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The Hong Kong Institute of Directors Response to the Consultation Conclusions on Review of the Corporate Governance Code and Associated Listing Rules

HKIoD commends the Exchange's review exercise to find ways to improve and enhance corporate governance among listed companies in Hong Kong. HKIoD responded to the Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules. More details can be found in our 18 March 2011 submission.

Follow this link to our submission:

http://www.hkiod.com/document/position_papers/HKIoD's_Response_to_Consultation_Paper_on_Review_of_the_Code_on_CG_Practices_and_Associated_Listing_Rules.pdf

Overall, we are with the Exchange on many of the conclusions. The Exchange has modified or dropped some of the original proposals. We recognize and appreciate the efforts to address and accommodate many different opinions from the market while preserving the integrity and philosophy of the review exercise. HKIoD continues to believe many of those original proposals have merits from a better corporate governance standpoint. Issuers are not prevented from and they should not discourage themselves from looking into some of those original proposals as they design corporate governance mechanisms to suit their specific needs.

Overall, we are certain that the changes will keep our already sound regulatory framework in step with ever higher expectations and in line with international best practices.

Issuers have flexibility

The approach taken in our regulatory framework to drive corporate governance among listed companies has been a combination of Rules, Code Principles (CPs) and Recommended Best Practices (RBPs).

Most of the changes that result from this consultation are CPs. The significance is, issuers are not imposed upon mandatory requirements, but are afforded much flexibility in striving for their corporate governance within the regulatory framework. We encourage directors and their boards to make use of that flexibility and decide the best approach for their purpose.

Directors have ultimate responsibility

Many of the changes that result from the conclusion will heighten the corporate governance responsibilities placed on directors and will elevate the important role directors and their boards will play in corporate governance.

Corporate governance is crucial to the development of companies and the economy at large, and directors are ultimately responsible for corporate governance. Better quality company directors should mean better corporate governance. For this reason, we are strongly behind

those changes that will call for directors to better understand and appreciate their duties; to undergo training and continuing development to acquire the skills and knowledge to meet corporate governance demands of the day; to dedicate their commitment in the affairs of the issuer; to set corporate strategic objectives and to monitor the progress in achieving those objectives; and to evaluate board performance on a regular basis.

It is fundamental to good corporate governance practices for a board to devise a suitable mechanism to perform the duties of a “corporate governance committee” as set out in Consultation Paper. The substance of the role and functions of a corporate governance committee being properly performed is more essential than the mere existence of a “corporate governance committee”. Issuers can decide for their own purpose whether to expand the duties of an existing committee or committees, or to establish a separate committee, or to handle the functions by the full board. Regardless, the board remains ultimately responsible for the issuer’s corporate governance.

The Rule to require disclosure in the Corporate Governance Report is appropriate. An issuer’s corporate governance practices constitute essential information that should be transparent to the market.

The board should also maintain an on-going dialogue with shareholders. A new CP recommends the board to establish a shareholder communication policy. A major responsibility falls on the board to review the shareholder communication policy regularly to ensure its effectiveness.

Directors’ duties

The Listing Rules will be amended to stress the expectation on directors to be fully aware of their duties under the law and the Listing Rules and to take an interest of the issuer’s affairs and obtain a general understanding of its business.

The Rule amendment is consistent with the values embodied in the HKIoD *Guidelines for Directors* and the HKIoD *Guide for Independent Non-Executive Directors*. The Listing Rules will have a Note to refer directors to the two HKIoD publications, in addition to the Companies Registry’s guidelines, for practical guidance. We consider the two HKIoD publications to be essential reference tools for directors and we are delighted at this recognition.

Follow these links to the two HKIoD publications:

- *HKIoD Guidelines for Directors*
<http://www.hkiod.com/guidelines-for-directors.html>
- *HKIoD Guide for Independent Non-Executive Directors*
<http://www.hkiod.com/INEDguide.html>

HKIoD members are of course also guided by our Code of Conduct.

Directors' time commitments

The Code will be amended to include a CP to require issuers to review the time required from directors and for directors to timely inform the issuer of any change to his significant commitments.

HKIoD believes all directors should devote sufficient time and attention to the affairs of the company. The ability of a person to devote sufficient time to attend to the issuer's board matters must be a key consideration of whether the person should warrant nomination to serve the board or for re-appointment.

Time commitment should normally not be a major issue for an ED (and such would normally be dealt with as part of the employment contract between the ED and the issuer). But for NEDs (including INEDs), the situations vary from individual to individual. We have always felt that the emphasis should be on whether a director has made an honest judgment as to the ability to devote sufficient time, not a broad brush requirement on the director to "limit the number of his other professional commitments". We think the Exchange drew the right conclusion there as a result of the consultation.

Issuers should however design and put in place their own control measures to assess and review the time required from directors and to ensure directors commit sufficient time and attention to perform their responsibilities.

On a related issue, the Exchange will not, for now, pursue the issue of whether to limit the number of INED positions an individual may hold. Situations vary from individual to individual and from issuer to issuer. A certain number of INED positions may be too many for some, but quite manageable for others. We believe the emphasis should be on whether a director has made an honest judgment as to the ability to devote sufficient time, not a broad brush requirement on the director to limit the number of INED positions he may hold.

Directors' training

The Exchange will raise the expectation on directors to acquire training and continuing development.

HKIoD believes all company directors, when they first assume their posts, should have a firm measure of competence to perform. Over time, they should strive to remain up-to-date with best corporate governance practices. Having directors who have up-to-date skills, knowledge and qualities to meet the corporate governance demands of today and who are attuned to best corporate governance practices can only benefit the issuers and their shareholders. We welcome the change to emphasize directors' training and development. We believe it will sharpen the saws of directors, to prepare them for the robust directorship needed ahead in the wake of the global financial crisis.

The Exchange proposed but concluded not to introduce the eight-hour minimum we supported. Although no minimum hours stipulated, we encourage all directors to persistently pursue training and continuing development. HKIoD now requires a minimum total of 10 hours per year for its members and a recommended best practice of 20 hours per year. We believe those to be suitable requirements.

Directors' insurance coverage

HKIoD has long advocated that, while directors must act with diligence to discharge duties, they must also be properly shielded from liability. While issuers should arrange the insurance for directors, the board should have key authority in determining the scope and level of coverage.

We also believe that the terms of the insurance coverage should be reviewed on a regular basis and no less than once per year, in order to better match the changing scale and type of the issuer's business activities and the associated risks they bring.

Board composition – INEDs to form one-third

The recommended practice of at least one-third of an issuer's board should be INEDs will be upgraded to a Rule. We support the change.

Given the heightened requirements and expectations on various board committees as proposed in the Consultation Paper, we think issuers will find value in recruiting more number of willing and able persons to join their boards as INEDs. It remains the decision of each issuer's board (and its nomination committee) to determine the right composition of the board to best suit the issuer's needs.

The new requirement will likely result in a need for more people willing and able to become INEDs. It is essential that we find individuals who have the skills, knowledge and qualities to meet corporate governance demands of today to fill INED positions, not just to make up the numbers. HKIoD maintains a roster of members who have positively indicated their willingness and who have conscientiously equipped themselves to become INEDs.

Given the possibility of a larger number of individuals with limited prior experience in company directorship being appointed to fill the additional INED positions, HKIoD wants to emphasize that proper initial training for first-time directors is one key aspect of the total quality of corporate governance training. HKIoD offers a variety of training courses, including many which are suitable for first-time listed-company directors.

HKIoD also believes it is crucial for issuers to provide proper induction to newly appointed directors, whether they are beginning or seasoned company directors.

Nomination committee and board effectiveness

Regarding the CP on the establishment and composition of nomination committee, we think that will create a strong impetus for issuers to establish such committee.

The principal responsibility of a nomination committee is two folds: to assess the structure, size and composition of the board as to be consistent with and able to carry out corporate strategic goals/objectives as determined by the board; and to identify and recommend appropriate candidates for election and re-election to board. The work of a nomination committee is necessary to build and maintain an effective board.

To have the nomination committee comprise (at least) a majority of INEDs is appropriate. Clearly the board needs objectivity and an independent view in matters such as recruiting and

nominating suitable board candidates. But there is also the need to promote board/committee dynamic and performance that also fosters an effective partnership between the board and management to benefit the issuer and its shareholders.

Remuneration committee and executive compensation

Regarding the new Rule on the establishment and composition of remuneration committee, we want to emphasize that executive director and senior management remuneration is an important corporate governance matter that is clearly within a board's oversight responsibilities. An issuer's board (and its remuneration committee) shall link at least some portion of executive compensation to well-conceived measures of performance with reference to the board's corporate goals and objectives.

To have the remuneration committee comprise (at least) a majority of INEDs is appropriate. Clearly the board needs objectivity and an independent view in executive compensation matters. But there is also the need to promote board/committee dynamic and performance that also fosters an effective partnership between the board and management to benefit the issuer and its shareholders.

Audit committee and whistle-blowing policy

RBP C.3.7 will be upgraded to a CP to state that issuers should include in audit committee's terms of reference arrangements for employees to raise concerns about improprieties in financial reporting. We support the change.

We also welcome the introduction of a new RBP recommending the audit committee to establish a whistle-blowing policy. The audit committee is an appropriate committee to be responsible for an issuer's whistle-blowing policy.

It is important for employees to be able to raise an alarm on financial reporting, internal control and other matters. It is equally important for a board to put in place policy and procedures to evaluate complaints and to judiciously decide which complaints truly warrant further actions.

Providing monthly updates to the board

With better information from the issuer (in the form of monthly updates or otherwise), directors will have better means to perform their monitor and oversight functions. Monthly updates are essential for the board to carry out its oversight function as well as to formulate better strategies for the issuer.

An issuer should provide information to enable the board to make timely and informed decisions. Though directors have duty to make inquiries and asked for relevant information, the new CP should enable better communication between directors and management on developments that may affect the issuer's businesses.

The board together with management should determine the nature and scope of information the board should receive. The monthly updates should include information that assists the board in carrying out its oversight function. Surely, it is not necessary and would even be counter-productive if there is "too much information". But to fulfill their monitoring

functions, NEDs (including INEDs) should receive financial information and ratios that enable them to readily understand results of operations, variations from budget, trends in business and other types of information that may in turn allow them to spot potential problems and risks facing the issuer. They should also receive highlights of media reports, analysts' reports and comments from investors that may raise concern, so to make sure they are addressed or the situation corrected as appropriate.

Chairman to meet INEDs and NEDs separately once a year

RBP A.2.7 will be upgraded to a CP to state that the Chairman should hold separate meetings with INEDs and NEDs at least once a year, without executive directors being present.

The original proposal was to have the CP as upgraded to state that the Chairman should hold separate meetings with only INEDs and only NEDs at least once a year. We do not see any reason why issuers should not adopt the practice if and when necessary.

Separate meetings without the presence of EDs could allow NEDs (and INEDs) to speak more freely to express concerns. Directors should act in the interest of shareholders as a whole, but to the extent that some NEDs represent particular shareholder interests, separate meetings with only those NEDs could allow those perspectives to be explored at greater depth, in order for those perspectives to be more properly assessed in the whole context of company and shareholder interest.

Board evaluation

A new RBP will be adopted to recommend evaluation of the board.

HKIoD generally supports the notion of board self-evaluation. Board (and committee) self-evaluation encourages a reflection on how effective the board (and its committees) is performing and what changes and adjustments might be prudent. We are aware of different approaches to conduct self-evaluations. Under the new RBP, boards should have the leeway in determining how they conduct their own.

Remuneration for INEDs

More is being expected of directors in terms of time commitment, responsibility and potential liability. INEDs will be more in demand, will have more duties resting on their shoulders and will be expected to expend more time and effort to attend to the affairs of the business they serve.

Like other members on the board, INEDs have the same duties under the rules and are at the same risk of legal action or regulatory sanctions. When INEDs are not remunerated at levels commensurate with their role and responsibilities, one can rightly call into question the adequate fulfillment of their functions. Sadly, the amount of time, effort and diligence put forth by INEDs is often interpreted as being reflective of the compensation INEDs receive.

It is in the best interest of a company to offer fair and appropriate remuneration level in order to attract quality INEDs thereby enhancing profile among investors, analysts and regulators.

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