December 2020

Building solid foundations

Fidelity International China Stewardship Report 2020



Mountain Tea Fields in Jinhua. (Photo by VCG / Contributor Images via Getty Images)

Prepared in cooperation with ZD Proxy Shareholder Services

This is for investment professionals only and should not be relied upon by private investors

Fidelity INTERNATIONAL

Contents

Introduction	**03**
Part 1: Rising participation on three fronts	**05**
Part 2: Engagement in action	**13**
Part 3: A shareholder's guide to voting in China	**19**

About Fidelity International

Fidelity International offers investment solutions and services and retirement expertise to more than 2.5 million customers globally. As a privately-held, purpose-driven company with a 50-year heritage, we think generationally and invest for the long term. Operating in more than 25 locations and with $611.4 billion in total assets*, our clients range from central banks, sovereign wealth funds, large corporates, financial institutions, insurers and wealth managers, to private individuals.

Our Workplace & Personal Financial Health business provides individuals, advisers and employers with access to world-class investment choices, third-party solutions, administration services and pension guidance. Together with our Investment Solutions & Services business, we invest $471 billion on behalf of our clients. By combining our asset management expertise with our solutions for workplace and personal investing, we work together to build better financial futures.

*Data as at 30 September 2020. Read more at fidelityinternational.com

About ZD Proxy Shareholder Services

Founded in 2016, ZD Proxy Shareholder Services is the first domestic proxy advisory firm in China. ZD's services have covered over 500 A-Share listed companies, with a clientele of international institutional investors from the US, Europe and Asia.

ZD has developed a comprehensive voting policy for the A-share market that integrates international best practices with local market rules and governance features. ZD provides clients with professional and independent voting recommendations as well as engagement advice in the A-share market. It is committed to building trust and safeguarding clients' long-term interests.

Read more at zdproxy.com

Introduction

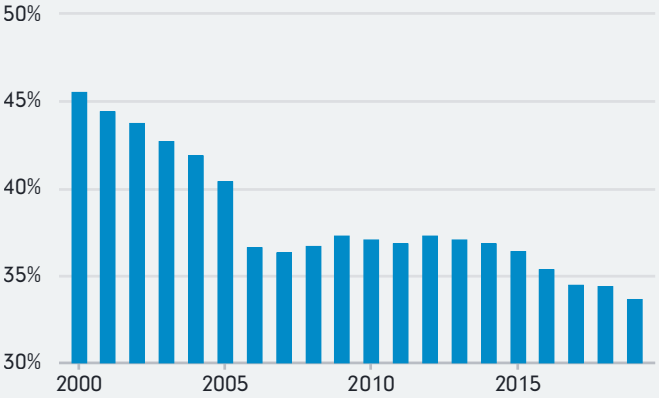
To many outsiders, Chinese equity investing might conjure up images of a huge, freewheeling market where millions of retail investors revel in speculation and sustainability is an alien concept.

China's markets have been changing shape over the last decade, as institutional influence expands in the onshore market and foreign investors pile in.

But developments on the ground in China show how stereotypes like this are swiftly becoming outdated. China's markets have been changing shape over the last decade, as institutional influence expands in the onshore market and foreign investors pile in. This paper employs both a proprietary survey of voting data and anecdotal evidence from corporate engagements to demonstrate how investors, companies and regulators in China have all played a part in building what is today a solid foundation for sustainable investment and engagement. Indeed, the clear picture that emerges from our study is one of steady progress across the board when it comes to investment stewardship in China.

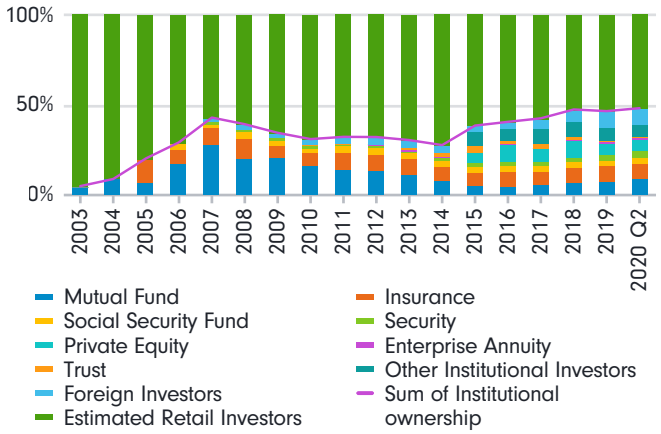
In this, Fidelity International's first China Stewardship Report, we examine the underpinnings for these developments across three main areas. First, the key starting point has been a steady decline in ownership concentration, which has opened the door for non-controlling interests to play a more active role in the governance of companies. Second, despite prevailing stereotypes the market has gradually rebalanced away from being retail-driven: individual investors owned 95 per cent of free-float shares in 2003, but this fell to 70 per cent in 2010 and stands at just over 50 percent today. Third, foreign participation has jumped over the last few years as China opens its financial borders, and this has helped bring domestic practices more in line with global standards.

Chart 1: Average controlling interest as a % of total shareholding across all A-shares declines in China



Source: Fidelity International, ZD Proxy, Wind, November 2020.

Chart 2: Institutional ownership across all A-shares rises in China (as a % of free-float)



Source: CICC, July 2020.

Setting the parameters

Stewardship is the bedrock of sustainable investing, so it's important to be clear upfront on what it entails, and what it doesn't. And that's not easy. One of the first challenges for investors seeking to fulfil their stewardship responsibilities in China lies in the technical term itself: there is no consensus Chinese translation yet for "stewardship" in the financial sense, or one of its key components, "engagement".

By our own measure, stewardship refers to investors acting as responsible capital providers by monitoring and influencing corporate behaviours for the better, through both voting and engagement. Stewardship requires a long-term view, and treats environmental, social, and governance (ESG) issues as equal in importance to the traditional operational and financial metrics of a company's performance. The premise, supported by a growing body of research, is that responsible voting and active engagement will drive better corporate behaviours and more sustainable financial returns. This in turn contributes to the healthy long-term development of capital markets globally.

In China, the gradual opening of the onshore market is bringing with it a greater focus on the importance of good stewardship. As investors around the world increase their allocations to Chinese A-shares, a current and detailed understanding of the state of voting and engagement in China's onshore markets is increasingly important.

This paper consists of three main sections: 1) an overview of voting and engagement activities among investors in China including how these have evolved over the years; 2) selected China case studies that demonstrate the power of voting and engagement in protecting and potentially increasing the value of an investment; and finally 3) a question-and-answer guide to help investors navigate the complex maze of onshore shareholder voting.

The findings that follow are based on a proprietary study conducted for Fidelity International by ZD Proxy Shareholder Services. The study encompassed 6,922 shareholder meetings and 43,280 resolutions made from 2017-2019 by 676 companies that were or have been constituents of the MSCI China A Onshore index during this period (including 79 A-share companies with dual H-share listings in Hong Kong).



Part 1: Rising participation on three fronts

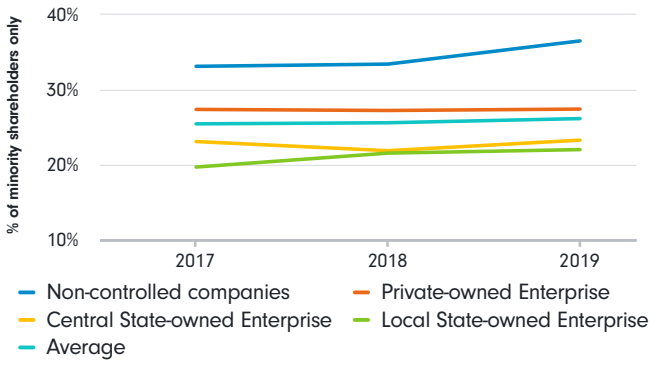
Rising participation on three fronts

Through voting and engagement, investors and companies interact in a context set by regulators. To understand how mindsets and behaviours are changing in such interactions, we take a close look at each of the key players: investors, companies, and regulators.

Investors are voting more

Voting participation has been slowly but steadily rising in China's onshore market. Excluding controlling interests, the average voting turnout has risen to 26.2 per cent of non-controlling shares last year, up marginally from 25.5 per cent in 2017. The change has been more pronounced at companies without a controlling shareholder, where the average voting participation rate has jumped to 36.5 per cent from 33.1 per cent over the same period.

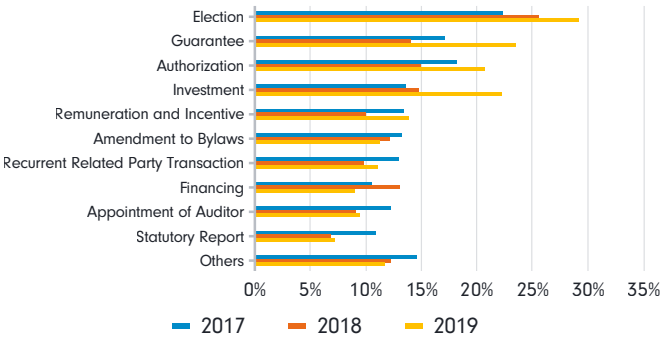
Chart 3: Voting turnout rises at companies without a controlling shareholder



Source: Fidelity International, ZD Proxy, November 2020.

Another notable change is that more shareholders are casting votes against resolutions they dislike, instead of swallowing them in silence. The number of resolutions receiving more than 10 per cent "against" votes (including from both minority and controlling shareholders) has jumped to 385 last year, an increase of about 20 per from 2017. Looking only at dissent among minority shareholders, the number of such resolutions rose to more than 1,600 last year. Among the measures seeing greater opposition, the most common ones involved board elections, loan guarantees and related-party transactions.

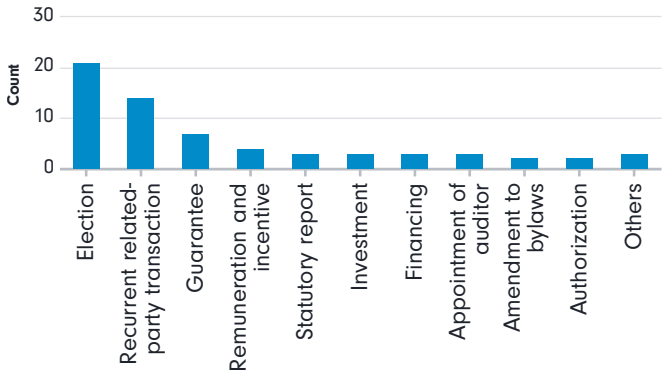
Chart 4: Frequency of dissent among noncontrolling shareholders by type of resolution



Source: Fidelity International, ZD Proxy, November 2020
Note: Percentage of resolutions by type where at least 10 percent of noncontrolling shareholders dissented. Only includes resolutions where companies disclosed voting by shareholder type.

A total of 65 resolutions were voted down in 2017-2019, with board elections and related-party transactions receiving the most rejections. Controlling shareholders are required to abstain from voting on related-party transactions, which at the margin can increase their chances of getting rejected.

Chart 5: Defeated resolutions by type (2017-2019)



Source: Fidelity International, ZD Proxy, November 2020

Engagements on the rise

The rising trend of participation in shareholder votes suggests that more shareholders and asset managers active in China are taking the responsibility of ownership more seriously - and exercising their ballots instead of simply voting with their feet and divesting, as they may have done in the past.

In addition to voting, there are growing indications that asset managers are starting to engage with public companies on ESG issues. The number of Chinese signatories to the Principles for Responsible Investment (PRI), a United Nations-backed network of ESG investing, has climbed to 51 asset owners, managers and service providers as of November 2020, from just seven in 2017.

Local asset managers are starting to build dedicated teams focused on sustainable investing and to take part in global ESG efforts such as the Climate Action 100+, an international initiative to engage key greenhouse emitters for

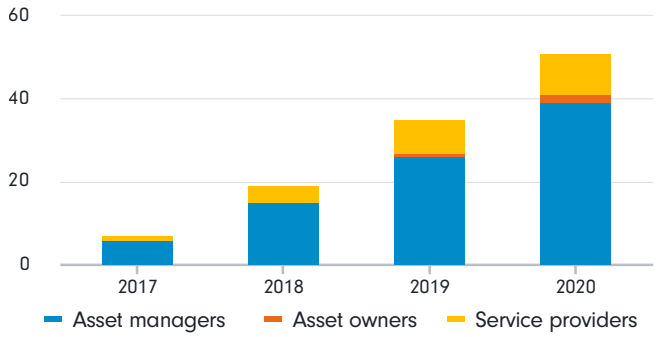
Voting case study #1: The dilutive, discounted share sale

Share placements have flourished this year after China's securities regulator eased rules on follow-on stock sales in February, allowing more flexible pricing. One company taking advantage of the new rule was a large airport operator, a state-owned enterprise. It announced a plan to sell new shares worth 3.2 billion renminbi to its controlling shareholder at a 29 per cent discount to the pricing-day close. With strong cashflows and low leverage, the company arguably had little urgent need to conduct fundraising. Moreover, minority investors were facing a substantial dilution, while the sale price seemingly favoured the controlling owner at the expense of other shareholders.

ZD Proxy advised institutional investors to oppose the plan and many contacted the company to voice their disapproval. Their views mattered here because the share sale constituted a related-party transaction, and the controlling shareholder had to abstain from the vote. In the end, a compromise was reached, with the company sweetening the deal for minority investors. The controlling shareholder offered short-term rent cuts to the airport operator to boost its profitability. In addition, the company pledged a minimum dividend payout ratio of 40 per cent in 2021-2023, partially compensating minority owners for the share dilution. The case shows how minority shareholders can negotiate a better outcome even when not blocking a transaction entirely.

cleaner energy. There is increasing demand from onshore investors for related products, with local investment management companies launching more than 70 ESG-related funds since 2005, with about a third of those debuting since 2019.

Chart 6: Cumulative number of China-based signatories to the UN's Principles for Responsible Investment by type



Source: PRI, Fidelity International, ZD Proxy, November 2020.

Companies are growing more responsive

For their own part, companies and managements are responding to rising participation among investors by making it easier to take part in voting and to initiate ESG engagement. Companies are already giving ample notice of shareholder meetings: 17.6 days on average for EGMs in 2019 (compared with a regulatory requirement of 15 days) and 24.8 days for AGMs (the requirement is 20 days).

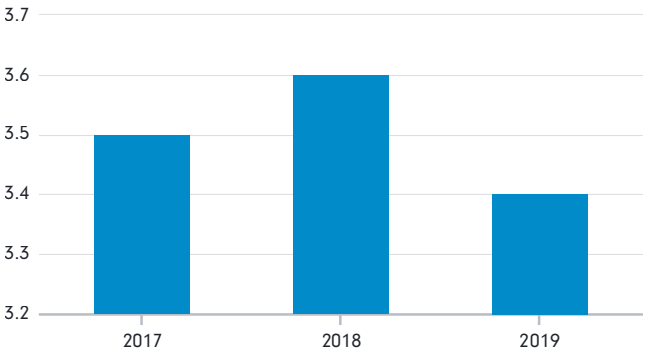
In addition, firms are making disclosures more efficient. Many companies used to release information about a single meeting in multiple filings made at different times, creating a headache for investors trying to keep track of what was happening and when. But that problem is easing. Last year, more than 51 per cent of firms made disclosures through a consolidated proxy book, which contains comprehensive information about a given meeting, up from about 49 per cent in 2017.

While improvements like this may appear small, for minority shareholders they represent a welcome and tangible step toward streamlining the procedural elements of investing in China. For example, China's onshore companies on average hold three to four shareholder meetings a year, whereas one is the norm for most firms listed elsewhere. Too many meetings can make it challenging for investors to exercise good voting stewardship and stay informed about the issues facing a company. Abstention is seldom a good option for responsible investors: PRI signatories are expected to participate actively in meetings and to vote on all resolutions where appropriate.

For their own part, companies and managements are responding to rising participation among investors by making it easier to take part in voting and to initiate ESG engagement.

Part of this problem of a proliferation of meetings at A-share firms stems from protective regulations requiring shareholder approval for relatively small things, such as financing through guarantee. As a result, Chinese property developers that frequently raise funds through guarantee hold the most meetings of all sectors. For example, Yango Group, a Shanghai-based developer, had a remarkable 25 shareholder meetings in 2018 and another 21 meetings last year.

Chart 7: Average number of shareholder meetings per year at A-share companies



Source: Fidelity International, ZD Proxy, November 2020.

Companies aren't just getting more responsive in matters of voting; on ESG issues, too, we see firms making more and better disclosures. Although ESG disclosure is not yet mandatory in China, a growing number of listed companies are making voluntary filings. Last year, a total of 945 onshore firms disclosed their ESG performance in so-called Corporate Social Responsibility reports, accounting for more than a quarter of A-share companies. That is up from 801 firms in 2017.

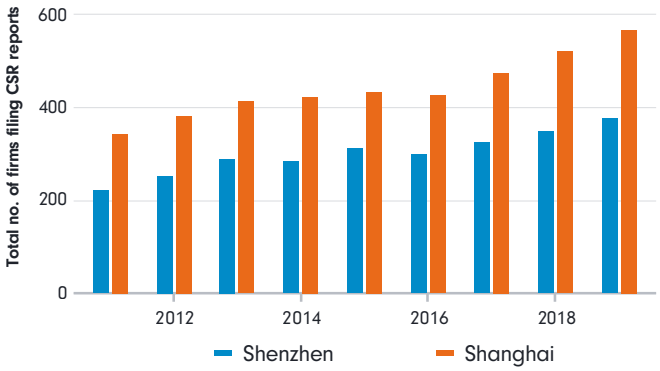
Voting case study #2: Keeping tabs on the auditors

Monitoring and voting responsibly on auditor appointments helps ensure quality disclosure, which is crucial to sound investment decisions. The Shanghai and Shenzhen stock exchanges have both revised rules this year to enhance transparency about accountants hired by public companies. A company planning to hire an audit firm must now disclose the latter's employee details, business history and professional track record. In addition, the Shanghai exchange requires disclosure of auditing fees as well as the criteria for setting them.

In August 2019, a maker of acoustic components decided to drop its auditor, Ruihua, which had been involved in an accounting scandal. ZD Proxy initially advised investors to endorse the company's nomination for replacement auditor, despite scant information being available about the firm. However, after stock exchanges revised their rules concerning accountants and auditors, new information came to light this year about the replacement audit firm: it surfaced that two of its signing partners had both received warning letters from regulators in recent years.

Given the new information, ZD Proxy recommended investors to vote against the re-appointment of the audit firm at the shareholder meeting this year. However, perhaps amid a lack of investor attention on the issue, the proposal gained shareholder approval with a high pass rate. Despite this outcome, the recent rule changes facilitating better disclosure of information about auditors and accountants offers an encouraging signal that transparency is improving - but active and engaged stewardship is still crucial.

Chart 8: More China-listed companies are publishing CSR reports



Source: Fidelity International, Syntao Finance, November 2020.

Regulators are laying the groundwork for deeper engagement

Chinese policymakers are taking an active approach and are refining stewardship-related rules to boost investor confidence. In October, the State Council, China's cabinet, issued guidelines to improve corporate governance, encouraging active engagement by institutional investors and smoothing their communication with company boards. In a Chinese regulatory context, this is the highest level of policy support for stewardship development.

Securities regulator

The groundwork for these advancements was laid in October 2018, when the China Securities Regulatory Commission (CSRC) amended the Code of Corporate Governance for Listed Companies (the Code), highlighting environmental considerations, social responsibilities and investor protections. While it stopped short of mandating ESG disclosures for listed firms, it was the first amendment since the Code came into effect in 2002. Key aspects of revision include the following:

- Introducing the concept of balanced and green development, and creating a framework for ESG disclosure
- Encouraging institutional investors to exercise their legitimate rights to vote, enquire, and make proposals
- Adding restrictions on controlling shareholders to protect smaller investors
- Requiring public firms to implement clear dividend policies

The revisions to the Code officially introduced the concepts of ESG and stewardship to China's capital markets and paved the way for further development.

In order to build on these developments, one natural next step for the CSRC to take would include the establishment of a formal stewardship code for China, similar to what we have seen in several other Asian markets in recent years. Such a move would further mobilize local asset managers and asset owners to vote and engage more with their investee companies. This would not only send a strong regulatory signal to the market regarding the priority of responsible ownership but would also provide clear guidance on how to deliver and report on it in a way that ensures transparency throughout the process.

Industry association

In keeping with the efforts of the State Council and CSRC, the Asset Management Association of China (AMAC), a fund industry organization supervised by the CSRC, has been actively encouraging its members to engage with public companies and enhance their governance. As early as 2012, AMAC issued guidelines to its members on how to cast votes at shareholder meetings, and how to avoid conflicts of interest.

In recent years, AMAC has organised a number of ESG forums and offered training courses on sustainable investment. It has also published

reports on China's ESG rating system and the quality of disclosure at companies. Currently, the association is conducting research on how Chinese institutional investors should engage with public firms, including what stewardship practices they might adopt from overseas players.

Stock exchanges

Some of the earliest disclosure guidelines for companies on ESG issues in China came from the local stock markets. In fact, the Shenzhen and Shanghai exchanges issued guidelines on social responsibility for public companies more than a decade ago, highlighting the interests of employees, customers, debtholders and communities, and encouraging social responsibility disclosures.

In September 2020, the Shanghai exchange added social responsibility to a voluntary disclosure list for companies on the STAR board, a popular new listing venue for technology startups.

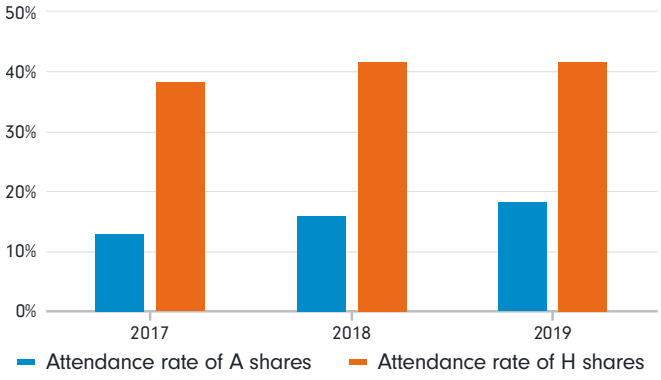
Following the CSRC's 2018 amendment of the Code of Governance, both exchanges have drafted new ESG disclosure rules, which are being refined in a consultation process. In September 2020, the Shanghai exchange added social responsibility to a voluntary disclosure list for companies on the STAR board, a popular new listing venue for technology startups. That same month, the Shenzhen bourse incorporated ESG elements in metrics for the quality of disclosure by public firms: poor ESG reporting will affect a company's disclosure rating. Taken together, this represents a wave of activity encouraging better ESG-related disclosure.

Conclusion (and room for improvement)

Our sample includes 79 Chinese companies that are dual-listed as A-shares in mainland China (Shanghai or Shenzhen) and also as H-shares in Hong Kong. A look at voting practices among these so-called A+H companies reveals room for improvement for onshore Chinese investors, especially to the extent that the Hong Kong market is less retail-driven and H-share owners there appear to be more active voters.

Excluding controlling interests, H-share holders show a significantly higher level of participation in meetings. For example, the shareholder voting participation rate of the H-share holders for the same firms stood at 42 per cent last year, compared to just 18 per cent for holders of A-shares.

Chart 9: Meeting attendance at dual-listed A+H companies by share type

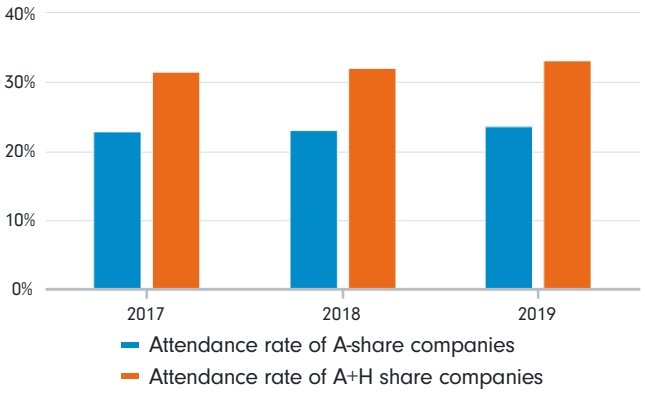


Source: Fidelity International, ZD Proxy, November 2020.

A look at the overall voting turnout at A+H companies compared with those at pure A-share companies reveals a similar pattern. Thanks to more active H-shareholders, the average meeting participation at A+H companies exceeds that of

onshore-only firms by nearly 10 percentage points, excluding controlling interests.

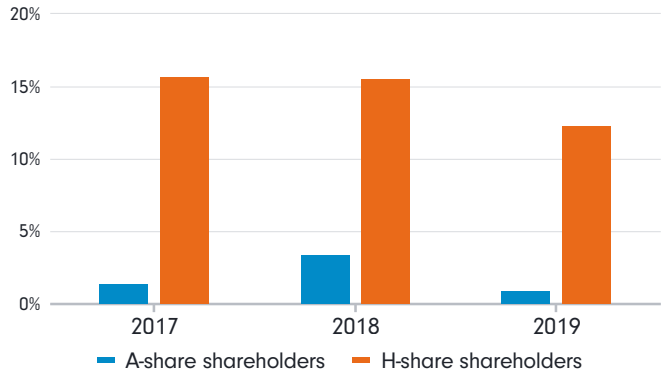
Chart 10: Meeting attendance at dual-listed A+H companies vs. A-share only firms



Source: Fidelity International, ZD Proxy, November 2020.

Voting records at A+H companies also indicate that H-share owners are much more likely to oppose resolutions. For example, around 12 per cent of all resolutions last year received "against" votes representing at least one tenth of the total vote among H-share holders; that compares to less than 1 per cent of all resolutions among A share holders facing the same levels of opposition.

Chart 11: Lower dissent rates among onshore shareholders at dual-listed A+H companies



Source: Fidelity International, ZD Proxy, November 2020.

Shareholder proposals still lacking, particularly on E and S issues

When it comes to shareholder proposals, minority investors continue to punch well below their weight in China's onshore market. Proposals tabled by shareholders of all stripes accounted for about 1.4 per cent of all resolutions included in our study. Furthermore, less than 5 per cent of these shareholder resolutions - a fraction of a fraction - are coming from 'real' minority shareholders. This is because controlling shareholders - who are entitled to table resolutions to meetings even after the initial agenda has been set - often do so at the behest of the board and management, as a way to get around a regulatory restriction on changing the meeting agenda once it has been announced.

At the same time, regarding resolutions related to environmental and social factors, we have yet to see outside shareholders in China come close to adopting the meaningful role they have played in other major markets in driving advances in corporate ESG agendas. This is another area ripe for greater activity.

In conclusion, it is clear from the above examples that despite the gains in recent years, there is still ample scope for outside shareholders to increase their participation as corporate stewards in China's onshore market. This is a matter of both participating more in the voting process but also amplifying their votes on issues of core concern. Greater success will also depend on engaging more directly and effectively with companies; in the next section we offer some practical examples of how to approach these types of engagements in China.



Part 2: Engagement in action

Engagement in action

When people think of shareholder activism in China, one example that often jumps out is the failed attempt by billionaire Yao Zhenhua to control the board of China Vanke, one of the country's biggest property developers, in 2016. The cause of Yao's failure remains open to dispute but the overall market conditions remain unready for shareholder activists, and high-profile confrontations such as these have been few and far between in China.

At the opposite end of the engagement spectrum from shareholder activism is investment stewardship. And while it doesn't attract the headlines that loud activist campaigns do, good stewardship - as characterised by diligent voting participation and constructive long-term engagement - has been steadily gaining ground in China.

Indeed, as we have seen, active voting and engagement have the potential to protect and even enhance the value of investments and returns. But how does it work in practice? And more importantly, is it working in China today?

In the following section, we seek to answer these questions with real-life cases that illustrate some of the more common scenarios investors in China are likely to encounter, based on Fidelity International's own on-the-ground experience. Also included here are the highlights of a recent conversation with Luo Nan, the Head of China at the United Nations-backed Principles for Responsible Investment, who describes how China's domestic asset managers and asset owners are increasingly coming to see the value in an ESG approach to investment.

ESG lessons from the field

Given they are among the world's biggest stock markets by value and number of companies, it's easy to forget that China's modern equity markets are only 30 years old. For many A-share companies, the priorities have been survival and growth. But that corporate mentality is starting to shift as the country rebalances its economy from a model of growth at all costs to one that stresses quality and sustainability. An expanding body of middle-class consumers who care about the environmental and social footprints of what they buy means companies need to take sustainability more seriously. The rise of sustainable investing offers further incentives for companies to step up their ESG efforts for the sake of easier financing. Given this confluence of factors, we find it unsurprising that companies are generally willing and, at times, eager to engage with investors on ESG issues.

Here, we share a few examples of our ESG-focused work with a good mix of Chinese companies, from state-owned entities (SOEs) and privately owned entities (POEs) to US-listed ADRs, to showcase the benefits of engagement in this huge and dynamic market.

Case 1: Capital allocation

A perennial and universal governance topic is capital allocation. In China, its pertinence is particularly acute for SOEs, whose senior management can face incentives that do not always prioritize the capital market and outside investors. As a result, it is not uncommon to find companies with excess cash that might be better returned to shareholders than spent on low-return

projects. Encouragingly, as part of its reforms, the government has been allowing SOEs to adopt equity-based incentive plans. We are seeing a change of attitude among SOE senior management, based on our engagement experience.

One example is a Chinese state-owned shipping company. Early in 2020 Fidelity's shipping analyst and an ESG specialist met a few of the company's board members including the chairman. We put forward our case for increasing the dividend pay-out ratio, pointing to the brightened business outlook and the much higher pay-out level of its global peers. The directors responded positively, and a few months later, the firm raised its fiscal 2019 pay-out by more than one-third from the previous year.

Most of the time, however, it takes much longer to see the impact of capital allocation engagements. Four years ago, we broached the topic with a state-owned airport operator. In addition to regularly revisiting the issue of capital allocation during our meetings with management, we also sent a formal letter to the board laying out our arguments. Earlier this year, the company raised its dividend pay-out ratio, acknowledging our persistent engagement as one of the factors behind the change.

Case 2: Climate change

For universal sustainability issues such as climate change, we believe collaborative engagement is an effective way to drive change. This is particularly true when it comes to top carbon emitters whose shares are widely held across investment firms. In this spirit, Fidelity has taken part in the Climate Action 100+ initiative[1] (CA100+). Our local presence and long investment history in Asia means we can offer to play a leading role in engagement with the region's top emitters.

One of the companies is a large oil and gas producer in China. Following several rounds of informal conversations, the company agreed to an engagement call with the investor group. During the engagement call we discussed in detail the strategy of the company's low carbon transition and the significance of disclosure on climate change management. The company acknowledged the importance of overcoming the challenges to its long-term success posed by climate change. It also explained that, over the medium term, its main strategy was to move further towards natural gas and away from crude oil, in line with government policies. As it further increases its natural gas production, the company is mindful of the associated methane emissions, which it also plans to reduce. Another pillar of its strategy is to increase the weight of renewable energy in its product mix.

We were pleased to see that within just three months of our initial engagement, the company told investors about its aspirations to cut carbon emissions to near-zero by 2050. While it fell short of a signed and specific commitment, this was the first public statement by a major Chinese SOE that is close to a carbon-neutral pledge. At the same time, the company also announced plans to invest in geothermal, wind, solar and pilot hydrogen projects. These measures may spur other companies in the region into action.

One month after the company's announcement, President Xi Jinping revealed China's pledge to be carbon neutral by 2060 at the United Nations Climate Summit, providing further impetus to the climate actions by Chinese companies.

[1] http://www.climateaction100.org/

Signatory of:

PRI Principles for Responsible Investment

Q&A with UNPRI

Luo Nan was appointed in 2017 as the first head of China at the United Nations-backed Principles for Responsible Investment (PRI) and is based in Beijing. She recently sat down for a video call with Flora Wang, Director of Sustainable Investing at Fidelity International in Hong Kong. In a wide-ranging discussion, Luo told Wang about the speed with which China-based asset owners and asset managers are embracing ESG factors, the important role global investors are playing in raising awareness of sustainability in China's onshore markets, and what's next as China makes increasingly bold strides towards carbon neutrality and other signs of progress on the ESG front. The following is an edited and condensed transcript of the conversation.

Q: The number of PRI signatories in China has risen rapidly over the past three years. What's driving this growth?

A: Fundamentally it comes down to the increased awareness and understanding among Chinese investors about why ESG matters from a risk-and-return standpoint and in driving real-world outcomes. Investors overseas have already had years to realize that ESG isn't just about generating alpha or managing investment risk or deploying investment screens. It's a holistic way of thinking about and practicing investment.

I see a few drivers for the rising number of China signatories to the PRI. First, having a presence in China since 2017 has allowed us to have continuous engagement with investors, policy makers and regulators, and to get prospective Chinese investors on board. PRI is seen a good platform for investors to show public commitment and leadership, and to learn and progress on the ESG front with peers globally. Furthermore, with more than 3,500 signatories globally representing over USD 100 trillion in AUM, PRI is viewed as one of the leading proponents of responsible investment.

International asset owners are another key driver of PRI's growth. They are becoming more and more explicit in requiring managers to incorporate ESG as part of the investment process. This has sent a clear signal to Chinese investors and managers, especially those that are internationally connected and who want to attract overseas clients. More asset managers have responded to this development by following suit.

Meanwhile, there is a better understanding in the Chinese market about the financial materiality of ESG factors. There is a growing body of academic and industry research and evidence showing how ESG factors can help to better manage investment risks and generate long-term returns.

I think there is a better understanding in the Chinese market about the financial materiality of ESG factors.

Finally, and importantly, ESG resonates with Chinese investors as it aligns with – and can be deployed to help deliver – China's national priority for green and high-quality economic development.

Q: How do China's asset managers differ from asset owners when it comes to embracing PRI?

A: The majority of our Chinese signatories so far have been asset managers. Compared to the global average and to many other markets, the proportion of asset owners relative to asset managers among Chinese signatories has been lower. Asset managers are more market oriented and there are clear market forces driving them to take a position on ESG and PRI.

We've seen a lot of positive signals from some of the biggest asset owners in China showing that they already have a good understanding of ESG and are working to implement it more broadly.

Market or regulatory pressure has been less for Chinese asset owners to act on ESG. ESG is a short acronym but not necessarily an easy concept to embed in investing as it implies systemic changes and requires dedicated resources. Education and mindset changes take time, especially if acting on them is not seen as a priority in the short term. The misalignment between short-term motivation and incentives, plus pressure on returns and the long-term nature of capital also make the ESG change challenging.

Nevertheless, there has been very positive progress this year with ESG uptake among big asset owners, from the sovereign wealth fund to the national pension fund. We expect to see further progress in time.

Q: What role do asset owners in China play in this process?

A: As is the case in all markets, asset owners hold a unique position in the investment chain to drive deep and market-wide adoption of ESG. This is true in China too, and asset owners hold both domestic and overseas asset managers accountable for implementation. It would be exciting to see the largest asset owners – such as the nationwide social security fund, China's sovereign wealth funds, and insurance companies – start to take active and leading roles on ESG. That would not only impact sustainable investment domestically but also overseas, including in the Belt and Road regions.

Q: It sounds like the easy wins have already been won, so what prospects remain for near-term changes on ESG in China?

A: Unlike in some overseas markets, listed companies are not yet required to make mandatory ESG disclosures in China to investors. Local and global investors have been expecting a standardized and internationally aligned ESG disclosure policy framework to be released by the Chinese regulator.

Though the timeline of further ESG regulation remains unclear, China's President Xi Jinping recently signaled a new vision and strong commitment for delivering carbon neutrality by 2060. This means ESG development could be – indeed, will have to be – accelerated. Economic and financial policy and regulatory change – alongside the increasing demand for ESG in the market – will play a critical role in the future of ESG in China.

Case 3: Incentive scheme

Last year, a company in the fast-moving consumer goods space proposed a stock inventive plan for its chairman and core executives, setting performance goals that were low relative to its track record. And the size of the chairman's potential award looked excessive at around 1 per cent of shares outstanding, with the exercise price set at about 50 per cent below the market value.

Fidelity wrote to the company's board expressing concerns over the performance targets, the chairman's award and a poor alignment of interests between the management and minority shareholders. The company acknowledged our comments and tweaked the plan by slightly reducing the awards and raising performance goals, but in our view this did not go far enough to address our key concerns. The incentive scheme passed in the end, and while the outcome was not entirely satisfactory, it was encouraging that the company responded to shareholder concerns. At the same time, many investors utilised their votes to express dissent, which in itself is a sign of market progress.

Case 4: Disclosure and transparency

There are many Chinese companies listed in the US in the form of American Depositary Receipts (ADRs). It is not yet mandatory for these companies to publish sustainability reports, so transparency and disclosure of their ESG impacts have been key topics in our engagements with them.

One example is an express delivery company with whom we started to engage in late 2018. We discussed issues such as safety and the environmental impact of their parcel boxes. It soon became clear to us that the company's poor ESG ratings by third parties were largely due not to a lack of attention to ESG on their part, but to a lack of disclosure of their activities. We met with the company management again in mid-2019, encouraging them to enhance disclosures in this area. A few months later, the company published its first ESG report in English, and in its 2020 report it added a much greater level of disclosure detail. Moreover, its board passed a motion this year to integrate ESG into daily operations and to align ESG targets with senior management compensation.

Conclusion

We are a staunch believer in the value of engagement, especially in a young market like China, where a great economic transformation is taking place and companies are experiencing rapid growth, innovation and disruption. Engagement can effect powerful change if conducted appropriately; a deep understanding of local rules and challenges is crucial. We believe a constructive approach focusing more on common ground than on disagreement works well in China, as in most of the markets where we invest.

Moreover, as a fundamental bottom-up investor, we cannot emphasize enough the value of direct and sustained engagement in making an accurate assessment of a company's ESG practices - as well as its financial performance. Disclosures alone are entirely inadequate when the goal is to develop a truly informed and holistic understanding of where a company stands today, let alone predicting where the future will take it.



Part 3: A shareholder's guide to voting in China

A shareholder's guide to voting in China

The final section of this report offers a Q&A "how-to guide" for investors who are keen to exercise their voting rights in China's onshore market.

1. How many shareholder meetings do Chinese companies hold on average?

Chinese firms held 3.4 shareholder meetings on average in 2019 and 3.6 in 2018. In some extreme cases, companies held more than 20 meetings a year. This is because shareholder approval can be required for relatively small matters, such as for certain types of financing favoured by property developers.

2. Who can convene a shareholder meeting?

Meetings are most often called by the board of directors. Independent directors, the board of supervisors, and shareholders who individually or collectively hold 10 per cent or more of the issued capital also have the right to propose a general meeting. In some cases, the board of supervisors and eligible shareholders can even convene and preside over general meetings.

In practice, shareholders only propose meetings when there is a fight for control over the listed company. As mentioned previously, this is rare, but included the 2016 case when billionaire Yao Zhenhua sought to convene an EGM and unseat all the board members of China Vanke. Although Yao's companies collectively held the largest Vanke stake, he failed to win the board's support and subsequently abandoned his attempts hold an EGM.

3. When do meetings take place?

According to the Shareholder Meeting Rules for Listed Companies (2016), public firms must hold an annual general meeting at no later than June 30 each year. Therefore, the voting season of the A-share market is usually between March and June.

EGMs are held whenever there are resolutions requiring shareholder approval. As a result, meetings abound, as shareholder approval is required for a wide range of company actions. The high frequency of meetings in the A-share market has posed challenges for investors studying proposals and voting.

4. How are resolutions tabled?

A vast majority of resolutions in the A-share market are tabled by the board of directors. Shareholders put forward proposals only in a small number of cases, although investors who individually or collectively own 3 per cent or more have the right to do so. In our research sample, only 1.4 per cent of the voting resolutions over the last three years came from shareholders. Furthermore, about 95 per cent of those so-called "shareholder proposals" were tabled by controlling shareholders at the request of the board and management, as companies are not allowed to add resolutions once the meeting notice is published.

It's worth noting that the right to nominate directors as part of the right to raise a shareholder proposal

is not clearly regulated in China. Current regulations do not clearly state a threshold for nomination. A general search for more information found only a reference in a 2001 CSRC document about rules for independent directors, which stated that shareholders who individually or collectively own at least a 1 per cent stake have the right to nominate candidates for independent directors.

In practice, listed companies usually apply the same threshold for nominations as for other shareholder proposals: investors who individually or collectively own more than 3 per cent can nominate candidates for directors and supervisors. However, some listed companies have set higher thresholds in their charters.

5. How do companies announce a shareholder meeting?

Shareholders must be notified 20 days before an AGM and 15 days before an EGM. Investors can find meeting notices through media designated by the CSRC, including the official websites of the Shanghai and Shenzhen stock exchanges and www.cninfo.com.cn.

Currently, most listed companies strictly follow the notice requirements, but there are still a small number of violators. Among our sample companies, 3.6 per cent of AGM notices and 2.3 per cent of EGM notices were issued late.

A 45-day notice period used to be required of Chinese companies listed overseas, including A+H dual-listed companies, but regulators have shortened the requirement in 2019 to match the rules for onshore firms.

6. Where can meeting materials be found?

Meeting materials form the main basis for shareholders analysing proposals. The Shanghai exchange has set clear disclosure rules whereby listed companies must publish meeting materials on the exchange website at least five days before a meeting is held.

Currently, there are three common ways of disclosure:

a) A company may disclose all the information about a meeting in one package named "shareholders meeting materials/documents/information". This helps investors to obtain all the necessary information efficiently, but unfortunately only a minority of firms are doing it, or do so only for AGMs and not EGMs.

b) A company may disclose a separate document for each voting resolution. For example, it may publish information on "2019 daily connected transactions" in a separate announcement. Currently, most A-share companies are following this practice.

c) A company may disclose information related to a voting resolution in the minutes of a board meeting at which the resolution was discussed and approved by the board. Generally, proposals are reviewed by the board before being tabled for shareholder meetings. This means of disclosure may cause shareholders to miss important information, as investors need to sift through all the board meeting minutes to look for the relevant information.

Overall, A-share companies have done a good job at disclosing meeting materials, but there is room for improvement in two areas: completeness and timeliness. For example, many companies fail to disclose their Financial Budget Report, which is subject to shareholder approval at AGMs. Some companies only disclose the report at the actual meeting and, as a result, investors who only vote by proxy or electronically have no choice but abstain or vote against.

Due to complex procedures, global investors are often required to send their voting instructions to custodian banks more than 10 days before a shareholder meeting. However, A-share companies may publish meeting materials only five days in advance under current exchange rules. This has caused many international investors to abstain or vote against proposals, in the absence of timely information.

7. How can shareholders send voting instructions?

Shareholders can either attend a general meeting in person or via proxy. They can cast votes in person at the meeting or use online platforms. There are designated websites for voting; investors may also give instructions through their online stock trading systems. Voting channels open on the day of the meeting itself.

8. How are meetings held?

A purely online setting is not allowed for general meetings in China; there must be an offline meeting room as well, with both on-site and electronic voting channels. All registered shareholders have the right to attend.

The Shenzhen exchange has previously tried promoting online virtual meetings, but only a tiny number of companies have tried it out and the vast majority of meetings remain offline.

9. What are the different approval thresholds for ordinary resolutions and special resolutions?

Ordinary resolutions require a minimum pass rate of 50 per cent. Special resolutions require a two-thirds majority approval. Whether a resolution is 'ordinary' or 'special' needs to be specified in the meeting notice. Below is a summary of the common resolutions based on the resolution type.

Table 1: A summary of common resolutions by resolution type

Resolution	Ordinary resolution	Special resolution
The working report of directors and supervisors	✓	
Annual report	✓	
Profit allocation	✓	
Director, supervisor election	✓	
Director, supervisor remuneration	✓	
Annual financial budget report, financial accounts	✓	
Employee share ownership scheme	✓	
Increase or decrease in registered capital		✓
Merger, spin-off, liquidation		✓
Amendments to articles of association		✓
Major asset purchase and/or disposal		✓
Major guarantee provision		✓
Share incentive scheme		✓

Sources: 2019 Guidance on Company Articles of Association.

10. How are thresholds for approving resolutions tallied?

Shareholders can vote for or against proposals, or abstain. The numerator for calculating the pass rate is the number of shares owned by those who vote "yes", while the denominator is the number of shares held by all attendants of the meeting who have the right to vote. Given the counting method, abstention has the same effect as voting against.

In practice, a small number of companies have set special rules in their Articles of Association on calculating the pass rate. For example, Aluminum Corporation of China excludes abstention shares from the denominator. This could boost the pass rate.

Besides calculating the overall pass rate, companies also disclose vote counts by share classes including A-shares, H-shares, and B-shares. And on major issues affecting minority investors, their votes also need to be tallied separately. Under Shenzhen exchange rules, such major issues include the appointment and remuneration of board members, dividend policies, connected transactions, restructurings, and incentive schemes, among others.

In particular, when A+H dual-listed companies hold shareholders' meetings, voting results on some proposals need to be separately counted and disclosed by the A-H split, and approval may be subject to specific thresholds for each class of shareholders.

11. When and how are meeting results disclosed?

A-share companies usually announce results on the general meeting day or the next day, through stock exchange websites or www.cninfo.com.cn.

Currently, Shanghai exchange rules are relatively vague on the timing of disclosure, requiring only "promptness". By comparison, the Shenzhen exchange has set clearer rules on timing whereby companies are required to disclose voting results on the same day of the meeting.

Voting results announcements usually contain two parts:

a) Attendance (both online and offline) and shares owned by attendants
b) Voting results for every resolution, which may include vote counts by shareholder type

It's uncommon, but in some cases companies disclose how Top 10 shareholders have cast their votes. For example, China Nonferrous Metal and Ningxia Western Venture Industrial have both disclosed ballots cast by their top owners at AGMs since 2015. China Vanke also did so in 2016 when billionaire Yao Zhenhua started a controversial fight for board control.

12. Is it one share, one vote?

Mostly but not always. In general, A-share companies must treat all shares as equal, but regulators made an exception for weighted voting rights (WVRs) on the Shanghai STAR board, which was launched for technology firms and startups in 2019. Subsequently, Shenzhen's ChiNext board also adopted new rules in 2020 allowing share classes with weighted voting rights.

Given the inevitable erosion of minority shareholder rights that comes with weighted voting rights, certain safeguards have been built into the WVR regime. The number of votes wielded by each share of the superior share class should not be more than ten times that of the ordinary shares. Post-listing, there should be no new issuance of

the superior voting shares except for rights issues or bonus issues, and the voting rights represented by the ordinary shares should be no less than 10 per cent. Moreover, the superior voting shares will be treated as ordinary shares and count as 'one vote, one share' in regards to voting on material resolutions such as proposals to amend Articles of Association the appointment and removal of independent directors and the audit firm, merger or liquidation of the company, or changes to the voting rights of the superior voting shares.

The introduction of WVRs must be done before a company becomes public and must be approved by shareholders holding at least two-thirds of issued capital. In addition, there are suitability tests on market cap, sales and profitability. For example, the STAR board requires an estimated market value of at least 10 billion renminbi, or an estimated market value of at least 5 billion renminbi while sales in the most recent year are no lower than 500 million renminbi.

Currently, the only A-share company with different share classes is UCloud Technology, which started trading on the STAR board in January. At the time of writing, another firm with weighted share classes was seeking regulatory approval to list on the same venue.

13. When do shareholders need to abstain from voting?

Voting abstention is required whenever there is a perceived conflict of interest. At board meetings, if a board member has a personal interest in a resolution, he or she must abstain from voting. At shareholder meetings, for connected transactions, shareholders deemed related parties must abstain from voting. These arrangements aim to help protect minority investors by limiting the voting power of controlling shareholders.

14. What matters are subject to shareholder approval?

In order to protect investors, a large array of matters are subject to shareholder approval in China. These include more mundane matters such as director election, dividend distribution, and financial accounts, which are also commonly seen in other markets. But also included are more unique items that are more likely treated as under board and management authority in other markets, such as investment plans, loan guarantees, and connected transactions.

15. Finally, what are some examples of potentially problematic resolutions?

In closing, we offer four areas where shareholder resolutions can potentially run into problems.

a) **Connected transactions involving financial units of parent groups.** Many parent groups of Chinese listed companies have financial subsidiaries which offer banking-like services to group members. It's not uncommon for a listed company to deposit large funds into a related financing firm, and to see the money then used to support other subsidiaries of their parent. These transactions can represent a unique set of risks that deserve attention. That said, such transactions can also provide legitimate benefits to the listed company, as the deposit and loan interest is often more favourable than that offered by commercial banks, and the services provided by such group financial companies can be more expedited and tailored. A case-by-

case approach that takes into account the specific situation of each company is most appropriate. For example, a large liquor producer had more than 30 billion renminbi in deposits with a related financing company, accounting for more than half of its cash and cash equivalents at the end of 2019. But it never received any loans from the financing firm, so the deposits looked excessive and had the additional effect of exposing the liquor maker to risks from the financial health of its sister units.

b) **Loan guarantees that may hurt shareholders.** Loan guarantee provisions are another typical resolution in China, where many listed companies rely heavily on debt financing. It's not uncommon for property developers to make guarantees exceeding their net asset value. Shareholder approval is required for any guarantee above 10 per cent of a listed company's net asset value. Approval is also needed if guarantees are made for the company's controlling owner or the owner's connected parties. When reviewing such resolutions, shareholders should be mindful of the fairness of the guarantee provision, insofar as the company is not taking on a liability larger than its proportionate equity ownership. It's less common now, but there have been cases in which a listed company provided a full guarantee to the loans of a subsidiary where the company only owns a 51 per cent stake, with the remaining 49 per cent owned by its controlling shareholder. In the event of default by the subsidiary, the company as the sole guarantor will be liable for paying back all the debt. For example, a maker of video surveillance products planned to offer guarantees worth around 20 billion renminbi on behalf of its 52 wholly-owned units and another 15 subsidiaries, some of which are partly owned by the listed firm's executives or their connected parties. The company submitted a connected-transaction proposal for the guarantee plans this year, but shareholders narrowly voted it down.

c) **Risky wealth management products.** Many A-share companies invest their idle funds in wealth management products. Shareholder approval is required for plans about the size and estimated risks of such investments. Such plans can be advantageous where the investment value is modest and risks are low. In practice, however, after indicating a low risk level in their initial proposals, some companies have gone on to purchase highly risky products. For example, a large machinery maker pledged to invest some 3.2 billion renminbi in low-risk wealth management products in 2019, but it ended up buying high-risk funds and trust products for more than 600 million renminbi. Given the potential for mismatching investment risk profiles, it is important for investors analysing these types of resolutions to review the company's track record in purchasing wealth management products, instead of solely focusing on what the company claims to do in the meeting circular.

d) **Stock incentive schemes with hidden risks.** The CSRC introduced detailed guidelines on stock incentive schemes in 2015 and 2016. There are two main types of such schemes in China: Equity Incentive Plans (EIPs) and Employee Stock Ownership Plans (ESOPs). EIPs

usually target executives, board members and core employees, while ESOPs may involve a large group of employees across corporate ranks. The former is subject to tighter regulatory oversight and more restrictive rules. ESOPs, on the other hand, face less oversight and lower approval hurdles. At shareholder meetings, they only require a 50 per cent pass rate, compared to a two-thirds majority approval for EIPs. Performance targets are required for EIPs but not ESOPs. A significant shareholder with a stake above 5 per cent needs to be excluded from an EIP, but can join an ESOP. Therefore, contrary to the common perception that EIPs are more problematic because they target executives, ESOPs are the ones that really deserve more shareholder scrutiny and voting analysis. There have been cases where large shareholders disguised their participation in ESOPs and successfully took up major share allocations with barely a challenge.

For example, this year a large dye maker launched an ESOP worth more than 600 million renminbi benefiting only seven people - including the chairman, who owns a 10.7 per cent stake. The award to the chairman alone accounted for nearly half of the entire share scheme. Meanwhile, the ESOP included no performance targets, but saw the company repurchase shares at a 20 per cent discount to the average market price. While from an outside shareholders' viewpoint the company's costs appeared to outweigh the benefits in this case, the ESOP was nevertheless approved at a general meeting.



A worker dyes the fabric of the isolation suit. Haian City, Jiangsu Province, China. (Photo by: Barcroft Media / Contributor Images via Getty Images)

Note: All fund related data and information in this Perspective is from Fidelity International and is as of November 2020. Views may no longer be current and may have already been acted upon by Fidelity.

Reference to specific securities should not be construed as a recommendation to buy or sell the securities but is included for the purpose of illustration only. Performance of the security is not a representation of the Fund's performance. Past performance is not indicative of future performance.

Important Information

Singapore

This publication is prepared on a general basis for information only. It does not have regard to the specific investment objectives, financial situation and particular needs of any specific person who may receive it. You should seek advice from a financial adviser.

Past performance and any forecasts on the economy, stock or bond market, or economic trends are not necessarily indicative of the future performance. Views expressed are subject to change, and cannot be construed as an advice or recommendation.

References to specific securities (if any) are included for the purposes of illustration only. This advertisement has not been reviewed by the Monetary Authority of Singapore.

FIL Investment Management (Singapore) Limited (Co. Reg. No.: 199006300E) Fidelity, Fidelity International, and the Fidelity International Logo and F Symbol are trademarks of FIL Limited.

CA-2020-443700-(G)