SLAUGHTER AND MAY / 50 HONG KONG

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HONG KONG STOCK EXCHANGE CONSULTS ON AMENDMENTS TO THE CORPORATE GOVERNANCE CODE AND RELATED RULES

Overview

The Hong Kong Stock Exchange (the **Exchange**) has issued a consultation paper with wide-ranging proposals to amend the Corporate Governance Code (**CG Code**) and related Listing Rules with the aim of promoting strong corporate governance practices amongst Hong Kong listed issuers. Of particular note is the proposal to phase out long-serving independent non-executive directors (**INEDs**) (i.e., those who have served nine years or more) which, if implemented, will affect numerous issuers, as around 31% of issuers as at 31 December 2023 had long-serving INEDs on their boards.

Key proposals that would apply on a mandatory basis include: (i) prohibiting an INED from holding more than six Hong Kong-listed directorships concurrently; (ii) capping an INED's tenure at nine years, but allowing the clock to reset after a two-year cooling off period; (iii) requiring a diversity policy for the workforce (including senior management); (iv) mandating disclosure of the annual review of the effectiveness of risk management / internal control systems; (v) enhanced requirements on directors' training, including a minimum of 24 hours of training within 18 months of appointment for first-time directors; and (vi) enhanced disclosures on dividend policy and dividend decisions.

Certain of the proposed amendments would apply on a "comply-or-explain" basis[1], including: (i) designating a "lead INED" (as a communication intermediary) for issuers whose board chair is not independent; (ii) ensuring that the nomination committee comprises different genders; and (iii) conducting and disclosing a board performance review at least every two years.

Timing - the amendments are proposed to come into effect from 1 January 2025 and would apply to corporate governance reports for financing years commencing on or after 1 January 2025, except the proposals relating to long-serving and over-boarded INEDs, which will be subject to a three-year transition period ending 31 December 2027.

Key action points - if the proposals are implemented, action points for issuers may include possible adjustments to their board composition and succession plans in light of the proposed requirements on over-boarded and long-serving INEDs[2], as well as re-evaluating policies and processes on diversity, risk management and dividends in light of the enhanced requirements and disclosures on these aspects. Unless a deviation can be explained, issuers (whose chairman is not an INED) should also consider the designation of a "lead INED", as well as conduct a biennial board performance review.

The consultation period will end on 16 August 2024. We welcome any enquiries or comments.

Analysis of the key proposals

Further detail on the more significant proposals is set out below. Unless otherwise specified, the proposed amendments will apply from 1 January 2025.

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[1] Code provisions in the CG Code apply on a "comply-or-explain" basis, which allows an issuer to deviate from the code provisions provided it sets out in its corporate governance report considered reasons for the deviation and explains how good corporate governance was achieved by means other than strict compliance with the relevant code provision.

[2] For example, under the proposals a long-serving INED may be redesignated as an NED, but holding any directorship at the listed issuer, its holding company or any of their respective subsidiaries or any core connected persons of the listed issuer would not count towards the two-year cooling off period.

<table>
<tr><th></th><th>Key Proposal</th><th>Mandatory or Comply-or-explain</th><th>Comments / Observations</th></tr>
<tr><td colspan="4">Board effectiveness and independence</td></tr>
<tr><td>1.</td><td>Long-serving INEDs:
(a) INEDs serving nine years or more (Long-serving INEDs) will no longer be considered independent.
(b) A Long-serving INED can be re-appointed as an INED of the same issuer after a two-year cooling-off period if they: (i) meet the independence criteria in Listing Rule 3.13 and (ii) have not, during the cooling-off period, served as a director of the relevant issuer, its holding company, any of their respective subsidiaries or any core connected persons of the issuer.
The nine-year period is calculated from the date of appointment or (if they were appointed prior to listing) the listing date. Any breaks in tenure that last under two years will still count towards the nine-year period.
A three-year transition period is proposed to apply as follows:
• The rule will apply from <u>1 January 2028</u>.
• A Long-serving INED as at 31 December 2027 will not be considered independent as at the conclusion of the next AGM of the issuer that follows 31 December 2027.
• An INED who becomes a Long-serving INED from 1 January 2028 onwards will not be considered independent as at the conclusion of the next AGM of the issuer following the completion of the nine-year tenure.</td><td>Mandatory</td><td>Under the proposal, a Long-serving INED can no longer serve as an INED until a two-year cooling off period has elapsed, but may serve in a different capacity (e.g., as a non-executive director of the issuer but doing so will not count towards the cooling-off period).
The nine-year tenure would count from the appointment date of the INED (or listing date if appointed prior to listing). A Long-serving INED must step down as an INED by the conclusion of the <u>next AGM</u> of the issuer after completing the nine-year tenure, meaning a shorter grace period before mandatory compliance when compared to the current code provision (under which the additional compliance obligations for Long-Serving INEDs are only triggered at the INED’s <u>further appointment</u>).
Any change relating to the above would also need to take into account other requirements for the composition of the board and for INEDs, including but not limited to the need to have at least three INEDs who should represent no less than one-third of the number of directors on the board and that the board cannot compose of directors of a single gender.</td></tr>
<tr><td>2.</td><td>Time commitment:
(a) INEDs to hold no more than six Hong Kong-listed issuer directorships simultaneously.
(b) Disclosure of the nomination committee’s assessment of each director’s time commitment and contribution, taking into consideration (amongst other factors) their listed issuer directorships and other significant external time commitments.</td><td>Mandatory</td><td>The proposal would introduce a “hard cap” of six Hong Kong-listed issuer directorships. There is currently no cap on the number of listed issuer directorships an INED can hold, though additional disclosures apply to proposed INEDs who will be holding their seventh (or more) listed issuer directorship (Over-Boarded INED).
Although significant time commitments that are not HK-listed directorships do not count towards the cap, they would be</td></tr>
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	Key Proposal	Mandatory or Comply-or-explain	Comments / Observations
	The new rule is proposed to apply to the following: • INEDs of IPO applicants who submit A1 filings on or after 1 January 2025; and • an INED of a listed issuer from 1 January 2028. However, an Over-Boarded INED as at 31 December 2027 has until the conclusion of the earliest AGM after 31 December 2027 at the issuer(s) that they serve to comply.		relevant as part of the nomination committee assessments.
3.	**Designation of a Lead INED** (only if the issuer's board chair is not an INED) to (a) serve as an intermediary for the other directors and shareholders and (b) be available to other directors and shareholders where normal communication channels with the chairman or management are inadequate. A board chairman who is an INED is expected to fulfil the role of the Lead INED unless another director has been appointed as a lead INED.	Comply-or-explain	The rationale for a Lead INED is to offer shareholders (especially minority shareholders) a clear point of contact for independent insight on aspects of an issuer's governance (e.g., INEDs' scrutiny of loans granted by the issuer and connected transactions). As this provision applies on a "comply-or-explain" basis, issuers subject to this provision may provide reasoned explanations for not appointing a Lead INED. The consultation notes one example may be to explain the alternative shareholder communication channels that are in place to address the investor concerns underpinning this proposal. The Exchange will issue more detailed guidance on the role of a Lead INED. It remains to be seen if it will clarify the "alternative shareholder communication channels" that are considered adequate.
4.	**Directors' training** (a) Continuous professional development for every director covering specific topics in each financial year.[3] (b) At least 24 hours of training within first 18 months of appointment for (i) first-time directors of Hong Kong-listed issuers and (ii) those who have not served as a Hong-Kong listed director for three years or more prior to the appointment. (c) Enhanced disclosure on directors' training.	Mandatory	Other than directors falling within (b), there is no minimum number of training hours, but specific topics must be covered each financial year by all directors, which extend beyond legal/regulatory matters.

[3] The relevant topics include, at a minimum: (i) the roles, functions and responsibilities of the board, its committees and its directors, and board effectiveness; (ii) issuers' obligations and directors' duties under Hong Kong law and the Exchange's Listing Rules, and key legal and regulatory developments (including Listing Rule updates) relevant to the discharge of such obligations and duties; (iii) corporate governance and ESG matters (including developments on sustainability or climate-related risks and opportunities relevant to the issuer and its business); (iv) risk management and internal controls; and (v) updates on industry-specific developments, business trends and strategies relevant to the issuer.

	Key Proposal	Mandatory or Comply-or-explain	Comments / Observations
5.	**Board performance reviews** at least every two years. Disclosure of the findings of the board performance review conducted during the reporting period.	Comply-or-explain	Regular evaluation on board performance will be upgraded from a recommended best practice to a code provision. The review is to focus on the performance of the board as a whole and it is open to issuers to decide whether it is an internal or external review.
6.	Disclosure of a **board skills matrix** (current mix and further skills the board is looking to acquire, if any).	Comply-or-explain	This may help illustrate the issuer's compliance with its diversity policy for the board.
Diversity			
7.	**Nomination committee** to comprise directors of different genders.	Comply-or-explain	There is an existing requirement for the majority of the nomination committee to comprise INEDs. Thus, any adjustment for gender may not necessarily mean an adjustment to the INEDs with regards to gender.
8.	Annual reviews of **board diversity policy** to be upgraded from a code provision to mandatory disclosure.	Mandatory	
9.	Have in place and disclose a **workforce diversity policy** (including senior management) and disclose gender ratio of senior management separately from the rest of the workforce.	Mandatory	Issuers are required to disclose any plans or measurable objectives for achieving gender diversity they may have and disclose the gender ratio of senior management separately from the rest of the workforce.
Risk management and internal controls			
10.	**Risk management and internal controls systems** (**RMIC Systems**): (a) Review effectiveness of RMIC Systems of issuer and subsidiaries on an (at least) annual basis to be upgraded from a code provision to mandatory. (b) Enhanced disclosures on the RMIC Systems, including supporting information for the board's conclusion that the RMIC systems are effective.	Mandatory	The relevant code provisions set out areas that are expected to be included in the review of the RMIC Systems. The Exchange will also issue guidance on the scope of the RMIC review.
Dividend			
11.	Enhanced disclosures regarding an issuer's **dividend policy** which will be upgraded from a code provision to mandatory.	Mandatory	An issuer does not have to have a dividend policy, but if it does not, it must include a negative statement and disclose the reasons for not having one.
12.	Enhanced disclosures of the board's **dividend decisions:**	Mandatory	Issuers are reminded to avoid boilerplate explanations.

	Key Proposal	Mandatory or Comply-or-explain	Comments / Observations
	(a) an explanation of the reasons for any material variation in the dividend rate between a dividend declared during the reporting period compared to that for the previous corresponding period; and (b) where the board decided not to declare any dividend, the reasons and the measures the issuer intends to take to enhance investors' return (if any).		

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