



Hong Kong

December 2018

HKEX PUBLISHES REVIEW OF CORPORATE GOVERNANCE PRACTICES AND UPDATES GUIDANCE ON ESG REPORTING

On 16 November 2018, the Stock Exchange of Hong Kong Limited (**HKEx**) issued its latest review of issuers' corporate governance practices and updated its guidance material on environmental, social and governance (**ESG**) reporting. It also reminded listed issuers of the amendments to the Corporate Governance Code and related Listing Rules which take effect on 1 January 2019, as set out in the Consultation Conclusions on the Review of the Corporate Governance Code and Related Listing Rules in July 2018 (**Consultation Conclusions**).

1. Annual review of issuers' compliance with the Corporate Governance Code and Corporate Governance Report

The Stock Exchange has completed its 2017/2018 review (**2017/2018 Review**) of Hong Kong issuers' compliance with the Corporate Governance Code and Corporate Governance Report (**Code**). The Code Provisions (**CPs**) are subject to "comply or explain" requirements: i.e. issuers must disclose whether they have complied with the CPs, and give considered reasons for any deviations from them, in their interim reports (and summary interim reports, if any), and in the corporate governance reports required to be included in their annual reports (and summary financial reports, if any). The 2017/2018 Review covers issuers' corporate governance reports with the financial year ends of June 2017, December 2017 and March 2018.

The 2017/2018 Review analysed disclosures made by 400 randomly selected issuers (**Sample Issuers**) and noted a high level of compliance with the Code including a 2% increase in the number of issuers which complied with all 78 CPs.

Key findings on compliance with CPs compared with 2016 review

Code Provisions		
	2017 / 2018 Review	2016 Review
Compliance with all 78 CPs	36%	34%
Compliance with 70 or more CPs	100%	100%
Level of full compliance with reference to market capitalisation	Large-cap > Mid-cap > Small-cap	Large-cap > Mid-cap > Small-cap

Mandatory Disclosure Requirements: key findings

The 2017/2018 Review also covered the Sample Issuers' disclosures under the Code's Mandatory Disclosure Requirements (**MDRs**) in sections G to Q. There was a high level of compliance with the MDRs by the Sample Issuers. 90% or more of them complied with sections G, H, J, K, N, P, Q and L (a) – (c), compared to relatively low compliance levels with sections I, M and O, ranging from 67% to 82%. Whilst the disclosures under the MDRs are generally of a high standard, HKEx notes that there is still room for improvement.

The review found that disclosures under sections I, M and O only partially met the disclosure requirements and were thus considered to be non-compliant. For example:

- Section I(i) requires disclosure of each director’s training record, but many Sample Issuers merely provided a statement as to whether their directors had participated in continuous training without detailing each director’s training record;
- Section M requires an analysis of remuneration regarding audit and non-audit services provided by issuers’ auditors, but some Sample Issuers did not disclose remuneration for auditors’ non-audit services; and
- Section O(c) requires issuers to provide procedures on putting forward proposals at shareholders’ meetings, which a number of Sample Issuers failed to follow.

MDRs (Sections G to Q of the Code)	
<p><u>G. Corporate Governance Practices</u></p> <p>A narrative statement on the issuer’s application of the principles in the Code, explaining whether it has complied with or deviated from the CPs</p>	99%
<p><u>H. Directors’ Securities Transactions</u></p> <p>Compliance with the Model Code for Securities Transactions by Directors of Listed Issuers</p>	100%

<p><u>I. Board of Directors</u></p> <p>a) composition of the board;</p> <p>b) number of board meetings held;</p> <p>c) director’s attendance of board and general meetings;</p> <p>d) alternate director’s attendance of board/committee meetings;</p> <p>e) a statement of the responsibilities, accountabilities and contributions of the board and management, and their delegation to management;</p> <p>f) non-compliance with Listing Rules 3.10 and 3.10A;</p> <p>g) reasons why an INED is considered independent despite failing to meet Listing Rule 3.13;</p> <p>h) relationship between board members; and</p> <p>i) directors’ training</p>	67%
<p><u>J. Chairman and Chief Executive</u></p> <p>Identity of the chairman and chief executive and whether their roles are separate</p>	99%
<p><u>K. Non-executive Directors</u></p> <p>The terms of appointment of the NEDs</p>	97%
<p><u>L. Board Committees</u></p> <p>a) role and function of the committee;</p> <p>b) composition of the committee; and</p> <p>c) number of meetings held during the year</p>	91%

<u>M. Auditor's Remuneration</u> An analysis of remuneration of audit and non-audit services provided by auditors	72%
<u>N. Company Secretary</u> Where an external service provider is engaged as company secretary, the primary contact at the issuer	99%
<u>O. Shareholders' Rights</u> How shareholders can convene extraordinary general meetings and ways in which they can contact the board to make enquiries and put forward proposals	82%
<u>P. Investor Relations</u> Changes to constitutional documents during the year	100%
<u>Q. Risk Management and Internal Control</u> Whether the issuer has an internal audit function, how often the internal control systems are reviewed and a statement on the effectiveness of the systems	90%

HKEx noted that where an MDR requires disclosure of several matters, Sample Issuers sometimes omitted one or more points, possibly inadvertently. It reminded issuers of the need to make complete disclosures and to provide reasons for non-disclosure on each matter to avoid breaching the Listing Rules. Going forward, HKEx will take further action against individual issuers regarding the breach if necessary.

Summary of work of the board committees

Considerable variance was noted in the quality of disclosure in areas requiring narrative statements or discussions of policy. In relation to disclosure on summary of work of the board committees (MDR section L (d)), while a small number reports provided clear and detailed explanation of each board committee's responsibilities and performance, the quality of a few was unsatisfactory. For example, those reports failed to separate the functions of the various board committees and

some failed to describe the committees' work during the year. HKEx was critical of issuers which adopted boilerplate phrases to describe policies and criteria. The review encourages issuers to provide informative summaries of the work performed by each board committee.

Board diversity policy

MDR section L(d)(ii) requires issuers to disclose their board diversity policy or a summary of the policy (if any), including any measurable objectives. In the 2017/2018 Review, HKEx also examined disclosures relating to board diversity. It noted that the majority of Sample Issuers confirmed their adoption of a board diversity policy, but that some failed to disclose their board diversity policies despite claiming to have one.

HKEx reminds issuers that they will breach the Listing Rules if they fail to explain a deviation from a CP. It also notes that it has contacted Sample Issuers which failed to disclose their board diversity policy without providing a considered explanation and will take follow-up action. It also calls for the inclusion of measurable objectives which an issuer has set for implementing the board diversity policy, and encourages issuers to disclose their progress on meeting these objectives.

Recommended Disclosures: key findings

The 2017/2018 Review analysed the Sample Issuers' disclosures under the Code's three Recommended Disclosures (RDs). Compliance with the RDs is voluntary, although issuers are encouraged, but not required, to state whether they have complied with the RDs and provide considered reasons for any deviation.

RDs (Sections R to T of the Code, which are voluntary)		
	Disclosure in Corporate Governance Report	Disclosure in Annual Report
<u>R. Share Interests of Senior Management</u> The number of shares held by senior management	1%	7%

<u>S. Investor Relations</u>		
a) Details of shareholders by type and aggregate shareholding;	1%	98%
b) Details of the last shareholders' meeting;	11%	2%
c) Indication of important shareholders' dates in the coming financial year; and	7%	39%
d) Public float capitalisation at the year end	3%	96%
<u>T. Management Functions</u>		
The division of responsibility between the board and management	92%	0%

HKEx notes that as some RDs are also required under the Listing Rules, a large majority of the Sample Issuers made the disclosure (e.g. under sections S(a) details of shareholders by type and S(d) public float capitalisation) in their annual reports rather than their corporate governance reports. HKEx therefore calls for issuers to link the relevant disclosures by cross-referencing to ensure easy identification of the information recommended in corporate governance reports.

The five CPs with the lowest compliance rates

In the 2017/2018 Review, HKEx set out a summary of the explanations given by the Sample Issuers in respect of the five CPs with the lowest compliance rates, A.2.1, A.4.1, E.1.2, A.5.1 and A.2.7, and its comments and recommendations.

Code Provisions		
	2017/2018 Review	2016 Review
Level of full compliance with reference to Hang Seng Index (HSI) / Non-HSI companies	HSI: 33% Non-HSI: 36%	HSI: 40% Non-HSI: 35%
CPs with the lowest compliance rates in ascending order	i. A.2.1 (64%): Separation of the roles of chairman and chief executive	i. A.2.1 (63%): Separation of the roles of chairman and chief executive
	ii. A.4.1 (85%): Non-executive directors (NEDs) being appointed for a specific term	ii. A.6.7 (80%): NEDs' attendance at general meetings
	iii. E.1.2 (90%): Chairman's attendance at general meetings	iii. E.1.2 (86%): Chairman's attendance at general meetings
	iv. A.5.1 (95%): Establishment of an nomination committee which comprises a majority of independent non-executive directors (INEDs)	iv. A.4.1 (88%): NEDs being appointed for a specific term
	v. A.2.7 (95%): The chairman should hold meetings with NEDs without the presence of executive directors	v. A.5.1 (95%): Establishment of a nomination committee which comprises a majority of INEDs

Disclosed compliance rate of Recommended Best Practices (RBPs)	11%	8%
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CPA.2.1: Separation of the roles of chairman and chief executive

HKEx focused on how Sample Issuers addressed the issue of the lack of checks and balances on the board. The most common reason for departure from this CP is that the same person occupying both roles provides for strong and consistent leadership and more effective formulation and implementation of long term business goals. Other explanations included that the company's structure was sufficient to address this issue; board members collectively made decisions; and the person holding the dual roles had profound experience and knowledge in business operations.

HKEx observed an improvement in Sample Issuers' explanations for the deviation compared to the previous reviews, but reiterated the importance of separating the chairman and chief executive roles. Separating the two roles allows the chairman to oversee management and lead the board, while the chief executive concentrates on strategies, operations and organisational issues.

CPA.4.1: NEDs being appointed for a specific term

All Sample Issuers deviating from this CP explained that the NEDs are subject to retirement by rotation according to their articles of association or equivalent constitutional documents. HKEx considers retirement by rotation to be another measure aimed at limiting a director's tenure which should be treated separately from the CP A.4.1 requirement for NEDs to be appointed for a specific term. It adds that issuers should specify the period of appointment of NEDs at intervals of no more than 3 years.

CPE.1.2: Chairman's attendance at the annual general meeting

A common reason given for the chairman not attending the annual general meeting (AGM) was that the chairman had other commitments (mainly business engagements). HKEx commented that the chairman, as leader of the board, is generally expected to prioritise the AGM over other commitments.

CPA.5.1: Establishment of a nomination committee which comprises a majority of INEDs

Many Sample Issuers that did not comply with this CP explained that it was in the best interest of the company for the board to collectively review and approve the appointment of new directors. HKEx however stressed the importance of establishing a nomination committee which is responsible for reviewing board composition and recommending suitable candidates for election and reelection as board members. In light of the new corporate governance regime effective on 1 January 2019, HKEx recommends that issuers currently without a nomination committee should establish one.

CPA.2.7: The chairman should hold meetings with NEDs (including INEDs) without the presence of executive directors

The most common reason for departure was that NEDs were able to communicate their views individually to the chairman. HKEx believes that periodic meetings would enhance communication between NEDs (including INEDs) and the chairman. It also reminds issuers that the amendment to CP A.2.7 effective on 1 January 2019 will require the chairman to hold meetings with the INEDs in the absence of other directors at least annually.

2. Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules (Consultation Conclusions)

Various Listing Rule amendments aimed at improving listed issuers' corporate governance standards will take effect on 1 January 2019. The amendments were set out in the HKEx's Consultation Conclusions on Review of the Corporate Governance Code and Related Listing Rules¹ published on 27 July 2018.

The amendments include:

1. a new disclosure requirement as to why an INED would be able to devote sufficient time to the board where he/she will be holding his/her seventh (or more) listed company directorship (amended CP A.5.5 of Appendix 14 to the Listing Rules);

¹ [https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2017-Review-of-the-CG-code-and-Related-LRs/Conclusions-\(July-2018\)/cp2017111cc.pdf?la=en](https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2017-Review-of-the-CG-code-and-Related-LRs/Conclusions-(July-2018)/cp2017111cc.pdf?la=en)

2. CP A.5.6 requiring issuers to have a policy concerning diversity of board members and to disclose the policy or a summary of the policy in their corporate governance reports will be upgraded to a Listing Rule (new Listing Rule 13.92);
3. amended disclosure requirements in respect of the election of an INED, including new requirements to disclose the process used for identifying the nominee; the perspectives, skills and experience that the nominee can bring to the board; and how the nominee would contribute to the board's diversity (amended CP A.5.5);
4. extended cooling off periods:
 - i) for a director, partner or principal or employee of a former professional adviser, from one to an additional second year before being considered independent (Listing Rule 3.13(3));
 - ii) for a former partner of an issuer's existing audit firm, from one year to two years before becoming a member of the issuer's audit committee (amended CP C.3.2);
 - iii) for persons with material interests in the issuer's principal business activities, from no cooling off period to a one year period before becoming an INED (amended Listing Rule 3.13(4));
5. a new disclosure requirement as to reasons why proposed directors are considered independent even where they hold cross-directorships or have significant links with other directors through involvements in other companies or bodies (new RBP A.3.3 of Appendix 14);
6. when determining the independence of a director under Listing Rule 3.13, the same factors also apply to the director's immediate family members (new Note 2 to Listing Rule 3.13);
7. a new requirement to disclose the issuer's nomination policy in its corporate governance report (amended MDR L. (d)(ii) of Appendix 14);
8. amended requirement for INEDs to meet with the chairman at least annually (rather than all NEDs as currently required) (amended CP A.2.7); and

9. a new requirement for issuers to have a policy on payment of dividends to be disclosed in annual reports (new CP E.1.5).

For further details of the amendments, please see our July 2018 newsletter².

On 18 December 2018, HKEx introduced e-training for issuers' directors to help them understand the new corporate governance requirements. The 45-minute e-training course covers the following topics of (i) corporate governance update 2018; (ii) appointment of INEDs; (iii) INEDs' role; (iv) directors' attendance at meetings and dividend policy; (v) weighted voting rights issuers' corporate governance requirements; and (vi) key messages and conclusions.

3. Updated ESG Reporting Guidance

HKEx has updated its "How to prepare an ESG report? A step-by-step guide to ESG reporting"³ (**Step-by-step Guide**) and Frequently Asked Questions⁴ (**FAQs**) on its ESG-related Listing Rules, having regard to recent international climate-related disclosure recommendations and with an emphasis on issuers' governance structure for ESG reporting.

The Step-by-step Guide and its appendices set out the recommended steps and procedures for issuers to consider when preparing an ESG report. In summary, an issuer is advised to:

- i) establish an ESG working group consisting of senior management and staff who have sufficient knowledge of both ESG matters and its operations;
- ii) understand the reporting requirements under the ESG Reporting Guide (Appendix 27 to the Main Board Listing Rules or Appendix 20 to the GEM Listing Rules) (**Reporting Guide**);
- iii) determine the parts of business to be reported on based on the ESG risks identified by the board;

2 <https://www.charltonslaw.com/hkex-issues-corporate-governance-code-consultation-conclusions-and-guidance-for-boards-and-directors/>

3 <https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Environmental-Social-and-Governance/How-to-Prepare-an-ESG-Report/steps.pdf?la=en>

4 https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Environmental-Social-and-Governance/ESG-Reporting-Guide-and-FAQs/FAQ_18.pdf?la=en

- iv) conduct a stakeholder engagement exercise (which means the process by which an issuer involves parties who may be affected by its decisions or can influence implementation of its decisions);
 - v) ascertain the material ESG issues that are relevant to its business and prioritise the issues accordingly; and
 - vi) write an ESG report covering: (a) a description of its ESG governance; (b) the reporting boundary; (c) a description on how it has applied the Reporting Principles under the Reporting Guide; (d) a report on each of the Reporting Guide's "comply or explain" provisions; and (e) key messages that it aims to convey to investors and other stakeholders.
- ii) Whether an issuer can cross-reference to disclosure in the ESG reports of its listed parent/subsidiary to fulfill its obligations under the Reporting Guide.

Cross-referencing can be used in its ESG report to refer to disclosure in the ESG reports of its listed parent/ subsidiaries. Any cross-referenced ESG reports must be available at the date of publication of the issuer's own ESG report.

- iii) Whether an issuer that has operations in multiple countries can use Hong Kong emission factors to calculate their operations' emissions in other countries.

The FAQs refer issuers with operations in other countries to international resource links⁵ included on the HKEx website.

The procedures in the Step-by-step Guide are not mandatory. HKEx recognises the uniqueness of each issuer and encourages an issuer to develop its own practice for ESG reporting in light of its own special circumstances.

In relation to the FAQs, HKEx has, in addition to updating its answers to several commonly asked questions about the ESG-related Listing Rules, added responses to the following three queries:

- i) Whether the ESG report is a "corporate communication" defined in Main Board Rule 1.01 (GEM Rule 1.01) and if so, whether an issuer is required to send it to its shareholders.

The ESG report is a "corporate communication". However, if an ESG report is published as a separate report or as information on the issuer's website under Note 1 to Main Board Rule 13.91 (Note 1 to GEM Rule 17.103), the issuer is not required to send printed copies of ESG reports, and/or printed notification as required under Main Board Rule 2.07A(2A)(d)/ GEM Rule 16.04A(2A)(d). This applies irrespective of whether shareholders have elected to receive corporate communications electronically or otherwise under Main Board Rule 2.07A/GEM Rule 16.04A. Issuers should however send printed copies of ESG reports to shareholders who have specifically requested receipt of printed copies of ESG reports.

HKEx is also planning to launch a public consultation on proposed changes to the ESG reporting framework in mid-2019 to respond to market participants' increased interest in sustainable economic development.

⁵ https://www.hkex.com.hk/listing/rules-and-guidance/other-resources/listed-issuers/environmental-social-and-governance/esg-resources-hyperlinks?sc_lang=en

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