

Client Alert

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Corporate Governance Code will tighten INED's independence assessment criteria in 2019

Summary

On 27 July 2018, The Stock Exchange of Hong Kong Limited (SEHK) published the [conclusion](#) on its "*Consultation Paper on Review of the Corporate Governance Code ("CG Code") and Related Listing Rules*" ("**CG Consultation**"). The amended CG Code and related Listing Rules will take effect on **1 January 2019**.

Furthermore, in response to the feedback to the CG Consultation, SEHK published the "[Guidance for Boards and Directors](#)" ("**Guidance**") to provide practical advice to directors. The Guidance does not form part of the Listing Rules. Issuers should make their own judgement on whether to apply the suggestions advised in the Guidance.

The major amendments to the CG Code include:

- (a) strengthen the transparency and accountability of the board and/or nomination committee on election of directors, including Independent Non-Executive Directors (INED);
- (b) impose a minimum annual meeting requirement amongst the chairman and INED;
- (c) enhance the independence criteria in assessing potential INED candidates;
- (d) upgrade the board diversity requirement to a mandatory requirement; and
- (e) require disclosure of dividend policy in the annual report as a comply or explain obligation.

What are the key changes?

Part I: INED

A. Factors affecting the independence of INED before the appointment

To strengthen the criteria for assessing potential INED's independence, the cooling off period will be amended in the following ways:





Affected parties	Current cooling off period	New cooling off period	Rule / Code Provisions (CP) ¹
1. Person with material interests in the issuer's principal business	Nil	One-year	Rule 3.13 (4)
2. Former professional adviser	One-year	Two-year	Rule 3.13 (3)
3. Former partner of the issuer's auditing firm who can be appointed as a member of the issuer's audit committee	One-year	Two-year	CP C.3.2

When determining the independence of a director under Rule 3.13, the same factors apply to the proposed director's immediate family members, such as the spouse and children under 18 years old (Note to Rule 3.13).

When two (or more) directors sit on each other's board (i.e. cross-directorship) or have significant links with each other, SEHK recommends disclosure in the corporate governance report explaining why such a director is considered independent (Recommended Best Practice A.3.3).

SEHK's Recommendation

SEHK recommends issuers to appoint INED at least two months prior to listing (paragraph 2.11 of the Guidance).

B. Time commitment of INED

In addition to the current requirements, the board should also disclose and explain the following additional information in the circular to the shareholders accompanying the resolution to elect the INED:

Affected parties	Additional requirement	Code Provisions (CP)
Proposed INED holding their seventh (or more) listed company directorship	The board should comply or explain why and how the INED would still be able to devote sufficient time to the board.	CP A.5.5 (2)

C. Chairman's annual meetings with INED

To align with international practice, the chairman should have at least one annual meeting with INED without the presence of other directors (i.e. non-executive directors and executive directors) (CP A.2.7). The issuer should explain in the annual report if it does not comply with this provision.

¹ While the references to the Listing Rules and CG Code in this paper are referring to the Main Board, the amendments apply equally to the GEM Listing Rules and the Code Provisions.



Part II: Board diversity and nomination policy

To promote board diversity, the board should disclose its diversity policy in the corporate governance report and its diversity consideration in the relevant circular.

Affected parties	Additional requirement	Rule / Code Provisions (CP)
1. All issuers	<p>All issuers should have a diversity policy and disclose the diversity policy or its summary in the corporate governance report.</p> <p>Diversity includes but not limited to gender, age, cultural and educational background or professional experience.</p>	<p>Upgrade the existing CP A.5.6 to Rule 13.92</p> <p>Appendix 14, Mandatory disclosure requirement L.(d)(ii)</p>
2. All issuers	<p>All issuers should disclose or explain the following additional information in the circular to the shareholders accompanying the resolution to appoint the INED and they should explain in the annual report if they do not comply:</p> <p>(a) the process used for identifying the nominee and why the board believes the individual should be elected and the reasons why it considers the individual to be independent;</p> <p>(b) if the proposed INED is holding their seventh or more listed company directorship, why the board believes the individual would still be able to devote sufficient time to the board;</p> <p>(c) the perspectives, skills and experience that the person can bring to the board; and</p> <p>(d) how the nominee would contribute to diversity of the board.</p>	CP A.5.5

SEHK's Recommendation

All listed companies are encouraged to:

- select from a broad range of candidates who are outside the board's circle of contacts, and in accordance with the issuer's diversity policy (paragraph 3.5 of the Guidance)
- consider board succession planning considerations and periodical review of the plan (paragraph 3.9(4) of the Guidance)
- disclose the board members' skills matrix in terms of the directors' skills, experience, attributes, competencies and contribution to the issuer's strategic direction, succession planning and diversity (paragraphs 4.10 - 4.12 of the Guidance)



In formulating the diversity policy, each issuer should consider its own business model and specific needs and disclose the rationale for the factors it uses. SEHK encourages issuers to consider the following suggestions (paragraph 4.9 of the Guidance):

- articulate the benefits of diversity
- express its commitment to diversity at all levels
- assess the diversity profile annually
- ensure that a diverse range of candidates are considered in the recruitment and selection practices at all levels
- state whether the issuer has identified and implemented programs that will assist staff development

Part III: Dividend Policy Disclosure

To facilitate shareholders and investors to make informed investment decisions while maintaining the flexibility for issuers to explain why they do not disclose a dividend policy, a new CP E.1.5 is introduced.

Affected parties	Additional requirement	Code Provisions (CP)
All issuers	All issuers should disclose its dividend policy in the annual report, otherwise they should explain in the annual report why they do not comply.	CP E.1.5

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Part IV: Risk management and internal control (voluntary in nature)

SEHK suggests all issuers to take the following possible steps to identify and manage risks (paragraphs 5.5 - 5.11 of the Guidance):

1. prepare a formally documented risk management policy and procedure endorsed by senior management and the board;
2. prepare an audit plan which reviews the internal control systems and the identified risks;
3. test the risk management system and rectify any identified weaknesses, in particular the process and management of notifiable and connected transactions;
4. analyse the source of potential internal and external risks that can arise in relation to the issuers' business;
5. create and review annually a risk register which is populated with key strategic risks that might prevent the issuer from achieving its strategic objectives;
6. plot 10-20 risks into a matrix that the board can consider and review the internal control systems to mitigate them;
7. strike a right balance between focusing excessively on eliminating risks and paying insufficient attention to risks; and
8. make adequate disclosure on the board's annual review of the issuers' risk management and internal control in the corporate governance report.