# Response to SEHK on Corporate Governance Consultation

***25th March 2011***

## Introduction

This document is the response of Webb-site.com to the Consultation Paper On Review of the Code on Corporate Governance Practices and Associated Listing Rules from The Stock Exchange of Hong Kong Ltd (the **Exchange**) launched on 17-Dec-2010. Before dealing with the 116 Questions in numeric order, we will make some general comments on its approach.

### Qualification to comment

Webb-site's editor David Webb is a substantial investor in several small-cap HK-listed companies. He worked as an in-house adviser to a HK-listed conglomerate for 4 years from 1994-1998, and prior to that was a corporate finance adviser based in Hong Kong from 1991-1994 and in London from 1986-1991. He has been a member of the SFC's Takeovers and Mergers Panel since 2001. He was an elected independent director of a large-cap HK-listed company, Hong Kong Exchanges and Clearing Ltd (**HKEx**, 0388) from 2003 to 2008. HKEx happens to be your parent company. This experience of corporate governance, from the inside and the outside, informs our response to your paper.

## INEDs & poll results

We attach the article The three wise monkeys of HK boards, together with the results of an opinion poll on Independent Non-executive Directors (**INEDs**) in HK-listed companies. They form an integral part of this submission. The poll was open from 15-Feb-2011 to 4-Mar-2011, and anyone was free to participate. Participation required the use of a PIN which was sent to the respondent's e-mail address to deter multiple voting.

As you can see, there were 176 respondents to most questions. 151 respondents said that controlling shareholders should not be allowed to vote on elections of INEDs in shareholder meetings, while only 19 said they should. Similarly, 151 said that executive directors should not vote on INED elections, while 17 said they should. 147 respondents agreed that independent directors should be elected only by independent shareholders, while only 19 disagreed. These are overwhelming majorities by any measure. Your consultation failed to address this most fundamental issue - in most HK-listed companies, INEDs serve at the pleasure of a controlling shareholder.

Only 6 out of 173 respondents said that the current system for appointing INEDs is working for investor interests, while 152 (96% of those who expressed a view) disagreed with that proposition. Interestingly, in the cross-tab analysis, of the 19 people who said controlling shareholders should be allowed to vote in INED elections, 12 of them admitted that the current system for appointing INEDs does not work for investor interests, while only 2 said that it does, and 5 were undecided.

As a consequence, it is unsurprising that when asked "Overall, how do you rate the performance of INEDs in HK?", nobody replied "very effective", and only 15 said "somewhat effective". The other categories were "generally ineffective" (60), "very ineffective" (46) and "completely ineffective" (45), a total of 151. So the best that can be said of INEDs is that less than 10% of the market thinks they are somewhat effective while the rest rates them somewhere between generally and completely ineffective.

So before you continue with shuffling the deckchairs on the Titanic, we urge you to rethink the appointment system for INEDs and build a better ship. This is far more important than tinkering with rules on how many committees they should form or how many boards they can sit on, or whether they should read articles on corporate governance. If INEDs were elected by independent shareholders, then the market would decide on a case-by-case basis, and by developing institutional guidelines, whether a busy candidate is worthy of election or re-election, whether he has stayed too long, or whether he has relevant skills.

The UK, for example, has the Institutional Voting Information Service (IVIS) run by the Association of British Insurers, and it has developed voting guidelines on numerous areas of corporate governance. So has the UK's National Association of Pension Funds. In the US and globally, Institutional Shareholders Services Inc, a leading proxy voting advisory firm, also develops voting policies by open consultation. Also in the US, the Council of Institutional Investors formulates voting policies.

But so long as you continue to allow controlling shareholders to elect the entire board, INEDs will not be independent, will not be electable or removable by independent shareholders, and will have no mandate or authority to perform an effective role in corporate governance.

Now we turn to the questions in your paper.

## Plain writing amendments (Q1)

No comments on this (as long as you fix the grammar issues), but we urge you again to produce a better electronic version of the Rules. The current consolidated PDF, of 1036 pages, has no bookmarks for chapters and no internal hyperlinks to navigate cross-references. As we move towards a tablet PC era, more users will want something where they can just tap or click on a link and jump to the correct reference, as many rules refer to other rules.

### In the beginning, there were the definitions, and then there was light...

You could also tidy up the definitions - for example, it says that "accounts" and "financial statements" have the same meaning but it doesn't say what that meaning is. You should do a global search-and-replace for the phrase "financial statements" and replace it with "accounts", then delete the definition. You also have a big chunk of definitions buried in Rule 19A.04. It would be better to keep all definitions in one place, Chapter 1.

Some defined terms are Capitalised, but many are not (and Chinese has no capitals). In order to avoid ambiguity, and make it clear when the reader should refer to a definition rather than assuming a common meaning, you should use **bold text** for any defined term throughout the Listing Rules, and in the electronic version, link them back to the definition.

## Directors' duties (Q2-3)

We support the proposed warning against delegation of responsibilities in Rule 3.08.

In the proposed Note to Rule 3.08, the reference to the Companies Registry is acceptable, as this is a Government agency and the purpose is to elucidate the requirements of Hong Kong law (the Companies Ordinance) as mentioned in the first paragraph of Rule 3.08. However, we do not support the following cross-reference:

> "directors are generally expected by the Exchange to follow the Guidelines for Directors and the Guide for Independent Non-executive Directors published by the Hong Kong Institute of Directors (www.hkiod)".

The HKIOD is not a regulator or statutory body, and the Exchange should not outsource standards-setting to such private-sector bodies. The guidelines issued by HKIOD may change from time to time and do not necessarily represent the standards that investors expect of directors, only what directors expect of directors. The HKIOD is a body of directors, not investors. The Exchange should publish its own guidelines. Finally, we note that ".hkiod" is not a top-level domain, so the web address is obviously wrong.

## Nomination committee and time commitments (Q4-10)

No to all. The proposed requirements that the Nomination Committee should regularly review the time required from a director to perform his responsibilities and whether he is spending sufficient time as required, and a confirmation from him that he has, are overly prescriptive and of no value. The same applies to the other proposals in relation to time commitment.

It should be up to shareholders (or in the case of INEDs, independent shareholders, as we propose) to assess whether directors can do their jobs, using whatever objective information is provided in addition to the attendance records at board meetings and AGMs. It is implicit in any director's decision to remain on a board that he should be allocating enough time to fulfil the "care and diligence" obligation in his duties, whether executive or non-executive.

## Limit on number of INED positions (Q11-13)

No. See our reasons in the attached article.

## Continuous Professional Development (Q14-16)

No. Again, this is overly prescriptive and unrealistic. If directors choose not to inform themselves of the laws and regulations (including Listing Rules) which they have agreed to uphold, then they are not carrying out their duties with proper care and diligence. Ignorance is no excuse for breaking the law and regulations. In practice, this is more about incentive and deterrent - the penalty for breaking Listing Rules is often no more than a a criticism ("you've been bad") or a censure ("you've been *very* bad").

A director cannot be fined, let alone jailed, for breaches of the Listing Rules, because the Rules lack statutory backing. For nine years since the Expert Group Consultation in 2002, the Exchange has opposed giving meaningful statutory backing to the Listing Rules. Click here for a history of this issue. What started as an Expert Group recommendation to transfer regulation of listed companies back to a Listing Authority under the SFC and to give all the rules statutory backing has ended with a Government proposal for statutory backing of a single rule on publishing price-sensitive information.

Of course, those directors who care about their reputation and are diligent in their work will inform themselves about their responsibilities, and will ensure that their companies provide the resources to do so. Anyway, the CPD proposal almost waters itself down to homeopathic levels by suggesting that "reading relevant books and articles" would count towards CPD hours. That would include reading Webb-site.com (and who doesn't?). But who is going to verify that the director has read them? Like homeopathy, the proposal would have no more effect than a placebo.

## Upgrading proportion of board that is INED to one-third (Q17-18)

We agree with this requirement, but it will make no difference to corporate governance quality as long as the INEDs are not elected by independent shareholders. See reasons in the attached article.

We disagree with the long transitional period. 31-Dec-2011 is a more reasonable deadline, for the following reasons:

- Over 80% of companies already comply. There are currently 273 out of 1419 (19.2%) that do not, but in 15 cases that is only because they have fewer than the required 3 INEDs, often because the are insolvent or undergoing restructuring
- By increasing to four INEDs, 167 of the 273 companies would comply with the one-third rule.
- Alternatively, by having 3 INEDs but losing one non-independent director, 103 companies would comply
- By doing both of these things, 209 companies would comply, implying a minimum of only 106 INED appointments to solve 209 cases
- That leaves 64 companies, each with at least 13 directors, which need to either appoint more than 1 INED or lose more than 1 non-independent director. Most of them are large-cap companies with boards stuffed full of family members or society figures. These companies should have no difficulty in reducing their board size or appointing more INEDs to achieve the target.

We will be happy to provide the working data for the above calculations upon request.

## Separate resolution for long-term INED re-election (Q19)

Yes, we support this, but in practice, there is almost always a separate resolution for election or re-election of each director, including INEDs, rather than en-bloc voting, so the proposed Code Provision does not add much. It appears that CP E.1.1, against bundling of resolutions, already requires the election or re-election of each director to be voted on separately as a "substantially separate issue". Indeed, the Note to E.1.1 gives the nomination of each person as a director as an example of a "substantially separate issue".

Again, the market reality is that the INED usually serves at the pleasure of a controlling shareholder. If INEDs were elected by independent shareholders, then those shareholders would decide, by their votes, whether a candidate who has served for many years remains acceptable.

## Reasons for election and independence of an INED (Q20)

It is unclear whether the proposal applies only to elections of people who are not already INEDs, or also to the first election after appointment by the board, or also to re-elections. We believe this should apply to all of these situations. Again, though, the proposal is meaningless if a controlling shareholder is going to vote in favour anyway.

We note that your consultation does not address other areas which ought to disqualify anyone from being considered "independent" under the Listing Rules:

- Being a director of any other company under common control: too often, the same INED sits at multiple levels in the same family tree of companies. When two of these companies do a connected transaction, or when one tries to privatise the other, the INED is conflicted out of giving an opinion to independent shareholders, because he owes a duty to both sides of the transaction. The pool of available candidates in HK to be INEDs is sufficient that they should not also be a director of a substantial shareholder (>=10%) of a listed company, or of any company controlled by that substantial shareholder.
- The rules still allow someone to work lifelong for a company and then come back as "independent" two

years after leaving. There are enough candidates out there that no former employee should ever be considered independent. By all means have them back as an NED, but not an independent one.

- Despite the wording of existing Rule 3.13(4), the Exchange still allows people who are directors or employees of banks and of others which do business with a listed issuer (except professional advisers) to be counted as INED. Apparently the Exchange regards directorship or employment with such a party as not being a conflict of interest. For example, the CEO of The Hongkong and Shanghai Banking Corporation sits as an INED of Cathay Pacific Airways Ltd (0293), even though it provides numerous services and lends money to the airline. Investors want to maximise return on equity, but bankers just want to maximise equity, as cover for their loans. The interests are different.
- The rules also allow cross-directorships which create conflicts of interest and potential reciprocity. The market is rife with such overlaps. For example, the Chairman of The Bank of East Asia, Ltd (**BEA**, 0023) is an INED of Vitasoy International Holdings Ltd (**Vitasoy**, 0345), while the Chairman of the latter is an INED of the former. They sit in each other's remuneration committees and audit committees. BEA is also a banker to Vitasoy. In another example, the Chairman of BEA is an INED of Hong Kong and China Gas Co Ltd (**Towngas**, 0003) while the Chairman of the latter is an INED of the former. BEA is also a banker to Towngas.

Again, if independent shareholders elected INEDs, then we doubt that investors would allow any of these conflicts to persist, even if the Listing Rules allowed them. Boards would have to put forward candidates who are free of such conflicts, or face investor nominations instead.

## Remuneration committee (Q21-29)

Yes to all of these except Q29 (see below), but again, this is just rearranging deckchairs on the Titanic, so long as the executive directors and their associates are allowed to vote as shareholders on the election of INEDs.

Transactions between listed companies and substantial (>=10%) shareholders above certain waiver-thresholds normally require independent shareholders' approval. Remuneration of substantial shareholders who are directors remains one of the few exceptions to this. If you are not going to establish an independent election system for INEDs, so that independent shareholders can safely delegate the decision on executive remuneration to INEDs, then you should amend the rules to require that the remuneration package of persons who are also substantial shareholders should be subject to independent shareholders' approval.

Until then, we will continue to see controlling shareholders who are also the Chairman or Chief Executive siphoning off company funds in the form of excessive remuneration, blessed by a remuneration committee of friendly INEDs whom he elected. Excess remuneration of a controlling shareholder is theft by another name.

On Q29, we disagree with removing the reference to performance-based remuneration. This is an important consideration for remuneration committees. Executive directors should be appropriately rewarded and incentivised for the performance of the business, and this is a separate matter from the performance of the board as a board. This is also reflected in current RBP B.1.5.

## Nomination Committee (Q30-38)

No to all of this. It is overly prescriptive and disregards the market reality. There is really no need for Nomination Committees in the Code, whether as an RBP or a CP. It's presence as a CP would also encourage the delegation that Rule 3.08 (directors' duties) is trying to discourage. It should be up to a board to decide whether to make nominations itself or to delegate this to a committee, and to evolve its own process for making those decisions. Ad-hoc search committees to fill important executive roles are sometimes appropriate, but the board should decide when to use them.

Where there is a controlling shareholder, he/it will often decide the board composition alone, and in that case, any committee process to rubber-stamp that choice is a charade.

Again, if independent shareholders elected INEDs, then the board would take their nomination process much more seriously, because it would have to nominate candidates for those seats who are acceptable to independent shareholders, and the investors could always nominate their own candidates if they are unhappy with the board's nominations.

## Corporate Governance Committee (Q39-45)

No to all of this. It is just more deck chairs on the Titanic. Again, it encourages the delegation that Rule 3.08 (directors' duties) seeks to discourage. Good corporate governance is a matter for the whole board. Shuffling around the 3 wise monkeys and sticking a new label on the committee will not solve the problem of bad

governance.

Again, if investors believe there is a deficit of corporate governance in a particular company, then an independent election system for INEDs would allow investors to install good candidates who could try to rectify this on the inside. They would not always be successful in such efforts, but they could try. An INEDs report within the annual report would allow them to report independently on whether they are satisfied (see attachment).

## Audit Committee & whistleblowers (Q46-48)

Yes to all these questions, but we believe the establishment of a whistleblowing "policy" should be a CP, not RBP, and by policy, you mean "system". The real problem here is that people will only blow the whistle against management if they believe in the independence of the audit committee from management and that the identity of the source will not be disclosed to management without his consent. So long as INEDs are elected by controlling shareholders and executive directors, it is hard to imagine whistleblowers having the necessary confidence and trust to use such a system.

Further, for a whistleblower system to work, the informant should be able to send an e-mail or hard copy letter to the audit committee, or at least to its chairman, at a published address which is not capable of being monitored by the management. We suggest that you specify this in the CP. The address needs to be publicly available, because if the would-be whistleblower has to ask management for the address then it will be obvious why he is asking.

In the meantime, whistleblowers are welcome to contact the SFC, ICAC or Police, or failing that, to contact Webb-site.com. Webb-site protects the identity of our sources so far as is legally possible.

## Senior management remuneration (Q49-51)

As the paper notes, there is no definition of what constitutes senior management - the issuer is allowed to decide for itself and list their biographies in the annual report accordingly. If you impose remuneration-disclosure without defining "senior management" then many more issuers will decide, as some do now, that there are no senior managers, other than executive directors. That way, they can simply "opt out" of disclosure.

The draft leaves Appendix 16 with a patchwork of measures - paragraph 25(6) requires unnamed disclosure of remuneration in bands for non-directors in the top 5, while paragraph 25A (as proposed) requires named disclosure for senior management in bands. What a mess. Surely, the people who are in the top 5, and more than that, should be regarded as senior. It is difficult to conceive a situation where someone is amongst the top 10 highest-paid individuals but is not considered important to the group. Whether they are in a managerial role or in a star-performer role is not relevant. The essential point is that they are important to the group and are paid accordingly. Similarly, if they are outside the top 10, then they are probably less important to a group, and we don't need to know their remuneration even if they are listed as senior managers.

Accordingly, we believe the way to streamline your proposal and remove the opt-out incentive is this:

- named remuneration disclosure of all directors and any non-directors who are amongst the top 10 highest-paid persons (including directors). The top 5 is too limited, because that might often exclude important people who are not directors, such as the CFO, head of internal audit or group legal counsel.
- all such top-10 persons should be included in the senior management biographies, so that investors know more than just their names.
- a *de minimis* threshold would be acceptable - we suggest excluding non-directors under HK$0.5m per year. Otherwise, a company with only 10 employees (including directors) might end up disclosing the tea-lady's salary and publishing her biography, which might be interesting, but not from a corporate governance perspective.
- actual numbers, no banding. This is just obfuscation, and makes it hard to tell whether someone gets as much as a 50% pay rise from one year to the next ($1m and $1,499,999 fall in the same band).
- issuers should still include biographies of other senior managers who are not among the top 10 earners, without disclosing their remuneration.

This disclosure would deter the practice of installing relatives of controlling shareholders and/or relatives of executive directors as non-directors and paying them excessive remuneration, which amounts to theft from independent shareholders.

We agree with the inclusion of sales commission in remuneration (Q50). Figures would be misleading if it were

excluded. Whatever form remuneration takes, its value should be disclosed. We agree with the disclosure of CEO remuneration (Q51), although if you adopt our streamlined proposal, then he should normally be in the top-10 earners anyway.

## Executive director remuneration (Q52)

Yes, and see our comment on Q29 above.

## Board evaluation (Q53)

No. This proposal calls either for introspective navel-gazing followed by self-congratulation, or a gravy-train for consultants at the expense of shareholders. If it ever became a Rule rather than RBP, then amongst badly-governed companies there would undoubtedly be the same opinion-shopping that goes on with so-called Independent Financial Advisers. Shareholders are the best judge of board performance - if they are not satisfied, they can in theory change the board, except where directors are unelected or government-appointed, as are 7 out of 13 are at your listed parent, HKEx.

In practice, again, controlling shareholders decide who the EDs and NEDs are, but independent shareholders should elect the INEDs.

## Board meetings (Q54-55)

Yes to Q54, and we note that Webb-site is the "market commentator" referred to in paragraph 184 of the paper. We made that comment in criticising a proposal by your listed parent, HKEx, to allow passing of written resolutions by signature of a majority of its directors without a board meeting. Shareholders of HKEx agreed with us, and voted down the proposal by a huge margin.

In Q54, by "a substantial directors" we assume you mean "a substantial shareholder".

In Q55, whether attendance by telephone or videoconferencing is counted is a matter for the Articles of Association of each issuer and applicable company law. We certainly would not want INEDs to be counted for the purpose of the Listing Rules as attending that way if they are not legally allowed to attend, speak or vote that way, because then their status would be downgraded to observers. So the note should be deleted.

CP A.1.7 (as renumbered) is ambiguous on whether all INEDs or just some INEDs should attend a meeting where there is a conflict for a substantial shareholder or director. We suggest that at least 3 INEDs should attend, except for those who themselves have a conflict. There's not much point in requiring a board to have 3 INEDs if only one or two of them shows up to such important meetings.

## Directors' Attendance at Board Meetings (Q56-58)

Yes to all, but in the case of telephonic and video attendance, that should only count for the Listing Rules if it is permitted by the issuer's constitution and applicable company law (see Q55 above).

## Resolutions in which a director has an interest (Q59)

We agree that the 5% threshold is not the appropriate test, and with the proposed amendment to Rule 13.44. However, it seems inappropriate to keep the exemption in note 1(3) of Appendix 3 if future issuers cannot actually use it, so that should be removed too, otherwise new listing candidates might continue to include it in their Articles.

Furthermore, there is no definition of "material interest", only guidance in Rule 2.16. We submit that you should at least specify that anyone who is a director, partner, officer or employee of a counterparty to a transaction should be regarded as having a material interest in that transaction and prohibited from voting. This is because they have a conflicting fiduciary duty to that organisation, whether or not they are remunerated by it or have a shareholding in it.

Counterparties include not just companies, but law partnerships, charities, governments and other organisations. For example, anyone who sits on the Executive Council of the HK Government should be regarded as having a material interest in transactions between a listed issuer and the Government. Examples of that include HKEx group's lease of the Stock Exchange trading floor premises from the Government.

These conflicts even extends to charitable donations - we are aware of several cases where listed company funds have been abused by making excessive donations to a local charity, a director of which was the spouse of the listed company's chairman and controlling shareholder. The donations were large relative to profits and beyond what could be justified as beneficial to the company. In effect, independent shareholders' funds were being stolen to enhance the social standing of the controlling family. In one case, they even named part of a

building after the family, not the company.

## Chairman & CEO (Q60-67)

Yes to Q60-66. However, on Q65, there is limited point in the Chairman meeting separately with INEDs and NEDs if he is himself an Executive Director. The Code does not contain any RBP or CP that the Chairman should not be an executive director. That should be a CP.

In practice, many companies continue to have one person as both Chairman and CEO. Where there is a controlling shareholder, which is 90% of cases, then in our view splitting the roles doesn't really make any difference to governance quality - the controlling shareholder elects them both and is often the same person. Even if an outside Chairman were introduced, he would still only serve at the pleasure of the controlling shareholder. In some companies, a husband-and-wife split the roles, and in others, two co-founder executive directors split the roles, which is just box-ticking the CP.

On Q66, effective communication between the board and shareholders, you should make it a Listing Rule that all companies provide an active e-mail address or form on their web sites for submission of messages to the board, and a CP that all such communications are acknowledged within 3 working days, even if automated. Currently, many companies provide no way to write to them other than a postal address.

On Q67, CP A.2.9 seems to be a repetition of the theme of the new sentence in A.2.6. Also, we don't think a Chairman can be expected to ensure constructive relations between EDs and NEDs - he can only facilitate them. Again, in reality, most companies have a controlling shareholder and if an NED or INED asks too many unwelcome questions or disagrees with the wishes of the controller too often then he will be shown the door. What investors actually need is INEDs they elect, with a mandate to ask questions, obtain answers, and act in the interests of the company rather than the interests of the controlling shareholder.

## Removal/retirement of directors and supervisors (Q68)

Yes. This is a point Webb-site raised with you in relation to the removal of the CEO of Sands China as CEO and director last year without giving any reasons, and also on previous occasions when annual reports have said that directors intend to offer themselves for re-election and have subsequently withdrawn.

## Changes in CEO (Q69)

Yes, of course.

## Disclosure of all civil judgements of fraud, breach of duty or other misconduct involving dishonesty (Q70)

Yes, because these are relevant to investors' assessment of the board and CEO and their probability of behaving the same way with investors' money.

## Disclosure of sanctions against a director under the Listing Rules relating to another issuer (Q71)

Yes, for the reasons stated. The complaint referred to in paragraph 229 was raised by Webb-site in Aug-2010.

## Publication of directors' information on the issuer's web site and HKEx web site (Q72-73)

Yes to both, but in the case of the issuer's web site, this should include all the updated information required by Listing Rule 13.51(2) in relation to each director. Investors should not have to comb through all the announcements since the last time a person was elected or appointed in order to find the subsequent changes, such as convictions.

We remind you of a previous complaint that the biographical information required in annual reports is much less than that which is required in circulars for election or re-election of directors. The annual report biographies should be upgraded to be the same as in the election circulars.

## Providing management accounts or management updates to the Board (Q74)

Paragraph 235 of your paper incorrectly states:

> "There is no requirement in the Rules or the Code for an issuer's management to update the board with its financial performance on a regular basis."

This is untrue, because Note 1 to CP A.6.2 already states that management should provide "monthly and other relevant internal financial statements" and the CP requires that it be supplied to the board "in a timely manner". We realise that in practice many companies have neither complied with this CP nor explained why they do not.

Indeed, when our editor David Webb resigned in 2008 from the board of your listed parent, HKEx, one of the reasons he gave was that he had not been provided with "certain information" which he had reasonably requested under the Code on Corporate Governance. That information included monthly management accounts, which were being held back and only released to the board on a quarterly basis in time to approve the quarterly results. The directors were being treated like outsiders in this respect.

In our view, directors of a listed company cannot properly carry out their duty to monitor the financial affairs of that company and ensure that it announces price-sensitive information (**PSI**) if they do not have timely access to relevant information. Your paper acknowledges this in paragraph 238. The concern (paragraph 237) about directors receiving PSI in management accounts is farcical. This is the "see no evil" approach of the 3 wise monkeys. If a director sees anything in the accounts which he regards as PSI (positive or negative), then he is obliged, by his undertaking to the Exchange, to raise it with the board and ensure that the company announces it under Listing Rule 13.09.

The proposed CP C.1.2 should refer only to management accounts and should not allow "management updates" as a soft alternative. It is a CP, and if an issuer cannot produce monthly management accounts for its board, then it should explain why not, because that is indicative of deficiencies in internal accounting and reporting systems. We also submit that the CP should set a sensible timeframe, of say 15 business days after the month-end. So change the last sentence to:

> "These should include monthly management accounts and be produced within 15 business days of the month end".

There is no prescribed format for management accounts - they will differ from one firm to the next. Complaints that the accounts "may be large" are not a good reason not to provide them. It is up to management to produce accounts in an intelligible and digestible form, not too large for the board to digest. It would defeat the purpose if management provides only textual narrative, telling the board that performance is in line with expectations.

You also need to reconcile the new CP with Note 1 of CP A.6.2.

## Next day disclosure of share issues (Q75-76)

No to both questions.

Listing Rule 13.25A is far more complicated than it needs to be. There should not be any exemptions to disclosure of new issues. The registrar of a company will only issue new shares if the company provides it with instructions to do so, and that is the point at which the issued share capital changes. If a company provides such instructions to a registrar, then it is equally capable of completing an online submission to HKEx with the same information.

Paragraph 243 lays out a concern that for a large corporation the exercise of share options "could be very difficult to monitor, especially for directors of overseas subsidiaries" and that the timeline for reporting is difficult to achieve. This is nonsense, because the exercise forms for such options will all come to a central point at the company, and there will be some verification process before the instruction is given to the registrar to issue the shares.

You can deal with this concern by clarifying that the increase in share capital is not triggered by the submission of an exercise form in Timbuktu but by the issue of a share by the company in HK or wherever the register is kept. So if a large company has hundreds or thousands of option-holders, it can just aggregate the exercises on the relevant date when it authorises the issue of the relevant shares, and file the form.

What matters, as far as investors are concerned, is that they know when new shares are issued and therefore tradable and could impact the market, and that they know what the denominator is when calculating their percentage shareholdings for the purpose of the disclosure of interest law.

If you continue allowing exemptions, then the 5% threshold for triggering disclosure is way too high. The typical daily volume in a company is 0.1-0.2% of its issued shares (25% to 50% per year), or less in the case of those with small public floats. So the secret issuance, for example, on conversion of bonds, of 4.99% of a stock is often equivalent to between 5 weeks and 10 weeks of turnover, and would have a big impact if dumped in the market in a short period. By comparison, when a substantial shareholder reduces his stake, he has to disclose any reduction through a 1% boundary, so that other investors know that he is selling. So your

threshold for disclosure of issues should not be higher than 1%.

But as we said, you shouldn't have exemptions at all. There are no exemptions for buybacks.

## Disclosing long term basis on which issuer generates or preserves business value (Q77)

We don't see the point in requiring this, because those companies that don't have any strategy or core business will just make up some bland and meaningless text to tick the box, and it will be obvious to any reader of their reports, as it is now, that they don't have a strategy or core business. No board will admit otherwise.

## Directors' insurance (Q78-79)

The reality is that very few directors of HK-listed companies will ever get sued for anything they do as a director, because the litigation rights of shareholders are so weak and shareholders have no class action rights. Instead of buying insurance, some companies may choose to absorb the residual risk by indemnifying directors in their appointment letters against all legal costs and civil liability incurred in connection with their work. Obviously it is a choice for directors on whether they are willing to work on those terms, or whether they might want to buy additional insurance themselves. Relying purely on an indemnity runs the risk of non-payment in the event that the issuer becomes insolvent, and the probability of litigation is higher during insolvencies than during normal solvent circumstances.

Directors' insurance at shareholders' expense is acceptable to investors as long as it does not cover the director's costs and fines if he is finally judicially found liable for offences or market misconduct. It is unfair for shareholders, through their companies, to have to bear the cost of wrong-doing by directors, whether by indemnity or by paying insurance premiums.

So in summary we support making this a CP but do not support taking it any higher to a Listing Rule. Rather, you should include a disclosure requirement in the Listing Rules as to whether or not the company buys insurance for directors, so that potential external candidates in director elections, particularly INEDs, can know whether they would have any cover if elected.

## Bundling of resolutions (Q80)

Yes. In paragraph 257 of your paper, you say:

> "If resolutions are "bundled" there is a possibility that the significance of a resolution may be hidden from shareholders by less controversial resolutions in the same bundle. For example a resolution on a controversial matter on a change to an issuer's articles of association may be bundled with several uncontroversial administrative amendments on the same subject."

This was indeed the case last year when your listed parent, HKEx, bundled a number of proposed changes to its articles of association, including a controversial one allowing written resolutions to be passed by signatures of a majority of directors without a board meeting. As you may know, Webb-site spotted it and urged investors to vote down the bundle, and they did (see also Q54-55 above). We are pleased to note that for the 2011 AGM, HKEx has unbundled proposed changes to the M&A into separate items and is not seeking to repeat the offending proposal.

## Voting by poll (Q81-84) and meetings in general

Yes to all, but qualified as follows. On Q81, we note that even if the Chairman takes advantage of the exemption to allow a show of hands on a procedural or administrative motion, shareholders present in person or by proxy at the meeting can still exercise their right to demand a poll, and if they fulfil the requirements of the Articles or relevant company law, then a poll must still be held. In most jurisdictions the criterion is 3 or 5 shareholders. This law is what Webb-site successfully used in Project Poll in 2003 onwards, when we forced all the blue chips to start counting their votes by poll. That campaign eliminated the opposition to poll voting from the large companies which carry the greatest influence over the Listing Rules, and on 1-Jan-2009, poll voting became mandatory in the Listing Rules.

So the ability for shareholders to demand a poll is a safeguard against abuse of the proposed exemptions. For example, if the Chairman seeks to adjourn the meeting in order to defer voting on a resolution which he knows will be defeated (from advanced sight of proxies), abusing one of the allowed reasons as a pretext, then those present in person may still demand a poll and veto the adjournment.

### Conflicted voting on adjournments

However, this raises a separate point not addressed in your paper. If there is a resolution on which certain shareholders are required to abstain (e.g., a majority shareholder involved in a connected transaction) then we submit that those shareholders should not be permitted to vote on an adjournment motion, because otherwise the Chairman could use that to defer a meeting and provide more time to rig the vote with friendly pseudo-independent shareholders. This should be introduced as a Listing Rule: you cannot vote on a motion of adjournment if the outstanding business includes an item on which you are not permitted to vote.

### Verifying abstentions

Another area that your paper does not address is the problem of verifying that those who were not supposed to vote have in fact abstained as required by Listing Rules. As most beneficial shareholders are not registered shareholders, the scrutineer cannot verify that those who vote are entitled to vote under the Listing Rules. This opens the door to corruption of the vote.

This can be done by, for example, holding shares through a company which has accounts with multiple brokers, and causing each broker to appoint a separate individual to attend the meeting, and then having them cast enough votes to overcome any opposition. The chairman will usually be able to obtain an advance tally from the registrar (who has received most of the public's instructions in advance from HKSCC Nominees Ltd) so the company will know how many votes to mobilise in favour.

The only way to be sure of abstentions is to reform the system, and require that abstaining parties must actually appoint a common proxy (or corporate representative) and instruct the proxy to abstain. The registrar would then be able to count up the number of shares in respect of which that proxy has been appointed, and hence be sure that those shares are properly excluded.

We suggest that HKEx establishes a special-purpose company called "Abstain Limited", and all conflicted beneficial shareholders would be required to nominate this company as proxy (or corporate representative), unless they were also registered shareholders. A Listing Rule would require the announcement of results of the meeting to disclose the number of shares which Abstain Limited held as proxy and to confirm that all the shares which should have abstained did abstain (or did not vote in favour, depending on the relevant rule). If it falls short of the expected number, then it would be up to the company to prove that those who failed to appoint Abstain Limited did not vote. If they cannot prove that to the satisfaction of the Exchange, then the resolution would be void.

### Language of meetings

There is still no requirement that meetings be held in a language that attending investors can understand. Printed circulars must be produced in (traditional) Chinese and English. Meetings are often held in Mandarin, Cantonese, or even other regional dialects, without any consecutive translation being provided. With the increasing number of international listings, AGMs may even be held in Russian, French, Portuguese, German or some other language. If we induce international investors to invest in this market by producing English-language disclosures, then we should allow them to participate in meetings by providing proper translation (consecutive or simultaneous) in the meeting. This should be a Listing Rule.

This is no more burdensome than requiring English versions of every document. Alternatively, if you want to exclude non-Chinese-speakers and readers from the market, then you could allow issuers to decide at the time of IPO not to produce their documents in English, but in the event that they ever start reporting in English then they cannot stop, and must provide English translation at all general meetings. We could not have a stop-start approach where they suck people in and then stop reporting in a language they understand.

### Market savvy - regulators should observe a sample of meetings

How many Listing Division staff have ever attended a shareholder meeting in HK? The experience would be illuminating - it should be part of continuing professional development for all Listing Division staff to attend at least one shareholder meeting per year. To facilitate this we suggest the following Listing Rule:

> "An issuer shall, upon prior notification from the Exchange, permit any authorised representative(s) of the Exchange to attend and observe the proceedings at any general meeting."

This would also allow you to do spot checks on whether the many required provisions for general meetings are actually being complied with.

### Minutes of meetings

Shareholder meetings (particularly when real investors like us attend, and not just employees of the company) often involve an interesting exchange of questions, answers, views and information, fleshing out items in the

annual report (in AGMs) or future business strategy, or identifying areas of concern for which directors offer no explanation, which is telling in itself. In the case of an EGM or SGM, there will often be questions on the matters at hand. Proper minutes should be kept recording this dialogue, not just boilerplate minutes prepared before the meeting with blanks for the number of votes. To avoid dispute on the minutes, an audio recording should be made, and the Chairman should ask speakers to state their name and whom they represent, if anyone.

There is nothing in the Listing Rules or Code on Corporate Governance on these points. There should be.

It is a requirement of many jurisdictions that the minutes of general meetings must be made available for inspection by members (registered shareholders) without charge and that a copy be provided to them on request and payment of a copying fee. For HK-incorporated companies, this is set out in s120 of the Companies Ordinance, and the Listing Rules expect companies from overseas jurisdictions to be no worse-governed than that. Specifically, the Listing Rules for PRC issuers require that minutes be available for inspection in HK.

These provisions should be modernised for the internet. We should not have to be registered shareholders and visit HK or pay to buy a copy of the minutes. The Listing Rules should require that all listed companies file their minutes of General Meetings on the HKEx web site within, say, 10 business days of the meeting (allowing enough time for transcription and translation), in Chinese and English.

So we suggest the following Listing Rule:

> Issuers must make audio recordings of shareholder meetings and must prepare accurate minutes which reflect the attendees, the comments and questions of shareholders (including proxies and corporate representatives), including their names and the names of the registered shareholders they represent, and the comments and answers provided by directors and other parties present at the meeting. A copy of the minutes must be filed on the HKEx web site within 10 business days of the meeting.

## Shareholders' approval to appoint and remove auditor (Q85-87)

Yes to all, but this doesn't address the core issue, because in practice, auditors are seldom removed and usually just resign or "fail to agree fees", which these provisions don't cover. We suspect that often a mutual "failure to agree upon fees" is just a pretext, either because the auditor wants to quit without giving other reasons, or because the company does, so the auditor asks for an excessive fee or the company offers too little, and then they part ways.

The solution is to require that the fees be agreed before the AGM in respect of the forthcoming year, and the appointment letter be signed by both sides, conditional only upon shareholders' approval of the appointment. Once that approval is obtained, the appointment becomes unconditional. Then, there would be a binding contract to provide audit services, and it would be harder for the auditor to quit before the next AGM or for the company to lose them.

## Directors' attendance at meetings (Q88-91)

Yes to all. Far too often, at General Meetings we find ourselves speaking only to the Executive Directors and perhaps one INED. Sometimes it emerges that INEDs are hiding in the audience, like the "junior" directors they are. It hardly fills shareholders with confidence when INEDs don't sit up front alongside the executive directors and Chairman-CEO-controlling shareholder. Again, this is why INEDs should be elected by independent shareholders, not by the controller.

Often, we are told that one or more INEDs had "an important meeting" to go to. Yet the board of which he is a member set the date for the general meeting weeks or months ago - they were capable of planning around it and picking a date when all or most directors could attend. So we say "presumably the other meeting is more important to this person than the affairs of this company". If that person is up for re-election (as he usually is every 3 years), then we vote against, because he couldn't make the effort to attend his own election, safe in the knowledge that the controlling shareholder will re-elect him.

Despite making these points, by attending successive AGMs of the same companies, we have often observed that the same people are absent, always having an important meeting to go to. They simply don't regard shareholders' views as relevant. In one company we know of, the Chairman never attends the AGM, and a more cynical investor might seriously doubt whether he still exists in body, let alone mind.

Attendance records by name would provide some incentive, but you may need to go further. A reasonable Listing Rule would be that if more than half the INEDs are absent then the Chairman must move that the meeting be adjourned and put it to a vote of independent shareholders, with controlling shareholders and executive directors abstaining. That would focus their attention!

The names of attendees should of course be in the minutes of AGM filed on the HKEx web site (as proposed above), so we shouldn't have to wait until the next annual report for proof of which directors attended.

## Auditor's attendance at AGMs (Q92)

Yes. In practice, they usually do attend. Section 141 of the Companies Ordinance requires that the auditors' report be "read before the company in general meeting", implicitly by the auditor, and although the report is is often "taken as read", the auditor needs to be there in case there is objection to that. Many other commonwealth jurisdictions have similar provisions.

On the wording, "ensure the external auditor attend" should read "ensure that the external auditor attends", and on the accounting policies, this should include their application, not just just the policies in isolation so insert "and their application," after "accounting policies". That way, shareholders can question whether the policy has been properly applied.

The audit report, after all, is addressed to the shareholders as a body. The shareholders meet as a body and should be free to quiz the auditor on their work. The fact that auditors have no statutory duty of care to individual investors is a separate issue which the Government should address by legislation.

## Shareholders rights (Q93)

Yes, because otherwise the rights of shareholders (with sufficient shareholdings) to propose resolutions or requisition general meetings will remain buried in obscure parts of corporate charters and applicable company law. See also Q66 above.

## Communications with shareholders (Q94)

Yes, and see also Q66 above. It is important that either an e-mail address or online message submission system should be available for investors to contact management at all times, and that prompt acknowledgement of receipt should be given, even if automated.

## Publish constitutional documents on website (Q95)

Yes. We have asked for this rule many times. It is the most fundamental document of any company and should be available online.

### Documents "available for inspection" should be filed

But don't stop there. Every day, we see circulars and prospectuses telling us that documents in relation to Major Transactions or IPOs are "available for inspection" at an address in HK. If they are important enough to be available for inspection, then they should be uploaded to the HKEx web site and left there permanently, so that future investors are not at a disadvantage to those who grab them while they can. Most of these documents were prepared on computers, so most of them don't even need to be scanned, except for signature pages - they can just be converted to PDF and uploaded.

These include, for example, contracts for acquisitions and disposals, shareholder agreements for the operation of joint ventures, the full deed creating warrants or convertible bonds (with full terms and conditions), the full rules of share option schemes, copies of service agreements, bond deeds containing covenants, and other important information.

Before the internet, we put these documents on display because we didn't have room for them in prospectuses, and the display time was limited because physical space costs money. But in the internet era, the current system is just a sham and a pretence at transparency.

The current system also produces a home-country bias in favour of HK investors who can make the effort to go and look at the things and take notes while they can, and even then it is a laborious process. By contrast, domestic companies filing with the US SEC have to upload all exhibits, including agreements, to EDGAR, where they are left permanently.

## Publishing procedures for Election of Directors (Q96)

Yes, but if this procedure is not included in the AGM circular then the circular should state where it can be found on the issuer's web site.

A more important issue is that the current requirements of paragraphs 4(4) and 4(5) of Appendix 3, on the shareholder nomination period for candidates for directorship, do not work well. Paragraph 4(5) stipulates that

nobody can be nominated until the day after the notice of general meeting has been dispatched. This puts investor candidates at an inherent disadvantage in the race for votes relative to incumbent directors or candidates nominated by the board in the circular. Some shareholders may have already voted before they hear about new candidates, and given the long chain of custody, there may not be enough time to change votes.

So it would be fairer to require the Articles to provide a "Pre-notice Period" during which candidates can be nominated, which lasts at least (say) 14 days from the date of the Pre-notice and ends not more than (say) 7 days before the notice of AGM is despatched, and then no more candidates will be admitted unless the meeting is adjourned and the company starts again. That way, it will be a fair race, with equal voting windows for both internal and external candidates. This would also remove the risk of companies needing to adjourn meetings when last-minute candidates come up.

Of course, if all directors (including INEDs) are still elected by controlling shareholders, then in 90% of companies this is academic. Publishing the nomination procedures could even give investors false hope.

## Significant changes to constitutional documents (Q97)

Yes. It should be simple enough to do this, if necessary by cross-referring to the relevant circular filed with HKEx, since changes to the articles of association require shareholders' approval.

## Company secretary's qualifications, experience and training (Q98-104)

Yes to Q98-103, except as follows. We accept that the Company Secretary need not be resident in HK, but in Q100, we would add new items:

> (e) familiarity with the requirements of the Companies Ordinance applicable to HK or overseas-incorporated companies (depending on whether the issuer is incorporated in HK or not)
>
> (f) familiarity with the requirements of the Securities and Futures Ordinance so far as it relates to listed companies, including the provisions on disclosure of interests, insider dealing, market misconduct, false and misleading disclosure and (coming soon) disclosure of price-sensitive information.

We say this because otherwise you are going to run into situations where foreign issuers and their boards are not properly reminded of their obligations by the company secretary, who really should be alert to these. In reality, an overseas company secretary is unlikely to have the necessary knowledge, and it will be necessary to have dual company secretaries, one for the country of incorporation (to satisfy filing requirements and company law there), and one from HK. Many foreign issuers will continue to outsource this to a HK solicitor, accountant or member of HKICS on a retainer basis, and that is reasonable.

On Q104, the transitional arrangement makes no sense. Those who have been company secretaries for the longest period of time are probably those who are most out of date with the rules and laws, because freshly-qualified people should be reasonably up to date. Yet you are saying that anyone who was working before 1995 (16 years ago) does not need to undergo CPD for another 6 years. In our view, all company secretaries should be able to find the time to do 15 CPD hours per year, and those who haven't seen a textbook in 16 years have the most catching up to do! It is only about 0.75% of their time. The requirement should start without transition.

### Qualified accountants

You should also bring back the requirement that every listed company should employ a qualified accountant, qualified in their head-office country. It was disgraceful that this was abolished. It is hard to imagine how companies can prepare decent monthly management accounts without having a qualified accountant.

## New section in Code on Company Secretary (Q105-112)

Yes to all. On F.1.1, disclose to whom? Also you mean "whom the issuer can contact". On F.1.4, insert "laws," before "rules and regulations". You may wish to add that the company secretary should assist the directors to obtain legal advice when needed in accordance with procedures agreed under A.1.6.

## Proposed non-substantive amendments (Q113-116)

Yes to all, but on Q113, for the grammar to work, you need to split it into two definitions:

> "announcement" - an announcement published under rule 2.07C
>
> "announce" - make an announcement

# The three wise monkeys of HK boards

***15th February 2011***

The Stock Exchange of Hong Kong Ltd (**SEHK**) has recently put out a consultation paper to review the Code on Corporate Governance Practices and associated Listing Rules. SEHK is itself owned by a listed company, Hong Kong Exchanges and Clearing Limited (**HKEx**, 0388), so whatever changes SEHK makes (with the approval of the SFC) will affect its parent.

The paper deals with two different areas - Part I on directors and Part II on shareholders. This article will focus on Part I.

The paper proposes a Listing Rule that one-third of the directors be labelled as "independent non-executive". That's in addition to the present requirement of 3 INEDs, which in turn was increased from 2 INEDs effective 30-Sep-2004 and from zero on 1-Aug-1993. So it has only taken 18 years to get this far, and what this proposal means in practice is no change if your board currently has fewer than 10 directors, because you already have at least 3/9 tagged as INEDs.

The Webb-site database shows that most listed companies have the bare minimum of INEDs. Currently, of 1416 primary-listed companies, 1100, or 77.7%, have 3 or fewer INEDs. The average number of INEDs is just 3.29, only 0.29 above the minimum. As for the ratio of INEDs, the database shows that there are only 279 companies with less than 1/3 tagged INED, or 19.7%, so 80.3% already comply with the proposed rule. That's mainly because most boards are smaller than 10 seats - our database shows that only 437 companies (30.9%) have more than 9 directors.

But what is an INED? The word "independent" is an adjective - so independent of what? The answer, of course, is that an INED should be independent of management and controlling shareholders. An INED is often required by the Listing Rules to opine on whether a connected transaction between the listed company and its controlling shareholder is fair and reasonable, or under the Takeover Code to opine on whether a privatisation proposal from the controlling shareholder is fair and reasonable, or whether a "whitewash waiver" should be granted, avoiding a takeover offer. An INED also often sits on a Remuneration Committee which determines, or advises the board, on the remuneration of executive directors, who are often also substantial shareholders of the company. An INED also often sits on an Audit Committee which reviews the accounts produced by management, and which reviews the internal controls intended to prevent management and staff from misappropriating (or stealing) the company's assets.



**The Audit Committee of HK Listco gets down to business**

But all of these checks and balances on the behaviour of management and controlling shareholders are undermined when they get to decide who the INEDs are, because the controlling shareholders and other directors are allowed to vote in shareholders' meetings on the election of INEDs. About 90% of HK-listed companies have a controlling (30%) or majority (50%) shareholder or group of shareholders who determine who should be "independent" of them in the board room. It is rather like having a parliamentary democracy in which the ruling party picks the members of the minority party.

The result is that many HK-listed companies fulfil the requirement to have 3 independent directors by picking 3 wise monkeys - see no evil, hear no evil, speak no evil. They serve at the pleasure of the King, and if they ask too many questions, or object to what the King wants to do, then they will be shown the door.

There is not a shred of evidence that the 2004 reforms, in which the number of INEDs was increased from 2 to 3 and audit committees were made mandatory, has made any difference to the quality of corporate governance in HK-listed companies. Nor has the fact that 80.3% of companies already have one-third of directors labelled "INED" made any difference. We still get regular fraud-induced failures like EganaGoldpfeil, Ocean Grand and Moulin. We still have INEDs who support connected transactions which are voted down or heavily opposed by independent shareholders, showing a complete lack of recognition by INEDs of what is in the best interests of the company. This is as much true for Government-controlled companies as it is for family-controlled companies. We still have INEDs who hold far too many other jobs and positions to devote enough time to do the job properly. We also have INEDs who have no relevant experience, either in the company's area of business or in financial, legal or accounting matters. Examples include school friends, golfing buddies, family doctors, or former mainland officials who are owed a favour. For many, a fee of HK$10-20k per month for turning up 4 times a year and facing almost no risk of litigation for neglecting the duties of the job is easy money.

We also have INEDs who sit as "independent" at multiple listed levels in the same corporate pyramid - so when a listed company does a deal with a listed subsidiary, or tries to privatise it, the INED is conflicted from giving an opinion on both sides. And we have INEDs who have spent all their working lives at a firm, then retire for a year before coming back as an INED, which the rules allow.

Much hand-wringing has taken place about the need for the right "mindset" and a better "quality" of INEDs. This misses the point. A few good companies, which want expertise and independent opinions in the boardroom, will pick good people, but many will just pick 3 wise monkeys, or noddies - they nod at everything. For these companies, incompetence, senility and ignorance are considered desirable attributes in INEDs.

Boards should of course be allowed to nominate candidates whom they think they can work with, and who they think will add value, but they must be candidates who are acceptable to independent shareholders. **Unless and until we exclude connected persons (directors and substantial (>10%) shareholders) from the shareholder vote, the INEDs will only be as independent and as capable as these conflicted parties want them to be.** After all, why should shareholders who cannot vote on connected transactions be allowed to elect the people who advise on those transactions?

Without that simple step, most of the SEHK proposals on boards and committees are just re-arranging deck chairs on the Titanic. We won't even bother to comment on them in detail. But with that simple step, more icebergs could be avoided, because INEDs would:

- be accountable to independent shareholders at the ballot box
- have a mandate to ask difficult questions without fear of removal
- only get elected or re-elected if a majority of independent shareholders (by votes cast) think they are suitable for the job

Many of the same people who currently hold INED positions would continue to serve, but if controllers proposed candidates with no relevant experience, or people who are too close to management, or people who are former employees, or people who are just too busy, then independent shareholders would likely vote them down. Similarly, if the INED has a history of presiding over companies which have breached the Listing Rules or collapsed in accounting frauds, then he is unlikely to be elected by independent shareholders.

To be clear, we are not calling for all directors to be elected this way. Controlling shareholders and management should still be able to call the shots and make strategic decisions about the business, electing executive directors and non-independent non-executive directors. All that we are asking for is that directors should not be called "independent" unless they have been elected by independent shareholders. **At the first AGM after a listing and at each AGM thereafter, all INEDs should be required to stand for re-election, so that the current body of independent shareholders can either endorse them or replace them.** Investors should not have to wait 3 years after listing to do this, nor should we have to wait 3 years to remove an under-performing INED.

Unlike the key-man importance of executive directors, the business of a company should not be dependent on particular INEDs, so there is no continuity risk in subjecting INEDs to annual re-election. Most of the time, they would receive support, and the annual election would keep them on their toes. If candidates are appointed by boards to fill vacancies, then they should not be called independent until independent shareholders have elected them, and a meeting should be convened for that purpose unless the AGM is pending.

This call for independently-elected directors is not a new call - we have made the same point in articles in 1999 and 2002.

## INEDs report

**We also submit that INEDs should have their own section in the annual report in which they each either confirm that they had no material disagreements with the rest of the board during the year, or state what those disagreements were.** They should confirm in that report whether they have received all the information they consider necessary to perform their duties. We should not have to wait until they resign before hearing whether they have concerns which investors should be made aware of. All too often, dissent is masked by statements that "the board" believes something, or even "the board, including the independent directors" believes something. That only means that a majority of all directors believes something, not unanimity. Whenever an INED disagrees with a statement made on behalf of the board, we should be told. The minority opinion in any judgement is almost always informative.

## Or stop pretending

The alternative to requiring independently-elected directors is to stop pretending that companies have independent directors. Drop all the rules, and be honest about the fact that controlling shareholders elect the entire board. Leave it up to companies to persuade the free market on whether they have a good board or not, but prohibit them from calling anyone "independent" unless the controlling shareholders and directors have abstained from voting on the election of that person. We don't favour this route, but it would be more honest than the current false comfort of tagging people as independent when they are usually not.

## A limit on seats?

The paper asks whether a limit on the number of INED seats held by a person should be set by Listing Rules or Code Provisions. We say no. The number of seats a person can responsibly handle depends on what other responsibilities he has - for example, if he is supposed to be a full-time CEO, or a legislator, or a member of the Executive Council (HK's cabinet), or sit on multiple Government committees or charities, then he may not be able to spare enough time to do handle more than 1 or 2 INED seats properly. On the other hand, if he is a retired former partner of a law or accounting firm, with no other responsibilities, then he might well be able to handle 5 or more positions and still have time to play golf. It also depends on the complexity of the business - a multinational bank or retailer, for example, or a simple small-cap consulting firm, might require different time commitments. A company struggling with financial or business restructuring would entail a larger time commitment.

The best way to resolve issues like this one is to allow the market to decide. Again, that means subjecting all INED candidates to a vote of independent shareholders. The market, in the form of institutional investor bodies and proxy advisory firms, would then evolve standards and make voting decisions to back up those standards, making exceptions where appropriate.

The Webb-site Database continuously tracks the number of directorships and the number of INED positions each person holds on companies with a primary listing in HK. At present, the database shows that the average person holds 1.354 INED positions, but 46 people (including 2 women) hold more than 5. Including other directorships (NED and ED), the database shows that there are 77 people who hold more than 5 seats (including 3 women), but the average number of HK-listed seats is just 1.249. That excludes seats on overseas-listed companies, private companies, charities, government boards and other positions.

HKEx itself shows up badly in this respect. There are 6 Government-appointed non-executive directors (we don't regard them as INEDs, because they are not subject to election by shareholders, let alone independent shareholders). Of these 6, the Chairman, Ronald Arculli, is a partner in a law firm, a member of HK's cabinet, sits on the board of 9 HK-listed companies (including HKEx), and is a member of 4 Government committees and a director of at least 2 charities. That's at least 17 positions. Another Government-appointed NED, Moses Cheng Mo Chi, is senior partner of a law firm, sits on the board of 11 HK-listed companies, chairs 4 Government committees and sits on one other, and also sits on 2 school councils. That's at least 19 positions including his day-job. He has the 5th-largest number of HK-listed directorships - here's a list of the busiest ones. Another Government-appointed director, Stephen Hui Chiu Chung, sits on 6 HK-listed boards and is also Managing Director of a brokerage in his day job.

It is notable that the Government-appointed directors of HKEx hold on average far more positions than those who are elected by shareholders. Unlike most listed companies, HKEx has no controlling shareholder (the Government is the largest, at 5.9%), so the 6 elected directors, although comprising a minority of the 13-member board, really are accountable to the outside shareholders and have to justify their position at each election (every 3 years by rotation). If Messrs Arculli, Cheng and Hui were subject to shareholder election then we doubt that they would be re-elected with their current workloads. Your editor David Webb was an elected INED of HKEx from 2003 to 2008, so he knows first-hand what this accountability means. In 2003, shareholders voted out 3 incumbent directors, and he was elected to fill one of the vacancies, running on his own ticket, and was re-elected in 2006 in a contested election, along with Christine Loh Kung-wai, whom he

nominated.

So we don't think that SEHK will find a lot of support from its parent HKEx for limiting the number of seats a person can hold. Let the market do that.

**What do you think? Take our opinion poll.**

# Poll results: INED poll

| | |
|---|---|
| Current time: | 14:59:36 25-Mar-2011 |
| Closing time: | 18:00:00 4-Mar-2011 |
| Time remaining: | **Poll closed** |

**1. Should controlling shareholders be allowed to vote on INED elections in AGMs?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 19 | 10.8% |
| No | 151 | 85.8% |
| Undecided | 6 | 3.4% |
| Total | 176 | 100.0% |

Crosstab with question: 2 Submit

**2. Should Executive Directors be allowed to vote on INED elections in AGMs?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 17 | 9.7% |
| No | 151 | 85.8% |
| Undecided | 8 | 4.5% |
| Total | 176 | 100.0% |

Crosstab with question: 1 Submit

**3. Should independent directors be elected only by independent shareholders?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 147 | 84.5% |
| No | 19 | 10.9% |
| Undecided | 8 | 4.6% |
| Total | 174 | 100.0% |

Crosstab with question: 1 Submit

**4. How often should each INED stand for re-election?**

| Answer | Responses | Share |
|---|---|---|
| At each Annual General Meeting | 77 | 43.8% |
| Every 2 years | 56 | 31.8% |
| Every 3 years | 31 | 17.6% |
| Undecided | 12 | 6.8% |
| Total | 176 | 100.0% |

Crosstab with question: 1 Submit

**5. Is the current system for appointing INEDs working for investor interests?**

| Answer | Responses | Share |
|---|---|---|
| Yes | 6 | 3.5% |
| No | 152 | 87.9% |
| Undecided | 15 | 8.7% |
| Total | 173 | 100.0% |

Crosstab with question: 1 Submit

**6. Overall, how do you rate the performance of INEDs in HK?**

| Answer | Responses | Share |
|---|---|---|
| Very effective | 0 | 0.0% |
| Somewhat effective | 15 | 8.5% |
| Generally ineffective | 60 | 34.1% |
| Very ineffective | 46 | 26.1% |
| Completely ineffective | 45 | 25.6% |
| Undecided | 10 | 5.7% |
| Total | 176 | 100.0% |

Crosstab with question: 1 Submit