HKEx Publishes Draft Consultation on Enhancements to Corporate Governance Code

13 August 2024

Introduction

On June 14, 2024, the Hong Kong Stock Exchange (the "HKEx") launched a two-month public consultation (the "Consultation") until August 16, 2024 to seek feedback on proposed enhancements to the current Corporate Governance Code (the "CG Code") in Hong Kong that aim to bolster good corporate governance practices among listed issuers.

Background

The HKEx conducts periodical review of the CG Code to ensure a high standard of corporate governance and to maintain investors' confidence in the market. The last round of amendments to the CG Code were introduced on January 1, 2021 and came into effect a year later (the "2022 Update").

In formulating the proposals in the Consultation, the HKEx has referenced regulatory developments in various jurisdictions (including the United Kingdom, Australia, Singapore, Malaysia and Mainland China) and their review findings from the Analysis of 2022 Corporate Governance Practice Disclosure (the "2022 Analysis") published in November 2023,[1] as well as market and industry feedback.

The 2022 Analysis is the fruit of the HKEx's review of the corporate governance reports of a sample of 400 listed issuers and their disclosures. It focused on issuers' compliance with some of the new requirements arising from the 2022 Update, with a particular emphasis on corporate culture, long-serving independent non-executive directors ("INEDs"), board diversity and risk management and internal controls. The HKEx observed that the 2022 Update resulted in a meaningful reduction of boards whose INEDs consisted of all long-serving INEDS, i.e., INEDS who have served

[1] HKEx's "Analysis of 2022 Corporate Governance Practice Disclosure" dated November 2023, available at https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/Review-of-Implementation-of-Code-on-Corporate-Governance-Practices/CG_Practices_2022_e.pdf.

tenures of more than nine years. There was also an 8% drop in the percentage of single-gender board issuers since the 2022 Update. The HKEx emphasised the importance of having periodic board refreshment as well as further improving gender diversity on the boards in order to foster the sharing of diverse perspectives and skill sets. Further, the HKEx noted that it is important for issuers to conduct regular monitoring of their internal control and risk management systems in place and review their effectiveness at least on an annual basis. As a result of these observations, the HKEx put forward new proposals in the Consultation to address any outstanding corporate governance concerns and areas where further enhancements can be made.

The Proposals

The proposals in the Consultation focus on five major areas. These include improving board effectiveness, promoting diversity, strengthening board independence, enhancing risk management and internal controls and enhancing capital management.

Board Effectiveness

The proposals on improving board effectiveness seek to enhance directors' accountability, skills and commitment to the board.

Lead INED

One of the key proposals requires issuers without an independent board chair (e.g., where the board chair is also the chief executive of the issuer) to designate an INED as a "Lead INED" who shall be responsible for facilitating better and more efficient communication between investors and the board, among the INEDs and between INEDs and other directors.[2] This is to strengthen the INEDs' independent voice and to address investors' concern that there is often a lack of access to the board. This requirement will bring Hong Kong in line with other jurisdictions including the United Kingdom, Singapore and Australia, all of which have adopted the concept of a Lead INED on a voluntary or "comply-or-explain" basis.

Hard Cap on Overboarding

Currently, the CG Code requires a board to provide an explanation to shareholders if it proposes to elect an INED who, if elected, will be holding his/her seventh (or more) directorship in a listed issuer. To ensure that INEDs would be able to devote sufficient time and attention to the companies' affairs and make meaningful contributions and safeguard high-quality decision-making on the board, the Consultation proposes to introduce a six-directorship cap on the number of Hong

[2] If an issuer already has an independent board chair, it is expected that the board chair would fulfill the role of the Lead INED.

Kong-listed issuer directorships that an INED may concurrently hold.[3] This requirement is proposed to be implemented over a three-year transition period to enable an orderly phasing out of INEDs who are overboarding.[4]

Mandatory Director Training

The existing CG Code does not require directors to undergo mandatory director training as part of their continuous professional development. As the HKEx discovered during its enforcement process that directors of listed issuers often lacked a thorough understanding of their duties, responsibilities and Listing Rule requirements, the Consultation thus proposes to require all directors to receive mandatory continuous professional development every year on specified topics and to require directors appointed for the first time or those who have not served for over three years to undergo a minimum of 24 hours' training, which must be completed within 18 months from the date of their appointment.

Strengthening Board Independence

Following the amendments introduced in the 2022 Update, the further appointment of an INED who has served more than nine years requires shareholders' approval by way of a separate resolution,[5] but there is currently no limit on the tenure of INEDs.

In an effort to further enhance board renewal, the Consultation seeks to impose a hard cap of nine years on the tenure of INEDs, with a three-year transition period. The nine-year tenure would commence from an issuer's listing date (where an INED is appointed prior to an issuer's listing) or the date of appointment of the INED (where an INED is appointed after an issuer's listing). Under the proposal, an INED who has reached the nine-year tenure will be allowed to serve again as an INED on the board of the same issuer after a two-year cooling-off period. It is hoped that the proposed change could help avoid complacency and entrenchment and bring fresh and diverse perspectives to the board.

Board and Workforce Diversity

Following the 2022 Update, some progress has been made to improve board diversity such that single-gender board issuers are required to appoint at least one director of a different gender by December 31, 2024. Despite this, the percentage of female directors on listed issuers' boards remains low.[6]

With a view to further promoting diversity in gender and skill sets, the Consultation introduces a requirement for issuers to have at least one director of a different gender on the nomination committee and imposes a mandatory obligation on

---

3 This covers directorships as executive directors, non-executive directors and INEDs.

4 The new rule is proposed to apply from January 1, 2028 onwards.

5 CG Code, B.2.3.

6 According to the Consultation Paper published by the HKEx in June 2024, as of December 31, 2023, approximately 17% of directors on the boards of listed issuers were female.

issuers to conduct an annual review of the board diversity policy and make separate disclosure of (among others) the gender ratio of senior management and workforce (excluding senior management).

Risk Management and Internal Controls

Currently, issuers who have conducted a review of the effectiveness of their risk management and internal control systems ("RMIC Systems") are required to disclose a summary of such systems in their annual Corporate Governance Report. However, such disclosure is often considered inadequate by the HKEx, and given that inadequate or ineffective RMIC Systems is a recurring theme in disciplinary actions the HKEx pursued against listed issuers and their senior management, the Consultation imposes a mandatory requirement on the board of issuers to conduct a review of the effectiveness of their RMIC Systems at least annually, which should include detailed disclosures of (among other things) the RMIC Systems in place, the review process, the board's confirmation on the appropriateness and effectiveness of the RMIC Systems, significant control failings or weaknesses identified and any remedial steps taken or proposed. With this change, the HKEx aims to improve transparency and accountability for investors and the market, and this will bring Hong Kong in line with the regulatory trends in Singapore and the United Kingdom which seek to tighten regulatory requirements on issuers' oversight of their RMIC systems' effectiveness.

Capital Management

Whilst listed issuers are currently required to disclose their dividend policy in their annual report, the HKEx aims to further enhance transparency and accountability regarding issuers' capital management and seeks to do so by aligning capital management disclosure with the regulatory developments in other jurisdictions in Asia where local regulators have introduced a broad range of measures to improve listed companies' capital management.

Thus, it is proposed in the Consultation that issuers be subject to a mandatory requirement to make enhanced disclosure of their dividend policy, which should include (i) disclosing the aim or objective of the policy and the board's key considerations when deciding whether to declare, recommend or pay any dividend and (ii) providing a confirmation that all dividend decisions during the reporting period were made according to its dividend policy (and if not, explaining any deviations). On the other hand, issuers who do not have a dividend policy would be required to state this fact and disclose the reasons for the absence of such policy. Requiring issuers to provide more information on their reasoning for their dividend policies (or lack thereof) could help safeguard shareholder interest and foster a better and more responsible culture of accountability in capital management.

Proposed Implementation Period

The Consultation closes on August 16, 2024. Subject to feedback to the Consultation, the HKEx proposes to implement the changes on January 1, 2025, with a three-year transitional period until December 31, 2027 for the implementation of the proposals imposing caps on the tenure of long-serving INEDs and overboarding in order to allow listed issuers more time to make the necessary adjustments to their boards.

Conclusion

These proposals demonstrate the HKEx's dedication in identifying areas of improvement to uphold a high standard of good corporate governance, elevate the quality of issuers and enhance the attractiveness of Hong Kong's highly regarded listed market.

To prepare for these anticipated changes, listed issuers should start reviewing their current board composition, RMIC Systems and capital management policies. Whilst there is a three-year transitional period for listed issuers to adjust their board composition to comply with the new rules on long-serving INEDs and overboarding, identifying suitable candidates to meet the new INED and diversity requirements would likely take some time. Directors of listed issuers should also prepare themselves for the mandatory training, review their current directorships and ensure that they continue to remain compliant with the regulatory requirements.

* * *

Please do not hesitate to contact us with any questions.

Gareth Hughes
Partner, Hong Kong
+852 2160 9808
ghughes@debevoise.com

Ed Northover
Partner, Hong Kong
+852 2160 9848
enorthover@debevoise.com

Wen-Wei Lai
International Counsel, Hong Kong
+852 2160 9860
wwlai@debevoise.com

Emily Lam
International Counsel, Hong Kong
+852 2160 9823
elam@debevoise.com

Tiffany Wu
Associate, Hong Kong
+852 2160 9842
tlwu@debevoise.com