



May 13, 2016

Ms. Carmen Chu
Executive Director (Banking Conduct)
Hong Kong Monetary Authority
55th Floor, Two International Finance Centre
8 Finance Street, Central
Hong Kong

Dear Ms. Chu,

ACGA's Response to the Consultation on Empowerment of Independent Non-Executive Directors in the Banking Industry in Hong Kong

We welcome the opportunity to respond to the Consultation Paper.

The Asian Corporate Governance Association (ACGA) is a not-for-profit 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, law and accounting firms, and universities. ACGA now has more than 100 corporate members, two thirds of which are institutional investors with around US\$24 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

ACGA's members place a high priority on issues of board capacity and director independence, and support HKMA's efforts to align the practices of Hong Kong's financial sector with the Basel Committee on Banking Supervision's 2015 Corporate Governance Principles for Banks. We have also seen a copy of the Hong Kong Institute of CPA's (HKICPA) response to the consultation and where appropriate will highlight our agreement with their many useful comments.

At the outset, we would like to stress one critical point which informs our view of one of the issues which informs this consultation. While we believe that director suitability is necessarily a fundamental concern in Hong Kong, we do not believe that the issue is correctly understood to be one of "shortage" of qualified candidates. This is false construct that has been used all too often to suggest that eager companies simply cannot find qualified independent director candidates. Rather, Hong Kong suffers from a scenario where capable candidates are often deterred by or overlooked due to weak regulatory and institutional incentives for engaged board members. This is not a problem unique to Hong Kong, but the ownership structure of Hong Kong financial institutions, both listed and unlisted, has made good board governance hard to achieve due to a persistent insider bias that stands in opposition

to the development of a healthy board culture. Like the HKMA, we believe that new regulatory strategies must now be explored if the financial services sector is to address its systemic risks.

I. Constituting the Board and its Committees

Nomination Committee Chair: We endorse the HKICPA's recommendation that the Listing Rules standard be applied to authorised institutions (AIs) and that Nomination Committees be chaired by an independent director and the committee not be dominated by executive directors.

II. Independent directors of AIs

Time Commitment: We agree with the concern expressed by the HKICPA about ensuring that directors have the time to devote to the requirements of the director's role. It is clear from the mixed record of director performance in Hong Kong that a discretionary "reminder" to directors has proven insufficient to guard against over-committed candidates. Indeed, we would regard it as a form of regulatory failure to overlook the seriousness of this issue. As a result, we would encourage the HKMA to adopt the standard common to listed companies in China and other regional markets which caps board directorships at five. This is a practical standard and given the complexities of AI governance we believe that such a limit would be easily understood and fully justified. Indeed, there is an argument that the limit should be less than five due to the systemic nature of financial institutions.

III. Independence and tenure

Cooling-off periods: We note that the 19 (b), (e), and (f) clauses rely on cooling-off periods to cure challenges to independence in the case of employees, executives, directors, shareholders, family members, and those with close ties to senior employees or shareholders. We believe that the insider-versus-independent mindset is best established by prohibiting insiders from serving in board roles reserved for independent directors. If companies are in need of qualified executives who can fill independent director roles, it would be preferable to develop a truly independent talent pool which can meet the governance needs of organisations without an insider bias. Executive directors who understand their role as a director of the company have an important role to play on boards, but independence need not be compromised in an effort to import "skill". This is trade-off is not in the public interest.

Material business relationships, cross directorships and significant links: Similarly, we are concerned that the soft approach taken in 19 (d) and footnote 10 as well as in 19 (g) leaves too much discretion in the hands of potentially conflicted parties. We would advocate a more prescriptive approach here to ensure that boards and Nominations Committees are empowered to take a pragmatic approach to these

issues. Small circle governance has long been a hallmark of poorly governed Hong Kong companies—and has affected AIs as well. This is to be discouraged and Nominations Committees would benefit from more explicit guidance than the language used in footnote 10 which relies on little more than a cautionary formulation.

Professional service providers: While we believe that AIs are well positioned to benefit from a strong talent pool of professionals from the legal, financial, and accounting industries in Hong Kong, we cannot endorse the three-year cooling off period advocated in the consultation. Sadly, significant professional and reputational issues can have a very long tail. Whether it is crucial advice on asset valuation or transaction matters, problems often materialise slowly and can take years to crystallise. In a similar fashion, we would note that the enforcement processes of most securities and accounting regulators in Hong Kong are often subject to repeated delays. In such an environment, three years is inadequate to be able to state with confidence that a potential candidate is free of conflicts or responsibility (ie, not subject to investigation or disciplinary action). As a result, we would avoid candidates who have provided services to AIs.

Conflicts of interest—government officials: Although not explicitly addressed in the Consultation, we believe that the HKICPA raises an important question concerning the suitability of former government officials in independent director roles. We note with interest that government officials are often sought-after for independent director roles. Nevertheless, we believe that Nomination Committees would benefit from guidance on considering the tools needed to address the unique conflicts of interest that this group of candidates may bring to a board. Here again, we are not confident that simple strategies like cooling-off periods may be adequate to resolving the actual or optical consequences of conflicts. We also note that other markets in this region have sought to bar politically connected persons from independent director roles at AIs. While this may not be an appropriate step for Hong Kong, the reasons for these policies should be carefully considered in order to set the right tone for independent director performance.

IV. Remuneration of Independent Directors

Basic fee: We support the proposal in paragraph 25 calling for HK\$400,000 to be established as a floor for basic directors' fees. Hong Kong has suffered from market failure, characterised by a race to bottom in some segments of the market, related to directors. As a result, we believe that a regulatory solution is fully justified.

V. Board practices in relation to Independent Directors

Term limits: We agree with the Listing Rule standard requiring independent directors with more than nine years of service to be subject to a separate resolution. While this will provide an opportunity for oversight for listed AIs, this strategy does not map with equivalent effectiveness to unlisted AIs. Rather than simply asking that Nomination Committees consider whether a given individual is still regarded to be “independent” and make a recommendation to the board, we believe there would be merit in asking the Nomination Committee to make a declaration to the HKMA specifying the basis on which this view is taken.

Alternates: We strongly support the prohibition against alternates for independent directors and would question the merit of accepting alternates for non-executive directors. Indeed, there have been questions raised about a pattern of poor governance performance by busy non-executives in joint venture AIs where larger regional firms or private equity firms have a tendency to appoint over-taxed insiders who lack skilled “alternates” who can fulfill their board obligations.

Information: We applaud the standards expressed in paragraphs 31 to 34 concerning timely access to information and outside experts. These are pragmatic suggestions which address common criticisms of market behaviour which undermines the ability of independent directors to meet their fiduciary obligations in Hong Kong. From a regulatory standpoint, steps to encourage accurate board and committee minutes noting dissenting views are much needed.

Senior or lead independent director: The HKICPA’s suggestion in relation to paragraph 36 that a senior independent director be appointed in the event that the chair is not an independent director would, in our view, reinforce the obligations of independent directors and work against the culture of passivity common to dysfunctional boards.

VI. Training and development requirements for independent directors

Director training: We strongly support the practical suggestions made in paragraphs 40 to 46. It is important that boards adopt an orientation to continuous learning and develop a shared commitment to understanding the company’s market and key business risks. Further, we believe that boards, and independent directors in particular, should avoid creating silos which can discourage independent directors who are not on Audit or Risk Committees from gaining a working knowledge of material operational challenges and financial reporting issues. While these issues naturally have a technical character, all board members share a fiduciary obligation on the oversight of these issues and how they are presented to shareholders and other external stakeholders.



In closing, we would encourage the HKMA to consider framing the conclusions of this consultation exercise and any subsequent guidance in a forthright way, both for the benefit of board governance, but also to send a clear message to the market concerning the importance of higher standards of behaviour by all directors.

Paragraph 10 of the consultation document offers a concise statement that we believe deserves to be highlighted: “It should be recognized that INEDs’ actions and votes in board meetings are in the service of the duty they owe **to the AI as a whole and the wider public interest, and not to any particular interest.**” This is something that Hong Kong companies, and their boards have long struggled to grasp. The HKMA is well positioned to demonstrate leadership by stressing the structure of directors’ true obligations.

We hope our comments are helpful and would be pleased to discuss them with you further.

Yours truly,

A handwritten signature in blue ink, appearing to read 'JA', written over a light blue horizontal line.

Jamie Allen
Secretary General

**Melissa Brown, Specialist Consultant, ACGA contributed to this submission.*