PATHS TO SOCIAL RISK REFORM FOR **THE HONG KONG FINANCIAL MARKETS**

Why the Hong Kong investment community should prioritize social risk reform and what we can do today

FOREWORD

Liberty Asia has partnered together with DLA Piper to draft a white paper evaluating Social Risk as part of complying with Environmental, Social, and Governance requirements.

DLA Piper, one of the leading global business law firms in the world, represents many of the largest multinational corporations. DLA Piper's clients cover nearly every major industry including energy and infrastructure, financial services, insurance, life sciences, media, sports and entertainment, real estate, and technology. The firm specializes in addressing the legal needs of global multinational corporations and is considered a trusted advisor and go to law firm for several Fortune 500 companies.

Liberty Asia, a not-for-profit organization aims to prevent human trafficking through legal advocacy, technological interventions, and strategic collaborations with NGOs, corporations, and financial institutions in Southeast Asia.

By collaborating with DLA Piper, Liberty Asia is able to blend advocacy and on the ground knowledge of social issues with DLA Piper's "insider" view on how businesses operate and what issues they are concerned with. We hope that this in turn results in a paper which can inspire real and practical change by key stakeholders in the business community.

We acknowledge the lead authors Jason Chang, DLA Piper and Archana Kotecha, LibertyAsia.

CONTENTS

EXECUTIVE SUMMARY 5

Introduction 7

PART I: BACKGROUND 8

What is Social Risk? 9

Towards a definition of social risk for Hong Kong and the investment community 10

PART II: CURRENT SOCIAL RISK ISSUES 12

Money is Flowing to Socially Responsible Companies 13

Money flows through negative screening and active ESG-conscious stock selection 13

Markets responding to mass demand with sustainability indices 14

It is unclear where the Hong Kong markets will sit in this new economy 15

Legal and regulatory enforcement regimes continue their focus on social risk issues 16

Jurisdictions in the Asia-Pacific Region 16

Enhanced Disclosure Regimes 18

Hong Kong's relevant laws and financial regulatory regimes 19

Hong Kong laws 19

Hong Kong on enhanced disclosures 19

HKEx's ESG Reporting Guide 20

Global frameworks set the tone from the top and use their alliances to pressure push for social risk reform 21

The UN Guiding Principles on Business and Human Rights 21

The OECD Guidelines for Multinational Enterprises 21

The United Nations Environment Programme Finance Initiative (UNEP FI) 22

Sustainable Stock Exchanges Initiative (SSE Initiative) 22

Equator Principles 22

Global frameworks are helpful to set the tone at the top but are limited when it comes to enacting real change on-the-ground 23

The rise of NGOs and non-profits have been a boon to social risk reform 23

PART III: PROGRESS IN HONG KONG 26

The Hong Kong Stock Exchange's ESG Reporting Guide 27

Substantive issues covered by the ESG Guide with an emphasis on issues relevant to social risk issues 27

How does the HKEx ESG Guide address some of the common issues prevalent in the Asia-Pacific region? 27

HKMA and SFC are not bound by ESG Requirements 29

PART IV: PROPOSED RECOMMENDATIONS 30

Integrating the identification and elimination of social risk into all relevant business functions 31

During the IPO process 31

Incorporating social risk into due diligence 32

Policies and procedures 32

Audits 33

Third-party supplier engagement 33

Integrating social risk into existing controls and compliance functions 33

Conclusion 35

EXECUTIVE SUMMARY

The Asia-Pacific business environment is rife with social risk, manifested as human trafficking, forced labour, modern day slavery, child labour, safety and work environment issues, and other labour rights violations.[1] In the modern business environment, a company's failure to manage social risks can result in serious legal, financial, and reputational consequences.

For investors seeking access to the Hong Kong financial markets, the situation is no different. Investors as well as the key gatekeepers to the financial markets, namely regulators, banks, shareholders, professional investors, and professional services providers (lawyers, accountants, etc.) have an increasing number of incentives to combat forced labour and other related social issues which often arise in the Asia-Pacific region. While social risk has historically tended to be grouped as part of the broader suite of Environment, Social and Governance ("ESG") issues, it is important to consider social risk also as a standalone issue and appreciate how damaging social risks can be for companies that do not adequate address or protect against social risks. Particularly in the Asia-Pacific region, social risk takes on increased importance in the business environment due to the high levels of forced labour and human rights issues in the region (some examples of which are discussed further in Part II of this paper).

Thus, instead of treating social risk as an ethical or moral issue that goes under the "corporate social responsibility" agenda, companies will increasingly face high-stakes vulnerabilities and, as a result, be increasingly held accountable on social risk. Adjusting to this new reality will be an important part of maintaining or increasing financial value for firms. Regulatory accountability is a boardroom issue and the shift of social risk to a regulatory accountability issue will ensure it forms an integral part of business practices going forward. A responsible board must address any actual or potential involvement in adverse social risk impacts as part of their risk management. If not, they will be inadequately prepared for future events, answerable to stakeholders for a failure to do so and may even expose themselves to liability. [2] This move from ethical to accountable is increasingly pushed by jurisdictions around the world, a phenomenon which began with laws passed in California and later in the United Kingdom, with more and more regions considering enhanced disclosure regimes each year.[3]

This paper will examine some of the reasons behind the increased profile of social risk issues in the business world, including:

- the increased investor demand for socially responsible companies;
- a continued crack down on forced labour by legal and regulatory enforcement regimes; and
- lobbying by global frameworks, NGOs, and non-profits for social risk reform.

In addition to exploring these causes for the increased global focus on social risk issues, this paper will examine and evaluate some of the steps taken to combat social risk issues in Hong Kong and the Asia-Pacific region more generally, and finally propose reforms to better address these social risk issues. Given the current and ever-evolving business, legal and regulatory landscape and DLA Piper's insight into how global businesses operate, this paper focuses on two necessary reforms:

1. first, there is a clear need for increased financial regulation of the Hong Kong markets in relation to social risk issues; and
2. second, the identification and elimination of social risk issues must be integrated into all relevant business functions.

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[1] "Trafficking in Persons." *The World Factbook*. Accessed August 10, 2016. https://www.cia.gov/library/publications/the-world-factbook/fields/2196.html.

[2] Jonathan Refoy, "Human Rights – the Boardroom Response." *Forbes*, November 17, 2016. Accessed November 27, 2016. http://www.forbes.com/sites/jonathanrefoy/2016/11/17/human-rights-the-boardroom-response/#5a66f1962450.

[3] Transparency in Supply Chains Act 2012 (California); Modern Slavery Act 2015 (UK).

THE NEED FOR INCREASED FINANCIAL REGULATION OF THE HONG KONG MARKETS IN RELATION TO SOCIAL RISK

Aside from the Hong Kong Stock Exchange ("HKEx"), most of the other core Hong Kong regulators or industry bodies have not issued any requirement for companies to demonstrate good social risk governance before accessing the Hong Kong markets. And while the HKEx's ESG Reporting Guide is a good starting point, it does not go far enough in addressing our modern day concerns. This is because the Asia-Pacific region's business environment can be characterized by its complexity, in terms of cultures, corruption and relatively weak enforcement of corporate legal liability laws, but also in corporate structures and supply chains. Complexities of this nature facilitate misuse as transparency becomes more difficult to achieve and gaps in reporting and accountability can more readily be exploited.

As a result, some of the most common social risk problems arising from outsourcing work to third-parties in sector specific high risk industries and jurisdictions continue to plague Asian countries with key perpetrators able to access the financial markets under the banner of "clean" holding companies. Therefore, our recommendations to increase regulation of the Hong Kong markets include increased focus on key performance indicators for social risk issues as well as amendments to the current HKEx's ESG Reporting Guide to provide for a closer review of a company's suppliers.

INTEGRATION OF SOCIAL RISK IDENTIFICATION AND ELIMINATION INTO BUSINESS FUNCTIONS

This paper argues that the identification and elimination of social risk issues must be integrated into all relevant business functions. Investment bankers, lawyers, accountants, and other relevant consultants play a key role in identifying business function "touch points" where integration of social risk evaluation makes the most sense. At a high level, our recommendations cover several business functions where social risk could be integrated, including during the IPO process, during a merger or acquisition, project finance, as well as routine audits and/or due diligence exercises such as third-party vendor and/or supplier review. Furthermore, a company may consider whether there are already any efficient and effective compliance review and/or monitoring procedures in place (e.g. anti-money laundering, anti-corruption, accounting fraud, etc.) and whether social risk issues could be integrated into those procedures.

By advocating for increased financial regulation as well as strengthened practices for identifying and eliminating social risk, together we can play an integral role in driving better investment decisions, improving public perception and awareness of social risk as an issue, and ultimately improving the lives of the people who live in our communities.

INTRODUCTION

The Asia-Pacific business environment is rife with social risk, manifested in human trafficking, forced labour, modern day slavery, child labour, safety and work environment issues, and other labour rights violations.[4] According to the Global Slavery Index, as of 2016 an estimated 30,435,300 people are considered modern slaves in the Asia-Pacific region. This accounts for 66.4% of the global total.[5] According to a 2016 survey by UNICEF, 10% of children aged 5 to 14 years in the East Asia and Pacific region are engaged in child labour.[6] And according to the U.S. Bureau of International Labour Affairs, in 2014, 168 million children ages 5 to 17 were engaged in child labour around the world. Out of these, 77.8 million (46%) were from the Asia-Pacific region.[7] These numbers exhibit the prevalence of social risk issues, particularly in the Asia-Pacific region and highlight the importance of the issue for business operators in the region. In the modern business environment, a company's failure to manage these social risks could result in the company being a part of these horrific social risk tragedies, not to mention could also result in the company suffering serious legal, financial, and reputational consequences.

Some of the more high-profile examples of social risk issues reported by the media include a global technology company who acknowledged over 100 cases of underage labour used by its suppliers in Asia in 2012.[8] The company's own internal audit report papers that were shared with the press reveal that eight of its third-party suppliers were identified as employing underage workers via forged identity papers.[9] Similarly in 2011, Indonesian workers manufacturing shoes for a major shoe and apparel company alleged that management physically and mentally abused them.[10] After the company conducted its own investigation, it acknowledged that these issues existed at the factory however it also stated that certain issues related to its supply chain were out of their control.[11]

While both of these examples resulted in negative press as well as legal and financial setbacks, none of these incidents have altogether stopped these two multinational companies from becoming successful businesses in the long run, proving that companies are capable of moving forward from social risk issues. And it is critical to note that what steps a company decides to take after social risk issues are identified is more telling of a company's ability to grow, survive, and move forward from its past. Rather than focus on the negative which occurs after the fact, this paper will focus on the dynamics at play in today's market as it relates to social risk issues and what sort of factors can help a company take the right steps to grow and move forward in a positive, accountable manner. A company does not operate in isolation, and the free-market mantra of "the business of business is business" needs to be contextualized within the communities that firms operate in.

The welfare of businesses is not, and should not be, diversified from the welfare of the communities of those impacted by the companies' work be they workers or neighbouring communities.

Part I of this paper provides background on the meaning of social risk and provides relevant scenarios where social risk issues have occurred in the Asia-Pacific region. This section also helps set up a framework for what is social risk for Hong Kong in comparison to other jurisdictions. Part II outlines the current business, legal and regulatory issues which are relevant to social risk with a particular focus on challenges faced by financial regulators and businesses. Part III analyses how the HKEx's recently enacted ESG Reporting Guide fares in addressing these social risk issues. Part IV proposes a way forward given the current business, legal and regulatory challenges.

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4 "Trafficking in Persons." *The World Factbook*. Accessed August 10, 2016. https://www.cia.gov/library/publications/the-world-factbook/fields/2196.html.

5 "Asia- Pacific – Global Slavery Index 2016." Global Slavery Index. Accessed August 10, 2016. http://www.globalslaveryindex.org/region/asia-pacific/.

6 Unicef. *Child Labour.* May 2016. Accessed August 10, 2016. http://data.unicef.org/topic/child-protection/child-labour/.

7 See https://www.dol.gov/agencies/ilab/resources/reports/child-labour/asia-pacific and https://www.dol.gov/agencies/ilab/our-work/child-forced-labour-trafficking

8 Juliette Garside, "Child Labour Uncovered in Apple's Supply Chain," (The Guardian, January 25, 2013), https://www.theguardian.com/technology/2013/jan/25/apple-child-labour-supply.

9 Ibid.

10 Ibid.

11 Daily Mail Reporter, "Nike Workers 'kicked, slapped and verbally abused' at Factories Making Converse," (Daily Mail, July 13, 2011), http://www.dailymail.co.uk/news/article-2014325/Nike-workers-kicked-slapped-verbally-abused-factories-making-Converse-line-Indonesia.html.

PART I
BACKGROUND

WHAT IS SOCIAL RISK?

In the broadest sense, social risk relates to the impact of the social and economic environment on the quality of life of the people subject to that environment.[12] The World Bank asserts that social risk is the likelihood that the individual's quality of life is reduced while a perception of insecurity, isolation, inequity and inequality is pronounced.[13] Social risks often arise in socially unstable situations which include communities with severe income disparities, food crises, dysfunctional cities as well as public health issues such as pandemics and chronic diseases.

The Association of Southeast Asian Nations ("ASEAN") has identified key factors in Asia's unskilled labour force as associated with an increased likelihood of social risk. An older and shrinking labour force, falling fertility rates, rising urbanization, shrinking family sizes, and unpaid employment have all contributed to an increase in economic and societal insecurity in the Southeast Asia region. ASEAN refers to "social protection" as the key to minimizing social risks and has advocated for increased corporate social responsibility ("CSR") in production supply chains. CSR often consists of corporate governance and monitoring initiatives designed to reduce worker poverty, unemployment, sickness, and disability, and to control resource consumption throughout the economic life cycle.[14] The Chinese government describes social risks as the "three agricultural issues" (farmer hardship, rural poverty and agricultural risk), unemployment, the "three disparities" (rich/poor, rural/urban, and east/west), and public safety and security issues such as with public demonstrations and protests.[15]

While the concept of "social risk" is broad and various governments, NGOs, and academia may define it in different ways, for the purposes of this paper, we focus on some of the most common social risk issues which manifest themselves within businesses and related commercial activities in the Asia-Pacific region. These issues primarily fall into the category of forced labour such as human trafficking, modern day slavery, child labour, safety and work environment issues, and other labour rights violations. Based upon our research into various media reports, below is a list of common scenarios where social risk issues could be linked to the business community:

- In Thailand, "ghost ships" enslave and even kill workers who are linked to the global prawns and fish supply chains for major U.K., European and U.S. supermarket chains. Large numbers of migrant men are forced to work for no pay for years at a time under threat of violence.[16] These boats are integral to the production of prawns and fish sold in leading supermarkets around the world.[17]
- Similarly, in Indonesia, six major fishing firms were found by government authorities to be engaged in illegal practices including slavery and tax evasion. The government revoked the business licenses of the fishing firms and released the workers who were held captive on the fishing boats for months at a time.[18]
- In China, a man from Sichuan took advantage of mentally disabled workers by "recruiting" and employing them at various factories in the region. The factories provided food only and no compensation, forced the workers to work without any protective gear despite the factory operating heavy machinery, and did not compensate any overtime. Government authorities also found that the workers were tortured, beaten and starved.[19]

[12] "Social Risk Management: The World Bank's Approach to Social Protection in a Globalizing World." The World Bank Social Protection Department. May 2003. http://siteresources.worldbank.org/SOCIALPROTECTION/Publications/20847129/SRMWBApproachtoSP.pdf

[13] "Regional Challenges in the Perspective of 2020: Regional Disparities and Future Challenges," (European Commission, June 2009), accessed August 17, 2016, http://ec.europa.eu/regional_policy/sources/docgener/studies/pdf/challenges2020/regional_challenges_new_social_risk.pdf.

[14] "Social Protection in ASEAN: Challenges and Initiatives for Post-2015 Vision," (ERIA, February 2015), accessed August 17, 2016, http://www.eria.org/ERIA-DP-2015-06.pdf.

[15] Taiwan. Mainland Affairs Council. *Assessing Social and Economic Risk in China.* 1-6. Accessed August 10, 2016. http://www.mac.gov.tw/public/Data/962816224871.pdf.

[16] "Revealed: Asian Slave Labour Producing Prawns for Supermarkets in US, UK." The Guardian. June 10, 2014. Accessed September 17, 2016. https://www.theguardian.com/global-development/2014/jun/10/supermarket-prawns-thailand-produced-slave-labour.

[17] "Revealed: Asian Slave Labour Producing Prawns for Supermarkets in US, UK." The Guardian. June 10, 2014.

[18] Govt Revokes Licenses of Six Major Fishing Firms." The Jakarta Post. June 23, 2015. Accessed September 17, 2016. http://www.thejakartapost.com/news/2015/06/23/govt-revokes-licenses-six-major-fishing-firms.html.

[19] "安徽界首黑砖窑事件调查：智障者遭贩卖成劳力." Sina. July 22, 2009. Accessed September 17, 2016. http://news.sina.com.cn/c/sd/2009-07-22/092818272706.shtml.

- In Malaysia and Indonesia, numerous palm oil plantations were revealed to have widespread abuses of basic human rights. Among the estimated 4+ million workers in the industry are thousands of child labourers and workers who face dangerous and abusive conditions. Debt bondage is common, and traffickers who prey on victims face few, if any, sanctions from business or government officials.[20]
- Similarly, Malaysian recruitment agents and factories which manufacture electronics use an illegal combination of high recruitment fees and wage deductions to force migrant workers into de facto debt bondage. These workers, largely from other countries in Southeast Asia, are subject to physical and verbal abuse, exploitative living conditions, and social isolation. Additionally, workers' passports are withheld and any form of resistance is met with threats of deportation and heavy financial penalties.[21]

One of the common factors that exist across all of these examples is the use of third-party manufacturers, suppliers, and labour brokers. Multinational companies are under a large amount of pressure to keep costs down and maximize profit margins. This pressure trickles downstream in the form of further price reductions for the goods provided and/or services rendered. As a result, some suppliers begin to either directly utilize forced labour or employ labour brokers who both create and exploit bonded workers. These manufacturers find their way into the supply chain simply because the drive to the lowest price possible naturally attracts those companies who are willing to take large amounts of risk. Improper monitoring and lack of desire by upstream buyers to enforce and/or monitor labour issues causes a natural by-product of wilful blindness which encourages the practice of outsourcing and turning a blind eye to violations in the name of keeping profit margins up and the speedy operation of business continuing.

Moreover, these practices are especially pervasive in regions with high levels of corruption and weak rule of law with companies using non-existent labour laws or under-enforced existing laws as a material advantage in the marketplace. For example, in 2015, reports detailing the presence of migrant camps along the borders of Thailand and Malaysia suggest the involvement of Thai officials in labour trafficking.[22] In addition, there was a decrease from 186 trafficking investigations in 2014 to 158 in 2015, which some suggest indicates a decline in enforcement capabilities.[23]

TOWARDS A DEFINITION OF SOCIAL RISK FOR HONG KONG AND THE INVESTMENT COMMUNITY

Hong Kong is uniquely placed as one of Asia's premier commercial and financial hubs as well as its unique role as a gateway between Mainland China and the rest of the world. Requiring that access to the Hong Kong financial markets include an effective conception of social risk would fundamentally change the business landscape from within. To do this, Hong Kong's financing models and professional standards should address social risk issues, including forced labour issues discussed above, human trafficking, modern day slavery, child labour, safety and work environment issues, and more, just as environmental risk issues have already been addressed and built into relevant processes for disclosures and due diligence in accessing financing.

More significantly, given that Hong Kong often serves as a platform for special purpose vehicles ("SPVs") or shell/holding companies where the underlying business and/or operations may span across various jurisdictions across the Asia-Pacific region, financing in Hong Kong should form part of the accountability matrix to ensure that no matter where the capital flows may end up, a social

[20] Al-Mahmood, Syed. "Palm-Oil Migrant Workers Tell of Abuses on Malaysian Plantations." Wall Street Journal. July 26, 2015. Accessed September 17, 2016. http://www.wsj.com/articles/palm-oil-migrant-workers-tell-of-abuses-on-malaysian-plantations-1437933321.

[21] Verite. "The Electronics Sector in Malaysia: A Case Study in Migrant Workers' Risk of Forced Labour." May 2012. Verite. Accessed September 18, 2016. http://www.verite.org/sites/default/files/ElectronicsMalaysia_MigrantWorkers_WhitePaperFINAL3.pdf.

[22] U.S. Department of State. *Trafficking in Persons Report*. June 2016. Accessed September 17, 2016. http://www.state.gov/documents/organization/258876.pdf.

[23] Ibid.

risk determination is made at the point of financing in Hong Kong. This is no different from current practices in relation to environmental assessments.

To this end, Hong Kong is uniquely positioned to make positive change as a financial centre that may act as a gateway to vet social risk factors for the financing of projects throughout the Asia-Pacific region. In recognizing that endorsing or turning a blind eye to social risk issues downstream is detrimental to the long-term sustainability of the Asia-Pacific business environment, the dialogue in Hong Kong should prioritize effective assessment, monitoring, and management around social risk which extends beyond the SPVs and shell/holding companies to realistically and practically consider whether the company's actions or inactions are directly and/or indirectly harbouring social risk elsewhere in the Asia-Pacific region.

Taking these steps will also help Hong Kong bridge the gap between its current regulatory practices with those in other parts of the world including California, the U.K. and Australia,[24] where some regulations on social risk issues are compulsory.[25]

[24] In the UK, organizations with a global turnover greater than £36 million (approx. USD 44 million) must publish an annual statement that sets out the steps necessary to ensure that no slavery or trafficking exists in the supply chain. In Australia, issuers of investment products must include a product disclosure statement with labour standards and ESG considerations taken into account during the process of selection, retention and realisation of the investment. See the Modern Slavery Act of 2015 for the UK and the Corporations Act of 2001 for Australia.

[25] KPMG International. (2015) *Currents of Change: The KPMG Survey of Corporate Responsibility Reporting 2015* www.kpmg.com/crreporting.

PART II
CURRENT SOCIAL RISK ISSUES

MONEY IS FLOWING TO SOCIALLY RESPONSIBLE COMPANIES

Investors across the world have reshaped strategies to address increased demand for ESG-conscious companies. According to the Global Sustainable Investment Alliance, sustainable investments totalled $21.4 trillion at the start of 2014, up from $13.3 trillion at the start of 2012, which is a 61% growth in two years. This $21.4 trillion represents 30.2% of all professionally managed assets in the world.[26] As investor demand for socially responsible investing increases, strategies for implementation are also evolving.

Another strong driver of shifting investor demand for more socially responsible companies is the millennial generation of investors (those born from the 1980s to early 2000s). Multiple surveys indicate that millennials are especially aware of ESG issues particularly due to social media and frequent use of the Internet has allowed further proliferation of knowledge and awareness of social risk issues. According to some figures, at the end of 2015, millennials controlled $2.45 trillion in spending power,[27] representing 20% of the total U.S. consumer market.[28] One market study found that in 2015, 90% of U.S. millennials were willing to choose brands with stronger social responsibility.[29] Millennial ESG-awareness has also been exhibited through activism. For example, in 2010, a student group called "United Students Against Sweatshops" partnered with Honduran sweatshop workers who worked for factories that belonged to a major shoe manufacturer who fired these workers without pay. The university students successfully protested against this major shoe manufacturer, which resulted in a major university withdrawing from its $1 million a year shoe contract with the manufacturer.[30]

Many business theories have also been raised to explain why money is increasingly flowing to socially responsible companies. Some studies have shown that socially responsible companies could be more profitable in the long run.[31] According to one survey, in 2014, 87% of Asian sustainable investors viewed ESG as a profitable venture[32] and, in another investment study in 2015, the same consulting firm found that U.S. firms with medium and high ESG performance ratings have significantly higher return-on-equity coefficients.[33] Additionally, some academic journals have cited a concept called Creating Shared Value ("CSV") which argues that profit-driven organizations may reduce social risk, invest in the community, and build a strong reputational value for the business all at the same time.

MONEY FLOWS THROUGH NEGATIVE SCREENING AND ACTIVE ESG-CONSCIOUS STOCK SELECTION

Socially responsible investing began as simple negative screening of companies, which is identifying and avoiding companies with poor social risk performance. This entailed crossing out companies with serious social risk red flags and simply avoiding any investment in such companies. However, over time, negative screening began to evolve and today investment firms not only apply negative screening but also consider ESG investing as a standalone strategy where many funds, ETFs, and mutual funds cater specifically to companies which meet various socially responsible benchmarks or criteria.[34]

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26 Global Sustainable Investment Alliance, *Global Sustainable Investment Review,* (2014), accessed August 8, 2016, http://www.ussif.org/Files/Publications/GSIA_Review.pdf, 3.

27 Katie Richards, "How Agencies Are Meeting Millennials' Demand for Socially Responsible Marketing" (Adweek, 15 Dec. 2015), accessed August 9, 2016, http://www.adweek.com/news/advertising-branding/agencies-are-carving-out-niche-socially-responsible-marketing-168592.

28 Trading Economics, "United States Consumer Spending 1950 – 2016" (2016), accessed August 9, 2016, http://www.tradingeconomics.com/united-states/consumer-spending.

29 CONE Communications, "CSR & Millennials" (2015 – 2016), accessed August 9, 2016, http://static1.squarespace.com/static/56b4a7472b8dde3df5b7013f/t/573b6cc507eaa0fb373ac275/1463512288277/092515_Infographic.jpg.

30 Palmquist, Rod. "Rod Palmquist: Student Campaign Takes on Nike Like Never Before." *Breaking News and Opinion on The Huffington Post.* (Huffington Post, 12 July 2010), accessed 10 August. 2016, http://www.huffingtonpost.com/rod-palmquist/student-campaign-takes-on_b_643375.html.

31 Ekatah, Innocent, Martin Samy, Roberta Bampton, and Abdel Halabi. "The Relationship Between Corporate Social Responsibility and Profitability: The Case of Royal Dutch Shell Plc." *Corp Reputation Rev Corporate Reputation Review* 14, no. 4 (2011): 249-61.

32 SGX Sustainability Indices, "Sustainable Investing is Gaining Global Momentum" (Singapore Exchange, 2014), accessed August 8, 2016, http://www.sgx.com/wps/wcm/connect/75044085-c079-4028-8a8b-c67cd3dc0dbf/SGX-Sustainable-Investing-Is-Gaining-Global-Momentum.pdf?MOD=AJPERES.

33 G. Serafeim, E. Kaiser, J. Linder, I. Naranjo, K. Nguyen-Taylor, & J. Streur, *The Role of the Corporation in Society: Implications for Investors* (Calvert Investments: The Calvert-Serafeim Series, Sept. 2015), accessed August 10, 2016, http://www.calvert.com/NRC/literature/documents/wp10012.pdf, 26.

34 Jennifer Ballen, "Sustainable Investing: Old Trend, New Implication," (Gitterman Wealth Management, May 19, 2016), accessed August 19, 2016.

The Singapore Stock Exchange reports that ESG investing has become one of the most popular investment strategies in the world with global companies spending $12.9 trillion.[35] While the Asia-Pacific region holds only 0.2% of all socially responsible investments around the globe, these investments grew by 32% from 2012 to 2014.[36] While this growth is quite aggressive, it dwarfs in contrast to the United States which alone had $6.57 trillion socially responsible investments ("SRIs") at the outset of 2014, growing 76% from 2012. This represented one out of every six dollars in the country.[37] Investor demand for reducing social risk drives United States SRIs on both a national and local level, and investors are quickly adjusting their investment strategies to match the global trend. A study from the London Business School found that among 42 private equity firms controlling combined assets of over $640 billion, 85% of the companies stated that pressure for ESG business practices is intensifying and that support for ESG business practices is widely supported among C-level executives.[38] From investors to corporate executives, socially responsible investing is a trend which is increasingly permeating the global investment environment.

MARKETS ARE RESPONDING TO MASS DEMAND WITH SUSTAINABILITY INDICES

As demand for socially responsible investing rises, so does the global demand for sustainability indices. Sustainability indices are indices composed of liquid, publicly listed stocks that are screened in accordance with ESG criteria. Sustainability indices establish benchmarks for company performance, act as a tool for investor research, provide managers with an investment outlook, and allow comparisons between SRI and non-SRI investments.[39]

The first sustainability index to gain widespread popularity was the Domini 400 Social Index, launched in 1990. Since the Domini 400 Social Index, sustainability indices exploded in popularity resulting in the creation of sustainability indices from notable research and investment firms such as Calvert Investments, Pax World Management, Sustainalytics, and WilderShares, as well as financial services groups including S&P Dow Jones, index provider FTSE Russell, index provider STOXX, and analytics firm MSCI.[40]

Demand for sustainability indices began to boom in 2009, especially when major media outlet Bloomberg, consulting firm Thomson Reuters, and analytics firm RiskMetrics Group all entered the sustainability index market at generally the same timeframe. Bloomberg launched what was at the time considered a ground-breaking sustainability data service with over 300,000 worldwide data terminals with access to sustainability data on about 3,000 companies. The company started this service to meet growing demand from socially responsible mutual funds and pension funds.[41] Thomson Reuters acquired a Swiss-based investment research firm, ASSET4, and through ASSET4's 400,000 workstations has become one of the world's largest financial information providers which also covers sustainability indices.[42] RiskMetrics Group acquired two sustainability research firms, KLD Research and Analytics and Innovest Strategic Value Advisors, and has become a leading provider of sustainability research and corporate data.[43] Companies use this financial data to meet their clients' investment demands of reducing ESG risks and delivering to investors the key data and metrics to allocate capital appropriately.

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35 SGX Sustainability Indices, "Sustainable Investing is Gaining Global Momentum" (Singapore Exchange, 2014)

36 Ibid.

37 US SIF Foundation, *The Impact of Sustainable and Responsible Investment* (Forum for Sustainable and Responsible Investment, June 2016), accessed August 8, 2016, http://www.ussif.org/files/Publications/USSIF_ImpactofSRI_FINAL.pdf, 2.

38 Ioannis Ioannou, "Investors are driving increased adoption of ESG policies, report finds" (London Business School, 23 Feb. 2015), accessed August 9, 2016, https://www.london.edu/news-and-events/news/investors-are-driving-increased-adoption-of-esg-policies#.V6mOmP6KCUl.

39 US SIF Foundation, *The Impact of Sustainable and Responsible Investment*, 12

40 Ibid. 12.

41 John O. Matthews & Cathy A. Ruskino, *Sustainability Disclosure: Increasingly Important for Banks and Commercial Lenders* (Commercial Lending Review, Sept. – Oct. 2010), 16.

42 Ibid. 16.

43 Ibid. 16.

As investors pressure companies for better management of social risk, sustainability indices have emerged as invaluable tools for investors to make clear, ESG-conscious decisions. The Singapore Exchange's ("SGX") recent creation of its own sustainability index in March 2016 marks the latest advancement in socially responsible investing, matching the trend of increased demand for social responsibility in Asia.

There are also opportunities for stock exchanges to work together internationally to develop sustainability indices and trade information on ESG-conscious practices. An example is the United Nations Sustainable Stock Exchanges Initiative (**UNSSEI**), which works with stock exchanges to develop more sustainable capital markets.[44] The Stock Exchange of Thailand is one of the 58 stock exchanges that have partnered with the UNSEII as part of a peer-to-peer learning exchange program. Through the UNSEII, 38 stock exchanges have provided sustainability indices to one another, and new stock exchanges continue to join the UNSEII as the popularity of sustainability indices and other ESG-conscious practices rise in the market.

Countries worldwide are legislating to protect against social risk

Beyond the steps taken by companies and stock exchanges to protect against social risk and promote ESG-conscious practices, countries are now legislating to force companies to report on actions taken to prevent social risks such as modern slavery. The most notable of these measures is the Modern Slavery Act in the United Kingdom, which has since sparked similar legislation in several other jurisdictions.[45]

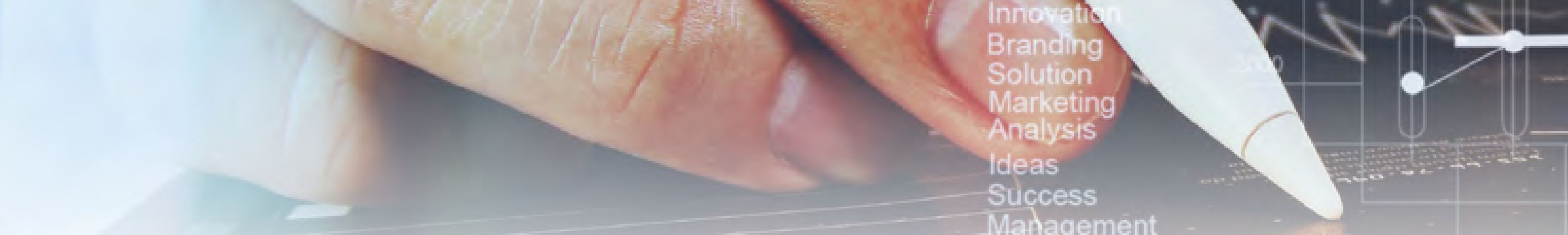
IT IS UNCLEAR WHERE THE HONG KONG MARKETS WILL SIT IN THIS NEW ECONOMY

As the world moves forward to address investor demand for ESG-conscious companies and money continues to flow into these new regimes, where does Hong Kong and its financial markets fall in fulfilling this demand? This paper argues that the Hong Kong investment community needs to prioritize social risk reform to position itself near the front of the pack and many of the key, practical steps outlined in this paper can help us move in that direction and remain competitive amongst other financial markets:

1. Will ESG-conscious investors choose to invest in companies listed on the Hong Kong stock exchange over other exchanges?
2. Will ESG-conscious investors and/or companies view the HKEx as a leader in building the socially-responsible financial platform of the future? Will ESG-conscious investors be attracted to the HKEx?

[44] United Nations Sustainable Stock Exchange Initiative, *2016 Report on Progress: A Paper prepared for the Sustainable Stock Exchanges 2016 Global Dialogue*, 6.

[45] Some examples include the Corporate Duty of Diligence Law in France, introduced in 2017; the Transparency in Supply Chains Act in California, introduced in 2012; the Swiss Responsible Business Initiative; and the EU Non-Financial Reporting Directive.



LEGAL AND REGULATORY ENFORCEMENT REGIMES CONTINUE THEIR FOCUS ON SOCIAL RISK ISSUES

Legal and regulatory enforcement regimes have also caught on to social risk issues with many jurisdictions now focusing on cracking down on trafficking and forced labour. This section outlines some of the existing laws and regulatory enforcement regimes that are relevant to social risk issues in the Asia-Pacific region, including those of Hong Kong.

JURISDICTIONS IN THE ASIA-PACIFIC REGION

Singapore

Although ranked the world's easiest place to do business with the best investment potential as well as the most transparency amongst countries in the Asia-Pacific region,[46] Singapore does not fare well in terms of internationally recognized civil, political and minority rights.[47] Approximately one-third of Singapore's total labour force is made up of foreign workers and some of this population is highly vulnerable to trafficking. Foreign domestic workers are often subjected to coercive practices such as debt bondage or passport confiscation, both commonly used to keep foreign domestic workers in an exploitative situation of forced labour or servitude. Other migrant workers are in the construction, performing arts, manufacturing, or service industries, including commercial sex industry.[48]

Singapore has made significant progress to combat human trafficking over the past several years. The government recently passed The Prevention of Human Trafficking Act 2014 ("PHTA"), a comprehensive anti-trafficking legislation that came into effect in March 2015. PHTA prohibits all forms of human trafficking and prescribes punishment of 10 year imprisonment for first-time offenders, a maximum fine of SGD $100,000 (approx. USD 72,000), plus the possibility of up to six strokes of the cane (which is a physical punishment), with repeat offenders facing heavier punishments.[49] PHTA, however, has been criticized for its relatively poor enforcement and its failure to adequately address victim protection and assistance issues.[50]

Thailand

Thailand attracts an estimated three to four million migrant workers from its neighbouring countries such as Myanmar, Cambodia, and Laos. Some migrant workers are being forced, coerced, and/or defrauded into labour or sex trafficking.[51] While sex trafficking is more prevalent due to the open and renowned sex industry in Thailand, forced labour, especially the use of slave labour in the fishing industry, has received much attention in the last few years.

In the last few years, Thailand has passed several initiatives in an effort to improve its human trafficking record. This includes a strengthened Anti-Trafficking in Persons Act 2015, the Royal Ordinance on Fisheries B.E.2558 (2015), the Anti-Money Laundering Act B.E.2558 (2015), the Human Trafficking Criminal Procedure Act B.E.2559 (2016) and the Anti-Trafficking in Persons Act (No. 3) B.E. 2560 (2017). Several joint collaborations have also been established via memoranda of understanding (MOUs) with various private sector enterprises in an effort to eliminate human rights abuses in the chicken processing sector. This includes MOUs with relevant Thailand government authorities, and various food producers.

Though Thailand anti-trafficking laws have been improved and are largely adequate, enforcement of the laws and prosecution of traffickers and corrupt officials complicit in trafficking crimes remains poor.[52] In the past years, criminal defamation law and computer crime laws have been used to silence researchers, journalists and whistle-blowers who disclose information on alleged

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46 Doing Business 2015, World Bank; Business Environment Rankings (BER) 2014, The Economist Intelligence Unit; The Global Competitiveness Report 2015-2016, World Economic Forum.

47 Stakeholder's Universal Periodic Review Submission to the UN Human Rights Council, Singapore Institute of International Affairs, May 2011.

48 U.S. Department of State, *Trafficking in Person Report* (2016).

49 Parliament: Human-trafficking law passed after debate on whether it goes far enough, The Straits Times, November 3, 2014, http://www.straitstimes.com/singapore/courts-crime/parliament-human-trafficking-law-passed-after-debate-on-whether-it-goes-far.

50 Ibid.

51 U.S. Department of State, *Trafficking in Person Report* (2016).

52 Servaes, Fiona. "Sex Trafficking Issues in Thailand, The case of Urban Light." Peace Development Fund. 2015. Pg. 5.

perpetrators of human trafficking and related crimes. Therefore, underreporting of human trafficking remains an issue.

Malaysia

Similar to Thailand, Malaysia offers attractive employment opportunities and is a destination, to a much lesser extent, for migrant workers from other countries in the Asia-Pacific region.[53] The majority of trafficking victims of Malaysia work in the palm oil and agricultural industries, at construction sites, and in the electronics industry as well as at homes as domestic workers. The electronics industry is the country's leading manufacturing industry and a key driver of the Malaysian economy as multinational companies from the U.S., Japan, Europe, Taiwan and South Korea have chosen Malaysia as their manufacturing base.[54] These workers have been subject to a dangerous combination of personal debt, high recruitment fees, and complicated recruitment processes.[55] A lack of transparency into working conditions, poor working conditions, and inadequate legal protections further exacerbate the issue.[56]

The Government of Malaysia applies relevant laws as the principal tools to combat the crime of human trafficking. Malaysia has enacted specific legislation related to trafficking in persons and smuggling of migrants, which was most recently amended in 2015. The principal act is subject to the Federal Constitution of Malaysia, which prohibits slavery and forced labour, and is supplemented by various laws that can be used to prosecute trafficking or trafficking-related offenses. For example, the Penal Code may be invoked to criminalize trafficking for the purposes of prostitution along with other prostitution-related offenses, forced labour, and habitual dealing in slaves. The Employment Act of 1955 contains minimum labour protection standards and provisions related to domestic servants, the Children and Young Persons (Employment) Act provides for limited employment of children for certain sectors, the Private Employment Agencies Act of 1981 regulates recruitment agencies, the Child Act of 2001 prohibits exploitative acts, custody transfers for any valuable consideration, as well as bringing a child into Malaysia on false pretences or without parental consent. Other acts with relevant provisions include the Passports Act of 1966, the Immigration Act 1959/63, Maritime Enforcement Agency Act 2004, Customs Act 1967, Security Offenses (Special Measures) Act 2012, and the Anti-Money Laundering and Anti-Terrorism Financing Act of 2001.

People's Republic of China

China's internal migrant population, estimated to exceed 294 million people, is vulnerable to trafficking where Chinese men, women, and children are subjected to forced labour in industries such as mining and manufacturing, some of which operate illegally or with very poor working conditions.[57] Chinese women and girls are also subjected to sex trafficking.[58] Traffickers typically recruit from rural areas of China and transfer the victims to urban centres offering fraudulent employment opportunities and subsequently forcing them into prostitution.[59] Incoming trafficking of foreign nationals from Vietnam, Laos, North Korea, and Cambodia also occur in the form of forced marriages and illegal adoption, a result of the gender imbalance caused by China's former one-child policy.

In recent years, China has taken strides to combat trafficking. The Anti-Human Trafficking Action Plan of China (2013 – 2020) sets up a goal of cracking down on human trafficking, establishing crime prevention mechanisms, rescuing victims, and improving relevant laws, regulations and policies. However, no Chinese policy to date addresses the labour exploitation of Chinese men, internally or overseas.[60]

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53 U.S. Department of State, *Trafficking in Person Report* (2016).

54 Verite. *Forced labour in the Production of Electronics Goods in Malaysia: A Comprehensive Study of Scope and Characteristics.* 2014, p. 22.

55 *Id.* at p. 19.

56 U.S. Department of State, *Trafficking in Person Report* (2016).

57 U.S. Department of State, *Trafficking in Person Report* (2016).

58 Brandeis University, "China Human Trafficking Data Sheet." Strategic Information Response Network. http://www.brandeis.edu/investigate/slavery/docs/china-uniap-datasheet-2010.pdf.

59 Id.

60 U.S. Department of State, *Trafficking in Person Report* (2016).

ENHANCED DISCLOSURE REGIMES

Within the past five to ten years, stock exchanges around the world have promoted or enacted new ESG reporting requirements. While governments are the most common issuers of sustainability reporting instruments, financial market regulators are the second most active issuers of sustainability reporting instruments after governments – these two groups together are responsible for almost one third (29 percent) of all sustainability reporting instruments identified in 2016.[61]

Growth in stock exchange reporting instruments has been particularly high in emerging markets: in 2016, almost half the stock exchange reporting instruments identified are in emerging markets, including locations such as Hong Kong, Shanghai, Shenzhen, Singapore, and Kuala Lumpur.[62] This may reflect an expectation from stock exchanges that sustainability and corporate governance standards make their markets more attractive to foreign investors and are in line with the growing international norm, among other incentives. Examples of stock exchanges implementing ESG-conscious policies are as follows:

YEAR	EXCHANGE	DESCRIPTION
2006	China, Shenzhen Stock Exchange (SZSE)	SZSE issued the "Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies" detailing social responsibility requirements for all listed companies.[63]
2007	Thailand, Stock Exchange of Thailand (SET)	SET issued the "Guidelines for Sustainability Reporting" mandating sustainability reporting for all listed companies.
2008	China, Shanghai Stock Exchange (SSE)	SSE issued the "Shanghai CSR Notice" and the "Shanghai Environmental Disclosure Guidelines," providing incentives for listed companies to promote CSR and allowing the SSE to take "necessary punishment measures" against companies violating disclosure rules.
2011	Germany, Deutsche Borse Regulatory Group	Deutsche Borse developed a two-tier system listing companies according to their level of ESG risk.
2012	Brazil, Ibovespa Brasil Sao Paulo Stock Exchange (IBOV)	IBOV released "comply or explain" recommendations for listed companies, encouraging them to publish a regular sustainability report or explain why not.
2014	Australia, Australian Securities Exchange (ASX)	ASX updated non-financial disclosure requirements, requiring companies to disclose if they have exposure to ESG risks and how they plan to combat these risks.
2015	Taiwan, Taiwan Stock Exchange (TWSE)	TWSE announced that listed companies must comply with mandatory CSR reporting according to Global Reporting Initiative (GRI) G4 guidelines.
2015	Singapore, Singapore Stock Exchange (SGX)	SGX released an ESG disclosure guide for listed companies and announced plans to mandate social responsibility reporting.

[61] KPMG, GRI, UNEP & Centre for Corporate Governance in South Africa, p.14.

[62] Id. at p.15.

[63] Shenzhen Stock Exchange, "Shenzhen Stock Exchange Social Responsibility Instructions to Listed Companies" (25 Sept. 2006), accessed August 11, 2016, http://www.szse.cn/main/en/RulesandRegulations/SZSERules/GeneralRules/10636.shtml.

Thus, it is increasingly becoming a *global* standard for listed companies to provide and disclose ESG information to stakeholders. Hong Kong, too, is quickly pivoting its policies and financial regulatory regimes to reflect this. All of these changes signal a global shift from viewing ESG and social risk issues as a "soft" corporate social responsibility to a "hard" regulatory regime.[64]

HONG KONG'S RELEVANT LAWS AND FINANCIAL REGULATORY REGIMES

Hong Kong laws

As Asia's financial hub, Hong Kong is an epicentre for commercial transactions and is bound to have exposure to the $150 billion global slave trade.[65] It is therefore important for Hong Kong to take steps to counter these crimes from occurring and manage the inherent risks. Many Hong Kong laws contain provisions related to or which impinge on aspects of human trafficking. The most relevant law in Hong Kong that addresses human trafficking is section 129 of the Crimes Ordinance, which criminalizes persons who take part in bringing another person into or out of Hong Kong for the purpose of prostitution.

Although forced labour is a major aspect of human trafficking and is prevalent among migrant workers in Hong Kong, any person who is moved into or out of Hong Kong for purposes of forced labour is not regarded as a victim of human trafficking according to Hong Kong law. The recent effort of the Hong Kong government in this area of law has been the amendment of the Prosecution Code in 2013 to include forced labour within the definition of human trafficking as guidelines for prosecutors to handle cases of exploitation and labour. However, the Prosecution Code carries no force of law in the absence of a corresponding or supporting legislation which directly addresses human trafficking.

A landmark judicial review case in Hong Kong in 2017 found the Hong Kong government is liable for its failure to pass laws protecting victims of forced labour and human trafficking.[66] The victim in this case claimed that there had been a continuing breach of his rights under article 4 of the Hong Kong Bill of Rights Ordinance, which prohibits servitude and forced labour. The court found the Hong Kong Immigration Department, Police Force and Labour Department were liable for their failure to respond to the victim's complaints that he was a victim of human trafficking. This case is significant because it indicates that, even where a country does not have laws specifically targeting human trafficking, the authorities still have a duty to protect against it – and where they fail to do so, they may be treated to a punishment that fits the crime.[67]

While the above issue has sparked discussion, the political, legal, and social landscape in Hong Kong is not yet open to a full scale legislative suite of protections for social risk. A more comprehensive anti-trafficking legislation that recognizes other forms of exploitation, particularly forced labour as a form of human trafficking is still in the distant future.

Hong Kong on enhanced disclosures

In 2014, Hong Kong reached an important milestone in ESG disclosure. The Companies Ordinance ("CO"), which came into effect in March 2014, requires all Hong Kong incorporated companies (unless exempted) to include in the business review section of their annual directors' reports, among other things, a discussion of their compliance with relevant laws and regulations that have a significant impact on them and an account of their key relationships with employees, customers, and third parties.[68]

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[64] Exten-Wright, Jonathan. "Human rights as a business and reputational risk," July 23, 2015. Accessed November 24, 2016. https://www.dlapiper.com/en/us/insights/publications/2015/07/human-rights-as-a-business-and-reputational-risk/.

[65] International Labor Organization. May 24, 2014. http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/publication/wcms_243391.pdf

[66] "Judge criticises Hong Kong's human trafficking regime after officials ignored forced labour victim." South China Morning Post. Dec. 24, 2016. http://www.scmp.com/news/hong-kong/law-crime/article/2056955/judge-criticises-hong-kongs-human-trafficking-regime-after

[67] "Man tricked into working in Hong Kong, then forced to work unpaid, beaten: Lawyers." Straits Times. Jan. 12, 2016. http://www.straitstimes.com/asia/east-asia/man-tricked-into-working-in-hong-kong-then-forced-to-work-unpaid-beaten-lawyers

[68] CO Schedule 5, section 2(b)(ii); CO Schedule 5, section 2(c)

Beginning this year, it will be mandatory for issuers to include in their annual directors' reports the matters set out in the CO. These enhanced disclosures are a positive step in the right direction and address some of Hong Kong's current business practices where companies project its operations abroad into other countries. As seen from the table above, in requiring companies to either "comply or explain" for ESG reporting, the Hong Kong Exchanges and Clearing Limited (HKEx) will be joining several of its international peers in ESG compliance.[69]

ESG disclosures reinforce the importance of measuring corporate performance beyond simple private numerical gain, but also take into account social impact and nontangible qualities like management practices, environmental risk mitigation, workplace quality (particularly downstream), and community and social impact. These are values which are becoming increasingly important to stakeholders. David Graham, HKEx's chief regulatory officer, stated a few advantages companies who evaluate and disclose their ESG performance may reap, including "better risk management, improved access to capital, greater capacity to meet supply chain demands and lower operational costs, to name but a few."[70] Moreover, Barclays, a major bank, found that introducing ESG criteria in fact improves financial performance of bond portfolios, which often represents a major part of institutional investors' investment strategies.[71] Studies have also shown that mandatory ESG disclosures tend to improve a company's internal compliance practices, which result in improved labour practices. Moreover, it was found that enhanced disclosures could even cause a ripple effect where unregulated competitors of firms subject to ESG disclosures would release their own ESG disclosures.[72] These enhanced disclosures seek to bring more visibility into the actual operations of the companies on-the-ground, solidifying the status of ESG issues as material information that can influence returns to investors.

HKEx's ESG Reporting Guide

In 2016, HKEx implemented their "ESG Reporting Guide" to address listed companies' ESG risks, including a change from "recommended" CSR disclosures to "comply or explain" disclosures. This also represents a positive change in the right direction. From a financial regulatory standpoint, it certainly appears that HKEx's ESG Reporting Guide is keeping pace with some of the leading financial markets.

However, as discussed in further detail later in this paper, the HkEx ESG Reporting Guide, while a step in the right direction, does not go quite far enough to address the current business environment and role the Hong Kong financial markets play in the Asia-Pacific economy.

GLOBAL FRAMEWORKS, NGOS, AND NON-PROFITS ARE FILLING IN THE GAPS AND PUSHING FOR MORE SOCIAL RISK REFORM

In addition to laws and regulations, global frameworks, NGOs, shareholders, and non-profits are often filling in the gaps where laws and regulations are silent or ineffective. While investors and companies may not be technically on the hook in terms of legal violations such as penalties and fines, international organizations, NGOs, and non-profits are gaining increasingly stronger pull in the form of political, business/commercial, and public relations influence, which can equally affect change within the community, spark an increase in shareholder activism, and hold companies accountable. The presence of these third party actors may help reduce social risk violations while providing remedy and justice for victims. This section aims to illustrate how these non-governmental organizations fill in the gaps and help shape change by influencing businesses particularly in the Asia-Pacific region.

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[69] Chan, Oswald. "ESG reporting standards – HK 'has plenty to catch up' in compliance" China Daily Asia, September 5, 2016, accessed November 23, 2016. http://www.chinadailyasia.com/hknews/2016-09/05/content_15490866.html

[70] Ibid.

[71] Albert Desclee, Jay Hyman, Lev Dynkin, and Simon Polbennikov, "Sustainable Investing and Bond Returns," Barclays Research, Oct 31, 2016, https://www.investmentbank.barclays.com/our-insights/esg-sustainable-investing-and-bond-returns.html?trid=3963811&cid=disp_sc00e00v00m04GLpa06pv29#tab3

[72] Ernst & Young and The Boston College Center for Corporate Citizenship (2014) Ioannou & Serafeim, *The Consequences of Mandatory Corporate Sustainability Reporting: Evidence from Four Countries* *http://www.hbs.edu/faculty/Publication%20Files/11-100_7f383b79-8dad-462d-90df-324e298acb49.pdf.*

GLOBAL FRAMEWORKS SET THE TONE FROM THE TOP AND USE ALLIANCES TO PUSH FOR SOCIAL RISK REFORM

The UN Guiding Principles on Business and Human Rights

In 2011, the United Nations Human Rights Council ("UNHRC") unanimously endorsed the UN Guiding Principles on Business and Human Rights ("UNGPs"), which outline the state's duty to protect human rights, the corporate responsibility to respect human rights, and recognise both the state and corporations' duties to prevent abuses of human rights and provide remedies to parties.[73]

The UNGPs do not bind corporations, but dozens of UN member states, are now working on National Action Plans (NAPs) to comply with their own duties, which include drafting regulations and incentives for companies.[74] In 2014, the UNHRC passed a resolution to begin the process of developing a binding treaty on business and human rights.

While several nations – namely, the United Kingdom, the Netherlands, Denmark, and Finland – have published and started the implementation of their NAPs, the contents of these plans have been found to be largely inadequate. All NAPs stated a commitment to the UNGPs, but focus on voluntary action to combat human rights abuses rather than the development of strong regulatory frameworks, provide inadequate judicial and non-judicial remedies for victims of these abuses, and fail to create a cohesive and concrete plan for future action.[75]

The OECD Guidelines for Multinational Enterprises

The Organization for Economic Co-operation and Development (the "OECD"), developed its first set of Guidelines for Multinational Enterprises (the "Guidelines") in 1976 and updated them for the fifth time in 2011. The Guidelines are non-binding recommendations on responsible conduct for businesses operating in or from the 34 member countries adhering to the Guidelines. The 2011 update, issued the same year as the adoption of the UNGPs, inserted a human rights chapter and rendered the content consistent with the principles of the UNGPs. In addition to human and labour rights, the Guidelines address a range of other areas of corporate responsibility, including environmental concerns, anti-bribery, consumer interests, transparency, development of local communities, and science and technology.

The Guidelines fulfil two key functions. First, they promote policies that improve the economic and social well-being of people around the world. The Guidelines encourage multinational companies to make a positive contribution and to minimize the negative impacts that affect society. Second, they create some binding legal obligations on member states and adhering governments. Governments are to implement the Guidelines and establish a dispute resolution mechanism. The Guidelines also call out for the creation of National Contact Points ("NCPs") that, among other things, receive and consider complaints.[76] This helps bridge together state and corporate interests by ensuring that the jurisdictions in which companies operate have proper channels to identify issues and access enforcement mechanisms related to human rights abuses.

The human rights chapter of the Guidelines includes the general obligation to respect human rights as well as practical steps such as carrying out human rights due diligence. The Guidelines provide that businesses should "co-operate in the remediation of adverse human rights impacts." Of note is the fact that the human rights section is the only topical one in the document to mention the responsibility of states "to protect human rights." None of the other substantive topical chapters mention further human rights obligations of the states. Thus, while the human rights chapter of the Guidelines

[73] United Nations Office of the High Commissioner, *Guiding Principles On Business and Human Rights*, (United Nations, New York and Geneva, 2011).

[74] "Guidance on National Action Plans on Business and Human Rights" (UNWG, December 2014), accessed September 16, 2016, http://www.ohchr.org/Documents/Issues/Business/UNWG_%20NAPGuidance.pdf

[75] "Assessment of Existing National Action Plans (NAPs) on Business and Human Rights" (ICAR, November 2014) accessed September 16, 2016 http://icar.ngo/wp-content/uploads/2014/10/ICAR-ECCJ-Assessments-of-Existing-NAPs.pdf

[76] OECD 2016, *Annual Report on the OECD Guidelines for Multinational Enterprises 2015*. Pgs. 27-50 http://mneguidelines.oecd.org/2015-Annual-Report-MNE-Guidelines-EN.pdf

essentially reiterate the UNGPs, the drawbacks are it does not contain further substantive details on human rights protections nor does it focus on victims of human rights infringements by corporations. Furthermore, there appears to be no consistent approach by the endorsing governments to implement the Guidelines and NCPs cannot impose sanctions on enterprises that are found to have breached the Guidelines.[77]

The United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a global partnership between UNEP and the financial sector. This unique partnership arose from the growing recognition of the links between finance and ESG challenges, and the role financial institutions could play for a more sustainable world. Over 200 institutions, including banks, insurers, and fund managers work with UNEP to understand the impact of environmental and social considerations on financial performance.

UNEP has contributed to the launch of the *Principles of Responsible Investment (PRI)* in 2006. The initiative includes an international network of investors working together to implement the six Principles for Responsible Investment with a goal to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision-making and ownership practices.

Sustainable Stock Exchanges Initiative (SSE Initiative)

SSE Initiative is organized by the UN Conference on Trade and Development ("UNCTAD"), the UN Global Compact, the UN Environment Program Finance Initiative ("UNEP FI"), and the Principles for Responsible Investment ("PRI"). It is a platform for exploring how stock exchanges can enhance corporate transparency and performance on ESG issues and encourage sustainable investment. The first five SSE Partner Exchanges, BM&FBOVESPA, the Egyptian Exchange, Johannesburg Stock Exchange, Borsa Istanbul, and Nasdaq are now joined by nearly all major stock exchanges worldwide from both developed and developing countries.

Equator Principles

Another group of actors heavily involved in multinational transactions are financial institutions. Similarly, there are organisations advocating for better social risk disclosure in the financial sector.

The Equator Principles ("EPs") are a widely studied public-private regulatory initiative that impose social and environmental requirements on borrowers and lenders in the project finance sector. It is a voluntary agreement among 84 financial institutions in 35 countries, including global banks such as Barclays, Citigroup, Credit Suisse, HSBC, ING, and RBS. The EPs create social and environmental standards for project finance – which is the private financing of large, revenue-producing infrastructure projects such as dams, pipelines, and wind farms, constructed by private companies for emerging and developing countries. The project finance sector is vitally important because the decisions on whether, how, and on what terms infrastructure projects are undertaken in poorer countries can have tremendous economic, social, and environmental consequences. The EPs commit participants to screen potential projects for social and environmental impact, reject those that fall short, and insist on ongoing and enforceable social and environmental standards for those financed projects.

These social and environmental standards rely directly upon those promulgated by the International Finance Corporation (IFC), the private-sector lending division of the World Bank Group. Because the EPs are taken directly from the IFC's Safeguard Policies and Performance Standards,[78] which set out specific social and environmental requirements, the EPs apply only to project finance as defined by the IFC. Project finance loans are non-recourse, meaning that lenders are repaid only through the revenues generated by the project. Thus, even if the project sponsor (the borrower) is financially strong, the lending banks face particularized financial risks from anything in the political or social environment that could threaten completion of a project.

[77] Cernic J. Letnar, *Corporate Responsibility for Human Rights: A critical analysis of the OECD guidelines for multinational enterprises*, (Hanse Law Review, 2008).

[78] The IFC's Environmental and Social Performance Standards define the responsibilities of IFC clients for managing their environmental and social risks.

The EPs have an impact on business and financial values, but as a result of their voluntary nature, the magnitude of this impact is limited. Interview results from UNEP Inquiry indicate that the primary motivations underlying the adoption of the EPs are their assistance in compliance and reputational influence. EPs help to provide guidelines for regulations, but do not lead to significant project modification.[79] This especially holds true in regards to smaller financial institutions that do not have the capacity for stringent project screening.

GLOBAL FRAMEWORKS ARE HELPFUL TO SET THE TONE AT THE TOP BUT ARE LIMITED WHEN IT COMES TO ENACTING REAL CHANGE ON-THE-GROUND

The various disclosure mandates set a good precedent for global frameworks. In xxx, ILRF made some progress in stopping shipments of goods manufactured by slave labour from entering the United States. The OECD Watch in xxx also [insert example of what they did]. Furthermore, various plaintiff litigation efforts have begun to move forward in the state of California against retailers, food processors and manufacturers due to the increased disclosure mandates.

However, many challenges still remain. The conflict lies within the flawed premise that, armed with specific information addressing social risk issues, consumers and investors will either reward "ethical" corporate behaviour, or punish firms with severe social risk issues. Though those formulating regulations may think that investors will effectively use disclosed information to help determine investment and divestment decisions, in actuality, investors may sometimes be inundated with information where it is not sufficiently comprehensive, may contain inconsistencies, and/or could be buried in a number of other disclosures thereby causing "disclosure overload". Such challenges still remain which point to additional work that needs to be undertaken to improve the entire disclosure process.

Furthermore, lawmakers who are reluctant to pass strict national or international human rights laws have assumed that disclosure *per se* can play a critical role in creating change, and that the marketplace can and will legislate with private means. However, unless there are significant legal or market-based penalties, states tend to abrogate their duties to protect human rights from abuses perpetrated by non-state actors. Organizations like the three mentioned above are relatively vague in formulation of actual procedures different parties are to take which leaves some to believe that disclosure regimes lack the requisite degree of enforcement to really push forward change.

Despite these limitations, the UNGPs, the Guidelines and the EPs all emphasize the companies' role in becoming more socially and environmentally responsible, in particular via the addressing of human rights abuses occurring in their business activities and the carrying out of human rights due diligence using internationally accepted standards. These standards are regularly reviewed and updated to reflect changing perceptions, ongoing learning, and emerging best practices.

As public perception continues to shift to increased awareness of these issues, stakeholders are demanding more from companies. It is expected that the various international organizations will continue to converge and bring about a more coordinated, coherent framework for companies to comply with.

THE RISE OF NGOS AND NON-PROFITS HAVE BEEN A BOON TO SOCIAL RISK REFORM

NGOs and non-profits are increasingly empowered by improved funding, increased information through better intelligence gathering tools, as well as strengthened coalition building adding yet another dimension for corporates to consider when framing their social risk management plan.

Reflecting the global rise of civil society, non-governmental organizations (NGOs) have increasingly exerted themselves as influential actors in the discussion on social risk. Empowered by the internet and other information technologies, non-profit activist investigators and watchdog groups have introduced social governance into the mainstream of public opinion, heralding a new standard of corporate accountability.

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[79] "The Equator Principles: Do they Make Banks More Suitable?" UNEP Inquiry, February 2016, accessed September 16, 2016, http://unepinquiry.org/wp-content/uploads/2016/02/The_Equator_Principles_Do_They_Make_Banks_More_Sustainable.pdf

Over the past two decades, the total number of operating NGOs has grown significantly all the while increased funding in social risk has ensured that these issues are readily exposed. For example, the number of registered NGOs in mainland China alone has increased from 354,000 groups in 2007[80] to roughly 500,000 groups in the present day[81], with an additional 1.5 million groups currently believed to be operating without official recognition.[82] Accounting for annual expenditures in excess of USD $1.2 trillion, NGOs worldwide have commanded increasing clout in the arena of public opinion, enjoying what some may consider a "trust premium" amidst widespread scepticism towards government and business institutions.[83]

Of particular significance, social risk factors feature prominently as the focus of many NGO campaigns, with a recent twelve-month report on activist campaigning placing corporate social responsibility (CSR) and human and labour rights among the top ten most targeted issues by visibility.[84]

Looking forward, the number of individuals donating money to NGOs is projected to grow from approximately 1.4 billion donors to 2.5 billion donors between 2014 and 2030.[85] With the drive towards corporate social responsibility gaining considerable momentum, shareholders would be prudent in safeguarding their investments against potential violations.

With increased funding and human capital alongside greater credibility in the popular sphere, NGOs have leveraged technological advances for enhanced impact. For example, launching a campaign in September 2010, a coalition of NGOs incorporated QR codes (a means of registering users with a click of a button using only a smartphone), documentary screenings, and an online petition as part of a multi-pronged movement protesting unfair trade and labour practices in the supply chain of a multinational food and beverage company.[86] As over 150,000 consumers pledged support for the campaign and grocery stores reacted by removing the company's products from their shelves,[87] the company issued a formal response to the protest in October 2011, committing to source 100% certified cocoa for all of its chocolate production lines by 2020.[88]

In 2010, a social media-based campaign against irresponsible palm oil sourcing led a multinational food and beverage company to sever its contracts with an Indonesian conglomerate, causing the palm oil supplier to suffer "a damaged reputation and loss of business, reflected by a dip in its share price."[89] While NGOs have recently expanded their endeavours to encompass financial institutions investing in irresponsible businesses,[90] they also play a critical role in global frameworks by providing ground level social risk

80 "Number of NGOs in China Grows to Nearly 500, 000," (China Daily, March 20, 2012), accessed August 17, 2016, http://www.chinadaily.com.cn/china/2012-03/20/content_14875389.htm.

81 "China's NGOs Go Global," The Diplomat, March 23, 2016, accessed August 17, 2016, http://thediplomat.com/2016/03/chinas-ngos-go-global/.

82 "Enter the Chinese NGO," The Economist, April 12, 2014, accessed August 17, 2016, http://www.economist.com/news/leaders/21600683-communist-party-giving-more-freedom-revolutionary-idea-enter-chinese-ngo.

83 George Serafeim et al., "The Role of the Corporation in Society: Implications for Investors," (Calvert Investments, September 2015), accessed August 17, 2016, http://www.calvert.com/NRC/literature/documents/wp10012.pdf.

84 "Global Trends in NGO and Activist Activity," (Sigwatch, May 2015), accessed August 17, 2016, http://www.sigwatch.com/fileadmin/Free_downloads/SIGWATCH_Activism_Trends_-_May_2015.pdf.

85 "Facts and Stats about NGOs Worldwide," www.OnGood.ngo. Accessed August 17, 2016. https://www.ongood.ngo/portal/facts-and-stats-about-ngos-worldwide.

86 "Campaign Protests Hershey's with QR Codes," Mashable, July 13, 2011, accessed August 17, 2016, http://mashable.com/2011/07/13/hershey-qr-protest/#PtcRvgyTYOqA.

87 "Raise the Bar, Hershey! Campaign Welcome's Hershey's Announcement to Source 100% Certified Cocoa by 2020 – Press Releases on CSRwire.Com," (CSR Wire, October 03, 2012), accessed August 17, 2016, http://www.csrwire.com/press_releases/34706-Raise-The-Bar-Hershey-Campaign-Welcome-s-Hershey-s-Announcement-To-Source-100-Certified-Cocoa-By-2020.

88 "Hershey to Source 100% Certified Cocoa by 2020," (The Hershey ❏ Company, October 03, 2012), accessed August 17, 2016, https://www.thehersheycompany.com/content/corporate/en_us/news-center/news-detail.html?1741328.

89 Lucie Harrild, "Lessons from the Palm Oil Showdown," (The Guardian, October 28, 2010), accessed August 17, 2016, ttps://www.theguardian.com/sustainable-business/palm-oil-greenpeace-social-media.

90 Oliver Milman, *US Investors Ploughing Billions into Palm Oil, Claims Report*, (The Guardian, July 26, 2016), accessed August 17, 2016, https://www.theguardian.com/sustainable-business/2016/jul/26/palm-oil-us-investors-deforestation-land-grabs-pension-funds-banks-forest-fires-climate-change.

evaluation and strengthening awareness for local impact groups. As the UNGPs, OECD Guidelines, and the EPs all lack enforcement mechanisms, current NGO efforts function as a stopgap that can later be integrated into enforcement and compliance plans moving forward.

Modern day NGO activism has contributed towards a new standard in corporate accountability. When social risk violations at any location and at all stages of business can be documented and disseminated on a global scale, companies can no longer default to the bare minimum mandated by jurisdictions with underdeveloped rule of law structures. Compliance in the realm of social risk management entails measures exceeding the provisions of local law, and those that may on its surface satisfy international frameworks and other rules and regulations. Particularly in jurisdictions where legal provisions for social responsibility are lacking and vigilance by NGOs is subsequently high, the robustness of a company's dispute resolution mechanism plays a deciding role in mitigating risk.

As campaigns to expose social risk violations have gained in frequency and reach, they have increasingly exhibited the ability to directly impact a business' reputation and profitability. The culmination of these developments has been a new default in corporate accountability, one that transcends the legal provisions of any individual jurisdiction, to embrace a more comprehensive set of expectations ordained by international popular consensus. As NGO activity exerts increasingly visible pressures, social risk evaluation constitutes a legitimate and crucial area of risk management.

PART III
PROGRESS IN HONG KONG

THE HONG KONG STOCK EXCHANGE'S ESG REPORTING GUIDE

Consistent with the trends outlined above as well as other financial markets from around the world, the Hong Kong Stock Exchange implemented its own ESG Reporting Guide ("ESG Guide") which for the most part became effective for issuers' financial years commencing on or after January 1, 2016.[91] The ESG Guide is significant because it is the first time a Hong Kong stock exchange has issued any notices for companies to demonstrate good social risk governance before accessing the Hong Kong markets. The ESG Guide adopts a "comply or explain" approach, which mandates the reporting of certain requirements. This standard is consistent with several other financial markets around the world.

SUBSTANTIVE ISSUES COVERED BY THE ESG GUIDE WITH AN EMPHASIS ON ISSUES RELEVANT TO SOCIAL RISK ISSUES

The ESG Guide is organized into two subject areas (Environmental and Social), plus Corporate Governance which is addressed separately. Each subject area has various aspects. Each aspect sets out general disclosures and key performance indicators ("KPIs") for issuers to report on in order to demonstrate how they performed.[92]

For corporations looking to minimize risk stemming from ESG, having a robust set of KPIs could help to monitor and integrate ESG issues into a company's other reports and pursue corporate sustainability in a measurable way. Of course, KPIs are limited in that companies should be aware that some areas that require fuller explanations of ESG can be overlooked by this numbers-centric approach. Yet, without data, ESG information cannot hope to reach key stakeholders in an efficient, quantifiable manner and, as a result, companies actively pursuing sustainability by being accountable may not be able to clearly differentiate themselves from those with weaker ESG monitoring programs.

In relation to the social aspect, the ESG Guide covers employment and labour practices (employment, health and safety, development and training, and labour standard), operating practices (supply chain management, product responsibility, anti-corruption and community) and community investment.[93] While some KPIs related to the environmental subject area will be upgraded from "recommended" to "comply or explain", KPIs related to the social subject area have not yet been upgraded to "comply or explain".

HOW DOES THE HKEX ESG GUIDE ADDRESS SOME OF THE COMMON ISSUES PREVALENT IN THE ASIA-PACIFIC REGION?

In order to evaluate how effective the HKEx ESG Guide is at combatting social risk, three hypothetical scenarios should be considered: 1) social risk issues within the company, 2) social risk issues occurring downstream at a mutually exclusive supplier, and 3) social risk issues occurring at one of the company's smaller suppliers who supplies goods to numerous other companies as well.

When issues are discovered in a company's own operations (that it is causing or contributing to) the organization is expected to prevent, mitigate and remedy these impacts. By contrast, when actual or potential adverse human rights impacts are discovered within an organization's supply chain (directly linked) but the company is not itself directly causing or contributing to those impacts, companies have a far more complex role to play. This can happen further down in the company's supply chain with third-party suppliers, it can also take the form of third-party labour agents or in the form of recruitment fees, administrative fees used to facilitate forced documents, debt bondage and trafficking across borders. In these instances, companies should seek to exercise whatever leverage they have to influence their third party business partners to prevent, mitigate or remedy those impacts when identified. The company may collaborate in providing remedy, but is not expected to provide remedy itself. When an enterprise cannot help to prevent or mitigate the adverse impact, it needs to consider severing its business relationships.[94] In many other instances, companies have a hard time identifying these social risk issues as the violations are not directly under the company's control.

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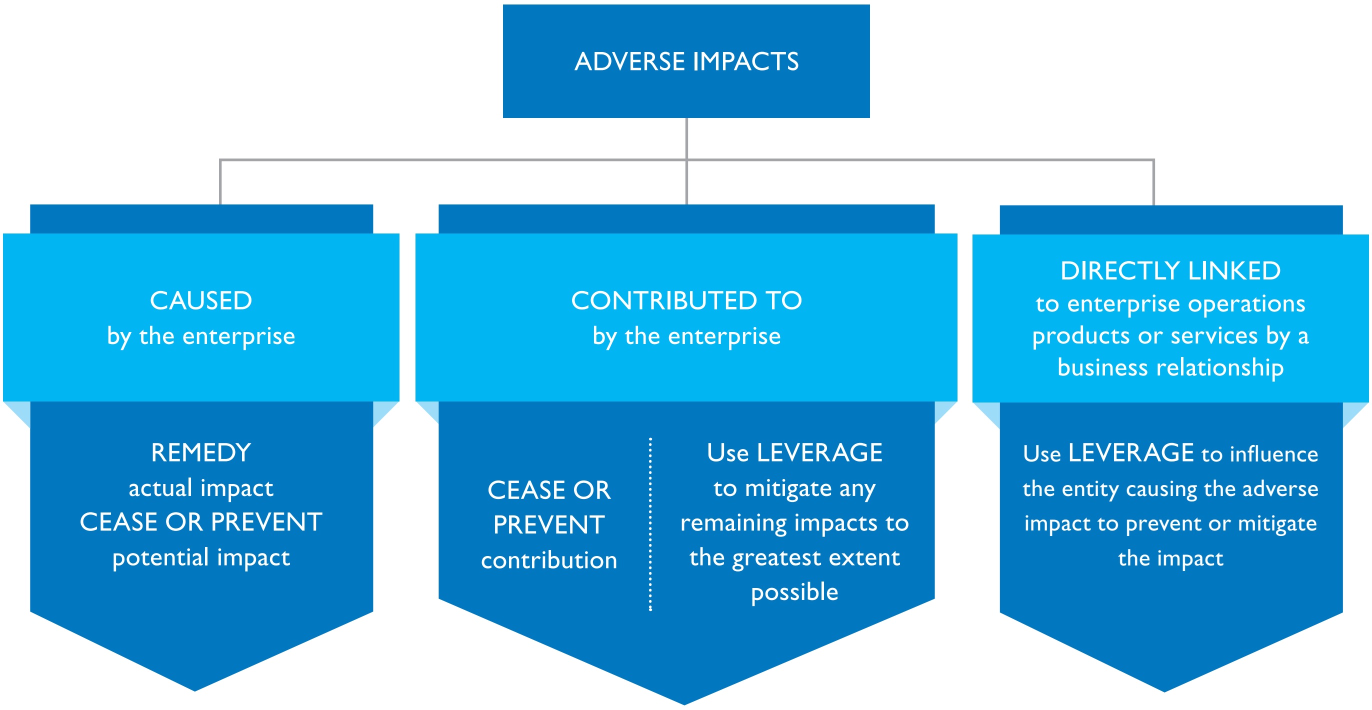
[91] The only exception are the Environmental KPIs which will be implemented for the issuers' financial years commencing on or after January 1, 2017.

[92] Ibid.

[93] Please refer to Appendix 1 for a condensed version of general disclosure and KPIs in respect of the social aspect.

[94] Ibid.

The following chart illustrates how adverse impacts should be addressed in accordance to the OECD's Guidelines for multinational enterprises:



The ESG Guideline has provided a comprehensive list of disclosable aspects for the public to assess the performance of companies' social compliance issues. However, the ESG Guide is limited to the compliance of companies themselves without an inquiry into the companies' third party business partners. Even though "supply chain management" is included in the ESG Guide, it only focuses on the policies and management of social risks in the supply chain and does not go far enough so as to further identify and/or investigate the actual or potential adverse human rights impacts, not to mention exercising leverage to influence their third party business partners to prevent, mitigate or remedy those impacts. Therefore, the ESG Guide leaves open the potential of companies to outsource these risks to third parties and essentially *look the other way*.

Managing business partners

In our modern day business environment, and especially in the Asia-Pacific region, outsourcing and engagement of third party business partners to provide goods and services within a company's a supply chain is a well-established business practice. Companies typically contract out a business process or labour need to another party, as it brings flexibility to scale the business and allows companies to pay less for only the products and/or services they need and when they need them. Certain costs can be reduced, such as initial investment, labour costs, taxes and local regulatory compliance. According to Deloitte, a typical Fortune 500 organization may use as many as 10,000 suppliers to meet its business objectives.[95] Simply put, it is often times easier and more economical to find a specialist supplier rather than to build something on your own from scratch and bear the risk.

[95] "Deloitte's Global Outsourcing and Insourcing Survey." Deloitte. December 2014. Accessed August 17, 2016. http://www2.deloitte.com/content/dam/Deloitte/us/Documents/strategy/us-2014-global-outsourcing-insourcing-survey-report-123114.pdf.

Meanwhile, outsourcing and third party contracting can also mean a lack of transparency and control over the supply chain. While the economic benefits of this model are well recognized, the problems arising from or associated with outsourcing cause concerns. Today, social risk issues are now the subject of specific accountability regimes such as the Californian Transparency in Supply Chains Act and the UK's Modern Slavery Act. Potential social risks include modern slavery, forced labour, underpaid workers, product safety and production issues, etc. Companies are often able to circumvent liabilities for such social risks and the associated non-compliant practices of their contracting parties by using arm's length contractual arrangements and complex corporate structuring and supply chains to evade liability. Even when companies do make efforts to audit their supply chain and mitigate social risks, violations may still be crop up and/or it may evolve into another form, making it even more difficult to identify.

While the ESG Guide requires disclosure of policies on managing environmental and social risks in the supply chain, it does not go far enough to identify where social risk is likely to exist. For example, the ESG Guide recommended disclosures include number of suppliers by geographical region, description of practices relating to engaging suppliers, number of suppliers where the practices are being implemented, and how they are implemented and monitored. The checklist focuses on the practices of and/or actions taken by the listed companies, rather than those of companies in the supply chain which is where the risks currently originate. Unless third parties in the supply chain are themselves listed companies, which is rarely the case, their social risks are generally not subject to the ESG Guide and will not be subject to remedial measures.

Generally speaking, social risk due diligence for third party business partners should not only apply to supply chains, but rather to any third party which is a material element or driver behind an organization seeking access to the financial markets. Financial institutions, such as banks, and those controlling access to the financial markets for corporations (whether via listing, raising finance or other means), rarely assess or conduct due diligence against the third-parties contracted by the party seeking funds. Financial institutions generally only require anti-money laundering and due diligence measures at the top company level without requiring checks further down the business chain where social risks are more likely to exist.

HKMA AND SFC ARE NOT BOUND BY ESG REQUIREMENTS

In terms of the ESG Guide's scope, it is notable that it currently only applies to the applicants and issuers of the Hong Kong Stock Exchange. It is not particularly enforced by other financial regulatory authorities in Hong Kong, including The Hong Kong Monetary Authority (HKMA), the government authority in Hong Kong responsible for maintaining monetary and banking stability, and The Securities and Futures Commission (SFC), which is responsible for administering the laws governing the securities and futures markets in Hong Kong and facilitating and encouraging the development of these markets. In other words, there is no such specific and binding guideline implemented in Hong Kong to deal with the environmental, social, and governance issues for those companies (including financial institutions) which are not listed on the Hong Kong Stock Exchange.

Therefore, there is a clear need for increased financial regulation of the Hong Kong markets in relation to social risk issues. Aside from the HKEx, none of the other core Hong Kong regulators or industry bodies has issued any requirement for companies to demonstrate good social risk governance before accessing the Hong Kong markets. And while the HKEx's ESG Reporting Guide is a good starting point, it does not go far enough in addressing our modern day concerns. The most common social risk example, as outlined above, arising from outsourcing work to third-parties in sector specific high risk industries and jurisdictions continue to plague Asian countries with key perpetrators able to access the financial markets under the banner of "clean" holding companies.

Therefore our recommendations include amendments to the current HKEx's ESG Reporting Guide to provide for social risk issues to be upgraded from "recommended" to "comply or explain" particularly regarding KPIs as well as a closer review of a company's suppliers due to the prevalence of outsourcing work and *looking the other way*.

PART IV
PROPOSED RECOMMENDATIONS

INTEGRATING THE IDENTIFICATION AND ELIMINATION OF SOCIAL RISK INTO ALL RELEVANT BUSINESS FUNCTIONS

Given the increased investor demand, the complexity of legal and regulatory issues involved, the current business and communications environment as well as the global frameworks, NGOs, and non-profits which are filling in the gaps of justice, companies have never been held more accountable than today to implement the identification and elimination of social risk issues into all relevant business functions (e.g. pre-IPO, M&A, financing, due diligence, policies/procedures, bank compliance processes, investment committee approval processes, annual reporting, audits, third-party supplier engagement, etc.). This will involve identifying clear business function "touchpoints" where integration of social risk evaluation makes the most sense. For investment bankers, lawyers, accountants, and other relevant consultants, key due diligence questions regarding a company's social risk profile should be addressed during the financing process. For companies looking to implement controls, a good place to start would include considering whether there are already any efficient and effective compliance review/monitoring procedures in place (e.g. anti-money laundering, anti-corruption, etc.) and whether social risk issues could be integrated into those procedures. In this section, we will explore a few simple models where social risk can be integrated.

DURING THE IPO PROCESS

Pre-IPO

Social risk due diligence for an IPO can be conducted at the outset of the IPO process. A sponsor/pre-IPO investor may conduct social risk due diligence into a potential applicant seeking to be listed on the Stock Exchange because non-compliance of ESG matters may affect the applicant's suitability for listing.

The Stock Exchange considers that systematic, intentional, and/or repeated breaches of laws and regulations, including those laws that cover ESG matters, by an applicant as well as the potential liabilities thereunder may affect the suitability for listing.[96] Furthermore, if any part of the applicant's financials relies on the non-compliant activities, the Stock Exchange may raise questions as to whether the applicant can meet the listing requirement without engaging those non-compliant activities. Generally speaking, illegal income would be carved out for the purpose of meeting the listing requirements. Although under the current regime, immaterial non-compliance may be resolved through disclosure, it can be suggested that material ESG non-compliance incidents, such as modern-day slavery, child labour and human trafficking, cannot be resolved by way of disclosure. In other words, any applicant who is involved in incidents of such ESG non-compliance will likely be rejected from listing on the Stock Exchange.

Due diligence during the IPO

Social risk due diligence may also be integrated into the sponsor's due diligence work. The sponsor's role provides that the sponsor must be closely involved in the preparation of the listing documents and must conduct reasonable due diligence to be able to make the sponsor's declaration required by the relevant rules. Social risk due diligence should be considered as part of the reasonable due diligence.

In specific, social risk due diligence should be embedded into the third party due diligence process because a company is exposed to business risks when dealing with third parties who may be involved with non-compliant practices. The sponsor may seek expert opinion such as an internal controls report which covers ESG or a separate ESG report to assess the applicant's ESG compliance including any required mitigation measures prior to listing.

Closing of IPO

During the closing of the IPO, underwriting agreements may include representations and warranties or covenants that the issuer is in compliance with ESG requirements, which may also be backed up by legal opinions stipulating that the issuer is free from any liabilities for ESG non-compliance and that the issuer is not involved in any ESG non-compliant activities.

[96] According to the guidance letter HKEX-GL86-16.

INCORPORATING SOCIAL RISK INTO DUE DILIGENCE

Due diligence is a paramount process that firms can take to ensure ESG compliance and reduce social risks from occurring alongside business activities. Companies have often operationalized the process behind due diligence and social risk due diligence can be integrated in the same manner. For instance, as part of complying with the U.S. Foreign Corrupt Practices Act ("FCPA"), companies conduct due diligence on third parties which include a review of the rationale for the transaction, certain relationships and qualifications, as well as the company's reputation in the market. When engaging a new third party supplier, a similar process may be undertaken to better understand the social risk profile of the target and transaction.

Mergers and Acquisitions

Pre-Acquisition Due Diligence

Like the IPO process, social risk due diligence can be integrated into the M&A process. Without adequate due diligence, companies merging or acquiring could be condoning social violations, which may yet continue after the transaction has closed. Recognizing the materiality of social risks, investors are now more than ever demanding its inclusion in securities filings and therefore due diligence has increasingly included social risks.

Given the unique nature of each M&A transaction, companies should avoid using a "ticking the boxes" approach and instead think critically into the business, its risk areas, and prioritize due diligence in the areas relevant to social risk that are applicable to the company. It is also important to note that if a HKEx listed company doesn't conduct adequate due diligence and the target company/asset has a material social risk issue, the HKEx may interpret the acquisition as a reverse takeover, thereby forcing the listed company to comply with new listing requirements.

During and Post- Acquisition

Building a new, integrated company during and post-acquisition is one of the key business challenges to a successful transaction. This same challenges apply for evaluating social risk profile of the target company, identifying which areas need enhancement, and how to integrate the target into the larger business in a consistent manner. Some common actions that companies take post-acquisition include increased training for on-boarding employees, reviewing and revising codes of conduct, ethics, and compliance procedures, and conducting any targeted audits in business areas that have yet to be assessed regarding social risk.

Complying with ESG matters is a steady, ongoing process, and companies may need to tailor their programs to suit their own needs as the risk profile may change from year to year. Companies should regard the annual disclosure on ESG risk as an opportunity for continued improvement.

POLICIES AND PROCEDURES

Another key area for management is to establish social risk related policies and procedures that are achievable and enforceable. These standards create a "tone at the top" for countering social risk that can then be applied throughout the corporation and its partners and vendors. Managers and supervisors have an obligation to foster an environment that promotes these values as a core element of corporate culture and ensure that employees under their direct and indirect supervision adhere to this culture. In addition, managers must develop internal controls that are able to both detect and prevent violations of social risk.

These controls may include a training program that assists employees in the identification of social risk issues, the creation of reporting protocols, and a system for testing the efficacy of these protocols. Employees must be aware as to what constitutes a breach of compliance and be willing to report this behaviour regardless of influences that suggest compromising compliance standards. To promote willingness, managers must establish confidential reporting channels that protect employees from potential retaliation. Measures may include an anonymous compliance hotline, the appointment of compliance officers, and maintaining an environment where workers feel comfortable reporting violations. An additional step that managers might take is the implementation of incentive programs that support compliance. By disseminating compliance

values on the ground level, the "tone at the top" is strengthened and ethical behaviour is reinforced throughout the whole corporation.

AUDITS

Internal audits within the company are paramount to reducing risk and ensuring effectiveness of ESG compliance programs. Periodic internal audits can help assess that programs are focusing on appropriate high-risk areas. To ensure that these audits are of use, the auditing professionals must have the appropriate level of authority to take action as well as a necessary distance from company management.

Moreover, regular external audits are also helpful to ensure independence and credibility. External audits can ascertain whether internal controls are working, and if not, bring to light methods to better the compliance program. Being proactive in seeking outside opinions will only help reduce risk and, in the long-term, mitigate weaknesses in the program.

THIRD-PARTY SUPPLIER ENGAGEMENT

Managing third-party suppliers is another critical aspect in mitigating social risk. Not only should companies engage in due diligence before contracting with third-parties, but firms should also continue to monitor third parties throughout the entire relationship lifecycle. This may include periodic audits, training, employee engagement.

Prior to engaging third-party suppliers, companies must develop a risk-based due diligence program to assess the social risk status of the third-party. Metrics can include the reputation of the third-party, partnerships that the third-party is involved in, reliance on subcontractors, company principles, legal and regulatory compliance, and past social risk issues.

To ensure that third-parties are abiding by corporate guiding principles, companies must clearly articulate compliance responsibilities. Contracts made with third-party suppliers should include provisions for corporate oversight via periodic independent audits, annual compliance reports, and annual compliance training. Audits should assess existing social risk management programs, the integrity of reporting channels, and the nature of the working environment.

Professional consultants and NGOs may play an integral role in the oversight process by functioning as an independent party that is capable of assessing social risk issues on the ground level. This process is critical because of changing regulations regarding the use of forced labour in production. For example, the United States has prohibited the import of any goods produced through forced labour with the 2016 amendment to the Smoot-Hawley Tariff Act of 1930. If any goods are suspected of being produced with the use of forced labour, whether in part or in whole, they will be detained at the border and not allowed admission into the United States.[97] Some consultants and NGOs may monitor these data points regularly and can check for third-parties against any number of regulatory lists of offenders from various jurisdictions.

INTEGRATING SOCIAL RISK INTO EXISTING CONTROLS AND COMPLIANCE FUNCTIONS

Conducting social risk due diligence is just one small aspect of the broader work companies need to undertake to integrate and implement ESG frameworks into their operations.[98] "Horizontal integration" of specific social risk impact assessment findings will only be effective if a company already has an ESG policy commitment "embedded into all relevant business functions" to ensure that the assessment findings are "properly understood, given due weight, and acted upon."

Therefore, a good place to start may be for the company to consider whether there are already any efficient and effective compliance review/monitoring procedures in place and whether social risk issues could be easily integrated into those procedures. Some key areas where major multinational companies have already integrated compliance functions horizontally across the entire business include anti-money laundering,

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[97] Bell, Sandra. "US prohibits imports made with forced labor," DLA Piper. November 9, 2016. Accessed November 24, 2016. https://www.dlapiper.com/en/uk/insights/publications/2016/11/law-a-la-mode-issue-21/us-prohibits-imports-made-with-forced-labor/.

[98] Proceedings of Global Forum on Responsible Business Conduct, Paris. June 9, 2016. Accessed August 20, 2016. http://mneguidelines.oecd.org/global-forum/GFRBC-2016-Summary.pdf.

anti-bribery anti-corruption, and "know your client" policies and procedures.[99] Many of these compliance functions permeate across all business functions and hold a high-level of accountability which goes all the way up to the board. Companies looking to integrate social risk into the company's culture may begin by evaluating these compliance functions as the process of uncovering and addressing these risks are similar to those relating to social risk.

Implementation isn't without challenges

While existing guidelines establish a global precedent for social risk compliance, a lack of specificity makes incorporation at the corporate level difficult. Moreover, though non-financial disclosures related to social risk may be a good start, it is still unclear whether this would in turn do enough to affect change. Furthermore, given the complexity of laws, regulations, perceptions, and potential risks, corporations are left to develop their own policies and procedures where company standards may vary greatly and no one-size-fits-all to address social risk concerns.

As a starting point to guide corporations to develop these policies and procedures, the HKEx can look to joining the UN Sustainable Stock Exchange Initiative as a partner stock exchange. This platform would enable the HKEx to connect with other stock exchanges that are looking to implement social risk guidelines, and also benefit from the experiences of other stock exchanges that have already implemented these controls and seen what works and what doesn't.

If the HKEx can augment its existing ESG Reporting Guide and its current disclosure policy of "Comply or Explain" by establishing a baseline for social risk compliance and *mandating* the integration of a social risk mitigation plan into relevant business functions, more clear and consistent standards would eventually develop throughout the market. These are some of the challenges the investment community will face today and in the near future on the path to social risk reform.

[99] Ibid.

CONCLUSION

By advocating for increased financial regulation as well as strengthened practices for identifying and eliminating social risk, together we can play an integral role in driving better investment decisions, improving public perception and awareness of social risk as an issue, and ultimately improving the lives of the people who live in our communities.

The progress that has already occurred in Hong Kong, namely through the introduction of the ESG Guide for the Hong Kong Stock Exchange, recognises the importance of good social risk governance for companies. However, it is important that companies accept responsibility for social risk and put in place their own procedures to identify, address and mitigate social risk within their business.

Companies that deliberately avoid discussion of social risk put themselves in jeopardy of severe reputational damage, liability at law and even loss of profit and commercial standing. Therefore, companies are encouraged to consider how to integrate functions for the identification of social risk into their existing structures, particularly at key risk points such as during the IPO process and in mergers and acquisitions, and build these functions into their operational policies, procedures and controls.