CULTIVATING BOARD CULTURE TOWARDS GREATER ACCOUNTABILITY

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Legal Briefings

With potential rule changes on the way listed companies should be thinking ahead, we look at key issues your company needs to know

Good corporate governance and a board-driven culture of compliance are now firmly expected by the Hong Kong Stock Exchange. Board culture is increasingly seen as key to good governance and long term sustainability. Regulatory changes have recently been proposed which focus on board culture and enhance the corporate governance regime for Hong Kong listed companies. The Stock Exchange consultation paper[1] issued in April 2021 proposes a number of Listing Rule changes. One of the proposals is to embed corporate culture in the Corporate Governance Code as a key to long-term sustainable performance.

The Stock Exchange also recently updated its policy statement[2] on Listing Rule enforcement, emphasising as one of its key priorities the holding accountable of individuals that are responsible for discharging duties in connection with listing matters. In addition to its previous focus on internal controls, the Stock Exchange now also includes a company's culture and attitude to compliance and corporate governance as important concepts underling its enforcement decisions.

In this Guidance Note we look at board culture, exploring the international trends, proposals for Hong Kong and the focus on culture as a factor in determining appropriate sanctions for rule breaches. We consider the key takeaways arising from these development for listed companies and provide some practical tips for company secretaries. With potential rule changes on the way, listed companies should be thinking ahead and start preparing for implementing new, and updating existing policies. Company secretaries play an important role in assisting boards with compliance and are well placed to help directors to establish and uphold a robust compliance culture.

BOARD CULTURE

INTERNATIONAL TRENDS

Internationally, there is growing focus on culture as part of corporate governance regulatory regimes. Jurisdictions such as the United Kingdom, Australia, Singapore and Japan have each introduced requirements for boards to establish an appropriate culture.

In 2016, the Financial Reporting Council published a report[3] on the results of its study exploring the relationship between corporate culture and long-term business success in the United Kingdom. Key findings from that report are worth highlighting as these themes underpinned regulatory developments and resulted in a focus on corporate culture as part of revisions to the United Kingdom's Corporate Governance Code in 2018:

- **Recognition of the value of culture**. The report noted that a healthy corporate culture should be viewed as a valuable asset and a source of competitive advantage, and important for creating long-term value. Directors should not wait until there is a crisis before focusing on culture.

- **Leadership**. Leaders should embody the desired culture. This is particularly the case for chief executives. The culture should be embedded throughout the business, at all levels and aspects.

- **Integration**. The report emphasised the need to empower and resource ethics, compliance and risk functions, as well as human resources and internal audit, to enable them to embed the values and culture of the company. These functions should be given greater recognition at the board level.

- **Measurement**. Boards should devote sufficient resources to evaluating culture and consider how they report on it. Boards should take responsibility for understanding behaviour throughout the company and challenging misalignment with values.

- **Aligning incentives**. Performance management and reward systems should support and encourage behaviours consistent with the company's purpose, values, strategy and business model. The board should ensure that this alignment is clearly explained to shareholders, employees and stakeholders.

PROPOSALS FOR HONG KONG

Hong Kong is also looking to implement changes in line with international developments. In its April 2021 consultation paper, the Stock Exchange set out proposed amendments to the Corporate Governance Code aimed at highlighting the importance of corporate culture.

Currently, the Corporate Governance Code[4] sets out the principles of good corporate governance for listed companies with two levels of recommendations: code provisions (where companies must explain the reasons for any non-compliance) and recommended best practices (where companies are encouraged to confirm their compliance or the reasons for any deviations). It sets out recommended practices for an effective board, which include recommendations on board composition, directors' responsibilities, accountability, delegation, board arrangements and risk management and internal controls. However, until these latest proposals, the Corporate Governance Code has not specifically drawn out board culture as a standalone focus area.

New code provision focused on board culture

The Stock Exchange is proposing to add a new code provision which focuses on board culture, requiring the following:

- The board should establish the company's purpose, value and strategy. These should be aligned with the company's culture.
- Directors are expected to promote the desired culture. In doing so, they should act with integrity and lead by example.
- The culture should instil and continually reinforce across the organisation acting lawfully, ethically and responsibly.

The Stock Exchange has indicated that it will provide guidance to explain the board's role in culture and set out the key elements commonly identified in a sound culture. The consultation paper identifies tone from the top, accountability, effective communication and challenge and incentives. These are the same themes highlighted in the Financial Reporting Council report discussed above.

Disclosures on culture

The Stock Exchange has also indicated that it will provide guidance on recommended key issues for disclosure to help stakeholders understand the company's culture. These may include the following:

- description of the company's vision, value and strategy, together with its culture, and how these affect the company's business model;

- description of the company's success measurements and a discussion on how the desired culture affects or contributes to performance. Success measurements include, for example, key performance indicators for areas such as revenue growth, profit margins, return on equity and market share;

- discussion on the measures used for assessing and monitoring culture. By way of example, this could include specific indicators such as turnover rate and whistleblowing data, and data on regulatory breaches;

- description of measures to ensure that the culture and expected behaviours are communicated to employees, for example through a code of conduct;

- information on the forums available for sharing ideas and concerns on any misconduct or misalignment identified and how they are dealt with; and

- discussion on the company's financial and non-financial incentives to support the desired culture.

Anti-corruption and whistleblowing

Anti-corruption and whistleblowing are essential to achieving a properly functioning corporate culture. The Stock Exchange is, therefore, proposing to elevate the existing recommended best practice on whistleblowing to a new code provision. This would require the company to establish a whistleblowing policy and a system for employees and those dealing with the company to be able to raise concerns about possible improprieties. The policy should ensure whistleblowing is anonymous and in confidence. The audit committee, or other designated committee comprising only independent non-executive directors, should be responsible for handling whistleblowing complaints. In addition, a new code provision is proposed requiring the company to establish anti-corruption policies.

The Stock Exchange will provide guidance to help companies to prepare their anti-corruption and whistleblowing policies. Such policies should include the policy scope, committees or personnel responsible and the reporting channels.

FOCUS ON CULTURE IN STOCK EXCHANGE'S POLICY STATEMENT

In early July 2021, the Hong Kong Stock Exchange updated its policy statement on Listing Rule enforcement. This contains important messages for listed company boards and senior management on the regulatory expectations for those responsible for Listing Rule compliance.

The Stock Exchange sets out the below three key concepts underling its enforcement decisions. Importantly, a company's culture and attitude to compliance and corporate governance are now included:

- **Responsibility** - Whilst primary responsibility sits with the directors, enforcement actions could also be brought against others, for instance senior management, where they cause by act or omission, or knowingly participate in a breach of the Listing Rules;

- **Controls and culture** - Listed companies are expected to implement appropriate and effective internal controls to ensure regulatory compliance. Compliance and corporate governance should be embedded in the company's culture and evidenced at the director and senior management levels; and

- **Cooperation** - Listed companies and their directors are expected to cooperate with the Stock Exchange. This includes a requirement to provide information reasonably requested as part of an investigation into any suspected breach of the Listing Rules.

The Stock Exchange has also updated its enforcement sanctions statement[5] to reflect the recent rule changes to enhance its disciplinary powers and sanctions which came into effect on 3 July 2021. Whether there is evidence of a good culture conducive to rule compliance and the promotion of good corporate governance is included among the factors that the Stock Exchange will apply in determining the appropriate sanctions for Listing Rule breaches.

To avoid the risk of enforcement action, it is more important than ever that listed company boards have in place, and keep under review, the necessary policies, systems and procedures to ensure effective compliance with the Listing Rules and match the regulatory expectations and standards. Given that compliance is now included as an important concept underlying enforcement decisions, boards must also embed a culture of compliance and uphold high corporate governance standards.

KEY TAKEAWAYS AND TIPS FOR COMPANY SECRETARIES

Whilst the threat of more serious enforcement action may currently be a driving factor for adopting a compliance culture, stakeholders are increasingly seeing the intrinsic value in well managed companies with an embedded culture of good corporate governance. The current regulatory focus on corporate culture within a corporate governance regime now shifts the emphasis from its use as a compliance tool to the fundamental sustainability benefits and value to investors and other stakeholders of an embedded, transparent culture with promotes governance compliance at all levels of the business.

Company secretaries have a key role to play in ensuring that companies are able to maintain high corporate governance standards and helping the board to formulate and push forward a robust compliance culture to meet both regulatory and investor expectations.

PRACTICAL TIPS FOR COMPANY SECRETARIES TO SUPPORT THE BOARD IN ANTICIPATION OF CHANGES TO THE CORPORATE GOVERNANCE CODE ON COMPANY CULTURE

- Work with the board to formulate the company's vision, value and strategy, ensuring this aligns with the company’s culture. Liaise with external consultants where required.
- Assist the board in preparing the disclosures on culture. The Stock Exchange expects that this should be precise, succinct and, in general, not more than one page.
- Review adequacy of, and update, any existing whistleblowing and anti-corruption policies or assist the board with preparing new policies.
- Assist the board to develop, update and publicise its other policies and codes of conduct in line with regulatory expectations.
- Assist the board to establish a platform for idea sharing and to escalate and discuss any concerns on misconduct or any misalignment of behaviours and culture.
- Ensure directors are regularly reminded of their duties to ensure they fully understand the nature of their responsibilities. This could be achieved through:
    - periodically circulating guidance notes on directors duties[6]; or
    - providing briefings on directors duties and other topics at board meetings (including for instance arranging external consultants to present on specialist topics such as internal controls, company culture).
- Ensure the company culture reflected in all board papers. Board packs, containing sufficient details on the matters to be discussed by the board, should be prepared by relevant senior management and circulated to the board reasonably in advance of the meeting, so that directors have sufficient time to review the documentation and request further information if required.
- Ensure board meetings are scheduled with sufficient time for adequate discussion of issues and at a convenient time for all directors to be able to fully participate and for issues to be raised.
- Diarise the testing and review of risk management and internal control systems and ensure that these are carried out on a timely basis with the results reported to the board. Follow up actions should also be monitored.
- Keep the board updated with the latest Stock Exchange guidance, in particular noting where updates may impact existing practices. For instance, if the proposed regulatory changes on corporate governance and culture mentioned above are implemented, provide to the board any guidance issued by the Stock Exchange.
- Assist with arranging training and professional development for directors and keeping attendance records.
- Keep full and proper minutes of shareholder and board meetings and ensure other record keeping is maintained to a good standard.

[1] Consultation Paper on the Review of Corporate Governance Code and Related Listing Rules dated April 2021.

[2] Enforcement of the Listing Rules – Policy Statement dated 8 July 2021.

[3] Corporate Culture and the Role of Boards – Report of Observations (July 2016).

[4] Appendix 14 to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (Listing Rules).

[5] Enforcement Sanctions Statement dated 8 July 2021.

[6] For example the HKICS Securities Law and Regulation Guidance Note (Fourth Issue) - Relating to Independent Non-Executive Directors - Selective Roles, Responsibilities and Liabilities.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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