ASIAN CORPORATE GOVERNANCE ASSOCIATION (ACGA)

Response to the "Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules"

April 2011

ACGA is pleased to have the opportunity to respond to the review of the Code on Corporate Governance Practices published by Hong Kong Exchanges and Clearing (HKEx) in December 2010. Our submission contains responses on selected questions and issues in the consultation paper. We would be pleased to discuss any of these issues further with HKEx.

PART 1: DIRECTORS

DIRECTOR DUTIES AND TIME COMMITMENTS

Question 2: Do you agree with our proposed change to Rule 3.08 to clarify the Responsibilities the Exchange expects of directors?

ACGA: Yes, expanding the language in Rule 3.08 should go some way in helping directors to understand their duties better. However, it is unlikely that new directors will fully understand the role without some level of training, coaching or mentoring. We believe that HKEx, as the frontline regulator of the stock market, could play a much more proactive role in ascertaining whether directors, especially first-time directors, display the skills and mindset required. The Exchange could, for example, set up a specialist department to undertake random or risk-based audits of issuers to assess whether their boards and directors are functioning as expected. If significant problems are found, HKEx could require boards or individual directors to undergo an appropriate educational programme—something that would not only be in the interest of the market and shareholders, but the issuer as well.

We appreciate that this proposal goes beyond the current compliance and monitoring work of the Exchange. However, precedents for such supervisory auditing exist in other areas of regulation in Hong Kong (eg, the HKICPA's regular audits and monitoring of CPA firms).

Question 3: Do you agree with our proposed addition of the Note to Rule 3.08 referring to the guidance issued by the Companies Registry and HKIOD?

ACGA: Yes, although it would be helpful to include in the Note the language used in the consultation paper to the effect that "neither the Rules nor the guidance referred to are intended to be exhaustive" and that directors should "seek appropriate advice if they are unclear on any aspect of their duties and responsibilities".

Question 4: Do you agree to include a new duty (CP A.5.2(e)) in the nomination committee's written terms of reference that it should regularly review the time required from a director to perform his responsibilities to the issuer, and whether he is meeting that requirement?

ACGA: Yes, this is a sensible addition. We have reservations, however, as to the practical impact of this measure in nomination committees that meet irregularly or only once per year (as seems to be the case in several smaller issuers in Hong Kong). Or where the chairman of the board sits on the nomination committee and, possibly, dampens open discussion on the effectiveness of the board and individual directors. Where nomination committees meet infrequently, the discussion of time commitments by directors should be elevated to the full board.

Question 5: Do you agree to include a new duty (CP A.5.2(f)) in the nomination committee's written terms of reference that it should review NEDs' annual confirmation that they have spent sufficient time on the issuer's business?

ACGA: Yes, with the same proviso as given above.

As noted in the Exchange's consultation paper, in a number of disciplinary cases "an obvious lack of attention given by INEDs to their duties was a contributing factor to the non-compliance with Rules by the issuer". It is important for a company to review whether its directors are meeting their commitments—whether they attend board meetings, properly prepare for those meetings, and devote attention to the company between board and committee meetings.

Question 6: Do you agree to include a disclosure requirement in the Corporate Governance Report (paragraph L(d)(ii) of Appendix 14) that NEDs have made annual confirmation to the nomination committee that they have spent sufficient time on the issuer's business?

ACGA: No. It is likely that such disclosures will quickly become boilerplate statements and of little value to investors.

Question 7: Do you agree to expanding CP A.5.3 (re-numbered CP A.6.3) to state that a director should limit his other professional commitments and acknowledge to the issuer that he will have sufficient time to meet his obligations?

ACGA: Yes, this is a sensible and practical addition. In its original form, this code provision was somewhat vague.

(continued)

Question 8: Do you agree to expanding CP A.5.3 (re-numbered CP A.6.3) to state that a NED should confirm annually to the nomination committee that he has spent sufficient time on the issuer's business?

ACGA response: Yes, with one qualification: while non-executive directors should give an account of themselves to the nomination committee (or board) on an annual basis, the way in which the new sentence has been written could be seen as leading to only one formulaic answer ("should confirm…that he has spent sufficient time…"). We suggest it be revised to the more neutral, "should report to the nomination committee annually on the time he/she has spent on the issuer's business".

Question 11: Do you consider that there should be a limit on the number of INED positions an individual may hold?

ACGA: Yes. Undertaking a directorship requires a considerable commitment of time, which is multiplied when a person is appointed to one or more board committees. If a director is retired, then clearly his or her capacity to take on non-executive directorships increases. If in full-time work, however, the capacity diminishes—especially if the person is a chairman, CEO or CFO. Indeed, there should be a lower limit for the latter category.

Question 12: If your answer to Question 11 is "yes", what should be the maximum?

ACGA: Four to five independent directorships seems a reasonable upper limit for any individual not in full-time employment. While some individuals may be able to cope with more, the increasing complexity in the role of directors, the greater knowledge and skills required, and the heightened responsibilities and legal liabilities all argue against setting a higher number. Indeed, even four to five independent directorships could be a considerable time commitment, depending on the nature and size of the companies in question, where they are located (ie, do directors have to travel to board meetings) and so on. And if individuals also sit on the boards of unlisted companies, charities or non-governmental organisations, then four to five INED positions may be too many.

Indeed, ACGA believes that there should be a general requirement for all directors to disclose all their directorial positions, not only those on listed company boards.

A limit of four or five directorships is also in line with guidelines set by global institutional investors. For example, the California State Teachers' Retirement Scheme (CalSTRS) recommends that people who do not have full-time employment should only hold four INED positions, while those who hold full-time jobs (eg, CEOs), should only hold one or two INED positions.

The California Public Employees' Retirement System (CalPERS) adopts the recommendations from the Report of the NACD (National Association of Corporate Directors) Blue Ribbon Commission on Director Professionalism, which in its 2005 edition stated that, "the Commission recommends that boards in general should consider the following guidelines for different categories of candidates:

> "If the person is an executive chairman, CEO or senior manager of another company, however, then five will almost certainly be too many outside directorships to manage. One to two additional directorships should be the maximum.
>
> "CEOs and other senior executives of public corporations: Boards should prefer individuals who hold no more than one or two public-company directorships[1] (including the position to be offered) in addition to membership on their own company board.
>
> "Other individuals with full-time positions: Boards should prefer individuals who hold no more than three or four public-company directorships (including the position to be offered) in addition to membership on their own organization's board.
>
> "Other individuals: Boards should prefer individuals who hold no more than five or six public-company directorships (including the position to be offered)."

Question 13: If your answer to Question 11 is "yes", do you think that the limitation should be a Rule or a CP?

ACGA: We believe it should be a Rule. While there are certain attractions in making this a Code Provision—in that it would allow directors some leeway in deciding how many boards they can cope with—it is also likely that a "comply or explain" solution would have only a limited impact on those directors who are determined to sit on a large number of boards.

The consultation paper emphasises that only a relatively small number and percentage of all independent directors hold more than five INED positions, and few individuals hold more than five directorships of any kind—hence there may be no need to set any limits. However, this data could also be used to argue that the market in Hong Kong generally sees five directorships as an upper limit and most people are happy to voluntarily keep below it. Hence, any new rule would not adversely affect the vast majority of directors. What it would do is limit the potential for abuse by a small number of directors who sit on too many boards. The wider benefits of this for capital market integrity and investor protection arguably outweigh any costs to a few individuals.

Such a rule would also be simple for the Exchange to monitor and enforce. If it introduces a code provision, how will it ascertain that the explanations of directors holding multiple directorships are meaningful?

---

[1] Significant time commitments to nonprofit and private-company directorships should also be considered in evaluating director availability.

DIRECTOR TRAINING AND INDEPENDENT DIRECTORS

Question 14: Do you agree that we should upgrade RBP A.5.5 (requirement for continuous professional development) to a CP (re-numbered CP A.6.5)?

ACGA: Yes. As the Exchange noted in the consultation paper: "A frequent reason given by directors at Exchange disciplinary hearings for non-compliance with the Rules is that they did not understand or were not aware of them".

Anecdotal evidence and enforcement data/experience indicate that the overall level of director training in Hong Kong-listed companies, especially among directors most at risk (ie, those new to the role or in newly listed companies), is insufficient.

Question 15: Do you agree that the minimum number of hours of directors training should be eight?

ACGA: No. Eight hours of training is less than the minimum of 10 hours required by the Hong Kong Institute of Directors of its members and the 15 hours required of certain professionals under the CPD programme in Hong Kong. Given the increasing complexity in the role of directors—not only on the regulatory side, but in terms of dealing with stakeholders, understanding fraud, supervising risk management and so on—it is hard to believe that a great deal can be covered in only eight hours.

Eight hours is also extremely low if the Exchange implements its proposal to allow a range of "training methods" to be counted in this total, such as giving speeches, writing articles and reading books.

While it may be true that some business leaders in Hong Kong believe they need no further training, it is probable that some of their shareholders might take a different view—especially in the current climate where newer issues and challenges such as environmental, social and governance risks (and reporting) are assuming greater importance.

It is also, surely, a mistake to establish a training standard for a market based on what is appropriate for and acceptable to the most "experienced, well-informed" directors. This will guarantee that less experienced or novice directors receive less training than they should. It would make more sense to agree on a higher minimum level of training for those most in need of it, then scale this down as directors become more experienced.

Question 16: What training methods do you consider to be acceptable for the requirements stated in the proposed CP (re-numbered RBP A.6.5)?

ACGA: We believe that a mix of formal training by professional/educational bodies and in-house company briefings would provide a good balance. The content of such training should be targetted at the needs of directors and their companies, including not only regulatory and financial topics, but sessions on how to be an effective board member, how to chair a board or committee meeting, how to communicate with shareholders and stakeholders, how to respond to unexpected social or political risks and so on.

While giving speeches, writing articles and reading books are all worthwhile endeavours, we do not believe that they can be classified as "training". If the Exchange pursues this path, we believe that this exercise will become trivialised and subject to abuse.

Question 17: Do you agree that we should upgrade RBP A.3.2 (at least one-third of an issuer's board should be INEDs) to a Rule (re-numbered Rule 3.10A)?

ACGA: Yes and No. While we agree that the RBP of one third should be upgraded to a Rule, a new RBP of one half should also be introduced. This would bring Hong Kong into line with international standards.

In this context, it is worth emphasising that the quality of independent directors is as important as their number. Such directors should not only be independent of management and the controlling shareholder, they should be experienced in business and able to contribute meaningfully to board discussions on strategy, financial accounts, personnel issues, risk management and other decisions reserved for the board. They should also have the authority and standing to be able to offer a different perspective in board discussions, if necessary, to views propounded by the chairman and other executive directors. An independent director who meets the "independence" criteria in the Listing Rules yet cannot read company accounts, has limited business experience, and is unwilling to contribute to board discussions, is of little value. Similarly, an independent director who makes bland comments or suggestions without first understanding the company's business is unlikely to be effective.

The rationale for a higher number of independent directors is not doctrinal (ie, following international standards for the sake of doing so). Rather it is practical: given the increased frequency of board meetings today, the larger number of board committees, and the greater responsibilities being given to independent directors (eg, as chairs and members of committees), many listed companies may find it difficult to run their boards properly with only one third of directors being independent.

As the consultation paper noted, as at August 31, 2010, a total of 1,071 companies (approximately 79% of all issuers) already had INEDs that constituted one-third of their boards. The fact that most issuers voluntarily achieved this level before a rule change was proposed suggests a trend towards more, not less, independent directors. Setting a new RBP of 50%, therefore, is not overly ambitious.

Question 19: Do you agree that we should upgrade RBP A.4.3 (shareholder to vote on a separate resolution for the further employment of an INED who has served more than nine years) to a CP (re-numbered CP A.4.3)?

ACGA: Yes. As a general principle, we would add that an independent director who is still contributing positively to a board after nine years could remain on the board and be redesignated as a (non-independent) non-executive director. If companies did this, it would remove any doubt as to the standing of such directors.

Question 20: Do you agree with our proposal to upgrade RBP A.4.8 (issuer should include explanation of its reasons for election and independence of an INED in a circular) to a CP (re-numbered CP A.5.5)?

ACGA: Yes. Apart from standard and often limited biographical detail, issuers in Hong Kong rarely provide an explanation as to why they have selected certain individuals as independent directors, why they consider them to be independent, and what they expect them to contribute to the board. Upgrading this RBP to a code provision should help to put greater onus on the company to think about the selection of independent directors and explain its decisions to shareholders.

This point also links to the deeper issue of the independence criteria contained in Rules 3.10 and 3.13 of the Listing Rules. Some of these stipulations are highly prescriptive and artificial, and arguably make little sense in listed companies with concentrated ownership and a dominant chairman/founding family that elicits strong feelings of loyalty from both staff and professional advisors. For example, allowing for only a two-year cooling-off period before a former executive or director of a company can become an independent director is unconvincing in a market like Hong Kong (Rule 3.13(7)).

Indeed, we believe that the entire section of the Listing Rules dealing with the independence criteria of independent directors needs to be reconsidered.

REMUNERATION AND NOMINATION COMMITTEES

We broadly support the Exchange's proposals to upgrade remuneration committees to a rule (from a code provision) and nomination committees to a code provision (from a recommended best practice). While we agree that the chairmanship of each committee should ideally be an independent director (although there may be times in some boards when a non-executive director is the better choice), we believe that the description of the composition of these committees needs to be modified from "comprising a majority of independent non-executive directors" to "comprising only non-executive directors, with independent directors in the majority". This is to guard against the practice, prevalent in some smaller issuers, of appointing a chairman, CEO or CFO as members of these committees—something that surely undermines their purpose and effectiveness.

CORPORATE GOVERNANCE COMMITTEE

We broadly support the Exchange's proposals for the terms of reference, purpose and composition of a corporate governance committee. We believe it makes sense to include the duties of such a committee as a code provision, since these are tasks that any board should keep under review (whether or not it has such a specialist committee), while adding the establishment of the committee as a recommended best practice.

While the decision to set up a corporate governance committee or expand the duties of an existing committee is for each company to decide, we have concerns about adding these duties to the audit committee (since most of them have sufficient work to do). If a company has a risk management committee, it could make sense to combine it with a corporate governance committee. Alternatively, the role of the nomination committee could be expanded, especially since some of them meet only once or twice per year. If the latter course is chosen, then any executive director sitting as part of a corporate governance committee would need to recuse themselves from nomination-committee deliberations.

AUDIT COMMITTEE

We agree that the terms of reference of audit committees should include reviewing arrangements for employees to raise concerns about improprieties in financial reporting (RBP C.3.7), and that meeting with the external auditor at least twice a year (rather than once) makes sense—assuming that these two meetings are spaced apart, not held in the same period. Upgrading the first to a code provision is also sensible, given the growing recognition and application of whistleblowing policies in Asia and around the world.

There may be confusion, however, if the terms-of-reference point above becomes a code provision, while the new proposal to encourage audit committees to set up a whistleblowing policy remains only a recommended best practice. How can they properly review arrangements if no policy or system is in place?

One issue not covered by the consultation and about which we have deep concern relates to the timing of audit committee meetings to approve interim and annual audited accounts. It is common practice in Hong Kong, and some other markets, for audit committees to meet one day or only a few hours before the full board gathers to sign off on the audited accounts. Following the board meeting, a company will typically release the accounts to the market. In other words, there is no time for companies or external auditors to address any serious issues raised by the audit committee. While well-run audit committees may have fully canvassed the accounts in the days or weeks before final approval, it appears that this is only the case in a minority of listed companies.

MANAGEMENT ACCOUNTS

We agree with the proposal to include a new code provision to the effect that companies should provide all board members with monthly updates on the issuer’s performance and current financial position.

PART 2: SHAREHOLDERS

SHAREHOLDERS' GENERAL MEETINGS

We agree that issuers should avoid bundling of resolutions as a matter of principle. The only rationale for bundling is, as the paper states, if resolutions are interdependent and form one significant proposal—in which case, issuers should be required to explain the reasons for doing so.

VOTING BY POLL

Question 81: Do you agree with our proposal to amend Rule 13.39(4) to allow a chairman at a general meeting to exempt procedural and administrative matters described in paragraph 274 from voting by poll?

ACGA: Not in its current form. While voting by hand on a limited number of purely "procedural and administrative matters" may be reasonable (eg, to adjourn a meeting if a typhoon is coming), we believe that the way in which this part of the consultation paper has been written could open the door to confusion and misinterpretation. It is not entirely clear, for example, if a chairman could claim as "administrative" something that shareholders might consider as substantive? The language in paragraph 274, meanwhile, implies that shareholders would have an opportunity to express their views in the meeting on the matter being voted on; yet this clearly would not be the case for shareholders voting by proxy and not in the meeting. Thirdly, the possibility that "administrative resolutions" would be used to end discussions which have "gone on for too long" could be open to abuse.

We believe that this part of the paper requires further work before any final decision is made.

Question 83: Do you agree that our proposed amendments to Rule 13.39(5) clarify disclosure in poll results?

ACGA: Yes. This should bring greater clarity to results announcements.

APPOINTMENT AND REMOVAL OF AUDITORS

We agree with the proposal to add a new rule requiring shareholder approval for both the appointment of an external auditor and removal of that auditor before the end of his term of office.

End.