December 14, 2017

Ms. Katherine Ng
Senior Vice President
Head of Policy, Listing Department
Hong Kong Exchanges and Clearing Ltd
12th Floor, One International Financial Centre
1 Harbour View Street
Central, Hong Kong

By post and email: katherineng@hkex.com.hk

Re: Consultation Paper on Review of the Corporate Governance Code and Related Listing Rules

Dear Katherine,

We welcome the opportunity to respond to the HKEx consultation on the review of the Hong Kong Corporate Governance Code.

The Asian Corporate Governance Association (ACGA) is a not-for-profit membership association chartered under the laws of Hong Kong. The association is dedicated to assisting companies and markets across Asia in their effort to improve corporate governance practices. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, insurance and accounting firms, and universities. ACGA now has more than 110 corporate members, two thirds of which are institutional investors with around US$30 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

We provide our comments in the order of the questions in the consultation paper. Please note, however, that we have chosen not to answer some questions. At the end of this letter, we also provide comments on a number of issues not included in the current consultation.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

PART I: INDEPENDENT NON-EXECUTIVE DIRECTORS

Topic 1.1: Overboarding and INED's time commitment

Question 1: Do you agree with our proposed amendment to Code Provision (CP) A.5.5 as described in paragraph 36? Namely, in addition to requiring the board to state its reasons for electing an INED and why it believes the person to be independent, it should explain, if the INED will be holding his seventh (or more) listed company directorship, why the person would still be able to devote sufficient time to the board.

We **agree,** in principle, with enhanced disclosure of the reasons for selecting a person as an independent director and why he or she will be independent. However, given the prevalence of concentrated family or state ownership among Hong Kong-listed issuers, we have concerns about the value of standardised statements on director independence. While the Listing Rules provides a definition of "independent director"—and this consultation seeks to strengthen it in certain areas—issuers need to be aware that the evolving expectations of global investors on independence set a higher bar than the HKEx Listing Rules. Merely stating that an INED nominee meets the criteria in the Rules may not be convincing to investors. Indeed, the critical wording above is 'why the board believes the person to be independent'. That is, independent in practice, not just on paper.

We **disagree** with the threshold of seven (7) directorships as a definition of over-boarding for independent directors. We believe that seven is much too high a number and that four to five is more sensible. Indeed, we argued the same in our submission to HKEx on the amendment of the CG Code in 2011. But even this depends on whether an INED holds a full-time or demanding position in another company. If INEDS are non-executive chairmen of other boards, we believe they should hold no more than two to three directorships in total, since the role of chairman is a demanding one. If INEDS are executive chairmen or CEOs of other companies, they should hold no more than two directorships in total (for the sake of clarity, this includes the directorship they hold as an executive chairman or CEO).

Another way to assess overboarding—and one used by some ACGA investor members—is to accept four or five directorships as the maximum and count the role of chairman or CEOs as being the equivalent of two directorships.

As we said in 2011:

> "Four to five independent directorships seems a reasonable upper limit for any individual not in full-time employment. While some individuals may be able to cope with more, the increasing complexity in the role of directors, the greater knowledge and skills required, and the heightened responsibilities and legal liabilities all argue against setting a higher number. Indeed, even four to five independent directorships could be a considerable time commitment, depending on the nature and size of the companies in question, where they are located (ie, do directors have to travel to board meetings) and so on. And if individuals also sit on the boards of unlisted companies, charities or non-governmental organisations, then four to five INED positions may be too many."

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

We stand by this statement today and believe that directors of listed companies should disclose all directorships they hold, not merely those on listed company boards. We would add, however, that being a director of a listed company has become even more complex today, with new issues such as climate change and cyber security on the agenda. This puts ever more onus on individual directors and nomination committees to justify, and avoid, over-boarding.

Finally, we would recommend that if INEDs are invited to join a new board, they should first inform the Nomination Committee(s) or equivalent of any companies they are serving. Additional directorships could have an adverse effect on one's performance and it seems fair and reasonable that this is discussed first with any current boards.

Topic 1.2: Board diversity

Question 2: Do you agree with our proposals to upgrade CP A.5.6 to a Rule (Rule 13.92) requiring issuers to have a diversity policy and to disclose the policy or a summary of it in their corporate governance reports?

We **agree** that it makes sense to upgrade the board diversity policy from a Code Provision to a Listing Rule and to mandate disclosure of it. However, we think the language here could be more precise. We believe that any credible diversity policy should comprise the following features:

- Content that is sufficiently detailed and company specific to allow a reasonable investor to gain value from reading it. The risk of allowing a "summary" version of the policy in company CG reports is that firms will repeat the language in Principle A.3 and simply say that their board has a "balance of skills, experience and diversity of perspectives appropriate to the requirements" of their business. Or they may also copy CP A.5.6 and say their policy on the selection of directors 'considers a number of factors, including gender, age, cultural and educational background, in addition to professional experience'.
- A focus not just on <u>board</u> diversity, but diversity within the workforce and management team generally. It is well-established that an impediment to gender balance in the board is the lack of "board ready" women executives.
- A description of the company's plans for providing board-preparation training to middle and senior managers, so as to provide as wide a basis as possible for future director selection—not just to increase the number of women on the board, but men from a diversity of backgrounds and countries.
- Targets and timeframes for achieving diversity objectives: there would be little value in having a diversity policy without targets for achieving such a policy. Inertia within boards is a powerful impediment to progress.

On a related matter, it is well recognised that gender diversity is lacking in Hong Kong-listed company boards. Indeed, the HKEx consultation paper makes this clear—only 12.2% of all directorships are held by women and more than one third of issuers (35%) had no women on their boards. At the current rate of change—a two-percentage point increase every 4.5 years—it will take another 18 years before women hold 20% of all director positions. While the pace of change may well speed up in the next 5-10 years, the current figures fairly reflect the glacial approach in Hong

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

Kong to gender diversity. Perhaps it is time for HKEx to consider a more robust policy and set quantitative, not just qualitative, targets?

Question 3: Do you agree with our proposal to amend CP A.5.5 that it requires the board to state in the circular to shareholders accompanying the resolution to elect the director:

(i) the process used for identifying the nominee;
(ii) the perspectives, skills and experience that the person is expected to bring to the board; and
(iii) how the nominee would contribute to the diversity of the board.

We **agree** with the spirit of this proposal, namely enhanced disclosure on director diversity and reasons for the selection of certain individuals. We also support the emphasis on individual skills and experience—something generally lacking in reporting on board composition in Hong Kong and Asia.

We **disagree,** however, with leaving this as a Code Provision only, subject to "comply or explain". Given the importance of these issues, we believe that such disclosure should be mandatory. This would also be more in keeping with the proposed upgrade of CP A.5.6 to a Rule, as suggested in Question 2.

Question 4: Do you agree with our proposal to amend Mandatory Disclosure Requirement L.(d)(ii) as described in paragraph 56?

We **agree.** This makes sense in line with the upgrade of CP A.5.6 to a Listing Rule.

Topic 1.3: Factors affecting INED's independence

Question 5: Do you agree with our proposal to revise Rule 3.13 (3) so that there is a three-year cooling off period for professional advisers before they can be considered independent, instead of the current one year?

We **agree** with the direction of this proposed rule change—short cooling-off periods clearly undermine the effectiveness of independent directors, current rules in Hong Kong are particularly weak on this point, and longer cooling-off periods should be better than short ones.

However, we **disagree** with the implication of the question—that a three-year cooling off period would ensure that directors, partners and employees of professional advisory firms are genuinely independent. Given Hong Kong's predominant family business culture, and the tight-knit nature of the business community, we remain sceptical that cooling-off periods are the right approach to defining independence. We are not against retired staff of professional advisers joining boards, but would prefer they do so as non-executive directors, rather than independent non-executive directors. The close relationship and loyalty between an adviser/advisory firm and a family/controlling shareholder is unlikely to diminish after three years.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

We would prefer a Rule that states that former professional advisers are unlikely to be considered independent in any circumstance. Paradoxically, this might benefit issuers by allowing them to appoint former professional advisers to their boards more quickly as non-executive directors. And it would encourage them to look further afield in Hong Kong or outside for stronger independent director candidates. If this sets too high a bar, then a cooling-off period of five years would be preferable.

Question 6: Do you agree with our proposal to revise CP C.3.2 so that there is a three-year cooling off period for a former partner of the issuer's existing audit firm before he can be a member of the issuer's audit committee?

We **agree** with the spirit of this proposal, which is in line with the revision above on Rule 3.13 (3) and should strengthen the independence, both real and perceived, of the audit committee.

We **disagree,** however, in leaving this as a Code Provision subject to "comply or explain", since this creates a potential inconsistency: if former partners/employees of professional advisory firms cannot serve as INEDs for three years, then they could also not be appointed to audit committees as INEDs during this time. It would be more consistent to reflect this in the Rules.

Strengthening this CP would also address the potential problem of issuers appointing former partners of their existing audit firms to their boards as non-executive directors (NED), then inviting them to join their audit committees. Rule 3.21 states that audit committees must comprise at least three members, the majority of whom must be independent, and that the committee chairman must also be independent. This leaves room for at least one non-executive director (NED) to join the committee. However, it is likely that many investors would question the legitimacy of having any members of an audit committee linked to an issuer's existing audit firm, since even former partners not involved in the audit previously would still have benefitted indirectly from the commercial relationship with the issuer.

Question 7: Do you agree with our proposal to revise Rule 3.13(4) to introduce a one-year cooling off period for a proposed INED who has had material interests in the issuer's principal business activities in the past year?

We **disagree** with this proposal, as we believe that a one-year cooling off period is too short. If HKEx believes three years is the appropriate minimum for professional advisers, then it would make sense to apply the same standard to people who have had a material business relationship.

Indeed, for the sake of consistency, we recommend that HKEx apply the same cooling-off period of three years across the independent-director criteria in Rule 3.13. This would mean, at the very least, increasing the current two-year cooling off periods to three years for the following individuals:

- Those who are or were "connected with a director, the chief executive or a substantial shareholder of the issuer";
- Those who are or were "an executive or director (other than an INED) of the issuer (or its holding or subsidiary companies, or core connected persons)".

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

However, even these changes would not resolve a key weakness in the INED definition: the fact that former executives of a company or its holding/subsidiary companies are still eligible to become independent directors. There have been cases in Hong Kong where executive directors stay on a board after retirement as NEDs, then transition to INEDs after two years. This rule is a relic of a period—the early 2000s—when the supply of independent directors was considerably smaller than today. We recommend it be removed from the INED criteria.

Question 8: Do you agree with our proposal to introduce a new RBP A.3.3 to recommend disclosure of INEDs' cross-directorships or having significant links with other directors through involvements in other companies or bodies in the Corporate Governance Report?

We **agree** that disclosure of cross-directorships is important and would provide greater transparency regarding the links between companies and directors. However, we **disagree** with making this a Recommended Best Practice (RBP). At the very least it should be a Code Provision, if not a Rule. One argument in favour of a rule is that this would locate all key requirements for INEDs in one place, rather than splitting them between the Listing Rules and CG Code. A second is that cross-directorships highlight potential areas for related-party transactions, a key CG challenge in Hong Kong and information critical for investors.

Question 9 & 10: Not answered.

PART II: NOMINATION POLICY

Question 11: Do you agree with our proposal to amend Mandatory Disclosure Requirement L.(d)(ii) of Appendix 14 to require an issuer to disclose its nomination policy adopted during the year?

We **agree**. While this proposal overlaps to some extent with the proposal above for disclosure on board diversity, requiring issues to articulate their director nomination policy would be beneficial. Many Nomination Committees are chaired by the chairman of the board or CEO (ie, insiders) and meet only once per year. This proposal may go some way towards nudging companies to think harder about nomination and develop a pipeline of candidates into the future.

In order to avoid boilerplate, we recommend that guidance be provided to issuers on what a meaningful director nomination policy looks like, including the use of a "skills matrix" to analyse the extent of any gap between a board's composition/skills and its current and future needs. A focus also on how the board evaluation process can lead to improved director nomination is also helpful.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

PART III: DIRECTORS' ATTENDANCE AT MEETINGS

Question 12: Do you agree with our proposal to amend CP A.6.7 by removing the last sentence of the current wording? That is, a requirement that directors should attend general meetings and develop a balanced understanding of the views of shareholders.

We **disagree**. Instead of removing this sentence, we recommend that it be amended as follows: "They should also attend annual general meetings and develop a balanced understanding of the views of shareholders."

Making director non-attendance at AGMs acceptable would be a regressive step. It is understandable that directors may not be able to attend all general meetings, but they should be expected to participate in the annual meeting as a minimum. Any non-attendance should also be explained.

Question 13: Do you agree with our proposal to revise CP A.2.7 to state that INEDs should meet at least annually with the chairman?

We **agree** with this proposal. Even if the chairman is an executive or insider, it would be beneficial for the INEDs to meet with him or her separately during the year and express their views on issues not fully discussed in board meetings, suggestions they may have for governance improvements, and any particular concerns they have about the company's operations but do not want to express in front of other executive directors or NEDs.

We recommend that issuers also allow INEDs to meet on their own at least once or twice during the year.

PART IV: DIVIDEND POLICY

Question 14: Do you agree with our proposal to introduce CP E.1.5 requiring the issuer to disclose its dividend policy in the annual report?

We **agree** that disclosure of dividend policies is beneficial and important. However, this should be broadened to include share-buyback and capital-allocation policies more generally.

We **disagree** with making this a Code Provision and believe it should be a Rule. As the HKEx paper notes, both the US and UK requires issuers to disclose a dividend policy. Since Hong Kong is also an international financial centre, it should benchmark itself in this regard against competing jurisdictions, not Singapore, which requires disclosure on a "comply or explain" basis only, or Australia, which makes it voluntary. HKEx also notes that China makes such disclosure mandatory too—another reason for Hong Kong to follow suit, as it also competes with Shanghai and Shenzhen.

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

Question 15: Not answered

Other points
The following points are issues that we recommend HKEx consider in the near future to bring Hong Kong's corporate governance standards more in line with international norms. The order in which they are appear is not intended to signify importance or priority.

1. **Appointment of INEDs pre-IPO:** The consultation paper notes (paragraph 8) that HKEx will provide guidance in due course on encouraging INEDs to be appointed at least two months prior to listing. While we are encouraged that the Exchange is reviewing this issue, we believe the minimum should be 6-12 months before listing. We wrote about pre-IPO governance preparation in our submission to the SFC in July 2012 on sponsor due diligence. Appendix 1 of our submission proposed eight criteria for judging the extent and integrity of such preparation by listing applicants and sponsors.

2. **Lead independent director:** We recommend that the CG Code be amended to encourage the appointment of a lead independent director (LID). Other international and Asian markets have adopted such a policy and found it a useful way to facilitate communication between independent directors and the chairman, and between the board and minority shareholders. In response to the development of investor "stewardship codes" around the region, and as part of their own active ownership policies, institutional investors are increasingly seeking meetings with directors, including independent directors, in addition to management. The LID concept is an efficient way to handle such demands and will likely grow in importance around Asia in future.

3. **Minimum three/One-third INED rules:** This is another part of the Listing Rules (Rule 3.10 and 3.10A) that we believe is outdated. The expected norm in developed markets today is at least one half or more of the board being independent, while markets in Asia such as India and Singapore already require 50% independence if the chairman is an insider. We recognize that there is an inherent risk in proposing higher quantitative targets: some issuers will merely box tick by appointing INEDs who are technically independent but add little value. Yet we believe that this can be countered by enhanced education as to the purpose and value of independent directors. Indeed, HKEx has already started doing this with its new educational videos on corporate governances. At the same time, investors have an important role to play in ensuring that companies choose higher quality INEDs. This leads to the next point:

4. **Election of INEDs:** We believe HKEx should undertake a review of the way in which independent directors are nominated and elected. We note that some issuers are becoming more open in explaining their selection of INEDs to investors, but more thought also needs to given to the process for voting on INEDs at annual general meetings. The status quo, whereby a controlling shareholder both nominates and effectively elects all INEDs, leaving minority investors will little more than the chance of a protest vote, is losing legitimacy in this region. Too many INEDs are either insufficiently competent or patently not independent. Since much of the framework for minority protection and good governance in Hong Kong and Asia is built upon the independent director concept, weaknesses in the

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818

foundation will lead to fragility in the overall structure. It is time for a comprehensive review, including examination of voting systems in other markets (eg, the UK) where minority shareholders are given enhanced voting rights on INEDs. One immediate reform in Hong Kong could be as follows:

5. **Disclosure of minority votes on INEDs:** Issuers should be required to separately disclose how minority investors voted on independent director candidates. If a candidate does not get "majority minority support", then he/she should be required to stand for re-election in the following and subsequent years (ie, the standard three-year term would not apply). The issuer would also be required to explain more fully why it believed the INED was independent, competent, and deserved the support of minority shareholders. In practice, this would likely lead to more extensive, and constructive, dialogue with institutional investors around INED nominations.

   Note: Careful consideration would need to be given to the definition of "minority shareholder". Since many independent institutional investors hold more than 5-10% of companies, the usual rules on "substantial shareholders" and "connected persons" could not apply. An upper limit of 15% seems more sensible.

6. **Separation of chairman and CEO**: In the family business context in Hong Kong, mandating a split chairman and CEO may seem either unfair or futile. This is no doubt why the concept is included in the CG Code as a Code Provision, rather than in the Listing Rules. Yet it is increasingly accepted that the two roles are substantially different, hence best filled by different people; and it is never clear how a chairman who is also a CEO is capable of supervising himself. One solution is to introduce a rule mandating a higher proportion of INEDs (at least 50%) if the chairman is also the CEO. Another would be for HKEx to take a more robust approach to reviewing the explanations in company CG reports as to why the roles are not split. Much disclosure on this point, in our view, is superficial and of little use to readers of annual reports. We recommend that HKEx review the options for addressing this problem.

We hope the foregoing comments are useful to the Exchange and we would be pleased to discuss them in more detail.

Yours truly,

Jamie Allen
Secretary General

ASIAN CORPORATE GOVERNANCE ASSOCIATION
Room 1801, 18th Floor, Wilson House, 19-27 Wyndham Street, Central, Hong Kong Tel 852 2160 1788 Fax 852 2147 3818