ESG, China & Human Rights

Why the time has come for investors to act

HONG KONG WATCH

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Johnny was the Founding Director of the organisation between 2017 and 2020 and is now responsible for overseeing our research and policy work. He has authored a number of Hong Kong Watch's in-depth reports, including our research on Red Capital, on why Hong Kong matters to China as an international financial hub and our report on the abuse of the Public Order Ordinance. He is a regular commentator on Hong Kong in international media, and has been published in The Spectator, The Independent, TIME, The Financial Times and South China Morning Post.

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Sam Goodman is the Senior Policy Adviser of Hong Kong Watch. He writes our monthly briefings, was co-author of our research on Red Capital in Hong Kong and wrote our recent paper on Canadian pension funds. Prior to joining Hong Kong Watch, he worked as a political adviser for the Labour Party, a parliamentary aide to several Labour Members of Parliament, and worked in the US House of Representatives for Congressman Bobby L Rush. He has a background in British foreign policy as the co-founder and co-chair of the New Diplomacy Project and the author of 'The Imperial Premiership: the role of the modern prime minister in foreign policymaking 1964-2015'.

Foreword

As investment into China grows, despite the increasing risks associated with that market, little attention is being given to gross human rights violations.

The relationship between human rights and investment is a complex policy area, and many businesses and financial institutions require expert guidance and better understanding of these issues. But as firms increasingly recognise the importance of sustainable and ethical investing practices, it is vital that human rights are not neglected and an imperative that the pursuit of profits does not come at the expense of fundamental principles.

My engagement with business, human rights and investment grew out of my work in Hong Kong. When I was a lawmaker in Hong Kong's Legislative Council, the democratic camp would frequently raise a full range of human rights issues and invite NGOs and civil societal groups to come discuss these issues in a formal setting. The civic space for discussing these issues has now been shut down. But one of the outworkings of those discussions was my focus on the issue of modern slavery in investment. Together with other human rights lawyers in Hong Kong, I co-sponsored a private member's bill to combat international human trafficking. The bill was modelled after the UK Modern Slavery Act 2015 and sought to strengthen the anti-money laundering rules to freeze illicit proceeds generated from modern slavery. We made steady progress by generating more focus on the relationship between business and human rights, and in successfully lobbying the Hong Kong Stock Exchange to include mandatory ESG reporting on forced labour and other unfair practices in supply chains. This requirement came into effect in July 2020. Why is Hong Kong important? There are more than 11 million victims of modern slavery in Asia, accounting for 40% of global victims. Billions of illicit proceeds are generated each year from the modern slave trade, these are in turn channeled through international financial markets and the banking system, including Hong Kong.

Foreword

Modern slavery is one key interface between human rights protection and businesses. There are many more. As authoritarian governments around the world crack down on democracy and freedom, businesses should not play a complicit role, particularly if they are major beneficiaries from open societies and the rule of law back home. Institutional investors and consumers should demand more transparency and responsible decision making, in the same manner as business decisions affecting climate change.

This report by the Hong Kong Watch is a comprehensive map setting out where the risks are and the list of policy recommendations that government decision makers should take into account. I congratulate the authors in navigating through the many complex issues, and to bring clarity to the issues which require our attention.

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Executive Summary

Ties between China and Global Finance are at record highs

Despite a growing fissure emerging between China and the West due to the human rights situations in Hong Kong and Xinjiang, the coronavirus pandemic, and the US-China Trade War, ties between China and Global Finance are growing and the total value of China's stock market has hit record highs.

> Global holdings of Chinese stocks and bonds had **surged about 40% to over $800 billion**

More money is being invested in China by Western pension funds, sovereign wealth funds and other institutional investors than ever before. On 14 July 2021, the Financial Times reported that global holdings of Chinese stocks and bonds had surged about 40 per cent to over $800 billion. As a result of domestic pressures, the Chinese government have been actively making it easier for institutional financiers to invest by: removing investment quotas from the Qualified Foreign Institutional Investor scheme and the Renminbi Qualified Foreign Institutional Investor scheme; increasing market access in banking, securities and insurance industries; and opening the domestic bond market to investors.

Simultaneously, some of the world's largest investors are driving the push for increasing capital flows into China. For example, Blackrock, the world's largest asset manager, has been a vocal advocate of greater investment into China. In August 2021, the firm called for China to no longer be considered an Emerging Market but instead for the country to be placed in a separate category and for equity portfolio allocations of investors into China to increase to two or three times their current size.

Can investment in China be justified in the era of ESG investing?

Paradoxically, rising investment into China coincides with the boom in 'Environmental, Social and Governance' (ESG) investing. In recent years, firms have begun to acknowledge that the environmental and social impacts of their investments matter alongside the returns on investment. They are therefore seeking to mitigate the environmental and social costs of their investments. As part of their 'social' duties, many have signed up to the United Nations Guiding Principles on Business and Human Rights, acknowledging that they have a duty to respect and protect human rights in contexts where they are investing.

Can investors square their increased commitment to 'responsible investing' with huge inflows into an authoritarian state like China? Firms currently argue that there is no conflict between their China portfolios and their ESG priorities. But this view cannot be justified. We identify three areas which should be of considerable concern to firms seeking to meet their ESG commitments: Human Rights, National Security and the Environment.

Human Rights

In practice, most of the attention of ESG investors has been placed on environmental costs, with little attention given to human rights. In July 2021, more than 34 per cent of the bonds in the ESG version of the J.P. Morgan Emerging Markets Bond Index were issued by countries labelled "not free" by Freedom House. Firms are particularly reticent about engaging with human rights in China because of their desire to capitalise on a growth market.

The result of this has been that there has been considerable investment into Chinese firms which have troubling human rights records. There is a clear knowledge gap between financial professionals who know that enormous amounts of the money of ordinary people, institutional investment, pensions and government funding is being invested in China, and the members of the public, media and policy makers who would have serious ethical and practical reservations about what seems to be a reckless and problematic course of action. This information gap has provided cover for financial institutions to pursue profit without regard for the social impacts of their ties with firms that are closely affiliated with egregious rights abuses in Hong Kong or Xinjiang.

Environmental Protection

But even firms pre-occupied by the environment have reason to be cautious of China. Firms deepening their ties with the Chinese government must consider the environmental costs of government policies. China generates the largest CO2 emissions in the world. While only accounting for 17% of GDP and 18% of the world's population, it produces 28% of the world's greenhouse gas emissions. This is partially because 60% of the country's electricity is currently generated by burning coal. China's CO2 emissions per dollar of GDP are running at about three times that of the EU, and the Global Subsidy Initiative estimates that China's subsidies for fossil fuels are running at about USD 100 billion per annum. Many prominent Chinese firms which feature on global investment indices directly benefit from these subsidies and policies.

National Security

Alongside these areas of concern, some Western investment in recent years runs counter to the stated foreign policy interests of democratic governments and national security. For example, some Western companies have directly funded Chinese companies that are destabilising the Southeast Asia region. The Burma Campaign's 'Dirty List' shows that several Chinese companies which receive British, Canadian and European institutional investment are heavily involved in arming and funding the military in Myanmar, which has just launched a coup and is the process of an extremely violent crackdown on protests (Burma Campaign, 2021). This demonstrates clearly that some investment is indirectly funding companies that are destabilising the region and the foreign policy interests of countries which support Myanmar's transition toward a democracy.

China's strategy of civil-military fusion is particularly important. This is the government's strategy to harness civilian enterprises, particularly dual-use technologies, for military ends. Institutional investment in some Chinese firms in key industries may inadvertently fund the upgrading of the Chinese military.

> *"Several Chinese companies which receive British, Canadian and European institutional investment are heavily involved in arming and funding the military in Myanmar."*

A spotlight on investment in 4 types of problematic Chinese firm

Our research finds that there are four types of firms which investors should scrutinise and consider divesting from:

1. Firms blacklisted by the United States.
2. Chinese technology giants complicit in human rights violations in Xinjiang.
3. China's state-backed banks which are the largest bankroller of Chinese state-owned enterprises.
4. China's fossil fuel giants.

Firms blacklisted by the United States

Most mainstream Chinese firms are reliant on state patronage and are often willing enforcers of the Chinese government's agenda. Some of these have been designated by the US Government as no-go stocks for US investors because of their ties with the People's Liberation Army and gross human rights violations in Xinjiang. Firms which have been blacklisted by the United States include Hikvision, China Unicom, SMIC, Zhejiang Dahua Technology, China Mobile, iFlytek and others.

But international investors around the world, outside the United States, continue to invest in many of these firms. Examples of investments by significant international institutional investors in these firms include:

- **The New Zealand Superannuation Fund has significant funds invested in 14 companies that the United States Government have blacklisted including Hikvision, China Unicom, SMIC, Zhejiang Dahua Technology, iFlytek and others.**
- **The Norwegian Sovereign Wealth Fund has money invested in China Mobile, China Unicom, and SMIC.**
- **Multiple Canadian and British pension funds have funds invested in firms including Hikvision, Zhejiang Dahua Technology, SMIC, and CNOOC.**
- **The Australian Super Fund has money invested in Hikvision and iFlytek.**

Chinese technology giants complicit in human rights violations in Xinjiang

Explicitly blacklisted firms are not the only firms where alarm bells should be ringing. Many mainstream Chinese firms, particularly the technology giants, have been involved in either the creation of the Xinjiang surveillance state, the creation of the prison camps or the use of forced labour. Investors should also be cautious of private technology firms like Alibaba and Tencent. Alibaba has produced facial recognition software that specifically targets Uyghurs and has helped construct the surveillance state and prison camps in which over a million Uyghurs are currently detained. It has also developed a privately run social credit application, Sesame Credit, which may be absorbed into the Chinese state's dystopian social credit system. WeChat, owned by Tencent, has been accused by Human Rights Watch of censoring and putting its users under surveillance on behalf of the Chinese state.

These firms currently receive enormous investment because they are heavily weighted in international indices.

- **Alibaba is the stock with the second heaviest weighting on the MSCI Emerging Markets Index and has the third heaviest weighting in the FTSE Russell Emerging Markets Index.[1]**
- **Tencent is the stock with the third heaviest weighting on MSCI Emerging Markets and second heaviest weighting in the FTSE Russell Emerging Markets Index.**
- **Both firms receive serious investment by index-tracking exchange-traded fund which follows either of these indices, as well as pretty much every bespoke China fund whether they are provided by Baillie Gifford, Blackrock, Schroders, Allianz Global, Vanguard or others.**
- **They are heavily invested in scores of serious pension funds in North America, Europe, East Asia, and Australasia (see Table 1, p.8).**
- **They also are paradoxically major holdings in a number of ESG funds. For example, Alibaba and Tencent are the 2nd and 3rd holding in Blackrock's iShares MSCI EM ESG Enhanced UCITS ETF. JP Morgan's Global Emerging Markets Research Enhanced Index Equity (ESG) UCITS ETF tells a similar story, with China making up over thirty five percent of the fund's weighting and Alibaba and Tencent accounting for a combined eight percent of the total fund.**

(1)
All references to equities were accurate as of 30 July 2021 unless otherwise stated

Table 1 - Selected institutional investment in Chinese equities

Latest public figures as of July 2021, unless otherwise stated

Institutional Investor	Funds Invested in Alibaba	Funds Invested in Tencent	Other key Chinese Equities
UK Parliamentary Contributory Pension Fund	£ 0.9m (USD$ 1.23m)	£ 2.3m (USD$ 3.16m)	China Construction Bank, Sinopec, CNOOC (Until 2019)
UK Universities Superannuation Scheme	£ 371.79m (USD$ 511m)	£ 413.96m (USD$ 569m)	China Construction Bank, Sinopec
Australian Super Fund (Balanced pre-mixed investment option)	Aus$563m (USD$ 403m)	Aus$409m (USD$ 293m)	Bank of China (Aus$4.9m), China Construction Bank (Aus$9m), Hikvision (Aus$3.2m), Iflytek (Aus$1.2m), China Mobile (Aus$13.3m)
Norwegian Sovereign Wealth Fund	USD$6.7bn	USD$5.9bn	Sinopec (US$205m), Baidu (US$759m), Bank of China (US$261m), China Construction Bank (US$1bn), China Mobile (US$371m), SMIC (US$92m), China Unicom (US$42m)
New Zealand Superannuation Fund	NZ$93.47m (USD$ 64.68m)	NZ$87.95m (USD$ 60.87m)	**14 entities sanctioned by US including:** AVIC (NZ$250,933), China Communications Construction Co. (NS$472,202), China Mobile (NZ$7,151,619), Hikvision (NZ$961,223), China Unicom (NZ$219,492), SMIC (NZ$2,306,284), Zhejiang Dahua Technology (NZ$219,670). **Others including:** iFlytek (NZ$229,702), Bank of China (NZ$5,871,296), China Construction Bank (NZ$15,384,971)
BCI (Canada)	Can$1.1bn in the two combined (Mar,2020) (USD$887m)		**March 2020:** China Communication Construction Group (C$2m), CNOOC (C$56.1m), Hikvision (C$45.3m), China Mobile (C$104.6m), Zhejiang Dahua Tech (C$14.42m), China Construction bank (C$91.98m)
CDPQ (Canada)	Can$938.6m (USD$744m)	Can$666.9m (USD$529m)	**18 companies on the US sanctions list, including:** AVIC, CNOOC Ltd, CoStar Group Inc, Inner Mongolia First Machinery Group Co, Zhejiang Dahua Technology Co, and Semiconductor Manufacturing International Corp.
Japan Government Pension Investment Fund	£ 2.57bn (USD$2.04bn)	£ 2.2bn (USD$1.74bn)	Sinopec (£62 million)

Chinese State-Owned Banks

Chinese state-owned banks are the largest bankroller of Chinese state-owned enterprises, who in turn have spent the last decade buying up a substantial amount of strategic infrastructure in the West, as well as being the largest lenders to the Belt and Road Initiative which has been accused of exploiting developing nations and being used as a tool for 'debt diplomacy'. These firms, in turn, fund Chinese-state owned enterprises like the China National Oil Corporation, China General Nuclear Power Group or Beijing Construction Engineering Group who have been blacklisted by the United States.

China's state-owned banks are a serious beneficiary of institutional investment. The Chinese Construction Bank is one of the top 10 constituents of both the MSCI Emerging Markets Index and the FTSE Russell Emerging Markets Index. As a result, these equities are prominent in global pension funds around the world.

Chinese Fossil Fuel Giants

Chinese fossil fuel giants currently continue to be major beneficiaries of investment. But firms looking to invest in the Chinese economy should be considering the role of state subsidies in the Chinese fossil fuel industry as they make their ESG calculations.

For example, the China Petroleum & Chemical Corporation, or Sinopec, is currently embedded deeply into many international funds and receives considerable pension fund investment. Yet Sinopec is the largest oil and gas refining company in the world. As with state-owned Chinese companies of its size, Sinopec has close links with the Chinese military and state, developing body armour for the Chinese military. Between January and September 2019, the firm received $450 million in government fossil fuel subsidies.

In March 2021, Sinopec announced that it had found abundant flows of natural gas and crude oil in the Uyghur region in Xinjiang, where over a million Uyghurs are currently incarcerated, stating that it would be one of its key drilling basins in 2021-25. This falls in direct contravention to a recent warning by the International Energy Agency that any new oil, coal, or natural gas investments risk the chance of the world meeting its 2050 carbon neutral target. Investors must monitor whether Uyghur forced labour is used in the mining of these resources.

Recommendations

The inconsistencies in regulations between global financial markets ensure that regulation by one or two international governments will not be sufficient to generate the type of behavioural change which is necessary to stop large amounts of money flowing into problematic Chinese equities and bonds.

Recognising this, our recommendations are split into two parts. Firstly, we consider what steps governments should be taking together. Multilateral regulatory action is needed in order to ensure that human rights are protected by investors. Secondly, we argue that firms must start to develop more robust and rigorous ESG guidelines when assessing investment into China.

The globalised nature of international finance means that governments cannot effectively regulate in isolation. What is needed is coordinated international action by governments to take place in concert with financial services firms beginning to acknowledge the ethical dilemmas inherent with investing in China and starting to take seriously potential ESG concerns.

Recommendations to Governments

On human rights and financial services

- Governments should enact legislation to ensure consistent ESG standards around the world.
- Governments should consider further legislative steps to halt investment in firms tied to gross human rights violations.
- Governments must properly address gross human rights violations in their financial regulatory frameworks.
- In 2021, the European Union is developing mandatory human rights due diligence regulations. This should refer to the UN Guiding Principles on Business and Human Rights (UNGPs) as the basis of engagement. Other countries and regulators should adopt similar regulatory regimes to ensure compliance worldwide.
- Governments should regulate to bar investment in firms complicit in genocide, ethnic cleansing, crimes against humanity or modern-day slavery.

On gross human rights violations in China

- Governments should designate which Chinese firms are complicit in crimes against humanity, genocide and other atrocity crimes against the Uyghurs and apply financial sanctions, including investment bans on those firms.

- Governments should bar the imports of goods where forced labour can reasonably be presumed to be in the supply chains.

- If firms complicit in the crackdown on human rights in Hong Kong or Xinjiang are international, their governments should consider withholding privileges until they stop aiding and abetting the repression in Hong Kong or Xinjiang.

Recommendations to investors and the financial services industry

On ESG and human rights

- Investment firms, standard setters and governments must give proper weight to human rights violations in their ESG metrics and regulatory frameworks.

- Firms complicit in genocide, crimes against humanity or modern-day slavery should be considered a 'sin stock'.

- Just as the Moody's or S&P ratings system acts to limit the potential credit rating of a company depending on which country the company is based within, a similar initiative ought to be considered when it comes to ESG. Countries could be ranked on a scale depending on their ESG score. The ESG rating of each firm could then be tied in some way, or even proportional to, the national ESG rating, with the potential ESG rating score capped by the national banding.

On ESG and China

- Investors should consider the extent of Chinese government fossil fuel subsidies when calculating ESG metrics.

- Companies and investors must undertake a process of enhanced human rights due diligence when engaging with firms that could possibly be tied to repression in Xinjiang.

- Firms based in Hong Kong should face serious ESG penalties, in terms of their weighting, if they are known to have:

  - *fired employees on the basis of their political stance;*
  - *boycotted advertising with Apple Daily or other pro-democracy news-outlets on the basis of their political stance;*
  - *endorsed the crackdown on Hong Kong's protestors;*
  - *frozen the assets of pro-democracy activists.*

- Investors should use their leverage with companies complicit in the crackdown in Hong Kong or Xinjiang to influence a change in behaviour.

Introduction

With the crackdown taking place in Hong Kong and outrage growing about crimes against humanity against Uyghurs in Xinjiang, Western governments are taking an increasingly strident position in their public statements and diplomacy towards China.

But while there has been a change in international government attitudes towards human rights in China, business as usual has continued for financial services institutions everywhere from Wall Street to Canary Wharf.

Growing access to China's financial markets has led to a rush into Chinese equities and bonds. Deference to fiduciary duty, the view that profit maximisation is what matters above all else, and is in fact the moral course of action, has ensured that little attention has been given as to how to shape investment decisions to avoid complicity in human rights violations.

This ambivalence towards detrimental socio-political trends cannot be squared with the emergence of Environmental, Social and Governance (ESG) investing – sustainable and responsible investing, in other words – as a mainstream priority and commitment for the world's largest investors.

This report argues that if firms want to be serious about ESG, they need to rethink their China strategies.

The first chapter introduces our main theme by asking the question: can investment into China be justified in the era of ESG investing? We provide a survey of important background trends including rising investment by global finance into China and the growth of ESG investing. We then identify three areas where which deserve scrutiny by firms investing in China: Human Rights, National Security and the Environment. Some of the firms which receive the greatest international investment from pension funds are complicit in the creation of the Xinjiang surveillance state, while Chinese fossil fuel companies like Sinopec – who receive hundreds of millions of dollars in state subsidies – are prominently placed on international indices. Questions should be asked about whether these firms should be major beneficiaries of global investment.

Chapter 2 contains a deep dive into the exposure of leading pension funds and sovereign wealth funds to Chinese equities. The chapter surveys institutional investors in the UK, Australia, Canada, New Zealand, Japan, South Korea, and Scandinavia. It points out that there are four types of firms which investors should scrutinise and consider divesting from: firms blacklisted by the United States, Chinese technology giants complicit in human rights violations in Xinjiang, China's state-backed banks which are the largest bankroller of Chinese state-owned enterprises, and China's fossil fuel giants.

The final chapter then evaluates existing policy measures and begins to articulate what policy makers and investors might do so that their approach to China better reflects the global ambition to step up in the arena of ESG and responsible investing.

Chapter 1

Can investment into China be justified in the era of responsible investing?

Despite the human rights situations in Hong Kong and Xinjiang, the coronavirus pandemic, and the US-China Trade War driving a growing fissure between China and the West, ties between China and Global Finance are growing, and the total value of China's stock market has hit record highs (Lockett, 2020c).

- **In 2020, foreign investors snapped up more than Rmb1tn worth of Chinese stocks and bonds (Lockett and Hale, 2020).**
- **In May 2021, foreign ownership of Chinese domestic bonds had hit an all-time high of over Rmb3.6 trillion, a four-fold increase compared with Rmb 840 billion holdings in 2017 (Gong, 2021).**
- **On 14 July 2021, the Financial Times reported that global holdings of Chinese stocks and bonds had surged about 40 per cent to over $800 billion (Lockett, 2021).**

Investment will only increase with the impending entry of Chinese government bonds to the FTSE World Government Bond Index, which will direct around $150 billion USD in additional passive investment to Chinese government bonds (HSBC, 2021).

Little attention has been paid to the ethical implications of these trends. Can rising investment into China be justified in the era of responsible investing? We argue that there is serious moral hazard associated with much of the investment into Chinese equities which investors have a duty to consider more fully

Understanding growing capital flows between China and the West

The main ways for international investors to access Chinese equities are through the Qualified Foreign Institutional Investor scheme (QFII), the Renminbi Qualified Foreign Institutional Investor Scheme (RQFII) and through Stock Connects between Hong Kong and Shanghai/Shenzhen. The QFII and RQFII are programs that allow specified licensed international investors to participate in mainland China's stock exchanges (Investopedia, 2020).

'Stock connect' schemes between Hong Kong and Shanghai/Shenzhen have also opened mainland stock markets to Western investors, opening opportunities for a wider range of investors. The Hong Kong-Shanghai/Shenzhen arrangements allow international investors to access China A-shares through Hong Kong despite these being denominated in the renminbi. Investors can access mainland equities via Hong Kong brokers (Hong Kong Watch, 2019).

The deepening of ties between the West and China has been a direct result of Chinese government policy. As a result of a combination of increasing domestic financial vulnerabilities, and the priority US negotiators placed on the opening of financial markets in US-China trade talks, the Chinese government has taken a range of steps to open up their financial markets to foreign investors. The steps include (USCC, 2020: 265):

- **Increasing market access in banking, securities and insurance industries;**
- **Granting foreign institutions equal treatment in credit and payment sectors;**
- **The removal of QFII / RFQII Investment quotas;**
- **Opening domestic bond market to investors.**

A consequence of opening-up the financial markets has been that several foreign firms have recently been allowed to buy out their partners in joint ventures and become controlling owners of their Chinese securities ventures. Since the signing of the phase-one trade deal between the US and China in 2018, JPMorgan has been able to secure full control of a futures venture in which it had a minority stake. Goldman Sachs and Morgan Stanley have become controlling owners of their Chinese securities ventures. Citigroup Inc., meanwhile, won a custodian license to act as a safe keeper of securities held by funds operating in the country, and Blackrock won approval to start the first non-Chinese wholly owned mutual-fund business in August 2020 (Lingling, Davis, Lim, 2020).

Another recent trend has been that major investment indices have increased the presence of Chinese stocks and bonds. In April 2018, the value that individual Hong Kong and overseas investors can trade in Chinese securities through Hong Kong was significantly increased. This led to the inclusion of A-shares in several benchmark MSCI and FTSE Russell indices in 2018-2020 (USCC, 2020: 265). Similarly, JP Morgan, FTSE and other index providers have increased the weighting of Chinese bonds on major bond market indices.

The increased financial flows and regulatory approvals have coincided with loose central bank policies elsewhere, pushing the bond yields that underpin global portfolio allocations to historic lows, ensuring that the yields on Chinese bonds are far higher than elsewhere.

For investors, riding the China-wave has seemed a no-brainer: China is increasingly profitable. It weathered the global pandemic better than most countries, it has some strong technology firms and its growth in the last ten years has been higher and more consistent than pretty much anywhere else (Ying, 2020).

Of course, many of these benefits may prove illusory. There are significant risks which some investors have not properly accounted for. Beijing's response to the 2008 Financial crash in China, which largely averted economic downturn, catalysed a credit boom and a spike in corporate and government debt (Magnus, 2018). The emergence of a huge 'shadow banking' industry is arguably the economy's Achilles heel. Kenneth Rogoff, a Professor of Public Policy at Harvard University said in 2018 that "China is the leading candidate for being at the centre of the next big financial crisis". (Gisiger, 2018)

The opaque political structure combined with the lack of free information flows and ad hoc state market intervention ensures that price signals are unreliable, and transparency is inhibited. July 2021 saw an assault on major players in China's private sector which caught investors by surprise. A number of academic tuition groups were informed that they could no longer make profit, raise capital or go public. This wiped out $16bn from the value of three of the sector's biggest companies in one day (Lockett, 2021b). As part of this, the government banned the use by education groups of a precarious legal structure called a variable interest entity, which underpins many other big US listings outside of education – sending investors into shock. Shortly afterwards, Tencent came under significant pressure when it was informed that it would be forced to end exclusive music licensing deals with record labels around the world (BBC, 2021). The pressure on Tencent sparked the widespread sell-off of Chinese tech stocks on 27 July 2021, with the value of Tencent falling the most in a decade. Tencent's shares shed 10 percent, while Alibaba's value dropped 7.7 per cent and Meituan's value dropped 17 per cent (Lockett, 2021c).[2]

But most international institutions in finance continue to consider the benefits to outweigh the potential pitfalls. These firms are acting as cheerleaders for China's gradual integration into global financial markets and have helped to spark a boom in investment in China.

Leading Wall Street figures like Stephen Schwarzman, Chief Executive of the top private equity firm Blackstone, and Larry Fink, Chairman and Chief Executive of Blackrock, one of the world's largest asset management firms, are increasingly important go-betweens for Beijing to the White House. British politicians like Lord Grimstone, who has held senior roles in Barclays, the City of London and the government, play a similar role in London (Pickard, 2015).

Blackrock's role is worth considering in greater depth. Their index-mirroring passive investment funds increasingly offer easy ways for fund managers to tap into China. "I continue to firmly believe China will be one of the biggest opportunities for BlackRock over the long term, both for asset managers and investors," Mr. Fink said in a March letter to shareholders, "despite the uncertainty and decoupling of global systems we're seeing today" (Lingling, Davis, Lim, 2020).

Blackrock played an important role in lobbying the index provider MSCI Inc to introduce and then increase the number of Chinese A-shares in the MSCI Emerging Market index Exchange Traded Fund (ETF). This index is now weighted so that nearly 40% of the index is made up of Chinese equities. Blackrock, Vanguard and other investment funds have built financial products which then passively track this index, helping funnel tens of billions of US Dollars into the Chinese stock market. In August 2021, Blackrock's research unit went further and argued that China was 'under-represented' in the portfolios of global investors and global benchmarks, that it should no longer be considered an emerging market, and recommended that investors boost their exposure to the country as much as three times (Johnson, 2021b).

(2)
A list of names and stock tickers for relevant Chinese firms can be found at Appendix 1.

Can rising investment into China be justified in the era of responsible investing?

Leading international financial institutions are driving the push for greater access to China and deeper financial flows. Few investors seem to be asking whether growing China portfolios should have a place in the era of Environmental, Social and Governance investing.

What is ESG investing?

Environmental, social and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments. Once considered relatively marginal, ESG is now very much in the mainstream. 2020 saw record sustainable fund sales (Mooney and Mathurin, 2021). By the end of the year, the total assets in sustainable funds hit a record of almost $1.7 trillion, which was a 50 per cent increase on the previous year, and ESG funds outperformed their competitors (Broadstock et al., 2021). Growing consciousness of the existential risk posed by climate change, the strong performance of ESG funds during the coronavirus pandemic, and the rising influence of socially aware millennial

By the end of 2020, the total assests in sustainable funds hit a record of almost

$1.7trillion,

50% **increase on previous year,** and ESG funds outperformed their competitors.

investors, all combine to ensure that there is growing pressure for firms to consider ESG criteria in their investment strategies and supply chains, and a growing acceptance that ESG is set to be a central part of the future of investing (Ruggie and Middleton, 2019).

Leading figures in finance are providing thought-leadership which is driving trends towards ESG. Mark Carney, the former Bank of England Governor and now the UN special envoy for climate action and finance, devoted his BBC Reith Lecture series to developing a new theory of value which incorporates environmental and social costs (Carney, 2020). Larry Fink, the head of Blackrock, in his 2021 letter to CEOs, underlined the centrality of ESG for the firms' future priorities. He wrote "I believe that the pandemic has presented such an existential crisis – such a stark reminder of our fragility – that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives" (Fink, 2021). Fink's letter underlined that the environment is not the only salient factor. Social factors – whether racial justice, human rights or wages – must be a priority.

There are a number of challenges which hinder the effectiveness of ESG investing. Notably, there is no standardised benchmark or set of standards for the calculation of ESG scores for individual companies, but rather a diverse array of different companies vying to set the standards. Each company combines a mixture of qualitative and quantitative research, complex algorithms to derive an ESG function, and some value judgments about the relative weighting of importance of issues to develop the ESG score for each firm (see e.g. MSCI, 2020). The joke goes that the best way to improve an ESG rating is to change your rating provider. SustainAbility reported that there were more than 600 ratings and rankings globally in 2018, and that will doubtless has grown since (Murray, 2021b).

The lack of shared common standards poses serious issues. Critics of ESG note that this opens up the opportunity for 'Greenwashing' – i.e. the practice of presenting a sustainable image without taking the corresponding action to develop genuinely environmentally friendly and socially conscious practices. This is particularly risky in contexts where the immediate profit motive and sustainability clash, an issue which is relevant when discussing investing in Chinese equities or firms complicit in human rights abuses.

Yet this is not to say that we should not take the trend towards ESG seriously. With major players in the industry staking considerable amounts of reputational capital on ESG trends combining with increasing urgency in discussions around Green Finance and Government initiatives like the new UK Sovereign Green Bond, there is genuinely a desire to move towards a more sustainable capitalism. The trillions invested into ESG funds in recent years is only set to increase.

There are steps being taken to rationalise and regulate the system. European leaders recently introduced the new Sustainable Finance Disclosure Regulation (SFDR) which introduces key transparency requirements to ensure that how financial products comply with sustainability requirements is publicly available and properly explained (BNP Paribas, 2021).

In addition to government action being implemented to ensure that there is transparency in ESG reporting, independent standard setters are working together towards a comprehensive ESG reporting system. Among various initiatives, 60 top companies agreed to work together to establish a common benchmark in January 2021 (Ward, 2021).

Firms currently argue that there is no conflict between their China portfolios and their ESG priorities. The Chief Executive Officer of Blackrock, the world's largest asset manager, Larry Fink, simultaneously poses as the pioneer of ESG and a champion for investment in China (Fink, 2021). HSBC touts its ESG credentials while pushing for greater access to China and justifying support for the National Security Law on the basis that China is 'too big to ignore'.

The status quo cannot be justified. Our analysis is that the deepening ties between China and Global Finance pose an array of ESG risks which are not yet adequately addressed. China is one of the greatest sources of carbon emissions in the world, its companies present a variety of social and governance risks because of poor auditing practices and the volatile domestic environment associated with operating under a totalitarian state, and gross human rights violations in Xinjiang province, Tibet, Hong Kong and elsewhere mean that certain equities should be considered 'sin stocks' to be avoided at all costs.

Is there a conflict between China investment strategies and ESG portfolios?

The remainder of the chapter is split into three parts, considering three areas where China's ESG record is not yet adequately considered by investors:

1. **Gross Human Rights Violations**
2. **National Security Risks**
3. **Environmental Hazard**

ESG risk 1:
Complicity in human rights violations

The first area where there are considerable hazards for those seeking to invest responsibly in China is the area of human rights. The evidence is mounting about human rights violations in China. The closure of Apple Daily, the mass arrests of the democratic movement, and the passage of the National Security Law combine to form the greatest ever blow to fundamental rights and freedoms in Hong Kong. Genocide, crimes against humanity and forced labour against the Uyghur people is a matter of grave concern. Add to this the desecration of cultural monuments in Tibet, the mass arrests of mainland human rights lawyers in China, and the development of one of the world's most technologically advanced surveillance states across the country, and one is left with a sense of the hazards posed for firms seeking to invest ethically.

The former UN High Commissioner for Human Rights, Zeid Ra'ad Al Hussein (2015), calls the UN Guiding Principles on Business and Human Rights 'the global authoritative standard, providing a blueprint for the steps all states and businesses should take to uphold human rights'. The UNGPs place a responsibility on businesses to protect human rights, which means at a minimum to avoid harming people's human rights through 'their own activities or through their business relationships and to address harms that do occur' (Ruggie and Middleton, 2019b). The majority of institutional investors are subscribed to these standards which lay an obligation for the 'S' in ESG not to be neglected, and for human rights due diligence to sit at the heart of business.

However, discussions about investing in China have generally failed to properly account for these considerations. The regulatory framework in international capitals has, until very recently, been inadequate to respond to the evolving human rights situation in China. Firms with vested interests in seeing China's markets open further have avoided paying proper attention to these questions.

Part of the reason that human rights in China has been neglected by investors is because of challenges associated with properly factoring human rights into ESG calculations. The social dimension in ESG is generally understood to be comparatively more difficult to quantify than environmental risks which can be calculated using big data. The result of this is that the 'S' in ESG can be wilfully neglected, even in supposedly ethical products. To see that this is the case, one only needs to look at JP Morgan's 'ESG' Emerging

Markets Bond Index. In July 2021, more than 34 per cent of the bonds in the ESG version JP Morgan EMBI index were issued by countries labelled "not free" by Freedom House. This is a greater weighting than those from "free" countries. The environment is properly considered, but social factors are underrepresented (Fletcher and Stubbington, 2021).

Similar reasoning underpins the significant presence of Chinese equities in many of the largest 'ESG' investment funds around the world. Products provided by financial services firms including JP Morgan (2021b, 2021c), Vanguard (2021), Goldman Sachs (2021), Schroders (2021b), and Blackrock (2021b) all sell ESG products dominated by Chinese companies:

- **Over 30 percent of Blackrock's iShares MSCI EM ESG Enhanced UCITS ETF is allocated to Chinese equities. Alibaba and Tencent are the 2nd and 3rd holding.**
- **JP Morgan's Global Emerging Markets Research Enhanced Index Equity (ESG) UCITS ETF tells a similar story, with China making up over thirty five percent of the fund's weighting and Alibaba and Tencent accounting for a combined eight percent of the total fund.**
- **Goldman Sachs Emerging Markets Equity ESG Portfolio R Acc finds over forty-five percent of equities in emerging Asian countries and Alibaba and Tencent accounting for over ten percent of the total fund.**
- **Similarly, Vanguard ESG Emerging Markets All Cap Equity Index has fifty-eight percent of its fund weighted in emerging Asian countries and Alibaba and Tencent make up well over ten percent of the total fund.**
- **Schroders Emerging Markets Sustainable Fund - Wholesale Class also has over thirty-three percent of its fund weighted in China, with Alibaba its fourth largest holding.**

The lack of strong data, combined with the subjective nature of much of the weighting, allows for a fuzziness or noisiness which means that businesses like HSBC and Blackrock can pose as ESG leaders while simultaneously deepening ties with Chinese government entities responsible for the crackdown in Hong Kong or elsewhere.

There is a growing body of evidence about firms which are complicit in the most egregious human rights violations in China against the Uyghur people. Reports by think tanks like ASPI (2020) show that many mainstream Chinese firms, particularly the technology giants, have been involved in either the creation of the Xinjiang surveillance state, the creation of the prison camps or the use of forced labour.

Firms which have problematic records include, but are not limited to, major technology giants such as Bytedance, Tencent, Alibaba, Hikvision, Huawei, Dahua, Megvii, China Unicom, Cloudwalk, China Mobile, among others. Many of these firms receive significant investment despite this, as the following case studies prove.

Case Study: The complicity of private tech firms with human rights violations

Why Alibaba and Tencent are problematic

The growth in the presence of China's weighting on global indices has particularly benefited certain firms which have a substantial presence on global emerging markets indices and investment funds which track China. Notable beneficiaries include private technology firms such as Alibaba and Tencent.

These firms particularly benefit because they are heavily weighted in international indices.

- **Alibaba is the stock with the second heaviest weighting on the MSCI Emerging Markets Index and has the third heaviest weighting in the FTSE Russell Emerging Markets Index.**
- **Tencent is the stock with the third heaviest weighting on MSCI Emerging Markets and second heaviest weighting in the FTSE Russell Emerging Markets Index.**

Both firms receive serious investment by any index-tracking exchange-traded fund which follow either of these indices, as well as pretty much every bespoke China fund whether they are provided by Baillie Gifford, Blackrock, Schroders, Allianz Global, Vanguard or others.[3]

Furthermore, the mark of approval given by global index providers ensures that pretty much every firm or pension provider that seeks exposure in Emerging Markets is likely to have holdings in Alibaba and Tencent. For example, 7.6% of the NEST Retirement Fund is held in the Northern Trust Emerging Markets Custom ESG Equity Index. Of this, 10.9% of the shares held by the fund are invested in either Alibaba or Tencent (Northern Trust, 2021).

But investments in Tencent and Alibaba may be problematic, as Chinese technology companies of their size cannot divorce themselves from the Chinese state which is increasingly using a mixture of surveillance and technology to oppress and target minorities within its borders.

Alongside Hikvision, Alibaba has produced facial recognition software that specifically targets Uyghurs and has helped construct the surveillance state

(3)
Links to funds found in references: Baillie Gifford, 2021; Blackrock, 2021; Schroders 2021.

and camps that over a million Uyghurs are currently detained in (Reuters, 2020b).

WeChat, owned by Tencent, has been accused by Human Rights Watch of censoring and putting its users under surveillance on behalf of the Chinese state. There have been numerous reports about people getting harassed, detained, or imprisoned for their private messages on WeChat. Uyghurs and Tibetans have been imprisoned for using WeChat to share religious materials (HRW, 2020).

A study by Citizen Lab in Canada showed that WeChat also surveils its users outside the PRC to build up the database it uses to censor PRC-registered accounts (Yang, 2020). In January 2021, a group of plaintiffs in California announced that they were taking Tencent to court alleging that the company's WeChat mobile app has censored and surveilled them and shared their data with Chinese authorities (Whalen, 2021).

The International Consortium of Investigative Journalists has found that WeChat had been hacked by authorities and used in Xinjiang to compile an intricate database to arrest Uyghurs. Uyghurs outside of China report that in attempts to call their relatives through WeChat they have been warned that their phones are compromised (Alecci, 2019).

Both companies have previously found themselves the focus of allegations of employment advertisements that discriminate against women. In 2018, Human Rights Watch found that Alibaba and Tencent had posted job advertisements boasting that there are "beautiful girls" or "goddesses" working for their companies. The human rights group noted that Alibaba's recruitment social media channel had posted a series of photos of several young female employees and described them as "late night benefits" (HRW, 2018).

Tencent's development of facial recognition software for its games (Hollister, 2021) and Alibaba's social credit score system (Sesame Credit) has led human rights groups to question the involvement and use of this technology in the Chinese Communist Party's state desire for a nation-wide surveillance and social credit system (Mitchell and Diamond, 2018). While Alibaba's social credit score remains voluntary and separate from government-run social credit systems, it is not hard to imagine private and public social credit scores being merged at a later date (Merics, 2021).

The requirement by the Chinese Government for large technology companies to protect and expand state security as part of China's cybersecurity laws have raised concerns about the independence of both Alibaba and Tencent (Abkowitz, 2021). This has led parliamentarians and governments to oppose investments made by the companies abroad which they claim may be used by the Chinese Communist Party to expand its spy network (Lau, 2021; Lynch and Gramer, 2020).

Sadly, these fears are not assuaged by the behaviour of the executives of Alibaba and Tencent. In an interview in June 2021, Alibaba co-founder and vice chairman Joe Tsai, threw his full weight behind the National Security Law and crackdown in Hong Kong, saying 'overall, since they instituted the national security law, everything is now stabilized.' (Lahiri, 2021)

The founder and CEO of Tencent, Pony Ma, has been a delegate to the National People's Congress since 2013, submitting a slew of proposals to regulate the internet, and even spoke at this year's session (Deng and Shen, 2021). There continues to be a significant amount of speculation about the extent of party membership within the Chinese tech community itself. In 2017, the CCP praised 11 individuals in Tencent's party branch, noting them as all company executives or heads of major business departments. The same article estimated that around 23 percent of staff at Tencent in 2017 were party members (Everington, 2020).

Whether it is the complicity of these big technology companies in the ongoing persecution and enslavement of the Uyghurs, the operation of China's surveillance state, or the lack of clear independent structures between their executives and the Chinese Communist Party state, there remain substantial reasons why Western fund managers should be cautious about investing in Alibaba or Tencent.

Dahua technology

Dahua Technology, headquartered in Hangzhou, Zhejiang Province, is one of China's largest artificial intelligence companies. As of 2019, it occupied the second largest share of the global video surveillance equipment and service market, with an annual revenue of US$3.7 billion. The company has 16,000 employees.

The company has been heavily involved in helping construct the surveillance infrastructure and camps that over a million Uyghurs are currently incarcerated in. Leaked screenshots of Dahua platforms and codes have found a user guide for a service targeted at Chinese law enforcement clients which can send a warning when its cameras detect someone it identifies of Uyghur ethnicity, as a well as a consumer-facing camera which offers to sort individuals by race (Bhuiyan, 2021).

Dahua has also been accused of being one of several companies participating in trials that use AI and facial recognition software to detect the emotion of Uyghurs. These cameras are alleged to have been installed in police stations in Xinjiang (Wakefield, 2021).

In March 2021, the Federal Communications Commission in the USA warned that Dahua's telecommunications equipment and services have been found to pose an unacceptable risk to U.S. national security or the security and safety of U.S. persons (Griffin, 2021). In October 2019, the company was added to a US entities list barring investment and in June 2021 it was added to a US sanctions list (Swanson and Mozur, 2019).

iFlytek

iFlytek is one of the largest voice technology companies in the world valued on the Shenzhen Stock Exchange at $10.8 billion. iFlytek's technology is integrated into WeChat allowing users to send around 6 billion voice texts in a day according to 2017 figures.

According to the company's annual report in 2019, around 60 percent of its profits come from "projects involving government subsidies." These include an "intelligent criminal investigation assistant system," as well as big data support for the Shanghai city government (Hvistendahl, 2020). In 2020, iFlytek revealed that it had received 1.4 million yuan in subsidies from the Chinese Government (Kawase, 2020).

As with other technology companies of its size, the chairman of iFlytek, Liu Qingfeng, is a delegate to China's National People's Congress. Speaking at last year's party gathering, the Chairman called for AI to be used to raise China out of poverty (Dai, 2020).

US academics have cited iFlytek as one of the companies at the heart of China's military-civil fusion strategy, citing evidence that the company has actively promoted its products to the People's Liberation Army (Hvistendahl, 2020). iFlytek also jointly runs a speech and language research laboratory with Xinjiang University (Fritz, 2021).

In 2017, Human Rights Watch reported that iFlytek has been working with the Ministry of Public Security to build a national voice pattern database. The ministry chose Anhui province where iFlytek is headquartered, as one of the pilot locations (HRW, 2017).

A subsidiary of iFlytek was reportedly contracted in 2016 by the police force in Kashgar to purchase 25 voiceprint terminals.

According to the procurement agreement, the technology would be used to collect speech samples for biometric dossiers that also include photos, fingerprints, and DNA samples.

In the same year, iFlytek signed a strategic cooperation agreement with the agency that operates the camps in Xinjiang where over a million Uyghurs are currently incarcerated. It is unclear exactly how iFlytek's technology is used in this context, but a post on Sohu, a Chinese platform, stated that iFlytek's work would "ensure the security and stability of prisons (Hvistendahl, 2020).

It has been reported that Uyghurs in Xinjiang are required to regularly provide voice recordings alongside with DNA, biometrics, and fingerprints at police check-points, where they use iFlytek's software (Byler, 2019).

In March 2020, the Massachusetts Institute of Technology broke off a relationship with Chinese voice recognition firm iFlytek after adopting tighter guidelines on partnerships (Murgia and Shepherd, 2019). This followed an announcement by the US Government that it would place the company on an entities list banning investment (CSIS, 2019).

Hikvision

Human Rights Watch has found that Hikvision is one of the principal Chinese companies involved in the construction of China's surveillance state and the camps that house over a million Uyghurs in Xinjiang (Buckley and Mozur, 2019).

Founded in 2001, Hikvision has been a supplier to hundreds of government-led surveillance projects in major cities including Shanghai, Hangzhou and Urumqi providing facial recognition cameras and biometric software. Around 42 per cent of the company is controlled by Chinese state-owned enterprises, with China Electronics Technology HIK Group owning 39.6 per cent of the company as the biggest shareholder (Deng, 2019).

In the first half of 2020, Hikvision received 1 billion RMB worth of Chinese government subsidies following US sanctions (Kawase, 2020).

Hikvision's complicity in human rights abuses in Xinjiang is particularly problematic. In 2017, Hikvision entered into five public-private partnerships with the authorities in Xinjiang, worth a combined total of approximately CNY 1.86 billion. The projects involve the production, installation, operation and maintenance of surveillance systems. The company confirmed the projects in its half-year report for 2019, which it has committed to operate and maintain for a period ranging from 11-21 years.

The Financial Times reported in 2018 that Hikvision's facial recognition cameras were to be placed at 967 mosques in Xinjiang (Feng, 2018). Reuters news agency also recently revealed that Hikvision has registered patents for facial recognition cameras that 'can detect, track, and monitor Uyghurs' going as far back as 2017 (Asher-Schapiro, 2021).

The Norway Council of Ethics has described Hikvision's involvement in human rights violations taking place in Xinjiang as "ongoing", with the company refusing to release any information on what it is doing to avoid involvement in ongoing human rights abuse against the Uyghurs.

In 2019, the US Government blacklisted Hikvision from the USA alongside a number of Chinese companies complicit in the persecution and human rights violations against the Uyghurs. A year later, Hikvision was put on a US entities list which bans US investment in the company.

On 3 June 2021, President Biden expanded the US entities list to add a further 59 Chinese companies. The entities list specifically cites Hikvision as providing surveillance technology and defence and other related material to the PRC (Whitehouse, 2021). In April 2021, the European Parliament passed a motion to remove Hikvision surveillance software from its building, including Hikvision temperature screening.

ESG risk 2:
National security and foreign policy risks

Alongside human rights concerns, some Western investment in recent years runs directly counter to the stated foreign policy interests of democratic governments and national security. For example, some Western companies have directly funded Chinese companies that are destabilising the Southeast Asia region.

The Burma Campaign's 'Dirty List' shows that several Chinese companies which receive British, Canadian and European institutional investment are heavily involved in arming and funding the military in Myanmar, which has just launched a coup and is the process of an extremely violent crackdown on protests (Burma Campaign, 2021). This demonstrates clearly that some investment is indirectly funding companies that are destabilising the region and the foreign policy interests of countries which support Myanmar's transition toward a democracy.

Increased western investment has driven a substantial amount of China's economic growth in the last three decades. The Chinese Government in turn has used this growth to build up and expand its military and cyber capabilities. This expansion of the Chinese military is being used to threaten neighbours in the South China Sea, the security and freedom of Taiwan, to peddle fake news in Europe, and launch cyber-attacks against Western companies.

There is a more direct risk associated with China's strategy of military-civil fusion. This has been written about copiously (CFR, 2018; State, 2020; CNAS, 2021), but in short, civil-military fusion is the Chinese government's strategy to harness civilian enterprises, particularly dual-use technologies, for military ends. In the words of the Council for Foreign Relations:

> *"Since Xi Jinping ascended to power in 2012, civil-military fusion has been part of nearly every major strategic initiative, including Made in China 2025 and Next Generation Artificial Intelligence Plan. The goal is to bolster the country's innovation system for dual-use technologies in various key industries like aviation, aerospace, automation, and information technology through 'integrated development'."*

The result of this is that the provision of funding for Chinese firms in a number of key industries may be inadvertently funding the upgrading of the Chinese military. Questions ought to be asked by firms and governments about whether this is beneficial.

More broadly, entrenched financial links between international investors and Chinese state-owned enterprises, which are ultimately controlled by the Chinese Communist Party, risks the co-opting of economic elites. This is a key pillar of the Chinese Communist Party's United Front Work and is covered in Hong Kong Watch's report on Red Capital in Hong Kong.

In response to these risks, the United States Government have established a list of firms which are tied to the People's Liberation Army or gross human rights abuses, other governments should consider doing the same. (See Appendix 1 for the full list).

Recommendation:
Governments should designate an entities list of Chinese firms with ties to the People's Liberation Army, barring investment into these firms

Case Study: China's state-owned banks

China's state-owned banks are a serious beneficiary of institutional investment. The Chinese Construction Bank is one of the top 10 constituents of both the MSCI Emerging Markets Index and the FTSE Russell Emerging Markets Index.

Chinese state-owned banks are the largest bankroller of Chinese state-owned enterprises, which in turn have spent the last decade buying up a substantial amount of strategic infrastructure in the West, as well as being the largest lenders to the Belt and Road Initiative which has been accused of exploiting developing nations and being used as a tool for 'debt diplomacy'. These firms, in turn, fund Chinese-state owned enterprises like the China National Oil Corporation, China General Nuclear Power Group or Beijing Construction Engineering Group who are heavily invested in the UK's energy and construction sectors.

Table 2 - Selection of firms sanctioned by the United States Government

Chinese Company	SOE/ Private	US investment ban (Oct 2019)[4]	Trump sanctions list (Nov 2020)[5]	Biden sanctions list (Jun 2021)[6]	Evidence of human rights abuse	Links with the PLA
Hikvision	Private	●	●	●	●	
Dahua Technology	Private	●	●	●	●	
Iflytek	Private	●			●	
CNOCC	SOE			●		●
China Mobile	SOE		●	●		●
China Unicom	SOE			●		●
AVIC	SOE		●	●		●
China Communications Construction Co.	SOE		●	●		●
China Shipbuilding Industry Group	SOE		●	●		●
Inner Mongolia First Machinery Group Corporation	SOE			●		●
China Spacesat Co.	Private		●	●		●

(4) https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-22210.pdf
(5) https://home.treasury.gov/system/files/126/13959.pdf
(6) https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/03/fact-sheet-executive-order-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/

ESG risk 3:
Environmental Hazard

Firms deepening their ties with the Chinese government must consider the environmental costs of Government policies.

China generates the largest CO2 emissions in the world (Paterson, 2021; Our World in Data, 2021). While only accounting for 17% of GDP and 18% of the world's population, it produces 28% of the world's greenhouse gas emissions. China's CO2 emissions per dollar of GDP are running at about three times that of the EU.

There are two reasons for this: China's reliance on exports and coal. Some 60% of China's electricity is generated by burning coal. For every unit of energy China consumes, it is producing about 50% more carbon than the US or EU (Paterson, 2021).

Notably subsidies are contributing to the picture. Paterson (2021) notes that, in the context of the coal industry: "The Global Subsidy Initiative (GSI) estimates that the industry receives subsidies of USD 25 billion annually versus USD 17 billion of subsides for renewables. In aggregate, the GSI estimates China's subsidies for fossil fuels are running at about USD 100 billion a year. These subsidies of course encourage the use of fossil fuels and negate some of the need for efficiency improvements. China is also sponsoring new coal-fired power stations in developing nations under its Belt and Road Initiative."

The policies leave Chinese exports vulnerable to an array of carbon taxes and other policy shifts as the West transitions towards a green economy. Have those investing in the Chinese economy considered these potential political changes closer to home? Furthermore, firms looking to invest in the Chinese economy should consider the role of state subsidies in the fossil fuel industry as they make their ESG calculations.

Recommendation:
Investors should consider the extent of Chinese government fossil fuel subsidies when calculating ESG metrics

Case Study: SINOPEC

China Petroleum & Chemical Corporation, or Sinopec, is the largest oil and gas refining company in the world. As with state-owned Chinese companies of its size, Sinopec has close links with the Chinese military and state, developing body armour for the Chinese military and is a supervising agency of the Beijing University of Chemical Technology, which ASPI has designated as high risk for its high proportion of defence research (Army Recognition, 2019; ASPI, 2021).

Sinopec has narrowly avoided being placed on the US sanctions list for its involvement in the development of artificial islands in the South China Sea in violation of international law, after it was found that the company had filling stations on the islands but has not yet participated in offshore drilling (Reuters, 2015).

In its annual report for 2020, Sinopec's Chairman Zhang Yuzhuo claimed that 'Sinopec Corp. is firmly committed to low-carbon, green, safe, responsible and sustainable development. We are committed to better integrating environmental, social and governance (ESG) considerations into our operations and development strategy.' (Sinopec, 2020) Yet, the company continues to mine thermal coal, Greenpeace has accused it of burning and dumping unwanted natural gas into the North Sea, and the indigenous community of Ecuador is currently taking Sinopec to court for its drilling and destruction of national parks (Sausmikat and Ganswindt, 2021; Carter, 2021; Long, 2019).

In March 2021, Sinopec announced that it had found abundant flows of natural gas and crude oil in the Uyghur region in Xinjiang, where over a million Uyghurs are currently incarcerated, stating that it would be one of its key drilling basins in 2021-25. This falls in direct contravention to a recent warning by the International Energy Agency that any new oil, coal, or natural gas investments risk the chance of the world meeting its 2050 carbon neutral target (Sausmikat and Ganswindt, 2021). Investors must monitor whether Uyghur forced labour is used in the mining of these resources.

Between January and September 2019, the firm received $450 million in government fossil fuel subsidies (Kawakami, 2019).

This firm is embedded deeply into many international funds, and receives considerable pension fund investment.

Chapter Summary

The growing ties between China and international finance deserve greater scrutiny and are very difficult to square with the drive for environmental, social and governance factors to be at the heart of investment strategies.

Human rights, as part of the 'S' of ESG are too often ignored. This is particularly seen in China where firms with troubling ties to gross human rights abuses in Xinjiang and elsewhere are prominently featured in China funds including ESG funds.

There has also been insufficient discussion of the potential moral hazard associated with investing in Chinese state-backed banks which bankroll state-owned enterprises, including those developing military technology for the People's Liberation Army. The Chinese government's disappointing record on the environment should also more seriously factor into ESG metrics.

Chapter 2

Global pension funds and sovereign wealth funds with considerable exposure to China

To this point, we have focused on the nature of ESG risks for firms investing in China. We now turn to a deeper consideration of the extent of global investment in China. In preparing this report, Hong Kong Watch examined the Chinese equities held by a range of global pension funds and sovereign wealth funds around the world. Some of these track indices like MSCI Emerging Markets, others take a more active investment fund strategy. This chapter lays out a range of case-studies. It is a representative sample set but is far from comprehensive. Readers may be surprised by the depth of Western institutional investment in Chinese equities and will notice a consistent theme: that certain Chinese tech firms, oil conglomerates and state-owned banks are the major beneficiaries.

United Kingdom

Case Study: UK Parliamentary Pension provider

Parliamentary Contributory Pension Fund

Funds Invested in Alibaba

£0.9m

Funds Invested in Tencent

£2.3m

The British Parliamentary Contributory Pension Fund, whose trustees include the Chair of the All-Party Parliamentary Group on China Richard Graham MP, has some exposure to Emerging Markets equities. According to its 2018-2019 annual report, the fund had 5.6% of its assets invested in the Blackrock Emerging Markets fund. This comes to £39.3 million (Parliamentary Contributory Pension Fund, 2019; Blackrock, 2021).

Major Chinese firms are therefore considerable beneficiaries of this investment. In 2021, the Blackrock Emerging Markets fund had invested 6.03% or over £2,300,000 in Tencent, 2.31% or over

Case Study:
UK Parliamentary
Pension provider

£900,000 in Alibaba, 1.88% or £738,000 in the China Construction Bank, and 1.67% or £656,000 in Sinopec.

It is worth noting that prior to the US government blacklisting investment in certain firms, the Blackrock Emerging Markets fund had serious investments in major firms which have since been sanctioned (Blackrock, 2019). Examples include CNOOC, a state-owned oil company which the US Government claimed facilitated the Communist Party's aggressive push in the South China Sea. In 2019, we calculate that the Parliamentary Pension Fund will have held £730,000 in CNOOC, as it made up 1.86% of the Emerging Markets Funds' portfolio.

Case Study: The Universities Superannuation Scheme

UK Universities Superannuation Scheme

Funds Invested in Alibaba

£371.79m

Funds Invested in Tencent

£413.96m

The UK Universities Superannuation Scheme (USS) is the largest private pension scheme in the country in terms of assets, covering all university staff. The USS Pension Fund boasts a strong commitment to responsible and ethical investing, claiming that it integrates ESG considerations into its financial methodology. In its statement on responsible investing, the USS Pension Fund lists the ESG matters it routinely considers, including climate change, human rights, bribery and corruption risk, reputational risk, and the social impacts of corporate activity (USS, 2018).

USS Pension Fund is also a signatory to the UN backed Principles for Responsible Investment and the second principle of its 'Ten Principles of Stewardship' states that: 'Companies (it invests in) should manage environmental and social factors (such as climate change, pollution, and human capital) that could impact their business, both directly and via reputational damage, and seek to minimise negative externalities. Companies should comply with regulation and adopt voluntary best practices to promote sustainable business practices including the UN Sustainable Development Goals.' (USS, 2020)

Of all the global holdings (not only those in Emerging Markets) in the British Universities Superannuation Scheme, one of the largest pension funds in Britain, Tencent is the second largest stock and Alibaba is the fifth largest stock. Given that £25 billion is invested in publicly listed equities, this means that the fund is investing hundreds of millions of pounds into the two firms.

Case Study:
The Universities
Superannuation Scheme

Looking at USS Pension Fund's investments as of 31 March 2021, Hong Kong Watch found that it had invested:

- **£413.96m in Tencent and £371.79m in Alibaba.**
- **£103.90m in China Construction Bank and £75.44m in China Merchants Bank.**
- **£52.11m in China Petroleum and Chemical Corporation. (USS, 2021)**

Case Study: Legal and General

Legal and General

Legal and General is the largest pension fund manager in the UK and one of the largest asset management groups in Europe, holding over £1 trillion in assets. Legal and General has a number of significant pension funds under its management, including the UK Civil Service pension scheme (Legal and General, 2021a).

L&G states that it is committed to 'inclusive capitalism' with a sustainability strategy that incorporates all three elements of ESG practice. One of its key areas of focus is growing business responsibility, writing that 'we are committed to strong governance and to developing sustainable supply chains where climate change, environmental and human rights risks are managed transparently.' (Legal and General, 2021a)

The UK pension fund, in its human rights policy published in 2020, states that it supports the principles set out in the UN Guiding Principles on Business and Human Rights, International Bill of Human Rights, and the International Labour Organisation's (ILO) Core Conventions. L&G writes that 'we will not tolerate, or condone, abuse of human rights within any part of our business or value chains and we will take seriously any allegations of human rights abuses.' (Legal and General, 2020b)

An investigation by Hong Kong Watch found that L&G was investing in Chinese companies complicit in human rights violations and with links to the People's Liberation Army.

The investigation found that L&G's China fund was investing UK pensions in Zhejiang Dahua Technology, which has produced facial recognition software for the Chinese Government which detects the race of individuals and offers to alerts the police when it identifies Uyghurs.

Case Study:
Legal and General

Analysing the recent list of Chinese companies that the Biden Administration has placed on a US sanctions list restricting investment due to their links to the People's Liberation Army, Hong Kong Watch found that L&G was invested in eight Chinese companies on the US sanctions list. These included: China Shipbuilding Industry Co, China Avionics Systems Co, Fujian Torch Electron Technology Co, Guizhou Space Appliance Co, Jiangxi Hongdu Aviation Industry Co, Changsha Jingjia Microelectronics Co, China Aerospace Times Electronics Co and CSSC Offshore and Marine Engineering Group Co. (Legal and General, 2021b)

However, when approached about these findings the firm stated that it had divested from these stocks as a result of the new sanctions regime, showing that the decisions of fund managers are being shaped by the new geopolitical environment.

Australia and New Zealand

Case Study: Australia's Pension Funds and Investment funds

Australian Commonwealth Superannuation Scheme

Funds Invested in Alibaba

Aus$ 51m

Funds Invested in Tencent

Aus$ 71.5m

Australia's pension funds are the fifth largest in the world. The largest is the Government's Commonwealth Superannuation Scheme, which was created for the pensions of government employees. As with other global pension funds, Alibaba and Tencent are two of its largest holdings, accounting for Aus$51m and Aus$71.5m respectively (Commonwealth Superannuation Corporation, 2021).

A similar trend is found in other Australian pension funds with Alibaba being 10th and Tencent being 14th in Aware Super's international holdings (Aware Super, 2021) and Alibaba being 10th and Tencent 20th in Uni Super's international holdings (Uni Super, 2021).

Australian Super is the second largest pension fund in Australia, managing over Aus$130bn worth of assets and investments. Australian Super's statement on ESG and Stewardship says that 'ESG factors are considered before we make an investment and throughout the life of the investment, whether we're investing directly or through external managers.' (Australian Super, 2021a)

Case Study: Australia's Pension Funds and Investment funds

Looking at Australian Super's premixed investment balanced option which accounted for Aus$139,099,048,62 as of 31 December 2020, Hong Kong Watch found that Australian Super had invested:

- **Heavily in Alibaba and Tencent, Aus$563m and Aus$409m respectively.**
- **In Chinese state banks including: Aus$4.9m in Bank of China and Aus$9m in China Construction Bank.**
- **In Hikvision, the surveillance company complicit in the persecution of the Uyghurs which is on a US sanctions list – this included Aus$3.2m in 2020.**
- **In Iflytek Co, a voice recognition software company that has also been accused of partnering with the Chinese state to use its technology to target Uyghurs – this included Aus$1.2m in 2020. (Australian Super, 2021b)**

Australian Super Fund

(Balanced pre-mixed investment option)

Funds Invested in Alibaba

Aus$ 563m

Funds Invested in Tencent

Aus$ 409m

The Australia and New Zealand Banking Group (ANZ) is the second largest bank by assets and third largest bank by market capitalisation in Australia. ANZ claims that it is 'committed to responsible investing' and does not invest in companies across a range of industries that have breached global norms or standards to a severe degree, including severe abuses of human rights, labour rights, the environment or other ESG (environmental, social, and governance) issues.' (ANZ, 2021a)

ANZ offers its customers a range of investment funds ranging from differing levels of risk from Growth Fund, Balanced Growth Fund, Balanced Fund, Conservative Balanced Fund, and Conservative Fund. (ANZ, 2021b) Looking at the portfolio holdings of ANZ's investment funds, Hong Kong Watch found all of them included Alibaba, Tencent, China Mobile, China Telecommunications Corporation, and China Petroleum and Chemical Corporation in their holdings irrespective of the risk. (ANZ, 2021c)

Macquarie Group Limited is an Australian multinational independent investment bank and financial services company, with A$595 billion in assets under management. Macquarie states that it is committed to ESG within its structures and 'supports fundamental human rights as set out in the Universal Declaration of Human Rights and core International Labour Organisation Conventions and manages human rights-related issues through the risk management framework'. (Macquarie, 2021a)

Case Study:
Australia's Pension Funds and Investment funds

Looking at the Walter Scott Emerging Markets Fund Macquarie offers, Hong Kong Watch found that Tencent is its second largest holding (3.91% of the fund) and Alibaba is its fifth largest holding (3.58% of the fund). (Macquarie, 2021b)

Case Study: The New Zealand Superannuation Fund

New Zealand Superannuation Fund

Funds Invested in Alibaba

NZ$ 93,473,023

Funds Invested in Tencent

NZ$ 87,957,441

The New Zealand Superannuation Fund is New Zealand's sovereign wealth fund. Founded in 2001, it has over NZ$59 billion under management. The fund states on its website that it 'must invest in a manner that does not damage New Zealand's reputation as a responsible member of the world community.' The New Zealand Supernation Fund points out that it one of the first investors to sign the United Nations Principles of Responsible Investment (NZ Super Fund, 2021a).

As with other funds, New Zealand Superannuation Fund states that 'we actively manage the long-term risks and opportunities that environmental, social and governance issues present to the Fund. In line with our mandate of best practice portfolio management, we are also committed to global best practice and domestic leadership in responsible investment.'

Looking at New Zealand Superannuation Fund as of 18 August 2020, Hong Kong Watch found that New Zealand Superannuation Fund (NZ Super Fund, 2021b) had invested:

- **In 14 Chinese companies on the US sanctions list for complicity in gross human rights violations or with links to the People's Liberation Army. This includes:**

Funds invested in		
Avic Xi'an Aircraft Industry Group Co	NZ$	250,933
China Aerospace Times Electronics Co	NZ$	15,568
China Avionics Systems Co	NZ$	79,667
China Communications Construction Co	NZ$	472,202
China Mobile	NZ$	7,151,619
China Railway Construction Corp	NZ$	413,905
China Spacesat Co	NZ$	145,848
China Telecom Corp	NZ$	734,796
China Unicom Hong Kong	NZ$	717,386
China United Network Communications	NZ$	219,492
Hangzhou Hikvision Digital Technology Co	NZ$	961,223
Inner Mongolia First Machinery Group Co	NZ$	17,819
Semiconductor Manufacturing International Corp	NZ$	2,306,284
Zhejiang Dahua Technology Co	NZ$	219,670

Case Study:
The New Zealand
Superannuation Fund

- **In Chinese surveillance companies complicit in gross human rights violations against the Uyghurs, including NZ$961,223 in Hangzhou Hikvision Digital Technology Co, NZ$219,670 in Zhejiang Dahua Technology Co, and NZ$229,702 in iFlytek.**
- **In Chinese state banks, including NZ$5,871,296 in Bank of China, NZ$2,405,389 in Agricultural Bank of China, NZ$15,348,971 in China Construction Bank Corp, NZ$1,363,081 in Bank of Communications Co, and NZ$8,666,423 in Industrial & Commercial Bank of China.**
- **In large technology companies with problematic human rights records, including NZ$93,473,023 in Alibaba and NZ$87,957,441 in Tencent.**

United States

Case Study: The Teachers Insurance and Annuity Association of America-College Retirement Equities Fund

The Teachers Insurance and Annuity Association of America-College Retirement Equities Fund

Funds Invested in Alibaba

US$ 84.9m

Funds Invested in Tencent

US$ 51m

The Teachers Insurance and Annuity Association of America-College Retirement Equities Fund (TIAA) is the leading pension provider for staff in US academic, research, medical, cultural and governmental fields. TIAA serves over 5 million active and retired employees participating at more than 15,000 institutions and had $1.3 trillion in combined assets under management with holdings in more than 50 countries in December 2020 (TIAA, 2021a).

TIAA claims that it has a 'leadership position in responsible investing' claiming that it 'integrates Environmental, Social, and Governance factors into our investment process using ESG data, research and tools.' (TIAA, 2021b)

Looking at the holdings of the TIAA-CREF Emerging Markets Equity Fund as of 31 July 2021, Hong Kong Watch found that TIAA (2021c) had:

- **$84.9m invested in Alibaba and over $50m invested in Tencent, as well as $61m in Baidu.**

Case Study: Vanguard Institutional Target Retirement Funds for US Colleges

Vanguard Institutional Target Retirement Funds for US Colleges

Funds Invested in Alibaba

US$ 4.4bn

Funds Invested in Tencent

US$ 4.6bn

Vanguard manages academic and staff retirement funds for a number of elite US Colleges worth billions of dollars, including the likes of Princeton (2020) and Colombia (2021). These institutional retirement funds mature at different dates depending on the cohort.

As with other investment funds, Vanguard on its website states that it believes "good corporate governance is key to helping these companies maximize returns over time, and we view effective management of environmental and social risks as an integrated component of good corporate governance practices.' (Vanguard, 2021a)

Vanguard boasts that it has a 'formal procedure to identify and monitor portfolio companies whose direct involvement in crimes against humanity or patterns of egregious abuses of human rights would warrant engagement or potential divestment.'

Hong Kong Watch analysed the allocation of Vanguard's Institutional Target Retirement Funds as of 31 July 2021 (Vanguard, 2021b). The allocation to Vanguard's Total International Stock Index Fund varied depending on the retirement date of pensioners. For those retiring in 2025, it made up twenty-two percent of the fund; for those retiring in 2030, it made up over twenty-five percent; and the allocation to the fund incrementally rises for those retiring later. Those planning to retire in 2065 who are invested with the Vanguard Institutional Retirement 2065 Fund will have 35% of their pension invested in the International Stock Index Fund.

Vanguard's Total International Stock Index Fund holdings (Vanguard, 2021c) as of 31 July 2021 included:

- **$4.6bn invested in Tencent and $4.4bn in Alibaba, as well as $569m in Baidu.**
- **$7.6m invested in Dahua technology and $17.3m in Iflytek two companies directly involved in the persecution of the Uyghurs.**
- **Nearly $2 billion invested in China's top four state run banks, including $364m in the Bank of China, $183m in the Agricultural Bank of China, $602m in the Industrial and Commercial Bank of China, and $834m in China Construction Bank.**

Case Study:
Vanguard Institutional
Target Retirement Funds
for US Colleges

- $134m invested in China Petroleum and Chemical Corp.
- $23m in AVIC China, $15m China United Network Communications, and $1m in CNOOC which alongside Dahua technology makes four companies on the US sanctions list.

Scandinavia

Case Study: The Norwegian Sovereign Wealth Fund

Norwegian Sovereign Wealth Fund

Funds Invested in Alibaba

NZ$ 93,473,023

Funds Invested in Tencent

NZ$ 87,957,441

Norway's Sovereign Wealth Fund, better known as the Government Pension Fund Global, is the largest in the world with nearly nine trillion pounds under management and 11,235 investments in 72 countries (Norwegian Sovereign Wealth Fund, 2021a).

Set up after Norway found oil in the 1969, the fund invests revenue from Norway's oil and gas industry in equities, fixed income and real estate. The fund owns 1.5 percent of all shares in the world's listed companies (Norwegian Sovereign Wealth Fund, 2021b).

The fund is overseen by a Council on Ethics appointed by Norway's Ministry of Finance, which has a set of guidelines to assess its investments and ensure they are consistent with ethics (GPFG, 2021a). These guidelines state that companies can be put under observation or excluded if there is an unacceptable risk that the company contributes to or is responsible for:

(a) serious or systematic human rights violations, such as murder, torture, deprivation of liberty, forced labour and the worst forms of child labour;

(b) serious violations of the rights of individuals in situations of war or conflict;

(c) severe environmental damage;

(d) acts or omissions that on an aggregate company level lead to unacceptable greenhouse gas emissions;

(e) gross corruption;

(f) other particularly serious violations of fundamental ethical norms.' (GPFG, 2021b)

Case Study: The Norwegian Sovereign Wealth Fund

However, looking at the Government Pension Fund Global accounts in 2020, which detailed its global holdings, Hong Kong Watch found the fund had:

- Invested heavily in problematic Chinese technology companies including: US$6.7bn in Alibaba, US$ 5.9bn in Tencent, and US$759m in Baidu.
- Invested heavily in the Chinese Petroleum and Chemical Corporation or better known as Sinopec and its subsidiaries, this includes US$205m in 2020.
- Invested heavily in Chinese state banks including: US$261m in Bank of China, US$134m in Agricultural Bank of China, US$1bn in China Construction Bank, US$775m in the Industrial and Commercial Bank of China, and US$51m in the Bank of Communications.
- Invested in three companies on the US sanctions list, including: US$371m in China Mobile, US$42m in China Unicom Hong Kong, and US$92m in Semiconductor Manufacturing International Corp. (Norwegian Sovereign Wealth Fund, 2021a)

Case Study: Alibaba and Tencent in Nordic Pension funds

ABP (Denmark)

Funds Invested in Alibaba

EUR€ 2.2bn

Funds Invested in Tencent

EUR€ 2.6bn

ABP is one of Denmark's largest pension providers, which claims that it regards 'corporate respect for human rights not only as a prerequisite for all our investments, but also as the precondition for these transitions to progress justly.'

Hong Kong Watch found that ABP (ABP, 2021) on 31 March 2021, had invested:

- **2.6bn euros in Tencent.**
- **2.2bn euros in Alibaba.**
- **67m euros in Sinopec.**

Alecta (Sweden)

Funds Invested in Alibaba

US$ 518m

Funds Invested in Tencent

US$ 112m

Alecta manages occupational pension plans for 2.6 million people and 35,000 businesses across Sweden. Alecta's ESG statement claims that the pension fund expects 'companies that we invest in to comply with the international conventions and agreements that the Swedish government has signed. Among these are conventions on environment, human rights, labour rights, anti-corruption and against controversial weapons, as well as initiatives such as the UN Global Compact and the OECD Guidelines for Multinational Enterprises.' (Alecta, 2020)

Hong Kong Watch found that Alecta (Fintel, 2021) on 22 April 2021, had invested:

- **US$518m in Alibaba.**
- **US$112m in Tencent.**

Canada

Case Study: Alibaba and Tencent in Nordic Pension funds

Canada Pension Plan Investment Board

Funds Invested in Alibaba

Can$ 2.787bn

Funds Invested in Tencent

Can$ 4.389bn

The Canada Pension Plan Investment Board (CPPIB) is the largest pension fund in Canada, managing over C$475 billion in assets on behalf of 20 million Canadians. According to CPPIB's investment principles, the fund integrates 'ESG factors into our investment analysis and asset management activities because we believe it supports generating better returns across our portfolio' (CPPIB, 2020a).

Funds like the CPPIB have been investing in China for over a decade, slowly increasing their exposure to the world's second largest economy. For instance, the CPPIB's first international office was opened in Hong Kong in 2008.

While the primary investment destination for Canadian pension funds remains the United States, the rise of Asia's economies and the changing global economic balance invariably has Canadian organizations looking to diversify. As of March 2019, the CPPIB had C$103.7 billion or 26.5 percent of its total fund invested in the Asia Pacific region. Chief among these markets is China, where the CPPIB has invested C$28 billion in mainland China and C$42 billion in Hong Kong over the past decade (True North Far East, 2019).

Hong Kong Watch found that in 2020, CPPIB (2020b) had invested:

- **C$156m in four Chinese companies on the US PLA entities list, including C$15m in the China Communications Construction Company, C$65m in China Mobile, C$19m in China United Network Communications, and C$57m in China National Offshore Oil Corp.**
- **C$776m of Canadian pensioners money invested in five Chinese state-owned banks, including the Agricultural Bank of China ($42m), Bank of China ($16m), Bank of Communications ($2m), China CITIC Bank Corp ($3m), and Postal Savings Bank of China Co Ltd ($713m).**
- **C$5.327bn invested in Alibaba and Tencent.**
- **In March 2021, CPPIB (2021) updated the list of its investments in China, Hong Kong Watch found that:**
    - *CPPIB continues to invest heavily in Alibaba (C$2.787bn) and Tencent (C$4.398bn).*

Case Study:
Alibaba and Tencent in
Nordic Pension funds

- *CPPIB continues to invest in Chinese state banks, including the Bank of China (C$14m), China Construction Bank Corp (C$66m), Bank of Communications (C$2m).*
- *CPPIB continues to invest in companies on the US sanctions list, including China Shipbuilding Industry Group Power Co (C$3m).*

BCI (Canada)

Funds Invested in Alibaba and Tencent

Can$ 1.1bn

(Mar,2020)

The British Columbia Investment Management Corporation (BCI) manages C$171.3 billion of assets and is a leading provider of investment management services for British Columbia's public sector.

Outlining its investment beliefs, BCI states that its 'continued success depends on using our best judgement and making ethical decisions that are aligned with our core values of integrity, accountability, team cohesiveness and transparency'. When it comes to ESG, BCI claims that 'as a long-term investor, incorporating environmental, social, and governance (ESG) considerations into our approach is an essential part of who we are and what we do – and it's an integral part of how we meet our responsibility to grow the value of our clients' funds.'

Hong Kong Watch found that in March 2020, BCI (2020) had:

- **C$217.34m invested in 9 Chinese companies on the US PLA entities list. This included $2m invest in China Communication Construction Group Company, $104.64m China Mobile, $56.51m CNOOC ltd (China National Offshore Oil Corp), $1.43m China Railway Construction Corpt, $0.97m China state construction group, $2.73m China Telecommunications Corp, $2.29m China Unicom Hong Kong, $1.44m CRRC Corp, and $45.33m Hikvision.**
- **C$106.4m of Canadian pensioners' money in two Chinese state banks. China Construction Bank ($91.98m) and the Bank of China's Hong Kong holdings (C$14.42m).**
- **C$35.33m in Hikvision and C$7.30m in Dahua technology two companies directly involved in the persecution of the Uyghurs.**
- **C$1.1bn in Alibaba and Tencent.**

Caisse de dépôt et placement du Québec (CDPQ), is the second largest pension fund by size in Canada. CDPQ manages C$365.5 billion on behalf of 6 million investors. CDPQ in its Stewardship Investing Report reiterates its approach to integrate ESG considerations into its investment strategy. In a message from CDPQ's management they assert that in a year which 'saw citizens around the world stand up in support of social justice.

Case Study:
Alibaba and Tencent in
Nordic Pension funds

CDPQ (Canada)

Funds Invested in Alibaba

Can$ 938.6m

Funds Invested in Tencent

Can$ $666.9m

The echo of their voices is a strong signal that encourages us to continue and expand our efforts to promote equity, diversity and inclusion.' (CDPQ, 2020a)

Looking at CDPQ's annual report for 2020 (CDPQ, 2020b), Hong Kong Watch found that it had invested:

- **In 18 companies on the US sanctions list, including: AVIC Shenyang Aircraft Co, AVIC Xi'an Aircraft Industry Group Co, AVIC Jonhon Optronic Technology Co, China Aerospace Times Electronics Co, China Communications Construction Co, China Mobile, China National Nuclear Power Co, China Railway Construction Corp, China Spacesat Co, China Shipbuilding Industry Co, China Telecom Corp, China Unicom Hong Kong, China United Network Communications, CNOOC Ltd, CoStar Group Inc, Inner Mongolia First Machinery Group Co, Zhejiang Dahua Technology Co, and Semiconductor Manufacturing International Corp.**
- **In Tencent (C$666.9m) and in Alibaba (C$938.6m).**
- **In iFlytek which has been implicated in providing audio surveillance technology to persecute the Uyghurs in Xinjiang.**
- **In the Bank of China and the Agricultural Bank of China.**

The Ontario Teachers' Pension Plan Board manages C$194 billion and administers the defined-benefit pensions for school teachers of the Canadian province of Ontario. Ontario Teachers investment guidelines state that it considers ESG factors when making investment decisions.

Hong Kong Watch found that as of 31 December 2020, the Ontario Teachers' Pension Plan Board invested: C$943.9m in Alibaba and Tencent. (OTPP, 2020)

East Asia

Case Study: The National Pension Service of South Korea

National Pension Service of South Korea

Funds Invested in Alibaba

£ 8.8bn

Funds Invested in Tencent

£ 6.6bn

Public pension funds being invested heavily into Alibaba and Tencent is not a problem that is limited to 'Western' countries. The National Pension Service of South Korea, which claims to manage its pension fund in 'consideration of environmental, social and governance factors' , has Alibaba as its 6th and Tencent as its 10th largest holding. Investing £8.8 billion (KRW1.40 trillion) in Alibaba and £6.6 billion (KRW1.05 trillion) in Tencent as of the end of 2019. (National Pension Service, 2020).

Case Study: Japan's Government Pension Investment Fund

Japan Government Pension Investment Fund

Funds Invested in Alibaba

£ 2.57bn

Funds Invested in Tencent

£ 2.2bn

A similar story can be found when it comes to Japan's Government Pension Investment Fund, which notes in its investment principles that 'even if some portfolio companies are able to boost their share price by pursuing temporary profits at the expense of the environment and society, this could potentially have a devastating effect on the overall portfolio of a universal owner if other companies, the overall economy and society as a whole are negatively impacted'. Yet as of 31 March 2021, the fund had invested £2.57 billion in Alibaba (JPY391 billion) and £2.2 billion in Tencent (JPY348 billion), as well as £62 million (JYP9.5 billion) in China Petroleum and Chemical (Government Pension Investment Fund, 2021).

Table 3 - Selected institutional investment in Chinese equities

Latest public figures as of July 2021, unless otherwise stated

Institutional Investor	Funds Invested in Alibaba	Funds Invested in Tencent	Other key Chinese Equities
UK Parliamentary Contributory Pension Fund	£ 0.9m	£ 2.3m	China Construction Bank, Sinopec, CNOOC (Until 2019)
UK Universities Superannuation Scheme	£ 371.79m	£ 413.96m	China Construction Bank, Sinopec
Australian Commonwealth Supernation Scheme	Aus$51m	Aus$71.5m	
Australian Super Fund (Balanced pre-mixed investment option)	Aus$563m	Aus$409m	Bank of China (Aus$4.9m), China Construction Bank (Aus$9m), Hikvision (Aus$3.2m), Iflytek (Aus$1.2m), China Mobile (Aus$13.3m)
New Zealand Superannuation Fund	NZ$93.47m	NZ$87.95m	**14 entities sanctioned by US including:** AVIC (NZ$250,933), China Communications Construction Co. (NS$472,202), China Mobile (NZ$7,151,619), Hikvision (NZ$961,223), China Unicom (NZ$219,492), SMIC (NZ$2,306,284), Zhejiang Dahua Technology (NZ$219,670). **Others including:** iFlytek (NZ$229,702), Bank of China (NZ$5,871,296), China Construction Bank (NZ$15,384,971)
The Teachers Insurance and Annuity Association of America-College Retirement Equities Fund	US$84.9m	US$51m	Baidu (US$61m)
Vanguard Institutional Target Retirement Funds for US Colleges	US$84.9m	US$51m	Sinopec (US$134m), iFlytek (US$17.3m), China Construction Bank (USS$834m), sanctioned firms including AVIC China (US$23m), China United Network Communications (US$15m), CNOOC (US$1m) and Dahua Technology (US$7.6m)

Institutional Investor	Funds Invested in Alibaba	Funds Invested in Tencent	Other key Chinese Equities
Norwegian Sovereign Wealth Fund	USD$6.7bn	USD$5.9bn	Sinopec (US$205m), Baidu (US$759m), Bank of China (US$261m), China Construction Bank (US$1bn), China Mobile (US$371m), SMIC (US$92m), China Unicom (US$42m)
ABP (Denmark)	EUR€ 2.2bn	EUR€ 2.6bn	Sinopec (EUR€ 67m)
Alecta (Sweden)	US$ 518m	US$ 112m	
Canada Pension Plan Investment Board	Can$ 2.787bn	Can$ 4.389bn	Bank of China (C$14m), China Construction Bank (C$66m), China Shipbuilding Industry Group Power Co. (C$3m)
BCI (Canada)	Can$1.1bn in the two combined (Mar,2020)		**March 2020:** China Communication Construction Group (C$2m), CNOOC (C$56.1m), Hikvision (C$45.3m), China Mobile (C$104.6m), Zhejiang Dahua Tech (C$14.42m), China Construction bank (C$91.98m)
CDPQ (Canada)	Can$938.6m	Can$666.9m	**18 companies on the US sanctions list, including:** AVIC, CNOOC Ltd, CoStar Group Inc, Inner Mongolia First Machinery Group Co, Zhejiang Dahua Technology Co, and Semiconductor Manufacturing International Corp.
National Pension Service of South Korea	£ 8.8bn	£ 6.6bn	Sinopec (£62 million)
Japan Government Pension Investment Fund	£ 2.57bn	£ 2.2bn	Sinopec (£62 million)

Chapter 3

What now? Evaluating existing policy responses and recommendations for the Future

The scale of international investment into Chinese bonds and equities coupled with the likelihood that existing trends continue pose serious questions for international policy makers and fund managers. This chapter asks what an appropriate response would look like. Initially we consider historic policy responses, examining particularly attempts by the US to blacklist investment into certain firms. This policy provides a powerful example of what might be done, but also shows the limits to unilateral action by individual governments. We then consider how this sort of policy might be strengthened, arguing that two elements are needed: multilateralism in policy making and buy-in from international financial institutions.

Evaluating existing policy responses

Until very recently there was little to no effort to curtail capital flows from the West into Chinese firms or bonds. International financial institutions were curtailed by Beijing in their bid to invest greater sums in China and were the greatest advocates of greater opening up.

Changing geopolitics has finally turned to financial markets, but only meaningfully in the United States. In this chapter we consider the benefits of the US government's investment ban list on specific problematic companies, and ways the investment ban in its current form is comparatively ineffective.

The US Government's investment ban list

With increased acknowledgement of the importance of ESG factors in investing, and growing geopolitical tensions between the US and China, the US Congress and the White House have begun to consider ties between Wall Street and China in greater depth since 2020.

In the final weeks of his Presidency, President Trump started to show the United States' full financial arsenal. The President had listed a range of Chinese firms as contributing to the Chinese 'military-industrial' complex earlier in the year, but in November 2020, an executive order banned American investors from holding shares in the listed companies (Lockett, 2020). The ban came into effect on January 11, while investors with existing stakes in the targeted companies have until November 2021 to divest.

The aim of this order is to make it more difficult for money to flow into China from the United States. In June 2021, President Biden expanded the US investment ban list to include Chinese firms involved in the creation of the surveillance state in Xinjiang. 59 firms were included on the list, including Huawei, the Semiconductor Manufacturing International Corporation and the China General Nuclear Corporation.

Multiple index providers removed these firms from their mainstream indices. MSCI dropped sanctioned firms from its MSCI Emerging Markets and China All Shares benchmark indices (Carnevali and Platt, 2021), FTSE Russell similarly removed firms from its indices including the FTSE GEIS and the FTSE Global China A Inclusion indices, and associated indices (Reuters, 2021).

Certain fund managers have been forced to change their portfolios by these developments. Blackrock and Vanguard ETFs were forced to divest from these stocks, considerably reducing the amount of money held in these funds.

It was not only in the United States that this kind of response has taken place. As discussed above in the Legal and General case study, we found that until a few months ago, the UK's largest pension fund was invested in a Chinese surveillance company linked to Uyghur camps and eight companies with links to the PLA and on President Biden's sanctions list.

However, the firm divested from these stocks as a result of the new sanctions regime, showing that the decisions of fund managers are being shaped by the new geopolitical environment.

Limits to effectiveness: The need for multilateralism and broader inconsistencies

But a serious barrier to the effectiveness of policy responses like this are that other international capitals have failed to act in unity with the United States. Following the US blacklisting of Chinese companies, a number of the companies paradoxically surged in value (Johnson, 2021). Firms such as China Unicom, China Telecom, the Semiconductor Manufacturing International Corporation and China Mobile all found their share-prices increase following the investment ban.

The reason for this is that essentially the blacklisting forced a mass dumping of these stocks by American investors, but because the firms continue to have a positive profit forecast, a sound business model, and because other major markets have not acted in unison, outside investors have sought to capitalise on cheaper share prices and their value has not been materially influenced.

The Blackrock iShares FTSE China Index ETF lost its top spot as the largest fund tracking onshore Chinese stocks. Investors flooded to China Asset Management's CSI 300 Index ETF instead, which saw its assets surge following the sanctions. Since the sanctions were announced in November last year, the FTSE China A50 and CSI 300, the two most representative indexes of China's onshore A-share market, have risen 25.7% and 21.1% respectively, according to data from Bloomberg published in December. Indeed, most of the companies being sanctioned have little to no operations or business in the US, she says, while one of the more prominent blacklisted names – SMIC (Semiconductor Manufacturing International Corporation) – saw its share price rise by nearly 25% after the announcement (Funds Europe, 2021).

Certainly, some other Western investors will be warded off investment, but there remains a jarring disparity in policies in Europe and the United Kingdom, as well as other markets like Tokyo, when compared with the United States.

There are currently minimal regulations in place in the City of London to ward against problematic investment. The same is true elsewhere. But without multilateral action, the effectiveness of US policy is set to be limited.

Notably, although much of the foreign investment in Hikvision has tailed off since the US investment ban and the outrage about their activities in Xinjiang, the British fund manager Schroders' joint venture with a Chinese owned bank owns 1% of Hikvision (Market Screener, 2021).

As discussed above, the Norwegian Sovereign Wealth Fund, New Zealand pension funds and others hold a range of equities which US investors are no longer able to access.

Recommendation:
Global financial regulators and governments should act together to stop investment in problematic Chinese companies.

Furthermore, while problematic entities are being screened out from United States investment, these investment barriers are being more than offset by the rapid inclusion of Chinese Government Bonds in Global investment indices. While investment in Chinese state-backed military companies may be about to drop, investment in Chinese government debt is soaring.

HSBC's analysis (HSBC, 2021) of the inclusion of China into the FTSE World Government Bond Index said: "The next milestone on the indexation journey is China's upcoming inclusion in the FTSE World Government Bond Index (WGBI), which is expected to take place in November this year. It is a major event that HSBC estimates will lead to passive inflows into Chinese government bonds (CGBs) worth USD140 billion to USD150 billion over a 36-month inclusion process."

Simultaneously, China is receiving greater weighting on international stock indices. This means that Chinese firms like Alibaba, Tencent, Sinopec and China Construction Bank which are not covered by the investment ban list are receiving greater investment than ever before.

Western regulators and governments must increase the consistency of their approach to Chinese capital or else render their respective actions ineffective. It is vital that governments act together.

Problem 1: Hong Kong and other financial centres acting as hubs for the investment in problematic Chinese companies

Even with Western multilateralism, some hubs like Hong Kong are set to cause problems. One of the barriers to global enforcement of responsible investing standards when it comes to rights-based issues and investment is the fact that hubs like Hong Kong continue to allow, and sometimes even encourage, problematic investments and therefore undermine efforts by the United States to take action to stem investment flows into firms tied to the Chinese military or the gross human rights abuses in Xinjiang.

An example of the complex dynamic is found in the case study of State Street Global Advisors. In January 2021, State Street said they would need to comply with US sanctions, meaning that the Tracker Fund of Hong Kong (Tracker Fund, 2021), Hong Kong's largest ETF ($12 billion in assets) which tracks the local Hang Seng Index, would need to remove blacklisted entities including China Unicom, China Mobile and CNOOC.

This sparked an outcry from the Hong Kong Monetary Authority who threatened to remove State Street from holding rights to produce the Tracker Fund. State Street reversed their decision under pressure but remain under considerable pressure (Huang, 2021). CSOP Asset Management (Bloomberg, 2021) are reportedly vying to replace them, and the share of the Hang Seng Index which contains mainland Chinese entities is only increasing.

The Tracker Fund is influential because many of the Mandatory Provident Fund providers invest in it, and participating dealers include significant international financial institutions including Barclays, BNP Paribas, HSBC, Goldman Sachs, JP Morgan and Morgan Stanley. The conflicting demands of Chinese, Hong Kong, European and United States regulators will make life increasingly difficult for firms in these contexts, and also is likely to stall attempts to halt capital flows into problematic companies.

Hong Kong's policies are making life increasingly easy for those seeking to invest in firms with problematic backgrounds. Evidently this is a matter of government policy. As our report on Red Capital in Hong Kong (Hong Kong Watch, 2021a) underlines, the ties between the Hong Kong government and Chinese state-owned entities have grown exponentially in recent years, both in public procurement and investment terms (for instance through the MPF investments and the Hong Kong government Future Fund).

Hong Kong continues to provide multiple services which makes it easy to invest in firms like Hikvision, IFlytek, ZTE and others who are known to have been involved in the creation of the Xinjiang surveillance state or are currently under sanctions by the US government. The stock connect schemes gives investors easy access to invest in sanctioned firms listed in Shanghai or Shenzhen including:

- China Unicom
- China Railway Construction Corp
- China Shipbuilding Industry Corp
- China CCC
- Hikvision
- ZTE
- AVIC Aircraft
- IFlytek

17% of ZTE, a firm which has been under US sanctions in recent years, is held by people who have bought shares through the Hong Kong Stock Exchange (ZTE, 2021).

The different standards adopted by the Hong Kong government to these issues is not only influential when it comes to investment in Chinese equities, but extensive reporting also shows that lax regulation in Hong Kong has aided other problematic actors. A recent CNN report underlined that in the Hong Kong neighbourhood of Wan Chai there are front companies housing: "an alleged financier for Hezbollah, the Lebanese militant group; an individual accused of helping Iran acquire millions of dollars of military equipment in violation of US sanctions; a man accused of helping Venezuelan President Nicolas Maduro plunder his country's resources; and a company that allegedly opened a bank in North Korea in violation of United Nations Security Council resolutions. As if that wasn't enough, there's also an office tied to a powerful Southeast Asian militia and a casino mogul accused of trafficking drugs, wildlife and even humans." (Berlinger, 2020) Differing standards internationally and the easy flow of money complicates efforts to stall investment meaningfully in problematic groups.

Problem 2:
Corporate hypocrisy: the case of HSBC

A second central problem inhibiting the effectiveness of human rights-based investment policy is corporate hypocrisy. If you undertake a cursory browse of HSBC's website you find whole sections dedicated to the British-based bank's 'commitment to doing business responsibly'.

In HSBC's 2020 Annual Report, the bank states that 'we aim to act with courageous integrity in all we do. This guiding principle means having the courage to make decisions based on doing the right thing for customers and never compromising our ethical standards.' The bank points to its ethical code of conduct for staff, the use of big data and AI, and for suppliers of goods and services as further evidence of its commitment to do business responsibly (HSBC, 2020).

As with other banks and investment funds, HSBC is increasingly interested in promoting its commitment to environmental, social and governance (ESG) issues. This includes outlining a strategy to 'a net zero future', a breakdown of its staff by ethnicity, gender, geography, and disability, as well as a conduct framework. HSBC's conduct framework includes a commitment that 'the decisions we make deliver fair treatment of customers and do not disrupt market integrity' and that HSBC engages 'with regulatory bodies in a timely, open and transparent manner.'

HSBC's statement on human rights states that the bank is guided by the International Bill of Human Rights and supports the UN Declaration of Human Rights and the principles concerning fundamental rights set out in the International Labour Organisation's Declaration on Fundamental Principles and Rights at Work (HSBC, 2015).

The bank states that it is 'committed to respecting human rights' and that 'in countries where local legislation conflicts with certain human rights, HSBC strives to act in the spirit of these principles while respecting and adhering to local legislation.'

Despite HSBC's claims of acting with 'courageous integrity' in all that it does, the British-based bank has found itself at the forefront of increased criticism regarding its support of the ongoing crackdown of the pro-democracy movement in Hong Kong.

In June 2020 the Asia-Pacific chief executive of HSBC Peter Wong Tung-shun took the unusual step of publicly backing the introduction of the draconian National Security Law in Hong Kong. HSBC's support for the law was reiterated again by its British based executives when they gave evidence to the House of Commons Foreign Affairs Select Committee in January 2021.

Aside from offering Beijing public support for its crackdown, HSBC has been actively supporting its efforts through the freezing of individual pro-democracy activists' bank accounts and accounts linked to groups who have raised funds to cover legal fees.

In the case of the former pro-democracy lawmaker and activist Ted Hui, HSBC froze his bank account and the bank accounts of his family after he revealed that he had left Hong Kong to go into exile. The bank claims it did so under the direction of the Hong Kong Police, who accused Mr Hui of money laundering (Hong Kong Watch, 2021a).

This has become a common charge used by the Hong Kong Police to target pro-democracy voices, with HBSC also freezing the account of pastor Ray Chan and the Good Neighbour North District Church on the grounds of 'money laundering'. The pastor and his church were known as being supportive of the pro-democracy movement throughout the anti-extradition protests in 2019.

One might also question the bank's stated commitment to its customers in Hong Kong, particularly those who have sought to move to the UK and take up the BNO visa scheme. A number of Hong Kongers who have their Mandatory Provident Fund with HSBC have reported that they are unable to withdraw their pensions despite leaving the city.

In response to Beijing saying that it no longer recognises BNO passports, HSBC and other MPF providers have refused BNO visas as documentation and evidence that Hong Kongers have the right to reside out of the city. In HSBC's case, it told some BNOs that even when they gain British citizenship this may not be enough to allow them to access their pension funds (Hong Kong Watch, 2021c).

HSBC's efforts to ingratiate itself with the Chinese Communist Party appears to have failed to win plaudits in Beijing. Reuters news agency has reported that nine Chinese state-owned enterprises have ended or cut back their ties with the bank, citing displeasure from the Chinese Government over the bank's handling of its involvement in the US case against Huawei's former Chief Financial Officer and the bank's lack of support for the National Security Law (Chatterjee and Tham, 2021).

Chinese regulators in Shanghai last August fined HSBC and three senior HSBC executives, and in a rare move publicised their names. HSBC bankers have also reported that the Chinese Government has sought to freeze the bank out of bond issuances, stymying its access to retail customers and locking it out of pitches for syndicated loans – lending done by groups of banks.

All of this points to two issues: first, that however much Western firms kowtow to Beijing and abandon their commitments to human rights and ethical investing, they can still find themselves frozen out and on the wrong side of the one-party state. Additionally, HSBC's ongoing insistence that China is 'too big to ignore' despite these dynamics shows the extent to which international finance is committed to the status quo and the barriers that there will be to more responsible investing in China.

Conclusions and Ways Forward

The inconsistencies in regulations between global financial markets ensure that regulation by one or two international governments will not be sufficient to generate the type of behavioural change which is necessary. There are therefore two steps that are needed: multilateral regulatory action by governments on the one hand, and for firms to start to regulate themselves and develop more robust and rigorous ESG guidelines when assessing investment into China on the other hand.

If individual governments act to stem capital flows without investment firms buying into the rationale for these policies, the disparate regulations in global financial markets around the world will render international policy responses ineffective. It is therefore vital that there is a culture shift and that firms start to acknowledge the social and environmental risks associated with investing in China.

There are a number of steps that governments and investors can take to ensure they are not inadvertently funding the worst kinds of repression.

First, it is vital that regulators and investors come together to consider a common set of standards for investors considering the human rights impact of investments. Fortunately, as discussed above, there is a globally agreed compact which has already been agreed on this front, the United Nations (UN) Guiding Principles on Business and Human Rights (UNGPs). The UNGPs reporting framework has been developed by 90 of the world's leading institutional investors and provides the basis for the elaboration of a more robust model for calculating the 'S' in ESG. This framework is being used by firms like Arabesque to use big data to develop quantitative analysis of human rights impacts. Think tanks such as the Institute for Human Rights and Business have elaborated guides for investors on how best to put human rights at the heart of their investment strategy (IHRB, 2013).

In October 2020, the United Nations-supported Principles for Responsible Investment (PRI, 2020) released a new report, *Why and How Investors Should Act on Human Rights*. The report from the PRI, a global organization of over 3,000 signatories with more than $103 trillion in assets, highlights the growing demands of stakeholders – employees, beneficiaries, clients, governments and wider society – for investors to consider various human rights issues in their decision making. This places the UNGPs at the heart of the 'S' of ESG, and with many leading global investors co-signatories, potentially lays the groundwork in principle for an important shift. Their follow up report (PRI, 2021) should make essential reading on why investors can and should act to incorporate the UNGPs at the heart of their strategies.

Recommendation:
In 2021, the European Union is developing mandatory human rights due diligence regulations. This should refer to the UNGPs as the basis of engagement. Other countries and regulators should adopt similar regulatory regimes to ensure compliance worldwide.

Recommendation:
The UN Guiding Principles on Business and Human Rights reporting framework should be the foundation benchmark for regulators, governments, investors and other firms in determining how to assess whether a stock complies with international standards when it comes to human rights.

Yet there are China specific actions which firms must also consider. For firms complicit in the worst crimes in areas like Xinjiang, governments and investors ought to take strong actions in order that those firms do not benefit from their engagement with gross human rights violations. One key area that might be considered is government driven investment bans. For a more detailed analysis, Investors for Human Rights published an in-depth paper in 2020 with guidance for investors on avoiding complicity with gross human rights violations (Investors for Human Rights, 2020).

Recommendation:
Governments should designate which Chinese firms are complicit in crimes against humanity against the Uyghurs and apply financial sanctions, including investment bans on those firms.

There are limits to the effectiveness of government led investment ban lists (see chapter 3) if taken alone, and firms have obligations themselves to undertake proper human rights due diligence, screening out investment in firms which have built the Xinjiang surveillance state.

Governments should also consider barring the import of goods tied to forced labour and strengthening modern slavery legislation in order to ensure that Uyghur forced labour is not found in supply chains.

Recommendation:
Companies and investors must undertake a process of enhanced human rights due diligence when engaging with firms that could possibly be tied to repression in Xinjiang, screening out firms known to be complicit in Xinjiang.

Yet there are a range of human rights issues beyond the most egregious crimes which ought also to be factored into ESG considerations when it comes to investing in China. These include complicity in the crackdown on the mainland and in Hong Kong.

Recommendation:
Governments should bar the imports of goods where forced labour can reasonably be presumed to be in the supply chains.

Many firms have aided and abetted the Chinese government in their dismantling of Hong Kong's freedoms. Firms have boycotted pro-democracy news outlets, fired pro-democracy employees, or frozen the assets of legally elected lawmakers. This kind of behaviour is clearly aiding and abetting the crackdown in Hong Kong, and therefore should at the very least lead to a serious downgrading of how these firms are considered by ESG metrics.

Recommendation:
Firms should face serious ESG penalties, in terms of their weighting, if they are known to have:

1. fired employees on the basis of their political stance;
2. boycotted advertising with Apple Daily or other pro-democracy news-outlets on the basis of their political stance;
3. endorsed the crackdown on Hong Kong's protestors;
4. frozen the assets of pro-democracy activists

Recommendation:
Investors should use their leverage within these companies to call them to change their behaviour.

Recommendation:
If firms complicit in this crackdown on human rights are international, their governments should consider withholding privileges until they stop aiding and abetting the repression in Hong Kong.

One final question which is worth considering for investors more widely is whether it is more ethical to invest in some economies than others. Investors are used to the idea of abiding by national sanctions against certain countries which are particularly problematic. Investment in firms based in Iran, North Korea, or increasingly Myanmar is widely considered to be a no-go area on the basis of ethical implications and national security.

The current framework invites investors to split countries into two categories: those under sanction and those not under sanction. Yet ESG metrics provide the opportunity for firms to take a more nuanced approach. While firms in country under sanctions ought to be considered as a category of 'sin stock', the algorithms being developed as part of the ESG framework provides an opportunity to consider a new ranking system which ranks countries according to how well the investment environment facilitates compliance with environmental, social and governance priorities.

Recommendation:

Just as the Moody's or S&P ratings system acts to limit the potential credit rating of a companyg depending on which context the company is based within, a similar initiative ought to be considered when it comes to ESG.

Countries could be ranked on a scale (say of 1 to 5) depending on their ESG score. The ESG rating of each firm could then be tied in some way, or even proportional to, the national ESG rating, with the potential ESG rating score capped by the national banding.

Chapter Summary

This report has raised a range of policy proposals and suggestions for the development of a better approach to the 'S' in ESG, with a particular emphasis on China. With the Chinese government's willingness to coopt red capital for its own ends, it is critical that Western businesses do not simultaneously provide back-up for the goals and aims of the Chinese Communist Party when the profit maximisation principle and ethical considerations clash.

However, there are a range of significant barriers to the mass roll-out of effective policy which will stem capital flows. The globalised nature of international finance means that governments cannot effectively regulate in isolation. What is needed is coordinated international action by governments to take place in concert with financial services firms beginning to acknowledge the ethical dilemmas inherent with investing in China and starting to take seriously potential ESG concerns.

Appendix:
List of cited Chinese firms (including stock tickers)

Technology giants complicit in Xinjiang

- Alibaba Group Holding Limited (BABA: NYSE) (9988.HK) (AHLA.DE);
- Tencent Holdings (TCEHY) (0700.HK);
- IFlytek Co. Ltd (002230.SZ);
- Hangzhou Hikvision Digital Technology Co., Ltd. (002415.SZ);
- Megvii;
- Sensetime;
- Bytedance;
- Cloudwalk Technology;
- Hangzhou Hikvision Digital Technology Co., Ltd.(002415.SZ);
- Huawei Technologies Co., Ltd.;
- Zhejiang Dahua Technology Co., Ltd. (002236.SZ).

The 'big four' Chinese state backed banks

- China Construction Bank Corporation (0939.HK);
- Bank of China Limited (3988.HK) (BACHY);
- Industrial and Commercial Bank of China (1398.HK) (BACHY);
- Agricultural Bank of China (1288.HK);
- Bank of Communications Co. Ltd. (3328.HK).

59 firms subject to President Biden's Executive Order 14032 prohibition on investment Defense and Related Materiel Sector of the Economy of the PRC:

- Aero Engine Corporation of China;
- Aerospace CH UAV Co., Ltd (002389.SZ);
- Aerospace Communications Holdings Group Company Limited;
- Aerosun Corporation (600501.SS);
- Anhui Greatwall Military Industry Company Limited (601606.SS);
- Aviation Industry Corporation of China, Ltd.;
- AVIC Aviation High-Technology Company Limited (600862.SS);
- AVIC Heavy Machinery Company Limited (600765.SS);
- AVIC Jonhon Optronic Technology Co., Ltd.(002179.SZ);
- AVIC Shenyang Aircraft Company Limited (600760.SS);
- AVIC Xi'An Aircraft Industry Group Company Ltd.(000768.SZ);
- Changsha Jingjia Microelectronics Company Limited (300474.SZ);
- China Academy of Launch Vehicle Technology;
- China Aerospace Science and Industry Corporation Limited;
- China Aerospace Science and Technology Corporation;
- China Aerospace Times Electronics Co., Ltd (600879.SS);
- China Avionics Systems Company Limited (600372.SS);
- China Communications Construction Company Limited (1800.HK) (601800.SS);
- China Electronics Technology Group Corporation;
- China General Nuclear Power Corporation;

- China Marine Information Electronics Company Limited (600764.SS);
- China Mobile Communications Group Co., Ltd.;
- China National Nuclear Corporation (601985.SS);
- China National Offshore Oil Corporation (0883.HK);
- China North Industries Group Corporation Limited (000065.SZ);
- China Nuclear Engineering Corporation Limited (601611.SS);
- China Railway Construction Corporation Limited (1186.HK) (601186.SS);
- China Satellite Communications Co., Ltd.(601698.SS);
- China Shipbuilding Industry Company Limited (601989.SS);
- China Shipbuilding Industry Group Power Company Limited (600482.SS);
- China South Industries Group Corporation;
- China Spacesat Co., Ltd.(600118.SS);
- China State Shipbuilding Corporation Limited (0728.HK) (601728.SS);
- China Telecommunications Corporation (0728.HK) (601728.SS);
- China United Network Communications Group Co., Ltd.(600050.SS);
- Costar Group Co., Ltd.(CSGP);
- CSSC Offshore & Marine Engineering (Group) Company Limited (0317.HK) (600685.SS);
- Fujian Torch Electron Technology Co., Ltd.(603678.SS);
- Guizhou Space Appliance Co., Ltd (002025.SZ);
- Hangzhou Hikvision Digital Technology Co., Ltd.(002415.SZ);
- Huawei Technologies Co., Ltd.;
- Inner Mongolia First Machinery Group Co., Ltd.(600967.SS);
- Inspur Group Co., Ltd.;
- Jiangxi Hongdu Aviation Industry Co., Ltd. (600316.SS);
- Nanjing Panda Electronics Company Limited (600775.SS);
- North Navigation Control Technology Co., Ltd. (600435.SS);
- Panda Electronics Group Co., Ltd.;
- Semiconductor Manufacturing International Corporation (0981.HK) (688981.SS);
- Shaanxi Zhongtian Rocket Technology Company Limited (003009.SZ);
- Zhonghang Electronic Measuring Instruments Company Limited (300114.SZ).

Own or Control, or Owned or Controlled by, Directly or Indirectly, a Person Who Operates or Has Operated in at Least One of These Two Sectors of the PRC Economy, or a Person Who Is Listed in the Annex to the E.O.:

- China Communications Construction Group (Limited);
- China Electronics Corporation;
- China Mobile Limited (0941.HK);
- China Telecom Corporation Limited (0728.HK) (601728.SS);
- China Unicom (Hong Kong) Limited (0762.HK);
- CNOOC Limited (0883.HK);
- Huawei Investment & Holding Co., Ltd.;
- Panda Electronics Group Co., Ltd.;
- Proven Glory Capital Limited;
- Proven Honour Capital Limited.

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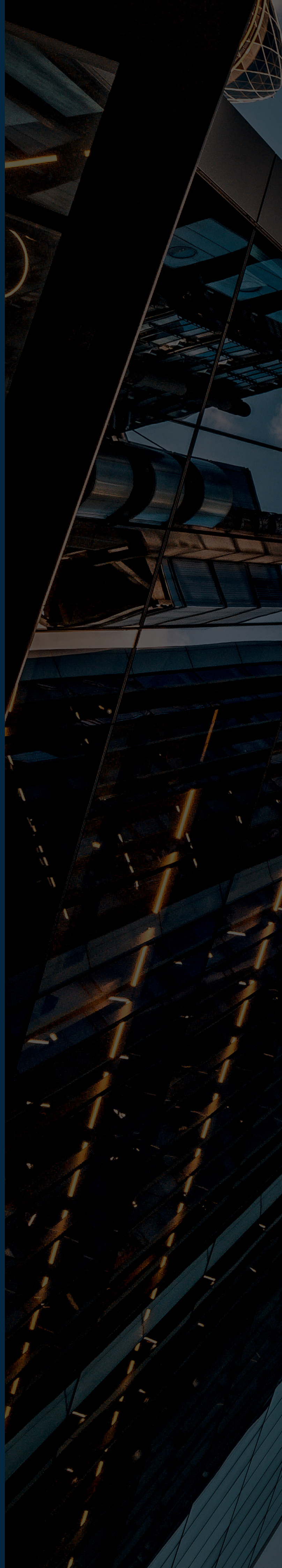

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