

## **Hong Kong Exchanges and Clearing Limited**

8<sup>th</sup> Floor, Two Exchange Square  
8 Connaught Place  
Central, Hong Kong

Submitted via the HKEX's online questionnaire.

## **Re: BlackRock response to the Exchange's consultation paper on "Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers"**

### **Background**

On 29 October 2021, the Stock Exchange of Hong Kong Limited (the Exchange) issued a consultation paper, and requested public feedback, on the "Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers."<sup>1,2</sup>

Key proposals include amendments to Chapter 17 of the Listing Rules. Chapter 17 of the Listing Rules currently applies to share option schemes of issuers and their subsidiaries, but does not cover share award schemes. The purpose of the consultation is to consider amending Chapter 17 to govern share award schemes as well. The consultation also reviews the current requirements of Chapter 17 and proposes changes in specific areas to provide more flexibility to issuers and to improve the disclosure of Share Grants.<sup>3,4</sup>

### **Executive Summary**

BlackRock Investment Stewardship (BIS) promotes corporate governance standards and sustainable business models that we believe contribute to the durable, long-term profitability BlackRock clients depend on to meet their financial goals. The BIS team welcomes and supports the Exchange's initiative as BIS believes there should be a consistent regulatory framework for all share schemes funded by new shares that may have a dilutive impact on public shareholders. Specifically, the proposed disclosure requirements regarding performance targets with a claw back mechanism would enhance transparency and allow shareholders to assess how share schemes promote the interests of an issuer and align scheme participants' interests with long term value creation of the issuer.

While we are supportive of the direction of the amendments, as highlighted in our response submitted online (and in full below), we have differing views on certain proposed amendments relating to Chapter 17. For example, we agree with the proposed definition of eligible participants to include directors and employees of the issuer and its subsidiaries; however, we do not believe that eligible participants should include Service Providers. Although there could be exceptional circumstances where Service Providers may be remunerated in company shares or share options, this should not be seen as a norm. Service Providers are unlikely to be as fundamental to the long-term sustainable growth of

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<sup>1</sup> HKEX. "Exchange publishes consultation paper on Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers." 29 October 2021.

<sup>2</sup> HKEX. "Consultation Paper – Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers." October 2021.

<sup>3</sup> See footnote #1.

<sup>4</sup> See footnote #2 at page 3.

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a company as employees and directors, especially as their service to an issuer should be governed by service contracts that are not likely to be exclusive.

Similarly, BIS agrees that there should be a minimum vesting period for these awards, but disagrees with the proposal that the minimum could be a 12-month vesting period. In our view, the minimum period for vesting the bulk of share awards should be 24 months or longer for closer alignment of rewards to longer term value creation. BIS differs as well on the proposal to require approval from the remuneration committee instead of Independent Non-Executive Directors (INEDs) for all Share Grants to Connected Persons. We recognize that the remuneration committee is responsible for an issuer's remuneration policy for directors and senior management. Our concern is over the low level of independence in the group of directors that approves Share Grants to Connected Persons, as remuneration committees are rarely 100% independent and the potential influence of non-independent directors on the committee. We suggest the Exchange require approval by only INEDs on the remuneration committee for all Share Grants to Connected Persons.

BIS differs as well on the proposal to relax the current shareholder approval requirement for grants of share awards to an INED, substantial shareholder, or controlling shareholder. For companies of large market capitalization, a share grant as small as 0.1% may constitute compensation of excessive absolute monetary value or a significant proportion of its annual profit. We recommend that the Exchange preserves the HKD 5 million threshold and applies it to all share grants to connected persons. BIS also believes that all share grants to a substantial or controlling shareholder should be subject to independent shareholder approval lest minority shareholder protections be eroded.

Lastly, we differ on the proposal that would allow changes to the terms of share awards or options granted be approved by the remuneration committee without shareholder approval. We believe changing these terms without shareholder approval risks undermining the merits of a share scheme that required initial shareholder approval but may subsequently be amended by the remuneration committee in a manner that would not have garnered the support of shareholders.

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BIS submitted the following response to the public consultation on the Hong Kong Exchanges and Clearing Limited (HKEX) **“Proposed Amendments to Listing Rules relating to Share Schemes of Listed Issuers”**

**Question 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. There should be a consistent regulatory framework for all share schemes funded by new shares and that have a dilutive impact on public shareholders.

**Question 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 key purpose of remuneration is to attract, retain and reward competent directors, executives and other key personnel who are fundamental to the long-term success of a company and the sustainable growth of shareholder value. Share-

based awards would allow these participants to have some “skin in the game” which helps align their interests with those of public shareholders. In particular, incentive plans that vest over time conditional upon achieving meaningful targets would facilitate a focus on longer-term value creation. That said, as mentioned in Paragraph 70 of the consultation paper, independent directors should not be given equity-based remuneration with performance-related elements so as to preserve their objectivity and independence.

**Question 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. While there could be special circumstances where Service Providers may be remunerated in company shares or share options, this should not be the norm. Service Providers are unlikely to be as fundamental to the long-term sustainable growth of a company as employees and directors, especially since their service to an issuer should be governed by service contracts which are likely to be non-exclusive. Even in Australia where service providers are technically allowed to participate in share schemes, we don't see that being done in practice. Companies which list on HKEX should have enough resources to pay their service providers without introducing dilution risks by involving them in share schemes.
- Should the HKEX decide to proceed with including Service Providers as Eligible Participants, companies that grant share incentives under this provision should disclose the business case for doing so and the details of any grants made, including the names of the Service Providers.

**Question 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.

- Yes. Such grants should be allowed but should only be made if there is a strong business reason to do so, if such reasons are well disclosed, and if these arrangements are subject to independent shareholder approvals where appropriate.

**Question 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.

- Yes. The proposal provides more guidance on how frequently such schemes should be refreshed. However, ideally, such proposals should be subject to shareholder approval on an annual basis, whether or not there have been refreshments to the scheme limit or changes in the amount of outstanding share awards or share options.
- The current proposal assumes that the 10% limit will be used over a three-year period, implying an annual average of about 3.3%, which is then compared to the annual average of the Advanced Mandate of 2% to 3% described in LD40-2 and LD40-3. We question the appropriateness of this given most share schemes we see in this market assume usage of the 10% limit over a ten-year period, implying an annual issuance of only about 1%, which is much lower than 3.3%. In our view, a dilution rate of 10% over three-years is unduly harmful to shareholders.

**Question 6** Do you agree with the proposal to allow the scheme mandate to be refreshed

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within three years from the date of the last shareholders' approval by obtaining independent shareholders' approval? Please provide reasons for your views.

- Yes. We don't have an issue with scheme mandates being refreshed within three years so long as they are approved by independent shareholders. As mentioned in our response to Question 5, we believe best practice is for remuneration plans, including scheme mandates, to be subject to a shareholder vote on an annual basis.

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

- Yes. Most companies are usually restricted by the 10% scheme mandate limit already and seldom approach the 30% threshold. That said, we do see companies having multiple share-based schemes. There should be an aggregate limit of 10% on maximum outstanding share options and share awards at any point in time.

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

- No. We do not believe Service Providers should be allowed to receive Share Grants.
- Should the HKEX decide to proceed with including Service Providers as Eligible Participants, we agree that there should be a sublimit on Share Grants, and such sublimits should be voted on by shareholders as a safeguard against excessive dilution arising from inappropriate Share Grants to Service Providers.

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

- No. While we agree there should be a minimum vesting period, the minimum period for vesting the bulk of the share awards should be 24 months or longer. In order to align incentives with long term value creation goals more effectively, we believe share awards should vest on a sliding scale over a period of at least two- to three-years, with at least half of the share awards vesting only after the second year (i.e. subject to a 24-month vesting period). Moreover, senior executives, who have a clearer role in driving the long-term success of the company, should have longer vesting periods, ideally three- to five-years. In addition, we believe the use of cliff vesting (which involves a significant portion, if not all, of awards vesting at a single point) should be avoided. BlackRock believes there should be a sufficient holding period beyond the vesting of awards to ensure alignment of grantees' interests and the long-term strategy and performance of the company.

**Question 10** Do you agree with the proposal that Share Grants to Employee Participants specifically identified by the issuer may vest within a shorter period or immediately if they are approved by the remuneration committee with the reasons and details disclosed? Please provide reasons for your views.

- No. If vesting is allowed within 12 months, approval should be sought from shareholders and not just the remuneration committee.

**Question 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, the proposed disclosure requirements would enhance transparency and allow shareholders to assess how share schemes promote the interests of an issuer and align scheme participants' interest with an issuer's strategic value drivers.
- Regarding performance targets, we believe there should be a relationship between the performance measures chosen, the key value drivers of the issuer and its long-term strategy taking into consideration the industry that the issuer operates in. We are aware that performance hurdles may be based on commercially sensitive information; in such cases we expect retrospective disclosure of performance against stated performance measures, the hurdles, and any other relevant information that explains the relationship between pay and performance.
- We would like to emphasize the importance of building claw back provisions into share schemes so that grantees would be required to forgo awards when such awards are not justified by actual performance and/or when awards were granted based on faulty financial reporting or deceptive business practices. We also favour recoupment from grantees whose behavior caused material financial harm to shareholders, material reputational risk to the company, or resulted in criminal investigation, even if such actions did not ultimately result in a material restatement of past results.

**Question 12** Do you agree that it is not necessary to impose a restriction on the grant price of shares under share award schemes? Please provide reasons for your views.

- Yes. This is consistent with market practices.

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

- Yes, we agree with the 1% Individual Limit to Share Grants. However, the HKEX should introduce an absolute limit as well to avoid potentially excessive pay to an individual. For companies of large market capitalization, 1% of issued shares can represent compensation of excessive scale. With Tencent as an example, its market capitalization as of 15<sup>th</sup> December 2021 is HKD 4.38 trillion, 1% of which is HKD 43.8 billion. It is hardly reasonable to reward any individual at such scale in a 12-month period.

**Question 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 recognize that the remuneration committee is responsible for an issuer's remuneration policy for directors and senior management. But we are also concerned about the low level of independence in the group of directors that approves Share Grants to Connected Persons, given remuneration committees are rarely 100% independent. We suggest the HKEX require approval by only independent directors on the remuneration committee for all Share Grants to Connected Persons.
- In any case, we would like to emphasize that issuers should disclose the voting record on share grants to ensure transparency of the decision-making process.

**Question 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.

- Yes. However, as explained in our response to question 13, a small percentage of shares of a company of large market capitalization may constitute compensation of excessive scale. Again, with Tencent as an example, 0.1% of its market capitalization is HKD 4.38 billion. We believe share grants of such scale to any connected person should not be exempted from an independent shareholder vote. As such, we recommend the HKEX includes a reasonable absolute threshold for the exemption. Please refer to our response to question 18 for more detail.

**Question 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 (>=10% voting power) of the issuer set out in paragraph 68 above? Please provide reasons for your views.

- No. First of all, we are doubtful that a substantial shareholder would require share grants to align his/her interest with other shareholders. When such an incentive is deemed necessary, it should be subject to an independent shareholder vote to avoid conflict of interest. Similar to our response to question 15, it is unreasonable to exempt a share grant of over HKD 4 billion to a substantial shareholder from independent shareholder approval.
- In the case of an INED, we are concerned that a share grant of a small percentage but large absolute amount would compromise his/her independence. Following the Tencent example, we doubt an INED holding HKD 4 billion worth of Tencent shares could continue to maintain his/her independence when fulfilling his/her board responsibilities. Also, to avoid compromising their independence, we believe share options or share awards with any performance-related elements should not be granted to INEDs.

**Question 17** Do you agree with the proposal to relax the current shareholder approval requirement for grants of share awards to a controlling shareholder (>=30% voting power) of the issuer set out in paragraph 69 above? Please provide reasons for your views.

- No. As argued in our response to question 16, we are doubtful that a controlling shareholder would require share grants to align his/her interest with other shareholders. When such an incentive is deemed necessary, it should be subject to an independent shareholder vote to avoid conflicts of interest. Similar to our response to question 16, it is unreasonable to exempt a share grant of over HKD 4 billion to a controlling shareholder from independent shareholder approval.
- Especially in the case of a controlling shareholder, who in most cases can dominate shareholder meetings as long as he/she is allowed to vote, the proposal to relax the current shareholder approval requirement would effectively allow the controlling shareholder to increase shareholdings by 0.1% every 12 months, diluting minority shareholders' interest. BlackRock strongly disagrees with the proposal, as this relaxation of the approval requirement would erode minority shareholder protections.

**Question 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. As explained in our responses to questions 13 and 15-17, for a company of large market capitalization such as Tencent, a share grant as small as 0.1% may constitute compensation of excessive absolute monetary value. The extent of dilution is not the sole criterion of a share scheme considered by investors. The



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absolute scale and cost of a share scheme is equally important in considering its significance to shareholder value. Especially for companies which may be enjoying high valuation, despite minimal cashflow, such as some biotech companies, a share scheme of 0.1% may represent a significant proportion of its annual profit. Increasingly, excessive executive pay, or pay not aligned with long-term performance, has the potential to harm the reputation of a company with its key stakeholders. As such, we recommend the HKEX preserves the HKD 5 million threshold and applies it to all share grants to connected persons.

**Question 19** Do you agree with the proposals to require disclosure of Share Grants to Related Entity 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. We believe the disclosure requirement is reasonable.
- While we disagree with allowing share grants to service providers, if the HKEX were to allow them, it is important to ensure transparency of these grants.

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

- Yes. The proposed disclosure requirement would improve transparency of the implementation of share schemes.

**Question 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. The proposed disclosure requirements would improve transparency in line with the requirements for option schemes.

**Question 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 agree with the disclosure requirement regarding matters reviewed by the remuneration committee. However, item (e) in paragraph 81 should be subject to shareholder vote, as explained in our response to question 23 and Proposal (K).

**Question 23** Do you agree with the proposal to require 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.

- No. We believe changes to the terms of share awards or options granted should be approved by shareholders and disagree with the view that Proposal (K) would not compromise investor protection. When shareholders approve a particular share scheme, the approval is based on an evaluation of the particular terms of the scheme, including the vesting terms of granted shares or options. Changing these terms without shareholder approval may risk undermining the merits of a share scheme that warrants shareholder support in the first place.
- For example, a long-term share award plan with a vesting period of three years seeking to align executive incentives with long-term value creation would have its purpose defeated if the vesting period is shortened to 12 months. Requiring a shareholder vote on changes to the terms of schemes would reduce the risk of

companies making material changes to the terms such that they defeat the purpose of the scheme.

**Question 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.

- Yes. We agree that the proposal would provide flexibility to scheme participants without causing significant harm to other shareholders.

**Question 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. We believe the proposal would be effective in addressing the concerns about undue influence of exercising voting rights of unvested shares.

**Question 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. The proposed disclosure requirements enhance transparency and would raise Hong Kong listed companies' disclosure quality to a level more comparable with those in other developed markets.

**Question 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. Unvested shares should not be entitled to voting rights. We agree that requiring enhanced disclosure on the number of unvested shares, and the related voting rights, would help shareholders and others monitor the scheme implementation.

**Question 28** Do you agree with our 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. Similar arrangements should be applied to share award schemes as have been applied to share option schemes.

**Question 29** Do you agree with the proposed exemption for Share Schemes of Insignificant Subsidiaries? Please provide reasons for your views.

- Yes. We believe the proposed exemption would reduce compliance burdens without drastically compromising shareholder protection.

**Question 30** Do you agree with our 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.

- [no view]



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**Question 31** Do you agree with our proposal to remove the recommended disclosure requirement for the fair value of options as if they have been granted prior to the approval of the scheme? Please provide reasons for your views.

- Yes. The requirement to disclose fair value of options and awards in annual reports and interim reports would make redundant the need for the recommended disclosure requirement.

**Question 32** Do you agree with our proposals to amend the Rules described in paragraph 100? Please provide reasons for your views.

- Yes. These proposals in paragraph 100 are minor changes which are in alignment with the expansion of Chapter 17's scope to cover all share schemes instead of only share option schemes, and do not substantially change existing Rules provisions.

[This response was submitted online and did not require signatures of respondents.]