Club, which advocate for companies to achieve a minimum of 30% female representation on boards and in leadership populations.

We expect boards to be comprised of at least 20% women, with a medium-term target of 30% by 2030. If this is not the case, and if the company fails to demonstrate that a credible plan has been put in place to meet these expectations, we may recommend a vote against the chair/member of the nomination committee or other responsible director.

Companies should also disclose gender information at the time of election to help promote gender diversity. If a company fails to disclose the gender of the nominated directors at the time of election, we may recommend an adverse vote. In cases where a company is founder and/or family-owned or dominated, with over 25% in share ownership, we may still recommend a vote against the chair of the nomination committee. We may also do the same in cases where the nomination chair is also an executive and a representative of a major shareholder.

As a signatory of the Hong Kong Board Diversity Initiative<sup>10</sup> and as a member of the 30% Club,<sup>11</sup> we support the 30% Club Hong Kong campaign to increase the percentage of women directors on company boards to 30% by 2030 for all companies in the Hang Seng Index.

## EXECUTIVE REMUNERATION

We are increasingly concerned that executive remuneration structures and practices in a number of countries are not fit for purpose, neither serving long-term investors nor aligning properly with the core long-term objectives of companies, and that poor practices are at risk of spreading to other countries where pay is more restrained.

Some of our key concerns relate to the limitations of 'pay for performance' models, which are common in countries like the US and the UK and which we see increasingly adopted in other countries. Although perhaps well-intentioned, this approach risks damaging, unintended consequences, including:

- Increasing quantum beyond the executive labour market median, and expanding pay disparities between executives and the broader workforce
- Encouraging short-termism or financial engineering, particularly in schemes which focus on share options or where large proportions of pay are subject to metrics like total shareholder return or earnings per share, which can focus executives on actions to drive up the share price in the short-term rather than on drivers of long-term strategic value. Focusing large portions of pay on incentive schemes risks strongly incentivising executives to hit targets over relatively short time frames, regardless of

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<sup>10</sup> [Commitment — Board Diversity HK](#)

<sup>11</sup> [30% Club HK announces Progress in Interim Goals | 30% Club \(30percentclub.org\)](#)

whether these actions are best aligned to long-term, high-quality sustainable returns to shareholders and other stakeholders.

- Obscuring meaningful assessments of performance in the context of long-term value due to the use of complex, overlapping incentive schemes.
- Undeserved windfall gains for executives which can result from share-based incentive schemes, which has occurred at many companies as a result of the market rally.

In China and Hong Kong, we are often concerned with the form of the scheme award. For example, schemes that offer shares at a significant discount, with potential excessive dilution; administration that might present conflicts of interests between the administrators and beneficiaries, and the lack of disclosure of performance hurdles. We may allow flexibility for companies that are at the beginning of their journey to increase the proportion of variable pay relative to their below-industry-average fixed pay. However, non-executive directors should only have fixed pay and not participate in variable pay schemes. We may vote for by exception for proposals that provide sufficient details in areas that we have identified above or blended schemes that include not only share options but also restricted shares units.

We continue to make the case for switching to simpler pay schemes aligned to long-term success and the desired culture in the organisation, based on a combination of fixed pay and long-term time-restricted stock, with an emphasis on long-term share ownership for executives.

We expand on our views on executive pay in our paper, *Remuneration Principles: Clarifying Expectations*.<sup>12</sup>

They can be summarised as follows:

1. **Simplicity:** Pay should be simple; for example, fixed pay (mix of cash and long-term shares) plus a single incentive scheme (an annual bonus).
2. **Alignment:** Pay should be aligned to long-term strategy and the desired corporate culture, incentivising long-term value creation, including wider social and environmental outcomes. Where metrics and targets are used in incentive pay, they should reflect strategic goals, rather than focus attention on total shareholder return, stock price appreciation or earnings per share.
3. **Shareholding:** Management should become long-term stakeholders in the company's success through substantial shareholdings. Significant shareholding requirements should remain in place for at least two years following departure from the company.
4. **Accountability:** Pay outcomes should reflect outcomes for long-term investors and take account of falls in a company's performance or reputation. The board should intervene and apply discretion whenever formulaic outcomes do not achieve this. The potential pay outcomes under

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<sup>12</sup> <https://www.hermes-investment.com/wp-content/uploads/2018/10/remuneration-principles-clarifying-expectations.pdf>. The principles contained in this paper are global in nature, but some of the specific references to structures are more applicable to certain markets such as the UK.

a policy should be rigorously scenario tested in advance, with a cap on the total possible pay published, to help reduce the risk of unintended consequences.

5. Stewardship: Pay outcomes should be communicable to all stakeholders, including employees and the public. Boards should take into account wider workforce pay practices and ratios when judging the appropriateness of pay opportunities and outcomes. Boards should then write to employees each year explaining the outcomes of executive pay and the alignment to long-term value, and the company's strategy and purpose. Companies and investors should regularly discuss strategy, long-term performance and the link to executive pay.

Executive pay in Chinese state-owned enterprises (SOEs) is significantly lower than in their global peers. We advocate that the total remuneration package of executives should reflect their contributions, abilities and responsibilities; pay and accountability should be closely aligned. Mainland Chinese companies have only recently 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.

While we do not automatically oppose all pay models that do not appear to align to our principles, we set various thresholds and requirements to guide our voting recommendations which are tailored to the context of each market. Through engagement with companies on these thresholds and requirements, we seek to improve market practice and encourage closer alignment with our principles.

## **PROTECTION OF SHAREHOLDER RIGHTS**

We rigorously defend shareholder rights on behalf of institutional investors, including the right to receive good quality corporate reporting and material information on a timely basis, to vote at shareholder meetings on issues such as the annual election of directors, to propose new candidates to the board or other shareholder resolutions.

We support a single share class structure, with one share one vote, and oppose any deviation from this.

### **Share issuance**

Hong Kong Stock Exchange Listing Rules allow companies to seek authority to issue up to 20% issued 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 issued share capital per year and often seek authority to reissue all repurchased shares under the share reissuance mandate.

While we respect the flexibility that companies require in managing their share capital, they rarely fully use the general share issuance allocation that they seek for shareholder approvals at annual general meetings (AGMs). We therefore strongly recommend a self-imposed target for general share issuance, including reissuance 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 the absolute maximum discount. In addition, we recommend that the company clearly discloses: the rationale for the placement and the number and percentages of shares issued in earlier placings; whether the funds from those placings have been used as intended; the discount at which the shares were issued; and details of the actual placements, including criteria for selecting these, in the proxy materials to keep shareholders adequately informed.

### **Pre-emption rights**

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

### **Share repurchases**

We expect boards to consider capital allocation in the context of a company's purpose and long-term strategy. We are concerned that buybacks may be chosen to improve the share price or other related metrics over the short-term, but are not always the best use of capital to support the creation of long-term, sustainable value.

### **Related party transactions**

Related party transactions (RPTs) are an important issue, particularly for minority shareholders, and require significant consideration. We expect companies to provide disclosure of RPTs before the minimum required notice period ahead of a vote on them and to engage actively with shareholders and their representatives to ensure that any questions from shareholders can be adequately answered.

While companies provide information on the nature and rationale of RPTs, we recommend further disclosure on how the transactions are continuously monitored over the approval period, the response to any breaches and the process of reporting, should any irregularities be discovered.

#### Related party transactions – Mainland China

We expect RPTs, especially finance-related transactions, to include detailed disclosure on the rationale of the use of a connected party, the terms of agreement, and the audit and assurance mechanisms put in place to ensure that the transactions are 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 the companies ahead of AGMs for more information on finance-related transactions. When shareholder meetings involve shareholders' approval of such 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 majority-owned by the company and there is no strong evidence that such a guarantee is necessary for the business to continue to operate.

### Related party transactions – Hong Kong

RPTs are often referred to as continuing connected transactions (CCTs). CCTs involve the provision of goods, services or financial assistance, which are carried out on a continuing or recurring basis and 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, and that such continued or one-off transactions be independently verified to show demonstrable benefits to the company. When asked, companies should be able to convince investors of their ability to monitor the proper implementation of such policies.

We normally recommend voting against financing arrangements, especially if such arrangements 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 provide expected outcomes of any financial guarantees or if it can convince us that the services provided are unique in nature and are not available from another third party.

### **Hybrid or virtual shareholder meetings**

Annual and other shareholder meetings are a critical part of corporate governance. As well as being the highest decision-making procedure of the company, they allow shareholders to hear directly from the company about its performance and to challenge directors on important topics, supporting strong transparency and accountability.

We believe dialogue between shareholders and the board is enhanced by the in-person meeting format of annual meetings. Although formats vary around the world, when working well, it presents the opportunity for shareholders to make points to the whole board, the ability to ask questions immediately in response to board comments and to build on the questions asked by others. Further, it is more difficult for directors to avoid challenging questions or topics; directors must provide answers in a public forum and, accordingly, be accountable for them.

However, we recognise that the restrictions brought about by the Covid-19 pandemic rendered in-person meetings unviable for many companies and that there were already valid arguments in favour of adopting alternative formats to improve shareholder access and participation, for example, in geographically dispersed countries or for companies with a global shareholder register.

Given this, we are supportive of meetings being convened in a 'hybrid' format – where shareholders have the option to join the meeting via an online platform or to join in person, provided all shareholder rights are protected or enhanced in both formats. Online participation can increase opportunities for participation, while retaining the accountability of in-person meetings.

We do not generally support 'virtual-only' meetings unless these are a temporary solution in response to restrictions on in-person gatherings, such as those prompted by the Covid-19 pandemic, or other exceptional circumstances. In those cases, we expect all shareholder rights to be protected and the meeting to be run as it should be in-person: giving ample opportunity for any

shareholder to ask questions, and for these questions to be answered live by the board. We also expect a clear commitment to return to in-person or hybrid meetings as soon as restrictions allow and for all shareholder rights to be protected.

For further information please refer to our *Principles of Annual Meeting Good Practice*.<sup>13</sup>

We will generally oppose requests for the authority to hold virtual-only meetings unless we gain comfort that it is to be used in exceptional circumstances only, and that the rights and access of attending shareholders are comparable to those of in-person meetings. For smaller companies we may relax the expectation that virtual-only meetings are for exceptional circumstances.

## **SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY**

Taking a responsible and long-term approach to social, environmental and ethical issues is critical to the creation and preservation of long-term sustainable returns and should be reflected in the company's values, purpose, strategy and culture. Companies must identify and disclose the most material social and environmental issues for the company and its significant stakeholders. They must seek to address the associated risks and opportunities through their core business strategy and value proposition. We expect boards and management to have oversight of material sustainability issues and to be accountable to shareholders for effectively managing the associated risks and opportunities.

We support the UN Sustainable Development Goals (SDGs) and believe that the private sector has an important role to play in achieving them by the increasingly pressing deadline of 2030. Companies should assess the relevance of each SDG, identifying those that they can make a direct contribution to, and incorporate the most material SDGs into their strategies. We encourage companies to go beyond highlighting any SDG that the company could be connected to and to be purposeful in selecting those to which it intends to make an active, direct contribution, including through the allocation of resources and setting targets. We urge companies to report on their approach to the SDGs and to engage with its shareholders and civil society on how best to contribute to the SDGs.

Further detail on our views on and expectations of companies with regards to a wide spectrum of environmental and social issues can be found in the EOS Engagement Plan.<sup>14</sup>

Below we highlight two key environmental and social topics which will inform our vote policies in 2023: climate change, and human and labour rights.

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<sup>13</sup> <https://www.hermes-investment.com/uploads/2021/12/a5ec14b0ee6794d4d12a05774f767e95/eos-principles-of-annual-meeting-good-practice-february-2021.pdf>

<sup>14</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)



## Climate change

The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the social, economic, and political consequences of climate change.

We strongly support the goal of the 2015 Paris Agreement – to limit global warming to well below 2°C and pursue efforts to not exceed 1.5°C of warming – and we expect companies to publicly do the same, as well as ensuring that any third-party organisations they support or are members of, such as trade bodies or lobbying organisations, are aligned to this goal.

We urge companies to:

- Establish strong governance of the risks and opportunities presented by climate change and the energy transition. Boards should ensure that climate-related issues are included on the board agenda at least annually. We expect the board and senior management to engage with outside experts who can advise on strategic risks and opportunities that climate change presents, including challenging the company's approach if necessary. For those companies materially exposed to climate-related risks and opportunities, we expect the energy transition to be clearly articulated in governance documents, including board committee charters and the articles of association.
- Commit to achieving net-zero emissions by 2050 at the latest and set supporting short- and medium-term science-based targets to reduce greenhouse gas emissions in line with the goals of the Paris Agreement. This should include material Scope 3 emissions associated with a company's value chain or use of products with an explanation of why any Scope 3 emissions are not included.
- Integrate climate considerations into the forward-looking strategy for the company. Companies should consider the implications of the energy transition on their business, and what aligning to the goals of the Paris Agreement will mean for their strategy, minimising the potential risks and capitalising on the opportunities presented by climate change.
- Adopt the framework set out by the Task Force on Climate-related Financial Disclosures (TCFD) for the management and reporting of climate-related risks and opportunities. Where the risks are particularly acute (for example in energy intensive sectors), this should include conducting scenario analysis to establish the potential financial and other impacts of climate change on the business at different levels of warming. Companies should ensure that the financial risks associated with climate change and the energy transition are appropriately reflected in reports and accounts. As outlined in the Audit section below, the audit committee should be responsible for ensuring these risks are accounted for and the external auditor should be engaged to provide an opinion on this matter.
- Ensure board oversight and robust governance processes are in place to identify incidents of misalignment of views between companies and organisations of which they are members. Where issues are identified, all

available avenues to influence these third parties should be used to encourage effective action on climate policy in line with the goals of the Paris Agreement. The company should be transparent about its governance procedures by describing the actions taken to reduce or eliminate any misalignment, and any progress made, in-line with the IIGCC Investor Expectations on Corporate Lobbying on Climate Policy.<sup>15</sup> Ultimately the board should be prepared to cease membership where misalignment persists without progress. Companies should also proactively support and advocate for positive action to mitigate climate change risks in their spheres of influence.

We engage intensively with companies across different countries and sectors on climate change and reinforce this through the voting recommendations we make to our clients at shareholder meetings.

In 2023, we continue to hold the chair or other responsible directors accountable through voting recommendations where we believe companies' actions are materially misaligned with the goals of the Paris Agreement and/or where companies are not responding sufficiently to the risks and opportunities posed by climate change. We include a particular focus on companies that are involved in activities that are clearly incompatible with limiting global warming to safe levels, such as causing deforestation and the expansion of coal-fired power. We assess companies using a range of frameworks and benchmarks, including the Transition Pathway Initiative (TPI),<sup>16</sup> the Climate Action 100+ benchmark,<sup>17</sup> Forest 500<sup>18</sup> and others.

In addition to the above criteria, we may also reflect other concerns about a company's response to climate change in our vote recommendations, for example, where a company has been unresponsive to investor concerns or where we have concerns about the views held by particular directors regarding the reality and urgency of climate change.

We will consider and support on a case-by-case basis shareholder resolutions relating to climate change and may file or co-file resolutions where we believe them to be warranted.

In principle, we support the concept of having a shareholder vote on climate change transition plans (so-called 'Vote on Transition' or 'Say on Climate' resolutions). We will support climate change transition plans which are aligned to the goals of the Paris Agreement, with indicators of alignment including science-based greenhouse gas reduction targets over the short, medium and long-term, supported by a clear and credible strategy to achieve these.

### **Human and labour rights**

We believe that how a company manages its human rights strategy is of critical importance to its licence to operate, its impact on people's lives and ultimately its ability to create and preserve long-term holistic value. We endorse and expect companies to align with the UN Guiding Principles on Business and

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<sup>15</sup> <https://www.iigcc.org/resource/investor-expectations-on-corporate-lobbying/>

<sup>16</sup> <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>

<sup>17</sup> <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

<sup>18</sup> <https://forest500.org/>

Human Rights (the UNGPs). The UNGPs framework outlines the corporate duty to respect human rights. Companies have a responsibility to disclose and act upon a policy commitment to human rights in their operations and value chains. This includes carrying out human rights due diligence to identify potential and actual human rights impacts; a plan to prevent, mitigate and account for how to address these impacts and providing or cooperating in the provision of remedy if a company has caused or contributed to adverse impacts.

Companies should have a governance structure for human rights which identifies board level oversight and executive accountability. They should report on obligations under the UNGPs, as well as under national legal requirements and relevant international frameworks.

The concept of human rights is simply the universal right to human dignity. However, we acknowledge that human rights strategies and impacts may involve complex and sensitive aspects and seek to engage with companies on these considerations. We may recommend a vote against relevant meeting items, such as re-electing a director, discharging management or approving its reporting if:

- a company is in clear breach of its applicable regulatory responsibilities related to human rights (such as the UK's Modern Slavery Act) or responsibilities outlined in the UNGPs; and/or
- there is sufficient evidence that a company has caused or contributed to egregious, adverse human rights impacts or controversies and has failed to provide appropriate remedy.

### **TRANSPARENCY, TAX AND AUDIT**

We believe that the quality of narrative reporting reflects the board's strategic thinking, its line of sight into operations and how well it oversees the company. Boards must report openly and transparently on the performance of the company and their stewardship of it over the year, acknowledging the challenges, as well as the achievements, the state of the market and the competitive landscape. It is also fundamental that each company reports in a way that allows investors to understand the main risks that the board has identified for the business, along with how the company manages and mitigates them. This includes environmental, social and governance, as well as financial and strategic, risks.

#### **Tax**

Companies should recognise the importance of taxation to the funding of public services on which they and their stakeholders rely and pay their fair contribution. The Covid-19 pandemic has emphasised the importance of companies paying their fair contribution as all businesses have directly or indirectly benefitted from government action to support the economy.

Fair payment of tax, based on the intention of tax law and in proportion to the location of economic value generated, is an important pillar of a company's social licence to operate. We believe that companies that seek to aggressively minimise their tax payments will face increasing reputational and financial risks.



We expect companies to:

- Comply with the intention of tax laws and regulations in all countries of operation.
- Pay taxes in-line with where economic value is generated.
- Publish a global tax policy describing their approach to tax risk, controls and oversight, including any material variations across the entity. This should include policy on corporate structuring in low tax jurisdictions, intra-group transactions and the use of tax incentives from public authorities.
- Ensure their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence.
- Disclose publicly the full extent of taxes paid or collected by them in each country. Reporting on each country should include the purpose of the local corporate entity along with comparable corporate data such as revenue, profit before tax and number of employees. We recommend use of the GRI reporting standard on tax.
- Ensure they have sufficient oversight of tax policy, risk and controls in board and board committee work.
- Avoid the use or promotion of aggressive tax avoidance strategies either for their corporate taxes or those of employees, contractors or customers.

### **Audit**

Shareholders in listed companies rely on the quality and robustness of the audited information those companies report to the market when making investment decisions, and when holding company management and boards to account. High quality and effective audits are vital to ensure the markets trust and have confidence in the information companies report.

Audits should provide assurance to shareholders that the financial statements present a prudent, true and fair view of the financial results, cash-flows and financial strength of a company. In recent years, we have seen a spate of business failures following poor quality audits. These high-profile cases have raised questions about the quality, relevance, professionalism and independence of audits and external audit firms, and strengthened calls for reform.

#### Audit committees

Shareholders, regulators and other stakeholders have increasingly focused on the role and performance of audit committees and how they discharge their duties.

Beyond the oversight of the financial reporting process and the appointment and oversight of the external auditor, audit committees have important risk and compliance oversight responsibilities, including oversight of internal audit and whistleblowing facilities, as delegated by boards or as specified by laws or regulations. Assignment of substantial non-audit-related oversight mandates to audit committees may be seen as a signal that the audit committee is overburdened, with the risk that duties are being delegated to management. A

better course of action may be to set up a further committee of the board to address other material non-audit matters.

#### Auditor rotation

Maintaining independent external assurance is a fundamental pillar of good stewardship and the fiduciary duty of a board of directors. Independence, and potentially audit quality, is at risk when the same assurance provider is maintained for too long – whether the audit partner or audit firm. Only by rotating the audit firm at regular intervals can auditor independence and quality be protected, in the interests of shareholders and other stakeholders. Our view is that auditor rotation can also add value as it welcomes a new firm with a different approach and a new set of subject specialists with a fresh pair of eyes, fresh challenge and opinions.

#### Non-audit services and fees

As part of overseeing the external auditor, the audit committee must establish and enforce a policy on what non-audit services the company can procure from the external auditor. We pay close attention to these services and related fees to ensure that they do not compromise auditor independence, which could compromise the integrity of the audit. The non-audit fees should normally be substantially lower than the audit fee.

As a guideline, non-audit fees should not exceed 50% of audit fees in any given year. If this is exceeded, there should be a clear explanation as to why it was necessary for the auditor to provide these services (for example, for certain services such as reviewing interim reporting or performing due diligence on transactions) and how the independence and objectivity of the audit was assured. In these cases, we also expect the committee to take action to ensure this does not reoccur, either by tendering for a new audit firm or reallocating non-audit work to a different firm.

We recognise that audit quality cannot be ensured solely through regular rotation of external auditors or reducing conflicts caused by the payment of fees for non-audit work. We expect audit committee chairs and committee members to understand the organisation, challenge management and external and internal audit teams, and to follow best practice guidance when appointing audit firms, such as those of the UK Investment Association to which we contributed.<sup>19</sup> Committee chairs and members should ensure they have sufficient time to fulfil their duties, which we expect to be significant, particularly for large, complex organisations. While the listing rule in Hong Kong and the corporate governance code in China expects companies' audit committee to be at least majority independent and chaired by an independent director or a financial expert, we continue to encourage companies to establish an entirely independent audit committee.

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<sup>19</sup> <https://www.ivis.co.uk/media/12498/Audit-tenders-guidelines.pdf>

### Accounting practices

We are concerned that accounting standards, as applied, do not always reflect underlying company performance. We encourage companies to apply accounting standards in a manner which is prudent and provides a true and fair view. Where application of the standards does not provide such a view, we expect companies and their auditors to make this clear to investors.

As such, we expect companies to avoid aggressive accounting practices that represent the company's financial position in a flattering light. This creates a reliance on the most optimistic of outcomes transpiring in subsequent years, which can easily compound up to the point that a preventable collapse finally occurs. We expect companies to recognise liabilities in a timely fashion, and to only realise profits where there is a very high degree of confidence in their quality. We also expect a clear indication of the quality of any unrealised profits found in the company's income statement.

### Audit and climate change

Where material or potentially material we expect companies to disclose climate and other environmental and social matters in its financial statements and clearly discuss the connection between accounting assumptions and the climate change impacts based on alignment to the Paris Agreement. We expect the auditor to communicate climate and other ESG matters as critical audit matters to the audit committee where material and involving challenging, subjective and or complex auditor judgement.

To the extent a company's financial statement does not adequately consider material climate risks and there is no corresponding explanation as to why, we may recommend a vote against the audit committee chair and auditor ratification. For more information on our corporate governance expectations related to climate change, please see the Climate Change section above.

## Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

## Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

## Why EOS?

EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

For more information, visit [www.hermes-investment.com](http://www.hermes-investment.com) or connect with us on social media:



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