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The Hong Kong Institute of Directors
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Guide for Independent Non-Executive Directors

Concise Practice Notes and Advisory Tips

- Essential for listed companies
- Reference for non-listed companies
and non-profit organisations

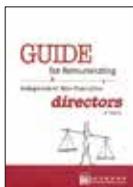
The Hong Kong Institute of Directors Publications



Guidelines for Directors * is a desk-top and reference book for both practising directors and newly appointed directors. It summarises the law and regulation and recommends good practices in areas into which the law has not yet reached.



Guide for Independent Non-Executive Directors * is a desk-top guide that complements the Guide for Remunerating Independent Non-Executive Directors and helps INEDs understand their role as an independent voice on the board and the responsibility and authority the role carries with it.



Guide for Remunerating Independent Non-Executive Directors provides companies with guidelines and assistance in engaging and remunerating INEDs with fair compensation packages, which together with appropriate motivation, enable INEDs to fulfill their responsibilities on the board, particularly from an independence perspective.



Report on the HKIoD Corporate Governance Scorecard documents findings of a survey on corporate governance practices of major listed companies that are Hang Seng Index constituents. It serves the purposes of raising community awareness, establishing benchmarks compatible with international standards and helping Hong Kong companies to enhance corporate governance.



Guidelines on Corporate Governance for SMEs in Hong Kong serves as a tool for SME directors in securing strategic directions, business development and internal control. It provides SMEs with guidelines in five categories of companies varying in scales of operations. It also addresses issues of family companies and integration of management practices with governance.



SME Corporate Governance Toolkit - From Guidelines to Implementation ("Toolkit") serves as a follow-up to Guidelines on Corporate Governance for SMEs in Hong Kong ("Guidelines") to facilitate SMEs in the implementation of corporate governance practices. While the Guidelines address the "what-to-do" aspects, the Toolkit covers the "how-to-do" steps of implementation. Both the Guidelines and the Toolkit are complementary reference tools for SMEs.

* **Guidelines for Directors** and **Guide for Independent Non-Executive Directors** are cited as reference materials on duties expected of directors in a note to HKEX Listing Rules 3.08 (Main Board) and 5.01 (GEM Board).

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HKIoD Guide for INEDs

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About HKIoD



香港董事學會
The Hong Kong Institute of Directors
FOUNDED 1997

The Hong Kong Institute of Directors (“HKIoD”) is Hong Kong’s premier body representing directors to foster the long-term success of companies through advocacy and standards-setting in corporate governance and professional development for directors. A non-profit-distributing organisation with membership consisting of directors from listed and non-listed companies, HKIoD is committed to providing directors with educational programmes and information service and establishing an influential voice in representing directors. With international perspectives and a multi-cultural environment, HKIoD conducts business in biliteracy and trilingualism. HKIoD is a member institute of the Global Network of Director Institutes, a worldwide alliance of leading director institutes.

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FOREWORD

As Hong Kong's premier body representing directors to promote corporate governance and director professionalism, The Hong Kong Institute of Directors defines corporate governance as the system established by the board to lead the company, in conformance and performance. Directors, whether executive or non-executive, jointly bear responsibility in steering the company.

With a mix of executive directors, non-executive directors and independent non-executive directors in our membership, our Institute is in a good position to facilitate teamwork on the board. This is done through educational programmes that benefit different but complementary board roles and enable team integration to achieve board effectiveness.

This Guide provides the Hong Kong independent non-executive directors with concise and user-friendly guidance. While offering practice guidance for a specific board role, we encourage the board and management as a team to make reference to this Guide. At the same time, we would like to draw your attention to the independent non-executive directors recognised by our Institute's Directors Of The Year Awards. These awardees serve as inspiring role models.

We would like to dedicate this publication to those who assume the role of independent non-executive director in serious and diligent service. Armed with this Guide, it is hoped that they will take on the role with great vigour and confidence.

Christopher To
Chairman of Council
The Hong Kong Institute of Directors
March 2021

FOREWORD

The challenges faced by Hong Kong's independent non-executive directors stem from a corporate governance setting that stipulates regulatory requirement of their role, whereas boards typically are controlled by the founding family or dominated by a close-knit shareholding group. Directors serving in such a role often question whether they are adding value and may feel powerless to voice contrary opinions or effect positive change.

This publication complements the training and education programmes offered by The Hong Kong Institute of Directors in empowering independent non-executive directors. It also highlights the significance of collaboration among various board roles as a team and between the board and management. I recommend it as a reference tool to all current and potential independent non-executive directors.

Independent non-executive directors may add value, not only to listed/regulated companies but also to all other types of companies. I would like to see more independent non-executive directors at work to enhance board effectiveness of many companies. We should embark on a journey leading to a majority of independent non-executive directors on the boards of listed companies.

Henry Lai
Immediate Past Chairman of Council and
Chairman of Corporate Governance Policies Committee
The Hong Kong Institute of Directors
March 2021

INTRODUCTION

Objectives

Taking up an appointment as an independent non-executive director carries with it an honour in trust bestowed, a commitment to service and acceptance of expectation in professionalism.

The role of independent non-executive directors is receiving increasing attention from the public and in particular from regulators and stakeholders. It is a global trend for regulators to prescribe moving towards majority independent non-executive directors on the boards of listed companies.

Published by The Hong Kong Institute of Directors ("HKIoD"), this Guide presents the functioning of independent non-executive directors ("INEDs") in board practice and working relationships with executive directors ("EDs"), other non-executive directors ("NEDs") and management.

In view of the significant role of INEDs, the publication of this Guide contributes to the HKIoD objective in public education. However, this Guide does not aim to establish rules or a roadmap through legislative and regulatory provisions or to provide guidance on how directors should handle specific situations that might arise. It is recommended that this Guide be read in conjunction with the HKIoD publication of *Guidelines for Directors*, which provides a detailed review of the role and duties of directors in general. Both publications are referenced in the notes to the *HKEX Listing Rules* (Main Board LR 3.08 and GEM Board LR 5.01). An abridged version of this Guide is published as chapter 3 of the HKEX publication *Making inroads into good Corporate Governance and ESG management*.

This Guide is subject to review and update from time to time. The current version of the Guide is the revised 6th edition.

Note: ESG stands for "Environmental, Social and Governance". ESG reporting is a megatrend for companies to disclose performance and contribution regarding sustainability.

Authority on expectations

Listed Companies: INEDs are mandatory roles on the boards of listed companies. There are regulatory stipulations on INEDs defined by the Stock Exchange of Hong Kong and the Securities and Futures Commission, highlighted as follows:-

- Each listed issuer must appoint INEDs representing at least one-third of the board’s seats, with a minimum number of three INEDs. One of the INEDs must have appropriate professional qualifications or accounting or related financial management expertise.
- Independence is defined by the details, in relation to material interests in business activities, advisory service, cross-directorship or significant links with other directors, family ties etc.
- An INED must have the character, integrity, independence and experience to fulfil the role.
- INEDs are expected to take an active role on board committees and are tasked with reviewing special transactions and discharging special duties on an independent board committee.

Non-listed Companies: Although there is no applicable mandatory requirement for non-listed companies, HKIoD encourages the appointment of INEDs to their boards in order to enhance diversity in perspectives on the board. There are companies which, though not listed, are regulated and are expected to appoint INEDs under regulatory conditions.

Non-profit-distributing Organisations: Non-profit-distributing organisations are usually funded by government or public donors or specific membership. The funding sources have expectations of the board members of these organisations to practise good corporate governance. Very often, the board members of these organisations are INEDs in nature or expected to fulfil their duty from an independent perspective.

The same principles and spirit of practice in corporate governance and director professionalism apply to all types of companies. While being essential for listed companies, this Guide may serve as useful reference for non-listed companies and non-profit-distributing organisations.

Quotable Insights

Dr The Hon Moses Cheng, Hon President and Founding Chairman, HKIoD and a renowned community leader, legal professional and INED:

“Today’s INED competence includes, *inter alia*, knowledgeability and catalyst action on ESG adoption by the board and company. Success factors include regular ESG subjects on the board’s agenda, extensive training in the company and applying ESG initiatives to daily operations. INEDs should ensure that ESG goals and achievements are communicated well by the company.”

Dr Kelvin Wong, Hon Council Member and Past Chairman, HKIoD and a well-recognised practitioner as both ED and INED of listed companies:

“The past two decades saw INEDs’ heightened oversight of governance particularly in internal control and risk management. The next two decades will see a paradigm shift in INED focus, to both financial and ESG performance, and extension from independence to interdependence and interplay among INEDs, NEDs and EDs. Board culture should develop in this direction.”

Dr David Wong, Hon Council Member and Past Deputy Chairman, HKIoD and a well-respected business leader and INED:

“INEDs play a significant role by acting independently, guarding against conflicts of interests and roles and ensuring proper corporate conduct. In contributing to shaping overall development, INEDs must be seasoned with vision in assessing business landscape and risks, particularly when the company engages in a major transaction or explores a new line of business.”

Extracts of citations on awardees by Judging Panel on granting **Directors Of The Year Awards** to INEDs:

- “strong communication skills enabling working relationships with other board members and the management team”;
- “sound judgement and balanced thinking”;
- “thoughtful input to strategic planning and corporate governance issues”;
- “effective and persuasive, acting as an independent sounding board to the executive team”;
- “emphasises on a culture of evolution to achieve a higher standard of corporate governance”;
- “(as chairman of audit committee) made significant contribution to transparency, risk management and internal controls of the company”;
- “discreet consideration of the interests of all shareholders and other stakeholders”;
- “strong commitment to corporate social responsibilities”.

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- Mrs Kate Mead for advice on the editorial style of the English version of this Guide and
- all those who helped in enabling the publication of this Guide.

I. INEDS IN PRACTICE: General Principles

1. Appointment

- (1) Before appointment, an INED candidate should learn, preferably through meeting the chairman, other board members and the CEO, about
 - how the board is organised and operates,
 - the major challenges and issues faced by the company,
 - the company's expectations of INEDs and
 - how the candidate may fit in and add value.
- (2) A written appointment letter should specify, *inter alia*, tenure, remuneration and coverage by Directors and Officers Liability Insurance.
- (3) Both listed and non-listed companies can benefit from having outside directors on the board. Hence, in the pre-IPO stage, a company will find it beneficial to appoint INEDs on the board, at least one year ahead of filing the Listing Application Form. This will strengthen board dynamics during IPO preparation and enhance the company's track record of corporate governance.

2. Board's collective roles

- (1) The board is ultimately responsible for corporate governance. All directors, including EDs, NEDs and INEDs, bear equal responsibility for fostering the company's long-term success. Collectively, the board is responsible for supervising management, directing the company and ensuring accountability.
- (2) It is axiomatic that every director must act towards the company with honesty, integrity and candour and exercise due care, skill and diligence.
- (3) While serving from an independent perspective, INEDs should participate in the board as a contributing team member.

3. Checks and balances

- (1) INEDs must ensure the interests of all shareholders (not only the interests of a particular faction or group) are considered by the board.
- (2) There are exceptions to the above in transactions such as takeovers, spin-offs, connected transactions and where INEDs serve on an independent board committee charged with protecting the interests of independent shareholders.

4. Devoting sufficient time

- (1) An INED must be able to afford the time realistically required to familiarise with the company, attend board and committee meetings, review board papers and relevant materials prior to meetings and communicate with the board chairman and management on significant matters.
- (2) An INED must exercise judgment to avoid overboarding. Although INEDs appointed to more than six listed-company boards must explain how they have the necessary time available to devote to each one, INEDs on fewer boards should also make an honest personal assessment of their time loading.

5. Education and training

Continuing education and training help to both empower INEDs in their roles and enlighten other board members and management on how best to work with INEDs.

6. Evolving governance

In keeping up to date, INEDs should learn how to stimulate board discussions, in such issues as enhancing governance standards (noting investors are ready to pay a premium for good governance), equal emphasis on conformance and performance, the rise of ESG reporting and the expansion of shareholder rights (along with the growing importance of institutional investors).

7. Independence

- (1) The independence of listed-company INEDs is defined by regulation in relation to material interests in business activities or significant links.
- (2) For INEDs, independence is, apart from regulatory definition, an attitude that reveals itself in addressing the company's business and affairs with objective perspective and independent judgment free from the influence of any interests. An independent attitude is not arrogance or a need to be different or challenging for the sake of it. One can be independent and remain a supportive member of the board by maintaining critical but constructive objectivity. This is often referred to as "loyal opposition".
- (3) One serving as an INED must have the courage to speak up if one does perceive an issue that requires attention.

8. Interest segregation

As an INED may have many outside interests, it is pertinent and necessary to disclose all relevant interests to the board and refrain from discussing and voting on matters with actual and potential conflicts of interest.

II. INEDS IN PRACTICE: Practical Aspects

1. Participating effectively

- (1) An INED should add value to the board with effective participation, such as contributing to quality discussions of the board and assuming special roles.
- (2) The following are advisory tips for INED participation:-
 - (a) Be inquisitive in questioning assumptions.
 - (b) Listen sensitively to the views of others, both inside and outside the board.
 - (c) Debate constructively.
 - (d) Motivate the board to see issues in a new or different way.
 - (e) Support management in leadership, complemented with supervisory monitoring.
 - (f) Provide input from general and/or specialist knowledge and relevant outside information.
 - (g) Provide a link to outside contacts.
 - (h) Assume multi-dimensional roles such as facilitator, catalyst, sounding board, ambassador, monitor and networker.
 - (i) Work on key committees of the board, particularly those committees that are required to be composed of majority INEDs and to be delegated in scrutinising issues before board endorsement.
 - (j) Gain the respect and trust of other board members.

2. Risk management

- (1) INEDs are well poised to address enterprise risk management from both insider and outsider perspectives, in achieving entity objectives against risks.
- (2) Risk management calls for the careful review of risk strategy including risk appetite, risk governance and culture, risk assessment, risk mitigation and monitoring.
- (3) Risk assessment is enabled by, *inter alia*, data analytics. INEDs must be alert in examining data analytics.

- (4) Risk management involves examining the effectiveness of the three lines of defence: the functions that own and manage risk, the functions that oversee or specialise in risk management, and the functions that provide independent assurance, i.e. internal audit.
- (5) The risk list covers financial risks, operational risks and reputational risks.
- (6) In today's world trend, institutional investors steer their investments towards companies that do well in ESG implementation. Companies that are behind in ESG implementation risk losing investment, stakeholder trust, reputation, opportunities for business expansion and supply-chain dynamism.

3. Scrutinising internal control

- (1) INEDs should make sure that a robust system of internal control is in place, in assurance of the company's operational effectiveness and efficiency, reliable financial reporting and compliance with laws, regulations and policies.
- (2) INEDs should exercise shrewd scrutiny over the internal controls that address errors and irregularities. The scope of internal controls covers measures of prevention, detection and correction of errors and irregularities and direction to generate desirable outcome.
- (3) INEDs should ensure the proper functioning of internal audit, performed by internal staff or an external professional adviser. Internal auditors report independently to the audit committee and/or board, not management, to assist in the oversight of the company's system of risk management and internal controls.

4. Shareholder relations

- (1) INEDs play an important role in shareholder relations.
- (2) Upon induction, INEDs should obtain a balanced understanding of the concerns, if any, of shareholders, particularly the institutional investors.
- (3) It is an INED's duty to attend general meetings and acquire understanding of shareholders' concerns and issues expressed thereat.
- (4) INEDs should exercise due care in reviewing the company's announcements and reports to shareholders before publication.
- (5) INEDs are at times required to take part in meeting investors, particularly on occasions of special transactions.

5. Skillsets

A competent INED is equipped with the following desirable skillsets:-

- (1) industry knowledge – of the company’s industry and insights from other industries.
- (2) successful experience as a company director – business and boardroom track record.
- (3) general knowledge of the laws and regulations required to be complied by the company.
- (4) financial literacy.
- (5) digital-governance literacy.
- (6) data-analytics literacy.
- (7) communication skills, particularly in influencing.
- (8) the fine art of dissent.

6. Sustainability

- (1) Corporate sustainability is communicated through ESG reporting, which is an evolving practice. INEDs should champion the ESG cause to the board – promoting board leadership in ESG adoption and oversight; ensuring management takes it to heart and works to permeate the corporate ESG culture.
- (2) INEDs may draw the board’s attention to the drivers for ESG adoption: opportunities for operational efficiency, new products and services, encouraging innovation, improved access of capital, enhanced risk management, talent attraction and retention, effective supply chain management, introducing Privacy Management Programme, rapid growth of green bond market, sustainability indices and improved reputation.
- (3) The board’s checklist for ESG implementation includes environmental impact and green policy, stakeholder issues covering supply chain conformance, employee relations and treatment (health and safety, development, training, diversity and equal opportunities), product responsibility, anti-corruption measures, personal data protection etc. The United Nations Sustainable Development Goals are standards for common reference.
- (4) INEDs should be alert to the “materiality”, “quantitative”, “consistency” and “balance” principles in ESG reporting.

Set up Privacy Management Programme to gain Customers' Trust



Organisations may refer to the **Best Practice Guide on Privacy Management Programme** issued by the Office of the Privacy Commissioner for Personal Data, Hong Kong.

Good Corporate Governance is Cornerstone to a Strong Economy



Corporate Governance Development Foundation Fund

A charitable organisation under Section 88 of the Inland Revenue Ordinance, the Corporate Governance Development Foundation Fund aims to provide and establish funds for the advancement of good corporate governance and contribution towards advancing the status of Hong Kong.

7. Working on board committees

7.1 Committee work

- (1) The key committees where INEDs play a pivotal role are the audit committee, nomination committee and remuneration committee. For review of special transactions, an independent board committee needs to be set up. An ESG committee, though not mandatory, helps a company focus on ESG adoption and ensures its ESG implementation is keeping pace with external trends.
- (2) General advisory tips for committee work
 - (a) When setting agenda, ensure coverage of regulatory stipulations.
 - (b) Be interactive in meeting with management, external auditor, internal auditor and external consultants.
 - (c) Ask for further management report, when the need arises, for clarification and as a basis for decision-making.
 - (d) Initiate independent studies of special issues, through engaging external advisers.

7.2 Working on audit committee

- (1) *HKEX Listing Rules*: composed of NEDs only, majority INEDs, chaired by INED.
- (2) The audit committee is tasked with overseeing external audit, internal audit, system of internal control, risk management and ESG reporting etc.
- (3) Additional advisory tips for the audit committee:-
 - (a) Convene private meetings with auditors, not only in regularly scheduled sessions but also when the need arises.
 - (b) Identify and query exceptions and potential loopholes in financial reports, internal audit findings and management responses.
 - (c) Go through the essentials in sub-sections II.2 on risks, II.3 on internal controls and, if there is no separate ESG committee, II.6 on sustainability.

7.3 Working on nomination committee

- (1) *HKEX Listing Rules*: composed of majority INEDs, chaired by INED or chairman of the board.
- (2) The nomination committee is tasked with establishing procedures for appointing new directors and renewal of existing directorships and reviewing nomination proposals.

- (3) Additional advisory tips for the nomination committee:-
- (a) Include in the board diversity policy the balance in experience, skills, gender, age, education, ethnicity, board roles *and* any other factors that are relevant to the company's business model.
 - (b) Ensure the board diversity policy is implemented in practice.
 - (c) In searching for a candidate to fill a vacancy on the board, set the criteria of assessment, which should include (i) the parameters after considering board diversity and components or factors missing in the current board composition and (ii) the candidate's competence, track record, reputation, connections, character, independence as well as time availability versus number of directorships.
 - (d) Discuss board and senior management succession and establish a formal succession plan with appropriate timing.
 - (e) Include in succession planning the elements of training and nurturing. It is not uncommon for a founder of the company to contemplate appointing to the board a younger family member with the intention to be groomed as successor. In this case, identifying a mentor from the board may help in coaching the new director.

7.4 Working on remuneration committee

- (1) *HKEX Listing Rules*: composed of majority INEDs, chaired by INED.
- (2) The remuneration committee is tasked with addressing policy and proposals for remunerating directors and senior management.
- (3) Additional advisory tips for the remuneration committee
 - (a) Note board responsibility for setting performance goals in line with targets and strategy and monitoring progress, complemented by remuneration committee responsibility for establishing executive compensation policy that covers incentives for long-term performance goals.
 - (b) Involve HR Director in meetings, who should provide information on industry trends and comparable companies when reviewing remuneration proposals.
 - (c) Consider how to align the remuneration of CEO and senior management with long-term interests of shareholders.
 - (d) Consider how to incentivise long-term performance goals of CEO and management. In adverse times, consider how to manage the expectations of CEO and management without jeopardising motivation.

7.5 Working on the voluntary ESG committee

INEDs may add value to the board by taking an active part in this committee. It is advisable to go through the essentials in sub-section II.6 on sustainability.

7.6 Working on an independent board committee

- (1) For a proposed special transaction, an independent board committee is tasked with reviewing, with advice by an independent financial adviser (“IFA”), whether such a transaction is in the interests of the company and is fair to the independent shareholders. In conclusion, the committee provides advice to the independent shareholders on how to vote.

- (2) Additional advisory tips for the independent board committee:-
 - (a) Ensure that the IFA is *bona fide* independent.
 - (b) Discuss thoroughly with the IFA.
 - (c) Examine analytically the IFA’s recommendation.
 - (d) Exercise judgment on the fairness and reasonableness of the subject transaction.
 - (e) Address concerns, if any, raised by the regulators.
 - (f) Attend the general meeting on the subject transaction and be prepared to answer queries raised by shareholders.

III. WORKING WITH INEDs: Guidelines for the Company

1. Team cultivation

The board functions as a team. In a two-way relationship, EDs, NEDs and management should ensure that INEDs are treated with inclusion, integration, motivation, empowerment and facilitation of work.

2. Chairman leadership

The board chairman should take the lead in cultivating the right attitude and work relationship with INEDs.

3. Chairman communication

The board chairman should conduct private sessions, apart from the mandatory annual session, with INEDs to discuss major issues and any concerns.

4. Terms of engagement

The company should offer reasonable remuneration and coverage of Directors and Officers Liability Insurance for INED engagement.

5. Enabling well-informed INEDs

The company should arrange for INEDs comprehensive induction and prompt updates on director duties.

6. Time allowance

INEDs should be given reasonable time to review documents before meetings and significant reports before announcement.

7. Management initiatives

Management should proactively communicate with INEDs between board meetings, giving timely alerts about potential crises and briefings on significant issues and new proposals.

8. Involvement

The company should invite INEDs to participate in major events and stakeholder engagements.

9. Facilitating advice

The company should provide INEDs with independent professional advice concerning special circumstances and as requested by INEDs, at company expense.

CONCLUSION

Given the enormous obligations and responsibilities, who would want to serve as an INED? Usually INEDs are mission-minded persons who are appropriately trained and who advocate good corporate governance.

Rewards for INEDs include fair remuneration, satisfaction from making effective contribution to the board, energy from the board's strong teamwork, inspiration from the chairman's capable leadership, being involved in establishing improved corporate governance by the company and working with a supportive and competent management in a co-operative corporate culture.

There are definite expectations of INEDs in performance. It is significant to develop a partnership of mutual respect and trust between the INEDs and other board members as well as management. It takes the whole board and management, working together, to realise the maximum value from INEDs.

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