



THE HONG KONG INSTITUTE OF CHARTERED SECRETARIES
香港特許秘書公會

The Duties and
Responsibilities of
Independent
Non-Executive Directors
of Hong Kong
Main Board
Listed Companies

January 2006

Sponsored by





The Hong Kong Institute of Chartered Secretaries 香港特許秘書公會

19 January 2006

Dear Sir,

Enclosed is a complimentary copy of the second edition of the report titled "The Duties and Responsibilities of Independent Non-Executive Directors (INEDs) of Hong Kong Main Board Listed Companies" recently published by the Institute for your reference. This Report provides an update of the rules and regulations concerning INEDs of the main board listed companies and re-examines their duties and responsibilities under the existing laws.

The first edition of the Report issued by the Institute was published in September 2003 and was widely reported and quoted. In the light of the changes to the Listing Rules during the past two years, the Institute decided to publish this second edition. Data was collected from an overall sample of 115 companies listed on the main board as the constituent stocks in the Hang Seng Composite Index as of 13 June 2005 and findings on issues such as the average board size, average number of INEDs on the boards, the average age of the INEDs, average length of service and average INEDs' fees have also been compiled. In addition, the second edition of the Report also makes recommendations in relation to the identification of new sources of potential INEDs and other relevant issues.

I have also enclosed a copy of the second edition of "The Essential Company Secretary" for your reference. This booklet summarizes the essential responsibilities and duties expected of a Company Secretary of a listed company. Not only does it help people who are now working as company secretaries in listed companies understand their own duties and responsibilities more fully, we trust that it will also help business people not directly involved in corporate secretarial matters understand the job nature of company secretaries. In particular, it will be of great use and relevance for those who are interested in joining this profession some day.

We hope that you will find our two recent publications useful and any comments thereon are most welcome.

Yours faithfully,

Phillip Baldwin
Chief Executive

The Hong Kong Institute of Chartered Secretaries
(Incorporated in Hong Kong and limited by guarantee)

Good Governance comes with Membership

The Hong Kong Institute of Chartered Secretaries (“HKICS”) is an independent professional body with approximately 4,700 members and 2,600 students. It is dedicated to the promotion of its members’ role in the formulation and effective implementation of good corporate governance policies in Hong Kong and throughout China as well as the development of the profession of Chartered Secretary.

HKICS was first established in 1949 as an association of Hong Kong members of the Institute of Chartered Secretaries and Administrators (“ICSA”) of London. It became a branch of ICSA in 1990 before gaining local status in 1994.

HKICS issues two sets of post nominals to its Members who qualify locally. One set on behalf of HKICS: FCS for Fellows and ACS for Associates, and one set on behalf of the international body ICSA: FCIS for Fellows and ACIS for Associates.

The Hong Kong Institute of Chartered Secretaries

3rd Floor
Hong Kong Diamond Exchange Building
8 Duddell Street
Central
Hong Kong
Tel: (852) 2881 6177
Fax: (852) 2881 5050
Email: ask@hkics.org.hk
Website: www.hkics.org.hk

Beijing Representative Office

Room 1710
U-SPACE Building
Block A
No. 8 Guangqumenwai Street
Chaoyang District
Beijing
China 100022
Tel: (8610) 5861 2050
Fax: (8610) 5861 2051
Email: bro@hkics.org.hk

This Report is sponsored by CLP Holdings (“CLP”). Although the views expressed in this Report should not be taken as those of CLP, its board or individual directors, CLP is pleased to contribute to the Institute’s ongoing participation in a constructive and informed debate on the future shape of corporate governance in Hong Kong.

Message from the President	iii
Foreword	iv
Preface	v
Introduction	1
Who is an INED?	1
The Duties and Responsibilities of Directors	5
The Growing Divergence between the Regulatory Duties and Responsibilities of INEDs and other Directors	9
The Current Duties and Responsibilities of INEDs in Hong Kong	
Listing Rules	9
Takeovers Code	12
Share Repurchases Code	12
Global Trends	
a. Composition	13
b. Insurance	14
c. Training	15
d. Remuneration	15
The Increasing Burden on INEDs	16
Survey Data and Analysis	
Methodology	18
Average Profile of INEDs	18
Key Findings	
A. Size of Boards	18
B. Number of INEDs	19
C. Representation by INEDs on Boards	20
D. Age	21
E. Gender	24
F. Length of Service	27
G. INEDs' Fees (excluding share options or other kinds of benefits)	28
H. Number of Directorships	30
I. Audit Committee	31
J. Remuneration Committee	32
K. Nomination Committee	33
Conclusions and Recommendations	
Composition	36
Liability	38
Training	39
Remuneration	40
How can the increasing demand for INEDs be met?	41
Senior/Lead INED	43
Summary	45
References	46

The Hong Kong Institute of Chartered Secretaries has always been dedicated to the promotion of its members' role in the formulation, and effective implementation, of good corporate governance policies.

In September 2003, the Institute published a report titled "The Duties and Responsibilities of Independent Non-Executive Directors of Hong Kong Listed Companies" with particular reference to Hong Kong's corporate environment. Since then, there have been significant changes such as the introduction of the Code on Corporate Governance Practices in the Listing Rules which replaced the former Code of Best Practice. There was also the addition of another appendix to the Listing Rules setting out specific rules concerning the Corporate Governance Report.

We must not forget that Hong Kong is an international financial city and we must not lose sight of what is happening in other jurisdictions regarding corporate governance practices. There have been substantial changes concerning corporate governance rules at the New York Stock Exchange, the London Stock Exchange and the Singapore Stock Exchange, although each jurisdiction may emphasise different aspects of corporate governance after taking into account the special features in its local community.

One thing is certain across all jurisdictions: the increasing burden placed upon independent non-executive directors of listed companies. The critical question for both the Institute's members and others working in the corporate governance/compliance field is: "What's next?"

In that regard, this new Report is timely as it contains updated analysis of the recent changes in several jurisdictions including Hong Kong. The survey data highlights the characteristics and the challenges that are being faced by the independent non-executive directors particularly of Hong Kong listed companies, which may give us useful clues as to what to expect in the future.

On behalf of the Institute, I must express our sincere gratitude to CLP Holdings who sponsored both this project and the previous one published in 2003. This Report has been a collaborative effort between the Institute's members and executive staff. I would like to thank all those who have contributed to this project, particularly Mr. Peter Greenwood, the former executive director and Company Secretary of CLP Holdings who initiated this research project, Mrs. April Chan, the current Company Secretary of CLP and her colleagues, Mr. Mike Scales, Corporation Secretary of The Hong Kong and Shanghai Banking Corporation Limited, Professor Say Goo of the Hong Kong University, Ms. Loretta Chan, Director, Technical & Research at the Institute and her fellow staff members and Ms Iris Fung, the part time research assistant. Without their dedication and expertise, this project would not have been possible.

We hope that this Report will be a helpful reference to those who are already serving, or contemplating to serve, our corporate community in the capacity of an Independent Non-Executive Director of a Hong Kong listed company.

Richard Leung

President

The Hong Kong Institute of Chartered Secretaries

January 2006

It is an honour and a pleasure to be asked to contribute this foreword to the second edition of the Report on “The Duties and Responsibilities of Independent Non-Executive Directors of Hong Kong Main Board Listed Companies”.

The concept of independent non-executive directors (“INEDs”) remains of primary global importance in protecting investors amidst a more demanding economic and regulatory environment. In Hong Kong, in particular, there is increasing recognition of the pivotal role INEDs play in providing an independent, objective view and in balancing the interests of minority shareholders, given the perception of prevalence of connected transactions among family-owned and Mainland enterprises.

The 2004 changes to the Listing Rules were aimed at improving investor protection and enhancing the transparency of issuers. This Report presents a concise and comprehensive account of INEDs’ role in this development.

The findings of The Hong Kong Institute of Chartered Secretaries in its previous report highlighted problems listed companies had in finding suitable INEDs with the appropriate background and qualifications capable of taking up these duties.

Hong Kong needs to work towards nurturing and training an adequate pool of talent as the market continues to expand and the number of listed companies continues to rapidly rise. This Report makes an important contribution to the tutelage of INEDs by familiarising professionals with a clear articulation of their duties and responsibilities. In addition, for INEDs to be truly effective, there needs to be a clear understanding of their roles on the part of stakeholders as well as investors in a company.

I commend The Hong Kong Institute of Chartered Secretaries for continuing to promote and highlight developments in this important area, and in the process helping to advance Hong Kong’s position as a leading financial centre.

There is no doubt this Report is of immense value in furthering good corporate governance practices and clarifying issues surrounding INEDs for market participants and practitioners alike. This Report makes for compulsory reading for all directors.

Charles Lee

Chairman

Hong Kong Exchanges and Clearing Limited

January 2006

I am honored to be invited to write the preface of the second edition of the Report on “The Duties and Responsibilities of Independent Non-Executive Directors of Hong Kong Main Board Listed Companies”.

It is not disputed that there has been an ever-increasing role and importance of independent non-executive directors (“INEDs”) to further strengthen the corporate governance of listed companies.

As I have the privilege to point out in the first edition of the Report, INEDs are the key to good corporate governance. The need for quality INEDs is imperative particularly in light of the accelerated development of our economic globalization and recent examples of massive corporate failures, which forces us, effectively, to play by a new set of rules to conform to globally accepted practices. That is, one that demands much greater integrity, transparency and accountability than in the past.

The recent changes to the Listing Rules of the Hong Kong Exchanges and Clearing Limited are evidence of the growing significance of INEDs to act as not only valuable strategic advisers in providing to the board valuable knowledge, expertise and experience but also as corporate guardians of shareholders’ interests.

In an attempt to advance the pivotal role of INEDs in corporate governance, the Listing Rules now requires the minimum number of INEDs for listed companies to be raised from two to three. It guarantees the views that INEDs carry significant weight in the board’s decisions. Issuers are also required to appoint at least one INED with appropriate financial management experience or professional qualifications.

Additional guidelines have also been introduced to assist issuers in assessing the independence of proposed INEDs. Tailored induction, training courses and continuing professional development programmes are in place to enhance the quality of INEDs and to further their understanding of their duties and the operation of business of the listed companies. These amendments and developments all reflect the increasing expectations on INEDs.

This Report will provide an insight into the above issues as well as future trends and challenges that companies will face with regard to INEDs. It is again my pleasure to recommend this Report to all listed companies in Hong Kong and all interested parties.

I commend The Hong Kong Institute of Chartered Secretaries on its continual endeavours to promote an understanding and acknowledgment of the importance of INEDs in relation to corporate governance of Hong Kong listed companies.

Cheng Mo Chi, Moses

Senior Partner, P.C. Woo & Co.

Founder Chairman, The Hong Kong Institute of Directors

January 2006

INTRODUCTION

As noted in the September 2003 edition of this publication by the Institute, over the past twelve years or so, corporate governance has become a major theme of corporate life and regulation in developed and developing economies. Good corporate governance has steadily moved from a matter of relative obscurity, through a phase where it was regarded as beneficial but optional, to the point where, in a post-Enron era, good governance is an essential and mandated requirement for any major corporation which needs the support of external capital providers and investors in general.

Independent non-executive directors (“INEDs”) have become an established element of effective corporate governance regimes – providing an independent check and balance and occupying the middle ground in the direction and supervision of publicly-owned companies between management, controlling shareholders and the wider shareholder base.

In the past two years, new rules relating to corporate governance and INEDs have been introduced. Apart from amendments to the Rules Governing the Listing of Securities (“the Listing Rules”) on The Stock Exchange of Hong Kong Limited (“the Exchange”), the Code on Corporate Governance Practices (“the Code”) and the Rules on the Corporate Governance Report have been incorporated into the Listing Rules as Appendix 14 and Appendix 23 respectively with effect from 1 January 2005. The Code has replaced the Code of Best Practice originally contained in Appendix 14.

The Code sets out the Exchange’s views on the principles of good corporate governance and two levels of recommendations, namely the Code Provisions and Recommended Best Practices. Issuers are expected to comply with the Code Provisions or explain the deviations if they choose not to comply. The Recommended Best Practices are provided as guidelines only; issuers are encouraged, but are not required, to explain if they choose not to follow the Recommended Best Practices.

As a result of the changes to the Listing Rules and the implementation of the Code, increased duties and responsibilities have been imposed on INEDs. The purpose of this Report is to review the current duties and responsibilities of INEDs. In doing so, this Report seeks to place these issues in the particular Hong Kong context, notably by reference to survey data and analysis, and to look at the implications of further expansion of the role of INEDs in Hong Kong.

WHO IS AN INED?

The INED is a creation of the Listing Rules which originally required listed companies to have two INEDs. Since 31 March 2004, the minimum number of INEDs required under the Listing Rules has increased to three and at least one of them must have appropriate professional qualifications or accounting or related financial management expertise. The Code recommends as a best practice that an issuer should appoint INEDs representing at least one-third of the board.

According to the note to Rule 3.10 of the Listing Rules elaborating on “appropriate accounting or related financial management expertise”, the Exchange expects the person to have, through experience as a public accountant or auditor or as a chief financial officer, controller or principal accounting officer of a public company or through performance of similar functions, experience with internal controls and in preparing or auditing comparable financial statements or experience reviewing or analyzing audited financial statements of public companies.

A listed issuer shall immediately inform the Exchange and publish an announcement in the newspapers containing the relevant details and reasons if at any time the number of the INEDs falls below the minimum requirement or at any time it has failed to meet the requirement set out in Rule 3.10 regarding the qualification of the INEDs. Any failure to meet those requirement(s) must be made good by the issuer within three months.

No Hong Kong statute or subsidiary legislation acknowledges the existence of the INED, still less defines the qualities or criteria, which constitute independent non-executive status. In March 2004, additional guidelines were introduced by the Exchange to assist issuers in assessing the independence of a non-executive director. Rule 3.13 of the Listing Rules provides that:–

“in assessing the independence of a non-executive director, the Exchange will take into account the following factors, none of which is necessarily conclusive. Independence is more likely to be questioned if the director:–

- (1) holds more than 1% of the total issued share capital of the listed issuer;

Notes:

- a. *A listed issuer wishing to appoint an INED holding an interest of more than 1% must satisfy the Exchange, prior to such appointment, that the candidate is independent. A candidate holding an interest of 5% or more will normally not be considered independent.*
- b. *When calculating the 1% limit set out in rule 3.13(1), the listed issuer must take into account the total number of shares held legally or beneficially by the director, together with the total number of shares which may be issued to the director or his nominee upon the exercise of any outstanding share options, convertible securities and other rights (whether contractual or otherwise) to call for the issue of shares.*

- (2) has received an interest in any securities of the listed issuer as a gift, or by means of other financial assistance, from a connected person

or the listed issuer itself. However, subject to Note 1 to rule 3.13(1), the director will still be considered independent if he receives shares or interests in securities from the listed issuer or its subsidiaries (but not from connected persons) as part of his director's fee or pursuant to share option schemes established in accordance with Chapter 17;

- (3) is a director, partner or principal of a professional adviser which currently provides or has within one year immediately prior to the date of his proposed appointment provided services, or is an employee of such professional adviser who is or has been involved in providing such services during the same period, to :
 - a. the listed issuer, its holding company or any of their respective subsidiaries or connected persons; or
 - b. any person who was a controlling shareholder or, where there was no controlling shareholder, any person who was the chief executive or a director (other than an INED), of the listed issuer within one year immediately prior to the date of the proposed appointment, or any of their associates;
- (4) has a material interest in any principal business activity of or is involved in any material business dealings with the listed issuer, its holding company or their respective subsidiaries or with any connected persons of the listed issuer;

- (5) is on the board specifically to protect the interests of an entity whose interests are not the same as those of the shareholders as a whole;
- (6) is or was connected with a director, the chief executive or a substantial shareholder of the listed issuer within two years immediately prior to the date of his proposed appointment;

Note:

Without prejudice to the generality of the foregoing, any person cohabiting as a spouse with, and any child, step-child, parent, step-parent, brother, sister, step-brother and step-sister of, a director, the chief executive or a substantial shareholder of the listed issuer is, for the purpose of rule 3.13 (6), considered to be connected with that director, chief executive or substantial shareholder. A father-in-law, mother-in-law, son-in-law, daughter-in-law, grandparent, grandchild, uncle, aunt, cousin, brother-in-law, sister-in-law, nephew and niece of a director, the chief executive or a substantial shareholder of the listed issuer may in some circumstances also be considered to be so connected. In such cases, the listed issuer will need to provide the Exchange with all relevant information to enable the Exchange to make a determination.

- (7) is, or has at any time during the two years immediately prior to the date of his proposed appointment been, an executive or director (other than an INED) of the listed issuer, of its holding company or of any of their respective subsidiaries or of any connected persons of the listed issuer; and

Note:

An “executive” includes any person who has any management function in the company and any person who acts as a company secretary of the company.

- (8) is financially dependent on the listed issuer, its holding company or any of their respective subsidiaries or connected persons of the listed issuer.”

It is also recommended as a best practice in the Code that if an INED serves more than nine years, any further appointment of such INED should be subject to a separate shareholders’ resolution since serving a term of nine years could be relevant to the determination of a non-executive director’s independence.

An INED must submit to the Exchange a written confirmation in respect of the above factors concerning his independence, and confirmation that there are no other factors that may affect his independence at the same time as the submission of his declaration and undertaking in Form B or H of Appendix 5 to the Listing Rules. The INED must inform the Exchange as soon as practicable if there is any subsequent change of circumstances which may affect his independence. Each INED must provide an annual confirmation of his independence to the listed issuer. The listed issuer must confirm in each of its annual reports whether it has received such confirmation and whether it still considers the INEDs to be independent.

The Listing Rules illustrate some factors which would prevent an individual being an INED – but do not offer a positive description of the qualifying criteria. The Exchange underlines the status of the explanation given in Rule 3.13 of the Listing Rules by a footnote which provides that “the factors set out in Rule 3.13 are included for guidance only and are not intended to be exhaustive. The Exchange may take account of other factors relevant to a particular case in assessing independence”.

It is not surprising that, given the immense variety of individual personal circumstances, the Exchange has decided not to attempt the task of exhaustive definition of what will constitute “independence”. Instead, it is left to every INED, under Rule 3.12 of the Listing Rules, to satisfy the Exchange that he has the character, integrity, independence and experience to fulfil his role effectively. Whilst every INED must satisfy the Exchange that he has the qualities “to fulfil his role effectively”, there is currently no explanation as to what is that role, as distinct from that of all directors of a listed issuer.

It is worth noting that there is a marked difference between the ways in which “independence” of an INED is determined in the U.K. and Hong Kong respectively. In the U.K., under The Combined Code on Corporate Governance as amended in July 2003 (“U.K. Combined Code”), it is for the board to “determine whether a director is independent in character and judgment and whether there are relationships or circumstances which are likely to

affect, or could appear to affect, the director's judgment". And in the event that the board determines that a director is independent notwithstanding the existence of certain relationships or circumstances as specified in the U.K. Combined Code which may appear to be relevant to its determination, the board should state the reasons for its determination in the annual report. In Hong Kong, the "independence" of an INED is to be determined by the Exchange which shall take into account, among other things, the factors set out in Rule 13.13 though the burden is still on the INED to satisfy the Exchange that he has the "independence" to fulfil his role effectively. As the Hong Kong market becomes more mature, the Exchange could consider adopting the U.K. "comply or explain" approach in the determination of independence. This would relieve the Exchange of the burden of making the decision on a case by case basis, which involves a great deal of time and administrative effort particularly with the increasing numbers of INEDs in the years to come.

THE DUTIES AND RESPONSIBILITIES OF DIRECTORS

A broad summary of the basic duties of directors in Hong Kong is set out in Rule 3.08 of the Listing Rules, which provides:-

"The board of directors of a listed issuer is collectively responsible for the management and operations of the listed issuer. The Exchange expects the directors, both collectively and individually, to fulfil fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with the standard established by

Hong Kong law. This means that every director must, in the performance of his duties as a director:-

- a. act honestly and in good faith in the interests of the company as a whole;
- b. act for proper purpose;
- c. be answerable to the listed issuer for the application or misapplication of its assets;
- d. avoid actual and potential conflicts of interest and duty;
- e. disclose fully and fairly his interests in contracts with the listed issuer; and
- f. apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the listed issuer."

In January 2004, the Companies Registry issued the "Non-statutory Guidelines on Directors' Duties" which outlined the general principles of directors' duties as follows:-

- a. act in good faith for the benefit of the company as a whole;
- b. use powers for a proper purpose for the benefit of members as a whole;
- c. not delegate powers except with proper authorization and duty to exercise independent judgment;

- d. exercise care, skill and diligence;
- e. avoid conflicts between personal interests and interests of the company;
- f. not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law;
- g. not to gain advantage from the use of position as a director;
- h. not to make unauthorized use of company's property or information;
- i. not to accept personal benefit from the third parties conferred because of position as a director;
- j. observe the company's memorandum and articles of association and resolutions; and
- k. keep proper books of account.

In the Code, the functions of non-executive directors include (but are not limited to) the following:—

- a. participating in board meetings of the issuer to bring an independent judgment to bear on issues of strategy, policy, performance, accountability, resources, key appointments and standards of conduct;
- b. taking the lead where potential conflicts of interests arise;

- c. serving on the audit, remuneration, nomination and other governance committee, if invited; and
- d. scrutinizing the issuer's performance in achieving agreed corporate goals and objectives, and monitoring the reporting of performance.

It is also recommended as best practices in the Code that non-executive directors, as equal board members, should give the board and any committees on which they serve such as audit, remuneration or nomination committees, the benefit of their skills, expertise and varied backgrounds and qualifications through regular attendance and active participation. Further, they should also make a positive contribution to the development of the issuer's strategy and policies through independent, constructive and informed comments.

With respect to the degree of skill and care which a director should exercise in the performance of his duties, the Standing Committee on Company Law Reform ("the SCCLR") commented in Phase I of its Corporate Governance Review (July 2001) that the traditional standard of care and skill at common law, laid down in *Re: City Equitable Fire Insurance Co. Ltd.* (1925 Ch. 407), is a fairly low standard. *City Equitable* suggests that a director: –

- a. need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience;

- b. is not bound to give continuous attention to the affairs of his company; and
- c. in respect of all duties that may properly be left to some other official, and in the absence of suspicion, is justified in trusting that official to perform such duties honestly.

In *Norman v Theodore Goddard (a firm)* (1991) BCLC 1028, Hoffmann J said that the court was entitled to take into account the knowledge, skill and experience which a director actually had, in addition to that which a person carrying out his functions should be expected to have.

In “*Corporate Governance – An Asia Pacific-Critique*” (Sweet & Maxwell Asia, 2002), Professor C.K. Low of the Chinese University of Hong Kong commented on the anomaly that, whilst directors have almost unfettered control of the affairs of a company, they are not subject to any statutory provisions with respect to the standards that are expected of them. Moreover, the *City Equitable* approach favoured the less than competent director, since he was more likely to be relieved of liability on grounds of lack of knowledge and experience. Professor Low noted that the effect of the common law doctrine was to endorse the view that, if a company appoints a director who is not competent, or does not possess the requisite level of knowledge or experience, the company and its shareholders, not the director himself, bear the consequences of his shortcomings.

However, the SCCLR found the current state of the law on fiduciary duties and the standards of care and skill in Hong Kong expected of directors generally acceptable. This was on the assumption that it is open for case law to demand higher standards of care and skill from directors, as evidenced in developments internationally.

A key characteristic of the legal treatment of the duties and responsibilities of directors is that no distinction is made between executive and non-executive directors. “*The Consultation Paper on Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties*” issued in the U.K. by the Law Commission and the Scottish Law Commission in 1998, confirmed that both types of directors have overall and equal responsibility for the leadership of a company and that traditionally the law has not distinguished between executive and non-executive directors.

Within the Hong Kong context the responsibilities of directors were discussed in 2001 in the Court of Appeal’s judgment in 2001 in “*In the Matter of B.F. Construction Company Limited*” when the Hon. Mr. Justice Rogers, V.P., stated that:-

“Executive directors and non-executive directors have the same responsibility in law as to the management of the company’s business. They have the same responsibility in law with regard to the finances of the company and as regards accounting to the shareholders for the company’s finances. The law, and, in particular, the Companies Ordinance does not have any regard as to whether a director has an executive position within the company or whether a director is paid a salary. The duties and responsibilities arising from a directorship are the same”.

The Code has also confirmed the case law position by providing that given the essential unitary nature of the board, non-executive directors have the same duties of care and skill and fiduciary duties as executive directors.

The basic duties of all directors are owed to the same party, namely the company as a whole. INEDs do not owe their duties only to independent shareholders (i.e. those other than a controlling shareholder of the issuer or its associates or, where there is no controlling shareholder, any shareholder other than director and chief executive of the issuer and their respective associates). This contributes to the principle of the “unitary board”, whereby all directors, executive and INED alike, have a collective responsibility for the direction of a company’s affairs which is owed to the company and all its shareholders equally.

That is not to say that the duties of executive and non-executive directors will always be identical. Neither are the duties of executive directors the same in every company. As Romer J pointed out in *Re City Equitable*:-

“the duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another... In order, therefore to ascertain the duties that a person appointed to the board of an established company undertakes to perform, it is necessary to consider not only the nature of the company’s business, but also the manner in which the work of the company is in fact distributed between the directors and the other officials of the company, provided always that this distribution is a reasonable one in the circumstances, and is not inconsistent with any express provisions of the articles of association”.

Executive directors may have additional and more onerous duties by reason of their employment relationship with the company than those which might attach to them purely as a result of their position as director (*Palmer’s Company Law*, paragraph 8.208, June 1999). This was also recognized in the Law Commission’s Consultation Paper, which pointed out that executive directors will have separate service contracts with the company, whereas the non-executive directors do not have service contracts with the company and are less concerned with the day to day running of the company, but rather bringing an outside perspective to the board’s deliberations with more concern for general policy and overall supervision.

The foundation for an analysis of the duties and responsibilities of executive and non-executive directors is clear and long-established – both are subject to the same legal framework, save to the extent that the executive directors may have additional responsibilities as a result of their terms of employment. However, with the recent trend of relying on non-executive directors to play a greater monitoring role over the executive directors and the management, developments in the Listing Rules and the Codes on Takeovers and Mergers (“Takeovers Code”) and Share Repurchases (“Share Repurchases Code”) are imposing additional duties not, as one might expect, on executive directors but, instead, on the INEDs – even though INEDs do not carry out any executive functions and are not involved in the day to day management of issuers.

THE GROWING DIVERGENCE BETWEEN THE REGULATORY DUTIES AND RESPONSIBILITIES OF INEDS AND OTHER DIRECTORS

One of the themes of this Report is the tension between the traditional view of a common legal framework applying to all directors, executive or non-executive, and a regulatory environment which makes a growing distinction between the two categories of directors. A second theme is that this distinction largely takes the form of placing additional functions and responsibilities on INEDs – albeit that their limited involvement in a company’s affairs may mean they are ill-placed to shoulder these tasks and their independent, modestly remunerated status does not motivate them to do so.

The following sections of this Report look at existing and potential regulatory requirements of INEDs in Hong Kong as well as the global trend towards further increasing the role of INEDs in corporate governance.

THE CURRENT DUTIES AND RESPONSIBILITIES OF INEDS IN HONG KONG

Listing Rules

a. Audit Committee

According to Rule 3.21, every listed issuer must establish an audit committee comprising non-executive directors (“NEDs”) only. It must comprise a minimum of three members with a majority of INEDs; at least one of the members must be an INED with appropriate professional qualifications or accounting or related financial management expertise. (The

definition of “appropriate accounting or related financial management expertise” is covered in the previous section “Who is an INED?”). The audit committee must be chaired by one of the INEDs. The committee must be established with a written terms of reference which clearly establish the committee’s authority and duties.

The Code provides that a former partner of the issuer’s existing auditing firm should be prohibited from acting as a member of the issuer’s audit committee for a period of one year commencing on the date of his ceasing:

- to be a partner of the firm; or
- to have any financial interest in the firm,

whichever is the later.

A listed issuer shall immediately inform the Exchange and publish in the newspapers an announcement containing the relevant details and reasons if the listed issuer fails to set up an audit committee or at any time has failed to meet any of the other requirements set out in Rule 3.21. Any failure to meet the requirement(s) as aforesaid must be made good by the issuer within three months.

According to the Code, the terms of reference of an audit committee should include at least the following duties:–

- to be primarily responsible for making recommendation to the board on the appointment, reappointment and removal of the external auditor, and to approve the remuneration and terms of engagement of the external auditor, and any questions of resignation or dismissal of that auditor;

- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process in accordance with applicable standard;
- to develop and implement policy on the engagement of an external auditor to supply non-audit services;
- to monitor integrity of financial statements of an issuer and the issuer's annual report and accounts, half-year report and, if prepared for publication, quarterly reports, and to review significant financial reporting judgments contained in them;
- to meet, at least once a year, with the issuer's auditors and consider any significant or unusual items that are, or may need to be, reflected in such reports and accounts;
- to review the issuer's financial controls, internal control and risk management systems;
- to discuss with the management the system of internal control and ensure that management has discharged its duty to have an effective internal control system;
- to consider any findings of major investigations of internal control matters as delegated by the board or on its own initiative and management's response;
- to ensure coordination between the internal and external auditors, and to ensure that the internal audit function is adequately resourced and has appropriate standing within the issuer, and to review and monitor the effectiveness of the internal audit function;

- to review the group's financial and accounting policies and practices;
- to review the external auditor's management letter, any material queries raised by the auditor to management in respect of the accounting records, financial accounts or systems of control and management's response;
- to ensure that the board will provide a timely response to the issues raised in the external auditor's management letter;
- to report to the board on the matters set out in the Code; and
- to consider other topics, as defined by the board.

b. Nomination Committee

It is presently not mandatory for a listed issuer to have a nomination committee. However, the Code recommends as a best practice that an issuer should establish a nomination committee, comprising a majority of INEDs. The nomination committee should be established with specific written terms of reference which deal clearly with its authority and duties including the following:–

- to review the structure, size and composition (including the skills, knowledge and experience) of the board on a regular basis and make recommendations to the board regarding any proposed changes;
- to identify individuals suitably qualified to become board members and select or make recommendations to the board on the selection of, individuals nominated for directorships;

- to assess the independence of INEDs; and
- to make recommendations to the board on relevant matters relating to the appointment or re-appointment of directors and succession planning for directors in particular the chairman and the chief executive officer.

c. Remuneration Committee

Under the Code, issuers should establish a remuneration committee, comprising a majority of INEDs. The remuneration committee should be established with specific written terms of reference which deal clearly with its authority and duties.

The remuneration committee should consult the chairman and/or chief executive officer about their proposals relating to the remuneration of other executive directors and have access to professional advice if considered necessary.

Its term of reference should include, as a minimum, the following specific duties:–

- to make recommendations to the board on the issuer's policy and structure for all remuneration of directors and senior management and on the establishment of a formal and transparent procedure for developing policy on such remuneration;
- to have the delegated responsibility to determine the specific remuneration packages of all executive directors and senior management and make recommendations to the board of the remuneration of NEDs. The remuneration committee should consider factors such as salaries paid by comparable companies,

time commitment and responsibilities of the directors, employment conditions elsewhere in the group and desirability of performance-based remuneration;

- to review and approve performance-based remuneration by reference to corporate goals and objectives resolved by the board from time to time;
- to review and approve the compensation payable to executive directors and senior management in connection with any loss or termination of their office or appointment;
- to review and approve compensation arrangements relating to dismissal or removal of directors for misconduct; and
- to ensure that no director or any of his associates is involved in deciding his own remuneration.

Regarding any service contracts of directors which are for a term of more than three years or, for the termination of which, the issuer has to give notice of more than one year or to pay compensation or make other payments equivalent to more than one year's emoluments, shareholders' approval for the service contracts shall be required under Rule 13.68 and the remuneration committee shall advise shareholders on how to vote. It will be discussed in greater detail in the next section.

d. Independent Board Committee

Under Rule 13.39 (6), issuers shall, in the case of connected transactions or transactions requiring independent shareholders' approval under the Listing Rules, establish an independent board committee, comprising

only INEDs without any material interest in the relevant transactions. A separate letter from the independent board committee advising shareholders on such transactions must be contained in the circular to shareholders. Such letter will advise shareholders as to whether the terms of the relevant transactions are fair and reasonable and whether such a transaction is in the interests of the issuer and its shareholders as a whole and advise shareholders on how to vote, after taking into account the recommendations of the independent financial adviser.

In respect of any service contracts (unless exempted under Rule 13.69) which require shareholders' approval under Rule 13.68, the remuneration committee of the issuer (if any) or the independent board committee shall form a view and advise shareholders as to whether the terms of such service contracts are fair, reasonable and in the interests of the issuer and its shareholders as a whole and advise shareholders on how to vote.

Takeovers Code

In the event of an offer for takeover or merger, it is a common practice for the board of the offeree company to establish an independent committee of the board to discharge the board's responsibilities in relation to the offer, in particular, in cases where any of the directors of an offeree company is faced with a conflict of interest.

Pursuant to Rule 2.8 of the Takeovers Code, members of an independent committee of a company's board of directors should consist of all NEDs of the company who have no direct or indirect interest in any offer or possible offer for consideration by the independent committee. In most of the takeovers and mergers where an

independent committee is required to be established, the responsibility to serve on that committee rests with INEDs of the offeree company.

The independent committee is advised by its financial advisor and its view must be included in the offeree board circular to shareholders. This is in addition to the joint and several responsibility of all directors of the offeree company issuing the document, where all directors jointly and severally accept full responsibility for the accuracy of information contained in the document and confirm, having made all reasonable inquiries, that to the best of their knowledge, opinions expressed in the document have been arrived at after due and careful consideration and there are no other facts not contained in the document, the omission of which would make any statement in the document misleading.

Share Repurchases Code

Pursuant to Rule 2 of the Share Repurchases Code, an independent committee of the company's board of directors should be established to advise shareholders on off-market share repurchases and their recommendation as to whether shareholders should approve or disapprove the off-market share repurchase proposal should be included in the circular to shareholders.

In the event of share repurchases by general offer, the rules of the Takeovers Code in relation to independent committees will normally apply.

Due to the stringent tests of independence monitored by the Securities and Futures Commission, the directors to be appointed to such independent committee are always the INEDs, providing a further example of the additional responsibilities of INEDs compared to other board members.

As shown above, the INEDs of Hong Kong listed companies have very important roles to play under the Listing Rules, Takeovers Code and Share Repurchases Code. With the establishment of audit, remuneration, nomination and independent board committees, the INEDs must assume greater responsibilities and commit more time and effort in coping with the ever increasing workload. Such additional responsibilities further distinguish the role of INEDs on the board from that of the other directors. More importantly, they will face the greater risk of potential claims which comes with their additional duties.

GLOBAL TRENDS

In the past two years, several countries have revised or issued some form of corporate governance rules and guidelines. The U.K. Combined Code came into effect on 1 November 2003. The New York Stock Exchange's Corporate Governance Rules ("NYSE Rules") were amended in November 2004. The Singapore Stock Exchange issued its revised Code of Corporate Governance ("SGX Code") in July 2005, which will come into effect subject to approval in its annual general meeting to be held on or about 1 January 2007. Both the U.K. and Singapore adopt the "comply or explain" approach whereas the U.S. uses a prescriptive approach. It is interesting to note that Singapore will have a new section entitled "Commentaries" in the SGX Code to provide additional guidance to listed companies on how they can better implement the "principles" and "guidelines" in the SGX Code. However, the listed companies will not be required to comply or explain any deviation from these commentaries. The developments in the above codes show an ongoing global corporate governance trend, as illustrated by the Sarbanes-Oxley Act in the U.S., towards greater reliance on INEDs to play a major part in good governance and the protection of

shareholder interests will continue. The following section will discuss the developments in four areas with reference to the corresponding rules abstracted from the above Codes and Rules.

a. Composition:

i. U.K. Combined Code requires that:

- at least half of the board excluding the Chairman should comprise NEDs determined by the board to be independent. (Smaller companies i.e. those below the FTSE 350 throughout the year immediately prior to the reporting year, should have at least two INEDs);
- there should be a nomination committee with a majority of INEDs. It should be chaired by an INED;
- a remuneration committee should be established with at least three members (two for smaller companies) who should all be INEDs;
- an audit committee should be established with at least three members (two for smaller companies) who should all be INEDs. At least one member must have recent and relevant financial experience.

ii. NYSE Rules requires that:

- listed companies must have a majority of independent directors;
- listed companies must have a nominating/corporate governance committee comprising entirely independent directors;

- listed companies must have a compensation committee comprising entirely independent directors;
- listed companies must have an audit committee with a minimum of three members who must satisfy the requirements for independence. Each member of the audit committee must be or become financially literate. At least one member must have accounting or related financial management expertise.

iii. SGX Code requires that:

- independent directors should make up at least one-third of the board;
- companies should establish a nominating committee, comprising at least three directors, the majority of whom including the chairman should be independent;
- the board should set up a remuneration committee comprising entirely NEDs, the majority of whom, including the Chairman, should be independent;
- the board should establish an audit committee comprising at least three NEDs, the majority of whom including the chairman should be independent. At least two members should have accounting or related financial management expertise or experience.

As shown in the above Codes and Rules, there is a global trend to require a strong and independent element on the board as well as in the board committees.

Moreover, the establishment of audit, remuneration and nomination committees has or will (in the case of Singapore) become mandatory in the three aforesaid countries with the INEDs being required to assume an important role therein. In Singapore, a survey “Corporate Governance and Directors and Officers Liability Survey of Listed Companies in Singapore” commissioned by Jardine Lloyd Thompson Limited and conducted by Corporate Governance and Financial Reporting Centre of NUS Business School, National University of Singapore in April 2004 (“D&O’s liability survey in Singapore”) showed that 68% of 105 listed companies in Singapore agreed that the audit committee should comprise entirely independent directors whereas 48% and 47% held the same views for remuneration committee and the nomination committee respectively. In short, it seems that there is a clear trend of increasing representation and importance of INEDs on the board as well as the aforesaid committees.

b. Insurance:

i. U.K. Combined Code requires that:

- appropriate insurance cover, in respect of legal action against the directors, should be arranged.

In the wake of major corporate scandals, additional regulations, and overarching investor scrutiny, directors perceive that their liability has greatly increased. Perceived risk has doubled since the U.S. government passed the Sarbanes-Oxley Act.

Purchase of Directors and Officers’ (D&O) liability insurance may help retain directors and in particular INEDs. “The Tillinghast 2004 Directors and Officers Liability Survey”

conducted by Towers Perrin in 2004 found that 99% of responding U.S. companies and 89% of the responding Canadian companies reported purchasing D&O liability insurance while the D&O's liability survey in Singapore found that 79% of the responding companies had provided D&O liability insurance and 60% agreed that having D&O liability insurance helps retain experienced directors. The third annual "What Directors Think" study, conducted in 2004 by Corporate Board Member and PricewaterhouseCoopers LLP ("What Directors Think study"), also found that 68% of responding board members feel that the risk as a director has increased in the last twelve months and 49% said D&O coverage was very important in their decision to serve on their current board. In light of these survey findings, the prevalence of D&O liability insurance is likely to continue and be of increasing importance in major markets.

c. Training:

i. U.K. Combined Code requires that:

- new directors should receive a full, formal and tailored induction on joining the board. All directors should regularly update and refresh their skills and knowledge.

ii. NYSE Rules requires that:

- director orientation and continuing education must be addressed in corporate governance guidelines, which must be adopted and disclosed by listed issuers.

iii. SGX Code requires that:

- every director should receive appropriate training when he is first appointed to the board. Directors should receive further relevant training.

The corporate scandals in the early 2000s have generated a great deal of interest in corporate governance. Investors have become more aware of the correlation between best practices and corporate efficiency and have begun promoting education in order to attain best practices.

Under the above Codes and Rules, all directors in the U.K., the U.S. and Singapore are required to receive continuous training or updates. In particular, the D&O's liability survey in Singapore found that 54% of respondents provided continuous education to their directors and officers on their legal duties and liabilities and 39% said they intended to do so in the near future.

d. Remuneration

INEDs' remuneration level is increasing around the world, which reflects their increasing responsibilities, workload and time commitment as a result of more obligations imposed by the corporate governance codes.

There are also trends emerging in compensation for service on board committees. In the U.S., committee retainers are increasing, particularly for committee chairmen. The retainer is intended to recognize increased time commitment in serving on committees. Another trend is the increase in committee meeting fees. This increase recognizes that not only do directors have multiple meetings to

attend, requiring significant time, but that a great deal of preparation work is required outside of the meetings.

The picture, which emerges from the corporate governance codes and relevant surveys in the U.K., the U.S. and Singapore, is that the existing trend towards an increased role of INEDs will continue. They can be expected to find themselves more involved in Hong Kong's corporate governance structure for listed companies in the future.

THE INCREASING BURDEN ON INEDS

From a Hong Kong regulatory perspective, as expressed in current regulation, a clear distinction is being made between the tasks conferred on INEDs, compared to their fellow board members. This highlights the conflict between the principle that all directors are equally responsible in law for a board's actions and decisions and, at the same time, assigning to categories of directors particular functions or responsibilities for which they are accountable. This conflict was implicit in the Code which stated that NEDs have the same duties of care and skill and fiduciary duties as executive directors, whilst also listing out a set of specific functions of NEDs which are different from those of executive directors.

This distinction between duties (considered to be identical for INEDs and executive directors alike) and functions (where a difference is expressly recognized) can be a hard one to comprehend at first sight – what is the difference between a function and a duty? In particular, if there is no legal sanction for failure to perform a function, can it properly be considered as amounting to a duty? The SCCLR found that the duties of an independent director in law were not different from those of an executive director, but that a distinction could be made between the functions of a director, as opposed to his duties. The SCCLR went on to

say that, in determining whether or not a director fulfilled his duties, the court may have regard to the functions assigned to him and that the position or task of a director, as an executive director or an INED, was relevant as one of the factors that might be considered in determining whether the director had met the relevant standard of care, skill and diligence.

It seems to follow that, to the extent that regulation now imposes specific functions or tasks on INEDs, such as in respect of audit committees, a failure to perform properly those tasks will place an INED at risk of liability for failure to meet the relevant standard of care, skill and diligence. This also suggests that their liability is now potentially greater than that of their executive colleagues since they have wider functions to perform.

In fact, in the recent Delaware case, *re Emerging Communications, Inc. Shareholder Litigation*, No. CIV.A.16415 (Del. Ch. May 3, 2004, revised June 4, 2004), Justice Jacobs ruled that officers and directors with specialized expertise can be held to have a higher standard of care than other directors. INEDs having appropriate professional qualification or accounting or related financial management expertise would have a higher risk while they are in hot demand to serve on the boards.

This extension of duties and, in consequence, potential liability will make it more difficult to find individuals in Hong Kong prepared to take on the burdens of independent non-executive directorship. Moreover, a further consequence will be that, as soon as an INED of a listed company is concerned about ethical, accounting or other issues within the company, resignation is the only prudent course to take (and the quicker the better) – rather than to stay on the board and defend the shareholders' interests.

Accepting the Exchange's underlying premise that INEDs have a major role to play in a properly balanced corporate governance regime, care needs to be taken in imposing additional duties and workload on INEDs beyond those with which they can realistically cope, given that:-

- (a) They will lack the in-depth and ongoing knowledge of the details of a company's business and activity which is available to executive directors and senior management.
- (b) INEDs cannot, and cannot be expected to, devote an increasing amount of their time and effort to the performance of their duties as INEDs – unless there is some accompanying increase in their motivation to accept the increasing burdens of their office.
- (c) This motivation can only exist in terms of any or all of the following:-
 - an ongoing, and in light of increasing workload, growing sense of civic responsibility to serve Hong Kong's corporate community through the acceptance of INED appointments;
 - increased remuneration – in which case, care will need to be taken that the levels of remuneration do not reach a point where INEDs' independence is jeopardized by a desire to retain office and the support of influential shareholders in order to continue to receive such remuneration; and

- a reduction in the liability (for example, in the form of a D&O liability cover) which INEDs face for any alleged default in the performance of their duties (having regard to the fact that those duties are now more extensive than those of other directors).

In reviewing the application of global practice in Hong Kong, regulators will need to bear in mind the specific nature of the Hong Kong environment. This includes a major difference between Hong Kong on the one hand, and the U.K., the U.S. and Singapore on the other hand, in terms of board representation. The lower level of share ownership concentration in the U.S. or the U.K. allows "outside" or independent directors a larger role on boards – as compared to Hong Kong where family-owned companies and state-owned enterprises are plentiful. The next Section of this Report describes Hong Kong's own landscape in terms of the number, profile and characteristics of the INEDs who currently serve on the boards of Hong Kong Main Board issuers. In doing so, this Report seeks to provide some guidance as to the possible implications, for Hong Kong, of further changes to legislation, regulation and recommended best practice as it applies to such companies.

SURVEY DATA AND ANALYSIS

METHODOLOGY

For the purposes of the survey of the present environment for INEDs in Hong Kong, the Institute took an overall sample of 115 companies listed on the Main Board as the constituent stocks in the Hang Seng Composite Index as at 13 June, 2005. The sample has been further broken down into four categories:–

- 33 companies in the Hang Seng Index as at 13 June, 2005 (the “HSI”);
- 22 non-HSI companies in the Hang Seng HK MidCap Index as at 13 June, 2005 (the “MidCap”);
- 30 non-HSI companies in the Hang Seng HK SmallCap Index as at 13 June, 2005 (the “SmallCap”); and
- 30 non-HSI companies in the Hang Seng Mainland Composite Index as at 13 June, 2005 (the “Mainland”).

The 82 non-HSI companies in the last three categories were chosen randomly.

The data used was obtained from publicly available sources, notably annual reports for 2003/04 and 2004/05 and corporate websites.

AVERAGE PROFILE OF INEDS

According to the survey, boards in Hong Kong companies have.....

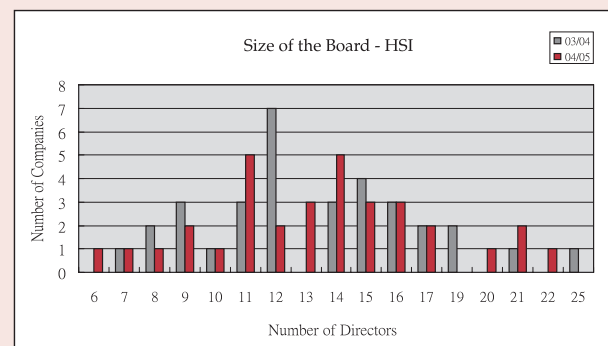
	2003/04	2004/05
1. average board size	11.4	11.7
2. average number of INEDs	3.3	3.7

INEDs on average.....

3. are aged	59.61 years old	58.70 years old
4. hold number of directorships	2.12	2.27
5. earn INEDs’ fees	\$152,628	\$169,034
6. have the following length of service	7.91 years	7.34 years

KEY FINDINGS

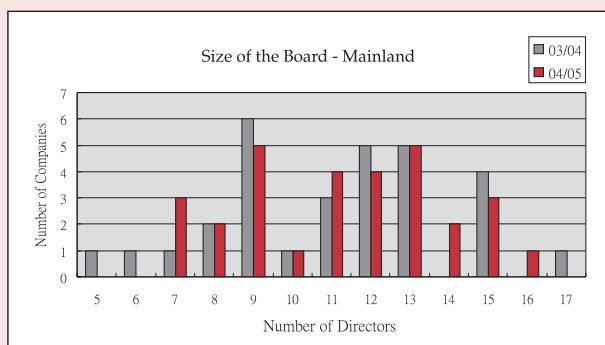
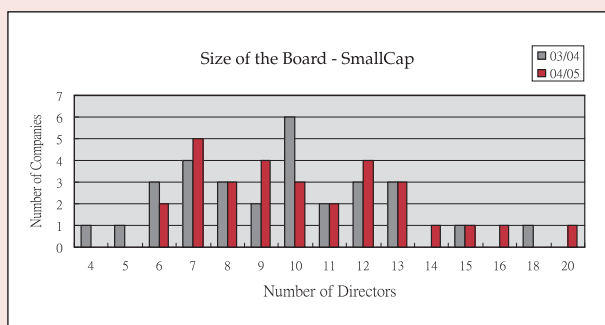
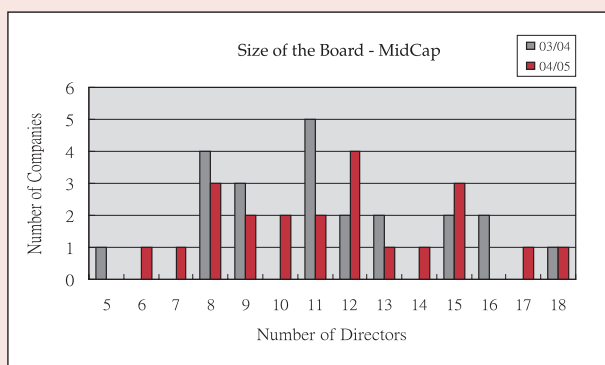
A. Size of Boards



(Note: In this chart and following charts:–

Single bar indicates that the data in the other year concerned was inapplicable.

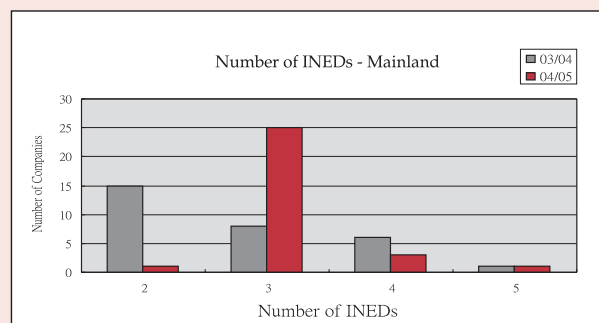
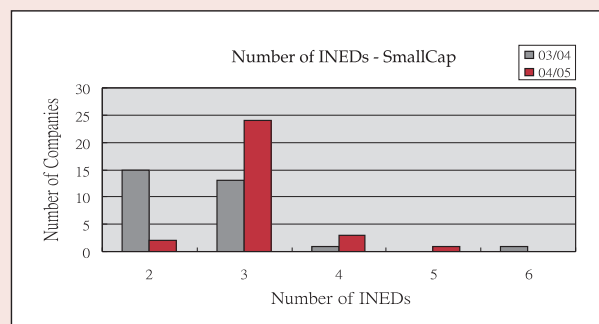
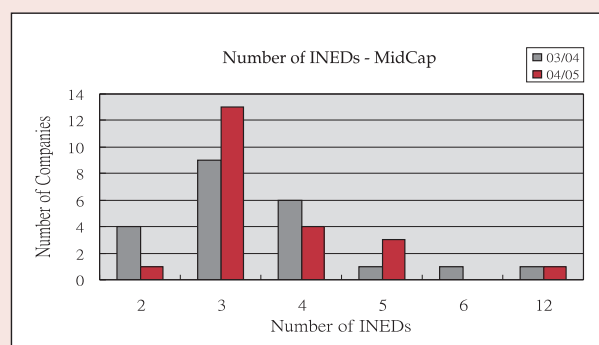
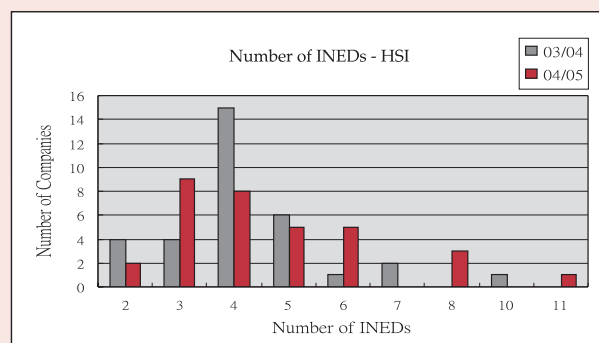
N/A denotes information was unavailable.)



This data highlights:

- The average board size of the surveyed companies was:
- | Financial Year | HSI | MidCap | SmallCap | Mainland |
|----------------|-------|--------|----------|----------|
| 2003-2004 | 13.48 | 11.32 | 9.57 | 11.10 |
| 2004-2005 | 13.58 | 11.45 | 10.37 | 11.27 |
- There is a significant variety in the size of the boards – ranging from 4 to 25 members.
 - The overall board size is increasing gradually.
 - HSI companies with larger capitalization have larger boards (which is probably to be expected).

B. Number of INEDs



From the data relating to the number of INEDs on the boards, it is noted that:

- The average number of INEDs for both financial years ended in 2004 and 2005 was:-

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	4.24	3.73	2.63	2.77
2004-2005	4.64	3.82	3.10	3.13

- There is a wide spread in the number of INEDs on individual boards – ranging from 2 to 12.
- Large companies have more INEDs (this is perhaps to be expected, but may indicate the difficulty faced by smaller capitalized companies in finding INEDs).
- The percentage of companies having only 3 INEDs, that is to say, the current minimum requirement under the Listing Rules was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	12%	41%	43%	27%
2004-2005	27%	59%	80%	83%

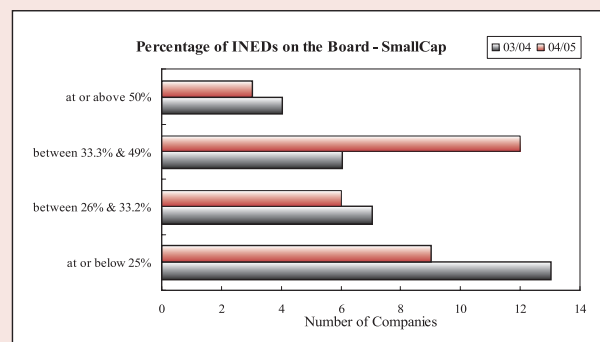
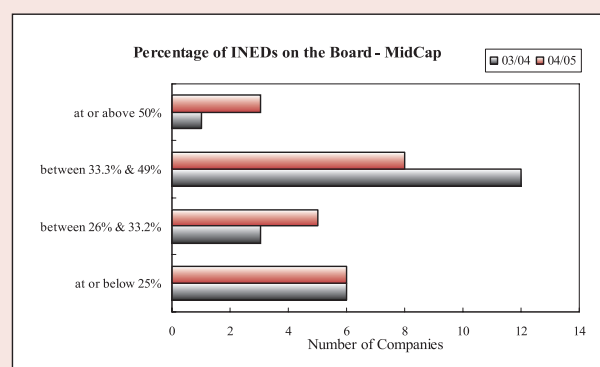
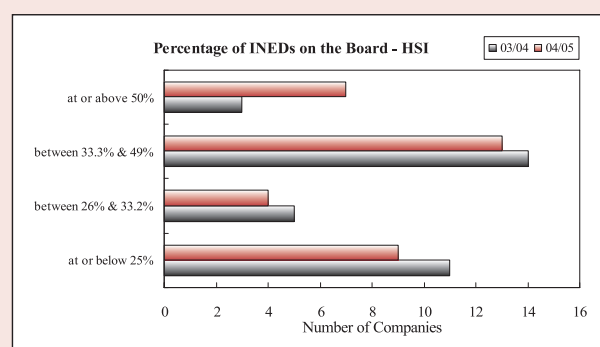
- The percentage of companies having 4 or more INEDs, that is to say, above the minimum requirement was:

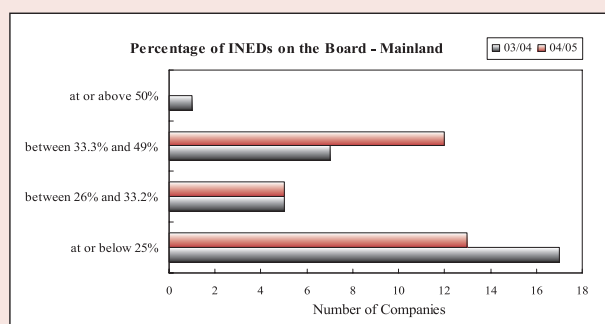
Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	76%	41%	7%	23%
2004-2005	67%	36%	13%	13%

- In 2004/05, a total of 6 companies, which had 2 INEDs only, failed to meet the minimum requirement as at their year-end. But all of them made good the shortfall within three months.

- As the minimum number of INEDs required increased from two to three, there was a sharp increase in the percentage of companies having 3 INEDs. However, the percentage of companies having 4 or more INEDs dropped except for the case of SmallCap. More companies tend to just meet the requirement instead of going for more than required. This perhaps reflects the keen competition for the INEDs among the companies resulting from a shortage of INEDs.

C. Representation by INEDs on Boards





Key points which can be extracted from this data include:-

- The number of the surveyed companies with more than one-third of their boards comprising INEDs was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	52%	59%	33%	27%
2004-2005	61%	50%	50%	40%

- An increasing number of companies have INEDs representing more than one-third of their boards. There were 42% and 50% of the companies with more than one-third of their boards being INEDs in 2003/04 and 2004/05 respectively.
- But it is still a tough challenge for the companies to raise the level of INED representation to comply with the recommended best practice in the Code that at least one-third of the board should be INEDs.

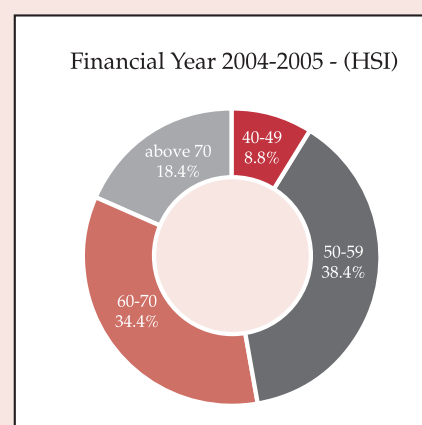
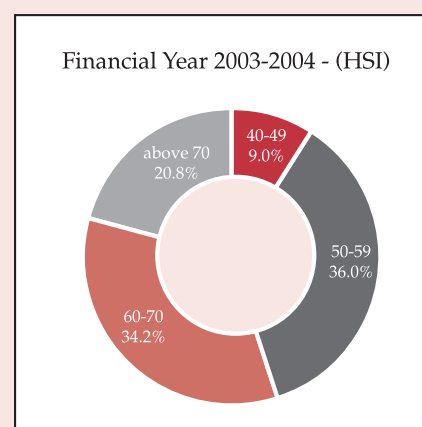
- The U.K. Combined Code requires at least half the board, excluding the chairman, should be INEDs. The large majority of the surveyed companies would not have complied with such a requirement:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	91%	95%	87%	97%
2004-2005	79%	86%	90%	100%

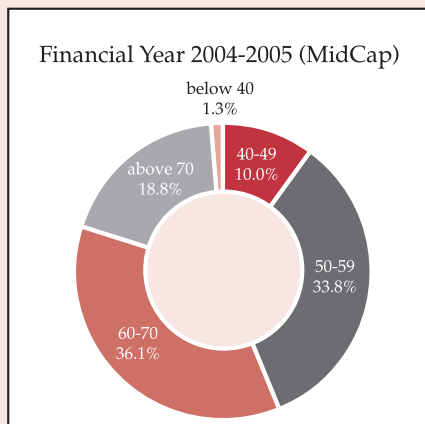
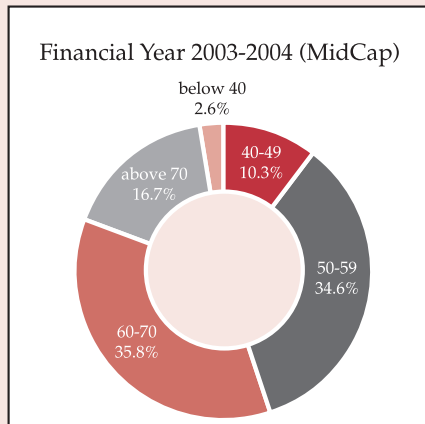
- There were only 13 (2003/04: 9) companies with more than half the board being INEDs in 2004/05.

D. Age

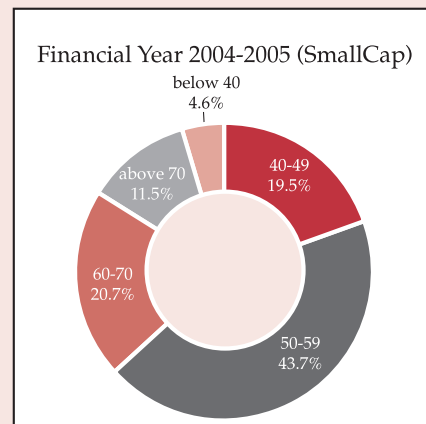
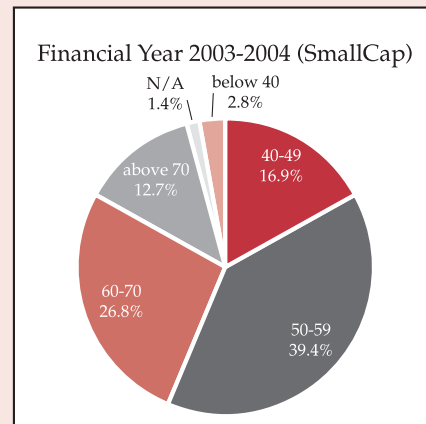
Age – HSI



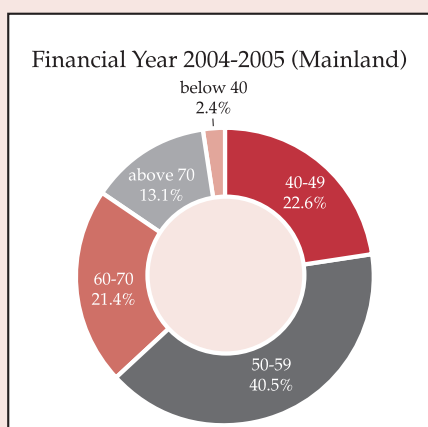
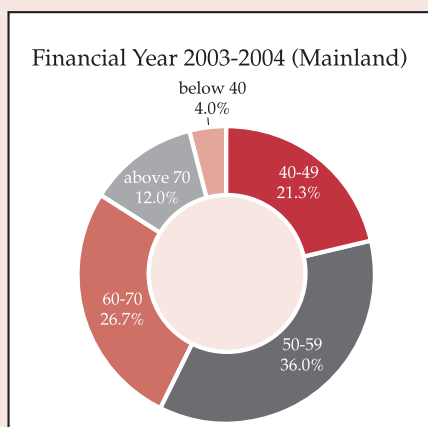
Age – MidCap



Age – SmallCap



Age – Mainland



- The average age of INEDs was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	62.1	61.2	58.0	57.3
2004-2005	61.6	61.4	56.5	56.7

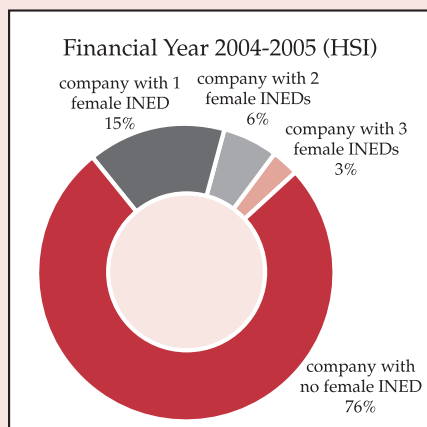
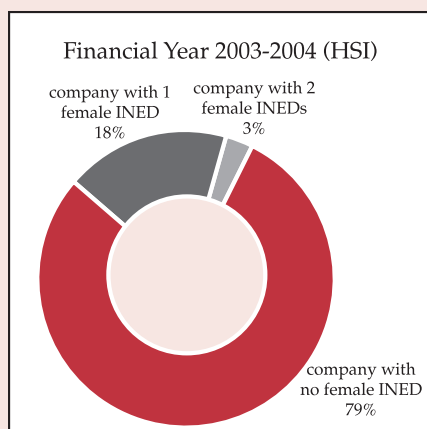
- The percentage of INEDs who were older than 60 was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	55.0%	52.5%	39.4%	38.7%
2004-2005	52.8%	54.9%	32.2%	34.5%

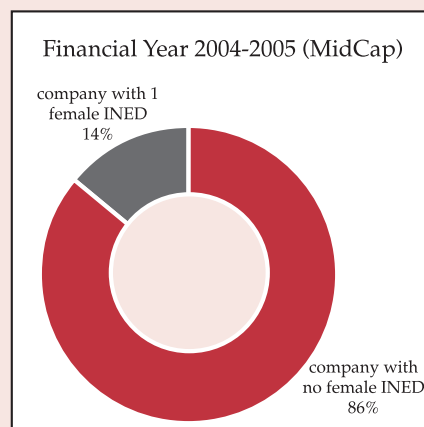
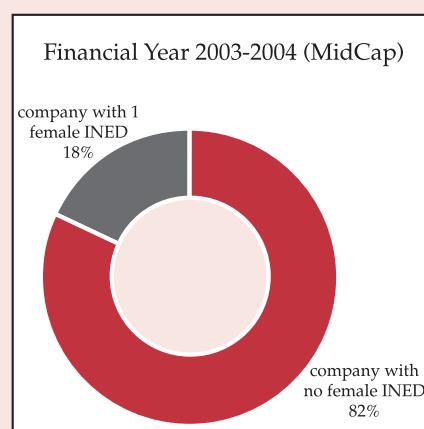
- The overall percentage of INEDs who were younger than 60 increased from 53.1% (in 2003/04) to 57.0% (in 2004/05). There is a trend to have younger INEDs on the boards.
- In 2003/04, 20.8% of the INEDs in the HSI (2004/05: 18.4%) were older than 70 and none was younger than 40 in either year.
- The INEDs on the boards of the SmallCap were younger. In 2003/04, 12.7% were older than 70 (2004/05: 11.5%) while 2.8% were younger than 40 (2004/05: 4.6%).
- The INEDs on the boards of the Mainland were younger, which may be because they were more recently established companies. In 2003/04, 12.0% were older than 70 (2004/05: 13.1%) while 4.0% were younger than 40 (2004/05: 2.4%).

E. Gender

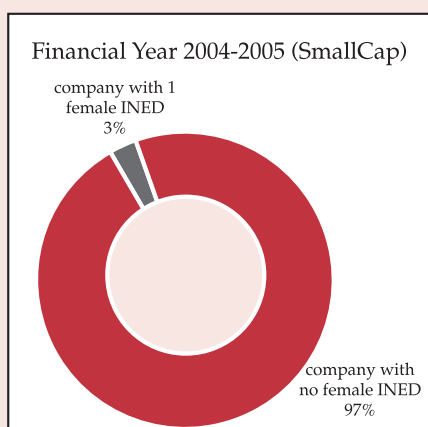
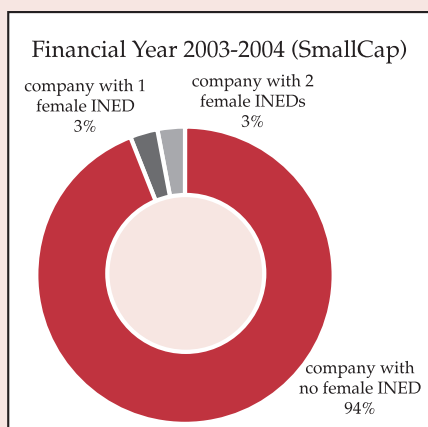
Gender – HSI



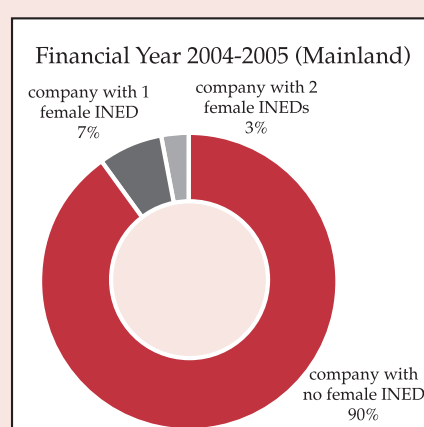
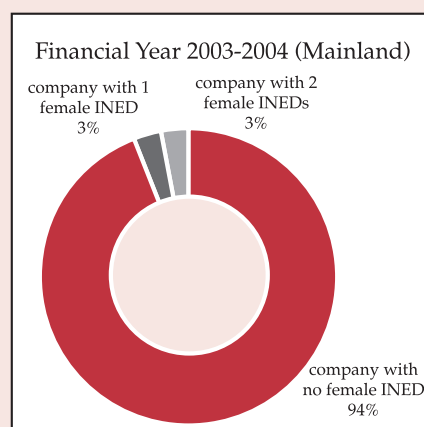
Gender – MidCap



Gender – SmallCap



Gender – Mainland

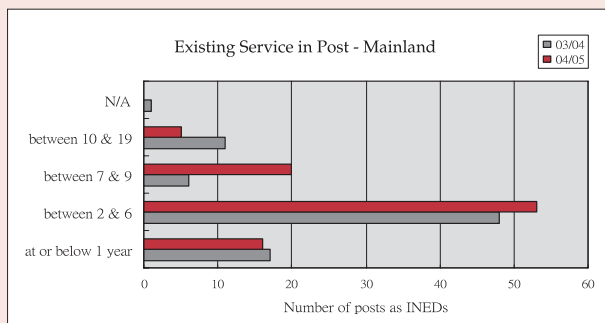
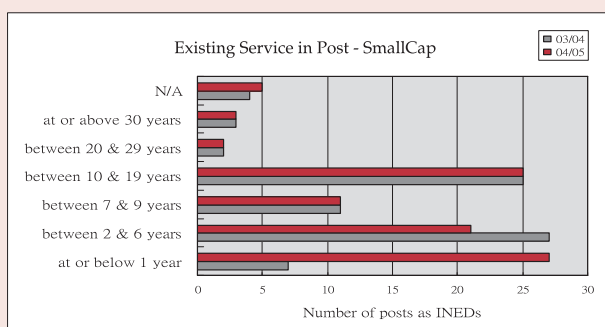
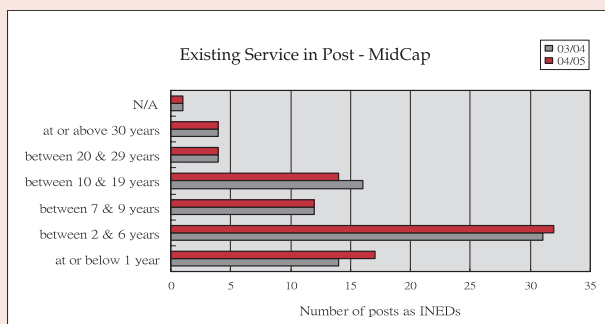
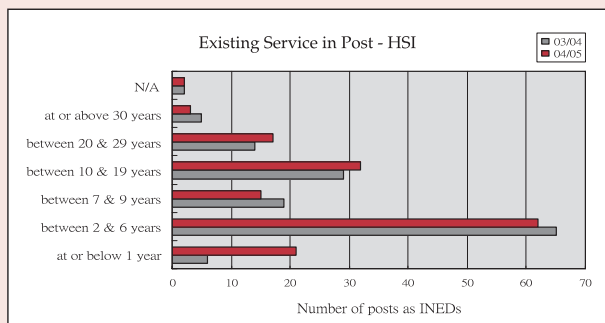


The data on the representation of female INEDs on the boards of the surveyed companies was quite striking.

- In 2003/04, only 5% of all INEDs (14 out of a total of 285 INEDs on the boards of the 115 surveyed companies covered by the survey) were female. In 2004/05, only 6% of all INEDs (18 out of a total of 321 INEDs) were female.
- 87% of all companies surveyed had no female INEDs in both financial years 2003/04 and 2004/05.
- In 2003/04, 3 out of the 115 surveyed companies had more than one female INED. No company had more than 2 female INEDs. In 2004/05, 4 companies had more than one female INED. Three of them had 2 female INEDs each and one only had 3 female INEDs.
- On average, there was a slight increase in the representation of female INEDs in 2004/05 as compared to 2003/04, mainly from the increase in the HSI and Mainland companies:
 - 21% of the HSI companies had female INEDs in 2003/04, which had increased to 24% in 2004/05.
 - 6% of Mainland companies had female INEDs in 2003/04, which had increased to 10% in 2004/05.
 - However, MidCap companies having female INEDs had decreased from 18% in 2003/04 to 14% in 2004/05 while SmallCap companies having female INEDs had also decreased from 6% in 2003/04 to 3% in 2004/05.

Overall, it is apparent that the broad mass of Main Board issuers is still characterized by a very low representation of female INEDs.

F. Length of Service



- Average length (years) of existing service in post was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	9.12	8.37	9.15	4.29
2004-2005	8.43	8.00	7.88	4.50

The overall average length of existing service in post decreased slightly from 7.91 years in 2003/04 to 7.34 years in 2004/05. None of the companies had an average length of existing service in post exceeding the nine-year period recommended by the Code, beyond which further appointment of such INED should be subject to a separate resolution to be approved by shareholders.

- The percentage of INEDs who had served for more than 9 years was:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	35%	30%	39%	13%
2004-2005	34%	27%	32%	5%

29% and 25% of all INEDs had served for more than 9 years in 2003/04 and 2004/05 respectively. The SmallCap had relatively higher percentage of INEDs serving for more than 9 years in 2003/04. Indeed, a large number of them (30 in 2003/04) had served between 10 to 30 years. It may indicate that small capitalization companies encounter more difficulties in finding new INEDs to replace those serving beyond 9 years.

- For the Mainland, the average length of existing service in post was shorter than the other groups since they were more recently established companies. In addition, none of the INEDs had served for more than 20 years in both financial years.

- In 2003/04, 8% of all INEDs (14% for the HSI; 10% for the MidCap and 7% for the SmallCap) had served for more than 20 years. In 2004/05, 7% of all INEDs (13% for the HSI; 10% for the MidCap and 5% for the SmallCap) had so served.

MidCap: HK\$133,997 in 2003/04 and HK\$172,154 in 2004/05

	2003/04	2004/05
Highest	HK\$309,100	HK\$329,353
Lowest	HK\$ 25,000	HK\$ 38,699

G. INEDs' Fees (excluding share options or other kinds of benefits)

SmallCap: HK\$178,445 in 2003/04 and HK\$156,236 in 2004/05

	2003/04	2004/05
Highest	HK\$ 995,772	HK\$ 575,720
Lowest	HK\$ 15,667	HK\$ 13,333

In the course of compilation of this Report, there was particular difficulty in obtaining accurate information from publicly available sources on INEDs' fees. On the basis of the information available, it appeared that: –

- Overall average INEDs' fees were HK\$152,628 in 2003/04 and HK\$169,034 in 2004/05

Mainland: HK\$110,576 in 2003/04 and HK\$122,303 in 2004/05

	2003/04	2004/05
Highest	HK\$ 995,772	HK\$1,278,709
Lowest	HK\$ 15,667	HK\$ 13,333

	2003/04	2004/05
Highest	HK\$275,000	HK\$309,000
Lowest	HK\$ 19,427	HK\$ 29,767

- Corresponding average INEDs' fees by the four categories were:–

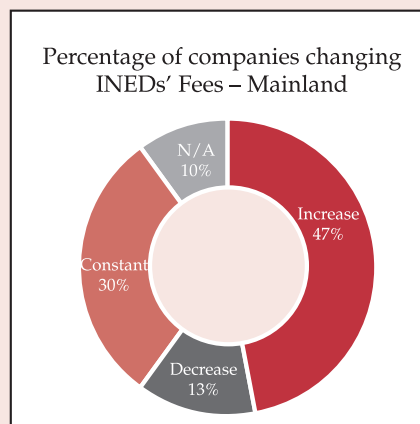
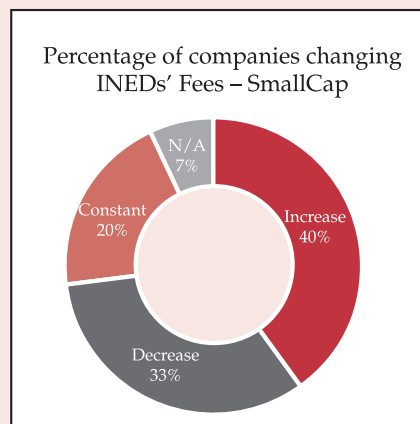
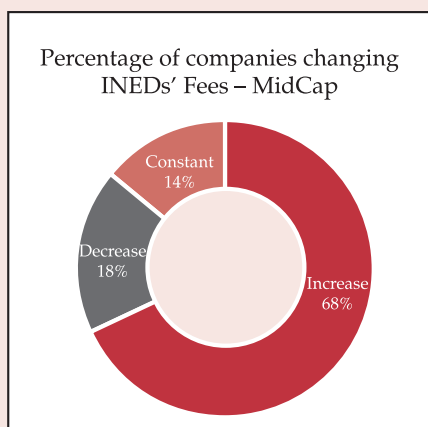
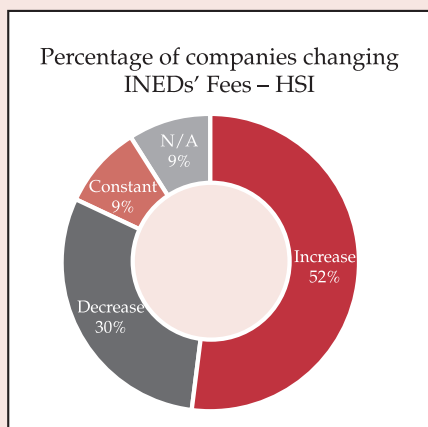
HSI: HK\$179,179 in 2003/04 and HK\$220,590 in 2004/05

(Notes: INEDs' fees of some companies were expressed in US\$, pounds and RMB. All of them were converted into HK\$ by using following exchange rates as at 13 July, 2005:

- US\$1 = HK\$7.78
- 1 pound = HK\$ 13.79
- RMB 1 = HK\$0.94)

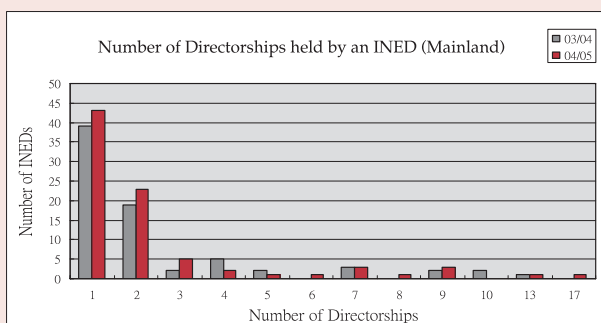
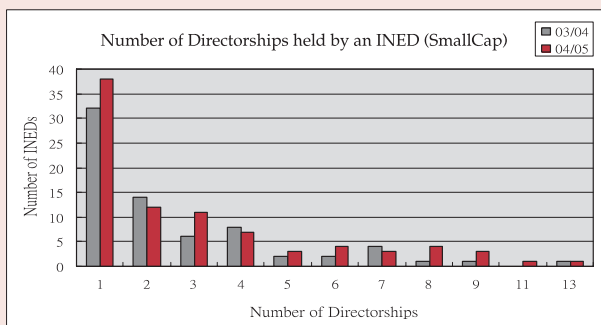
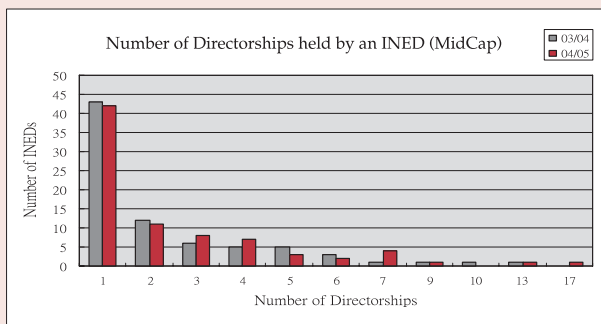
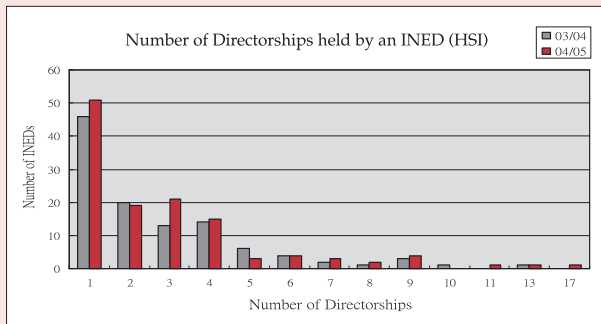
	2003/04	2004/05
Highest	HK\$817,747	HK\$1,278,709
Lowest	HK\$ 35,000	HK\$ 32,083

- Regarding changes in INEDs' fees between the financial years ended in 2004 and 2005,



- Overall, 50% of all companies surveyed reported an increase in the INEDs' fees, which might be due to the increased workload and time devoted by the INEDs. In 2004/05, a majority of companies in all categories (52% for the HSI; 68% for the MidCap; 40% for the SmallCap and 47% for the Mainland) had an increase in INEDs' fees, compared to 2003/04.
- The Mainland paid relatively lower INEDs' fees than the other groups in both financial years, which may be due to lower cost of living in the Mainland China.

H. Number of Directorships



- In 2003/04, 285 INEDs in the surveyed 115 companies held a total of 603 directorships in Hong Kong listed companies. In 2004/05, 321 INEDs in the surveyed 115 companies held a total of 730 directorships in Hong Kong listed companies.
- 56.1% and 54.2% of all INEDs in the surveyed 115 companies in 2003/04 and 2004/05 respectively held no directorships in any other Hong Kong listed companies.

- Average number of directorships held by INEDs:

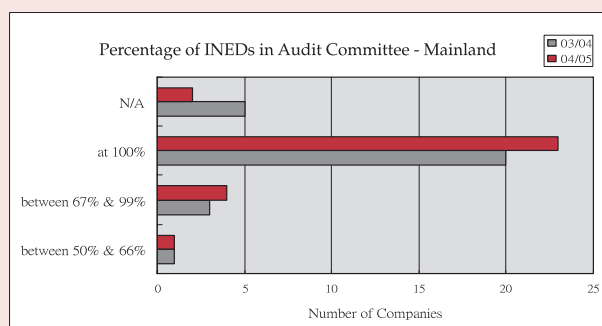
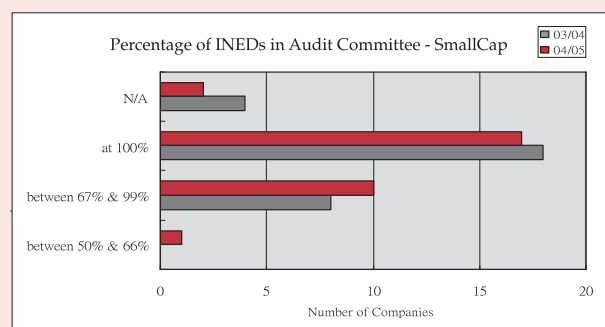
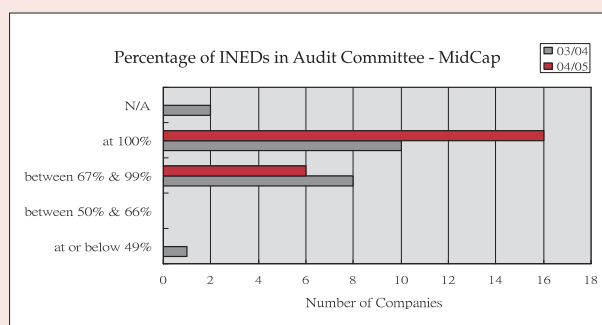
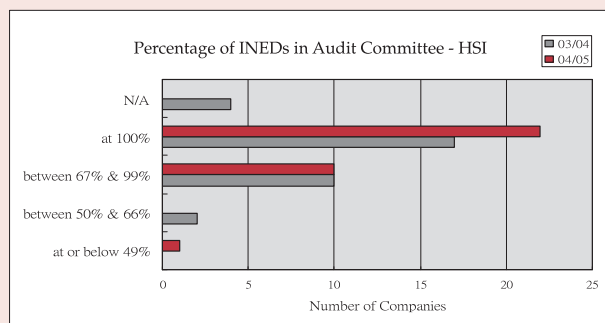
Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	2.8	2.4	2.7	2.5
2004-2005	2.9	2.6	3.1	2.5

- Percentage of INEDs holding more than five directorships i.e. beyond the maximum number recommended in the U.K. by the National Association of Pension Funds:

Financial Year	HSI	MidCap	SmallCap	Mainland
2003-2004	10.8%	9.0%	12.7%	10.7%
2004-2005	12.8%	11.3%	18.4%	11.9%

- Unexpectedly, the INEDs on the SmallCap boards held more directorships in Hong Kong. This means that the INEDs in this group of companies might not be able to devote adequate time and attention to all the companies they served as INEDs. Further, it may reflect that there was a limited source for the smaller capitalization companies in finding INEDs. They might only find some “well-known”, “experienced” INEDs to serve on their boards.

I. Audit Committee



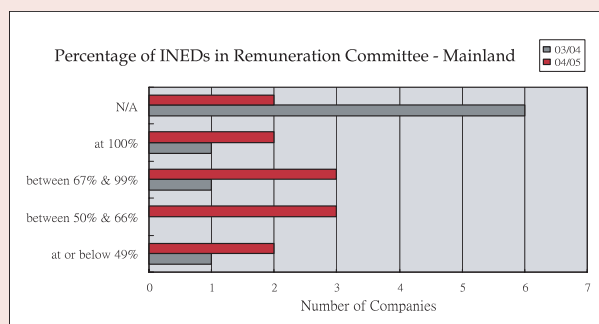
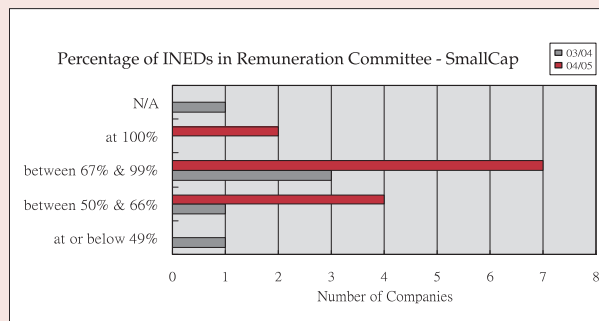
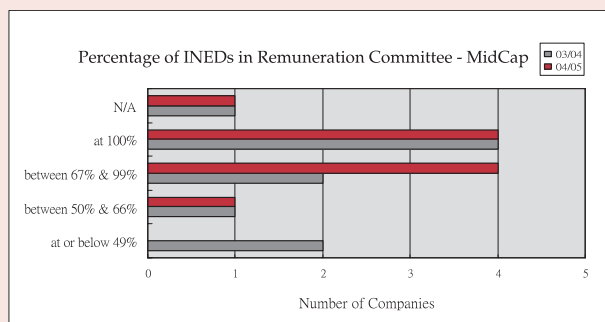
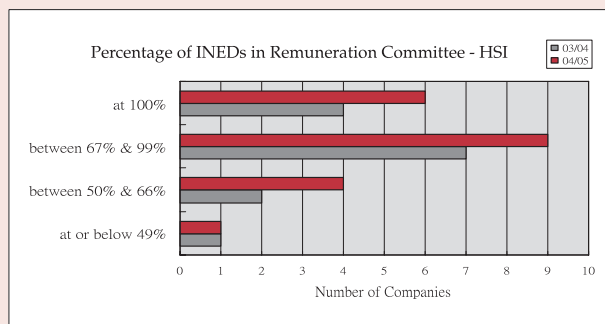
- In 2003/04, 112 out of 115 surveyed companies had an audit committee. In 2004/05, all the companies had an audit committee.

- In 2004/05, there were 7 companies, having only 2 members in their respective audit committees. They failed to meet the current minimum requirement under the Listing Rules as at the end of their financial years. But they made good the shortfall within the prescribed time limit.
- Apart from 15 companies which had not provided information regarding the composition of their respective audit committees, 58% of all companies had an audit committee comprising only INEDs in 2003/04. However, 2 companies did not have a majority (i.e. more than half) of INEDs in their respective audit committees.
- Apart from 4 companies which had not provided information regarding the composition of their respective audit committees, 68% of all companies had an audit committee comprising only INEDs in 2004/05. However, 1 company only had one INED out of 3 members in its audit committee but it made good the shortfall within the prescribed time limit.
- On average, more companies had an audit committee comprising only INEDs in 2004/05 as compared to 2003/04:
 - 52% of the HSI companies had an audit committee comprising only INEDs in 2003/04, which had increased to 67% in 2004/05;
 - 47% of the MidCap companies had an audit committee comprising only INEDs in 2003/04, which had increased to 73% in 2004/05;

- 69% of the Mainland companies had an audit committee comprising only INEDs in 2003/04, which had increased to 77% in 2004/05;
- 60% of the SmallCap companies had an audit committee comprising only INEDs in 2003/04, which had decreased to 57% in 2004/05.

- The U.K. Combined Code and the NYSE Rules require all listed issuers to have an audit committee comprising independent directors only. A large majority of surveyed companies would have complied with such rules.

J. Remuneration Committee



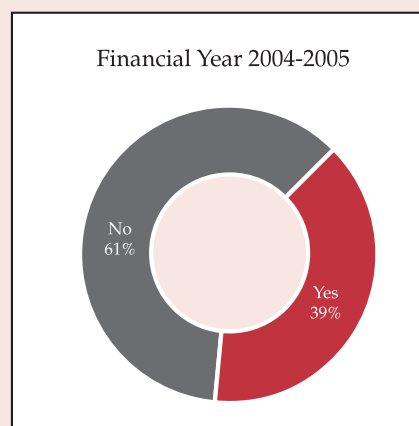
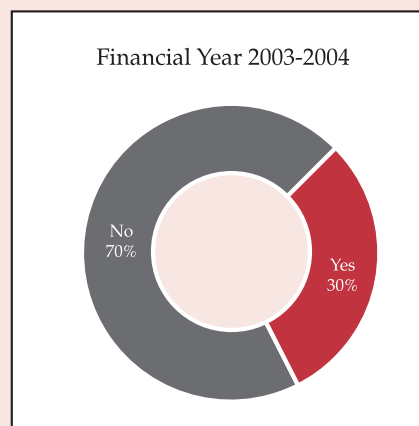
- 34% (39 companies) and 48% (55 companies) of 115 surveyed companies had a remuneration committee in 2003/04 and 2004/05 respectively.
- On average, more companies had a remuneration committee in 2004/05 as compared to 2003/04.
 - 42% of the HSI companies had a remuneration committee in 2003/04, which had increased to 61% in 2004/05;
 - 20% of the SmallCap companies had a remuneration committee in 2003/04, which had increased to 43% in 2004/05;
 - 30% of the Mainland companies had a remuneration committee in 2003/04, which had increased to 40% in 2004/05;

The corresponding figure in the MidCap remained the same as 45% in both financial years 2003/04 and 2004/05.

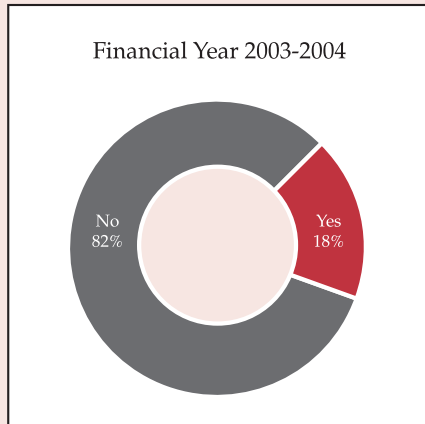
- In addition, 9 more companies will establish a remuneration committee in the coming financial year.
- Regarding the representation of INEDs in the remuneration committee:
 - In 2003/04, 85% of 39 companies had a remuneration committee with a majority (i.e. more than half) of INEDs; in 2004/05, 91% of 55 companies had a remuneration committee with a majority (i.e. more than half) of INEDs;
 - In 2003/04, 23% of 39 companies had a remuneration committee comprising INEDs only; in 2004/05, 25% of 55 companies had a remuneration committee comprising INEDs only.
- The SGX Code, the U.K. Combined Code and the NYSE Rules require that all the listed issuers should have a remuneration committee. More and more Hong Kong Main Board listed companies are moving to this standard. However, most of the surveyed companies did not have a remuneration committee comprising entirely INEDs, which is required in the U.K. and the U.S.

K. Nomination Committee

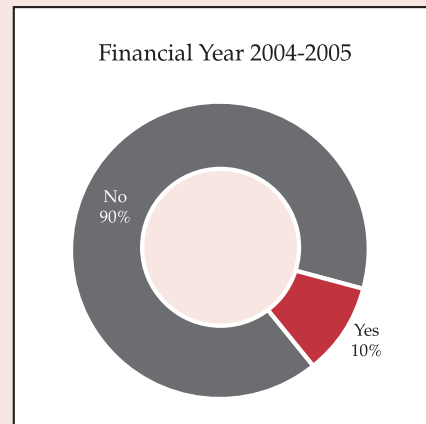
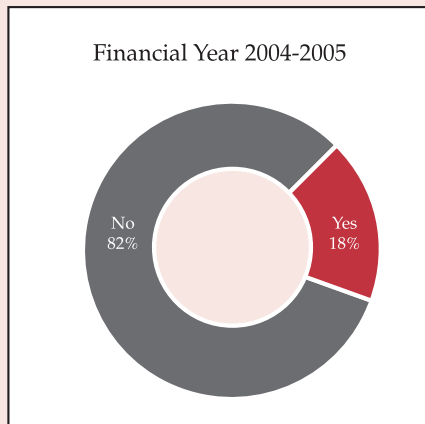
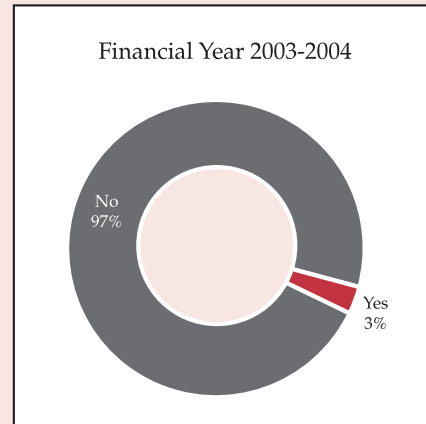
Percentage of Companies having Nomination Committee – HSI



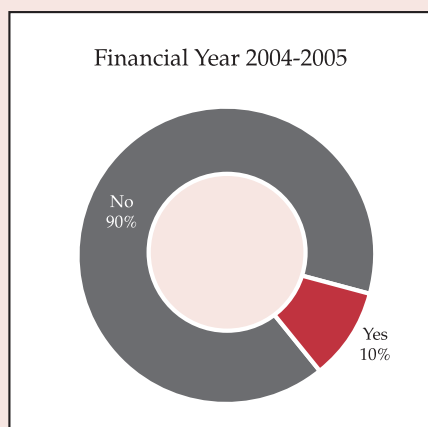
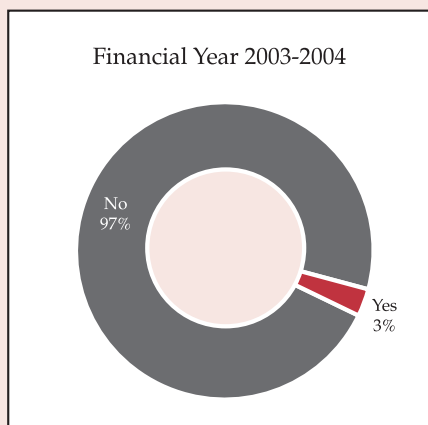
Percentage of Companies having Nomination
Committee – MidCap



Percentage of Companies having Nomination
Committee – SmallCap



Percentage of Companies having Nomination Committee – Mainland



- 14% (16 companies) and 20% (23 companies) of 115 surveyed companies had a nomination committee in 2003/04 and 2004/05 respectively.

- On average, a few more companies had a nomination committee in 2004/05 as compared to 2003/04.
 - 30% HSI companies had a nomination committee in 2003/04, which had increased to 39% in 2004/05;
 - 18% MidCap companies had a nomination committee in both financial years 2003/04 and 2004/05;
 - only 1 SmallCap company had a nomination committee in 2003/04, which had increased to 3 in 2004/05;
 - only 1 Mainland company had a nomination committee in 2003/04, which had increased to 3 in 2004/05.
- 3 more companies will establish a nomination committee in the coming financial year.
- Regarding the representation of INEDs in the nomination committee:
 - 9 companies had a nomination committee with a majority (i.e. more than half) of INEDs in 2003/04, which had increased to 13 in 2004/05;
 - In 2003/04, 4 out of 16 companies had a nomination committee comprising INEDs only; in 2004/05, 6 out of 23 companies had a nomination committee comprising INEDs only.

- Although the number of companies having nomination committee increased, there was a large majority of the surveyed companies not having a nomination committee. Among those having nomination committee, few of them consist of INEDs only.
- The SGX Code, the U.K. Combined Code and the NYSE Rules require that all the listed issuers should have a nomination committee. In the U.S., the nomination committee must consist of independent directors only. At present, Hong Kong companies remain weak on this front. It will be a challenge to require all the Hong Kong Main Board listed companies to have a nomination committee. It will be an even bigger challenge to require them to consist of INEDs only.

CONCLUSIONS AND RECOMMENDATIONS

In light of global trends in the development of the role of INEDs and having regard to the current landscape and profile of Hong Kong's INEDs as explained in the survey data and analysis set out earlier in this Report, it is possible to suggest a range of conclusions and recommendations which might be taken into account in the consideration of further changes in the role and responsibilities of Hong Kong's INEDs particularly in respect of the following areas: –

- Composition
- Liability
- Training
- Remuneration

Each of these areas is discussed below: –

Composition:

- Board: In view of the global trend to have independent directors dominating boards, the recommended best practice to have at least one-third of the board being INEDs may become a minimum standard in the Code in the near future, as is the case with the SGX Code. According to our survey, there were 42% and 50% of the surveyed companies already with more than one-third of their boards being INEDs in 2003/04 and 2004/05 respectively. However, given the family-dominated nature of most of the listed companies in Hong Kong, it is not likely that it will become mandatory in the near future to have a majority of independent directors on boards in Hong Kong. As evidenced in the survey "Corporate Governance and Directors' & Officers' Liability of Listed Companies in Hong Kong" commissioned by Jardine Lloyd Thompson Ltd and conducted by Policy 21 Ltd of The University of Hong Kong ("D&O's liability survey in HK") in October 2004, only 25% of the responding companies took the view that the majority of directors on the board should be independent directors.
- Audit Committee: Hong Kong companies should be ready to have an audit committee comprising entirely independent directors, which is a trend in the U.K. and the U.S. The D&O's liability survey in HK found that 71% of the responding companies agreed that the audit committee should consist entirely of independent directors. In our research, 68% of 115 surveyed companies have an audit committee comprising only INEDs in 2004/05. Hence, a large majority of companies would have already complied with the Listing Rules if they were required to have an entirely independent audit committee.

- (c) **Remuneration Committee:** Although there is a trend to have a remuneration committee comprising entirely independent directors in the U.K. and the U.S., Hong Kong listed companies have only recently established remuneration committees in response to new requirements in the Code. 48% of our surveyed companies have established a remuneration committee in 2004/05. Of those having a remuneration committee, only 25% have an independent remuneration committee. It is thus a challenge to require all listed companies to have an independent remuneration committee within a short period of time. Whilst aiming to have an independent remuneration committee in the long run, it is recommended that listed companies should establish one comprising only NEDs with a majority of INEDs from now on, as required in the SGX Code. This can prevent executive directors from being involved with the design of their own remuneration packages.
- (d) **Nomination Committee:** Regarding the nomination committee, it is now a recommended best practice under the Code to establish a nomination committee with a majority of INEDs. In our research, only 20% of all companies surveyed have established a nomination committee in 2004/05. Of those having a nomination committee, only 6 companies have an independent nomination committee. The above recommended best practice may become a minimum requirement under the Code in the future to be in line with the international practice as is the case in the U.K., the U.S. and Singapore.
- (e) **INEDs:** In light of the requirement or recommendation to establish the aforesaid three committees and the steadily increasing number of listed companies (891 companies on the Main Board and 205 companies on the GEM Board as at the end of the first quarter of 2005), a larger pool of INEDs should be built up in Hong Kong. In simple terms and assuming an average board size of 13 members for a Main Board listed company, if one-third of the directors of all such companies are required to be INEDs (and assuming that an INED should not serve on more than one board), a total of 3,861 appointees would be required for Main Board listed companies, and extra appointees may be required for GEM Board listed companies.
- (f) The current pool of Hong Kong INEDs is too small. Our findings also show that there is an imbalance in terms of both age and gender of the board members. There is a remarkable under-representation of women on the boards. In a 2002 study “Developing Leadership for the 21st Century” by Korn/Ferry International, 66% of senior executives expected boards of directors to become more diverse in nationality and gender in the coming decade while 41% of companies surveyed said they were implementing strategies to improve opportunities for leadership advancement among women. Regarding the age, only 2.2% of the INEDs of 115 surveyed companies in our research in 2004/05 is aged below 40. None of the INEDs in the HSI is below 40. It seems that Hong Kong listed companies are not benefiting from the input and insight of a younger generation of directors. Hong Kong listed companies should explore new sources of potential INEDs.

- (g) To meet the increasing need for more INEDs and to enhance the board effectiveness, a wider range of INEDs should be identified. We recommend that, rather than proceeding by personal contacts and informal solicitation, this should be done by way of a formal and structured recruitment process, a concept which may still be new in Hong Kong but is an emerging trend worldwide. This recommendation will be discussed in great detail under the section “How can the increasing demand for INEDs be met?”
- (h) Another of our recommendations relating to the composition of the board is the appointment of a senior/lead INED. It is an idea which has already been introduced in the U.K. and Singapore, though in different ways. It is our recommendation that this should be introduced in Hong Kong in the near future. We discuss this idea in detail under the section “Senior/Lead INED”.

Liability:

- (a) While INEDs are facing greater risk, consideration should be given to controlling the liability of the INEDs. Whilst preserving overall legal consistency of treatment of all directors, one way is to consider replacing the subjective standard of care and skill laid down in *City Equitable* with a statutory objective standard of care. This would allow the courts

to judge directors’ liability for the functions they perform, rather than their individual level of knowledge and experience. In “*Corporate Governance – An Asia Pacific Critique*” Professor C. K. Low argued that this should be combined with the introduction of a statutory business judgment rule, affording protection to directors who make properly informed and rational business decisions in good faith. In “*Corporate Governance – The Hong Kong Debate*” (Sweet & Maxwell Asia 2003), Professor Say Goo points out that the “business judgment rule requires a director to have made a business judgment in good faith and the duty of care towards the company and the shareholders is fulfilled if he or she:–

- is not interested in the subject matter (the Hong Kong equivalent is if there is no conflict of interest);
- is informed about the subject to the extent that he or she reasonably believes to be appropriate (the Hong Kong equivalent is that they have exercised due diligence); and
- he or she rationally believes that the business judgment is in the best interests of the company (the Hong Kong equivalent is that they act in the best interest of the company).”

- (b) To protect directors from the risk of potential claims, companies should provide D&O liability insurance, which is currently recommended as a best practice in the Code. In the D&O's liability survey in HK in 2004, 62% of Hong Kong listed companies agreed that having D&O liability insurance would help retain experienced directors. However, the same survey found that only about 60.5% of companies had provided D&O liability insurance. It seems that providing D&O liability insurance in Hong Kong is still not as common as in the U.S., Canada and Singapore. This may be due to the fact that prior to 13 February 2004, a company could not exempt any officer or indemnify him against any liability arising out of his negligence, default or breach of duty or trust.
- (c) Pursuant to the amendments to the Companies Ordinance in 2003 (which amendments came into force on 13 February 2004), companies may purchase and maintain for any officer of the company insurance against any liability to the company or any other party in respect of any negligence, default, breach of duty or breach of trust of which the officer may be guilty in relation to the company or against any liability incurred by the officer in defending any proceedings taken against him for such negligence, default, breach of duty or breach of trust. With the new law allowing companies to purchase D&O liability insurance, such insurance is likely to become more common in Hong Kong.

- (d) In its recent publication "Guide for Remunerating Independent Non-Executive Directors" in 2005, the Hong Kong Institute of Directors also advocates coverage by the company of D&O liability insurance for all board members, including INEDs.

Training:

- (a) The increasing complexity and velocity of corporate life, coupled with heightened demands and expectations on INEDs, makes it important that INEDs are intellectually and professionally able to perform the duties imposed on them. In particular, the audit committee is clearly being asked to do more. INEDs today must be equipped with more skills to enable them to discharge the additional duties.
- (b) Companies in Hong Kong should provide not only an induction programme for new directors, but also regularly provide continuing education for all directors. Director's participation in continuous professional development and the issuer's responsibility to arrange and fund a suitable development programme which are now recommended best practices may well become a requirement in the Code.
- (c) For induction programmes, INEDs should be educated on corporate governance and what it means to serve on committees. They should be educated on their responsibilities as a director and on the key legal and financial issues. In addition, companies should provide new directors with similar training programmes to those which companies have for new employees to learn about that company.

- (d) With continuing education, INEDs can keep up with changes in law, corporate governance, marketing and management trends, and relevant industry developments. They would have opportunities to exchange ideas, share experience with other directors and experts when taking training programmes. As an incentive for continuing professional development, companies should reimburse INEDs for any relevant expenses incurred. For the training to be effective, it is recommended that regular appraisals of the board and the board committees should be conducted and the ongoing training should be devised in accordance with the weaknesses or inadequacy as identified in the appraisals.
 - (e) Although INEDs are independent from the daily operation, training would serve to give INEDs a better grounding in the key aspects of the role and responsibilities of directors, to alert them to the “red flags” of which they should be aware when performing their duties. It would help them perform their duties effectively and make more efficient use of their time.
- Remuneration:
- (a) As more committees will have to be established on which the INEDs are expected to play an important role, the workload of INEDs will also increase and the trend of increasing remuneration will continue.
 - (b) In addition to the increase in INEDs’ fees, the committee compensation should also increase, especially for the chairman and the members of the audit committee who are associated with special risk and work. In the What Directors Think study, 92% of respondents believed that the audit committee chairman should receive additional compensation. Respondents reported that they support bringing certain committees’ compensation more in line with the current demand on their time as well as the risk and responsibilities they shoulder.
 - (c) As more obligations will be imposed on the INEDs in the future, INEDs will have to perform more duties, face greater risk and devote more time on the boards, especially for those serving on committees. It is recommended that Hong Kong listed companies should consider increasing committee compensation to attract and retain members.
 - (d) The remuneration of the INEDs does, however, have a bearing on their “independence” or at least perception of their “independence”. Care will have to be taken to set INEDs’ fees at a level which reflects their workload and responsibilities, but does not prejudice their independence by constituting a substantial proportion of their livelihoods.

HOW CAN THE INCREASING DEMAND FOR INEDS BE MET?

Following the implementation of the Code and the amendment to the Listing Rules in the past two years or so, the INEDs are expected to play more important roles and have more responsibilities, as evidenced by their representation in the different board committees which are required or recommended to be set up, as the case may be. The existing and traditional method of identifying INEDs in Hong Kong, which is usually informal and relies very much on personal networks may no longer be able to cope with the increasing demand for INEDs. The use of the traditional recruitment method always means that people having largely similar background or experience will be recruited. The low level of diversity in terms of skills, experience and knowledge in the board may very likely mean a narrow range of perspectives. A board with high diversity can enhance board effectiveness and in the light of the requirement or recommendation to set up board committees of various kinds, each having different focus and terms of reference, it is all the more important that INEDs with different skills and expertise should be recruited if the functions of such committees are to be fully and properly fulfilled.

In the *“Review of the Role and Effectiveness of Non-Executive Directors”* published in the U.K. in January 2003 (*“Higgs Report”*), it was recommended that there should be a broadening of the range of individuals from whom the NEDs can be identified and recruited. It commented that the standard way (essentially one of personal contact which is widely used by most of the listed companies in Hong Kong as well as other countries) by which INEDs are selected often overlooks talented individuals with a wide variety of experience, background and skills required for

effective board performance. Pursuant to the recommendation of the Higgs Report, a group of business leaders and others chaired by Dean Tyson of the London Business School was set up to study how companies can draw on broader pools of talent with varied background, experiences and perspectives so as to enhance board effectiveness. In the report which contains the group’s findings (*“Tyson Report”*) which was published in June 2003, it was recommended that the selection of NEDs should rest on a careful assessment of the needs and challenges facing a particular company and on a broad, transparent and rigorous search which reflects this assessment since “identification of NED talent cannot take place in a vacuum without reference to a particular company and its needs, which will always be unique and subject to change”. Apart from identifying the four personal attributes suggested by the Higgs Report as the essential qualities of NEDs, namely integrity, sound judgement, ability and willingness to challenge and probe and strong interpersonal skills, companies should then recruit NEDs with such skills and experience which according to their own assessment are lacking in their companies. The reference to and the recommendations in respect of “NEDs” in the Tyson Report are equally applicable to INEDs in Hong Kong.

Our assessment is that the major problem in relation to INEDs which most listed companies in Hong Kong now face, is not a lack of supply of talented INEDs candidates. Rather, it is a lack of effective means to identify and recruit the right talent for their boardrooms. We believe that a formal search as recommended in the Tyson Report through advertisement, relevant industry publications or executive search firms is feasible in Hong Kong though we anticipate that it may take some time for listed companies to adapt to this approach.

A formal and rigorous search is also likely to ease the imbalance in different aspects now present in the boards of many Hong Kong listed companies. It is the current practice for listed companies to invite people with boardroom or top management experience to be their INEDs. Such experience is undoubtedly valuable but there is no reason to suggest that it guarantees the four personal attributes of NEDs as suggested in the Higgs Report or is essential for effectively discharging the duties of NEDs. This current practice may be the main reason for the under-representation of women or young people in the boardroom since generally speaking, people with such experience tend to come from the more senior age group and are more probably of male gender.

It is suggested in the Tyson Report that companies can extend their search for NEDs to new pools of talents which are very often overlooked under the traditional recruitment method. The pools include the so-called “marzipan layer” of corporate management just below the board level, private companies and organizations in the non-commercial sectors. As the Higgs Report observed, the marzipan layer of corporate management is a largely unexploited source of NED talent. They are mostly relatively young and keen to gain a broader perspective and develop skills relevant to future role as a director. Another source of NEDs is professionals, such as lawyers, accountants and company/chartered secretaries. According to the finding in the Tyson Report which generally coincides with our observation of the Hong Kong situation, women are better represented in professional services than in the top management positions in the corporate sector. Hence recruitment from professionals will very probably result in an increase of women serving as NEDs at the same time.

Another possible source is the human resources (“HR”) profession. The skills and experience of the HR profession are particularly relevant to the remuneration committee and the nomination committee. Geoff Armstrong, Director General of the Chartered Institute for Personnel & Development commented that the HR profession “would bring a new dimension to the non-executive role and ensure that an organization’s key driver of value - namely its people - is taken seriously at board level”. Further, their expertise in dealing with issues like remuneration, induction, training, and performance management are actually the kind of skills required for NEDs serving on the remuneration and nomination committee or for provision of training to directors.

As succinctly put by the Tyson Report, the traditional method of identifying and recruiting NEDs is by “who you know” rather than “what you need”. This method is hardly able to meet the challenges which Hong Kong listed companies are now facing. It may be the right time to consider using a rigorous and formal search which identifies the NED talent with reference to the particular needs of a company. It is our recommendation that the formal recruitment method is a feasible idea for Hong Kong and is the right way to go. It can help alleviate the imbalance of many boards in terms of age and gender, widen the pool of available NEDs candidates and increase the diversity of the boards to ensure a wider range of perspectives and knowledge which can be brought to bear on the issues of company strategy, risk and performance.

SENIOR/LEAD INED

The U.K. Combined Code requires each listed company to appoint one of its INEDs to be the senior/lead INED (“SID”). Under the U.K. Combined Code, a SID has the following duties:–

- (a) be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate;
- (b) meet with the NEDs without the presence of the chairman at least annually to appraise the chairman’s performance and on such other occasions as are deemed appropriate;
- (c) attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.

In the Guidance Note issued by the Institute of Chartered Secretaries and Administrators, it is also suggested that the SID should chair the nomination committee when considering succession to the position of chairman of the board.

In Singapore, the appointment of a SID has been recommended in the SGX Code. It provides that “companies may appoint an independent non-executive director to be the lead independent director where the Chairman and the CEO is the same person, where the Chairman and the CEO are related by close family ties, or where the Chairman and the CEO are part of the executive management team” and the SID (if appointed) “should be available to shareholders where they have concerns which contact through the normal channels of the Chairman, CEO or Finance Director

has failed to resolve or for which such contact is inappropriate”. The concept of SID has been introduced under “commentaries” in Singapore which is optional in nature while it is a requirement under the U.K. Combined Code, the non-compliance of which has to be explained by the listed companies.

Does Hong Kong need the concept of SID? The Exchange has given its view on this issue in the “Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report” (“Exposure Paper”) published in January 2004. The Exchange did not consider “the typical board structure in Hong Kong warrants the appointment of any senior independent directors”. The reason cited is that “while most listed issuers in Hong Kong have controlling shareholders, it is not clear whether any additional benefit will be derived from such appointment”. This reasoning is questionable and, for that matter, might arguably support the appointment of SID.

There has been some criticism of the concept of the SID mainly on the grounds that any difficulty between a company and its shareholders should be resolved by the chairman and the opening up of an additional channel of communication for shareholders is likely to confuse shareholder relationships. This argument may only be valid if the chairman is demonstrably independent. Some propose an alternative of adopting the strictest approach of separating the chairman and CEO entirely by having an independent chairman and a separate and unrelated individual as the CEO. This, however, may not be practical for places like Hong Kong where most of the listed companies are still controlled by families.

Since the implementation of the Code in January 2005, listed companies in Hong Kong have been required to split the roles of chairman and the CEO who should not be the same person. Further, they should disclose in the Corporate Governance Report the identity of the chairman and the CEO and their relationship. It is not clear how many listed companies have already segregated the roles of chairman and the CEO and, of those who have already done so, whether and how many of those separate chairmen and CEOs are not related by family ties. Given the family-controlled nature of many listed companies in Hong Kong, it is very likely that there is a low level of independence in the chairmanship. It can be expected that there will be great resistance from listed companies with such a shareholding structure if the strict requirement for having an independent chairman is proposed. Contrary to what has been stated in the Exposure Paper, the “family control” characteristic prevailing in Hong Kong and the presumably low level of independence in the chairmanship may arguably be the appropriate scenario for having a SID whose duties (as the U.K. Combined Code provides) should include meeting with the other NEDs annually without the presence of the chairman to appraise his performance.

Hong Kong should consider the appointment of SID as an additional point of liaison for shareholders who can utilize this channel when the contact through the normal channels of Chairman, CEO or Finance Director is inappropriate or cannot resolve the issue in question. Additionally, the SID can coordinate with all the INEDs, consolidate all their influence and form a healthy balance within the board. He can

also be invited at each annual general meeting to give an account of the contribution of all INEDs throughout the year and to take questions from the shareholders. In the U.K. Combined Code, the relationship of the company and the institutional shareholders is a main focus and the SID is also required to attend sufficient meetings with them to listen to their views in order to help develop a balanced understanding of their concerns. Such focus is probably due to the trend in the U.K. of investing through the institutional investors who thus hold the largest proportion of shares in U.K. listed companies and have greater influence over corporate governance of the companies. In the U.K., the Institutional Shareholders’ Committee has drawn up a Statement of Principles (last updated in September 2005) which sets out the best practice for institutional shareholders and/or agents in relation to their responsibilities in respect of the companies in which they invest. The SID’s duty in relation to the institutional investors may, however, not be as important to Hong Kong as it is in the U.K.

It is recommended that listed companies in Hong Kong should be required to appoint one of their INEDs to be the SID with the responsibilities stipulated above. The SID can help facilitate communication between the company and its shareholders, in particular the minority shareholders, and contribute to the good corporate governance of listed companies in Hong Kong.

SUMMARY

A balanced and effective corporate governance structure requires all the components of that structure to play their part – whether they be management, executive directors, INEDs, other directors, auditors, shareholders or regulators.

In the case of INEDs, the Exchange has rightly identified the role of INEDs as increasingly important in improving corporate governance standards. This Report argues that great care must be taken in the course of ongoing regulatory development to identify those areas where INEDs may most effectively support good governance and not to take the duties and responsibilities imposed on INEDs beyond the point which surpasses the willingness, availability and capacity of Hong Kong's businessmen and businesswomen to assume and discharge those duties.

As a consequence of the reforms introduced worldwide in the past two years, including the implementation of the Code in Hong Kong, a stronger emphasis has been put on the monitoring role of the INEDs in other major markets as well as in Hong Kong. However, the danger of having too much focus on such role may lead to a division within the unitary board, generating defensiveness on the part of the executive directors and distrust between executive directors and INEDs. It is our view that the monitoring role of an INED should not be overemphasized to the neglect of his or her positive strategic role. With their roles in the boards and the sub-committees, such as the remuneration committees and the nomination committees becoming increasingly important, INEDs should seek to contribute to the strategy, development and implementation of the company policies and to enhance their role thereby providing a source of confidence to both investors and other stakeholders of the companies.

REFERENCES

- The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited
- The Codes on Takeovers and Mergers and Share Repurchases of the Securities and Futures Commission of Hong Kong
- The Combined Code on Corporate Governance (July 2003) of the London Stock Exchange
- Consultation Paper on Company Directors: Regulatory Conflicts of Interests and Formulating a Statement of Duties – The Law Commission and The Scottish Law Commission (1998)
- Corporate Governance Review by The Standing Committee on Company Law Reform – A Consultation Paper on Proposals made in Phase I of the Review (Hong Kong, July 2001)
- Palmer’s Company Law (Sweet & Maxwell)
- Corporate Governance – An Asia-Pacific Critique (edited by Professor C. K. Low, Sweet & Maxwell Asia, 2002)
- Corporate Governance – The Hong Kong Debate (written by S.H. Goo and Anne Carver, Sweet & Maxwell Asia, 2003)
- In the Matter of B. F. Construction Company Ltd., Hong Kong Court of Appeal, 2001
- Re City Equitable Fire Insurance Co. Ltd. (1925 Ch.407)
- Non-statutory Guidelines of Directors’ Duties – Companies Registry (Hong Kong, January 2004)
- The Corporate Governance Rules (November 2004) of the New York Stock Exchange
- The Code of Corporate Governance (July 2005) of the Singapore Stock Exchange
- Non Executive Director Research by Ernst & Young LLP (November 2004)
- The Tillinghast 2004 Directors and Officers Liability Survey – Executive Summary of U.S. and Canadian Results by Towers Perrin
- What Directors Think 2004 by Corporate Board Member, PricewaterhouseCoopers LLP
- Survey on Corporate Governance and Directors’ & Officers’ Liability of Listed Companies in Hong Kong (conducted by Policy 21 Limited of The University of Hong Kong and commissioned by Jardine Lloyd Thompson Limited, October 2004)
- Corporate Governance and Directors and Officers Liability Survey of Listed Companies in Singapore (conducted by Corporate Governance and Financial Reporting Centre of NUS Business School, National University of Singapore and commissioned by Jardine Lloyd Thompson Private Limited, April 2004)
- Developing Leadership for the 21st Century by Korn/Ferry International (2002)
- Companies Ordinance (Chapter 32 of the Laws of Hong Kong)
- Guide for Remunerating Independent Non-Executive Directors by The Hong Kong Institute of Directors (2005)
- The Tyson Report on the Recruitment and Development of Non-Executive Directors (2003)
- ICSA Guidance Note

- The Higgs Review of the Role and Effectiveness of Non-executive Directors (2003)
- The “Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report” (2004)
- Comments on Proposed Revisions to The Code of Corporate Governance submitted by Singapore Business Federation (2005)
- Creating accountability within the board: The work of the effective non-executive director by Dr Terry McNulty, Dr John Roberts & Dr Philip Stiles



The Hong Kong Institute of Chartered Secretaries 香 港 特 許 秘 書 公 會

(Incorporated in Hong Kong and limited by guarantee)
(於 香 港 註 冊 成 立 之 擔 保 有 限 公 司)

3/F, Hong Kong Diamond Exchange Building,
8 Duddell Street, Central, Hong Kong
香港中環都爹利街8號香港鑽石會大廈3樓

Tel電話 : (852) 2881 6177 Fax圖文傳真 : (852) 2881 5050
Email電子郵件 : ask@hkics.org.hk Website網址 : www.hkics.org.hk