Corporate governance and proxy voting guidelines for Hong Kong securities

JANUARY 2019

Contents

These guidelines should be read in conjunction with the BlackRock Investment Stewardship Global Corporate Governance and Engagement Principles.

Executive summary

BlackRock, Inc. and its subsidiaries (collectively, "BlackRock") seek to make proxy voting decisions in the manner most likely to protect and enhance the economic value of the securities held in client accounts. BlackRock has developed guidelines for the key markets in which it invests. The market specific guidelines incorporate the legal framework as well as the specific practices of each market. There may be slight variances due to differing market practices.

Our policies for Hong Kong are based on the Companies Ordinance, the Listing Rules of the Hong Kong Stock Exchange (the Exchange), particularly its Chapter 13 Continuing Obligations, Chapter 14 Notifiable Transactions, Chapter 14A Connected Transactions, Appendix 14 Corporate Governance Code and Corporate Governance Report and Appendix 27 Environmental, Social, and Governance Reporting Guide, and the Codes on Takeovers and Mergers and Share Buy-backs by the Securities and Futures Commission. These all have in common the principles of accountability, transparency, fairness and responsibility.

Our approach to voting and corporate engagement is also informed by guidance on exercising ownership responsibilities issued by organizations such as the United Nations (the Principles of Responsible Investment) and the International Corporate Governance Network. We are actively involved in these and a number of other regional and global organizations and believe our principles are consistent with their guidance.

"Comply or explain" approach

Appendix 14 Corporate Governance Code and Corporate Governance Report of the Listing Rules (the Code) sets out the principles of good corporate governance, and two levels of recommendations: 1) code provisions; and 2) recommended best practices. The code provisions are implemented on a comply or explain basis. The Code allows companies to choose to not adopt the code provisions as long as a cogent explanation has been provided for the non-compliance with the particular practice. BlackRock expects companies that do not follow code provisions to provide explicit justification of any deviation by explaining how these serve the interests of the company's shareholders. Recommended best practices are only for guidance. BlackRock encourages companies to aim for higher standards than merely complying with what is required.

Engagement

BlackRock takes an engagement-first approach to corporate governance, to the extent possible, as we believe this approach results in both better informed decisions and a more consistent dialogue with companies. Activities are coordinated by the Greater China Investment Stewardship team, bringing in investment colleagues as relevant to the focus of the engagement.

We have meetings and discussions with board directors and management to discuss aspects of corporate governance such as management of succession planning of the board, executive remuneration, board structure and performance, related-party transactions, quality of company disclosure and any environmental and social issues which we believe have the potential to unnecessarily increase the risk profile of the company. We may also participate in joint intervention with other shareholders where concerns have been identified by a number of investors. Alternatively, for our active holdings, we may consider reducing our holding in a company which is unresponsive to shareholder concerns; or for index as well as active holdings, we may publicly oppose management who are unresponsive to these concerns.

Proxy voting approach

BlackRock is one of the world's largest institutional investors, with extensive investment and engagement experience globally. BlackRock aims to vote at 100% of the annual and extraordinary shareholder meetings where we have the voting authority to do so and where there are no opportunity costs associated with exercising a vote (such as share blocking constraints) that are expected to outweigh in the determination of the Investment Stewardship Group the benefit BlackRock clients would derive by voting on the proposal.

These guidelines will be used to assist BlackRock in assessing proposals presented at shareholder meetings. When assessing any proposal put to shareholders BlackRock takes into account the unique circumstances of the relevant company and our assessment of the impact of such a proposal on the sustainable growth of the company. We aim to engage with management or members of the board, as appropriate, on contentious and high profile issues before determining how to vote.

Corporate governance and proxy voting guidelines

These guidelines are divided into eight key themes as follows:

- Boards and directors
- Accounts, statutory reports, auditors, and audit-related issues
- Capital management
- Mergers, asset sales, related-party and other special transactions
- Strategy, purpose, and culture
- Compensation and benefits
- Environment and social risks and opportunities
- General corporate governance matters

Boards and directors

Composition of the board of directors

The board of a listed company should comprise competent individuals who have the requisite skills and experience to fully discharge their duties to shareholders. BlackRock expects the independent directors to possess between them the necessary breadth of experience and diversity of skills and to provide objective oversight in the decision-making process of the board without any conflicts of interest or undue influence from connected parties.

Board independence

At a minimum, we believe independent directors should comprise at least one third of the board for these directors to represent an effective voice. Ideally, a board should consist of a majority of independent directors. In cases where the board is not at least one third independent and where no explanation has been provided, BlackRock may consider voting against the re-election of the chair of the nomination committee, and / or the chair of the board, particularly if there are other corporate governance concerns.

Assessment of independence

An independent director is a director who is not a member of management (a non-executive director) and who:

- Does not have, and does not represent a shareholder with, a substantial shareholding in the company
- Has not within the last five years been employed in an executive capacity by the company or another group company, and has not been appointed a director immediately after ceasing to hold any such employment
- Has not within the last three years been a principal or employee of a material professional adviser or a material consultant to the company or another group member
- Is not a material supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a material supplier or customer
- Has no material contractual relationship with the company or another group member other than as a director of the company
- Is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company
- Is not an immediate family member of any of the aforementioned
- Is not connected through interlocking directorships with the company

Conflicts of interest

BlackRock believes that all independent directors should be free from material conflicts of interest. Non-executive directors, their immediate family or a related professional company, who or which have provided material professional services to a company at any time during the last three years, may be placed in a position where they may have to make decisions that may place their interests against those of the shareholders they represent. BlackRock may vote against the election / re-election of a director where an identified conflict of interest may pose a significant and unnecessary risk to shareholders. All potential conflicts of interest should be declared prior to appointment and at each board meeting in relation to any specific agenda items.

Separation of chairman and CEO position

We believe that independent leadership is important in the board room. There are two accepted structures for independent board leadership: 1) an independent chairman; or 2) a lead independent director. We generally consider the designation of a lead independent director as an acceptable alternative to an independent chair if the lead independent director has a term of at least one year and has powers to: 1) introduce items on board meeting agendas; 2) call meetings of the independent directors; and 3) preside at meetings of independent directors. Where a company does not have a lead independent director that meets these criteria, we generally support the separation of chairman and CEO.

Length of service

BlackRock believes that shareholders are best served when there is orderly renewal of the board. This should result in directors with accumulated experience while at the same time introduce fresh minds and experience to the board as well as provide adequate succession planning. An effective renewal process will ensure non-executive directors do not serve for such lengths of time that may impair their independence.

Where a company considers a director with nine or more years' service to be independent we expect a cogent explanation justifying the independent classification. Where such explanation is absent, we may consider voting against such a director on the basis of a lack of independence on the board.

Board effectiveness

To ensure that the board remains effective, regular reviews of how it makes decisions and the information it receives should be carried out and assessments made of gaps in skills or experience amongst the members. In identifying potential candidates, boards should take into consideration the diversity of experience, expertise and perspectives of the current directors and how that might be augmented by incoming directors. Diversity also recognizes differences relating to gender, age, ethnicity, and cultural background. Our publicly available commentary explains our approach to engaging on board diversity.

We believe that directors are in the best position to assess the composition and optimal size of the board but we would be concerned if a board seemed too small to have an appropriate balance of directors or too large to be effective.

We expect the board to establish a robust process to evaluate the performance of the board as a whole and the contributions of each director. BlackRock believes that annual performance reviews of directors and the board contribute to a more efficiently functioning board.

Share ownership by non-executive directors

BlackRock believes listed companies should have a clear and disclosed policy on non-executive director share ownership. We believe that non-executive directors should have some "skin in the game" in order to align their interests with those of public shareholders. Such policies should require non-executive directors, within a reasonable amount of time after joining the board, to accumulate a meaningful investment.

Where a non-executive director continues serving on a board and fails to accumulate a meaningful investment and other significant corporate governance issues exist, BlackRock may vote against the individual.

Nomination procedure

The company should have a formal and transparent procedure for the appointment and re-appointment of directors. The board should adopt a procedure that can ensure a diverse range of candidates to be considered. Such procedure may involve the engagement of an external professional search firm.

The procedure for the nomination and evaluation of the board should be disclosed in the corporate governance section in the annual report. We seek information to understand how the board composition reflects the company's stated strategy, trends impacting the business and succession expectations. Where this information is not provided, BlackRock may consider voting against re-election of members on the nomination committee.

Disclosure of director information

BlackRock expects the following information to be disclosed in the annual report and company website, and the meeting circular when a director is seeking election / re-election:

- Directors' full name and age
- Date appointed to the board (in the case of re-elections)
- Brief biography detailing the directors' educational background, working experience, and any other board positions held
- Specific discussion on the skills and experience the director is expected to contribute to the board
- The company's assessment of the director's independence including details of any current dealings with the company

Particularly when a director is seeking election / re-election it is imperative the above information is provided to allow us to determine whether to support the appointment. Where this information is not forthcoming BlackRock may consider voting against the election / re-election of that director.

External board mandates

As the role of director is increasingly demanding, directors must be able to commit an appropriate amount of time to board and committee matters. Given the nature of the role, it is important a director has flexibility for unforeseen events. BlackRock is especially concerned that where a full-time executive has a non-executive director role or roles at unrelated companies, there may be a risk that the ability to contribute in either role could be compromised in the event of unforeseen circumstances.

BlackRock expects companies to provide a clear explanation of the capacity to contribute in situations where a board candidate is (1) a director serving on more than six other public company boards; (2) a chairman of another listed company, or (3) an executive officer at a public company and is serving on more than two other public company boards. When looking at the number of board mandates, BlackRock will consider if the board memberships are of listed companies in the same group and/or for similar sectors.

BlackRock may vote against the election / re-election of a director where there is a risk the director may be over committed in respect of other responsibilities and / or commitments (taking into account outside employments and / or board mandates on private companies / investment trusts / foundations). In case of an executive officer, we would vote against his/her election/re-election only at external boards.

BlackRock may vote against the election of an outside executive as the chairman of the board as we expect the chairman to have more time availability than other non-executive board members. We expect the company to explain why it is necessary for this external executive to lead the board of directors.

Meetings

Directors should ensure they attend all board and relevant committee meetings. BlackRock will consider voting against a director who attends fewer than 75% of board and relevant committee meetings for the past term of being a director, unless compelling reasons for the absenteeism have been disclosed. However, BlackRock will disregard attendance in the first year following appointment as the director may have had commitments made prior to joining the board.

Committees[1]

Appropriately structured board committees provide an efficient mechanism which allows the board to focus on key issues such as audit, board renewal, compensation, risk, and any other issues deemed important. Board committees can also provide an important role dealing with conflicts of interests.

BlackRock expects all companies to establish an audit committee, a compensation committee, and a nomination committee. All committees should have written terms of reference which should, inter alia, clearly set out the committee's roles and responsibilities, composition, structure, membership requirements and the procedures for inviting non-committee members to attend meetings. All committee terms of reference should be available to investors on the company's website.

All committees should be given the power and resources to meet their obligations under the terms of reference. This will include the right of access to management and the ability to select service providers and advisors at a reasonable cost to the company.

The chairman of a committee should be independent. It is preferable for the chairman of the board not to chair board committees as this may lead to a concentration of power in a single director.

Audit committee

The audit committee should comprise only non-executive directors and a majority of independent directors, and an independent chair, with at least one member having appropriate accounting or related financial background.

[1] Rule 3.21 & 3.25 of the Listing Rules requires companies to establish an audit committee and a compensation committee respectively. However, it is only a code provision for companies to establish a nomination committee. The code provision was upgraded from a "recommended best practice" in 2012.

The terms of reference for the audit committee should have appropriate powers to determine the scope of the audit process, review the effectiveness of the external auditor, assess, review, and authorize non-audit work, have access to the internal audit process and to make recommendations regarding the appointment and removal of the external auditor.

Where a risk committee has been established in addition to an audit committee, clear disclosure needs to be made on the responsibilities of each committee and how they interact.

BlackRock generally does not support the election of an executive director to be on the audit committee. Where the audit committee does not comprise a majority of independent directors and the chair is not independent, BlackRock will consider voting against the non-independent members of the audit committee particularly if there are other corporate governance issues. Further, where there is evidence showing failure of the audit committee relating to the preparation of financial statements, fraud and general accountability to shareholders, we will consider voting against the re-election of members of the audit committee.

Compensation committee

The compensation committee should comprise a majority of independent non-executive directors and have an independent chair. The responsibilities of the compensation committee should include a review of and recommendations to the board on issues including but not limited to:

- The company's compensation, recruitment, retention, and termination policies for senior executives
- Executive director and senior executives fixed and performance-based compensation to ensure that executives are motivated to pursue the long-term growth and success of the company
- The compensation framework for non-executive directors

Where BlackRock believes the compensation committee has failed in its role, we will consider voting against the re-election of the chair / members of the committee.

Nomination committee

The nomination committee should comprise a majority of independent non-executive directors and have an independent chair. The responsibilities of the nomination committee should include a review of and recommendations to the board on issues including but not limited to:

- Assessing the competencies of all directors to ensure the board has an appropriate range of skills and expertise
- Implementing a plan for identifying, assessing, and enhancing director competencies
- Reviewing, at least annually, the succession plans of the board
- Ensuring the size and composition of the board is conducive to making appropriate decisions

- Reviewing the time required by each non-executive director to undertake their role and whether non-executive directors are meeting that requirement

- Ensuring a process for the evaluation of the performance of the board, its committees, and directors, and reporting the process to shareholders in the corporation governance report in the annual report

- The appointment and re-election of directors

- Maintaining a watching brief on the development of management and potential for senior executive succession planning from the level below senior executives

Circumstances where BlackRock may consider voting against the re-election of the chair and / or members of the nomination committee include but are not limited to:

- If the composition of the board continues to reflect poor succession planning, renewal, or other composition deficiency

- If the committee approved the nomination or re-election of an individual who has demonstrated a lack of integrity or inability to represent the interests of shareholders, or who has an actual or perceived material conflict of interest that poses a risk to shareholders

- If the committee fails to hold a meeting in the reporting year

Risk management

BlackRock believes that the board is responsible for assessing a company's risk profile relative to its business. Companies should implement controls and processes to oversee, manage, and control the risks relevant to their business, including operating, environmental, health, and safety of the labor force, as well as other social, market, and financial risks. BlackRock expects companies to disclose how these risks are being managed in their annual report and / or website.

Accounts, statutory reports, auditors and audit-related issues

Accounts and statutory reports

BlackRock recognizes the critical importance of financial statements that provide a true and fair view of a company's financial condition. Statutory reports such as Directors' Report and the Annual Report also serve to depict a fair picture of the company's business strategy, operational performance, risk management, and financial strength. Where there is an unqualified auditor's report for the financial statements and where the accounts and statutory reports are disclosed in a timely manner and with the requested information, we will support proposals to approve accounts and statutory reports.

Auditors and audit-related issues

The appointment of the auditor and the auditor's compensation needs to be reviewed and approved by shareholders on an annual basis. BlackRock expects the audit firms to be well qualified to undertake the task on behalf of shareholders. When a listed company proposes to appoint a different audit firm, BlackRock expects the company to provide a reasonable explanation for changing its audit firm, assuring shareholders that there are no disputes with company management connected with the auditor ceasing to hold office. Where no explanation is provided, BlackRock may consider voting against the appointment of a new audit firm and against the re-election of members on the audit committee.

BlackRock's view is that a demonstrably independent audit is essential for investor confidence. BlackRock expects companies to make detailed disclosure on auditor compensation. Where non-audit fees exceed the level of audit fees in any year, BlackRock will review the nature of the non-audit fees and any explanation provided by the company for the significant level of non-audit fees. Full details of all non-audit work should be disclosed. If there is a lack of explanation of the non-audit services or we believe there is a risk that the type of non-audit services provided may impair the independence of the audit, we may consider voting against the re-appointment of the external auditor and the re-election of members on the audit committee.

Capital management

Allocation of profits / dividends

With the exception of companies incorporated in China, Hong Kong listed companies can declare a dividend by way of a board resolution, although some still submit a resolution to shareholders at a general meeting. These resolutions, when proposed, are generally not contentious and supportable. However, where dividend payout ratios appear, without explanation, to be too high or too low BlackRock may consider voting against relevant individuals on the board.

Placements, share buybacks, and reissuances of shares

The Listing Rules require shareholder approval for the following:

- To issue shares without pre-emptive rights. Companies can seek shareholder approval to issue up to 20% of equity and with a discount of up to 20% (known as the general mandate)
- To buy back up to 10% of shares on issue in a 12 month period (buyback mandate)
- To re-issue the shares that have been bought back (reissuance mandate)

The above mandates are often sought at the annual general meeting and shareholder approval is only for the next 12 months.

While BlackRock recognizes an issuer's need for the flexibility to raise funds and the capability to do so quickly at times, we consider the dilution risk implied by a general mandate of 20% in size and 20% in discount as potentially excessive. BlackRock will consider voting against a general mandate request for a 20% issuance at a 20% discount where a cogent explanation for the need to have such flexibility has not been provided in the explanatory memorandum. When seeking shareholder approval for a general mandate we expect disclosure of the following:

- An explanation for the need of a general mandate request and rationale for the proposed size and discount limit with reference to company's financial position and capital expenditure plans
- Details of any placements made under general mandates in the last five years
- Alternative financing methods considered by the board

When shareholders are asked to approve the general mandate as well as a buyback of shares a further request for a re-issuance of shares bought back does not seem necessary. BlackRock generally does not support a re-issuance mandates unless a cogent explanation is provided.

Rights issues and open offers

A rights issue does not require shareholder approval as long as the rights issue does not increase either the number of issued shares or the market capitalization of the issuer by more than 50% on its own or when aggregated with any other rights issues or open offers in the past 12 months. When this threshold is exceeded, a rights issue needs to be approved by shareholders in a general meeting and any controlling shareholders and their associates or, where there are no controlling shareholders, non-independent non-executive directors, and the chief executive of the issuer shall abstain from voting in favor.

Open offers[2] require minority shareholders' approval unless the new shares are to be issued under the authority of an existing general mandate.

Rights issues, open offers and specific mandate placings, individually or when aggregated within a rolling 12-month period that would result in a cumulative material value dilution of 25% or more are disallowed by the Exchange, unless there are exceptional circumstances.

Dual class shares

Effective voting rights are central to the rights of ownership and we believe strongly in one vote for one share as a guiding principle that supports good corporate governance. Shareholders, as the residual claimants, have the strongest interest in protecting company value, and voting power should match economic exposure.

We are concerned that the creation of a dual share class now permitted for certain companies under the Listing Rules of the Hong Kong Stock Exchange may result in an over-concentration of power in the hands of a few shareholders, thus disenfranchising other shareholders and amplifying the potential conflict of interest, which the one share, one vote principle is designed to mitigate. Where a company believes there is a valid argument for dual-class listing full disclosure of the rationale for the differential class structure should be disclosed. Further, such companies should review these structures on a regular basis or as company circumstances change. Additionally, they should receive shareholder approval of their capital structure on a periodic basis via a management proposal at an annual general meeting. The proposal should give unaffiliated shareholders the opportunity to affirm the current structure or establish mechanisms to end or phase out controlling structures at the appropriate time, while minimizing costs to shareholders.

As always, independent directors are expected to protect the interests of all shareholders and BlackRock will potentially vote against re-election of independent directors in companies with dual class share structures if valid concerns arise relating to the economic interests of unaffiliated shareholders being compromised.

[2] An offer to existing shareholders to subscribe securities, whether or not in proportion to their existing holdings, which are not allotted to them in renounceable documents.

Mergers, asset sales, related-party and other special transactions

In reviewing merger and asset sale proposals, BlackRock's primary concern is the best long-term interests of shareholders. While these proposals vary widely in scope and substance, we closely examine certain salient features in our analyses. For mergers and asset sales, we assess the degree to which the proposed transaction represents a premium to the company's trading price. In order to filter out the effects of pre-merger news leaks on the parties' share prices, we consider the share price over multiple time periods prior to the date of the merger announcement. In most cases, business combinations should provide a premium. We may consider comparable transaction analyses provided by the parties' financial advisors and our own valuation assessments. For companies facing insolvency or bankruptcy, a premium may not apply. Where the transaction involves related parties we expect the board to establish a committee comprised of independent directors to review the transaction and report to shareholders. There needs to be a clear favorable business reason for any such transaction.

Unanimous board approval and arm's-length negotiations are preferred. We will consider whether the transaction involves a dissenting board member or does not appear to be the result of an arm's-length bidding process. We may also consider whether executive and / or board members' financial interests in a given transaction appear likely to affect their ability to place shareholder interests before their own.

Related-party transactions

Related-party transactions (RPTs) are common at Hong Kong listed companies. These are transactions between the company and its related-parties, as defined in details in the Chapter 14A of Listing Rules. According to the materiality and nature of the transaction, it may need to be disclosed or submitted to a shareholder meeting for approval. Any shareholder who has a material interest in the transaction must abstain from voting on the resolution. If an RPT requires shareholders' approval, the issuer is required to establish an independent board committee comprised solely of independent non-executive directors and appoint an independent financial adviser to assist the independent board committee to prepare a recommendation to disinterested shareholders.

Broadly speaking, there are two types of related-party transactions: 1) one-off transactions, typically asset purchases or disposals; 2) recurring RPTs that are within the ordinary course of business, usually in the form of an ongoing goods and services purchase and provision agreement.

BlackRock assesses one-off RPTs on a case by case basis. Key factors we take into consideration include the strategic rationale and the fairness of the transaction terms. Moreover, BlackRock expects the company to disclose in detail the decision-making process the board has gone through and the process the independent directors have gone through to arrive at their recommendation to minority shareholders.

Recurring RPTs involving the purchase and provision of goods and non-financial services are disclosed in the annual report in detail and are subject to approval by shareholders at least once every three years. In most cases, these transactions are within the normal course of business and are done at arms-length terms. Where disclosure is sufficient, BlackRock generally finds these proposals supportable.

Financial services agreements

It is common among Chinese State-Owned Enterprises (SOEs) to establish a finance company within the business group (hereinafter referred to as Group Finance Companies [GFCs]). GFCs are set up to provide a range of financial services (mainly deposit, loan, and settlement related) to the group member companies. The main purpose is to better utilize capital within the same group by channeling funds among members through the GFC as companies are banned from directly borrowing from or lending to another corporate entity. GFCs are typically majority owned by the unlisted group parent, which also controls the listed company. A listed company obtains services from a GFC by entering into a financial service agreement, which requires shareholder approval once every three years.

BlackRock recognizes the merits of dealing with a GFC compared to a commercial bank, such as preferential deposit and loan interest rate, and expedited and customized settlement services. However, we are concerned with certain risk aspects unique to dealing with GFCs. While GFCs are subject to the same capital requirements and are also monitored by the China Banking Regulatory Commission (CBRC), as a private entity there is not the same level of transparency compared to large commercial banks, the majority of which are listed. Another key difference between a GFC and a commercial bank is that a GFC only deals with member companies within the same group whilst a commercial bank deals with all participants in the economy. As a result, GFCs are exposed to risks concentrated in a business group while a commercial bank's risk is much more diversified. Moreover, transactions with GFCs are related-party transactions and therefore exposed to conflicts of interest. An extreme example of such conflicts left unchecked is a listed company being exploited by the group as a window of financing given its access to the wider capital market.

BlackRock believes companies can mitigate these risks by establishing a robust internal review and audit process to ensure each deposit at and loan from the GFC is has a sound business and capital management rationale. Companies should also aim to achieve a level of transparency beyond the minimum requirement around transactions with GFCs and GFCs themselves. BlackRock may consider voting in favor of a financial service agreement if in our assessment a company has set up an effective risk management mechanism in place to address the conflict of interest, and has disclosed sufficient information about the GFC and the transactions with it. Relevant information includes but is not limited to:

- Rationale behind the deposit and loan limit requested
- Decision-making process of placing deposits and obtaining loans from the GFC
- Key financial metrics of the GFC such as loan to deposit rate, capital adequacy ratio, and amount of non-performing loans
- Activities other than taking deposits and making loans that the GFC may engage such as equity investments, entrust loans, and finance leasing
- Interest rates paid on deposits and charged for loans by deposit and loan type
- The corporate governance structure of the GFC and its loan approving process
- Percentage of the company's capital deposited at the GFC versus that at a commercial bank

BlackRock expects such disclosure to be made not only in the meeting circular when shareholder approval is being sought once every three years but also in the annual report so that investors get to review these transactions and the financial strength of the GFC on an annual basis.

Strategy, purpose, and culture

Strategy, purpose, and culture are more nuanced than many aspects of governance. An understanding of these matters, the involvement of the board in their articulation as well as oversight of their implementation are key for long-term investors to assess the company's ability to generate value over time. BlackRock thus seeks from companies clear and insightful explanations in this area, and for transparency on these matters to become the norm for Hong Kong listed companies.

BlackRock expects companies to articulate the strategic milestones against which shareholders should assess performance, specifically, public disclosure of financial targets to be shared with all shareholders, for instance long-term return on capital or alternative criteria of value creation. We expect companies to provide information on how the board contributes to strategy, purpose and culture and oversees management's implementation of the agreed plans and policies.

In the absence of this information, and / or when we have concerns, we believe that engagement is preferable to voting to communicate expectations on these matters to the company. In our engagements, we will underscore the importance of a clear articulation of strategy, purpose and culture by the board. These aspects should be well-understood both by management and staff as well as transparent to investors to be able to assess if management and the board are exercising appropriate stewardship of resources and, over time, the company is moving consistently in the direction stated.

Compensation and benefits

The key purpose of compensation is to reward, attract, and retain competent directors, executives and other staff who are fundamental to the long term sustainable growth of shareholder value, with reward for executives contingent on controllable outcomes that add value. Each company faces different issues at different times, has different value drivers and accordingly, BlackRock believes that each company should structure their compensation policies and practices in a manner that suits the needs of that particular company.

Director and executive compensation is disclosed on an individual basis with detailed breakdown of the compensation components[3] as required by the Companies Ordinance. However, not many companies disclose the rationale behind compensation decisions particularly performance-based pay. This is especially problematic given the level of director and executive compensation has recently been on the rise, significantly so in certain sectors. Where there is performance-based pay, BlackRock expects companies to disclose the key performance metrics selected and the rationale for their inclusion, e.g. why these metrics are suitable considering the company's development stage, business strategy, and the nature of the industry the company is in.

Non-executive director compensation

The role of the non-executive director is to monitor the strategy, performance, and compensation of the executives and to protect the interests of shareholders in the long term. Non-executive directors should receive sufficient compensation to attract and retain suitably qualified non-executive directors and encourage them to undertake their role diligently. The executive arm and any major shareholder should not have any undue influence over the compensation of non-executive directors.

[3] Disclosure of Chinese companies dual-listed in the Mainland Exchanges and the Hong Kong Exchanges varies. Some align their disclosure to those of the Hong Kong-incorporated companies while the majority sticks to the disclosure practice of Chinese companies, which only gives a lump-sum number for each director and senior executive without a breakdown of the pay components such as base salary, performance bonus, and benefits.

Non-executive director compensation should be structured in such a way that it aligns the interests of the directors with those of the shareholders they represent. The structure of non-executive director compensation should not provide any disincentive to resign from the board should an issue of conflict or any other issue that would impair a director's independence arise.

Non-executive directors should receive a fixed annual fee, including additional fixed fees for board committee membership for their services. BlackRock supports non-executive directors entering into "salary sacrifice" arrangements whereby a portion of their fees is received by way of fully paid shares purchased on market.

BlackRock does not generally support the granting of options to non-executive directors as such securities do not have the same risk profile as the ordinary shares held by ordinary shareholders and therefore may not align the interests of directors with those shareholders they represent. Non-executive directors should not receive performance-based compensation, as to do so would more closely align their interests with those of management, whose performance and compensation they are intended to monitor on behalf of shareholders. Where options or performance-based compensation have been granted to non-executive directors, BlackRock will consider voting against any such proposals and the re-election of the chair of the compensation committee.

Equity-based incentive plans

Equity-based incentive schemes for executives of Hong Kong companies are common. The most often used pay vehicle is stock options. The adoption and refreshment of a stock option requires shareholder approval in a general meeting. Under the Listing Rules, the size of an option scheme is capped at 10% of the issued capital. However, companies can refresh a stock option scheme upon shareholder approval although the aggregate number of options outstanding should not exceed 30% of the issued capital. The exercise price of the stock options must be no less than the market price at the time of the grant. The Listing Rules do not require the vesting of options to be conditioned on meeting certain performance conditions. We support incentive plans that foster the sustainable achievement of results. The vesting time frames associated with incentive plans should facilitate a focus on long-term value creation.

Dilution

To ensure that equity based compensation plans operate in a way that benefits both employees and shareholders, BlackRock expects to see a limit on the amount of dilution that can occur across all plans that a company may have. BlackRock may consider voting against an options plan if it may lead to over 10% cumulative dilution over ten years inclusive of existing plans, or if a plan is not transparent in demonstrating the distribution of option awards between senior executives and other staff.

Environmental and social risks and opportunities

As part of its investment process on behalf of its clients, BlackRock assesses a range of factors that might affect the long-term financial sustainability of the companies in which we invest, including how companies identify and manage the material environmental and social (E&S) risks or opportunities relevant to their business activities. Evolving regulations and increasingly stringent enforcement are issues Hong Kong companies have to plan for which could significantly impact current operations as well as expansion plans; the board has to be cognizant of these risks in shaping the company's growth strategy.

BlackRock expects listed companies to disclose all material risks and opportunities relating to E&S issues and how they are managed. The framework for disclosure should include but not be limited to:

- Identification of E&S risks specific to the company
- Clear outline of board and management responsibilities on E&S issues
- Policies and processes to manage E&S risks as well as an explanation of how they are implemented and monitored
- Disclosure of key targets and indicators across the whole company
- Regular reporting on performance against policies and targets

Where BlackRock has concerns regarding the disclosure and management of E&S issues, we may consider voting against the election / re-election of directors who are ultimately responsible for such issues.

General corporate governance matters

BlackRock believes that shareholders have a right to timely and detailed information on the financial performance and viability of the companies in which they invest. In addition, companies should publish information on the governance structures in place and the rights of shareholders to influence these. The reporting and disclosure provided by companies helps shareholders assess whether their economic interests have been protected and the quality of the board's oversight of management. BlackRock believes shareholders should have the right to vote on key corporate governance matters, including on changes to governance mechanisms, to submit proposals to the shareholders' meeting, and to call special meetings of shareholders.

Amendments to articles of association

These proposals vary from routine changes to reflect regulatory change to significant changes that substantially alter the governance of the company. We will review these proposals on a case-by-case basis and support those proposals that we believe are in the best interests of shareholders.

Anti-takeover devices

BlackRock believes that transactions or practices that are intended to impede a potential takeover can be limiting to shareholders. BlackRock will generally not support proposals that introduce or renew anti-takeover devices.

Bundled proposals

We believe that shareholders should have the opportunity to review substantial issues individually without having to accept bundled proposals. Where several measures are grouped together, BlackRock may reject the overall proposal if it includes those that contradict or impede the rights and economic interests of shareholders.

Shareholder proposals

Whilst we recognize the importance of the right of shareholders to submit proposals to general meetings in jurisdictions where this is permitted, we will not support those that are frivolous or that cover any issues that we believe are the purview of the board or management, have been addressed adequately, or where the company has disclosed that such issues will be addressed. We will support shareholder proposals that we believe enhance shareholders' rights or are in the best economic interests of long-term shareholders.