Submission to the Hong Kong Stock Exchange:

Consultation Paper on the Review of the Corporate Governance Code and Listing Rules (April 2021)

17 June 2021

THE REMEDY PROJECT

SUBMISSION TO THE HONG KONG STOCK EXCHANGE ON ITS CONSULTATION PAPER ON THE REVIEW OF CORPORATE GOVERNANCE CODE AND LISTING RULES (APRIL 2021)

June 17, 2021

I. EXECUTIVE SUMMARY

1. The Remedy Project Limited ("**The Remedy Project**") is a social enterprise that works with companies and workers to develop and improve remediation mechanisms to redress labour grievances for fair, effective and enduring positive outcomes. We also work with government bodies, law enforcement agencies, international organisations, and civil society organisations across Asia and beyond to provide policy advice, conduct research, and build capacity to combat forced labour, human trafficking, and other forms of exploitation.

2. The Remedy Project welcomes the review of the Corporate Governance Code (the "**Code**") and Listing Rules in the Hong Kong Stock Exchange's ("**HKEX**") April 2021 consultation paper ("**Consultation Paper**"). The Remedy Project commends the HKEX's proposals to strengthen the linkage between corporate governance ("**CG**") and Environmental, Social and Governance ("**ESG**") considerations.

3. In this paper, The Remedy Project responds to Questions 11 and 12 in the Consultation Paper, as set out below:[1]

    - Question 11: Do you agree with our proposal to elaborate the linkage in the Code by (a) setting out the relationship between CG and ESG in the introductory section; and (b) including ESG risks in the context of risk management under the Code?

    - Question 12: Do you agree with our proposal to amend the Listing Rules ("**Rules**") and the Environmental, Social and Governance Reporting Guide ("**ESG Guide**") to require publication of ESG reports at the same time as publication of annual reports?

4. The Remedy Project **agrees** with these proposed changes. Businesses have a responsibility to respect the human rights of all stakeholders impacted by, or directly involved in their operations, including its employees, supply chain workers, local communities, and consumers. Respect for human rights is a key tenet of the "S" in ESG, and companies that fail to do so can be exposed to significant financial, legal, and reputational risks. ESG considerations should therefore form a core part of a company's business strategy, with board-level oversight, and not simply paid lip-service. An increased emphasis on the linkage between CG and ESG is a much-needed step in this direction.

5. However, while the proposed changes in the Consultation Paper are a highly commendable first step, they can be strengthened through the express recognition of board responsibility for ESG risk management practices in Principle D.2 and sections D.2.3 and D.2.4. of the Code. We suggest amendments in paragraph 15 below to strengthen the linkage between CG and ESG. The Remedy Project believes that without express references to board responsibility and accountability for ESG risk management, the envisioned linkage cannot be established in practice.

[1] The Remedy Project's submission will focus on the above two questions as the remaining proposals in the consultation are not directly relevant to our mission or areas of focus.

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II. BACKGROUND

6. The protection of human rights is a core component of the "S" aspect of ESG.[2] The United Nations Guiding Principles on Business and Human Rights ("**UNGPs**") make clear that businesses have a responsibility to protect and respect human rights and remedy any violations of rights.[3] In the decade since the UNGPs were first published, initiatives to bring sustainable investment principles into the mainstream have gained momentum. These include the United Nations Sustainable Stock Exchange Initiative (of which HKEX is a supporter), the United Nations Principles for Responsible Investment and the Global Reporting Initiative.

7. The ESG movement has been accelerated by the enactment of national laws to encourage business disclosure of efforts taken to address modern slavery risks. Pursuant to the UNGPs, states have a duty to protect human rights through encouraging businesses to communicate how they address their human rights impacts.[4] Many states have laws on modern slavery reporting – including the UK's Modern Slavery Act, California's Transparency in Supply Chains Act, Australia's Modern Slavery Act – and on mandatory human rights due diligence, such as France's Duty of Vigilance law and the Netherlands' Child Labour Due Diligence Act. Courts have also shown a willingness to hold corporations accountable for human rights violations and adverse ESG effects arising from their operations. In 2020, the Supreme Court of Canada ruled that violations of customary international law (*e.g.*, prohibitions against slavery and forced labour) could form the basis of civil actions against Canadian companies.[5] Earlier this year, a Dutch court ordered Royal Dutch Shell to significantly accelerate planned carbon emission cuts.[6]

8. In this fast-evolving landscape, The Remedy Project believes that it is no longer adequate to treat ESG disclosure as a box-ticking exercise or public relations opportunity. Hong Kong-listed companies should be encouraged to respect and protect human and environmental rights, and to remediate (where necessary) human rights violations and/or adverse environmental effects of their operations. Corporate responsibility to protect human rights has moved beyond voluntary standards and requires investment in corporate governance processes of due diligence, disclosure, and establishing functioning and effective grievance mechanisms. With responsibility must come accountability.

III. RESPONSE TO QUESTION 11

9. The Remedy Project **agrees** with the HKEX's proposal to amend the Code to set out the linkage between CG and ESG in the introductory section, and to set out ESG risks in the context of risk management in the Code.

10. We further **recommend** that Principle D.2 and sections D.2.3 and D.2.4. of the Code are further amended to address the gaps in existing ESG risk management practices and ESG materiality assessments. Our proposed amendments are out in paragraph 15 below.

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[2] For further reading, please refer to What institutional investors need to know about the 'S' in ESG, United Nations Principles for Responsible Investment. Accessed: https://www.unpri.org/pri-blog/what-institutional-investors-need-to-know-about-the-s-in-esg/6635.article.

[3] *See* UNGP Principle II.A.11.

[4] *See* UNGP Principle I.B.3.(d).

[5] *Nevsun Resources Ltd v Araya,* 2020 SCC 5

[6] Explainer: What the Dutch court carbon emissions ruling means for Shell, Reuters. Accessed: https://www.reuters.com/business/sustainable-business/what-dutch-court-carbon-emissions-ruling-means-shell-2021-05-26/

Emphasis of the linkage between CG and ESG highlights the importance of board accountability for ESG management

11. The board has a critical responsibility to ensure the company manages ESG issues that relate to its business. Pursuant to the UNGPs, a company's commitment to respect human rights "*should be embedded from the top of the business enterprise through all its functions, which otherwise may act without awareness or regard for human rights*".[7] A key part of a director's fiduciary responsibility is the duty of care.[8] Directors therefore need to inform themselves of the risks that arise from ESG issues and evaluate how the company's operations may impact ESG factors.[9] Failure to do so may expose directors and officers to personal liability.

12. Evaluation of the ESG-related effects of a company's business should form part of its day-to-day compliance. As with other compliance programs, ESG risk management must be supported by board-level commitment, effective due diligence processes for risk detection, meaningful remediation procedures and proper disclosure. However, according to a survey conducted by BDO, only 54% of Hong Kong-listed companies surveyed disclosed information on board oversight of ESG issues in 2020. [10] The Remedy Project therefore hopes that the proposed changes will lead to greater understanding, ownership and mainstreaming of ESG-related processes at the board-level and across all relevant business functions.

Express inclusion of material ESG risks in the risk management section of the Code emphasizes the importance of board oversight

13. As recognized by the HKEX and international guidance,[11] senior management should assess the materiality of ESG risks faced by a business. However, only 60% of Hong Kong listed companies surveyed by BDO in 2020 disclosed that they had conducted a materiality assessment. [12] Of those companies, only around 50% provided detailed disclosure on how ESG issues have been prioritized and presented. [13] The lack of an adequate ESG materiality assessment, or the neglect of ESG issues may increase a company's exposure to ESG-related risks. Notably, in March 2019 a Hong Kong-listed company involved in the construction of a casino was implicated in a lawsuit involving labour abuse of Chinese migrant construction workers in Saipan.[14] Yet, when the company published its

7 See UNGP Guiding Principle 16 Commentary. Accessed at: https://globalnaps.org/ungp/guiding-principle-16/
8 See also Rule 3.08 of the HKEX Main Board Listing Rules and Principle 4 of A Guide on Director's Duties.
9 For more details, please refer to Running the Risks: How Corporate Boards Can Oversee Environmental, Social and Governance Issues, Veena Ramani and Hannah Saltman, Ceres. Accessed: https://corpgov.law.harvard.edu/2019/11/25/running-the-risks-how-corporate-boards-can-oversee-environmental-social-and-governance-issues/
10 BDO Survey: Fourth-year ESG reporting performance survey shows the evolvement in overall ESG involvement of majority listed companies but which remain inadequate to meet the requirements of the Revised Guide, BDO. Accessed: https://www.bdo.com.hk/en-gb/news/2021/bdo-survey-fourth-year-esg-reporting-performance-survey-shows-the-evolvement-in-overall-esg-involve
11 Please refer to A Practical Guide to Sustainability Report Using GRI and SASB Standards, Produced by the Global Reporting Initiative (GRI) and Sustainability Accounting Standards (SASB). Accessed: https://www.globalreporting.org/media/mlkjpn1i/gri-sasb-joint-publication-april-2021.pdf
12 BDO Survey: Fourth-year ESG reporting performance survey shows the evolvement in overall ESG involvement of majority listed companies but which remain inadequate to meet the requirements of the Revised Guide, BDO. Accessed: https://www.bdo.com.hk/en-gb/news/2021/bdo-survey-fourth-year-esg-reporting-performance-survey-shows-the-evolvement-in-overall-esg-involve
13 *Ibid.*
14 For more details, please refer to "Hong Kong owner of Pacific Island casino sued over forced labor, trafficking claims", Reuters and "Labour exploitation in Saipan (again): what difference does 20 years make?", Business & Human Rights Resource Centre. Accessed at:

2019 ESG report in July 2020, it stated that its operations only had a minimal risk exposure to forced labour and that they considered this a non-material risk.[15]

14. Significant improvement in the identification and management of material ESG risks is evidently required. The proposed change highlights board responsibility for evaluating and determining the nature and extent of ESG risks. The Remedy Project hopes that this will improve materiality mapping of ESG issues, and more importantly, encourage the implementation of company procedures to remedy (where identified) adverse ESG effects arising from business operations. This should involve, at the very least, meaningful human rights due diligence processes, a company-wide commitment to a human rights policy, effective and accessible grievance mechanisms to remediate adverse impacts, and meaningful engagement with all stakeholders in the ESG risk management process. The Operational Guidelines for Businesses on Remediation of Human Rights Grievances, authored by The Remedy Project in partnership with the United Nations International Organization for Migration, provide a structure for Hong Kong listed companies to develop these mechanisms to remediate grievances.[16]

15. To address the gaps in existing ESG risk management practices and materiality assessments, The Remedy Project recommends that Principle D.2 and sections D.2.3 and D.2.4. of the Code are further amended as follows (The Remedy Project's additional changes are shown in **bold**, the HKEX's proposed changes are <u>underlined</u>):

    Principle D.2

    *The board is responsible for evaluating and determining the nature and extent of the risks it is willing to take in achieving the issuer's strategic objectives, and ensuring that the issuer establishes and maintains appropriate and effective risk management and internal control systems. <u>Such risks would include, amongst others, material risks relating to ESG (please refer to the ESG Reporting Guide in Appendix 27 to the Exchange Listing Rules for further information)</u>. The board should oversee management in the design, implementation and monitoring of the risk management and internal control systems, **including the identification, evaluation and management of material ESG-related issues** and management should provide a confirmation to the board on the effectiveness of these systems.*

    Section D.2.3

    The board's annual review should, in particular, consider:

    (a) the changes, since the last annual review, in the nature and extent of significant risks (<u>including ESG risks</u>), and the issuer's ability to respond to changes in its business and the external environment;

    (b) the scope and quality of management's ongoing monitoring of risks (<u>including ESG risks</u>) and of the internal control systems, and where applicable, the work of its internal audit function and other assurance providers;

https://www.reuters.com/article/us-saipan-casino-idUSKCN1QW007 and https://www.business-humanrights.org/en/blog/labour-exploitation-in-saipan-again-what-difference-does-20-years-make/, respectively.

15 *See* Imperial Pacific International Holdings 2019 Environmental, Social & Governance Report. Accessed: https://www1.hkexnews.hk/listedco/listconews/sehk/2020/0727/2020072701281.pdf

16 The Operational Guidelines for Businesses on Remediation of Human Rights Grievances are available on The Remedy Project's website: https://www.remedyproject.co/publications.

(c) the extent and frequency of communication of monitoring results to the board (or board committee(s)) which enables it to assess control of the issuer and the effectiveness of risk management, ***including whether key performance indicators used to measure ESG performance are fit for purpose****;*

*(d) significant control failings or weaknesses that have been identified during the period****, including any shortcomings in ESG compliance in the past year, steps taken to remediate failures and prevent future non-compliance****. Also, the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the issuer's financial performance or condition; and*

(e) the effectiveness of the issuer's processes for financial reporting and Exchange Listing Rule compliance.

Section D.2.4

Issuers should disclose, in the Corporate Governance Report, a narrative statement on how they have complied with the risk management and internal control code provisions during the reporting period. In particular, they should disclose:

(a) the process used to identify, evaluate and manage significant risks ***(including ESG risks and the process and criteria used to assess material ESG factors)****;*

(b) the main features of the risk management and internal control systems;

(c) an acknowledgement by the board that it is responsible for the risk management and internal control systems and reviewing their effectiveness. It should also explain that such systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss;

(d) the process used to review the effectiveness of the risk management and internal control systems and to resolve material internal control defects; and

(e) the procedures and internal controls for the handling and dissemination of inside information.

IV. RESPONSE TO QUESTION 12

16. The Remedy Project **supports** the HKEX's proposal to require publication of the annual report and the ESG report at the same time.

Simultaneous publication reaffirms the importance of ESG considerations in the development of overall business strategy

17. ESG issues can no longer be relegated to the side lines. Risks from environmental and social factors can fundamentally affect a company's core business. The significant financial, legal, and reputational risks are illustrated by the ESG-related events recently reported in the financial press. A shipment owned by a Hong Kong and Tokyo-listed fashion company was recently impounded by U.S. Customs and Border Protection following allegations of forced labour in its supply chain.[17] As noted above, a Dutch court has ordered Royal Dutch Shell to significantly accelerate planned carbon emission cuts.[18] Allegations of forced labour practices at Malaysia-listed Top Glove Corp Bhd. have allegedly affected the company's planned listing in Hong Kong.[19]

18. Moreover, ESG initiatives at corporations can drive better financial performance through improved risk management and increased stakeholder engagement, especially in the long-run.[20] A review of over 1,000 studies published on ESG performance and financial performance found a positive relationship between ESG and financial performance (measured by operational metrics such as return on equity, return on assets or stock price) for 58% of studies.[21] Conversely, companies with a known history of ESG incidents exhibit "*a four-factor alpha of negative 3.5% per year, even when controlling for other risk factors*".[22] However, ESG disclosure on its own does not drive financial performance – measuring and disclosing ESG metrics without actual implementation of an ESG risk management strategy is ineffective.[23]

19. Requiring issuers to publish ESG reports at the same time as their annual reports affirms the fact that ESG considerations should form part of a company's annual strategic planning. The Remedy Project considers this a small but symbolic step towards the integration of ESG issues into the overall financial and business strategy of Hong Kong-listed companies.

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17 Uniqlo shirts blocked at U.S. border in January on China forced labour concern. Accessed: https://www.reuters.com/world/china/uniqlo-shirts-blocked-us-border-january-china-forced-labour-concern-2021-05-19/.

18 Explainer: What the Dutch court carbon emissions ruling means for Shell, Reuters. Accessed: https://www.reuters.com/business/sustainable-business/what-dutch-court-carbon-emissions-ruling-means-shell-2021-05-26/

19 Malaysia's Top Glove halves HK listing size to $1 bln, cites ownership dilution concerns. Accessed: https://www.reuters.com/article/top-glove-listing-idUSL4N2MG0E0.

20 ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020, Tensie Whelan, Ulrich Atz, Tracy Van Holt and Casey Clark, CFA, NYU Stern and Rockefeller Asset Management. Accessed: https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf

21 *Ibid.*

22 *Ibid*. This is a summary of findings made in a study titled: The Price of Ignoring ESG Risks, S. Glossner.

23 *Ibid*.

Simultaneous publication facilitates proper shareholder discussion of ESG issues at the company's annual general meeting

20. ESG reporting has become part of the key information relied on by investors to make investment decisions about their portfolio companies. Large asset managers, and investor-led and company-led coalitions are increasingly vocal in urging companies to improve ESG strategies both in Hong Kong and abroad. Shareholder activism and conversations about corporate responsibility to uphold human rights principles are now mainstream. For example, BlackRock's Head of Investment Stewardship in APAC, Amar Gill, recently stated that BlackRock would be likely to vote against the re-election of company directors that fail to set climate targets.[24] Chevron Corp.'s shareholders voted for a proposal to reduce emissions from the company's customers despite a board recommendation to reject the proposal.[25] At Exxon Mobil, shareholders BlackRock, Vanguard and State Street voted against Exxon's leadership team by supporting activist hedge fund, Engine No. 1 to appoint three directors to Exxon's board.[26]

21. The simultaneous publication of ESG reports and annual reports will enable shareholders (and the public) to obtain a fuller picture of a company's overall performance, well ahead of the company's annual general meeting. The Remedy Project welcomes this proposed change, which will facilitate shareholders' ability to make investment decisions that include an assessment of both the company's financial and ESG performance.

V. CONCLUSION

22. The Remedy Project welcomes the changes proposed in Questions 11 and 12 above. The emphasis on improving corporate governance and increasing board oversight of ESG risks is commendable. These changes are a positive step towards pushing Hong Kong-listed companies to move towards more meaningful engagement with ESG. Nonetheless, to remedy current gaps in ESG reporting and ESG materiality assessments, The Remedy Project has recommended additional consequential changes to the proposed Code, as outlined above.

23. ESG factors will always relate to and affect an issuer's business. In the future, The Remedy Project hopes that the board and senior management of Hong Kong-listed companies approach ESG reporting as an opportunity to identify, evaluate and remediate the human rights and environmental impacts of their business. Businesses have a responsibility to respect the rights of stakeholders that are directly involved and/or impacted by a company's operations. From the company's perspective, ESG risks are material because failure to implement adequate risk management systems and corporate governance structures can lead to serious financial, legal, and reputational consequences, both for the company and its directors. With the proliferation of mandatory human rights due diligence laws and modern slavery disclosures globally, companies can no longer afford to treat ESG reporting as a mere annual box-ticking exercise or public relations opportunity.

[24] BlackRock leverages voting power in Hong Kong companies to spur climate-change targets and disclosures, South China Morning Post. Accessed: https://www.scmp.com/business/money/markets-investing/article/3134303/blackrock-leverages-voting-power-hong-kong

[25] Chevron investors back climate proposal in rebuke to C-suite, Bloomberg. Accessed: https://www.bloomberg.com/news/articles/2021-05-26/chevron-investors-back-climate-proposal-in-rebuke-to-management

[26] Exxon's Board Defeat Signals the Rise of Social-Good Activists, The New York Times. Accessed: https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html.