ACGA

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31 December 2021

By email: [redacted]

Re: Proposed Amendments to the Listing Rules relating to Share Schemes of Listed Issuers

Dear Sir or Madam,

The Asian Corporate Governance Association (ACGA) is a non-profit membership association founded in Hong Kong in 1999. We conduct independent research on corporate governance and ESG, and advocate at the regulatory and corporate level across Asia-Pacific to improve standards and practices. ACGA is entirely funded by a network of more than 110 member firms, of which 80% are institutional investors with more than US$36 trillion in assets under management globally.

We refer to the consultation paper on **"Proposed Amendments to the Listing Rules relating to Share Schemes of Listed Issuers"** released by Hong Kong Exchanges and Clearing (HKEX) on 29 October 2021.

ACGA supports the extension of chapter 17 of the Listing Rules to cover the award of new or existing shares in addition to options. It is unfortunate that a 1999 proposal to do the same was shelved, relegating minority protection in respect of share awards to rules on general/special mandates and connected transactions.

While we welcome the revival of the proposal, we believe that core elements are not in the best interests of investors. In particular, the proposals concerning shareholder ratification of awards to connected persons, as well as controlling and substantial shareholders, represents a weakening of existing rules. It will be more difficult for minority shareholders to veto sizeable share awards to insiders and majority owners. In effect, investors will have less ability to reject share grants than they currently have under the Chapter 14A connected party rules. With respect, the same pretext for diluting the rules on share awards being given today as it was 20 years ago—to afford issuers greater flexibility—does not justify a downgrade in corporate governance standards.

With regards to **Q2** and **Q3** of the consultation paper, while the proposals should lead to greater clarity from issuers on who gets an equity grant and why, we would urge the list of eligible participants to be limited to directors and employees. The primary purpose of share awards is to incentivize participants who are vested in the long-term performance of the firm, rather than serve as an alternative to cash in compensating external suppliers and consultants.

ACGA would also take this opportunity to repeat our comments made in the September 2021 Consultation Paper on the Review of the Corporate Governance Code and Related Listing Rules regarding equity-based remuneration to INEDs. ACGA strongly supports the view that INEDs should not be recipients of share awards. Equity grants to independents risks undermining their autonomy by tying their fortunes too closely to management. Under the proposals in this consultation paper (**Q14**), current shareholder approval requirements on grants of shares to INEDs and substantial

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shareholders will be relaxed, making it more difficult for investors to vote against such awards. If it is to be a recommended best practice (under the upcoming amendments to the CG Code) that issuers do not award equity grants to INEDs, we fail to see the benefit of making it more difficult for shareholders to veto these awards.

We set out below where we have a specific response to the 32 questions posed in the consultation paper:

1. Do you agree with the proposal to amend Chapter 17 to also govern share award schemes involving the grant of new shares of listed issuers? Please provide reasons for your views.

Yes.

ACGA notes the proliferation of share incentive plans among issuers, and in particular generous equity grants allotted to employees and insiders. In the past we have drawn attention to market concerns over the scope and size of such schemes, in particular the dilutive effect on shareholders.

The proposed extension of Chapter 17 of the Listing Rules to cover grants of new shares is a welcome development but the new regime will not apply to all issuers. Several of the largest companies trading here are active dispensers of shares and options to employees, including Alibaba Group, JD.com and Baidu. Yet they are exempt from the Chapter 17 rules because of the automatic waivers they receive as secondary listings.

We reiterate our comments made in June 2021 during the Exchange's consultation on the listing regime for overseas issuers, namely that there is a growing number of secondary-listed firms who are large and influential in the market yet follow much lower governance standards by virtue of the automatic waivers they receive from the Exchange. ACGA believes the rationale for granting these waivers is questionable, as many of these firms already enjoy significant exemptions from rules and regulations in their primary exchange. We urge a comprehensive review by HKEX of the basis for granting such broad waivers to secondary issuers.

2. Do you agree with the proposed definition of eligible participants to include directors and employees of the issuer and its subsidiaries (including persons who are granted shares or options under the scheme as an inducement to enter into employment contracts with these companies)? Please provide reasons for your views.

Yes.

The primary purpose of share schemes is purportedly to promote employee loyalty, improve retention and encourage a long-term view on company performance. To achieve these goals, grants of shares should be made to employees who are retained on a permanent basis.

ACGA would encourage characterizing employee participants under a scheme to be those employed on a full-time contract, or individuals employed on a part-time contract who work a pro-rata equivalent of 50% or more of a comparable full-time position.

We would also encourage a limit on the number of shares which can be awarded to a selected employee under a scheme. We note that in HKEX's share award scheme, it caps this figure at 1%.

3. Do you agree with the proposal that eligible participants shall include Service Providers, subject to additional disclosure and approval by the remuneration committee? Please provide reasons for your views.

No.

ACGA does not believe it is in the best interests of shareholders for issuers to use award schemes as compensation for third parties who are not directly invested in the long-term performance of the company. It is apparent that companies currently make use of these schemes as a substitute for cash to reward suppliers, customers, consultants, and advisors.

Figures from HKEX appear to bear this out: the Exchange disclosed in its 2020 review of issuers' annual reports that around one third of 266 listed companies who granted share options in 2019 did so to participants who were not their directors, chief executives, substantial shareholders, or employees. The grantees were instead largely consultants and advisors.

Under the proposal, share rewards to third parties would be granted on the basis that these people provide services to the issuer group on a "continuing and recurring basis in its ordinary and usual course of business which are material to the long-term growth of the issuer group". Examples cited include independent contractors or consultants working on a contract basis. This is a broad definition which gives issuers ample scope to compensate third parties at their convenience. The lack of bright-line criteria, as HKEX notes is adopted in Canada and Australia, leaves the category open to generous interpretation and potential abuse.

Indeed, we note the Securities and Futures Commission (SFC) finding of "unusual aspects" of share option schemes in its review of the Exchange's regulatory performance published in June 2020. This included share options being exercised out of the money when the exercise price was higher than the trading price. Grantees were found to be paying premiums of 1.67% to 22.49%. In one highlighted case, options representing 8.28% of the issuer's share capital were granted to nine consultants whose identities were not disclosed. The options were all exercised out of the money at a premium of 11.11% one week after the options were granted.

The SFC also drew attention to the fact that issuers have been negligent in making proper disclosure of the recipients of share options. The regulator studied 426 announcements in 2019 relating to the grant of share options and found that in more than 35% of cases, the identities of recipients were not disclosed. In many cases companies made sizeable grants yet simply referred to the individuals as those "who have made or will make a contribution'' to the issuer.

The proposed parameters in the service providers category arguably give issuers broad scope to award shares to fit their circumstances. We are wary that shareholders may be given generic disclosure. We would also urge the Exchange at the very least to set criteria similar to the rules set in Australia and Canada, where service providers must have rendered services for a certain period (12 months in Canada), or on a percentage basis (equivalent to 40% of their work).

4. Do you agree with the proposal that eligible participants shall include Related Entity Participants, subject to additional disclosure and approval by the remuneration committee? Please provide reasons for your views.

No.

We repeat our comments above in respect of awarding shares to third parties who are not vested in the performance of the company. In our view these schemes should be restricted to directors and full-time employees of the issuer, as is the case in Malaysia and the PRC.

The proposal would include directors and employees of associated companies in the category of Related Entity Participants. The listed issuer does not normally control its associated companies, although it may have influence over them. As the consultation paper itself notes, there may be circumstances where the interests of such related entities may not be aligned with those of the issuer. In our view, the Related Entity category gives issuers overly generous scope to compensate individuals such as family members and close associates.

5. Do you agree with the proposal to allow the scheme mandate to be refreshed once every three years by obtaining shareholders' approval? Please provide reasons for your views.

No.

Under the proposal, there will be 10% scheme mandate limit refreshable every three years with shareholder approval. Additional refreshments could be made within those three years with independent shareholder approval.

On average, issuers would be able to issue share grants of up to 3.3% annually, assuming there are no refreshments within the three years. We consider this figure to be high. The Exchange has also stated its willingness to grant waivers from the scheme mandate limit on a case-by-case basis for issuers in the internet technology sector. Together with the ubiquitous general mandate and special mandate, this creates opportunities for liberal dilution at minority shareholders' expense.

6. Do you agree with the proposal to allow the scheme mandate to be refreshed within three years from the date of the last shareholders' approval by obtaining independent shareholders' approval? Please provide reasons for your views.

No. We repeat our comments above.

7. Do you agree with the proposal to remove the 30% limit on outstanding options? Please provide reasons for your views.

No. ACGA is of the view that there should be a requirement that the number of outstanding options should be capped. A limit should be maintained, even if in the experience of the Exchange, it is uncommon for issuers to have large percentages of outstanding share options at any time.

8. Do you agree with the proposal to require a sublimit on Share Grants to Service Providers? Please provide reasons for your views.

ACGA disagrees with the proposal to award share grants to Service Providers. Should the proposal go ahead, there should be a sublimit. We believe it is more appropriate for independent directors, rather than the remuneration committee, to set any sublimit.

9. Do you agree with the proposal to require a minimum 12-month vesting period? Please provide reasons for your views.

Yes. This is in line with the purported basis for awarding share awards, which is to incentivize and adopt a long-term view on performance.

11. Do you agree with the proposed disclosure requirements relating to (a) performance targets; and (b) clawback mechanism? Please provide reasons for your views.

Yes. ACGA is of the view however that it would be more beneficial to require (rather than simply disclose whether they exist) performance targets and a clawback mechanism as part of any bona fides share reward scheme.

13. Do you agree with the proposal to apply the 1% Individual Limit to Share Grants (including grants of share awards and share options) to an individual participant? Please provide reasons for your views.

Yes. The figure of 1% represents a significant block of shares in the case of large issuers, the value potentially running to hundreds of millions of dollars.

14. Do you agree with the proposal to require approval from the remuneration committee instead of INEDs for all Share Grants to Connected Persons? Please provide reasons for your views.

No. We are of the view that this role should fall to INEDs. Even with a majority of INEDs on a remuneration committee, there is the possibility that directors who are close to the connected person (and themselves participants of the scheme) may be a dominant figure who has undue influence over the outcome.

15. Do you agree with the proposal to relax the current shareholder approval requirement for grants of share awards to a director (who is not an INED) or a chief executive set out in paragraph 65 above? Please provide reasons for your views.

No. We are disappointed the Exchange is seeking to weaken existing rules for shareholder approval where awards are made to connected persons. The proposal would see approval for these grants shifted from INEDs to the remuneration committee, with independent shareholder approval only required where share grants to connected parties exceed 0.1% of issued shares.

16. Do you agree with the proposal to also relax the current shareholder approval requirement for grants of share awards to an INED or substantial shareholder of the issuer set out in paragraph 68 above? Please provide reasons for your views.

No.

We strongly support the view that INEDs should not be given equity-based compensation. Although we welcome the upcoming revision to the CG Code that INEDs generally should not receive equity-based remuneration with performance-related elements we are disappointed that it will only be a "recommended best practice" (ie, not subject to "comply or explain" in the Code). As we said in our submission on proposed changes to the CG Code in July 2021, this means that the measure can, and probably will, be easily ignored. We believe it should be upgraded to a code provision if not a listing rule.

Share ownership by independents risks undermining their independence by tying their fortunes too closely to management. Granting stock options complicates the relationship with management and creates a perception that the independence of INEDs has or will be compromised.

Under the proposal, current shareholder approval requirements on grants of shares to INEDs and substantial shareholders will be relaxed. This will make it more difficult for minority shareholders to veto share awards to insiders and majority owners. In particular, grants below the threshold of 0.1% can equate to large blocks of securities which can be awarded with no input from minority investors where the issuer is large.

In respect of grants to substantial shareholders, approval should rest with INEDs rather than the remuneration committee for the same reasons expressed in **Q14** above.

17. Do you agree with the proposal to relax the current shareholder approval requirement for grants of share awards to a controlling shareholder of the issuer set out in paragraph 69 above? Please provide reasons for your views.

No. We view this as an erosion of minority shareholders' ability to veto large grants of shares to controlling shareholders and are disappointed the requirements are being relaxed.

18. Do you agree with the proposal to remove the HK$5 million de minimis threshold for grants of options to an INED or substantial shareholder of the issuer? Please provide reasons for your views.

No. ACGA is of the view that there should be a de minimis threshold. While we appreciate that HK$5m may not be realistic and the figure has not been revised in 20 years, given the points we raise about large grants of shares being possible with limited or no shareholder input, we would urge the setting of a threshold to curb excessive compensation and minimise the dilutive effect on shareholders.

19. Do you agree with the proposals to require disclosure of Share Grants to Related Party Participants or Service Providers on an individual basis if the grants to an individual Related Entity Participant or Service Provider exceed 0.1% of the issuer's issued shares over any 12-month period? Please provide reasons for your views.

Yes.

20. Do you agree with the proposed disclosure requirement for the grant announcement? Please provide reasons for your views.

Yes.

21. Do you agree with the proposed disclosure requirements for Share Grants in an issuer's interim reports and annual reports? Please provide reasons for your views.

Yes.

22. Do you agree with the proposal to require disclosure of matters reviewed by the remuneration committee during the reporting period in the Corporate Governance Report? Please provide reasons for your views.

Yes. We would hope that issuers adopt a more detailed and qualitative approach to disclosure of the work of the remuneration committee than currently exists.

23. Do you agree with the proposal to require that changes to the terms of share award or option granted be approved by the remuneration committee and/or shareholders of the issuer if the initial grant of the award or option requires such approval? Please provide reasons for your views.

Yes.

24. Do you agree with the proposal to provide a waiver for a transfer of share awards or options granted under Share Schemes as described in paragraph 86? Please provide reasons for your views.

Our only comment is that such a waiver should not be granted unless the ultimate beneficiaries of the trust are disclosed.

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25. Do you agree with the proposal to restrict the voting rights of unvested shares held by the trustee of a Share Scheme and require disclosure of the number of such unvested shares in monthly returns? Please provide reasons for your views.

Yes.

26. Do you agree with the proposed disclosure requirements for Share Schemes funded by existing shares of listed issuers? Please provide reasons for your views.

Yes.

27. Do you agree with the proposal to restrict the voting rights of unvested shares held by the trustee of a Share Scheme and require disclosure of the number of such unvested shares in monthly returns? Please provide reasons for your views.

Yes.

28. Do you agree with the proposal to amend Chapter 17 to also govern share award schemes funded by new or existing shares of subsidiaries of listed issuers? Please provide reasons for your views.

Yes.

30. Do you agree with the proposal to amend Chapter 17 to also govern Share Schemes involving grants of shares or options through trust or similar arrangements for the benefit of specified participants? Please provide reasons for your views.

Yes.

Please do not hesitate to contact us if you require further elaboration.

Yours sincerely,

Jane Moir
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