HKEx Publishes Analysis of Corporate Governance Practice Disclosure

On 17 November 2023, The Stock Exchange of Hong Kong Limited (**HKEx**) published its "Analysis of 2022 Corporate Governance Practice Disclosure", setting out its findings and guidance following its latest review of listed companies' compliance with the Corporate Governance Code (**Corporate Governance Code**).[1] The HKEx reviewed the corporate governance reports (**Corporate Governance Reports**) and disclosures of 400 randomly selected listed companies, representing 15.8% of all listed companies as of 31 December 2022. It focused particularly on assessing compliance with the new Corporate Governance Code requirements introduced on 1 January 2022 (**2022 Update**), including those relating to corporate culture, long-serving INEDs, diversity, and risk management and internal controls. Generally, the HKEx observed an overall improvement in compliance with the Corporate Governance Code compared to previous reviews.

For a summary of the 2022 Update, please see Charltons' January 2022 newsletter.

Key Findings and Recommendations

Corporate Culture

Code Provision (**CP**)[2] A.1.1 was newly implemented as part of the 2022 Update and emphasised the responsibility of boards of listed companies to set the companies' purpose, values and strategy and make sure that these are in line with the listed companies' cultures. It also requires listed company directors to act with integrity and take active steps to promote the culture of the listed company.

All of the listed companies sampled responded that they had complied with CP A.1.1, although the HKEx noted that some companies' disclosure lacked sufficient detail. It emphasised that merely describing a listed company's general corporate governance approach would not offer adequate information regarding the company's culture and its alignment with the company's purpose, values and strategy. The HKEx commented that good disclosure requires comprehensive disclosure which should include:

- details of the different factors considered by the board and directors when assessing the alignment of the listed company's purpose, values, and strategy with its culture; and
- how the desired culture supports the achievement of the listed company's long-term business objectives

and how it is implemented throughout the entire organisation.

Although the high level of compliance is promising, the HKEx also noted some areas for improvement. Over half of the Corporate Governance Reports reviewed did not include a section dedicated specifically to corporate culture and related disclosures were sometimes contained outside the Corporate Governance Report, for example in the ESG report, the chairman's statement or the management discussion and analysis. Acknowledging that the Corporate Governance Code does not specify the location for presentation of information on corporate culture, the HKEx commented that appropriate cross-references should be included in the Corporate Governance Report if these disclosures are made outside of it.

Reduction and Re-election of Long-serving INEDs

In light of concerns that long-serving independent non-executive directors (**INEDs**), may be less objective given the prolonged time served on the board, that is more than nine years, the 2022 Update compelled further disclosures when re-electing long-serving INEDs. CP B.2.3 requires listed companies to disclose the factors considered, the process and the discussions of the board or nomination committee relating to the conclusion that the long-serving INED is independent and should be elected. CP B.2.4 further requires listed companies whose INEDs are all long-serving INEDs to: (i) disclose each long-serving INED's tenure; and (ii) appoint a new INED at the next annual general meeting (**AGM**). The latter requirement came into effect on 1 January 2023, whereas the other 2022 Update changes came into effect on 1 January 2022.

The HKEx noted a significant drop in the number of listed companies with all long-serving INEDs. As of 31 August 2023, around 1,500 directorships were held by long-serving INEDs across 800 listed companies. Only 2% of all listed companies had INEDs who were all long-serving INEDs, a 4% drop from before the 2022 Update. All the companies sampled in this review complied with the first limb of CP B.2.4 and more than half complied with the second limb of CP B.2.4 and had appointed a new INED before their 2023 AGM.

The listed companies included in the sample all provided reasons for re-electing Long Serving INEDs in their shareholder circulars and disclosed the factors considered in determining their suitability for re-election. Reasons commonly given to explain why a long-serving INED remains independent and reasons given to support their re-election included their extensive experience, skills and/or knowledge (82%), their impartial judgment and objective contribution during their term of service (59%) and satisfaction of Main Board Rule 3.13 Independence Criteria (56%).

The HKEx highlighted that new INEDs are crucial to preventing board entrenchment, encouraging diversity and introducing fresh viewpoints. If a listed company chooses to re-elect a long-serving INED, it must provide the necessary information for the market to evaluate the thoroughness of its nomination process. This would include disclosing the actions taken by the nomination committee, such as reviewing the performance of the long-serving INED and assessing their ability to contribute impartially to the board. The listed company should also disclose how the board evaluated the nomination committee's recommendation.

Although fewer listed companies quoted Main Board Rule 3.13 as a reason for re-election compared to the last review in 2019, the HKEx noted that Main Board Rule 3.13 mainly addresses the director's actual or potential conflicts of interests and relying on this rule only is insufficient to explain the director's continued ability to bring fresh perspectives and independent judgment to the board. When evaluating a long-serving INED's ongoing suitability, the board (or nomination committee) should assess the INED's mindset and determine if they can still provide an independent and objective contribution. The HKEx also encouraged the use of board evaluations and board skills matrixes to assess the abilities of the board and any deficiencies.

Board Diversity

The HKEx believes that board diversity introduces diverse viewpoints to the board and improves board performance and decision-making. Under Main Board Listing Rule 13.92 (GEM Listing Rule 17.104), the nomination committee (or the board) must have a policy ensuring diversity of board members and all listed companies must appoint at least one director of a different gender by 31 December 2024. Additionally, paragraph J of the Mandatory Disclosure Requirements[3] and CP B.1.3 mandate listed companies to conduct a review of board diversity policies annually, set timed goals for board gender diversity, and disclose gender ratios with concrete objectives to enhance workforce gender diversity.

The HKEx found that as of 31 August 2022, 17.3% of directors of listed companies were female (compared to 15.2% before the 2022 Update) and 21.4% of all listed companies had single-gender boards (compared to 29.6% before the 2022 Update). It also noted that the proportion of female chairs of Nomination Committees, Audit Committees and Remuneration Committees remained low at 10%, 9% and 12%, respectively. All sampled listed companies had put in place and annually reviewed their board diversity policies, however around 40% failed to disclose timelines and targets for achieving board gender diversity as required under the Corporate Governance Code.[4] Among the 60% that included gender diversity targets, most aimed to fulfill the gender diversity requirement under Main Board Listing Rule 13.92 by the December 2024 deadline. Some listed companies set targets beyond the basic requirements such as committing to ensure that 20% of the board made up of female directors by 2025 and actions to increase diversity at the workforce level in addition to the board level.

As part of the review, the HKEx also followed up on listed companies with a single-gender board listed between July 2019 and December 2020 that had yet to appoint a female director at the time of the HKEx's Analysis of IPO Applicants' Corporate Governance in 2021[5] and listed companies with a single-gender board listed between January 2021 and June 2022. Half of these listed companies had already appointed a female director, and most of those who had not had committed to meet the December 2024 deadline.

The HKEx warned listed companies that still have single gender boards that they should not delay compliance with Main Board Listing Rule 13.92 and the Corporate Governance Code until closer to the December 2024 deadline, but should take active steps to appoint at least one different gender director (for example on a director's retirement by rotation). Listed companies are encouraged to adopt higher gender representation ratios depending on the skills, experience and needs of the current board and the circumstances of the company. The HKEx reminded listed companies that they need to disclose numerical targets and timelines for achieving board gender diversity. It recommended disclosing: details of the actions taken by the listed company and the programmes it has put in place and information on its progress in meeting its numerical targets and timelines, and if they will not be met, the steps it is taking to achieve its diversity goals. Where a diversity target or timeline is revised, or circumstances have changed making it more difficult for a listed company to meet its diversity commitments, listed companies should give a reasoned explanation. Although not compulsory, the HKEx also encourages listed companies to foster a more diverse talent pipeline and increase gender diversity on board committees.

Risk Management and Internal Controls

Under paragraph H of the Mandatory Disclosure Requirements, Corporate Governance Reports must disclose: (i) whether the listed company has put in place an internal audit function; (ii) the frequency of reviewing its risk management and internal control systems (**Internal Control Systems**); and (iii) whether the company considers its Internal Control Systems to be effective and adequate. CP D.2.1 further imposes a duty on directors to monitor the Internal Control Systems, review their effectiveness every year and report the results in the company's Corporate Governance Report.

The HKEx observed that most Corporate Governance Reports reviewed included disclosures regarding the listed company's business risks, an overview of the Internal Control Systems implemented, a summary of the review of the Internal Control Systems and confirmation by the directors that the Internal Control Systems were effective. However, some disclosures failed to provide specific details explaining how the Internal Control Systems' design addressed the identified business risks. Some Corporate Governance Reports also did not elaborate on the supporting reasons behind the board's confirmation that the Internal Control Systems were efficient.

To provide constructive disclosure to shareholders, the HKEx suggested including details of: (i) the structure of the Internal Control Systems including the main individuals and departments in charge of maintaining the Internal Control Systems; and (ii) the procedures for conducting regular reviews and monitoring of the proper functioning of the Internal Control Systems. It also recommended using flowcharts and graphics where appropriate.

The HKEx also noted that Corporate Governance Reports should include details of the listed company's annual internal controls review to support the conclusion that the Internal Control Systems are effective. It recommended disclosing:

- whether the listed company's board has confirmed the Internal Control Systems' effectiveness;

- the confirmations received by the board or the listed company in support of its determination that the Internal Control Systems are effective. These confirmations can be from management,[6] the audit committee, the internal audit function, other departments, and/or external advisers;

- any significant areas of concern,[7] such as material weaknesses, that were identified during the review (and if so, how these were remedied); and

- changes made to the Internal Control Systems during the year with an explanation of what the changes were and the reasons for their implementation.

Compliance with Code Provisions

	2022 Review	2019 Review	2017/2018 Review
Compliance with all 78 CPs	49%	41%	36%
Compliance with 70 or more CPs	99.5% (Note)	100%	100%

Note: Two sampled listed companies had prolonged vacancies in the chairman and/or chief executive officer positions due to special circumstances, and have been excluded by the HKEx in presenting certain statistics.

The CP least complied with was CP C.2.1 (61%) which requires the separation of the roles of chairman and chief executive. The main reason given for the same person occupying the roles of chairman and chief executive was that this arrangement allows for more consistent leadership and enables the effective implementation of strategies. Other reasons given for non-compliance included that: (i) the balance of power and authority was not impaired; (ii) contributions were made by all members of the board; and (iii) the individual assuming both roles being of high calibre, and having extensive experience and knowledge of the listed company's operations. However, the HKEx reiterated the requirement under CP C.2.1, stating that the chairman and the chief executive play different roles in the company's management. The HKEx regards the chairman as responsible for the overall effectiveness of the board in directing the company, and the chief executive as responsible for overseeing the company's operations. It believes the separation of these roles and their responsibilities is necessary to achieve checks and balances on the exercise of power. HKEx recommends that listed companies who fail to comply with this CP should disclose the alternative measures adopted to ensure that important decisions are scrutinised and that the exercise of power by a single chairman and chief executive is monitored.

The other CPs with the lowest compliance rates were CP F.2.2 on AGM attendance by the chairmen of the board and board committees (95%); CP C.5.1 on board meetings at least four times a year (97%); CP B.2.2 on retirement of directors by rotation at least once every three years (97%); and CP C.1.6 on non-executive directors' attendance at general meetings (97%).

Mandatory Disclosure Requirements

The level of compliance with the mandatory disclosure requirements was generally high. However, the HKEx identified three Mandatory Disclosure Requirements which some of the listed companies sampled did not comply with or only partially complied with. These were the disclosures under paragraphs B(h), J(b) and L(c).

- Paragraph B(h): Relationships between board members, and between the chairman and chief executive – 16% of the listed companies sampled failed to make any disclosures under this paragraph. The HKEx commented that if this paragraph is not applicable, a negative statement should be included in the Corporate Governance Report.

- Paragraph J(b): Diversity – Listed companies often fail to include numerical targets and concrete timelines to achieve board gender diversity.

- Paragraph L(c): Investor Relations (shareholders' communication policy) – Listed companies failed to disclose their review of the implementation and effectiveness of their shareholders' communication policies.

The HKEx reminded listed companies that the information required by the Mandatory Disclosure Requirements (including all information required under the Mandatory Disclosure Requirements' sub-paragraphs) must be disclosed in their Corporate Governance Reports. If a Mandatory Disclosure Requirement does not apply, they must include a negative statement. The HKEx observed that some listed companies included disclosures required by the Mandatory Disclosure Requirements in their annual reports (but not their Corporate Governance Reports), while one referred to its diversity policy as disclosed on its website. It reiterated the requirement for information disclosed under the Corporate Governance Code to be included in listed companies' Corporate Governance Reports and the need to include cross-references where appropriate.

Common Compliance Pitfalls for CPs

The "comply or explain" approach adopted by the Corporate Governance Code is designed to allow room for listed companies to deviate from the requirements under the Corporate Governance Code and adopt alternative means of ensuring effective corporate governance. Under paragraph A(c) of the Mandatory Disclosure Requirements, if listed companies deviate from the CPs, they must disclose considered reasons for the deviation in their Corporate Governance Report and explain how the alternative measures adopted achieved good corporate governance.

The HKEx identified three main issues. First, some listed companies reported non-compliance with certain CPs but failed to explain the reasons for non-compliance or whether alternative measures were in place to address potential issues arising from the non-compliance. Second, some Corporate Governance Reports stated that there was full compliance, however, a closer review of the report revealed non-compliance with specific CPs. The HKEx reminded listed companies of the requirement to report all non-compliances under paragraph A(c) of the Mandatory Disclosure Requirements. Third, some listed companies misinterpreted the CPs. For instance, a company in the sample erred in interpreting CP C.6.1 as prohibiting external parties from acting as the company secretary, when this is permitted. The HKEx advised listed companies to refer to guidance published by the HKEx for clarification of its requirements. Listed companies should also refer to the most up-to-date versions of the Corporate Governance Code and materials to ensure their compliance.

Recommended Best Practices

While the Recommended Best Practices are not compulsory, the HKEx encourages their voluntary adoption since they often extend the compulsory provisions and their adoption will allow listed companies to achieve a higher standard of corporate governance.

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[1] Appendix 14 of the Main Board Listing Rules (Appendix 15 to the GEM Listing Rules)
[2] Part 2 Appendix 14 to the Main Board Listing Rules (Part 2 Appendix 15 to the GEM Listing Rules)
[3] Part 1 Appendix 14 of the Main Board Listing Rules (Part 1 Appendix 15 to the GEM Listing Rules)
[4] Paragraph J of the Mandatory Disclosure Requirements and CP B.1.3.
[5] Analysis of IPO Applicants' Corporate Governance and ESG Practice Disclosure in 2020/2021, https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Environmental-Social-and-Governance/Reports-on-ESGPD/esgreport_2020_2021.pdf
[6] This reflects recommended best practice D.2.8.
[7] This reflects recommended best practice D.2.9.

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