The first in a series of thought leadership pieces based on the Institute's recently published *Report on Improving Corporate Governance in Hong Kong*

The importance of independent non-executive directors on corporate boards – a comparative review

This article discusses one of the recommendations from the report, prepared by Syren Johnstone and Say H Goo, on the independence of Independent Non-Executive Directors (INEDs), currently confirmed through a written confirmation to The Stock Exchange of Hong Kong (SEHK), should be made subject to the provisions of the Securities and Futures Ordinance (SFO) dealing with giving false or misleading information to regulatory agencies.

Importance of independence

The importance of independence in INEDs has risen with each corporate scandal. Over the years scandals at firms such as Arthur Andersen, Lehman Brothers, Enron and recently Wells Fargo, have demonstrated the importance of ensuring the board is aware of the activities of the management they are overseeing and are prepared to challenge executives. As Murray Steele, an experienced non-executive director who retired after over 30 years as a senior lecturer at Cranfield School of Management told the *Financial Times*, "When you look at some of the bigger disasters, you find the non-executives' mindset had become the same as the executives', therefore you don't get challenge."

Ensuring the independence of INEDs through written declarations that are accountable under the law provides greater assurance to shareholders that INEDs they elect are truly independent, and hence more likely to be in a position to challenge the executives of the firm, ensure they are meeting set targets and monitor performance against agreed goals. In general, shareholders can be more confident that the board is working in the interests of the company and their interests as owners.

International divide between board and regulatory responsibility

The Institute's report highlighted developments in Hong Kong and four markets namely, the United Kingdom, the United States, Mainland China and Singapore.

In three of these markets, the U.K., the U.S. and Singapore, the determination of independence is the responsibility of the boards, while in Hong Kong and Mainland China, independence is confirmed by regulatory agencies, the SEHK and the China Securities Regulatory Commission (CSRC), respectively. This divide in responsibility does not mean that the legal requirements are also equivalent in the relevant jurisdictions, however – with stricter rules in the U.S. and China, and relatively looser requirements in Hong Kong, the U.K. and Singapore.

Singapore's listing requirements call for INEDs to make up at least one third of the board, rising to over half when the Chairman and CEO are the same person, are closely related, or the Chairman is in the management team or not independent. Independence is described in the listing rules, but the board is responsible for identifying whether directors can be considered independent.

In the U.K., rules regarding independence are included in the Corporate Governance Code on a "comply or explain" basis, meaning that any deviation from the code is required to be explained by the company but is not prohibited. However, after six years of service on a board the reappointment should be subject to rigorous review, which increases to annual reviews after nine years.

In the U.S. however, the rules are different. The New York Stock Exchange Listed Companies Manual requires boards to be formed of a majority of independent directors and ensure that the independence of directors meets the requirements of the Exchange, which include general and specific situations where a director would be regarded as not independent. These rules are backed by disclosure obligations subject to Federal securities laws under Regulation S-K of the U.S. Securities Act of 1933, meaning that a false disclosure would be subject to liability under Federal law.

In Mainland China there is a rigid regime for determining independence, which includes a restriction that INEDs are not allowed to hold board positions for more than six consecutive years. Plus, the requirements set out by the CSRC mean that all directors need to apply to the agency in order to be confirmed, and those directors regarded as INEDs must confirm their independence through disclosers, with the threat of a fine for false or misleading information.

Recommendations for Hong Kong

In Hong Kong, at least one third of a board must be independent and the responsibility for determining independence falls to the SEHK. Like the CSRC in Mainland China, the SEHK requires INEDs to confirm their independence, and thus they rely on the accuracy of the information provided to them. However, unlike in Mainland China and the U.S., giving false or misleading disclosures in Hong Kong is merely a breach of listing rules with limited consequences, compared to the harsher penalties in other markets.

The Institute is therefore calling for these written confirmations to be brought under section 384(3) of the SFO, which would mean that individuals providing false or misleading information would be committing an offence. This does not require any change in the law as the SFO already recognizes the importance of regulatory agencies being provided with truthful information. Nor is it difficult or novel to implement: a form of written confirmation would merely need to include the requisite language - this is already done in relation to declarations made by independent initial public offering (IPO) sponsors in connection with listing applications. Should INEDs be subject to a lower standard of accountability than IPO sponsors?