# Sound Corporate Governance as Bedrock for Quality Listing Market

## The Hong Kong Chartered Governance Institute's 14th Biennial Corporate Governance Conference

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Good afternoon. It is my pleasure to speak to you about corporate governance today. Thank you for your kind invitation.

I once heard corporate governance is like a good cup of coffee which is essential to a productive day at work. I look forward to sharing more with you today, including the initiatives in the pipeline to help our listed companies strengthen governance, protect shareholders' interests and stay globally competitive.

### Challenges in a dynamic business world

You would all agree when I say the corporate world today is challenging in many ways. Recent news headlines are dominated by topics of macro and market volatility and geopolitical tensions. In the meantime, advances in technology, including artificial intelligence, and the emergence of sustainability issues also impact businesses significantly. Companies need to adapt to these changes and find ways to harness them to future-proof their operations. And from talent retention to creating a diverse and inclusive workplace, the list of challenges simply goes on and on.

Therefore, building corporate resilience is critical for companies to survive if not succeed in today's dynamic, competitive and uncertain business environment. While staying focused on financial performance, companies must develop acute awareness, foresight and agility to anticipate and tackle emerging challenges, and seize fresh opportunities that come their way.

### Zeroing in on corporate governance

For Hong Kong, upholding good corporate governance is especially important to our large and deep capital markets. If international ranking on corporate governance serves as a guide, it is time for Hong Kong to step up its act to maintain the competitiveness of our listed companies.

In today's tight monetary environment, investors are demanding more from businesses. Their overwhelming feedback is that they demand honesty and integrity, in addition to a decent investment return. Boards of directors are expected to take their fiduciary duties seriously, and companies must have robust internal controls to safeguard their business and assets.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

International developments in corporate governance have been significant in the last couple of years. For example, the UK has enhanced requirements for directors to report on the board's decisions and their outcomes against the company's strategy and objectives, and on the internal control environment. Mainland China, Japan and South Korea have also introduced initiatives to improve listed companies' capital efficiency and encourage them to disclose their efforts in enhancing corporate value and investor returns.

Here in Hong Kong, as you know, the Stock Exchange of Hong Kong (Exchange) has closed its consultation on proposed enhancements to its Corporate Governance Code (CG Code). Preliminary feedback is that certain proposals may shake up some deep-seated practices in our market. In these challenging times, we understand it is only natural for companies to find ways to cut back and streamline, but they must be careful not to cut corners on the core corporate governance standards.

## Insights from misconduct cases

Sound internal controls are integral to good corporate governance. Lax internal controls and directors' failure in their duties are common features in corporate misconduct cases.

From 2020 to June 2024, around 170 cases of misconduct were referred to the SFC for investigation. The issues were wide-ranging, including unauthorised loans or fund transfers to third parties and misappropriation of companies' assets. A good proportion of these cases relate to suspicious loan transactions which were subsequently impaired, resulting in multibillion dollar losses to shareholders.

These misconduct cases follow a typical pattern: the loans were sometimes authorised by the chairman or a director but not approved by the board. Many were granted with insufficient risk or credit assessments, loan collaterals or due diligence. Also, the company failed to properly monitor the repayment of the loan or act promptly to recover it. Despite these control deficiencies, the directors often confirmed in the corporate annual report that the company implemented effective risk management and internal control systems.

The SFC intervened in many of these cases. In a recent example, we exercised our statutory power to suspend dealings in Tianyun International Holdings Limited's shares over missing corporate funds[1]. While regulatory and legal actions are taken to punish bad actors and compensate investors, these actions would normally take years. To mitigate harm to investors, more should be done on buttressing corporate internal controls to detect and pre-empt corporate misconduct.

## Importance of robust internal controls

To tackle the problem of internal control deficiency, the SFC and the Accounting and Financial Reporting Council have joined forces. The two regulators issued a Joint Statement in July 2023 to alert the market to these dubious transactions and set out our expectations on directors, audit committees and auditors.

[1] The SFC suspended dealings in Tianyun International Holdings Limited shares on 15 April 2024. See the SFC's press release for details.

Our message is crystal clear: investors in the public market rely on a company's financial disclosures for a true picture of its financial condition. The board of a listed company should be held accountable for safeguarding the integrity of a company's financial disclosures and for overseeing robust internal controls to detect and prevent corporate misconduct.

At present, the CG Code recommends that the board of directors provide a confirmation on the effectiveness of risk management and internal control systems in the corporate governance report (CG report). In the vast majority of cases we reviewed, the directors confirmed that their internal control systems were sound, but, in fact, deficiencies were still prevalent. Only a handful admitted their internal controls were inadequate. To strengthen the board's accountability, the Exchange has recently proposed to mandate the board to disclose its review of the effectiveness of the company's risk management and internal control systems.

## Quality of directors

I now turn to the issue of the quality of directors.

At the heart of good corporate governance is a strong and competent board of directors with expertise, integrity and foresight who can steer their companies through economic ups and downs. Therefore, directors must act honestly and in good faith for the benefits of the company and shareholders. It is also their obligation to act diligently to advance the company's business and generate an acceptable return for its shareholders.

This principle is widely accepted as the minimum standard for directors. But in some cases, very young and inexperienced family members or acquaintances were appointed as directors, which raises serious red flags on the quality and interests of directors. Well-managed companies are expected to establish a formal process for identifying, selecting and appointing director candidates with the appropriate skills, qualifications and experience to serve as directors.

To safeguard director standards, the Exchange has proposed to require all directors to attend mandatory continuous professional training and first-time directors to go through a minimum period[2] of induction training. Just like all other professionals, corporate directors must stay relevant by updating their knowledge and skills.

## Role of independent non-executive directors

Let's move from directors to independent non-executive directors (INEDs), a subject of lively debate recently. The Exchange has proposed a "hard cap" of nine years for the tenure of INEDs. We note that there are views representing listed companies, such as those of The Hong Kong Chartered Governance Institute (HKCGI), that an INED should be considered independent based on the independence of mind rather than the number of years they served. There are certainly long-serving INEDs who remain highly independent.

On the other hand, groups representing investors said the proposal hasn't gone far enough. In their opinion, a board of mainly long-serving INEDs might suffer from entrenchment or

[2] The proposal is for first-time directors to complete no less than 24 hours of continuous professional development within 18 months of the date of their appointment.

groupthink. In addition, a prolonged period of service may also compromise INEDs' independence through close association with management.

While there is no hard-and-fast rule to determine the ideal tenure, we believe implementing a hard cap of nine years aligns better with international best standards. In this region, Singapore and Malaysia introduced tenure limits of nine years and 12 years for independent directors in January 2023 and January 2022 respectively, while Mainland China has set a tenure limit of six years for independent directors of listed companies. In addition, the corporate governance codes in the UK and Australia recognise respectively that board service of more than nine and 10 years could impact a director's independence. While there is no hard cap on the tenure of INEDs in the US and UK, they both have other safeguards in place[3]. For instance, at least half of the board is required to comprise INEDs, whereas Hong Kong requires only one third and a minimum of three INEDs on the board.

In its supplementary submission, HKCGI proposed to address the concerns raised here through additional guidance, market education and allowing more time for proposal implementation. These suggestions are now being carefully considered.

Here we come to the overboarding issue. A decade has passed since the Exchange last proposed to limit the number of INED positions that one person may hold. The proposal was eventually not adopted, largely based on comments that a hard cap may unfairly impact many directors and punish those competent and diligent INEDs who can devote sufficient time to multiple companies.

The Exchange's recent proposal to cap Hong Kong listed issuer directorships at six for an INED would only affect 23 directors. This reflects a broad recognition that an INED should have sufficient capacity to handle board affairs in an increasingly complex environment. Other major markets have recognised this and implemented measures to tackle the issue of overboarding directors. To maintain our world-class regulation and ensure high-quality decision-making on the boards of our listed companies, Hong Kong should make no exception.

## Diversity

My last point is about diversity, a topic that is close to my heart. We all know diversity is fast becoming an important driver of board effectiveness.

The board diversity requirements on listed companies were introduced on a comply-or-explain basis in September 2013, and we have come a long way since then. In 2012, the proportion of women holding directorships on the boards of Hong Kong-listed companies was reported to be just above 10%. Since then, women's participation has improved significantly, advancing to 15% in 2021, and further to nearly 19% in 2024 after the requirement to phase out single-gender boards was introduced in 2022. In terms of gender diversity on corporate boards, Hong Kong's performance is comparable with other Asian markets such as Mainland China, Japan and Singapore, but lags behind the US, the UK and Australia.

[3] The selection of directors presented to shareholders' voting in the US can only be made by INEDs while the appointment of INEDs must be approved by independent shareholders in the UK. There are currently no such requirements in Hong Kong.

In this round of consultation, the Exchange has proposed further enhancements on diversity for boards and the workforce. Fostering diversity is not just a corporate priority that underpins good governance, but it is also an imperative to promote more balanced and inclusive decision-making. This will certainly lead to better business outcomes in an increasingly complex and unpredictable business landscape. Listed companies should lead by example and serve as the agent of change to embrace diversity and inclusion at all levels of management.

## Conclusion

Ladies and gentlemen, the other day, a senior executive of a major financial group from Japan visited and shared with me their journey of corporate governance reform over the past few years. Years back, the group went down this reform path to meet the higher standard imposed by the Tokyo Stock Exchange. It was “painful” for the board and management, but the reform has now paid off. Indeed, many argue Japan’s corporate governance reform along with other macro factors has contributed to the strength of the Japanese stock market, even though liquidity has been generally tight for global markets.

Locally, we have surely heard voices that this is not the best time for corporate governance reforms, when companies struggle to survive. However, one should always have time for good corporate governance, particularly in challenging times. So it is time for all of us to move forward and brew this uplifting cup of coffee together, before we would require a strong dose of medicine instead due to more procrastination that gives rise to governance issues.

Thank you.