

## The evolving role of the Independent Non-Executive Director

### Hong Kong Institute of Directors' Speaker Luncheon Meeting

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First of all, I want to thank the Hong Kong Institute of Directors (HKIoD) for inviting me back once again. I think the last time I spoke at your luncheon was four years ago. Time flies and so much has happened since then.

Today I want to talk about the changing role of the Independent Non-Executive Director (INED). This is an important part of how we can improve corporate governance and preserve Hong Kong's reputation as a premiere capital-raising centre.

Some recent developments in our market make it clear that nowadays much more is expected of an INED than in the past.

Interestingly, I have never been an INED of a listed company, and in fact as the Chairman of the Securities and Futures Commission (SFC), I am not permitted to be a director of any listed company. But I have spent quite a bit of time sitting in different boardrooms around town in different capacities.

So what I have to say today is my view from a regulator's perspective and also from the perspective of a former auditor.

I also think that there is some commonality among the roles of an INED, an independent auditor and a regulator: we share the responsibility to look after the interests of minority shareholders.

#### **Corporate governance**

Over the past couple of decades, corporate governance problems seem to have become both more frequent and more serious. We saw what happened with Enron, then came Lehman Brothers and the Global Financial Crisis. Here in Hong Kong, we have also had our fair share of corporate governance issues with listed companies.

So it's understandable that much more emphasis is placed on the importance of INEDs now than 20 years ago.

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



So in a moment I will talk about recent regulatory changes in Hong Kong which have a direct bearing on INEDs. The new listing regime and the SFC's adoption of a front-loaded regulatory approach also have major implications for INEDs.

### *INEDs in Hong Kong and the rest of the world*

To set the scene, let's review the current requirements for INEDs in Hong Kong and other major markets.

Here in Hong Kong, the Listing Rules require the boards of listed companies to have at least three INEDs, who must make up at least one-third of the board.

As in most other major financial centres, in Hong Kong the important role played by INEDs is clearly set out in a Corporate Governance Code. The common theme running through all of these is that INEDs should challenge management and provide an independent review of management's performance.

When it comes to the election of INEDs, Hong Kong's rules are similar to those in other markets. That is, shareholder approval is required for their appointment.

The notable exception is the UK, which has a dual voting mechanism. The election of INEDs must be approved by all shareholders and also by a vote of independent shareholders alone.

How does compensation for INEDs in Hong Kong stack up to other markets?

For HSI constituent stocks, INED remuneration is over \$500,000 a year. However, for non-constituent stocks, especially the small cap companies, the fee for INEDs is considerably lower. That is more than 50% higher than comparable companies in Singapore and just slightly ahead of companies listed in Australia but much lower than in the US.

### **Factors to consider before assuming an INED role**

So before you accept an INED appointment, you should ask yourself: how well do you know the management or controlling shareholder? Do you understand the company's business? Does the company have qualified audited accounts, or a clean corporate governance or compliance record? Are you prepared to devote a significant time commitment?

Last May, the SFC published an issue of its *Enforcement Reporter* which set out what is expected of an INED. This includes checks and balances, scepticism and independent judgement.

### **Regulatory developments**

Late last year, Hong Kong Exchanges and Clearing Limited (HKEX) issued a consultation paper on changes to its Corporate Governance Code which bear on the role of INEDs. The consultation closed in December 2017 and the conclusions are expected to be finalised this summer.

Among other proposals to enhance the corporate governance of listed companies, it covered board diversity, factors affecting INEDs' independence and "overboarding" which is about the number of boards a person serves on at the same time.



Currently in Hong Kong, there are about 4,100 listed companies' INEDs, and more than 40 persons hold more than six INED positions. There are two people tied for the record—they each hold 15 INED positions.

There are only so many hours in a day, so it's reasonable to ask how one person can keep up with what's going on with so many companies.

But should regulators do something about this? Set a cap? The Mainland imposes a maximum of five INED positions.

Or is it best to rely on a person's own capability and experience to make the judgement?

HKEX's consultation proposes that when a company elects an INED who holds more than six listed company directorships, it should explain why this person would still be able to devote sufficient time to the board.

There is currently a one-year cooling-off period for someone nominated to be an INED who has been a director, partner, principal or an employee of a professional adviser. HKEX proposes to extend this to three years.

And for a nominated INED who has had material interests in the company's principal business in the past year, there will now be a one-year cooling-off period.

#### *New listing regime*

As I'm sure you've all heard by now, Hong Kong has a new listing regime for companies with Weighted Voting Rights (WVR). INEDs will have additional responsibilities under this regime, as these companies will be required to have a corporate governance committee comprised entirely of INEDs.

This committee will focus on risks related to the WVR structure, with an emphasis on reviewing and monitoring how conflicts of interest are managed and compliance with requirements for connected transactions. The goal is to prevent the beneficiaries of WVR from doing things which only benefit themselves and harm the interests of investors.

#### *HKMA guideline*

In addition, a recent guideline published by the Hong Kong Monetary Authority (HKMA) covered similar ground. The best practices set out in HKMA's circular target locally-incorporated banks, and do not cover foreign banks.

They include that INEDs must have an appropriate background and expertise, including professional knowledge of operational, financial and reputational risks. At least one INED should have a background in accounting, banking or the financial industry.

There is also a time commitment requirement. INEDs should devote time to meetings with management as well as briefings on industry developments and regulatory requirements.

Moreover, banks should consider whether INEDs remain independent if they have served on the board for more than nine years.

As for INEDs' remuneration, HKMA recommends a minimum of \$400,000 a year, with additional payments for membership or chairing of board committees.



For comparison, a large listed bank in Hong Kong paid INEDs annual fees of between \$150,000 and \$200,000 in 2015.

HKMA's new requirements mean that where these institutions are listed, they will be subject to stricter rules than non-banking listed companies.

#### *The SFC's front-loaded regulatory approach*

Turning to the SFC, over the past year we introduced a new approach to policing Hong Kong's listed market. Let me briefly mention what this means in practice for listed companies.

The SFC has moved out from "behind-the-scenes" and now makes its direct presence felt through early, proactive interventions. We now deal directly with companies and listing applicants when it comes to issues of concerns to the SFC.

In many cases, these concerns have involved acquisitions of questionable assets, businesses with a change of control, lack of sponsor due diligence or poor disclosure.

We call this approach "front-loaded" because it emphasises earlier and more targeted intervention, with an aim to deliver a faster response and maximise the impact of our actions.

To achieve this, we use our existing statutory powers in the "Statutory Listing Rules" under the Securities and Futures Ordinance (SFO) – referred to as "SMLR". Section 6 of the SMLR gives us the power to object to listings and under section 8 we can suspend trading.

In 2017, the number of cases involving the potential or actual exercise of SMLR powers increased substantially to around 40 from only two or three cases per year in the past.

We have usually adopted this front-loaded approach in dealing with post-IPO transactions, but recently we stepped up our front-loaded approach to IPO cases.

This means that listing applicants, sponsors and other parties involved in an IPO process can be investigated at the application stage where we have grounds to suspect that the SMLR provisions are triggered. There will be enforcement consequences if breaches of the SFO are identified, even if the listing application is withdrawn.

If necessary, we can combine our powers under the SMLR with our investigative powers under the SFO. These are usually SFO section 179, the power to require production of records and documents concerning listed companies, and section 182, to conduct enforcement investigations.

You may have seen recent news reports about our searches and investigations into the use of networks of companies to commit fraud and market manipulation.

#### **Regulatory action against INEDs**

It's worth mentioning that under the law in Hong Kong, it's now well established that INEDs, non-executive directors and executive directors all have the same duty of care and fiduciary duties.

You may be interested to know that in 2016, in the case of Freeman FinTech Corporation Limited, the SFC sought disqualification orders in the Court of First Instance against 10



Freeman directors including four INEDs and an NED who is a member of the Liu family, descended from the founder of Chong Hing Bank, formerly Liu Chong Hing Bank.

In this case, the SFC alleged that the directors caused Freeman to indirectly buy a stake in the parent company of Chong Hing Bank in disregard of the ability of other Liu family members to object to the purchase. As it turned out, the other Liu family members did object. Freeman could not complete the acquisition and this resulted in a loss of almost \$77 million.

The SFC claimed that the 10 directors breached their duties of care by not asking the right questions before approving the acquisition.

In another case, just last month we started proceedings in the Market Misconduct Tribunal against Magic Holdings International Limited and its nine directors. We alleged that they failed to disclose inside information in a timely manner after a preliminary agreement was reached on the sale of the company to L'Oréal, the French cosmetics giant. Of these nine directors, two were NEDs and three were INEDs.

I cannot comment any more on these cases as the legal process is still ongoing. But it should be clear that regulators including the SFC are increasingly holding INEDs responsible for the misconduct of companies. With INEDs playing an increasingly important role in ensuring effective corporate governance, they can also expect to bear more legal responsibility when things go wrong.

### *Carillion*

If you need a recommendation for bedtime reading, you may want to pick up the recent UK House of Parliament report on the collapse of Carillion, one of the largest house builders in the UK.

Carillion's collapse was sudden and caught everyone by surprise, including the UK Government, as it was a major government contractor. The company's 2016 accounts, published on 1 March 2017, presented a rosy picture and on the back of those results, it paid a record dividend of £79 million—£55 million of which was paid on 10 June 2017. It also awarded large performance bonuses to senior executives.

On 10 July 2017, just four months after the accounts were published, the company announced a profit warning caused by a reduction of £845 million in the value of its contracts.

In January 2018, with liabilities of nearly £7 billion and just £29 million in cash, Carillion went into liquidation.

The Parliament's report laid blame on the management, the Board and also the auditors, and this was what it said about the INEDs:

“Non-executives are there to scrutinise executive management. They have a particularly vital role in challenging risk management and strategy and should act as a bulwark against reckless executives. Carillion's NEDs were, however, unable to provide any remotely convincing evidence of their effective impact.”

I am sure we haven't seen the end of this very sad affair, but I wouldn't like to be one of the directors.



## **Conclusion**

To wrap up, I will just note that I have come across cases where people agreed to be an INED at the invitation of friends and lived to regret it. You may have heard similar stories.

Thankfully, nowadays there is much more awareness of the importance of getting corporate governance right. We hope that this will give INEDs the courage to exercise their independent judgement to do what is in the interest of the company as a whole. Hopefully it will also convince listed companies to let their INEDs do their jobs.

HKIoD does a lot of excellent work promoting this type of awareness, and to conclude I just want to thank them again for giving me the opportunity to speak today.