

Submission by the Hong Kong Investment Funds Association in response to the HKEX Consultation Paper - Review of Corporate Governance Code and Related Listing Rules
(June 18, 2021)

(I) Overall comments

We welcome the issuance of this Consultation Paper (“Paper”) by the HKEX which aims to enhance the corporate governance standards of listed companies, thus according better protection to minority shareholders.

By and large, we believe the proposals put forward are in order. [Please see our answers to the specific questions raised (see (II))].

But we believe that the Paper has not addressed the gist of the problem: how to ensure that issuers achieve independence and accountability of the Board, which is the bedrock of a robust corporate governance framework.

To achieve meaningful outcomes, it is imperative that the HKEX requires each issuer to:

- have a “at least 50% independent” Board; and
- appoint a lead INED or designate an INED that is responsible for investor engagement.

To allow issuers sufficient time to prepare, this can be implemented in two phases – start off by incorporating the requirements in the Recommended Best Practice (“RBP”) and then upgrade them to Code Provisions (“CP”) in three years’ time.

We wish to stress that these two proposals are not something “nice to have” – they are just basic hygiene factors that any financial centers should have. If Hong Kong is to prove its mettle as an IFC, it cannot just continue to tinker at the edges. The authorities should demonstrate the resolve to introduce structural changes to the corporate governance framework. If the authorities believe otherwise, we wish to have their insights as to why they think so; and their visions, if any, regarding the way forward.

- Why is it important to have a “at least 50% independent” Board?

The requirement of one-third board independence has been in place since 2012, and the effectiveness of INEDs at the Board has proved to be marginal at best. If the HKEX believes that the current regime is working, why does it need to propose something so basic under Qtn 3 (to require disclosure of a policy to ensure independent views and input are available to the board...)? Isn’t it an integral part of the role of INEDs to provide independent views?

Furthermore, Qtn 7 also proposes to upgrade a CP to Rule requiring issuers to establish a NC chaired by an INED and comprising a majority of INEDs. If the HKEX believes that this principle is meaningful, why does it think this should not be applied more generally?

For a board to fulfil its oversight role effectively, it needs to be sufficiently independent. The current independence requirement of one-third is not sufficient for INEDs to discharge their responsibilities effectively, especially considering the controlling shareholders – which is a common feature in Hong Kong – often own enough votes to elect or remove them.

Only with at least 50% board independence will independents and non-independents be on an equal footing. Only with this, will there be a fundamental change to the dynamics which enable INEDs to express views without bias or conflict of interest; and to counterbalance the undue influence of controlling shareholders.

- Why do we need a Lead INED or a designated INED for investor engagement? What is the expectation of investors?

Underlying this suggestion is a basic expectation of investors – INEDs should be accountable to and represent the views of minority shareholders as much as those of the controlling shareholders. The only way an independent director can be expected to act independently is for the INED to be aware at all times that he/she is accountable to all shareholders (not just the controlling shareholder) and would be required to explain to the minority shareholders. (e.g. when major issues are discussed, e.g. M&A, RPTs, what are the factors that came into consideration and what are not being considered?) The perspective on the quality of the Board discussions, including the contribution of the INEDs, can greatly enhance the understanding of the company's value proposition and sustainability.

Ultimately, what this boils down to is something very modest, but basic: investors just wish to have an INED who is responsible for shareholder engagement so as to facilitate investors to perform the stewardship function, which ultimately have a bearing on how to allocate capital amongst companies.

However, albeit repeated exhortations by the investor community all these years, this request has been put on the backburner by the regulators. The Consultation Paper has briefly touched upon this point, but stops short of doing anything.

Investors have all along been pointing out that it is imperative that they should be able to have access to INEDs to have their insights and views. However, the authorities and the issuers have maintained that engaging with INEDs is not necessary because the appropriate contact point should be the management, as they are well-versed with the ins and outs of the operation of the company and are in the

best position to represent the company to share the company strategy and direction. They don't see why there is a need for investors to talk to INEDs, let alone to have a lead INED.

While we subscribe that the issuer's management can provide useful insights about the company policies, strategies and operational issues; access to INEDs is of equal, if not of greater importance. INEDs can provide independent perspectives on major issues, such as related party transactions and major M&A proposals as well as other critical issues. Investors should be able to engage with both the management and INEDs, and we see this as complementary rather than mutually exclusive.

The push back seems to reflect that many issuers and even the authorities are oblivious of the fact that INEDs are accountable not only to the controlling shareholders who appoint them, but to all shareholders who have an economic interest in the company.

All board members have a fiduciary responsibility to protect the best interests of the company. This is their responsibility in principle; it needs to also be true in reality. Controlling shareholders, executive directors and NEDs will often have conflicts of interest. The role of INEDs is crucial in that there is a representation on the board of directors who are not conflicted, able to bring up for discussion matters that need to be discussed but that may get ignored or dismissed by those who have potential conflicts of interest. INEDs are meant to be the voice of those who are not conflicted and to vote accordingly.

If INEDs are shielded from having to communicate with minority shareholders and to be accountable to them – which unfortunately is the current market practice – what is the incentive for them to act out the “independent” role, to query the controlling shareholders, to voice dissenting views and to bring up pertinent questions to controlling shareholders and/or management on major issues? Why would they exercise professional scepticism and raise independent views on major issues at which minority shareholders are most vulnerable – and it is precisely here where their independence is needed most? How can anyone ensure INEDs exercise independence and be critical if they do not have to explain the decisions to anyone other than the controlling shareholders?

A classic example is “related party transactions”. Throughout the years, Hong Kong has seen dubious transactions approved by board directors, as well as poor quality management accepted with little oversight or major changes in management initiated by the board. There is scant evidence that directors are playing the role expected of them, to act in the interests of the company and all shareholders.

But when managers ask for meetings with INEDs to discuss these, the answer they typically get is that the management, let alone, the INEDs should not say more than what is contained in the Notice or else they will fall foul of the Rules. They fail to

understand that what investors are looking for is NOT insider information, but the rationales and the thought process underlying the transactions; and the contribution of INEDs in the deliberation process.

If there are no regulatory initiatives to ensure that INEDs are accountable to minority shareholders, and that they act accordingly, we will only continue to have a system where “independent” directors exist in name only.

The Hong Kong market has always been populated by companies which have controlling shareholders: family, individual founder or state-controlled. And this is further aggravated by the introduction of WVRs and secondary listings. Against this backdrop, it is even more important and urgent to introduce measures to ensure accountability so as to ensure that HK will achieve the standards that commensurate with its position as an IFC.

In the Paper, weak arguments have been put forward to rebut the appointment of a lead INED, such as “*creating hierarchy and difficulties in finding candidates*”. Our question is if someone is ready to take up the post of INED, why would he/she have so much reservations about taking up the role of lead INED? What issues does he/she envisage which have put him/her off? Ultimately, irrespective of whether he/she is the lead or not, he/she should be accountable to the minority shareholders.

We wish to understand why the HKEX believes that the aforesaid concerns, if any, are so formidable; that it is not appropriate to even bring up the idea of a lead INED for market consultation?

We understand that there is much angst amongst issuers about the introduction of Lead INEDs, but we believe that there are practical solutions to make this palatable, e.g. allow co-Lead INEDs; or a rotation system where INEDs will take turns to be the Lead INED.

A lead INED is a must. The rise in the appointments of lead/senior INEDs globally echoes the demand of investors. To investors, the question should be how, rather than why.

(II) Comments on the respective questions raised in the Consultation Paper

Question 1 Do you agree with our proposal to introduce a CP requiring an issuer’s board to set culture in alignment with issuer’s purpose, value and strategy?

We agree with the proposal. A company’s culture will help set the tone and direction of the company, as well as the attitude and conduct of its management and employees. Thus, setting the culture is pivotal. However, the problem with many listed cos is not the lack of culture, but the lack of the culture that is conducive to a

deliberation process that takes into account the interest of all investors, in particular minority shareholders. More often than not, there is a tendency to focus too much on achieving consensus; and independence is not achieved.

Unless the culture set is to foster an independent mindset, we don't see how this CP will foster CG.

Question 2 Do you agree with our proposal to: (a) introduce a CP requiring establishment of an anti-corruption policy; and (b) upgrade a RBP to CP requiring establishment of a whistleblowing policy?

We agree with both proposals. But establishing the policy is only a first step – issuers should disclose, inter alia, who has ownership of the policies, what is the role of the Board in these policies, who are responsible for ensuring their effectiveness, and how do the whistleblowing and anti-corruption policies work; and the protection accorded to whistle-blowers.

Question 3 Do you agree with our proposal to introduce a CP requiring disclosure of a policy to ensure independent views and input are available to the board, and an annual review of the implementation and effectiveness of such policy?

What is critical is to ensure that not only independent views and inputs are available, but are considered by the Board.

Furthermore, to prevent this from turning into a tick the box exercise, we believe that there should be clear disclosures as to how the Board assesses the effectiveness of the policy; what sort of metrics are being used, and more importantly, the follow up actions to address the gaps, if identified.

One tool to achieve this is to increase the robustness of board evaluation by upgrading the board evaluation from the RBP to CP and require the disclosure of the following items about board evaluation – e.g. what are the areas that are being evaluated, the criteria being used, who is performing the evaluation, what follow up actions are taken with respect to the findings.

Question 4(a) Do you agree with our proposal regarding re-election of Long Serving INEDs to revise an existing CP to require (i) independent shareholders' approval; and (ii) Additional Disclosure?

Members generally support the proposal to require independent shareholders' approval for re-election of long-serving INEDs, as well as additional disclosures on the factors considered, the process and the board or nomination committee's decision in justifying the director's independence.

As some members have pointed out, it takes one to two terms for INEDs to learn about the business and the sector. And that they would start to make contributions from the 2nd term; and INEDs contribution peaks around term 3. So, we understand the logic behind the nine-year term.

But, to enable minority shareholders to have a greater say in the process, shouldn't independent approval come earlier, say at six-year? If the INEDs' performance meets the expectations of the minority shareholders, we don't see why they will not vote them in. But at least, this can ensure that INEDs are subject to more robust review and scrutiny earlier in the lifecycle.

Apart from the long stint, another problem of INEDs is the lack of "independence" in substance. We would exhort HKEX to amend the CP re nomination and appointment of INEDs:

- INED nominees should not hold cross-directorships or have significant links with other directors through involvements in other companies or bodies.
- No exemptions and no discretion should be allowed for the appointment of INEDs which have specific relationships or external factors that make their independence questionable.
- There should be a longer cooling off period, (3-5 years instead of 1-2 years as proposed), and this should also apply to secondary listed issuers. Also, we would exhort the HKEX to provide clarification regarding how a director's tenure is being calculated for the purposes of counting the cooling off period.

Question 4(b) Do you agree with our proposal to introduce a CP requiring an issuer to appoint a new INED at the forthcoming AGM where all the INEDs on the board are Long Serving INEDs, and disclosing the length of tenure of the Long Serving INEDs on the board on a named basis in the shareholders' circular?

We agree with the proposal of adding a CP requiring the appointment of a new INED at the forthcoming AGM where all the INEDs have served on the board for at least nine years. But in the first place, to prevent the latter from happening, should there be mechanisms to stagger the refreshment process such that at any one time amongst INEDs, Long Serving INEDs would not constitute a majority.

In addition, we believe that the HKEX should require mandatory disclosure of the length of tenure of all Board directors, including INEDs, on a named basis in the shareholders' circular and the annual report. The information would shed more light on the independence and refreshment of the board members.

Question 5 Do you agree with our proposal to introduce a new RBP that an issuer generally should not grant equity-based remuneration (e.g. share options or grants) with performance-related elements to INEDs as this may lead to bias in their decision-making and compromise their objectivity and independence?

Agree with this proposal; as equity-based remuneration may compromise INEDs' objectivity and independence, which is most needed if they are to discharge their oversight responsibilities appropriately.

In addition, there is the general observation that INEDs' pay for public companies listed on the HKEX is relatively low. This may discourage quality candidates from taking a board director position or indirectly result in the over-boarding phenomenon. We encourage the HKEX to conduct a survey to ascertain the current state of play and to encourage competitive compensation for attracting quality independent directors.

Question 6(a) Do you agree with our proposal to highlight that diversity is not considered to be achieved by a single gender board in the note of the Rule?

Single-gender board is not acceptable; and will potentially discourage candidates from minority groups to join.

Under the proposal, after the revised Rules become effective, existing issuers with single gender boards will be allowed a three-year transition period to appoint at least a director of the absent gender. The transition period is too long. It should be the financial year commencing on or after January 1, 2022.

Question 6(b) Do you agree with our proposal to introduce a MDR requiring all listed issuers to set and disclose numerical targets and timelines for achieving gender diversity at both: (a) board level; and (b) across the workforce (including senior management)?

We support the proposal – to introduce a MDR re the establishment of a time-bound long-term target of 30% women on the board, and the interim targets.

Question 6(c) Do you agree with our proposal to introduce a CP requiring the board to review the implementation and effectiveness of its board diversity policy annually?

We agree with the proposal. Issuers should include an annual review of the implementation and effectiveness of its board diversity policy as part of board evaluation process.

Question 6(d) Do you agree with our proposal to amend the relevant forms to include directors' gender information?

This is a good starting point; but gender is only one aspect of diversity. Issuers should also disclose other aspects of diversity of their directors, e.g. ethnicity,

nationality, age, expertise in the relevant forms; and the skills/expertise that each director contributes to the Board.

Question 7 Do you agree with our proposal to upgrade a CP to Rule requiring issuers to establish a NC chaired by an INED and comprising a majority of INEDs?

We agree with this proposal, which is in line with international best practices.

However, if the HKEX believes that this principle is meaningful for the NC, why doesn't it apply to the Board generally? We would exhort the HKEX to provide justifications for the differentiated treatment.

Question 8 Do you agree with our proposal to upgrade a CP to a MDR to require disclosure of the issuer's shareholders communication policy (which includes channels for shareholders to communicate their views on various matters affecting issuers, as well as steps taken to solicit and understand the views of shareholders and stakeholders) and annual review of such policy to ensure its effectiveness?

We are supportive of the proposal to "upgrade a CP to a MDR to require disclosure of the shareholder communication policy (e.g. channels, steps) and annual review to ensure its effectiveness."

However, our concern is that the proposal, as it currently stands, can only at best be a paper exercise - we don't think any issuers will find it difficult to come up with a communication policy. What is important, but is missing from the proposed requirements, is who from the issuer would be engaging with the investors, and what are to be communicated - there are major gaps between what investors believe should be in place and what the issuers would be ready to commit. Unless the gaps are bridged (which the CP has not even touched on), any communication policy and assessment of effectiveness will at best be perfunctory.

Also, to prevent this from turning into a box-ticking exercise, we suggest the MDR to require issuers to disclose actions taken or to be taken following the annual review of the policy. This is to ensure that issuers will walk the talk. In particular, issuers' engagement with investors should go beyond the topic of financial results. The board owning the ultimate responsibility and oversight of material matters including ESG topics.

Whatever the arrangement, it should be made known to the minority shareholders. In the disclosure document, there should be a dedicated section explaining how INEDs engage investors. It should clearly spell out, amongst others, (1) how they communicate with the minority shareholders (2) which INEDs are responsible for engagement; (3) how frequent; (4) number of meetings held; (5) how are inputs by minority shareholders being factored in at the Board discussion, if at all.

Question 9 Do you agree with our proposal to introduce a Rule requiring disclosure of directors' attendance in the poll results announcements?

We agree with the proposal requiring disclosure of directors' attendance in the poll results announcement, as it is often a sign of directors' commitment to the company. However, attendance numbers are not sufficient. In addition, directors should also disclose the number of public boards and their respective roles.

Many Hong Kong-listed companies have over-boarded directors. Based on [the HKEX data as at 15 April 2021](#), more than 60 board directors sit on more than six public boards, with 17 board directors serving at least 10 public boards and up to 19 public boards. These are unhealthy figures and we wish to understand how the HKEX intends to address the issue of over-boarding.

Question 10 Do you agree with our proposal to delete the CP that requires issuers to appoint NEDs for a specific term?

Agree.

Question 11 Do you agree with our proposal to elaborate the linkage in the Code by (a) setting out the relationship between CG and ESG in the introductory section; and (b) including ESG risks in the context of risk management under the Code?

We support this proposal, as we believe that this will enable the Board and management to take a holistic approach by integrating ESG into the business strategy and risk management framework, instead of treating them in silos.

Issuers should be encouraged to align management remuneration with long-term value creation, including sustainability related goals of the company and more specifically ESG metrics.

In addition, the HKEX should set a clear roadmap and specific timeline for implementing the recommendations of the TCFD so as to guide issuers towards TCFD aligned reports by 2025. Also, the HKEX should consider incorporating SASB standards into the ESG Reporting Guide so as to help issuers determine the material ESG metrics for the relevant sectors for linking with incentive plans.

Question 12 Do you agree with our proposal to amend the Rules and the ESG Guide to require publication of ESG reports at the same time as publication of annual reports?

Agree, we believe that it is a must.

Question 14 In addition to the topics mentioned in this paper, do you have any comments regarding what to be included in the CG GL which may be helpful to issuers for achieving the Principles set out in the Code?

See (I)

Globally there has been an increased focus on an outcomes-based measurement. In the UK, the revised 2020 stewardship code has placed a strong focus on activities and outcomes of stewardship.

The HKEX should be moving in the same direction to require issuers to demonstrate how they transpose the requirements and achieve meaningful outcomes. For a number of the proposals outlined in the Consultation Paper, issuers should disclose how they assess their effectiveness, the metrics being used, (e.g. anti-corruption policy, whistleblowing policy, shareholders communication policy) and how they have been faring on those counts.

Question 15 Do you agree with our proposed implementation dates of: (a) for all proposals (except the proposals on Long Serving INED): financial year commencing on or after 1 January 2022; and (b) for proposals on Long Serving INED: financial year commencing on or after 1 January 2023?

All requirements should be implemented at the same time, i.e. financial year commencing on January 1, 2022. We do not see any compelling reason to have a staggered implementation schedule.

(End)