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BY HAND AND BY EMAIL

Corporate and Investor Communications Department
Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
8 Connaught Place
Central
Hong Kong

Dear Sirs,

Consultation Paper on Review of Corporate Governance Code and Related Listing Rules

Ernst & Young is pleased to respond in this letter to the request of The Stock Exchange of Hong Kong Limited for feedback on the captioned consultation paper ("Consultation Paper"). Terms used in this letter shall have the same meanings as in the Consultation Paper.

We welcome the Exchange's ongoing commitment to elevating the quality of Hong Kong listed issuers and promoting strong corporate governance practices.

Whilst each proposal may be viewed as a standalone proposal, we suggest that a holistic approach should be taken when considering proposals relating to directors and INEDs, so that the Exchange may attract more directors of the right calibre to serve on the boards of Hong Kong listed companies and more companies to come to list in Hong Kong. We agree with the majority of the Exchange's proposals but have reservation on some proposals including the two proposals set out below.

We are concerned that the pool of eligible INED candidates is not big enough to enable a smooth implementation of the proposed hard cap on INEDs' tenure, and a hard cap may also have the undesirable effect of forcing valuable INEDs off the board. We suggest that the Exchange retains the existing CPs to allow more time for issuers to carry out their board refreshment process.

We also have reservation about the proposal to introduce a new CP requiring issuers without an independent board chair to designate one INED as a Lead INED. We are concerned that this proposed CP may merely result in many issuers explaining why they have not appointed a Lead INED and/or the Lead INED spending time clarifying his/her role to shareholders/investors.

Please refer to the rest of the letter for our detailed comments on some of the key proposals/issues.

Should you have any questions on our comments, please do not hesitate to contact our [REDACTED] in Hong Kong, [REDACTED], on [REDACTED].

Yours faithfully,

[REDACTED]

Certified Public Accountants
Hong Kong

DETAILED COMMENTS

Independence of INEDs

Jurisdictional comparison

We have checked the rules regarding INEDs' tenure imposed by the 19 exchanges on the Exchange's list of recognised exchanges.

The US does not impose any tenure limit for the assessment of INEDs' independence. The UK, Australia and Saudi Arabia impose a cap of 9 to 10 years on a "comply or explain" basis, similar to Hong Kong's existing requirements. Singapore imposes a hard cap of 9 years on INEDs' tenure.

Impact on listed issuers

As of 31 December 2023, there were approximately 1,500 directorships held by Long Serving INEDs on the boards of approximately 810 issuers (approximately 31% of all issuers listed on the Exchange). There were approximately 30 issuers (approximately 1.3% of all issuers) whose INEDs were all Long Serving INEDs. According to the information as at 15 August 2024 on the Board Diversity & Inclusion in Focus page of the HKEX website, there were 26 issuers whose INEDs were all Long Serving INEDs, two of which were Hang Seng Index Constituents.

Our comments

Whilst we agree to the application of a bright-line test on directors' time commitment below (i.e., a hard cap of six Hong Kong listed issuer directorships), we do not agree to impose an outright bright-line test on assessment of directors' independence (i.e., a hard cap of nine years on the tenure of INEDs). Time commitment is a quantitative measure, but independence is a qualitative assessment which may or may not fade as time goes by. We suggest the Exchange to keep the existing CPs instead of imposing a hard cap on INEDs' tenure.

We understand that the tenure of non-executive directors is an area of focus for institutional investors who have stated that serving more than 9 or 12 years is relevant to their determination of a non-executive director's independence. Board refreshment may better be driven by market forces than regulatory intervention. The new INED appointment CP (i.e., an issuer whose INEDs are all Long Serving INEDs should appoint a new INED at the forthcoming AGM) only came into effect for financial years commencing on or after 1 January 2023. Furthermore, considering the substantial percentage of issuers still retaining Long Serving INEDs on their boards, the Exchange should allow more time for issuers to carry out their board refreshment process. The size of the talent pool is a practical issue faced by listed

issuers. It is not easy to look for a right INED. Replacing all Long Serving INEDs could be a daunting task for listed issuers.

We also question whether a listed issuer will definitely benefit from replacing all its Long Serving INEDs. A hard cap may have the undesirable effect of forcing valuable INEDs off the board. Various overseas researches have cited the benefits of retaining Long Serving INEDs who may have particular expertise and motivation to improve board effectiveness and ultimately firm performance. One research found that firms with a Long Serving INED perform better than firms without one, using 15 years of data on the S&P 1,500 firms. More details on the aforementioned research articles are set out in the Appendix.

Lead INED

We note that Exchange's proposal to introduce a new CP requiring issuers without an independent board chair to designate one INED as a Lead INED to enhance engagement with investors and shareholders. It is stated in paragraphs 29 to 32 of the Consultation Paper that (1) the Exchange would not expect a Lead INED to discuss the issuer's results and operational matters with potential investors or shareholders; (2) the role of the Lead INED is also not intended to duplicate other existing board roles, for example the chairs of board committees; and (3) a Lead INED would not be solely responsible for answering queries from shareholders at an AGM; but (4) issuers may also choose to define a role for the Lead INED that includes functions beyond those contemplated under the Exchange's proposal.

We have reservation about the proposal to introduce this new CP. Whilst the Exchange is trying to define the role of a Lead INED, it seems to be giving a free hand to issuers to define such a role. Some shareholders and investors may find it confusing and the Lead INED may end up explaining to these shareholders/investors that he or she is not in a position to answer their questions. Some of the functions of the Lead INED may arguably be competently assumed by the existing chairs of the mandatory board committees who have clearly defined areas of responsibilities. We are concerned that this proposed CP may merely result in many issuers explaining why they have not appointed a Lead INED and/or the Lead INED spending time clarifying his/her role to shareholders/investors.

Overboarding INEDs and directors' time commitment

We agree with the Exchanges' proposal to introduce a new Listing Rule that mandates a six-directorship cap on the number of Hong Kong listed issuer directorships that an INED may hold, and to implement this new requirement over a three-year transition period to enable an orderly phasing out of Overboarding INEDs (INEDs who are holding seven or more listed issuer directorships). In forming our opinion, we have considered the following factors:

- We agree that INEDs in particular have to be able to devote sufficient time and attention to the company's affairs, especially when the business environment in which companies operate is becoming increasingly complex, and the responsibilities of directors have become more demanding.
- The Exchange recognises that an individual's available time and attention is affected by a range of commitments, including the individual's directorship roles (listed or non-listed), full or part-time occupations, commitments in public service, on statutory bodies or non-profit organisations and other commitments. We note that the Exchange has not proposed that an issuer counts other commitments when calculating whether a director has exceeded the proposed six-directorship cap. We agree that such other commitments may affect director effectiveness and so issuers should continue to consider other commitments as part of their nomination committee assessments.
- We do not expect the proposal, with a three-year transition period, to impact the majority of the issuers as there were only 23 Overboarding INEDs serving on the boards of 181 issuers (approximately 7% of all issuers) as at 31 December 2023, with five Overboarding INEDs holding ten or more listed issuer directorships. According to the information as at 15 August 2024 on the Board Diversity & Inclusion in Focus page of the HKEX website, there were only 19 Overboarding INEDs serving on the boards of 138 issuers.
- The existing CP B.3.4(b) of the CG Code came into effect on 1 January 2019, more than four years ago. Issuers should be well prepared for the Exchange's proposed upgrade of this "comply or explain" requirement to a hard cap.

Mandatory director training

Existing directors

We absolutely agree that directors of listed companies should have the knowledge and skillsets to discharge their duties. We agree with the proposal to introduce new Listing Rule requirements that all existing directors of issuers listed on the Exchange participate in mandatory continuous professional development, without specifying a minimum number of training hours. Directors should upgrade their knowledge and develop and refresh their skills on an ongoing basis amidst an evolving market and continuous regulatory developments.

First-time Directors

We note that the Exchange defines “First-time Directors” as directors who: (a) are appointed as a director of an issuer listed on the Exchange for the first time (i.e., have no prior experience as a director of an issuer listed on the Exchange); or (b) have not served as a director of an issuer listed on the Exchange for a period of three years or more prior to their appointment; and that the Exchange proposes to impose a minimum training requirement of 24 hours which must be completed within 18 months of the date of their appointment. The Exchange also proposes that the training requirements apply to First-time Directors, even if they are also directors of overseas issuers, as the Exchange considers it important that directors of Hong Kong listed issuers have sufficient knowledge and understanding of their duties and responsibilities as directors of issuers listed in Hong Kong.

We also note that the proposed mandatory training for all directors covers the following areas: (a) the roles, functions and responsibilities of the board, its committees and its directors, and board effectiveness; (b) issuers’ obligations and directors’ duties under Hong Kong law and the Listing Rules, and key legal and regulatory developments (including Listing Rule updates) relevant to the discharge of such obligations and duties; (c) corporate governance and ESG matters (including developments on sustainability or climate-related risks and opportunities relevant to the issuer and its business); (d) risk management and internal controls; and (e) updates on industry-specific developments, business trends and strategies relevant to the issuer.

In general, we consider that the proposals are largely in the right direction, and that the Exchange may further require the completion of, say, at least 12 training hours during the first 12 months of the appointment to ensure First-time Directors have sufficient knowledge to fulfil their responsibilities at an early stage. However, we are of the view that the Exchange should (1) consider granting certain exemptions to directors of overseas issuers and directors who are members of professional bodies requiring mandatory continuing professional development (“CPD”); and (2) reconsider the “reset” mechanism in counting the minimum hours of training as detailed below.

First-time Directors - exemptions

It appears that only training area (b) above is “Hong Kong-specific”. Directors who have served on the boards of companies listed on recognised exchanges for a number of years should have certain exemptions in terms of the minimum hours of training when they become First-time Directors of companies listed on the Exchange. If these directors can produce recent records of training in the above areas (e.g., 12 hours in the past 18 months before becoming a First-time Director), the Exchange should allow them to complete only, say, 12 hours of training within 18 months of their appointment, with emphasis on Hong Kong law and Listing Rules.

Likewise, if a First-time Director is a member of a professional body requiring mandatory CPD can produce training records in the above area in the past 18 months before becoming a First-time Director, those CPD hours should be counted towards fulfilling the Exchange's proposed 24 hours of training. We believe that these exemptions will not diminish the quality of First-time Directors - in fact, they will help ensure that the proposed training hours will not deter competent candidates from serving as directors of Hong Kong listed companies, esp. INEDs.

The Consultation Paper does not discuss the treatment of directors of companies with a secondary listing on the Exchange. Rule 19C.11 of the Main Board Listing Rules contains a long list of Listing Rules that do not apply to secondary issuers such as the CG Code and Chapters 14 and 14A. It appears onerous to require First-time Directors of a company seeking/with a secondary listing on the Exchange to complete the same amount of mandatory training as First-time Directors of a company seeking/with a primary listing.

The existing CP C.1.1(a) in the CG Code requires, on a "comply or explain" basis, an issuer to provide newly appointed directors with a comprehensive, formal and tailored induction upon appointment. The Exchange clarifies that the 24-hour training requirement for First-time Directors would be separate from and additional to general induction training provided by an issuer to newly appointed directors. We agree with such a differentiation because the 24-hour training requirement is specific to the individual as a director whereas the general induction training is for newcomers to familiarise themselves with the issuer.

First-time Directors - the "reset" mechanism

The Exchange also proposes that in the event that, prior to the completion of the required 24 hours of training, a First-time Director ceases to be a director of the issuer and is subsequently appointed as a director of another (or the same) issuer listed on the Exchange, this requirement would reset, and the director would be required to complete a minimum of 24 hours of training within 18 months from such subsequent appointment. The Exchange did not explain the rationale behind this proposal which ties the training received by a director (as an individual) to a specific issuer. Only training area (e) above is issuer-specific. We suggest the Exchange to reconsider this proposal and recognise the non-issuer specific training hours that the First-time Director received in a past directorship of a Hong Kong listed issuer in the past 18 months.

Other proposals relating to board effectiveness

We agree in principle to the proposals to:

- Upgrade the current RBP (introduced in 2012) to a CP requiring issuers, on a “comply or explain” basis, to conduct regular board performance reviews on the board’s performance as a whole at least every two years and make disclosure; and
- Introduce a new CP requiring issuers to maintain a board skills matrix and make disclosure.

We suggest the Exchange to consider applying the tiered approach in its implementation of the climate-related disclosures (announced in April 2024) to the above proposals, e.g., by introducing the above CPs to Main Board issuers whilst introducing/retaining the above proposals as RBPs for GEM issuers.

Board and workforce diversity

At EY, diversity and inclusiveness are core to who we are and how we work. We agree that diversity is a key driver of board performance and quality decision-making. We agree with the Exchange’s proposals to:

- introduce a Listing Rule to require issuers to have and disclose a diversity policy for their workforce (including senior management), with Rule wording that recognises that the demographics in a particular industry or country where an issuer operates may make the formulation of diversity targets on a workforce level more challenging;
- upgrade from a CP to a MDR the requirement on the annual review of the implementation of an issuer’s board diversity policy;
- require as a revised MDR separate disclosure of the gender ratio of: (i) senior management; and (ii) the workforce (excluding senior management) in the CG Report; and
- codify the arrangements during temporary deviations from the requirement for issuers to have directors of different genders on the board (immediate announcement and re-compliance within three months).

However, we have reservation about the proposal to introduce a CP requiring issuers to have at least one director of a different gender on the nomination committee at this juncture. We suggest introducing it as a voluntary RBP instead. The Exchange may propose upgrading it to a CP later after gender diversity at the board level has further improved.

The transitional arrangement for single gender board (banned in the 2022 Update) will end on 31 December 2024. According to the information as at 15 August 2024 on the Board Diversity & Inclusion in Focus page of the HKEX website, there were still 14.0% of the issuers with no female director and 46.8% with only one female director. There may be a wave of appointment of female directors, many of whom will likely be First-time Directors, during the coming four months before the transition arrangement ends. The priority is to make sure First-time Directors undertake the necessary mandatory training to equip them with sufficient knowledge to discharge their duties as a listed company director. Even if the female director is not a First-time Director, the only female director may already be sitting on the audit committee and/or remuneration committee and may have little desire to sit on the nomination committee. Furthermore, if the only female director is not an INED, the inclusion of this director in the nomination committee will make the committee less independent.

Risk management and internal control

We agree that good corporate governance starts with having in place effective RMIC Systems, and that issuers should make detailed disclosure on the review of their RMIC Systems' effectiveness to provide transparency and accountability for investors and the market. We agree with the Exchange's proposals to:

- emphasise in Principle D.2 the board's responsibility for the issuer's risk management and internal controls and for the (at least) annual reviews of the effectiveness of the RMIC Systems; and
- upgrade the requirement to conduct (at least) annual reviews of the effectiveness of the issuer's RMIC Systems to mandatory and require detailed disclosures on (a) the RMIC Systems in place (including any significant changes made to the RMIC Systems); (b) the process through which the review of the RMIC Systems was conducted; (c) a confirmation from the board on the appropriateness and effectiveness of the RMIC Systems, as well as information supporting the board's conclusion (including confirmations received (as applicable) from management, the relevant board committee(s) with responsibility for the issuer's RMIC Systems, any other internal departments, the issuer's independent auditors and/or other external providers); and (d) details of any significant control failings or weaknesses identified during the review and/or previously reported but unresolved, and any remedial steps taken or proposed.

Other minor Rule amendments

Disclosure on modified auditors' opinion

We agree with the Exchange that issuers who receive a modified auditors' opinion should enhance their disclosure in the annual reports. We agree with the Exchange's proposal to codify the following recommended disclosures in respect of issuers' modified auditors' opinions into the Listing Rules: (a) details of the modifications and their impact on the issuer's financial position; (b) management's position and basis on major judgmental areas, and how it is different from that of the auditors; (c) the audit committee's view towards the modifications, and whether the audit committee has reviewed and agreed with management's position concerning major judgmental areas; and (d) the issuer's proposed plans to address the modifications.

Financial information

We agree that directors need timely, high-quality information to facilitate their thorough consideration of issues prior to, and informed discussions at, board meetings. Monthly updates should include monthly management accounts and management updates, which are important for the assessment of the issuer's financial performance and position and the identification of any abnormalities. We agree with the Exchange's proposal to clarify its expectation of the provision of monthly updates in CP D.1.2 of the CG Code (and the note thereto) and to make it clear that directors are entitled to and should request such information if the management does not provide it.